



State of Rhode Island
Office of the General Treasurer

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

January-2023

RECOMMENDATION:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): Approve a commitment of up to \$50 million to HPS Specialty Loan Fund VI-L, L.P. (“SLF VI”). The leveraged structure may use up to 2.0x debt/equity but targets leverage of 1.0x. ERSRI has historically allocated to levered vehicles for sector-diversified senior secured direct lending strategies such as SLF VI to offset fee drag and due to the lower-risk nature of the underlying funds. ERSRI previously committed \$50 million to HPS Specialty Loan Fund V-L, L.P. (“SLF V”) a 2021 vintage fund.
- [Rhode Island OPEB System Trust](#): Approve a commitment of up to \$4 million to HPS Specialty Loan Fund VI-L, L.P. (“SLF VI”).

Current Partnerships	Vintage Year/ Initial Investment	Type	Values in USD*				Net Performance*		
			Amount Committed	Amount Drawn	Amount Distributed	Amount Unfunded	Valuation	Net IRR (%)	Net Multiple of Investment
HPS Specialty Loan Fund V-L	2021	Direct Lending	50,000,000	24,218,793	1,262,920	26,250,000	24,712,269	11.26%	1.07

*ERSRI values and performance as of 6/30/2022

ASSET CLASS: Private Credit

SUB-STRATEGY: Direct Lending (Upper Middle-Market and Large Market, Sponsor and Non-Sponsor Lending)

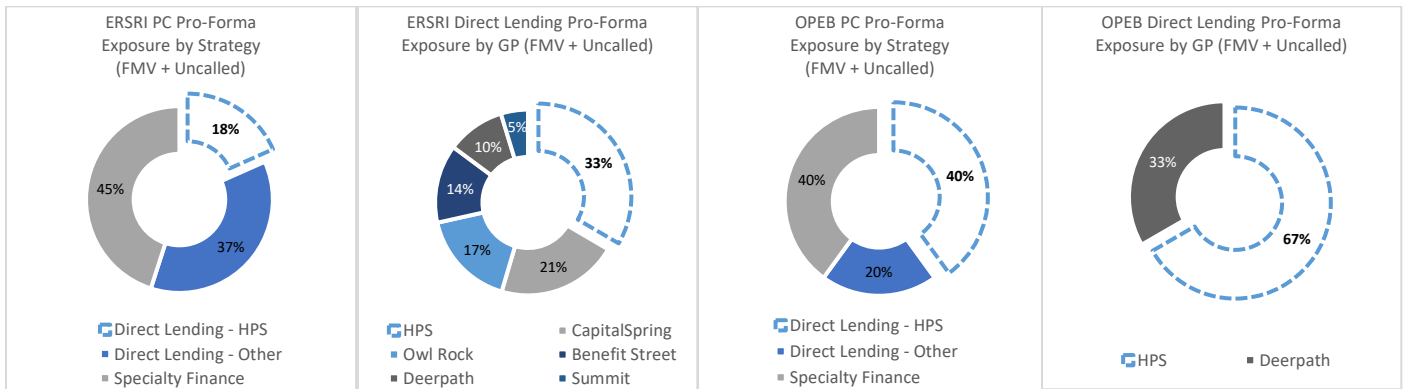
ALLOCATION:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): The target allocation for Private Credit is 3% and the actual allocation as of December 31, 2022 is 3.4%. The pacing plan for 2023 is \$100 million to 2-4 primary funds per year at \$25-50 million per fund. Pending approval, ERSRI’s 2023 vintage commitments will be \$50 million.
- [Rhode Island OPEB System Trust](#): The target allocation for Private Credit is 5% and the actual allocation as of December 31, 2022 is 0.4%. The pacing plan for 2023 is \$9 million committed to 2-4 primary funds at \$2-5 million per fund. Pending approval, OPEB’s 2023 vintage commitments will be \$4 million.

