PRIVATE CAPITAL QUARTERLY

SECOND QUARTER 2020

INSIDE THIS ISSUE

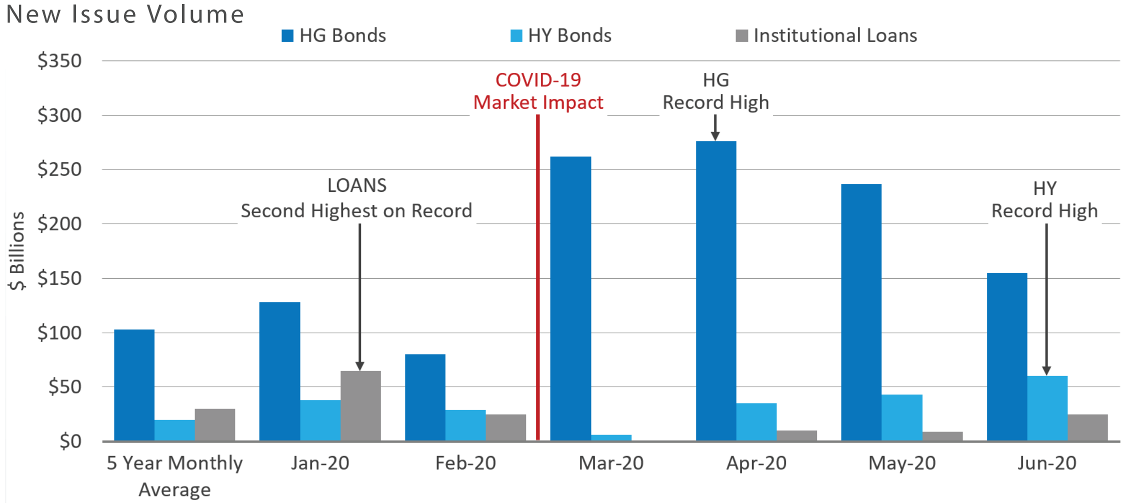
FEG investment advisors

Earlier this year, fears of COVID-19 and the potential impact of the ensuing global pandemic on the U.S. economy led to a major upheaval in credit markets and other global markets not witnessed since the Great Financial Crisis of 2008. Option-adjusted spreads for high yield bonds, which represent a key gauge of credit risk, reached ~1100 basis points over Treasuries, implying high single-digit to low double-digit defaults. Enter the Federal Reserve (Fed), which stepped in to stabilize the markets with unprecedented stimulus efforts, pledging unlimited asset purchases—including corporate debt—for the first time in history on March 23, a monetary move which proved to be successful in stabilizing the credit markets. Some might even argue it was too successful, as both high grade and high yield bonds saw record highs in new monthly issuance following the Fed's intervention, as companies were quick to refinance or term out their debt in order to help weather the current recession.

Distressed — Did We Miss It?

RECORD NEW ISSUANCE IN 2Q 2020

New Issue Volume



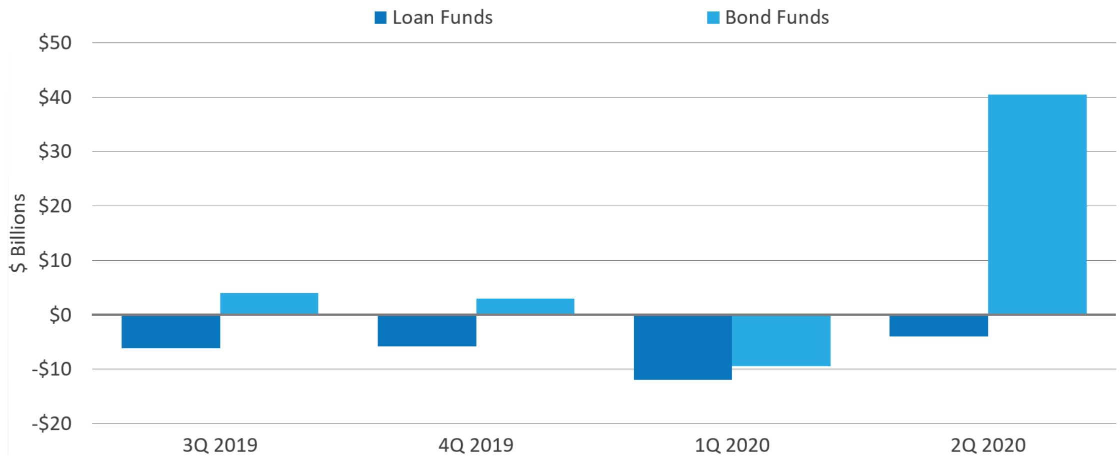
Data source: LCD, an offering of S&P Global Market Intelligence

As the pandemic spread throughout March and into the second quarter of 2020, many U.S. citizens transitioned to working from home. When it became clear that a large swath of the labor market could work successfully from home, investor attitudes shifted away from intense fear—which was being reflected in the markets—toward embracing action, as events started to become seemingly more manageable. Some investors focused on making fresh allocations to active high yield and bank loan managers, reflecting a belief that the manager's existing portfolio holdings had been inappropriately cheapened in price due to technical dislocation and the investors were consequently buying in at an attractive entry point. Other investors were less confident in the face of a near-term market or economic recovery and instead chose to allocate to distressed debt managers, who offer drawdown structures that would take advantage of the market dislocation over a multi-year period. Yet another group of investors opted for a blended approach, allocating to both active high yield and bank loan managers, as well as to distressed debt managers.

