BARINGS VIEWPOINTS

July 2017

SEEKING ATTRACTIVE RISK-ADJUSTED RETURNS IN PRIVATE JUNIOR CAPITAL

In an economic environment that continues to be characterized by low interest rates and a search by investors for yield, private, middle-market debt is increasingly appealing. At Barings, we see investment opportunities up and down the capital structure in this asset class—from senior secured loans to mezzanine debt and other forms of junior capital. In this paper, we will focus specifically on the junior part of capital structure. Based on our 25 years of experience in this market, we believe that private junior capital investments offer the potential for attractive, long-term risk-adjusted returns relative to comparable asset classes. Current market dynamics also make now a particularly interesting time to consider an allocation to this asset class.

Highlights

- Private junior capital investments have delivered attractive risk-adjusted returns relative to comparable asset classes over the last 15+ years*
- These investments offer current income streams and potential returns that stack up well on an absolute and relative basis
- We believe Barings' 25-year track record and experience in investing across the capital structure and geographies, position us to capitalize on the current opportunity

Why now?

Given current market conditions and the perception that we may be in the later stages of the credit cycle, some investors are questioning whether this is a good time to invest in private junior capital. For investors that continue to seek higher yields, we believe it is. As detailed below, private junior capital can offer attractive absolute and relative returns as well as other key characteristics that may benefit investors in today's environment, and through the cycle, including:

LOW RELATIVE VOLATILITY / LOSSES: Private junior capital has historically shown less return volatility through multiple credit cycles than private equity and public debt.

LOW CORRELATION TO PUBLIC DEBT AND EQUITY: The asset class can also offer attractive diversity benefits given its relatively low historical correlation to public equities and public credit.

CONSERVATIVE CREDIT STRUCTURES: Private junior credit investments have historically had lower leverage and higher equity cushions than broadly syndicated markets. As these deals are directly originated and negotiated, and given the illiquidity, the credit agreements tend to be more favorable to creditors than investors would typically experience in the broadly syndicated markets, thus providing more protections throughout credit cycles.

Current market conditions also remain favorable for the asset class on both an absolute and relative basis. On an absolute basis, we believe the continued low-interest-rate environment combined with low but positive economic growth provides a sound backdrop for credit investing generally. This in turn has led to a relatively robust M&A market, which is a key driver of demand for private credit including junior capital. The yields on junior capital investments—while differing somewhat from region to region—are attractive and relatively stable in the low double-digit range (contractually) with further upside from smaller equity co-investment features.

On a relative basis, junior capital investments may help to provide diversification benefits when incorporated into broader institutional portfolios. Notably, due to the "originate to hold" nature of private junior capital, these investments tend to have lower volatility relative to liquid traded assets. Additionally, given the contractual current income streams, junior capital portfolios can act as a nice complement to traditional private equity investments by de-risking the investment over time and minimizing the J-curve type return profile.

**Past performance is not necessarily an indicator of future performance.*

Defining Junior Capital

Before delving deeper into the potential benefits of private junior capital, it is important to understand the structure and characteristics of the asset class. Private junior capital consists of investments in the subordinated part of a capital structure. These investments are most commonly subordinated debt financings for middle-market companies in the developed world including North America, Europe and the developed Asia-Pacific region, including Australia and New Zealand. Our area of focus is investments made in 'performing' companies as opposed to distressed situations where capital is provided to support turnarounds as "rescue capital." Junior capital investments sit behind first-lien debt in a company's capital structure. In the event of a default or other credit event, junior capital investors would receive payment after first-lien debt holders but ahead of equity. As compensation for taking this additional credit risk, junior capital investors earn increased returns, typically in the form of higher interest coupon payments and at times opportunities to share in equity returns as a potential return enhancer.

At Barings, we offer a full array of financing solutions—up and down the capital structure—for companies and their private equity sponsors. This includes different structures across the junior capital spectrum. In turn, we are able to provide our investors with access to a variety of junior capital investment types, each providing different risk and return dynamics. (FIGURE 1) illustrates the various junior capital investments where Barings is active as a manager.

