

**ORANGE COUNTY EMPLOYEES RETIREMENT SYSTEM  
BOARD OF RETIREMENT  
2223 E. WELLINGTON AVENUE, SUITE 100  
SANTA ANA, CALIFORNIA**

**INVESTMENT MANAGER MONITORING  
SUBCOMMITTEE MEETING**

**September 6, 2018  
9:00 A.M.**

**MINUTES**

The Chair called the meeting to order at 9:01 a.m. and read the opening statement into the record. Attendance was as follows:

Present: Charles Packard, Chair; Russell Baldwin, Vice Chair; Frank Eley; and Shawn Dewane

Also present: Steve Delaney, Chief Executive Officer; Molly Murphy, CFA, Chief Investment Officer; David Beeson, Investment Officer; Tarek Turaigi, CFA, Investment Officer; Stina Walander-Sarkin, Investment Analyst; Julius Cuaresma, Investment Analyst; Anthony Beltran, Visual Technician; and Brittany Cleberg, Recording Secretary

**A. INDIVIDUAL MANAGER PRESENTATIONS**

Mr. Beeson introduced the presenting direct lending managers for the day's meeting, briefly refreshing the Committee of the direct lending history and opportunity set. He described how these managers capitalize on the direct lending supply-demand imbalance that arose from the 2008 Global Financial Crisis: facing increased regulatory restrictions, U.S. and European banks dramatically reduced their balance sheets by exiting the middle market direct lending space. He reported that there were no performance issues; rather, staff is trying to better analyze and anticipate the go-forward opportunity set in the U.S. vs. Europe, as well as the relative opportunity set within the middle market opportunity set.

Mr. Beeson and Ms. Murphy provided background on Monroe. They discussed staff's and Meketa's efforts in properly re-categorizing OCERS' two Monroe investments: (1) Monroe Private Credit Fund II – due to this fund's higher risk-return and use of leverage, Fund II was re-categorized as Private Debt under the Private Equity asset class; and (2) Monroe Senior Secured Direct Loan Fund – due to this fund's lower risk-return, less levered portfolio, the Senior Secured Fund remained as Private Credit, under the Credit asset class.

Mr. Dewane, Ms. Murphy, and Mr. Beeson briefly discussed business development companies, specifically as it relates to Monroe Capital.

Ms. Murphy and Mr. Baldwin further discussed leverage.

Ms. Murphy further noted the not uncommon use of advanced leverage or additional leverage, i.e., underlying companies' lending to have leverage, then the investment manager adding fund-level leverage to their investment into the underlying company. She also referenced staff's and Meketa's view of leverage –she observed the importance of making the explicit distinction between true, direct lending, fixed income vs. manufactured direct lending, fixed income-oriented products that are financially engineered in order to generate an equity-like risk-return product.

Mr. Dewane and Ms. Murphy discussed the cyclical course of direct lending strategies, i.e., when participants are fearful, there are true, strictly defined 1<sup>st</sup> and 2<sup>nd</sup> lien structures used, and when participants are greedy, there are intentionally blurred lines across 1<sup>st</sup> lien and 2<sup>nd</sup> lien loans where uni-tranche structures are loosely defined.

Mr. Beeson added that most direct lending managers employ spurious terminology across 1<sup>st</sup> lien, 2<sup>nd</sup> lien, and uni-tranche, but OCERS' managers are primarily senior secured, 1<sup>st</sup> lien.

Ms. Murphy further reported that OCERS prefers senior secured 1<sup>st</sup> lien loans, with, at the margin, some positive optionality for 2<sup>nd</sup> lien, mezzanine level loans.

## **MONROE CAPITAL**

### **Presentation by R. Sean Duff & Zia Uddin**

#### **The key highlights of the presentation were:**

Firm update: Monroe, a U.S. direct lending firm, manages approximately \$5.6 billion in senior secured loans, junior secured loans, unsecured loans, mezzanine investments, warrants, and equity co-investments targeting the middle market and lower middle market. Monroe has approximately 100 employees located across the U.S. – Monroe's Chicago headquarters are surrounded by satellite offices in Atlanta, Boston, Dallas, Los Angeles, and San Francisco.

Market Overview/Outlook: The manager observed that: (1) larger credit managers are raising even more assets – it is getting generally crowded, but private credit is not going away – further, most loans are libor-based floating rate, so it is an interest rate hedge; (2) price is driving deals; (3) less LP-ideal and GP-ideal structuring, i.e., cov-lite deals. Monroe reported they are still getting 3-5 covenants per deal, and more importantly, they are generally the only lender on these deals, so they can get premium pricing. While the manager reasonably believes that a recession will occur within the next three years, the manager believes this will recession will be a soft landing.