Fast-forward to the end of the second quarter 2020 and we are seemingly living in multiple worlds. Those who have been quarantined and working from home may indeed feel like they have been living out a variation of the 1999 movie *The Matrix*. In one world, the COVID-19 pandemic rages on, social unrest continues in the U.S., and unemployment remains high—albeit less high than initially anticipated. In a second world—one represented by the chart showing meaningful second quarter inflows into the high yield bond market—seemingly detached from the first, investors have fully embraced the "Powell Put," wagering the worst of the pandemic is in the past, civil unrest will soon subside, and unemployment will decline, all in short order.

As in *The Matrix*, FEG believes that the distressed opportunity set exists in yet another world which falls between the daily, heart-wrenching headlines defining the first world and the Fed stimulus-induced second world. FEG takes the view that this third world is a closer approximation to the "real world" and is therefore the world in which distressed debt investors are likely to find opportunities.

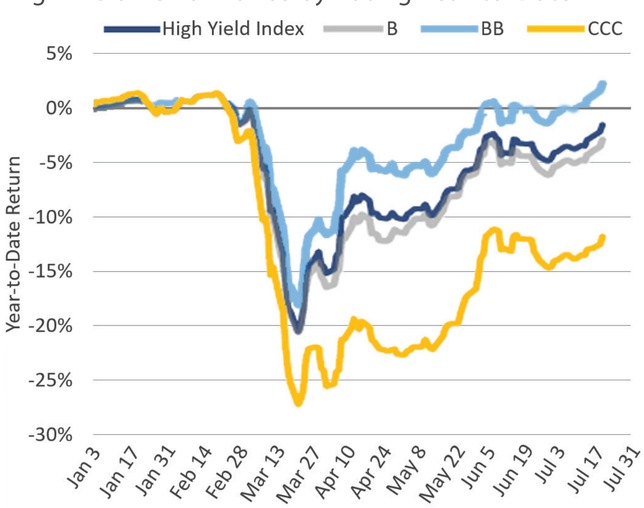
HIGH YIELD BOND FUNDS TAKE IN ~$40 BILLION IN 2Q 2020
HY and Loan Fund Flows (Weekly Reporters Only)



Data source: Lipper

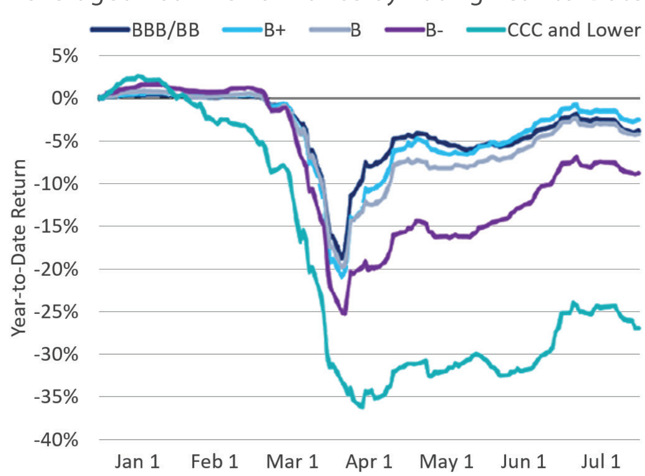
This third world is one that has already been contemplated by the credit markets. While higher quality credits—particularly those embraced by Fed stimulus—have rallied off March lows, the overall credit markets remain bifurcated by credit quality and by sector. For example, both CCC-rated high yield bonds and bank loan performance remains well below that of higher quality issuers. Within sectors, the majority of defaults year-to-date have taken place in oil and gas—which had already been ravaged by low commodity prices pre-COVID—telecommunications, retailers, metals/minerals, business equipment/services, and leisure. This bifurcation has left sectors less exposed to commodity prices and COVID-19 relatively unscathed.

CCC-RATED BONDS REMAIN CHALLENGED
High Yield Performance by Rating Year-to-Date



Data source: Beach Point Capital Management; data as of July 17, 2020

CCC-RATED BANK LOANS HAVE ALSO LAGGED
Leveraged Loan Performance by Rating Year-to-Date



Data source: Beach Point Capital Management; data as of July 17, 2020

From the perspective of those investors who chose to allocate to active high yield and bank loan managers in the second quarter—i.e., winners of the second world—many have already begun to ask what to do with their gains. For those real-world believers who chose the more conservative route of allocating to distressed debt managers, the market's bifurcation speaks well, as lagging credits continue to offer compelling opportunities that should play out over the next few years.

In terms of the winners of the second world, FEG believes the "easy" gains have already been realized in below investment-grade credit in 2020. Credit spreads will likely continue to grind tighter—and bond prices higher—as the economy recovers over time. Active manager selection, rather than buying ETFs or passive funds, should help investors continue mitigating default risk going forward, which should allow for ~6% coupons to drive returns.

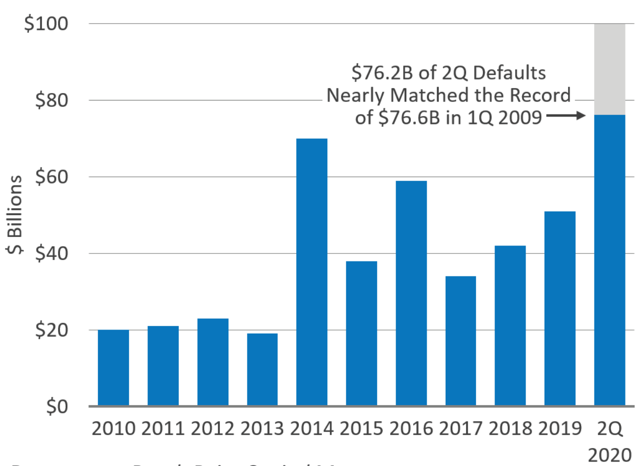
Did We Miss It?

