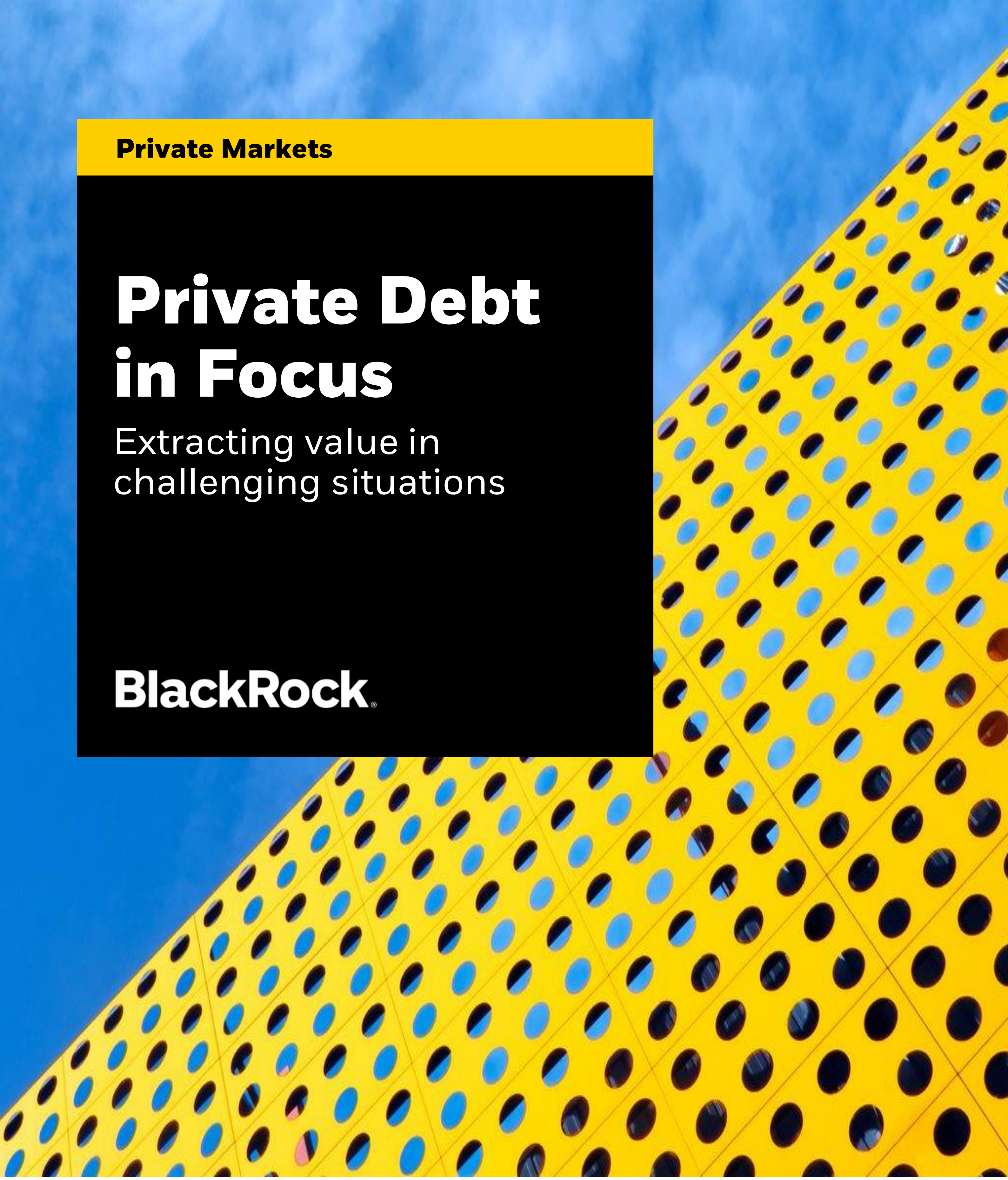

Private Markets

Private Debt in Focus

Extracting value in challenging situations

BlackRock

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Private Debt in Focus

June 2024

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Key takeaways

- We see a transatlantic divergence coming in monetary policy, with the Fed likely easing by year's end, and the ECB potentially cutting rates in June.
- More broadly, we expect a sustained period of "high-for-longer" interest rates, posing challenges for some businesses.
- As some of our portfolio companies become challenged, it's vital to have mechanisms such as covenants that permit greater input in negotiations in the event of a restructuring.
- It's increasingly important to differentiate between investments in performing companies and assets, versus opportunistic situations, and to structure the financing accordingly.

Introduction

In recent quarters, the outlook for private debt investments has remained broadly favorable. One sign is the covenant default rate, which has fallen despite a persistently high cost of capital.

According to the Lincoln International Proprietary Market Database the covenant default rate has fallen from 4.5% in the first quarter of 2023 to 3.4% in the fourth quarter.

As our macro credit research team has highlighted, the past few months have been characterized by a backdrop of resilience, including solid economic growth and fading concerns related to a near-term recession, especially in the U.S.

This, coupled with persistently elevated inflation, has caused the market to reprice its expectations for the start "timing" and magnitude of the Federal Reserve's (Fed) interest rate cuts. While we still expect the Fed to begin its easing cycle in the second half of the year, we no longer view the risks to that (relatively wide) timeframe as skewed to the earlier side. Rather, we now view them as more balanced.

We see potential for the European Central Bank (ECB) to begin its rate-cutting cycle in June. Three factors underpin this view: the wide growth differential between the U.S. and the Euro Area; the fact the U.S. has experienced more upside surprises in inflation data over the past three months; and recent public commentary from the ECB (and Fed). Additionally, we expect the Bank of England (BoE) to begin easing around the same time as the ECB.

