BARINGS

CAPITAL SOLUTIONS

Understanding the Breadth of Investment Opportunities in Capital Solutions

INSIGHTS

Capital solutions constitute an increasingly popular investment category that seeks to provide equity-like returns with less correlated market risk throughout the credit cycle.

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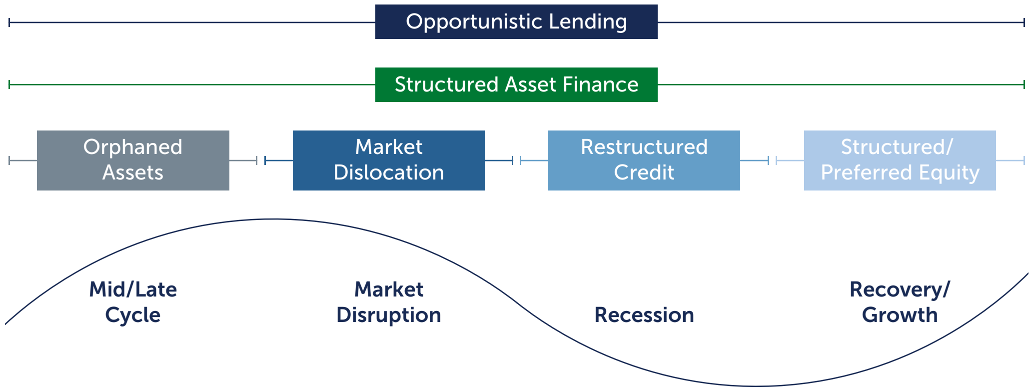
“Capital solutions” is a term that has become increasingly popular as a way for asset managers to describe flexible, often credit-focused strategies that provide investors access to unique or bespoke deal flow and investment opportunities. But it’s not always easy for investors to wade through a sea of varying definitions to get to the core of what a manager actually means when they describe their strategy. In this paper, we provide insight into the rationale for capital solutions strategies and background on why they are gaining so much traction in the market today. We also describe how we, at Barings, define our Capital Solutions strategy and where we expect to see particular opportunities in the years to come.

The history of capital solutions strategies and distressed debt strategies is almost indistinguishable. A decade ago, even as far back as the financial crisis, these more credit-focused “opportunistic” strategies were almost entirely focused on buying broadly syndicated loans and bonds at discounts for a pull to par trade, or looking for opportunities to restructure a company’s balance sheet and swap debt for equity to achieve targeted returns. But much has changed since then. The massive growth in private credit markets, combined with structural changes in public markets, have created new opportunities to use creative financing structures that go beyond buying discounted public debt or swapping debt for equity. Moreover, while distressed debt strategies of the past often were more appropriate late in the business cycle, the market today offers a compelling range of investment opportunities throughout the entire cycle. The objective of this more comprehensive approach is to generate equity-like returns through a diverse universe of credit opportunities—both public and private—that should be less correlated to traditional equity and fixed income markets.

In terms of portfolio positioning, a capital solutions offering today can be viewed as complementary to existing public and private credit strategies. While much of capital solutions’ appeal results from a potential to generate equity-like returns, its investments largely lie along the credit spectrum and may be more appropriately considered an extension or enhanced variant of traditional direct lending or private credit.

Figure 1: Designed to Invest Through Market Cycles



For illustrative purposes only. Source: Barings.

The Opportunity Set

In implementing capital solutions strategies, managers can choose from a wide variety of investment scenarios and structures. Some of these are more tied to particular parts of certain businesses or to phases of the economic cycle. Other strategies are appropriate through the entire business cycle and/or may be more idiosyncratic.

At Barings, we view **opportunistic lending** as the core of a capital solutions portfolio. These bilateral, senior loans span a highly diversified mix of industries and are typically made to companies facing economic challenges or those in illiquid situations that are unable to access traditional capital markets. Often, this type of lending is for the purposes of refinancing or acquisitions, and opportunities tend to arise throughout the business cycle.

Structured asset financing is another potential opportunity within capital solutions that, like opportunistic lending, spans the entire market cycle. With structured asset financing, managers acquire or finance assets or pools of assets that generate stable cash flows and look well-positioned to deliver attractive, less correlated risk-adjusted returns. An example are loans made to pharmaceutical companies that are tied to revenue from their patent royalties, a niche area in which revenue is uncorrelated to general economic conditions.