Delving into the fundamentals can help real world investors better understand the distressed opportunity set looking forward. First, consider the overall size of the U.S. high yield and bank loan markets, which have doubled in size since 2008. While the distressed ratio—bonds trading at 1000 basis points or more—has declined in conjunction with the recent credit rally, the overall size of the remaining distressed opportunity remains robust. Second, FEG believes there will likely be unintended consequences stemming from the Fed's massive intervention. The Fed's actions allowed some companies that may have otherwise run out of capital to further lever their balance sheets. At some point, good businesses with bad capital structures will need to face the music, leading to further distressed investment opportunities. It is worth remembering that prior to COVID-19, corporate leverage for below investment-grade companies had already reached elevated levels.

Looking at recent default action provides a sense of what may still be yet to come. According to JP Morgan Research, default activity rose sharply in the second quarter, with $76.2 billion in defaults—$47.1 billion in bonds and $29.1 billion in loans. These numbers effectively match the prior record of $76.6 billion from the first quarter of 2009 and bring year-to-date total defaults to $100 billion. Moving ahead, defaults and downgrades are likely to continue to play out, creating further opportunities for distressed debt managers. Bank loans are another area where further weakness is possible. Deteriorating covenants and weaker demand from collateralized loan obligations (CLOs) for CCC-rated loans—which comprise ~60% of the demand for the asset class—and further outflows from loan mutual funds and exchange traded funds (ETFs), coupled with a rising downgrade cycle could create more pressure on bank loans. Importantly, CCC loans comprise approximately 34% of the bank loan market, according to Credit Suisse Research.

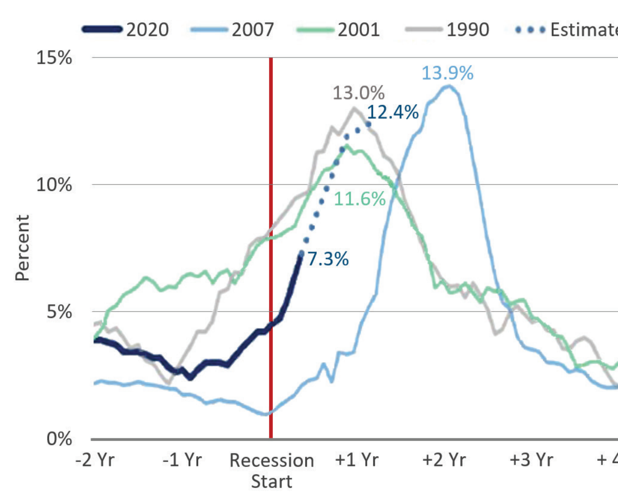
ANNUAL DEFAULT VOLUMES

High Yield and Bank Loans



Data source: Beach Point Capital Management

DEFAULT RATE FORECAST



Data source: Beach Point Capital Management

Across the pond, Europe and the UK remain in recession as well. European high yield bonds and bank loans are much smaller asset classes than their U.S. counterparts, often trading by appointment. European banks' non-performing loan conditions remained in various stages of improvement pre-COVID-19, as banks were focused on gradually improving their balance sheets and selling off non-performing assets over time. The European Commission recently stated that it expects the EU economy to shrink 8.3% in 2020, considerably worse than the 7.4% slump predicted two months ago. Furthermore, the commission expects the UK economy to decline by 10%.[1] As recessionary forces typically coincide with an increase in default rates, it should come as no surprise that European speculative-grade corporate default rates could reach 8.5% by March 2021, according to S&P Global Ratings. With the recovery in European banks stalled and recessionary forces expected to linger, a robust distressed opportunity set for distressed debt managers focused on Europe should be anticipated.

Conclusion

Pre-COVID-19, the credit cycle for U.S. and European companies was arguably in extended innings, to reference a tired baseball metaphor. Indeed, the FEG Investment Forum back in September 2019 featured distressed opportunities and managers, under the belief that a turn in the credit cycle was overdue. While it is nearly impossible to predict the catalyst for a turn in the credit cycle, there is some certainty in that something always comes along to turn the cycle. FEG believes the easy money has been made in credit and that spreads will likely grind tighter as the economy gradually recovers. Given the bifurcated nature of the credit markets coupled with the meaningful increase in corporate defaults in 2020, FEG anticipates a meaningful distressed opportunity set will remain in place over the next few years for real-world investors. In short, no, we did not miss it.