PORTFOLIO FIT:

- [Rhode Island Employees Retirement Systems Pooled Trust](#): The ERSRI Private Credit portfolio is primarily comprised of a core of direct lending strategies and complemented by a set of specialty finance strategies. SLF VI will seek to originate senior secured loans directly to upper middle-market companies with an average EBITDA of ~\$100 million. Over 90% of the fund is expected to be first lien debt, with the remainder opportunistically allocated primarily to second lien loans. SLF VI is a global strategy targeting an allocation of 65-80% to North America and the remainder primarily to Europe and Australia/New Zealand. The SLF strategy is industry agnostic and broadly diversified by sector. The fund will target 70-100 loans generally sized between \$100-325 million or greater across both sponsor-backed and non-sponsor opportunities. Historically, over 75% of the strategy’s origination volume has been non-sponsor or non-traditional sponsor-backed opportunities outside of a competitive LBO financing process. These less competitive sourcing channels tend to result in better pricing, structure, and/or terms. ERSRI seeks to build a balanced direct lending allocation benefitting from deal flow consistency and implicit owner support inherent in sponsor-backed deals as well as stronger pricing and structural downside protections of non-sponsor loans. Within the ERSRI portfolio, the SLF strategy represents the greatest non-sponsor exposure. Upon approval, the SLF strategy will represent ~18% of the Private Credit portfolio’s total exposure and ~33% of the direct lending sub-strategy on a pro-forma basis, calculated as 12/31/2022 fair market value + unfunded commitments to-date.

- [Rhode Island OPEB System Trust](#): The Private Credit portfolio is in the process of ramping up to its target allocation through commitments made in tandem with those from ERSRI. The portfolio construction of the OPEB Private Credit allocation is meant to mirror the approach taken by ERSRI upon full ramp. Pending approach of the recommended commitment, SLF VI would represent the entirety of the portfolio’s exposure to upper-middle market and non-sponsor direct lending. On a pro-forma basis, HPS will represent ~40% of the Private Credit portfolio’s total exposure and ~67% of the direct lending sub-strategy on a pro-forma basis, calculated as 12/31/2022 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. SLF VI will be managed by a large and experienced team of 36 investment professionals dedicated to the strategy and the firm has 104 investment professionals dedicated to direct lending. Scale has become a meaningful advantage for HPS in recent years as it is one of a handful of direct lenders that can provide capital solutions to borrowers at the large end of the market who seek loan tranches of up to \$1 billion or greater in an environment where broadly syndicated loan issuance has dwindled. While these loans will represent a smaller portion of its deals, HPS’ capability to accommodate these needs allows it to dictate terms and extract significant discounts or fees. Moreover, one of the firm’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.

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 an extended major global credit crisis with a high degree of corporate defaults. 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 a dedicated nine-person restructuring and value creation team that manages the workout process and enhance post-reorg equity following restructuring and can take the keys and run a defaulted company if needed.

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 has a three-person dedicated ESG team and expects to shortly hire two additional members as well as to continue growing this team 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 pre-defined High-Risk Zones, which have led to passing 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 onboarded the services of Persefoni to begin measuring the carbon footprints of its portfolio companies and engaged ESG consulting firm ACA group to help further refine its ESG framework and address gaps to the PRI standards.. The firm also considers ESG metric-tied rate reduction triggers for certain loans, particularly in Europe and has included such terms in a handful of investments to date.

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 high-end of industry standards but in-line with non-sponsor focused peers. The headline fees are 1.25% on invested levered capital during the investment period and 1.0% thereafter. As participants in the first close, ERSRI and OPEB will benefit from a 10% management fee discount during the investment period, reducing this fee to 1.125%. Additionally, if aggregate Cliffwater client commitments exceed \$150 million, the investment period fee will be further reduced by 4.5bp fee to 1.08% from that point onward. The fund charges carried interest of 15% on a deal-by-deal basis (with a clawback) subject to a 7% non-compounded preferred return. The carry structure and non-compounded hurdle is not in-line with peers, however HPS's specialized strategy focusing on non-sponsored lending has allowed it to generate premium net returns without significantly more risk as the strategy targets an unlevered 3-year yield of 10% or greater.