As business cycle conditions change, other solutions may be employed with the goal of capturing upside across market cycles. At the start of the business cycle, as growth starts to resume, opportunities often arise in **structured or preferred equity**. This entails providing capital in the form of hybrid securities—such as convertible notes and preferred shares—as well as through custom financing solutions to businesses growing especially quickly or in turnaround. It is not uncommon for managers in the market today to be more heavily weighted toward structured/preferred equity as a means of generating their targeted returns. The potential downsides to this approach, of course, are that it centers on one point of the business cycle and increases a portfolio's exposure to the fluctuations in the equity market.

During the middle to late stages of the business cycle, particularly during the **dislocation in public secondary markets** that often precedes a recession, technical factors can cause prices to fall below fundamental values, creating potential buying opportunities. Often, these opportunities arise on the back of sell-offs in certain industries or in single-name credits with a limited following. Orphaned assets also tend to become available in secondary markets at attractive prices as some owners of special purpose vehicles reach their borrowing limits.

Finally, amid a recession, investment opportunities can emerge as a result of **debt restructurings and equity reorganizations**, which often involve intense, direct negotiation on a bilateral basis or as part of a steering committee. Like the other financing opportunities within capital solutions, these financings can offer investors the potential to earn equity-like returns with credit protections. To a significant degree, the potential to earn such returns without dipping down to junior or mezzanine credits is due to what we define as the complexity premium characteristic of the investments across this space.

Capital Solutions in Action

FINANCING EXPANSION FOR COASTAL MARINA HOLDINGS

Coastal Marina Holdings is an owner and operator of marinas in Charleston, South Carolina, a market that is densely populated and lacks available boating slip capacity to meet growing demand. In 2020, CMH purchased three marinas and was seeking capital to expand. One of the reasons CMH ultimately turned to Barings was because of the longstanding relationship between the two companies, and CMH's conviction that Barings would not only provide a creative and flexible financing solution, but also serve as a trusted partner and appropriate steward for this asset over the long term.

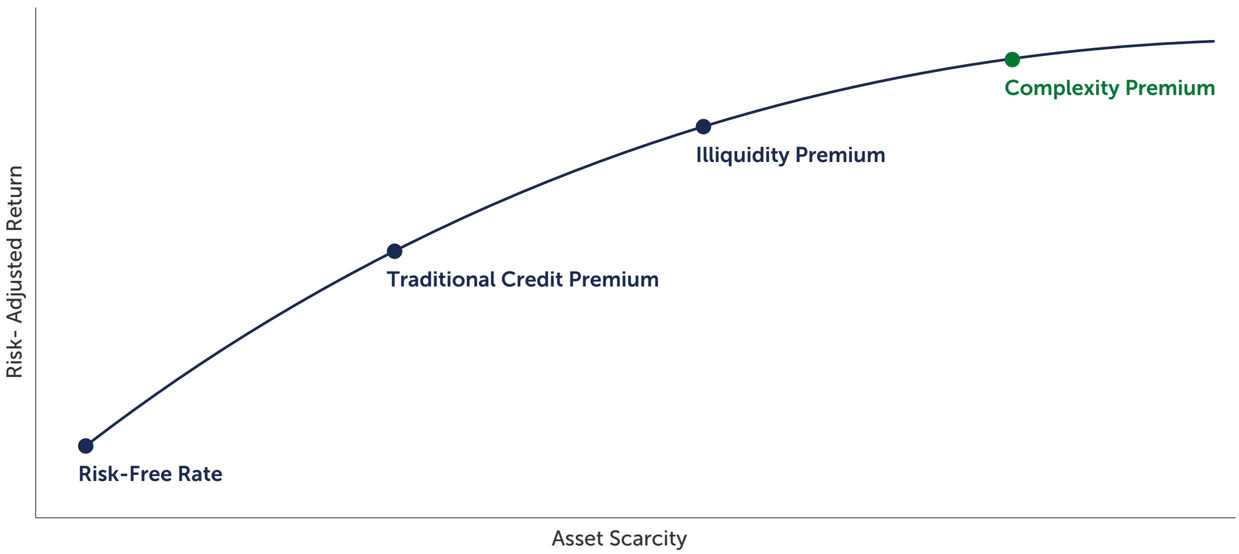
In November 2021, Barings provided CMH with a delayed-draw term loan and received a share of the common equity, which equated to a discount on the loan. The proceeds allowed CMH to continue its merger and acquisition strategy, while also adding slip capacity at its existing marinas, and to create a boating club. The next year, Barings structured a common equity line that can be drawn at a predetermined pace over a set timeline. This gives the company the flexibility to pursue growth at its own pace while maintaining a strong balance sheet as it continues to raise senior financing. Coupling the region's economic health and growing demand for boating-related facilities with CMH management's deep experience in marina management, real estate and hospitality, this partnership has provided opportunities for the company to create multiple recurring revenue streams from dry & wet slips, office, retail, & restaurant space, fuel sales and boat club memberships.