1 https://www.cnn.com/2020/07/07/economy/eu-commission-summer-2020-forecast/index.html

PRIVATE EQUITY

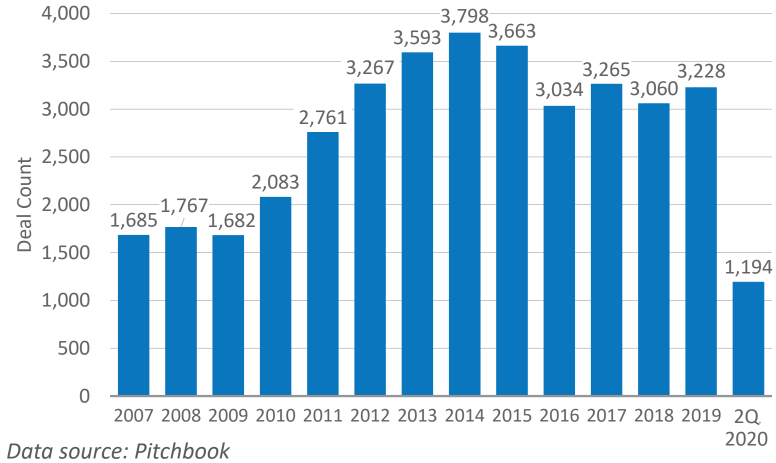
Venture Capital

- COVID-19-related lockdowns, stay-at-home orders, and public market volatility disrupted venture capital business practices and pressured venture-backed companies in the second quarter.
- The number of investments in seed- and early-stage financing rounds fell during the quarter due to the increased difficulty of meeting face-to-face. Managers focused instead on assisting existing companies through the pandemic. Although deal volume and capital flows for late-stage valuations remained relatively stable, the number of first financings by venture capital funds in the first half of 2020 was well off the levels seen in 2018 and 2019.
- Venture capitalists looked to protect existing portfolio companies during the quarter rather than fund new ones. There were 57 mega-deals (financing rounds of over $100 million) in the second quarter, including DoorDash, which raised $400 million in June.
- Life science activity has been relatively unaffected by COVID-19 thus far, with investment activity for the first half of the year continuing at a robust pace. Notably, pharmaceutical and biotech exit activity has surpassed software for the first time in over 10 years. The public market's increasing demand for drug therapies has driven the IPO market for life science companies.
- Venture capital fund performance remained strong through the first quarter as the impact of COVID-19 on portfolio company operations was more fully experienced in the second quarter.

INVESTOR IMPLICATIONS: Investors should expect volatility in near-term performance and a choppy investment and exit market. Life science investments have generally performed well, given the recent IPO market.

