NORTHERN TRUST
ASSET MANAGEMENT

50 SOUTH CAPITAL
A SUBSIDIARY OF NORTHERN TRUST CORPORATION

PRIVATE EQUITY, PRIVATE CREDIT AND HEDGE FUNDS AMIDST COVID-19 VOLATILITY

While the COVID-19 pandemic's impact on public markets has been striking and swift, private markets are not immune from the economic and market reality but do have structural advantages that are of value to long term investors. Northern Trust Asset Management's alternatives platform, 50 South Capital Advisors, has a long 20 year history in allocating capital through varying market environments and working with partners across the private equity, private credit and hedge fund landscape. Below we share our views on how our managers are reacting to the environment, and how we think about constructing portfolios to best capitalize on future opportunities.

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PRIVATE EQUITY

What are private equity managers saying about the impact on the private markets?

The impact of the coronavirus on private markets is evolving by the day. The first reaction we hear from managers is that it is "too early to tell with any certainty." They are actively engaged with company management to understand the extent of the economic impact and ensure sufficient liquidity and breathing room in their debt facilities.

Generally, our managers believe this will offer companies an opportunity to build market share in the medium- to long-term, primarily through add-on acquisitions and consolidation of competitors who do not have strong balance sheets. This is consistent with what we saw during the last recession in 2008-2009, where firms that were focused on building value long term and had sufficient liquidity could play offense. All firms agree that deal activity is expected to slow down significantly in the near-term. During the global financial crisis in 2008, U.S. private equity deals fell significantly. Once the market has rationalized the risks and fallout from COVID-19, we could see add-on acquisitions pick up as noted.

Valuations should reset to the downside over the short-term, delaying exit opportunities for business that were acquired over the last several years. We expect, in general, this will mean slower distributions to investors. New deal activity is also expected to decline, potentially driving a short-term slowdown in capital calls from certain managers. However, one trend that has emerged over the last several years is the use of capital call facilities to warehouse platform acquisitions and delay investor level capital call activity to improve fund returns. These credit facilities were not used as aggressively or as widely during the global financial crisis, and we anticipate managers which have utilized these facilities in recent years will see an increase in capital calls to pay down these lines. This should have limited impact on our portfolios due to our focus on lower- and middle-market firms where this pick up as noted.

We have been impressed by the swift and proactive approach managers have taken to work with their management teams to implement adjustments to protect their portfolio companies.

What do private equity managers expect will happen to their portfolios and how are they responding?

Communications from private equity managers have been frequent and have focused on both policies to protect employees' health and the financial impact on portfolio companies. We have been impressed by the swift and proactive approach managers have taken to work with their management teams to implement adjustments to protect their portfolio companies. From our discussions, it appears that managers' business continuity plans have been executed and are generally working effectively.

Private equity managers are generally asking underlying portfolio companies to focus on three areas:

- Business continuity procedures
- Impact on businesses and 2020 financial forecasts
- Managing liquidity and staying in active dialogue with lenders

The impact from COVID-19 appears to be highly dependent on a company's supply chains and customer bases. One interesting outcome of the U.S. and China trade policy negotiations has been that many U.S. based companies which sourced supplies from China based manufacturers had already started to pivot towards alternative supplies outside of China. However, those businesses which continue to rely heavily on China-based supply chains, sole source providers, or those which sell into the travel and leisure industries, are expected to be more negatively impacted.

In terms of liquidity, a key item of discussion among lenders is on businesses facing short-term cash flow declines. Our understanding at this early point is that these discussions are proceeding well. In the lower and lower mid-market, where we focus our investment efforts, lenders are characterized as generally being more relationship oriented, long term holders, and lending at lower cash flow multiples than the larger and mega markets. This gives companies significant flexibility in managing through periods of stress.

There will be companies who will experience almost no impact or will have strong performance in this environment. These are businesses that are well funded, mission critical enterprises which can play "offense" and look to take market share from competitors not positioned similarly, and businesses which are benefitting from the change in consumer behavior, including the increase in activities performed from home.

What are the most likely opportunities for investors in private equity?

There should be a number of opportunities for private equity, just as we saw coming out of the last recession. It is important to remember that private equity has certain structural features that are designed to insulate it from volatile periods such as this, which may allow for outperformance relative to long-only equity markets:

- Fund managers do not face redemptions requiring them to sell at precisely the wrong time. Thus, managers can take a long-term view of investments, position companies to weather the storm, and wait to exit.
- A long-term view allows managers to play offense and acquire companies at lower valuations from sellers with a shorter-term view or who may be liquidity constrained.
- We construct diverse private equity portfolios, designed to provide further downside mitigation while still affording the opportunity to produce favorable long term returns.

Our experience coming out of the last recession also taught us the opportunities to purchase private equity interests in the secondary market should be compelling. Many investors who have allocated to private equity over the last decade may wish to sell their interests to raise cash, or re-allocate that capital. Managers focused on the private equity secondary market with capital to deploy are poised to take advantage of this deal flow and expected market repricing.

PRIVATE CREDIT

What are private credit managers saying about market volatility?

Comments have been similar to those conversations with our private equity managers. Lenders are segmenting portfolios into those companies most affected and those least affected by the COVID-19 crisis. It is still early, but current sentiment is that loans can be restructured or extended where necessary. In some cases, private equity sponsors may be required to inject capital to cure defaults, if they do occur. Deal flow will likely slow in the first half of 2020, but lenders including our financial sponsors expect that more add-on activity will occur at underlying portfolio companies.