For private debt investors, this naturally raises concerns about the ability for businesses with floating rate debt to withstand this "high-for-longer" interest rate environment. The potential for inflation reacceleration is also a key risk to margins, in our view.

We believe that private debt will continue to prove a durable asset class in this environment. The negotiated nature of most deals, with favorable lending structures and underwriting standards offer protection. And in challenging times, private debt investors can be proactive, help solve problems and create better outcomes.

To show how this can work, we're devoting this edition of ***Private Debt in Focus*** to four investments that became challenged and how we navigated the situation to optimize yields and returns.

Direct lending

The Investment:

In May 2022, we invested in a provider of IT, communications and print solutions to small and mid-sized businesses in the UK – a sub-industry where the direct lending platform frequently invests. Our GBP39 million financing supported the refinancing of the company's existing debt and supported the acquisition of a target company in the cloud space.

We viewed this investment as attractive given that IT services is a large market benefitting from robust adoption of hybrid working environments, broad transition to the cloud and the proliferation of bring-your-own-device trends, which has increased the need for secure systems.

With respect to the company, it had a strong product and compelling value proposition for customers. The company also had an attractive financial profile which included recurring, visible revenues, solid EBITDA margins and good cash flow generation.

The Challenge:

Following an acquisition, the company faced material customer losses at the target company, as well as several integration-related issues which led to underperformance. Together, these led to a leverage covenant breach in December 2022.

We negotiated a temporary covenant reset, allowing it to carry a higher proportion of debt relative to earnings. But continued underperformance resulted in an additional covenant breach and a need for more liquidity by the company.