U.S. VENTURE CAPITAL FIRST-FINANCING INVESTMENTS FALL

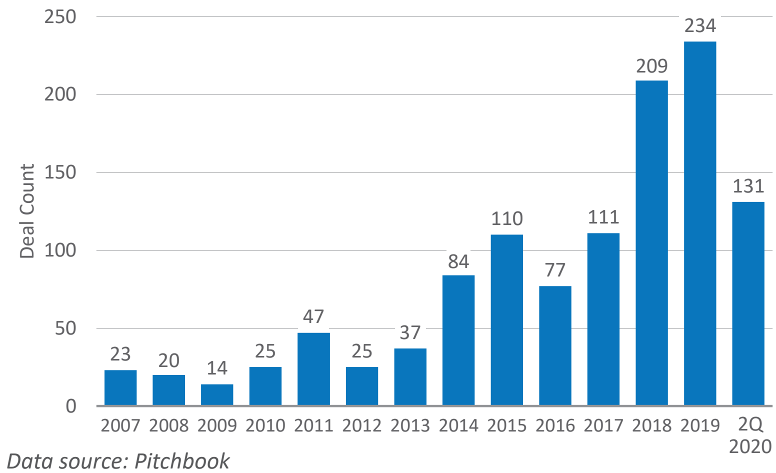
Deal Activity



Data source: Pitchbook

MEGA-ROUNDS ABOVE 2019's RECORD PACE

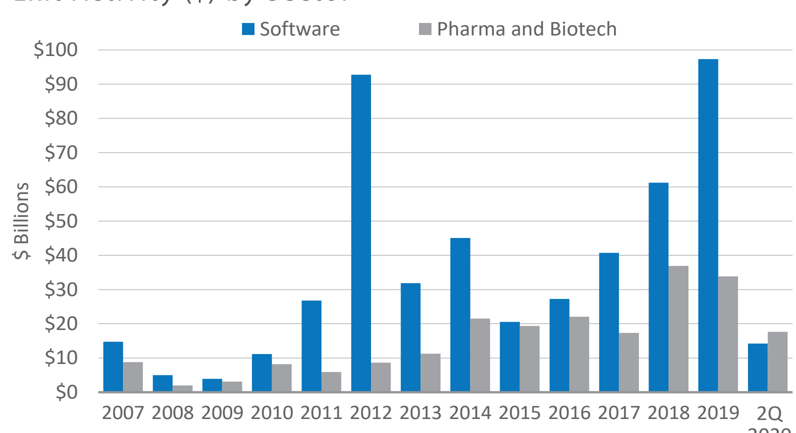
Mega-Round Deal Activity



Data source: Pitchbook

LIFE SCIENCE EXITS EXCEED SOFTWARE

Exit Activity ($) by Sector



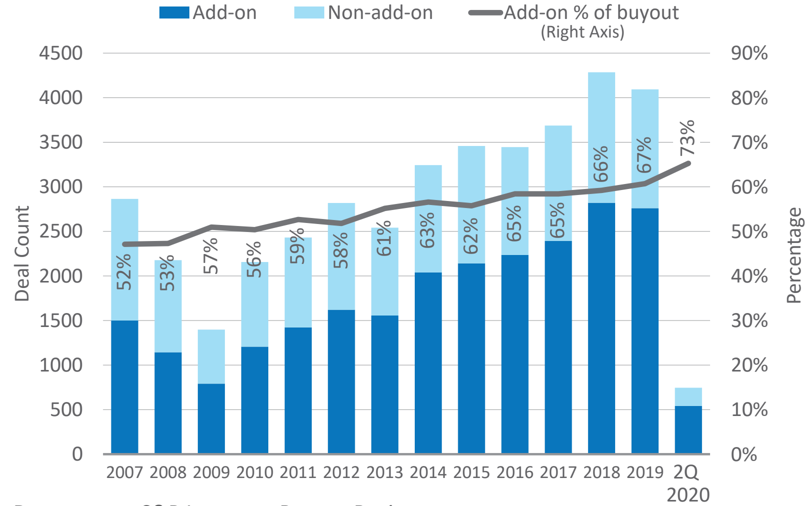
Data source: Pitchbook

Buyouts

- Investors were able to navigate travel restrictions and complete second quarter fundraising due diligence virtually, as opposed to in person. Through June 30, 2020, global leveraged buyout funds raised roughly $125 billion of aggregate capital commitments, representing a roughly 12% decrease from the same period last year.[1]
- Through June 30, 2020, U.S. private equity deal volume was down approximately 40% year-over-year.[2] Many deals closed in the second quarter were negotiated prior to the COVID-19 pandemic. In the near term, private equity firms are likely to prioritize add-on acquisitions.
- The median purchase price multiple for a U.S. buyout transaction was 14.3x earnings before interest, taxes, depreciation, and amortization (EBITDA). Leverage ratios remained relatively constant, at 5.4x EBITDA.[3]
- Exit activity in the quarter fell sharply as private equity firms chose to hold investments rather than sell at depressed values. Through June 30, 2020, U.S. private equity exit value and volume were down 44% and 41%, respectively, year-over-year. Consequently, holding periods for assets are likely to be extended.[4]
- Private equity fund performance remained strong through the first quarter, with the impact of COVID-19 on portfolio company operations more fully pronounced in the second quarter.[5]

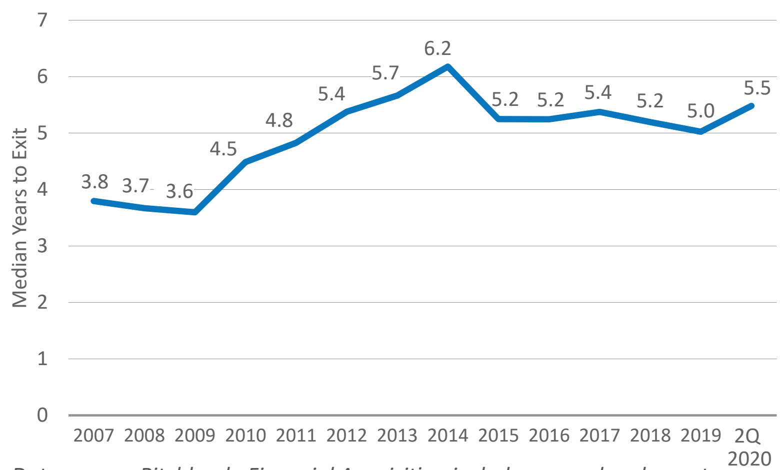
INVESTOR IMPLICATIONS: Investors who remain cautious and partner with managers focused on creating value via operational improvements rather than financial engineering should be well-positioned to benefit in the new, post-pandemic world.

ADD-ONS AS PROPORTION OF TOTAL U.S. PRIVATE EQUITY BUYOUTS



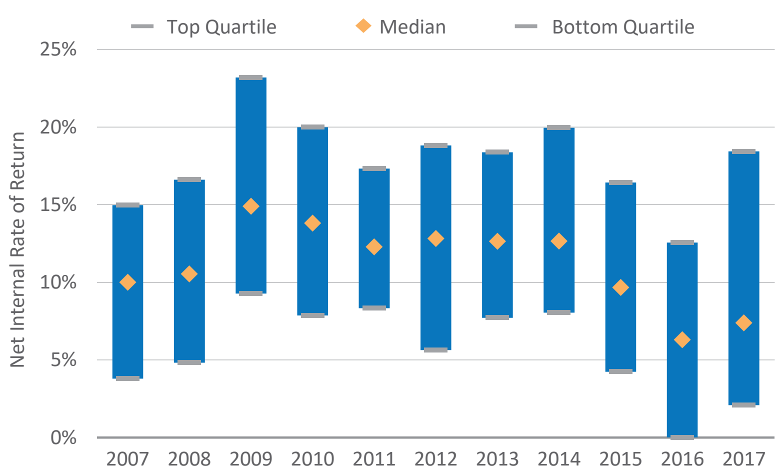
Data source: S&P Leverage Buyout Review

U.S. PRIVATE EQUITY MEDIAN YEARS TO EXIT



Data source: Pitchbook; Financial Acquisition includes secondary buyout and buyout by management