FIGURE 1: A VARIETY OF PRIVATE JUNIOR CAPITAL INVESTMENT OPPORTUNITIES

LAST-OUT UNITRANCHE AND 2ND LIEN

Unitranche structures, which effectively combine senior and junior capital into one senior secured term loan, have continued to gain prominence as financing solutions, particularly in Europe. A unitranche loan can be bifurcated into different payment priorities, thus offering different risk/return profiles via: a 'first-out' tranche and a 'last-out' tranche. The sharing of proceeds and the division of income between the first-out and the last-out tranche is governed by an agreement among lenders. The key features of the agreement among lenders are that the last-out tranche only receives its capital back after the first-out is fully repaid, but the last-out tranche receives a greater proportion of the unitranche's interest income. The subordinated or last-out tranche can also be considered junior capital—it can offer higher potential returns while retaining its status as a senior secured loan.

MEZZANINE DEBT

We generally categorize mezzanine debt into two primary buckets based on the contractual return components of the security:

- Predominantly Cash-Pay investments—subordinated investments which have a contractual cash interest coupon that is greater than its contractual payment-in-kind (PIK) coupon (if any).
- Predominantly PIK investments—subordinated investments which have a contractual PIK interest coupon that is greater than its contractual cash interest coupon (if any). As the name suggests, these differ from predominantly cash-pay investments in that the majority of interest income accrues to the principal balance over the life of the investment ,with full principal, plus the accrued PIK interest paid at maturity (or earlier if pre-paid).

SENIOR/PREFERRED EQUITY

As the name implies, Senior/Preferred Equity maintains a preferred position relative to the common equity. These investments generally have a contractual return, typically in the form of payment-in-kind, as well as higher proportion of nominal-cost warrants that have the potential to generate capital appreciation.

COMMON EQUITY

Mezzanine debt is often accompanied by an opportunity to invest in common equity either directly or via nominal cost warrants. Generally these equity co-investments represent a relatively modest percentage of the overall debt investment (typically up to 20%), but have the potential to provide attractive upside.

FIGURE 2: A VARIETY OF JUNIOR CAPITAL INVESTMENT OPTIONS SPAN THE RISK/RETURN SPECTRUM

	Last-Out Unitranche / 2nd Lien	Predominately Cash-Pay Junior Capital	Predominately PIK Junior Capital	Senior / Preferred Equity
Target Return	10%–12%	12%–14%	14%–18%	18%+
Return Components	8%–12% cash	6%–11% cash 1%–10% PIK Quarterly compounding	0%–10% cash 13%–17% PIK Quarterly compounding	8%–20% PIK Quarterly compounding (or more frequent)

For Illustrative Purposes Only. There is no guarantee that any target return or return components will be achieved.
SOURCE: *BARINGS MARKET OBSERVATIONS AND ESTIMATES. AS OF JUNE 2017.*

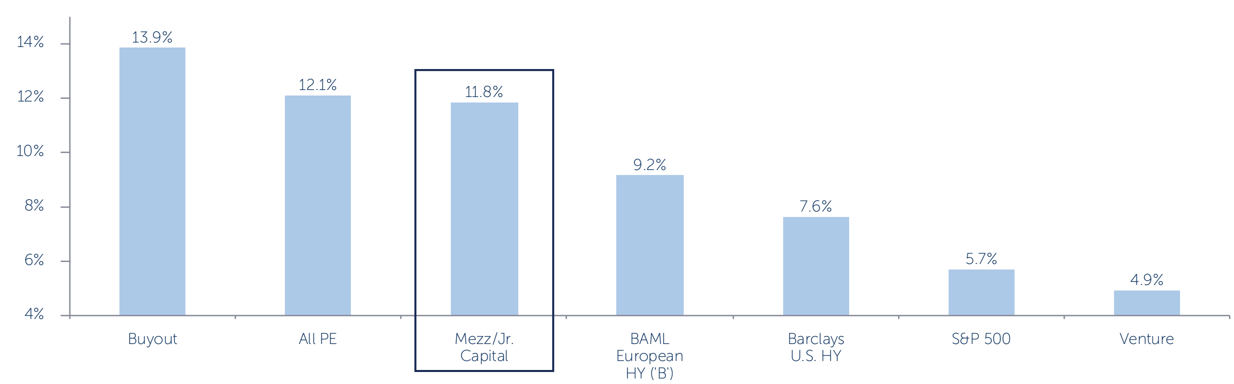
How does junior capital stack up relative to other asset classes?