From an investor perspective, this partnership has offered access to a unique and potentially high-yielding asset that is less correlated with broader markets. Because Barings strategically financed this platform for a long-term holding period that incentivizes growth and reinvestment, we believe it will increasingly evolve into a platform that provides consistent and healthy cash flows.

The Complexity Premium

The investment appeal of capital solutions lies largely in the potential for compelling returns, which stems from sourcing and structuring bespoke and complex solutions to meet what are often idiosyncratic needs of companies. Through capital solutions investment strategies, managers—and by extension, investors—are positioned to capture the potential investment premium that comes with the complexity inherent in these solutions. The complexity premium sits atop a familiar hierarchy of risk-adjusted return premia and scarcity.

Figure 2: Breaking Down the Complexity Premium



For illustrative purposes only. There are no assurances that the complexity risk premium will be achieved.

At the lower end of the risk premium spectrum is the risk-free return provided by U.S. Treasuries. Moving up the spectrum gradually starts the increase in asset scarcity, and leads to the credit premium that is typically associated with higher-yielding liquid or broadly syndicated assets such as high yield bonds and loans. Next on the spectrum is the illiquidity premium typical of private or illiquid assets, which can include middle market loans and private placements, as well as areas like infrastructure debt and real estate debt.

The complexity premium sits at the higher end of the spectrum and stems from the complexity inherent in sourcing and structuring deals in this space. A key driver of this potential premium is the fact that the type of assets from which it is generated are often in short supply and difficult to source. Another contributing factor is that the solutions in this space are rarely, if ever, off-the-shelf packages. Instead, they are highly bespoke and typically bi-lateral constructions requiring the creativity and hands-on involvement of experienced investment management teams and legal experts working alongside company owners and managers. In addition, identifying and pricing risks in this space, and then executing the complex financing solutions, typically requires a capacity for in-depth data gathering and analysis, as well as a thorough knowledge of a borrower's specific circumstances and industry.

Three Questions Investors Should Ask of Their Managers

Given that capital solutions represent a relatively new and complex investment alternative—the definition of which can vary widely by manager—there are a number of important questions and considerations for investors to be aware of when considering investments in this space.

HOW IS A MANAGER SEEKING TO ACHIEVE ITS TARGETED RETURNS?

While seeking equity-like returns is a well-telegraphed goal of many capital solutions strategies, arguably less understood is how managers are seeking to achieve their targeted returns. At Barings, the protection of capital and careful attention to identifying and managing risk are critical components. For this reason, we emphasize senior secured instruments and ensure that numerous investor protections are put in place. Many investors, unfortunately, come to know only after the fact that their portfolio consists of junior- or mezzanine-level credits that were selected for their return characteristics but lack certain protections. It is also important to consider the structures created, and whether they are positioned to capture the complexity premium as a result of their bespoke or complex nature. In addition to their risk and return profiles, the solutions should not be highly correlated to other holdings in an investor portfolio and should reflect a wide array of industries, sectors and geographies.

HOW IS A MANAGER SOURCING DEALS?

One contributor to the complexity premium typical of this space is the fact that a manager is tasked with originating certain types of deals that often are in short supply and/or difficult to source. For this reason, having access to a wide funnel of potential opportunities is a prerequisite for selectively sourcing and structuring the bespoke investments capable of delivering the attractive returns and capital protection investors seek. In some cases, companies that ultimately enter into financing arrangements may not have been actively seeking funds—perhaps because they were unfamiliar with the process or because a situation that quickly arose was transient rather than structural or long term. For managers, an origination network able to access these potential capital seekers, particularly those with needs that may be unconventional, often consists of a mix of banks and intermediaries; restructuring, advisory and legal firms; global sponsors; clients; and members of personal, company and affiliate networks. This level of breadth and depth plays a critical role in a manager's ability to access deals, ultimately positioning them to create more robust portfolios with the characteristics their investors seek.

