FIRST EAGLE
INVESTMENT MANAGEMENT

January 2019

First Eagle Private Credit Team

Middle Market Direct Lending Annual Letter

In 2018, our Middle Market Direct Lending group originated an attractive mix of proprietary middle market loan investments for our clients. These loans again met our high standards for quality, while providing risk/return profiles that represent significant potential value relative to other fixed income investment alternatives. We continued to focus on providing first-lien debt to finance private-equity-led acquisitions of core middle market companies, typically borrowers with $15 million to $50 million of EBITDA. While this segment of the private credit market has not been immune to well-publicized trends impacting the broader credit markets, the effects have been mitigated by structural differences in the middle market. We believe that our target market should remain relatively healthy and that our team and our investment portfolios are well-positioned to meet the challenges the markets may present. In many important ways, challenging conditions, economic uncertainty and increased volatility highlight the value of our investment strategy, our origination platform and the track record we have established over the past 15 years.

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Market Overview

Important market themes in 2018 included continued growth in senior stretch, unitranche and covenant-lite transactions, along with more aggressive use of EBITDA adjustments in measuring leverage and setting financial covenants.

As in recent years, floating-rate, private debt investments continued to be attractive to a wide range of investors in 2018. Capital inflows to the asset class from nonbank, financial institutional investors have been important to the stability of the private-equity or "sponsored" segment of the middle market, filling a gap created by the commercial banks' retreat from the market following the financial crisis. The pace of these inflows in recent years has at times exceeded the demand for capital generated from M&A and refinancing activity, resulting in pressure on credit spreads. In 2018, the pressure on spreads largely abated as the market established a new equilibrium. Lender protections, however, generally continued to weaken as many investors were willing to accept looser structures and terms to obtain deal flow or better pricing. Important market themes in 2018 included continued growth in senior-stretch, unitranche and covenant-lite transactions, along with more aggressive use of EBITDA adjustments in measuring leverage and setting financial covenants.

Excess liquidity was most evident in the upper middle market (defined as borrowers with EBITDA greater than $50 million) and broadly syndicated market. In the core middle market, covenant-lite transactions were actually an exception, and unitranche lending represented only about 15% of market volume. However, the more liberal use of EBITDA adjustments and add-backs clearly required extensive direct due diligence and careful structuring. In this market, average purchase price multiples increased from 8.9x in 2014 to 10.9x in 2018. During the same period, first-lien senior debt leverage rose as well, albeit more modestly, from 3.8x in 2014 to 4.4x in 2018. In other words, a greater percentage of the increase in purchase prices was funded with equity rather than with debt.[1]

Competition among lenders continued to intensify in the private debt market as a whole, with established firms and newer entrants raising significant capital and, in many cases, employing more aggressive lending tactics to put it to work. Among the newer entrants, many lack extensive origination networks, long-term track records and experience managing through economic cycles. These firms have tended to focus on the upper end of the middle market rather than the core middle market, where long-standing direct relationships are an important barrier to entry. Many of them have also promised higher yields that are not consistent with traditional senior debt. The longer-term, established competitors in our market tend to be prudent lenders that have proven their ability to manage through cycles and that appreciate the importance of industry expertise, direct due diligence and appropriate deal structures, regardless of market conditions.

Our target market differs significantly from the broadly syndicated, or liquid, loan markets, as evidenced by market dynamics at the end of last year. In the fourth quarter of 2018, despite what we believed to be relatively solid underlying economic fundamentals, increased equity market volatility directly affected the broadly

1. TRLPC US MM Purchase Price Multiples for LBO Deals (Institutional & Private) as of Q3 2018.

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syndicated loan market, which experienced major outflows of investor capital—primarily redemptions in retail loan funds. These outflows resulted in significant price declines in the secondary markets, as well as material changes in the pricing and structures of the new deals that came to the market in December. The middle market was impacted as well, but to a much lesser extent because this sector is characterized by less-liquid club deals, in which a handful of lenders work together to provide a company's debt requirements. These lenders are typically long-term investors with permanent capital. In addition, financings in this sector are often arranged based on long-standing relationships with private equity sponsors and firsthand knowledge of the borrowers' risk profile. The preponderance of long-term, institutional capital and the direct, negotiated nature of the transactions in the core middle market have historically resulted in significantly less volatility.

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Industry specialization continues to be a valued and increasing trend among our targeted private equity firms. Most of our middle market private equity customers now specialize in select industries, including healthcare, technology, telecom, financial services and others. We prefer this approach, not only because we believe it results in better investment decisions, but also because it makes us more competitive in the industries where we have developed extensive experience and expertise.