Portfolio Strategy: Monroe seeks portfolio companies who generate an average EBITDA of \$18 – 20 million, with a particular focus on companies below \$30 million. Monroe structures their own deals such that they can drive pricing, leverage, covenants, etc. Further, they are generally the only lender, thereby obviating the need to obtain 50-70% consent from other lenders.

Performance: The manager reported 9.2% net IRR for their unlevered vehicle, Monroe Senior Secured Direct Loan Fund, and 13.8% for their levered vehicle, Monroe Private Credit Fund II.

Mr. Packard, Ms. Murphy, and Mr. Duff discussed Monroe's rationale behind their levered and unlevered vehicles.

Mr. Duff observed that in 14 years, Monroe has experienced 11 defaults, across \$6 billion in 296 loans.

Mr. Packard asked for further details regarding Monroe's defaults.

Mr. Uddin responded, particularly noting that Monroe has actually recovered 0.7x their original investment, so Monroe effectively still got most of their original investment money back on those defaults.

Mr. Baldwin asked how Monroe would position the portfolio in the next recession.

Mr. Uddin responded, describing that portfolio companies are #1 – 3 in their industry; when there is a recession, companies with \$1-10 million in EBITDA will suffer, whereas their portfolio companies of \$15-30 million in EBITDA will buy these weaker competitors at a discount. Net-net, he stated that their portfolio companies will come out stronger post the recession. He described that their targeted opportunity set is open to idiosyncratic, company specific risk, not macro, i.e., they do not have currency risks. When Monroe does find compelling cyclical companies, they will structure the loans appropriately - when such companies generate excess cash flow, when they generate \$X million in EBITDA, Monroe will take Y%, and pay down Z debt. While Monroe is not macro market timers, they have worked with companies according to their own respective, company-specific cycles.

Mr. Baldwin also asked about portfolio companies' exposure and risks to tariffs and commodities.

Mr. Duff responded that Monroe intentionally avoids commodity-exposed companies.

Mr. Uddin also responded that they seek companies with recurring revenue, i.e., companies that provide SAAS to real estate businesses, 95% recurring revenue in the form of contractual monthly subscriptions.

Mr. Duff further observed that Monroe underwrites to consistent and contractual multi-year revenue and cash flow. He noted that they structure deals with monthly covenants, with access to monthly reporting, specifically financials. Monroe is able to visit portfolio companies, armed with all this transparent data on zero days notice; he described this is not something Monroe wants to do, but covenants are structured such that they can.

Mr. Eley and Mr. Duff discussed China, particularly China's exposure to private credit and how it is structurally regulated and blocked by the U.S. due to intellectual property concerns as well as national security concerns.

Mr. Packard asked how 25-year old businesses could continue to operate without a strong banking relationship, whereby they are left to borrow at Monroe's usury 9-10% rate.

Mr. Uddin responded that borrowers know that Monroe can and will execute in a timely fashion – he explained that Monroe has a different value proposition relative to banks. Monroe's smaller size relative to institutional banks confers a unique flexibility that such banks cannot provide. Further, Monroe's loans are shorter duration; he provided an example, citing their loans are not 9% for 5 years; rather they are 9% for two years to fund the borrower's near-term needed transaction.

Mr. Baldwin and Mr. Duff discussed Monroe's prepayment penalties.

Mr. Duff explained that is roughly 8.5% of total return.

Mr. Eley and Mr. Uddin discussed Monroe's closing fees.

Mr. Uddin explained that they are the same as mortgage closing fees. Monroe is able to generate 12% of total return through closing fees. He acquiesced, agreeing that they are expensive, but explained that from the borrower's perspective, they are not looking at the costs as an absolute number, but rather as an alternative – over the long-term, the borrower perceives this as a necessary, short-term, one-time cost.

Mr. Eley and Mr. Uddin continued Mr. Baldwin's earlier question and discussion concerning recessions and cyclical businesses.

Mr. Uddin reported that they have structured excess cash flow sweeps in their loans – for specific cyclical businesses, they will structure it quarterly or even monthly, vs. yearly.

Ms. Murphy described that staff and consultants have a bifurcated direct lending preference – in the U.S., the bias is towards the smaller end of the market; conversely, in Europe, the bias is towards the higher end.

