
Q&A with Bill Sacher: The State of Private Credit Investing During the COVID-19 Pandemic




Jeff Diehl, Managing Partner & Head of Investments, recently moderated a webinar with Bill Sacher, Partner & Head of Private Credit, in which they shared perspectives on the state of private credit markets, actions that Adams Street is taking to manage existing portfolios, and a view on private credit opportunities during this period of disruption. This Q&A presents a summary of questions submitted during the April 9, 2020 webinar.

Q: Assuming the base case scenario of a U-shaped recovery starting in Q3 of 2020, what type of private credit strategies are you looking at as the most attractive to invest in within the current environment?

BS: Right now, given the uncertainty, investors still ought to be picky and try to play a little more defensively. We would favor being senior in the capital structure, for the most part, for both the security and the superior rights in bankruptcy, etc. We also like the idea of helping provide existing companies, where we have some demonstrated history, with incremental capital. But principally, as we do even in performing environments, we look for what we believe are fundamentally sound businesses with enduring enterprise value, which may be affected by some weakening demand but who we believe should be in the position to recover on the other side.

Q: How concerned are you about underlying companies' ability to make interest payments and service their loan obligations each month, in particular as the cost of capital has gone up and yields for lenders are higher?

BS: For existing businesses, we are laser-focused on liquidity. We are in contact weekly, if not daily, with many of the underlying portfolio companies. In many cases, we are getting 13-week cash flows and we are paying very close attention to evolving liquidity needs. In the market, in general, the downturn for many companies is going to mount. Adams Street entered the cycle at 4.8x leverage but the market is at 6x, and we believe some of those companies with higher leverage are going to struggle as a result. That is why I expect to see more rescue opportunities that require a balance sheet fix for fundamentally sound businesses, and even some that are hardcore distressed. While credit spreads have gone up for new deals, the quantum of debt has gone down, and so we believe the stress on the underlying companies should more or less even out. And it is, frankly, one of the drivers for bringing leverage down. You set the leverage levels based on your expectations of the companies' ability to service that debt. This time around, it may be a little bit counterintuitive, but we would rather underwrite to a recession scenario, where everyone is focused on how bad it could get and building fortress-like capital structures, than where we were at the top of the pre-disruption period, where everything was being structured with very optimistic assumptions that, in retrospect, now will never be realized.



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Q: How do you see competitors faring with their current portfolio and also with their ability to execute on new deals relative to your situation?

BS: This is probably the single occurrence that has created the advantageous environment. Many competitors who participate in the liquid markets are gone, for now, as a player in new deals. And we see many of the direct competitors who we deal with day-to-day are also more focused on their internal issues. If they have portfolio company problems, and some levered competitors, particularly BDCs, are also concerned about their own internal liquidity needs. There are still players who are open for business like we are, but we believe the competition has materially decreased.

Q: Do you see more opportunity in new originations or buying in the secondary loan market?

BS: We believe the secondary loan market purchase opportunities are very compelling, but we currently expect our focus now is still going to be heavily weighted towards new deals, or add-on deals for existing portfolio investments. There are other ways to capitalize on the opportunity within the secondary market, and we are currently considering those avenues.

Q: What do you think the window of opportunity is for the secondary and broadly syndicated loan market in the existing dislocation?

BS: It is really hard to predict. Each of these cycles are different and the last few had windows of opportunity that lasted a few months, rather than years or quarters. Investors need to be prepared in advance. We believe Adams Street's platform positions us to act quickly. We have insight and access to the private equity sponsors who back many of these deals, which not all secondary loan buyers possess. We are viewed, as a general matter, as a favored financing partner for most of the private equity sponsors backing these deals. All things being equal, we anticipate those sponsors would rather see us hold their debt than have it be traded away to unfriendly hands.

Q: What are your projections for default rates and recoveries across middle market direct lending in aggregate?

BS: We think the private market, which has in the last year seen some deterioration of covenant protections, but for the most part contains maintenance-based financial covenants, positions middle-market debt to have strong recovery rates compared to liquid markets. Which, frankly, has been the case for the last 25 years through multiple cycles, but we surmise it may be particularly true in this cycle we are in today.

Q: How do you plan on underwriting companies if the firm is still largely working from home and not traveling?

BS: Underwriting is a bit more challenging as we can't conduct onsite visits. However, as a platform, we have the experience of investing in sponsor funds for more than 40 years. We have a proprietary database of 23,000 portfolio companies. The frequency of sponsor-to-sponsor LBO activity remains not only quite high, but is increasing. In a number of cases, we already have some historical experience with the companies that are being re-LBO'ed, which aids in the challenge of being unable to physically visit the company. I do think that with Adams Street's robust video conference capabilities, the level of interaction with management teams will remain as high, and certainly so with the private equity sponsors as well.

Q: Do you engage in both sponsor and non-sponsor deals, and do you see a difference in times of crisis?

BS: The current environment highlights the pros and cons of each approach. I think one of the limitations of non-sponsored private equity deals is that they tend to be closely held, and the financial resources of those owners can be limited. This downturn has been deep and very quick, and it has left some people unprepared; I would think that a lot of non-sponsored deals have owners who are now struggling. This may be a catalyst for bringing those companies back to the market, and we anticipate a resumption of LBO activity when that occurs. One of the advantages of being in private equity sponsor-backed deals is that in our experience sponsors tend to have the liquidity to support their businesses - this is exactly the time where that shows its worth.

Q: Aside from the quality tilt, are there certain attributes you favor such as company size, sector, etc.?

BS: There are some obvious sectors on the front lines of this shutdown that we believe investors should avoid. In general, we tend to favor more defensive businesses. We look for companies that have a material presence in their market, a resilient market share, and a long history of earnings that we expect them to endure through the period in which we'll be a lender to the underlying business. Ultimately, we like to keep our portfolios diversified and not make any big sector bets. At the end of the day, we seek to have our portfolios decently represented by a good swath of the US economy. But at the moment we're looking more for defensive businesses that we expect should fare reasonably well in an environment that is recessionary in nature.

Q: Do you think the severity of the hit to earnings is priced in at current levels? Is the recent rebound short-lived or something we expect to continue?

BS: This is pure speculation on my part, and I assume that we're referring to valuation levels in the public markets. I believe the coronavirus effect on the markets will exist for a finite period. Whether it's one, two, or three quarters is anyone's guess at this point. I do think the hit to the economy is real and will linger for a while. You don't go from full speed to zero and back to full speed instantly. We're not out of the woods yet in terms of volatility, even though these recent bull market days are making people feel a bit better about the world. ■



Portfolio Attributes

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