BUYOUT PERFORMANCE BY VINTAGE YEAR



Data source: Thomson One; data as of March 31, 2020

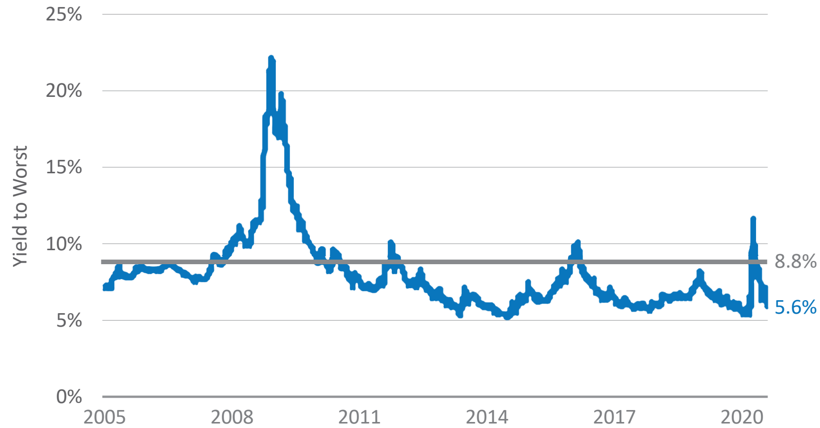
1 Pitchbook; Data of June 30, 2020
2 Pitchbook; Data of March 31, 2020
3 Pitchbook; Data of June 30, 2020
4 Pitchbook; Data of June 30, 2020
5 Thomson One; Data as of March 31, 2020

PRIVATE DEBT

- Considerable improvement in the public credit markets—most notably in high yield bonds—during the second quarter is likely to benefit the marks of both senior and mezzanine lenders.
- Despite the improvement in the broad high yield markets, a meaningful distressed opportunity persists due primarily to the bifurcation in the market by both credit quality and sector.
- Private debt fundraising activity has shifted materially away from direct lending year-over-year in favor of distressed debt strategies.
- Renewed interest in distressed debt has led to an increase in the number of private debt funds coming to market. According to Preqin, a record-high 486 funds are currently in the market, seeking $239 billion across strategies.[1]
- In conjunction with a more challenged economic environment, private lending funds with fresh capital to put to work anticipate a strong vintage year in 2021.
- COVID-19 hit some sectors disproportionately harder than others, leading to distressed opportunities in sectors such as retail, leisure, and consumer durables.

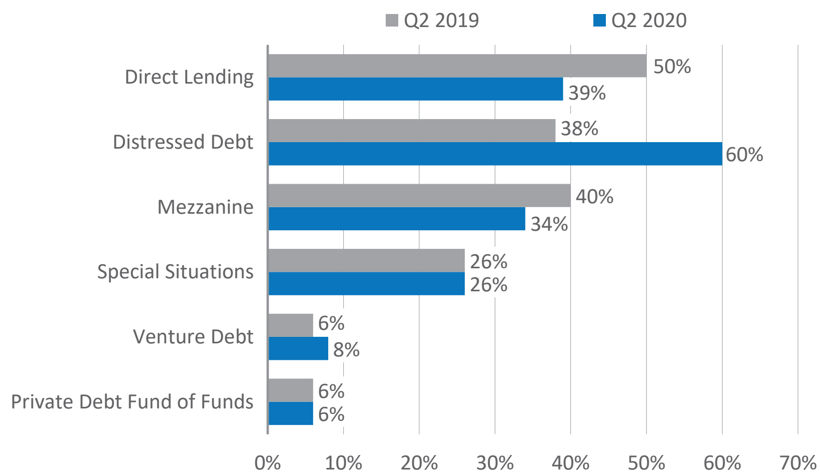
INVESTOR IMPLICATIONS: Investors who have not yet allocated to distressed may still take advantage of the opportunity set; they may also wish to re-focus their efforts on performing lending strategies in the back half of 2020 and 2021.

BARCLAYS HIGH YIELD INDEX YIELD TO WORST



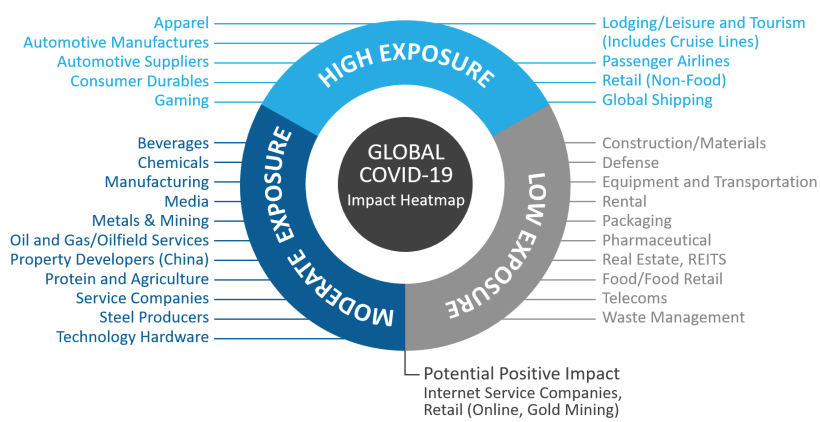
Data sources: Bloomberg, L.P., Barclays; data as of July 28, 2020

SEARCH ACTIVITY SHIFTS FROM DIRECT LENDING TO DISTRESSED



Data source: Preqin Pro

COVID-19 EXASPERATED SOME EXTISING TRENDS, LEADING TO DEFAULTS



Data source: Preqin Quarterly Update Q2 2020

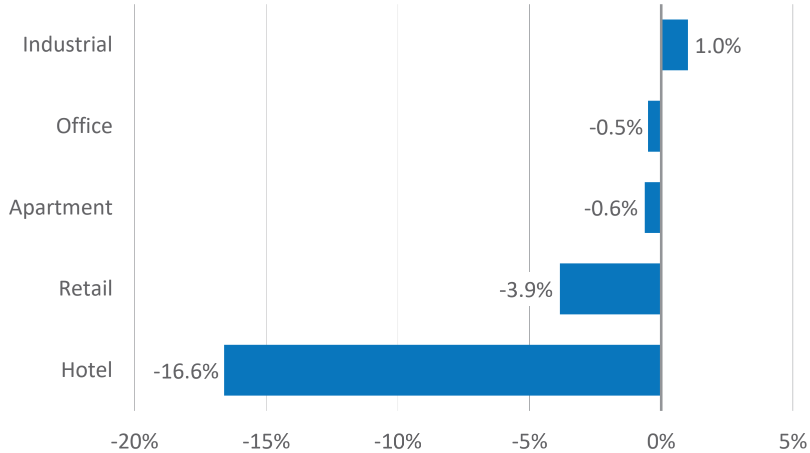
1 Preqin Quarterly Update: Private Debt Q2 2020