Private junior capital stacks up well on a variety of measures relative to asset classes including private equity and high yield.

A history of attractive returns...

Given the lack of liquidity in the asset class, investors have historically been compensated more than in other liquid credit alternatives. While past returns are not necessarily indicative of future results, it is notable that private junior capital returns have been impressive relative to asset classes including private equity and below investment grade public credit. (FIGURE 3) shows that since 2000, junior capital returns—in this case illustrated using Preqin data for traditional mezzanine debt—have averaged 11.8% per annum, outpacing high yield bonds, public equities and venture capital over the same time period, and have generated returns similar to private equity funds, more broadly.

FIGURE 3: HOW JUNIOR CAPITAL RETURNS HAVE STACKED UP 2000–JUNE 2016



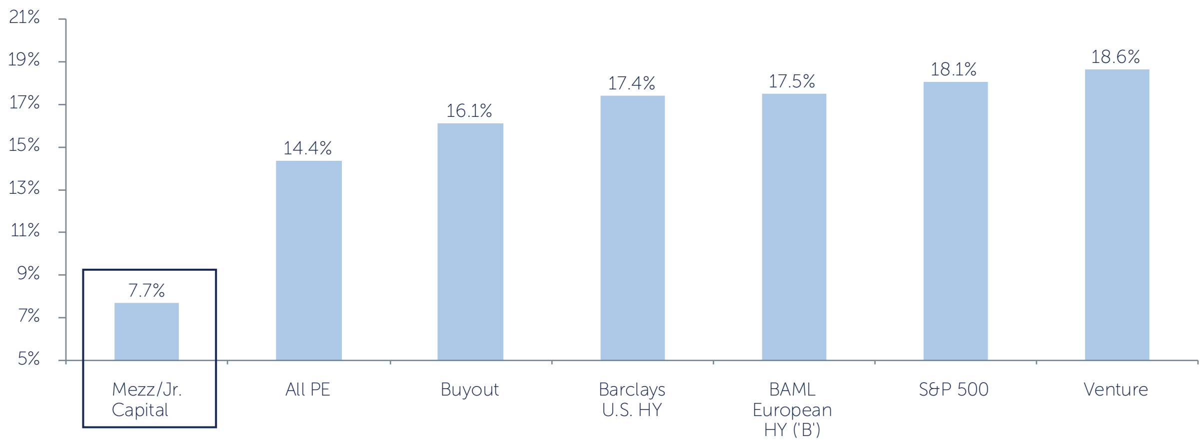
SOURCE: *GROSS TOTAL RETURNS PRESENTED FOR PUBLIC MARKETS: S&P 500, BC AGG BC HY ANNUAL RETURNS FROM FACTSET; BAML EUROPEAN HIGH YIELD BOND ("B") INDEX, PRIVATE MARKETS FROM PREQIN (NET IRR RESULTS FOR EACH YEAR). DATA FROM 2000 THROUGH JUNE 2016.*
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

...with notably lower volatility.
Importantly, market-level returns for traditional mezzanine, again as provided by Preqin, over this time period have been achieved with notably lower volatility than comparable asset classes. Thus on a risk-adjusted basis, traditional mezzanine has been among the best performers.

What drives the lower volatility of the asset class? Some of it relates to the private nature of junior capital investments, which, similar to private equity, means that asset prices are not marked to market on a daily basis and tend to be less subject to volatility from money flows in and out of the asset class. This insulates junior capital investments to a degree in that they are less impacted by daily movements in market sentiment, geopolitics and other headline-grabbing events. Instead, performance is driven primarily by credit fundamentals.

