



State of Rhode Island
Office of the General Treasurer

HPS Specialty Loan Fund V-L, L.P. - Staff Recommendation

July-2021

RECOMMENDATION: Approve a commitment of up to \$50 million to HPS Specialty Loan Fund V-L, L.P., the levered vehicle for Specialty Loan Fund V. The levered structure may use up to 1.0x debt/equity but is expected to remain within a range of 0.5-0.8x. ERSRI has historically chosen to allocate to levered structures when committing to sector-diversified senior secured direct lending strategies to offset fee drag and due to the low-risk nature of the underlying funds.

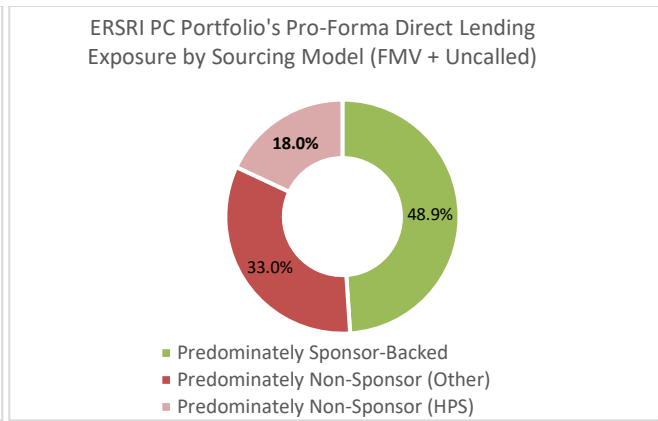
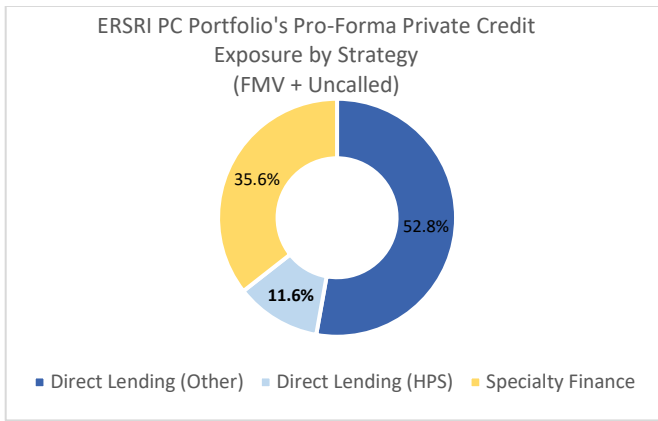
ASSET CLASS: Private Credit

SUB-STRATEGY: Middle-market direct lending (primarily non-sponsor)

ALLOCATION: The target allocation for private equity is 3.0% effective 7/1/2021, and the actual allocation as of June 6/30/2021 is 1.9%. The pacing plan for private credit is \$150 million per year committed to 2 - 3 primary funds per year at \$30 - \$70 million per primary fund. The last primary commitment within private credit was \$30 million to Atalaya Asset Income Fund V, approved in January 2021.

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. HPS Specialty Loan Fund V ("SLF V") will seek to originate loans directly to middle market and upper-middle market corporate borrowers generating \$75 million to \$350+ million of EBITDA. Historically, HPS's SLF platform has had a mix of ~94% first lien and ~6% second lien in their previous funds, and SLF V has been 100% first lien to-date. HPS will primarily lend to companies based in the U.S. and allocate up to one third of its capital to international borrowers, primarily in Europe and Oceania. The SLF V portfolio will be sector-agnostic and highly diversified by issuer. Notably, HPS expects that 50-70% of SLF V loans will be originated through non-sponsor sourcing channels, which are less competitive and generally result in better pricing and structure. ERSRI seeks to build a balanced direct lending allocation that benefits from the deal flow consistency and implicit owner support inherent in sponsor-backed deals as well as the stronger pricing and structural downside protections of non-sponsor exposure. To date the direct lending portfolio has skewed toward sponsored backed direct lending and this commitment will add more diversification to non-sponsored backed transactions.

Upon approval, HPS Specialty Loan Fund V would represent 11.6% of the total Private Credit portfolio's exposure and 18.0% of the direct lending sub-strategy on a pro-forma basis, calculated as 12/31/2020 fair market value + unfunded commitments to-date.



MERITS: Specialty Direct Lending is one of ten credit strategies that HPS manages. The SLF strategy benefits from significant shared resources which contribute to its sourcing and underwriting efforts. HPS SLF V will be managed by a large and experienced team of 25 investment professionals dedicated to direct lending and over 80 investment professionals including shared resources. HPS also has a dedicated nine-person restructuring/portfolio management team. One of the team’s key strengths is its ability to negotiate structural downside protections and favorable terms in its loans, including at least one maintenance covenant and call protections in most deals. HPS’ resources, combined with its diligent underwriting practices, have mitigated default risk and resulted in zero realized losses within the SLF platform to-date.

Furthermore, HPS’ scale and strategic relationships allow the firm to generate enough deal flow in the non-sponsored lending segment to make it the primary share of its portfolio. The firm will also pursue sponsor-backed deals in less competitive situations where it sees greater value, particularly during periods of market dislocation during which new issue spreads widen and capital markets are less supportive for borrowers.

CONCERNS: While the SLF platform has built a meaningful track record since the strategy’s inception was in 2010, it has not undergone the real-life stress test of a major global credit crisis. This is mitigated by the team’s strong leadership and resources. Michael Patterson, Global Head of Direct Lending, has an extensive history in distressed debt. Additionally, HPS is well equipped to handle non-performing loans. When HPS loans enter non-performing status, the firm employs its internal restructuring team which manages the workout process and enhance post-reorg equity following restructuring.

ESG: HPS is classified as an ESG **Leader**. The firm is a UN PRI signatory and has an ESG team led by its Chief Administrative Officer, Faith Rosenfeld. HPS recently made its first dedicated ESG hire and expects to make additional such hires in the coming years. As part of its due diligence process, each investment team must complete an ESG checklist and present an assessment of ESG concerns in six pre-defined High-Risk Zones (animal rights, coal, controversial weapons, mining & extraction, nuclear, and tobacco & nicotine) as part to the investment committee. As a result of this process, the team has passed on deals that exhibit too much exposure to High-Risk Zones. Each company’s checklist is updated at least one per year and presented at annual portfolio reviews. The firm has made two investments in Europe that included rate reduction triggers tied to ESG metrics and will consider including such features in future investments.

HPS has a strong culture of promoting diversity, equity, and inclusion (DEI). The firm is a founding signatory to ILPA’s Diversity in Action Initiative. HPS also partners with several organizations to promote diversity and equity in education and the workplace. This includes a \$10 million partnership with Howard University to establish the HPS Center for Financial Excellence at the Howard University School of Business.

FEES: The fees are on the higher end of industry standards but in-line with other non-sponsor peers. Due to its relationship with Cliffwater, ERSRI will pay a discounted management fee of 1.25%, compared to the fund’s typical management fee of 1.50%. The fund charges carried interest of 15% subject to a 7% non-compounded preferred return. However, historically the non-sponsored strategy has allowed HPS to generate premium net returns without significantly more risk.