FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Investcorp's Ratings at 'BB'; Outlook Stable

Thu 12 Nov, 2020 - 11:28 AM ET

Fitch Ratings - Chicago - 12 Nov 2020: Fitch Ratings has affirmed the Long-Term Issuer Default Rating (IDR) and Short-Term IDR of Investcorp Holdings B.S.C. and its related entities (collectively, Investcorp) at 'BB' and 'B', respectively. The Rating Outlook is Stable.

Today's rating actions have been taken as part of a periodic peer review of the alternative investment manager (IM) industry, which comprises nine publicly rated global firms. For more information on the broader sector review, please see, "Fitch Completes Alternative Investment Manager Peer Review," available at www.fitchratings.com.

KEY RATING DRIVERS

IDR AND SENIOR UNSECURED DEBT

The rating affirmation reflects the locked-in nature of most of Investcorp's fee streams, its strong client franchise and high degree of brand name recognition in the Gulf, supported by its investment track record and long-term relationships in the region. The affirmation also reflects the vulnerability of Investcorp's business model to a market downturn and Fitch's view of the firm's ability to maintain credit metrics in line with expectations.

Rating constraints include the firm's increased earnings volatility and placement risk relative to peers, given its business model of offering investments to clients on a fully underwritten deal-by-deal (DBD) basis and its sizable co-investment portfolio, which is subject to fair value changes. Activity fees, which are earned from transactional activities and have comprised almost half of Investcorp's core fees over the past several years, are also susceptible to market volatility.

While the impact of oil price volatility on Investcorp's portfolio companies is limited, depressed oil prices will likely have fiscal impacts in the region. Still, Investcorp's Gulf investors have demonstrated relatively low sensitivity to oil price movements, as evidenced by record levels of DBD placement activity during previous periods of volatility in the energy sector. While Fitch believes Gulf investors will continue to explore opportunities to diversify outside of the region, potential liquidity challenges could disrupt efforts in the near term.

Assets under management (AUM) totaled $32.2 billion at fiscal year-end 2020 (June 30, 2020), up 14.4% from FYE19, driven by a combination of organic and inorganic growth. Fundraising and placement activity remained solid during the year, with net client flows representing 7.6% of beginning AUM. That said, Fitch believes fundraising activity will be less certain during FY21, given the continued economic impact of the coronavirus.

In September 2019, Investcorp entered the direct lending space with an acquisition of a majority stake (76%) in CM Investment Partners (CMIP), the investment advisor to CM Finance, a publicly traded business development company (BDC). As of June 30, 2020, the AUM relating to CMIP amounted to $270.6 million.

In May 2020, Investcorp entered into a 50/50 joint venture (JV) with Tages Group, a leading European alternative asset management firm, which added $1.7 billion of AUM to the platform. The JV, Investcorp-Tages Limited, will manage the absolute return investments of the combined entities, which Fitch believes adds scale and expands Investcorp's investor base, product suite and geographic reach.

Fitch also believes execution risks are associated with Investcorp's growth strategy to more than double AUM, to $50 billion, over the medium term through organic and inorganic growth. Further, the firm's ability to meaningfully execute on certain strategic initiatives, including the institutionalization of its investor base and the ability to expand committed capital fund structures, will be delayed by the impact the global coronavirus pandemic, in Fitch's view.

Core operating performance, as measured by fee-related EBITDA (FEBITDA), which excludes investment income from co-investments, performance fees and performance-related compensation, deteriorated in FY20, due to the economic impact of the coronavirus. FEBITDA was almost halved at $80 million in FY20, compared with $150 million in the prior year, primarily driven by a significant reduction in activity fees, lower management fees and slightly higher expenses. The firm's FEBITDA margin was 28.1% in FY20, which is in line with Fitch's quantitative benchmark range for 'bbb' category alternative IMs of 20%-30% and down from 43.7% in FY19.

Management fees declined 5.6% in FY20, which was primarily driven by fund maturities, fee reductions on fund extensions and, to a lesser extent, the suspension of fees on certain private equity (PE) investments, due to the valuation impact of the coronavirus pandemic. Also, in FY19, PE management fees were boosted by catch-up fees and the acceleration of deferred fees for deals exited during the year.

Activity fees were down 29% in FY20, reflecting reduced levels of acquisitions, placements and exit activity during the year.

In FY20, Investcorp incurred losses of $110 million on its balance sheet investments, compared with asset-based income of $89 million in FY19, due to valuation declines in certain U.S. retail sector exposures.

Realized net performance fees, which tend to be lumpy from period to period due to deal activity and market volatility, totaled $2 million in FY20, down from $32 million in FY19.