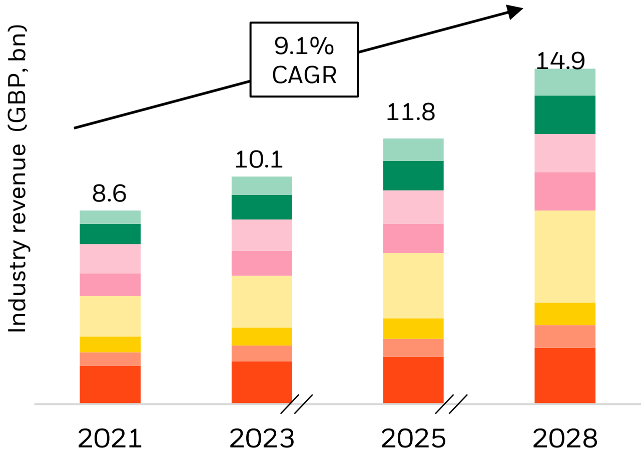
The Restructuring:

After several months of discussions with the sponsor, the new management team and chairman, we provided GBP4 million of additional financing to help the company manage its working capital needs and to meet overdue payments to suppliers, which had been affecting new business and operations.

In addition, this new liquidity would provide a buffer for the management to execute on a revised 18-month business plan which focused on retaining existing customers while winning new business, along with a strategic reduction in workforce.

The consensual, debt-led restructuring plan included the new-money commitment and capitalization of interest owed to us as payment in kind for up to 12 months. Payment in kind debt benefits from a premium margin, being priced

IT Managed Services set to grow



Source: OC&C Market Model, BlackRock. The chart shows the size of the UK IT Managed Services in revenue (GBP, billions). 2023,2025 and 2028 are forecasts. 9.1% is the Compound Annual Growth Rate (CAGR) over the period. Data as of 29 February 2024. **Past performance is not a reliable indicator of current or future results. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

above any cash paying debt and benefits from a compounding effect as it earns interest on interest until the debt is paid back. The team also negotiated enhanced economics and improved covenants, including a fixed and enterprise-value linked exit fee, which provides upside depending on the valuation of the company upon a sale.

We also received extended call protection should the company refinance our debt earlier than planned, as well as a base interest rate floor should we enter an interest-rate cutting cycle. Lastly, we negotiated significantly improved lender governance and control, and enhanced access and information rights, including three board observer seats, the ability to appoint a chief restructuring officer and additional independent board members along with the ability to control the exit or sale process.

The Outcome:

While this is a live investment, the initial execution of the revised business plan is tracking to expectations and we feel confident that our restructuring plan will help the company stabilize revenues, align its costs and de-leverage the business. This should position it for a potential sale to a strategic buyer or a private equity firm within 12 to 18 months.

Source: BlackRock. As of 30 April 2024. **Past performance is not indicative of current or future results.**

Infrastructure debt

The Investment:

We were the sole investor in US$70 million of senior secured holding-company notes that were used to finance two power plants located near Mexico City – Plant 1, a brownfield (operating) open-cycle gas-fired power plant and Plant 2, a greenfield (new development) combined cycle gas-fired power project.

These notes are subordinate to the company's operating company debt. The operating company conducts the business, and the holding company owns the shares of the operating company (OpCo). Typically, the OpCo debt is lower-yielding, but senior in the capital stack, while the HoldCo debt is higher yielding with lower seniority.

Our investment thesis rested on the fact that the plants would continue to be operational and any dividends from the two plants after OpCo debt was serviced would flow to HoldCo debt holders. The plants are located close to areas of high power demand in Mexico City.

Lastly, the plants would benefit from contracted USD-denominated cash flows with a government-backed utility under a 20-year purchase power agreement.

The Challenge:

For any greenfield project, we build in a cushion into our underwriting in case there are construction delays, as was the case with Plant 2. Also, costs ran above budget, which delayed the official date of first operation by an additional six months beyond our underwriting cushion date. Shortly after going live, Plant 2 suffered from unexpected US$11.5 million in increased gas costs caused by the Texas winter storm in February 2021. As a result, Plant 2 would not have enough cash to pay dividends to HoldCo investors. In addition, dividends from Plant 1 would not be sufficient for HoldCo debt to make full interest payments in calendar year 2022.