With purchase-price multiples at elevated levels, some private equity firms have also increased their strategic focus on "platform" building, which entails acquiring a company in a desired industry at a market multiple and creating franchise value by acquiring smaller competitors at lower multiples. This strategy, which relies on a combination of multiple expansion and cost synergies, can be very effective, but it is a type of investing where direct due diligence and hands-on structuring are crucial for lenders.

Overall Middle Market Portfolio

We have originated about 100 loans annually for the past few years. We believe our current portfolio of middle market loans clearly reflects our conservative bias and focus on the preservation of capital as well as our view of current market conditions. At year-end 2018, overall loan-to-value (LTV) averaged about 50%, and senior debt-to-EBITDA was 4.2x. The portfolio consisted of 96.5% first-lien loans and 3.2% second-lien and last-out loans. Covenant-lite transactions accounted for just 7.3%, and our internal credit ratings remained stable, overall, relative to 2017. The portfolio remained largely domestic, with 98% of exposure to US-domiciled companies. At the close of 2018, the unlevered yield on the overall portfolio was 7.8%. The consistent performance of our portfolio reflects our industry preferences, our selectivity and our diversification. As a result, we have minimal exposure to sectors we consider to be cyclical or challenged including retail, energy, agriculture, commodities and building materials.

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Higher interest rates increased the cost of capital for most borrowers in 2018, including our portfolio companies. Inflation and wage pressures in some sectors

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were offset to a degree by lower energy prices, and the tariff wars did not have a noticeable impact on our domestic portfolio. In our view, top-line growth was healthy, EBITDA was up on average and, as was the case for middle market companies across the industry,[2] our borrowers generally continued to demonstrate comfortable interest- and fixed-charge-coverage ratios, with ample cushions to compensate for potential margin pressure.

2018 Lending Activity

The weighted average yield on the newly originated loans in 2018 was 8.0%. An 8.0% yield represents a risk premium of about 525 basis points over LIBOR (including original issue discount), a level we believe represents very attractive risk-adjusted returns relative to other fixed income alternatives. Our well-established origination networks combined with refinancing activity in our existing portfolios enabled us to maintain a high degree of selectivity again this year. We closed 89 transactions in 2018: 46 new leveraged buyouts and/or refinancings—a small fraction of the opportunities we evaluated during the course of the year—and 43 add-ons of existing portfolio loans (*Exhibit 1*).

Exhibit 1.

2018 New Deal Origination

Deals completed	89
New deals	46
Add-ons	43
First lien	97.5%
Second lien	2.5%
Average senior LTV	50%
Average senior leverage multiple	4.4x

Since our founding in 2004, we have done business with more than 250 private equity firms; 50 of these are sponsors who show us most of the opportunities they consider at an early stage in their due diligence process. Every year, we generate a significant portion of our new business from these long-standing relationships. In 2018 we completed transactions with 47 different sponsors, four of which were first-time customers.

Diversification is a hallmark of our credit philosophy, and 2018 was no exception. Regardless of the attractiveness of any financing opportunity, we carefully limit individual exposure levels in order to maximize granularity in each of our portfolios. Our individual position exposures at the portfolio level have averaged 0.6% and have rarely exceeded 2%. Loan documentation and covenants are always important parts of our investment decisions. Evaluating the trade-offs between the quality of the borrower, the degree of leverage, documentation and pricing, requires careful analysis, especially when market conditions are challenging. We believe we are well-prepared to evaluate these trade-offs because of the market segment we focus on, our industry expertise and the fact that we directly originate, which enables us to conduct first-hand due diligence and negotiate documentation.

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2. “Desktop CLO 2019,” Wells Fargo Securities, November 19, 2018.

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and last-out positions comprised 2.5% of 2018 originations and were generally acceptable only when we already held a significant piece of the senior debt in the company and took a small slice of the junior tranche as a yield enhancer. Covenant-lite transactions accounted for just 7% of our deals and were concentrated in our upper middle market investments.

Our market presence gives us a bird's-eye view into the domestic economy, and we continue to see the potential for economic growth and fundamental strength in most sectors. That said, we are always focused on the economic cycle and maintain strict underwriting standards, seeking to avoid companies and sectors that we believe are more likely to struggle in a downturn. The following overview of a loan we structured in the environmental services sector provides a good example of the characteristics and structures we look for in our investments.

Deal Structure

First lien	4.5x
First-lien LTV	<50%
Junior debt	mezzanine

This transaction was attractive to us for several key reasons. The buyer was one of our top-tier customers with proven expertise in the sector. The environmental services sector tends to be noncyclical, and our diligence made us comfortable with the company's position in its markets and the quality of its cash flows. The terms of our first-lien, 4.5x leveraged and less-than-50% LTV loan were within our parameters for traditional senior debt, and the terms and conditions of the mezzanine debt were also acceptable to us. We negotiated financial covenants designed to help protect our investment in the event of poor performance and priced our risk at LIBOR plus 450 basis points with 100 basis points up-front, to yield 7.75%, or a risk premium of 483 basis points.