Mr. Packard asked about currency risks.

Ms. Murphy responded that OCERS' managers are USD denominated, but the portfolio companies underwritten to in Europe are euro denominated.

***The Committee recessed at 9:53 a.m.***

***The Committee reconvened at 10:11 a.m.***

Mr. Beeson introduced Alcentra, a European private lender. He reported that in April 2016 OCERS committed \$110 million to Alcentra's Clareant European Direct Lending Fund II (Levered) which may employ up to 1.0x leverage. He described that Fund II is currently 85% drawn down. He also discussed the firm's c-level organizational change: Paul Hatfield, Global Co-CIO, retired from Alcentra earlier in the year, effective June 29, 2018. Vijay Rajguru (previously Global Co-CIO) assumed the role of Global CIO.

## **ALCENTRA**

### ***Presentation by Graeme Delaney-Smith & Scott Hamilton***

#### **The key highlights of the presentation were:**

Firm update: The manager reported that Alcentra manages approximately €35 billion with about €6 billion dedicated to direct lending.

Market Overview/Outlook: The manager described that whereas there has been a vast reduction in the junior debt European market, the senior capital market has increased. The manager further explained that the European market is relatively immature, as many sources of capital are still not available in Europe – private debt accounts for approximately 80% of corporate lending in the U.S., while the figure is only approximately 20% in Europe.

Portfolio Strategy: The manager targets lower middle market companies that generate in the range of €10-75 million EBITDA; these targeted investments are profitable, cash generative businesses in attractive, defensive industries such as healthcare and business services, vs. cyclical industries and capital-intensive industries. The manager also discussed their in-house legal team, and the important role the team plays in structuring deals and the competitive advantage this team provides to the overall firm.

Performance: Fund II, through the end of March 2018, has generated a 9.9% net IRR.

Mr. Delaney-Smith and Mr. Baldwin discussed Alcentra's competitive advantages.

Mr. Delaney-Smith explained that borrower's want to: (1) move at their own pace; (2) work with one lender, i.e., just Alcentra, vs. five lenders; and (3) structure loans collectively for one large check size to account for all underlying deals and not deal by deal. The borrower is comforted by Alcentra's track record of closing and executing the loan faster and cheaper, saving the borrower from frictional costs, i.e., legal costs for each deal.

Mr. Baldwin and Mr. Delaney-Smith discussed the Brexit situation and its potential impact on Alcentra's portfolio companies.

Mr. Beeson, Mr. Packard, and Mr. Delaney-Smith continued the discussion regarding the U.S. and European direct lending markets, particularly the immaturity of the European markets and how Alcentra is positioned to capitalize on the relative inefficiencies seen between the two markets. Mr. Delaney-Smith discussed arrangement fees, and Alcentra's belief that Europe's direct lending sector will transition from a bank-led sector to an investment manager-led direct sector, and consequently, a larger, exploitable opportunity set for Alcentra.

Mr. Packard and Mr. Delaney-Smith discussed Alcentra's loans, specifically as it concerns the jurisdictions those loans fall under, and the perceived vs. actual advantages one jurisdiction has relative to another, namely the U.K. relative to the balance of the European Union. He observed that although U.K. did have 1<sup>st</sup> mover advantage out of the 2008 Global Financial Crisis, it is still Alcentra's largest allocation, largely due to the U.K.'s rigorous security enforcement laws.

Mr. Delaney-Smith also noted that Alcentra works with several legal firms in each country and each jurisdiction.

Mr. Baldwin and Mr. Delaney-Smith discussed Environmental, Social, and Governance (ESG), namely as it pertains to the companies Alcentra lends to and the role it plays in their investment process.

Mr. Delaney-Smith observed ESG has always been a fundamental function in their process and the sustainability the company has.

Mr. Eley and Ms. Murphy discussed the fee structure for Alcentra, particularly as it relates to the trade-off in structuring for a hard hurdle and giving up catch-up and liquidity terms.

***The Committee recessed at 11:10 a.m.***

***The Committee reconvened at 11:22 a.m.***

Mr. Beeson provided background information regarding OCERS' investments into Park Square. OCERS committed \$50 million to the Credit Opportunities II Fund in November 2013 and an additional \$50 million in May 2015 for a total commitment size of \$100 million. OCERS closed on a \$50 million commitment to Credit Opportunities III in December 2016.