In addition, the long-term, contracted income streams provided by junior capital investments help to provide investors with visibility and lower volatility. This differentiates private junior capital from traditional private equity strategies, which may rely more on capital appreciation and increasing valuations. The income streams from junior capital investments also commence at the beginning of an investment's life, meaning that investors start receiving distributions right away, where in other asset classes, distributions may be years away, creating an element of uncertainty and contributing to greater volatility.

FIGURE 4: RETURN VOLATILITY (STANDARD DEVIATION OF ANNUAL RETURNS) 2000–JUNE 2016



SOURCE: *GROSS TOTAL RETURNS PRESENTED FOR PUBLIC MARKETS: S&P 500, BC AGG BC HY ANNUAL RETURNS FROM FACTSET; BAML EUROPEAN HIGH YIELD BOND ("B") INDEX, PRIVATE MARKETS FROM PREQIN (NET IRR RESULTS FOR EACH YEAR). DATA FROM 2000 THROUGH JUNE 2016.*
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

BARINGS—A STRONG, ESTABLISHED TRACK RECORD INVESTING IN JUNIOR CAPITAL ACROSS GEOGRAPHIES

$8 BILLION *invested in* **500** PLATFORM **COMPANIES**

177 JUNIOR CAPITAL **TRANSACTIONS** SINCE 2010 *with* **70** FINANCIAL SPONSORS

65 PRIVATE FINANCE INVESTMENT PROFESSIONALS *located in* **7** COUNTRIES *on* **4** CONTINENTS

25 YEARS *investing in* NORTH AMERICA

12 YEARS *investing in* EUROPE

8 YEARS *investing in* AUSTRALIA

SOURCE: *BARINGS. AS OF DECEMBER 31, 2016.*

Experience, long track record of returns

For over 25 years and across multiple credit cycles, Barings has invested in private middle-market businesses. We believe that our platform is differentiated by a long, proven track record, a global reach, the ability to invest up and down the capital structure and our capital preservation mindset. We have invested junior capital in over 500 companies since our group was formalized in 1992. These investments have achieved a gross IRR of 14.8%, which equates to a gross multiple on invested capital (MOIC) of 1.5x.

The returns that we have achieved for our investors have also been broad-based rather than concentrated in a small number of outperforming investments. This speaks to the visibility of the returns achievable in the asset class and our strict focus on risk management. Our track record includes over 330 fully realized investments, which we believe is notable in the market.

FIGURE 5: BARINGS' JUNIOR CAPITAL TRACK RECORD

Global Junior Capital Track Record		
	Since Inception[1]	2010 Onward[2]
Investment Count	509	181
Gross IRR	14.8%	15.7%
Gross MOIC	1.5x	-

U.S.	
Investment Count:	128
Invested Amount:	$2.0 billion
Gross IRR:	**15.6%**

Europe and Asia Pacific[3]	
Investment Count:	53
Invested Amount:	$1.0 billion
Gross IRR:	**15.9%**

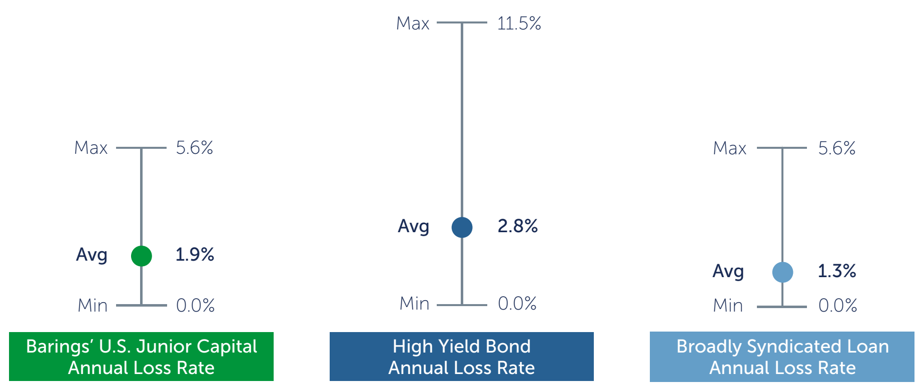
SOURCE: *BARINGS. AS OF DECEMBER 31, 2016.*