PRIVATE REAL ESTATE

- The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI), posted a loss of 1.0% during the second quarter, following a 0.7% gain in the first quarter of 2020. This is the lowest return since the fourth quarter of 2009 which was the midst of the financial crisis.[1]
- For the second quarter of 2020, U.S. private real estate transaction volume fell approximately 68% compared to 2019.[2] Despite significant "dry powder" available for investment, economic uncertainty kept investors on the sidelines. Assessing basic underwriting metrics for real estate (net operating income), in particular, remained challenging for investors.
- The real estate market continued to be characterized by a wide disparity in performance of property types in the second quarter. Industrial, data centers and multi-family continued to outperformin the second quarter of 2020, while retail and hotel properties experienced significant declines in the first half of the year.
- While still early, indications are that private real estate funds will experience markdowns in value for the second quarter, but the effect will likely vary depending on property type exposure.

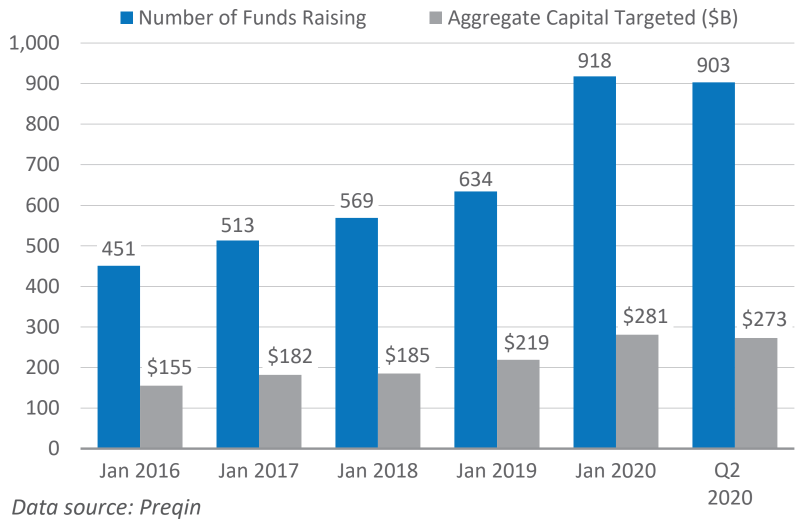
INVESTOR IMPLICATIONS: With significant capital for private real estate on the sidelines and limited transaction activity, any deals coming to market will likely see significant competition, potentially driving down returns. Therefore, we expect the distressed opportunity to unfold slowly and will require patient capital to selectively target deals with attractive returns.

NATIONAL PROPERTY INDEX SECTOR RETURNS



Data source: NCREIF

CLOSED-END PRIVATE REAL ESTATE FUNDS IN MARKET 2016 – 2020



Data source: Preqin

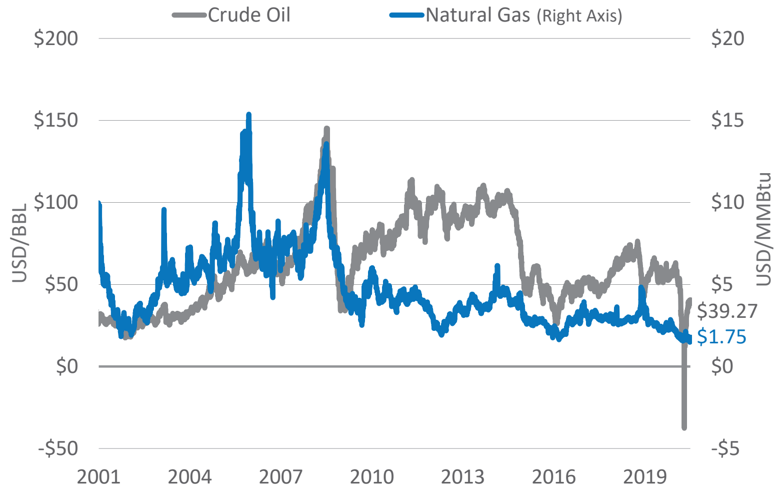
1 NCREIF; Data of June 30, 2020
2 Preqin; Data of June 30, 2020

NATURAL RESOURCES

- The U.S. energy sector experienced a dramatic recovery in the second quarter of 2020. Following a 66% decline in the first quarter, oil rose 92% to close at $39.27/barrel as of June 30th. Natural gas prices also rose in the second quarter, but by a more modest 6.8% to close at $1.75/MMBtu.[1] An increase in economic activity following 'lock-downs' in the first quarter was the key driver of higher prices.
- Through June 30, 2020, deal volume in the energy sector totaled $2.6 billion, which was an increase from the first quarter, but still the third-lowest level since the 2008-2009 financial crisis.[2] Bankruptcies continued through the second quarter, with 18 upstream companies filing for Chapter 11, a trend that is expected to continue in the coming quarters. Upstream E&P operators continue to face high levels of debt and low commodity prices.
- The U.S. oil rig count fell by a staggering 70% to 188 rigs at the end of the second quarter—a 20-year low. The natural gas rig count fell 26.5% to 75. Upstream energy companies continued to curtail production in response to record low prices in the first quarter.[3]