Mr. Beeson also noted that whereas the prior two managers were focused on the lower end, Park Square invests in higher up EBITDA companies, ranging from €100-400 million. Since they are larger companies, they are less risky, and so the return profile is relatively lower, i.e., an 11-13% gross levered return. He further explained that they can only apply leverage on senior assets at a 1:1 ratio, and not on junior debt. He also noted that while Park Square will primarily focus on European companies, they can have 20% in the U.S.

Mr. Eley and Ms. Murphy discussed TorreyCove's view on Park Square.

## **PARK SQUARE CAPITAL**

### ***Presentation by Osvaldo Pereira & Roger Kempink***

#### **The key highlights of the presentation were:**

*Firm update:* Park Square, a European credit focused firm (specifically on the junior debt and large-size senior debt space), manages approximately €7 billion. In addition to Park Square's offices in New York, London, Luxembourg, the manager also opened a Paris office. The manager has increased staff, particularly with language capabilities in order to facilitate the manager's ability to structure deals in various European countries. The manager now employs 90 people, with 40 investment professionals to cover 40 portfolio companies.

*Market Overview/Outlook:* The manager observed that overall leverage levels are moderate, and are relatively lower in Europe than in the U.S. Most of the deals Park Square structures are sponsored – private equity is paying more, with some multiples approaching 20x; the corollary is that for Park Square, there is additional capital, i.e., equity, below them, and so there is a larger margin of safety for Park Square's deals.

*Portfolio Strategy:* As credit investors, Park Square appreciates that they do not participate in the upside, so the main focus is on preserving capital, while conservatively seeking 2 – 2.5x their investment. They seek to get involved early in deals that have conservative structures and tight loan documentation. Park Square lends to companies with strong barriers to entry, strong cash flow, and strong management teams. The manager reported that if one converts their portfolio companies' EBITDA from € to \$, their portfolio companies would be in the S&P.

*Performance:* As of June, 2018, Credit Opportunities II has generated a net IRR of 6.1% since inception on a mark-to-market basis.

Mr. Eley, Mr. Baldwin and Mr. Pereira discussed how differing interest rate regimes in the U.S. affect the rest of the world, particularly the impact upon each country's respective debt and currencies.

Mr. Pereira explained that Park Square makes more through floating rate debt; further, as volatility picks up, such uncertainty lends itself to Park Square's ability to lend at higher rates.

Mr. Eley and Mr. Pereira discussed Park Square's performance.

Mr. Pereira also noted that Park Square provides performance data on a marked-to-market basis.

Mr. Baldwin and Mr. Pereira discussed ESG and Park Square's ESG policy as it relates to their investment process, particularly, negative and positive screening. They also discussed Park Square's internal policy, as it relates to hiring and diversity.

Mr. Packard and Ms. Murphy discussed the permanence and ongoing viability of direct lending.

Ms. Murphy compared the opportunity set in the U.S. relative to Europe. As the day's presenting managers had earlier suggested, Europe is still finding its way in terms of access to capital from banks and other sources; she further explained that GDP growth in the U.S. is far advanced relative to Europe, noting the importance of where market participants are in the direct lending cycle relative to the economic cycle.

Mr. Beeson also reported upon staff's focus on managers who are disciplined in terms of covenants structured and in terms of portfolio company diversification.

Mr. Dewane and Ms. Murphy discussed performance rankings across the managers. They also discussed the importance of understanding the leverage applied, both at the company level and at the investment manager level, as well as portfolio diversification across sectors and industries.

Mr. Dewane and Ms. Murphy discussed the forward-looking roadmap of OCERS' direct lending portfolio, particularly as concerns OCERS' geographical allocations, and the rationale driving it. Ms. Murphy again described that staff and consultants have a bifurcated direct lending preference – in the U.S., the bias is towards the smaller end of the market; conversely, in Europe, the bias is towards the higher end. She also noted that OCERS' goal is a more concentrated portfolio, whereby OCERS can capitalize on its size and attain more LP-friendly terms.

**PUBLIC COMMENTS:**

None

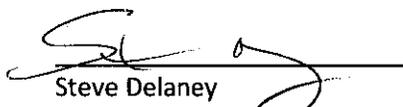
**COMMITTEE MEMBER/STAFF COMMENTS:**

None

**ADJOURNMENT:**

The Chair adjourned the meeting at 12:18 a.m.

Submitted by:

  
Steve Delaney  
Secretary to the Committee

Approved by:

  
Charles Packard  
Chair