The Restructuring:

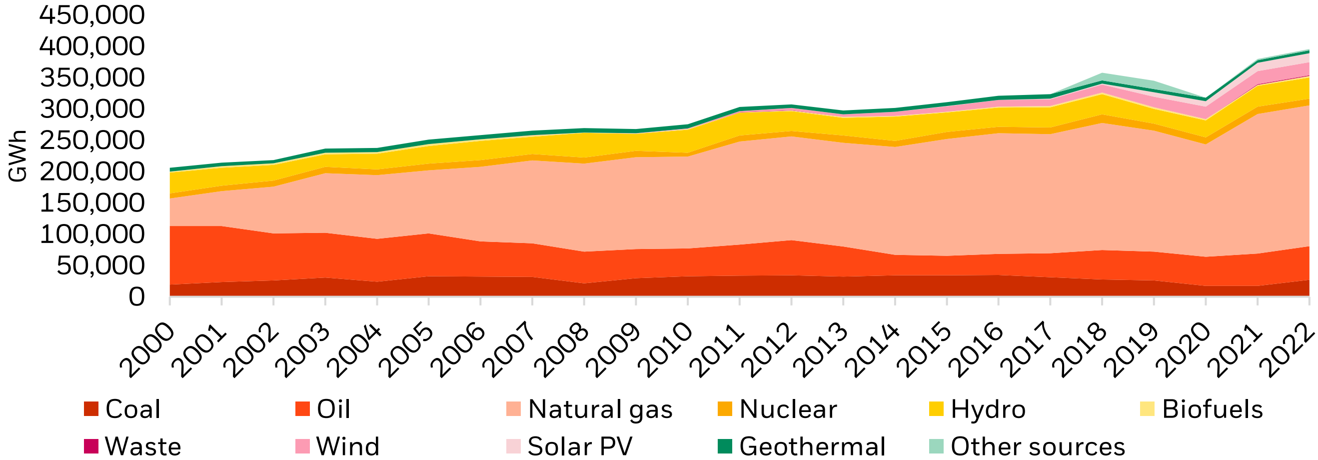
As the HoldCo and its sponsor faced liquidity stress, we still saw value in the plants and therefore opted to defer the 2022 semi-annual cash-interest payments in the form of payment in kind. We also negotiated compensation for our investors with an amendment fee. In addition, we brought forward the HoldCo debt's maturity date to July 2024 from July 2025 to allow our investors to receive their money back one year ahead of schedule. We also increased the debt's prepayment fee to 102% of PAR value of the loan regardless of the prepayment reason, which would compensate us should the sponsor decide to refinance our loan earlier than expected.

The Outcome:

The decision to use payment in kind at the HoldCo level proved beneficial as it allowed time for the sponsor to complete the business plan, which increased the attractiveness of the plants.

The plants were acquired by a new sponsor which led to a repayment of our HoldCo loan in July 2023. The loan was repaid at 102% of PAR together with accrued interest, generating a Gross IRR in excess of what we'd negotiated initially. Ultimately, this was a positive restructuring event and demonstrated the importance of being a lead or sole lender to negotiate the optimal restructuring terms for our investors.

Electricity produced by natural gas has become the dominant source in Mexico



Source: IEA.org, as of 31 December 2022. The chart shows the evolution of electricity generation sources in Mexico since 2000 measured in Gigawatt hours (GWh). **Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.**

Source: BlackRock. As of 30 April 2024. **Past performance is not indicative of current or future results.**

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Real estate

The Investment:

This was a US$39.3 million horizontal risk retention position in a US$780 million securitization. Secured by a portfolio of 48 hotels across the U.S, this interest-only loan was floating-rate with a two-year initial term and three one-year extension options. Our investment was motivated by the borrower's strong sponsorship with equity contribution, and a diversity of demand drivers, presenting an attractive return profile.

The Challenge:

The hotel industry was one of the first sectors to experience direct impacts from the COVID-19 pandemic, as travel declined and the portfolio's occupancy dropped. In April 2020, the original sponsor failed to make the interest payment and defaulted on the loan.