1. *Inception dates include 1992 for North America, 2005 for Europe and 2009 for developed Asia Pacific. Data through December 31, 2016.*
2. *2010 Onward: Investments made between 2010 through December 31, 2016. 2010 represents first full year of global mezzanine operation.*
3. *Europe and Asia Pacific includes U.K., Continental Europe and Australia (and certain other developed Asian markets).*

Capital preservation—core to our culture and investment process

Capital preservation is at the heart of our investment philosophy, and we take great steps to ensure transactions are structured to protect capital. Due to the illiquid nature of private junior capital, the investments tend to have stronger structural protections built into the credit agreements than are typical in public credit investing. Examples include maintenance financial covenants, restricted payments and other limitations. These covenants are intended to provide early warning triggers should financial performance deteriorate, and give us the ability to renegotiate terms in an effort to avoid default. Importantly, our team has invested through many credit cycles, working with sponsors and borrowers to address potential issues when they arise by acting quickly and decisively. We believe this depth of experience—in good times, and importantly in bad times—sets us apart from competitors. This is illustrated by the low annualized loss rates achieved in our junior capital strategies since 2000, relative to high yield bonds and broadly syndicated loans.

FIGURE 6: BARINGS U.S. JUNIOR CAPITAL ANNUAL LOSS RATES (2000–2015)



SOURCE: *BARINGS AND CREDIT SUISSE CREDIT DEFAUT REVIEW. AS OF APRIL 2016.*

A global reach

In our experience, generating the best returns for our investors over the long term involves reviewing a large number of potential investments to select from. This is why we have built a large, global platform with 65 dedicated private finance investment professionals located in seven offices on four continents. In the last 36 months ending December 31, 2016, the team reviewed over 3,750 opportunities, closing on 200 investments. By creating a large funnel of investment opportunities, we can be more selective and avoid adverse deal selection.

Our efforts in junior private capital—and in private credit more broadly—are focused on developed markets, specifically North America, Europe and developed Asia-Pacific, primarily Australia and New Zealand. Each of these regions has different characteristics—from supply/demand dynamics to market depth, to the types of financing that are being done. This is why having a local presence in each market is so critical. Additionally, as relative value changes between regions over time, global managers like Barings can adjust allocations to pursue the best relative value at any given time.

A presence up and down the capital structure

At Barings, we invest across the full capital structure—from private senior secured loans to private junior capital and equity co-investments. Just as looking across geographies enables us to understand where relative value exists at any point in time, the ability to invest across the capital structure enables us to invest in the part of the capital structure that we think offers most value.

This ability to go up and down the capital structure, we believe, sets us apart from peers when we are working with sponsors to find financing solutions for middle market companies. Not only are we able to offer these companies a wide variety of solutions, but this enables us to identify the most attractive place in the capital structure to invest in any given transaction.

This comprehensive solutions approach has helped us to establish strong sponsor relationships. We have a broad network of private equity sponsors and in the last three years carried out transactions with over 100 sponsors. By diversifying our business across sponsors, we also mitigate risk for our own investors.

Conclusion

In an environment where the hunt for yield continues, junior capital investments offer investors a potentially differentiated and attractive source of risk-adjusted returns. But when looking further out on the risk curve in private credit—or in any asset class—partnering with the right manager is absolutely critical. At Barings, our strict focus on risk management and credit underwriting have formed the bedrock of our investment process in junior capital for decades, and we will believe they will remain critical for success in the future.

Barings is a $288+ billion* global financial services firm dedicated to meeting the evolving investment and capital needs of our clients. We build lasting partnerships that leverage our distinctive expertise across traditional and alternative asset classes to deliver innovative solutions and exceptional service. A member of the MassMutual Financial Group, Barings maintains a strong global presence with over 600 investment professionals and offices in 16 countries.

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*As of June 30, 2017.