Investcorp's leverage, as measured by debt to tangible equity, amounted to 0.9x at FYE20, up from 0.4x at FYE19. The increase reflects the valuation impact of balance sheet investments and a change in Fitch's classification of debt. As part of its transition to a holding company, client bank deposits (which were excluded from prior leverage calculations) were transferred into a client trust, which subsequently extended a $261 million revolving loan facility to the company. There are no changes to the economics of these liabilities, as balances and client distributions are typically retained and primarily used to fund new investments.

Debt to FEBITDA increased to 9.3x at FYE20 from 2.6x at FYE19. On a hybrid basis, leverage is in line with Fitch's 'bb' category quantitative benchmark range for alternative investment managers (IMs).

Fitch believes Investcorp maintained adequate liquidity as of FYE20 with $309 million of cash, deposits with financial institutions and other liquid assets, along with $684 million of borrowing capacity on its corporate revolvers and $233 million of available liquidity from client trusts. Additionally, Investcorp had $810 million of balance sheet co-investments at FYE20, which could serve as additional collateral for debt, although it is comprised of relatively illiquid investments. Aside from client assets, which are due on demand, the firm's nearest debt maturity is June 2023.

Fitch believes the extension of credit offered by Investcorp's clients provides flexibility to the firm to execute on investment opportunities, although the withdrawal of client assets would reduce the firm's liquidity. Still, Investcorp has long-standing client relationships that have proven to be sticky throughout various market cycles.

Debt service coverage, defined as FEBITDA divided by interest expense, was 2.7x for FY20, which down from 3.6x in FY19 and in line with Fitch's quantitative benchmark of 2x-4x for alternative investment managers (IMs) in the 'bb' rating category.

Unfunded deal acquisitions and unfunded co-investment commitments to various investments totaled $193 million at FYE20, which Fitch believes will be funded over time with cash on hand and operating cash flow. Fitch believes the company has significant discretion over the timing of these funding commitments.

The Stable Outlook reflects Fitch's expectation that Investcorp will maintain credit metrics in line with the agency's quantitative benchmark range for 'bb' category alternative IMs.

The senior unsecured debt rating is equalized with Investcorp's Long-Term IDR, reflecting the largely unsecured funding profile, expectations for average recovery prospects under a stress scenario and joint and several guarantees by Investcorp S.A., which is the principal operating and asset owning arm of the firm.

RATING SENSITIVITIES

IDRs AND SENIOR UNSECURED DEBT

Factors that could, individually or collectively, lead to a negative rating action/downgrade include:

-- Material declines in AUM that impair the firm's management fee generating capacity; a reduction in liquidity; or material changes in leverage and/or interest coverage resulting from a material degradation of balance sheet assets and/or weaker investment performance that adversely impacts the firm's ability to generate FEBITDA. More specifically, increases in balance sheet and/or cash flow leverage, such that these metrics approach or exceed 1.0x and 6.0x, respectively, under Fitch's hybrid leverage analysis, could negatively affect ratings.

Factors that could, individually or collectively, lead to positive rating action/upgrade include:

-- Fee-paying AUM growth, enhanced scalability of the platform and AUM diversity, institutionalizing the investor base, an increase in management fee contributions from committed capital fund structures, a reduction in leverage and strengthened interest coverage, while maintaining adequate liquidity and co-investment funding.

The senior unsecured debt rating is equalized with Investcorp's IDRs and, therefore, would be expected to move in tandem. Although not envisioned by Fitch, an increase in secured debt as a percentage of total debt could result in the unsecured debt rating being notched below Investcorp's Long-Term IDR.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Investcorp Capital Ltd.	LT IDR	BB Rating Outlook Stable	Affirmed	BB Rating Outlook Stable
	ST IDR	B	Affirmed	B
• senior unsecured	LT	BB	Affirmed	BB
Investcorp S.A.	LT IDR	BB Rating Outlook Stable	Affirmed	BB Rating Outlook Stable
	ST IDR	B	Affirmed	B

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Dafina Dunmore
Director
Primary Rating Analyst
+1 312 368 3136
Fitch Ratings, Inc.
One North Wacker Drive Chicago, IL 60606

David Pierce
Director

Secondary Rating Analyst
+44 20 3530 1014

Greg Fayvilevich
Senior Director
Committee Chairperson
+1 212 908 9151

MEDIA CONTACTS

Jessica Torchia
New York
+1 212 908 0653
jessica.torchia@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Corporate Hybrids Treatment and Notching Criteria - Effective from 11 November 2019 to 12 November 2020 (pub. 11 Nov 2019)

Non-Bank Financial Institutions Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Investcorp Capital Ltd.	EU Endorsed
Investcorp Holdings B.S.C.	EU Endorsed
Investcorp S.A.	EU Endorsed

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