We focus on managers in the lower to lower-middle market, so the companies in our portfolio tend to be U.S.-centric both in their investments and supply chain. This has somewhat insulated managers to-date from the COVID-19 crisis. Though there will be an obvious impact to the U.S. economy due to the health crisis, many of the other macro factors driving this crisis will have less impact on our managers.

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What do managers expect will happen to their portfolios and how are managers reacting?

Though still early, direct lending managers that we work with have seen a few dynamics at play in their portfolio.

- Increasingly over the past few weeks, managers have seen additional drawdowns on revolvers going from about 15-20% drawn to around 60% drawn. Our managers feel comfortable providing this liquidity to companies, given their senior credit position and loan covenants. This dynamic provides additional mitigation in times of turbulence.
- Managers do still anticipate defaults, despite companies drawing on revolvers. Those managers who have experience during a market correction, like the managers we partner with, should be better positioned to work with their portfolio and provide enough breathing room to weather the storm.
- Our managers have Libor floors in place in their existing loans, and in some cases are attempting to negotiate higher floors. We have also seen direct lending funds negotiating a higher rate to investors thus creating a natural floor for yield to investors.
- In anticipation of a market correction during the deployment of our sponsor backed credit strategy, we put guidelines in place with our managers such as eliminating loans to energy companies. We are requiring that all loans have covenants, and managers should be the lead or co-lead on loans in our portfolio. All of this was done primarily with first lien, senior secured loans that are "first out" in the capital structure. We anticipate our strategy having ample dry powder and to benefit from the ability to deploy into a more attractive market environment.

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What are the most likely opportunities for investors in private credit?

We believe there are a few key opportunities:

- Market pricing should reset. Yields on unitranche loans (hybrid loan structure combining senior and subordinated debt into one loan) are expected to increase 150 basis points of pricing and senior loan yields may rise 100 basis points, on average. Thus when the market re-opens we believe we are going to walk into a more attractive lending environment.
- Those managers who have been through a credit cycle should be better prepared. Not only should their financial sponsors have the dry powder needed to weather this storm, but a wave of restructurings are likely to occur. Managers with less experience in this type of environment may not have the experience to navigate these workouts
- Secondary purchases of loans from manager portfolios will likely increase. This offers the opportunity buying lower risk loans at an attractive yield, by purchasing "healthy credits" from a distressed seller.

HEDGE FUNDS

What are hedge fund managers saying about market volatility?

Our frequent conversations with hedge funds over the past several weeks have indicated that managers are generally staying calm and focused through market volatility. They are managing portfolios to preserve capital in the near-term and take advantage of the sell-off in the medium to longer term. Hedge funds have broadly been reducing risk through bringing down gross and net exposures (long investments minus short investments), through thoughtful portfolio and risk management.

More broadly, actions by the Federal Reserve have been effective in helping to steady the market's infrastructure. They also tempered concerns about market fragility and liquidity that were prominent and negatively impacting mega hedge funds in the first half of March. Model-driven and computer-generated strategies that have grown over the last 10 years have resulted in gaps in liquidity when bid/ask spreads widen, and some larger funds have struggled during this market decline as they risk moving the market when trying to reduce risk. Smaller, fundamentally-oriented managers have generally been in a better position to navigate this period relative to larger funds, and have been able to manage portfolios and to adjust exposures.

What do hedge fund managers expect will happen to their portfolios and how are they responding?

There is significant dispersion in hedge fund performance. The level of beta in portfolios, asset class and strategy positioning, and levels of short exposure are driving returns. Generally, managers have been reducing risk to dampen portfolio volatility amidst sharply higher market volatility. We have seen managers broadly fall into two camps with the degree of risk reduction and how they are navigating this environment.

- **High conviction managers** generally have longer holding periods based on deep fundamental company analysis. These managers are maintaining positions where fundamentals support staying the course, and they are taking advantage of opportunities to add to positions at compelling levels.
- **Trading-oriented managers** have generally outperformed to-date and reduced exposures more meaningfully, intending to manage portfolios at small gross exposures through near-term volatility. These managers are pointing to opportunities at compelling prices, but will wait to add meaningfully until they see markets acting more orderly.

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What are the most likely opportunities for investors in hedge funds?

The long awaited distressed credit cycle is expected to arrive, as the impact of the COVID-19 crisis on economic growth reverberates through to company balance sheets. We have positions in managers who have significant experience in distressed investing, and are expected to increase distressed in their portfolios as situations emerge. There will also be opportunities for us to invest in new managers who focus on distressed and have been waiting for a more robust opportunity set for their strategies.

Spreads in merger arbitrage have blown out in March amidst uncertainty around whether pending deals will close and whether financing will be secured. Not all deals currently in the market will be at risk, and managers expect that spreads will tighten as there is more clarity around the crisis broadly and individual deals specifically.

Long/short managers across equity and credit are identifying opportunities to add to existing long positions or buy into new long positions at compelling levels. There will be companies that continue to show earnings growth or simply outperform in a weaker demand environment, and managers see exciting entry points for positions in those businesses. Conversely, there will be many new opportunities for short positions from companies that are most severely affected by a slowdown in demand and a recession, and managers already identifying industries and companies they feel are most vulnerable.

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