HOW MUCH STRUCTURING EXPERIENCE DOES A MANAGER HAVE?

Since the potentially most rewarding capital solutions investments often involve creative structuring, managers should have broad and deep experience crafting such solutions over an entire market cycle and across a wide range of industries. Experience should consist of structuring and underwriting financings, as well as restructuring existing financings, in both public and private markets. At Barings, for instance, we have been negotiating complex transactions—including restructurings, which often come with a fair amount of risk—since 2008. As a result, we are very comfortable digging deep into these types of situations, analyzing their inherent risk and pricing it appropriately. Successful managers in this space also often have access to legal expertise, as well as hands-on operating experience. Another characteristic to look for is the alignment of interests between managers and investors.

Capital Solutions in Action

HELPING A COMPANY GO PRIVATE

Barings recently completed a transaction with one of the largest U.K. providers of community-based social care for adults and children with behavioral health issues and disabilities. The company is in a strong competitive position due to a structural undersupply of operators that can provide adequate care, high barriers to entry given infrastructure and regulatory requirements, and demand for the non-discretionary nature of the services its users require, which offers potential protection from government funding cuts.

The company was publicly traded on the AIM market until 2022, when the original management team and private investors took it private. To finance the transaction, Barings provided an investment in the form of a secured, second lien preferred capital instrument. The investment was secured over a robust business and substantial freehold portfolio—coupled with equity to enhance upside potential—and senior to management's rolled equity. Part of the complexity of the deal involved having to meet the tight timeline imposed by the U.K. Takeover Code.

In this case, exit risk is mitigated by having a defined exit date in the medium term, when the company is required to begin a sale process. There is also a call option for the founders to purchase the small equity portion subject to an attractive multiple.

Key Takeaway

In whatever way economic conditions unfold over the coming months and years, they are bound to present new challenges for companies and continued demand for creative financing solutions. As a result, we expect to see investment opportunities across the full array of investment categories discussed in this paper. For instance, defaults are likely to increase as the broader economy slows—creating opportunities for liquidity solutions as well as liability management. If we continue to see heightened volatility in the liquid markets, there may also be opportunities to take advantage of dislocations and identify attractive entry points. That is to say, while many opportunities stem from the evolution in private markets, we expect to see windows of opportunity in the public markets as well, particularly given the amount of capital on the sidelines. Ultimately, managers with the abilty to provide creative financing solutions and source the complexity premium in a unique way look best-positioned to navigate this evolving landscape and potentially deliver attractive, long-term, risk-adjusted returns for investors.

Why Barings?

Barings' Capital Solutions platform focuses on providing investors attractive, through-the-cycle, risk-adjusted returns that are less correlated with traditional debt and equity markets.

One of the key differentiators of our strategy is our cross-platform investment capability. Positioned at the intersection of public and private markets, we have the flexibility to tactically identify and **source differentiated assets across the illiquidity spectrum**, including both control and non-control investments. This breadth, coupled with our expertise and **creative approach to structuring deals**, supports superior underwriting and execution—and positions us to capitalize on significant off-the-run, bespoke investment opportunities. Of course, these situations involve taking calculated risks, which underscores the necessity for in-house talent and resources to effectively analyze and underwrite the fundamentals of every investment. Given our positioning within the firm, we also have the ability to leverage Barings' broader expertise across areas like high yield, private credit and real estate.

Finally, we have a **long track record** of negotiating complex transactions and delivering strong returns to investors through multiple market cycles. Since our 2008 inception, we have gained extensive experience tailoring financing solutions to companies and assets in complex situations.

Capital Solutions Investment Activity (2021–2022)

TOTAL ACTIVITY

$3.9	94%	2008	150+
Billion Invested	*Invested Into Mid-Sized Transactions*	*Track Record Inception*	*Restructurings Since 2008*

NORTH AMERICA

39	$3.0
Investments	*Billion Invested*

EUROPE

23	$0.9
Investments	*Billion Invested*

Barings is a $362+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

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