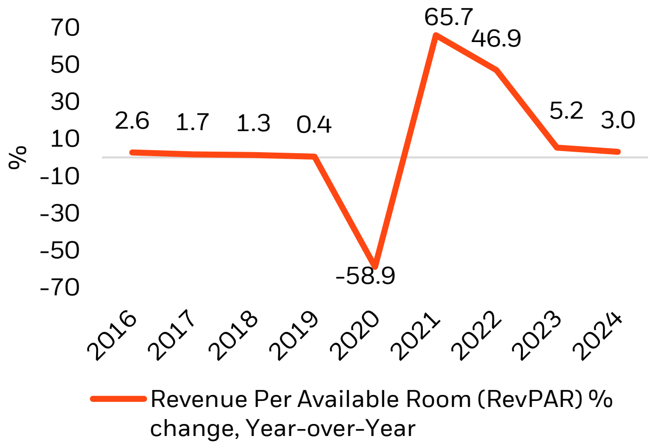
The Restructuring:

As the controlling class in the securitization, we worked with a special servicer to solicit offers for a debt assumption. In September 2021, a top-tier real estate firm was selected to assume the existing debt. It paid the accrued interest, servicer advances, special servicer and workout fees, and debt service reserve. We agreed to modify and extend the loan from 2022 to 2027.

The Outcome:

The new sponsor contributed over US$100 million to bring the loan current and fund property renovations. Since then, the portfolio has recovered with occupancy and revenue per room improving each quarter.

Hotel industry recovery sustained



Source: CBRE, BlackRock. The chart shows the year-over-year % change in the RevPAR for the U.S. hotel industry which is a measure of potential profitability. 2024 is a forecast. Data as of 31 March 2024. **Select figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

Opportunistic credit

Unlike performing companies or assets, opportunistic credit investing often focuses on debt positions that are already in a challenged, distressed or stressed state.

The Challenge:

A publicly traded company in Hong Kong purchased a leading international school in Singapore, paying 90% of the closing price upfront in February 2020 through equity and local Singapore bank debt, with the remaining 10% to be paid in November 2022.

When the parent company's publication of its first-half 2022 audit was delayed amid strict quarantine measures in mainland China, the trading of its stock was suspended, triggering a technical default on its Singapore bank debt. Additionally, the parent company was not able to fund the remaining 10% purchase price by the 2022 deadline, due to onshore capital control.

The Investment:

The parent company would require a bridge loan to refinance the Singapore bank debt, pay the remaining 10% of the purchase price for the Singapore School, and to fund campus expansion.

Through an existing relationship with a majority owner of the parent company, we had exclusive access to the deal, though competitors offered better debt pricing terms. We benefitted from direct access to the Singapore school's management team during investment due diligence.

In January 2023, we provided mid-teen cost bridge financing of US$143 million to the Singapore school. By lending directly to the school instead of the parent company, we had direct collateral and stronger legal protection.

Our investment thesis was that, as a premium for-profit international school with a long operating history, the school would see growth, as it served the rising expat population in Singapore. Our first-lien, senior-secured term loan was secured against cash flows and assets from Singapore-based entities, and structured with an initial low loan to value ratio of 29%.

The Outcome:

In January 2024, our loan was refinanced, 18 months ahead of the maturity date. The investment realized a double-digit gross IRR – in excess of our initial base case.

Exploring key covenants

Sample of Private Debt Covenants

1. **Leverage Covenant:** A maintenance leverage covenant, indicating the financial health of a business, is typically included in deals and tested on a quarterly basis (breach of which would result in an Event of Default). Typically, expressed as ratios such as Debt to EBITDA, Debt to Total Assets, etc. and can be viewed on a Gross (Total Debt) or Net (Total Debt – Cash on Balance Sheet) level.

2. **Interest Coverage Ratio Covenant:** Measures the capability of a borrower to service interest on outstanding debt. Typically, expressed as EBITDA divided by debt interest payments only.