We decline transactions for a variety of reasons. Industry sector is the first hurdle in our analysis and we quickly pass on opportunities when the capital structure is too aggressive, as often occurs when a competitor is offering a unitranche alternative. Unitranche structures, although in fact first lien, are characterized by higher senior debt leverage and LTV ratios, essentially blending a degree of subordinated debt risk into the senior tranche. The following example of a transaction we lost to a competitor is a good case in point.

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Deal Structure Proposed by First Eagle

First lien	4.5x
Second lien	6.0x
First-lien LTV	46%

Deal Structure Proposed by Competitor

Unitranche	6.0x
Unitranche LTV	62%

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All of our portfolio managers add value to the origination process with their industry expertise and workout experience gained from exposure to multiple cycles.

The borrower was a food supplement manufacturer. We were generally constructive on the sector, and we liked the company's market position and the private equity investor. After conducting preliminary diligence, we suggested a structure consisting of a first-lien loan from us with leverage up to 4.5x and 46% LTV, and a second-lien loan to be provided by a subordinated lender that would bring total leverage up to 6.0x. The competing offer was a unitranche transaction with 6.0x all senior leverage, over 60% LTV and pricing only 100 basis points wider than what we had proposed. We ended up passing on that transaction due to what we considered to be excessive senior debt. However, we do selectively make unitranche or senior-stretch loans when we believe they offer an appropriate risk/return profile. We are always cognizant that in the event of default, the loss severity for senior-stretch and subordinated debt is likely to be significantly higher than for traditional senior loans.

Our Team

We have a highly cohesive and seasoned team of 63 people, including 30 investment professionals focused on the middle market and seven investment professionals focused on the broadly syndicated loan market. Our senior investment team averages nearly 25 years of experience.[3] Our credit culture, consistency of approach and underwriting process have been well-established over 15 years. We maintain strong relationships with some of the leading private equity firms that value our stability, industry expertise, record of closing and thoughtful collaboration in difficult situations and markets. All of our portfolio managers add value to the origination process with their industry expertise and workout experience gained from exposure to multiple cycles. Two of the four new sponsor relationships we established in 2018 stemmed from our expertise in insurance and financial services, for example, enabling us to lead five transactions in the sector.

We are more than a year into NewStar Financial's integration into First Eagle Investment Management, and the results of the merger have exceeded our expectations with no disruption in our market presence or investment approach. First Eagle's depth of management, size, investment track record and investor relationships enable us to continue the careful growth of our platform while potentially creating value for our borrowers and attractive returns for our investors. First Eagle has a long, successful history of investing with a focus on preventing permanent impairment of capital, and we are proud to have a shared investment philosophy.

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Outlook

We cannot know with certainty when the economy will begin to slow down, but we are always mindful of a potential downturn, and for every investment we model a rigorous downside case in order to evaluate how the company will potentially react to stress. In our view, our conservative approach has served us very well and has resulted in an annual loss rate of 22 basis points since our inception 15 years ago.

3. As of December 31, 2018.

Past performance does not guarantee future results.
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We see continued potential for positive overall trends in the US economy in 2019. When the environment for credit does get more difficult, however, we believe there will be significant dispersion of investment performance among middle market managers, with those focused on unitranche and second-lien transactions likely to experience lower recoveries and higher losses in the event of default. In fact, in a recent report, Moody's estimated that recovery rates for defaulted second-lien loans will decline from a historical average of 43% to just 14%—a 67% drop.[4] We expect that our focus on traditional, first-lien debt will differentiate us from other managers who focus on higher-yielding assets. If the economy does slow or market defaults increase, we may see improved lending conditions and more attractive opportunities for lenders who have access to long-term capital and have built conservative, less-volatile portfolios.

We expect to see a continuation of the marginal improvement in deal terms and pricing we witnessed in the fourth quarter, especially if volatility in the equity markets remains elevated. Our outlook assumes modest economic expansion in the US economy, accompanied by heightened volatility and the continuation of aggressive lending by many competitors—conditions that clearly warrant a cautious approach and disciplined underwriting.

We thank you for your confidence in us and look forward to continuing to serve as prudent stewards of your capital in 2019 and beyond.

Tim Conway
Head of Private Credit

Pat McAuliffe
Head of Origination

Dan McCready
Head of Credit Risk Management

Joe Sileo
Head of Capital Markets

4. "Convergence of Loan and High-Yield Bond Markets Sets Stage for Lower Recoveries in Next Downturn," Moody's Investors Service, August 16, 2018.

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Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting; and
- Less regulation and higher fees than mutual funds.
- Use of leverage which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy.
- Carried interest which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements.
- Below investment-grade loans which may default and adversely affect returns

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