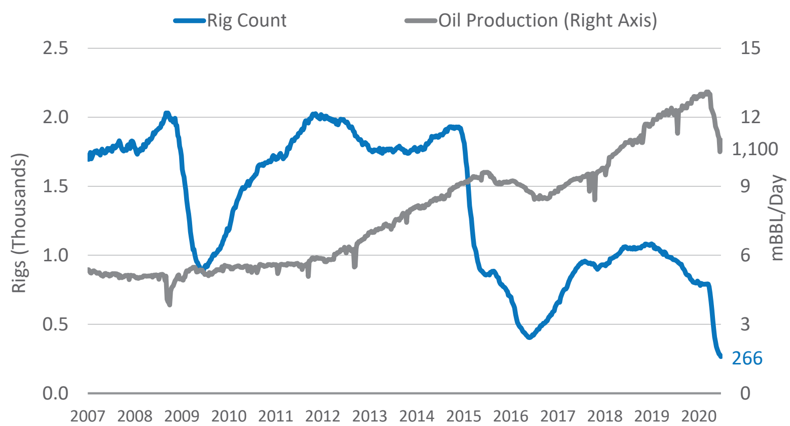
INVESTOR IMPLICATIONS: The current energy landscape is characterized by an extreme lack of capital availability, which should lead to attractive deal flow for managers with capital to deploy. Private energy fund performance should see a rebound when second quarter numbers are finalized, reflecting higher commodity prices.

CRUDE OIL AND NATURAL GAS PRICES



Data source: Bloomberg, L.P.

U.S. RIG COUNT AND DAILY OIL PRODUCTION



Data source: Bloomberg, L.P.; data as of June 26, 2020

1 Energy Information Administration www.eia.gov June 30, 2020
2 EnCap X Quarterly Report; June 30, 2020
3 Baker Hughes; Data of June 30, 2020

INDICES

Bloomberg Barclays US Corporate High Yield Index represents the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded but, Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. The index includes the corporate sectors: Industrials, Utilities, and Finance, encompassing both US and non-US Corporations. See www.bloomberg.com for more information

The Russell Indices are constructed by Russell Investment. There are a wide range of indices created by Russell covering companies with different market capitalizations, fundamental characteristics, and style tilts. See www.russellinvestments.com for more information.

The FTSE NAREIT Composite Index (NAREIT) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded REIT securities in the U.S. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

The S&P 500 Index is capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

HFRI ED: Distressed/Restructuring Index — Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.
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All data is as of June 30, 2020 unless otherwise noted.

RESEARCH AND PORTFOLIO MANAGEMENT TEAM

LILLIAN B. AMBROSIUS
Research Analyst
Responsive Investing

CHERYL A. BARKER
Vice President
Research

NOLAN M. BEAN, CFA, CAIA
Managing Principal
Head of Institutional Investments

KEITH M. BERLIN
Senior Vice President
Director of Global Fixed Income and Credit

PATRICK BONNELL
Research Analyst
Global Fixed Income and Credit

CHRISTIAN S. BUSKEN
Senior Vice President
Director of Real Assets

KEVIN J. CONROY, CFA, CAIA
Vice President
Hedged Strategies

GREGORY M. DOWLING, CFA, CAIA
Managing Principal
Chief Investment Officer, Head of Research

SUSAN MAHAN FASIG, CFA
Managing Principal
Portfolio Manager, Private Investments

ANTHONY L. FESTA, CFA
Managing Principal
Head of Portfolio Strategy

MICHAEL B. FRANKE, CFA, CAIA
Senior Research Analyst
Hedged Strategies

ANANYA HANDA
Senior Research Analyst
Global Fixed Income and Credit

EMILY C. HOGYA
Senior Portfolio Analyst
Portfolio Management

BRIAN A. HOOPER, CFA
Senior Vice President
Global Equities

GREGORY D. HOUSER, CFA, CAIA
Director
Research

MARK A. KOENIG, CFA
Senior Vice President
Director of Quantitative Analysis

J. ALAN LENAHAN, CFA, CAIA
Managing Principal
Chief Investment Officer,
Head of Portfolio Management

CHARLIE W. LUECKE
Senior Research Analyst
Private Equity

LAUREN M. MAYERNIK
Senior Research Analyst
Private Equity

SEAN P. McCHESNEY
Vice President
Hedged Strategies

MICHAEL J. O'CONNOR, CFA, CAIA
Vice President
Assistant Portfolio Manager,
Public Investments

D. TAYLOR SIMPSON
Senior Research Analyst
Real Assets

BENJAMIN C. SULLIVAN
Senior Research Analyst
Global Equities

G. SCOTT TABOR, CAIA
Senior Vice President
Private Capital

STEVEN G. THIEME, CFA, CAIA
Senior Research Analyst
Hedged Equity

DANIEL I. TIRPACK, J.D.
Senior Research Analyst
Real Assets

NATHAN C. WERNER, CFA, CAIA
Senior Vice President
Director of Private Equity

201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400
information@feg.com
www.feg.com

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