3. **Fixed Charge Coverage Ratio Covenant (FCCR):** Measures the capability of a borrower to pay its fixed expenses, including mandatory debt payments of principal and interest. Typically, expressed as (EBITDA minus CAPEX and cash taxes) divided by (cash interest expense plus mandatory debt repayment).

4. **Liquidity Covenants:** Establish a minimum target level that a borrower must hold in liquid assets. This allows lenders to ensure that should the borrower encounter challenges, there is at least a minimum level of cash that can be used for operating expenses and interest payments.

5. **Incurrence Covenants:** Prevent a borrower from taking certain actions that may be deemed detrimental to the long run success of the business. For example, a business that engages in a roll-up strategy (M&A of smaller peers in the respective industry) may only be able to pursue further M&A if it meets a specified test.

6. **Reporting Covenants:** Establish a deadline for a borrower to provide financial statements to investors. Typically, this is conducted on a monthly, quarterly and annual schedule and allows investors to review business and financial performance and to determine if any investor engagement with sponsors and business management is needed if there are early warning signs of financial difficulty.

7. **Profitability Covenants:** Establish a target profitability level that a business must reached by a set timeline. This allows a lender to feel confidence that a business is not borrowing debt indefinitely and that the company has a clear path to profitability which is directly and indirectly linked to a sale. A highly profitable business increases the likelihood it will become a desirable acquisition target. Typically, expressed as a minimum revenue target switching to minimum EBITDA target after a defined number of years.

Conclusion

The examples in this edition of *Private Debt in Focus* demonstrate that certain investments can require more active portfolio management. And this careful management on the part of a lending partner can play a major role in leading to the best outcomes for the borrowers, as well as the best returns for investors. These challenging situations can also be opportunities to strengthen our partnerships with portfolio companies and provide additional value to investors.

In private debt, covenants are an integral part of the underwriting process, and can allow lenders to have significant input into the restructuring process to help borrowers right the ship in challenging circumstances.

While restructuring mechanisms vary, experienced lenders can defer cash-paying debt to payment in kind debt at a higher rate to provide interest relief to the borrower for a short, defined period. At the same time, restructurings can negotiate pulling forward the maturity date on debt to allow investors to receive their capital ahead of schedule. And those same negotiations can also attach some equity upside to the debt so that investors benefit when a turnaround story is successful.

Opportunities can arise in performing companies or assets as well as in distressed situations. In the latter, experienced lenders can structure an investment to target a return that is commensurate with the complexity and risk of the investment.

Our platform, with a 23+ year trackrecord of managing Private Debt, employs a well-structured investment process that has allowed us to generate strong track records and achieve targeted investment outcomes. Our investment process commences with Deal Sourcing, transitioning to Underwriting (due diligence and structuring) and then to Portfolio Management. This repeatable process allows us to appropriately mitigate the risks against the potential rewards of any investment. A key part of the underwriting process is to include structural protections such as maintenance (financial covenants which are tested on a regular basis) and incurrence covenants (tested when the borrower wishes to take a specific action) that provide protection for us as lenders by governing what a business may or may not be able to do.

BlackRock Private Debt

USD $85B

Assets under management in direct lending, opportunistic, special sits, multi-debt solutions, infrastructure, and real estate debt

23+

Years of investing track record seeking to deliver attractive results through market cycles

200+

Investment professionals executing on cycle tested capabilities

18

Offices across the globe providing unparalleled local and global market access & perspective

2000+

Investment opportunities reviewed annually

Strategy AUM

USD $45B

Direct Lending

USD $3B

Venture & Growth

USD $6B

Opportunistic Credit

USD $6B

Multi-Strategy Debt

USD $3B

Real Estate Debt

USD $21B

Infrastructure Debt

All figures shown above are as of 12/31/2023 unless otherwise stated. Figures may not add up due to rounding.

Want to learn more about BlackRock's private debt capabilities?

Visit our website and get in touch with us.

Source: BlackRock. As of 30 April 2024. **Past performance is not indicative of current or future results.**

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