



State of Rhode Island
Office of the General Treasurer

Deerpath Capital Advantage Fund VI (US), L.P. - Staff Recommendation

August-2022

RECOMMENDATION: Approve a commitment of up to \$30 million to Deerpath Capital Advantage VI (US), LP (“Deerpath VI”) from the Rhode Island Employees Retirement Systems Pooled Trust. This is a levered vehicle that will target 2.0x debt/equity. ERSRI has historically allocated to levered vehicles for sector-diversified senior secured direct lending strategies such as Deerpath VI to offset fee drag and due to the lower-risk nature of the underlying funds.

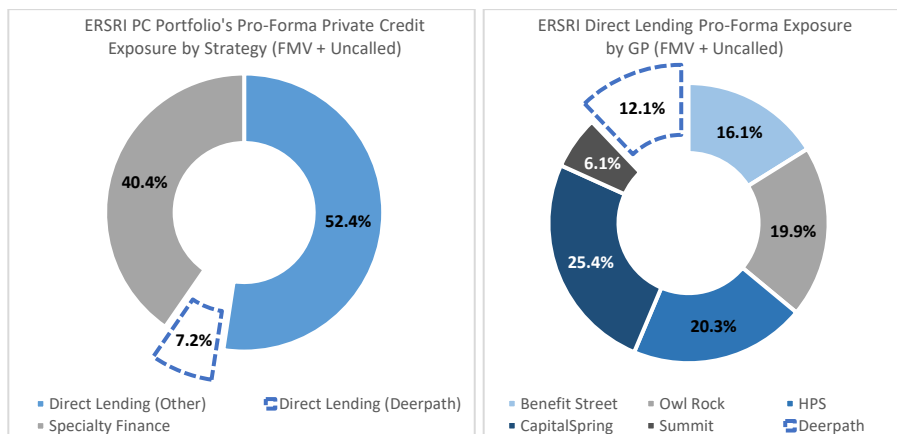
ASSET CLASS: Private Credit

SUB-STRATEGY: Direct Lending (Lower Middle-Market, Sponsor-Backed)

ALLOCATION: The target allocation to Private Credit is 3.0%, and the actual allocation as of 6/30/2022 is 2.9%. The pacing plan for private credit is \$170 million per year committed to 2-4 primary funds per year at \$30-\$50 million per fund. Pending approval of the recommended commitment to Deerpath VI, ERSRI’s aggregate commitments for Private Credit will total \$110 million for calendar year 2022.

PORTFOLIO FIT: The ERSRI Private Credit portfolio is primarily comprised of a core of direct lending strategies complemented by a set of specialty finance strategies that provide additional diversification. Deerpath VI will seek to originate loans directly to lower middle market sponsor-backed corporate borrowers in the U.S. and Canada, generally with enterprise values between \$50 million and \$150 million. Over 95% of the fund will be first lien senior debt, with the remainder comprised of select equity co-investments. The Deerpath VI portfolio will be broadly diversified by sector and by issuer, with approximately 40-50 positions and max hold sizes under 3%. Deerpath focuses on platform lending to U.S. buyout sponsors with a buy-and-build approach and growth equity sponsors who utilize financing to grow EBITDA and naturally deleverage their portfolio companies over-time. The firm has lent to the lower middle market since its founding in 2007 and provides ERSRI with a differentiated exposure within direct lending. To-date, ERSRI has primarily committed to direct lending strategies that target the true middle market and upper middle market, where competition tends to be greater. Deerpath has demonstrated discipline and consistency within the smaller segment of the market whereas other GPs with longer track records have migrated up market as fund sizes have grown.

Upon approval, Deerpath VI represent 7.2% of the total Private Credit portfolio’s exposure and 12.1% of the direct lending sub-strategy on a pro-forma basis, calculated as 6/30/2022 fair market value + unfunded commitments to-date.



MERITS: Deerpath has extensive and dedicated experience lending to the sponsor-backed lower middle market. The firm was established in 2007 and has maintained a focus on its single strategy, growing fund size incrementally. It takes a conservative safety-first approach to lending, focusing on downside protection and targeting low debt-to-EBITDA, generally in the 3.5-4.0x range, as well as high operating cash flow coverage. The firm prefers companies with long operating histories, with a median operating history of over 20 years. As a result of these practices, Deerpath has a very low realized loss rate since inception. In the event of a workout scenario, the firm has a dedicated workout specialist who works with the sponsor to negotiate remedies for any covenant breaches, facilitate portfolio company sale and debt refinance, or if needed assume ownership and manage the company.

Deerpath is well-known to lower middle market sponsors and has consistently sourced opportunities in this segment. The firm has 22 professionals focusing on origination and execution that actively cover and call on approximately 350 sponsors, with additional sponsors providing inbound deal flow due to Deerpath's reputation. The firm has extended approximately 700 loans since inception. In addition to new loans, Deerpath does a meaningful amount of repeat activity with known counterparties, including loan expansions which represent approximately one-third of deal flow.

CONCERNS: Deerpath focuses on the smaller end of the middle market which may have a greater share of companies with short operating histories and a relatively higher variability of financial performance, impacting credit quality. Mitigating this concern is Deerpath's extensive history and disciplined approach to investing in this space. The firm is very selective, with only approximately 4% of 2021 platform deal flow ultimately making it into the portfolio. Deerpath is one few direct lenders that existed during the Global Financial Crisis and when underwriting a deal, it often uses 2008 conditions as a stress test. Additionally, as one of a handful of experienced lenders to this end of the market, Deerpath can often lend at a premium spread and with better covenant protection compared to more competitive larger market segments.

ESG: Deerpath is classified as an ESG **Integrator**. The firm established an ESG Policy in 2016 and became a signatory to the United Nations Principals of Responsible Investing in 2017. Deerpath recently hired NorthPeak Advisory to review and help update its ESG policy and procedures. Antonella Napolitano, Global Head of Investor Relations, oversees ESG integration at the firm and Deerpath and the firm has an ESG committee. Investment professionals are trained in Deerpath's ESG policy and procedures. The firm screens out sectors it feels are susceptible to reputational risks or are ethically challenged, including pornography, strip mining, tobacco, and weapons. If a firm makes it through this screen, Deerpath evaluates the prospective borrower's ESG policy and if none exists or the policy is deemed insufficient, Deerpath recommends changes and improvements. The firm also sends an ESG questionnaire to all prospective borrowers.

Deerpath has a strong culture of promoting diversity, equity, and inclusion (DEI). The firm has a goal of creating a more diverse workforce through initiatives including broadening its recruitment channels to better source applicants coming from underrepresented minority backgrounds and expanding its internship opportunities to year-round. Deerpath was one of 25 firms that participated in the summer 2021 Avante diversity undergraduate internship program to promote inclusion in the SBIC industry. Deerpath will not invest with companies that do not have non-discrimination policies.

FEES: The fees are in-line with industry standards. Due to Rhode Island's relationship with Cliffwater, ERSRI will pay a discounted management fee of 0.9% on fair asset value (compared to a standard 1.0% fee) with no fees charged on undrawn commitments. Due to Rhode Island's relationship with Cliffwater, ERSRI will benefit from a reduced carry of 13.5% (compared to a standard 15%) after a 7% hurdle is achieved with a 100% GP catch-up.