Public and Private Debt: Compelling Complements for Investors

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Overview

As investors seek returns in a low interest rate world, many find themselves trying to determine how best to allocate to credit to ***maximize yield and manage risk*** in a cost-efficient framework. We believe this can be achieved by concurrently accessing a broad and growing opportunity set in both the liquid credit and traditional middle markets. In this report, we will discuss why we believe a convergence of these markets is creating an attractive investment opportunity for managers positioned to exploit this dynamic to potentially benefit investors, specifically by leveraging differentiated intelligence and sourcing to achieve preferential deal flow and economics. In addition, we will address how liquid credit and corporate direct lending are complementary strategies that in our view, when paired, present a compelling risk-adjusted return opportunity relative to traditional fixed income across market environments.

We seek to demonstrate how a "side by side" allocation to liquid credit and corporate direct lending with an established manager can ***afford an investor a broader opportunity set and increased diversification***[1] through exposure to both high-quality, middle market companies and larger, more established issuers. In addition to an information edge and the potential for favorable allocations and preferred economics, managers ***can tactically utilize liquidity to achieve an attractive, income-producing portfolio in varied market environments for investors***. As a result of our leading $151.1 billion[2] global credit franchise and cross-platform collaboration, we believe Ares is well-equipped to capitalize on the growing convergence of the liquid and middle markets.

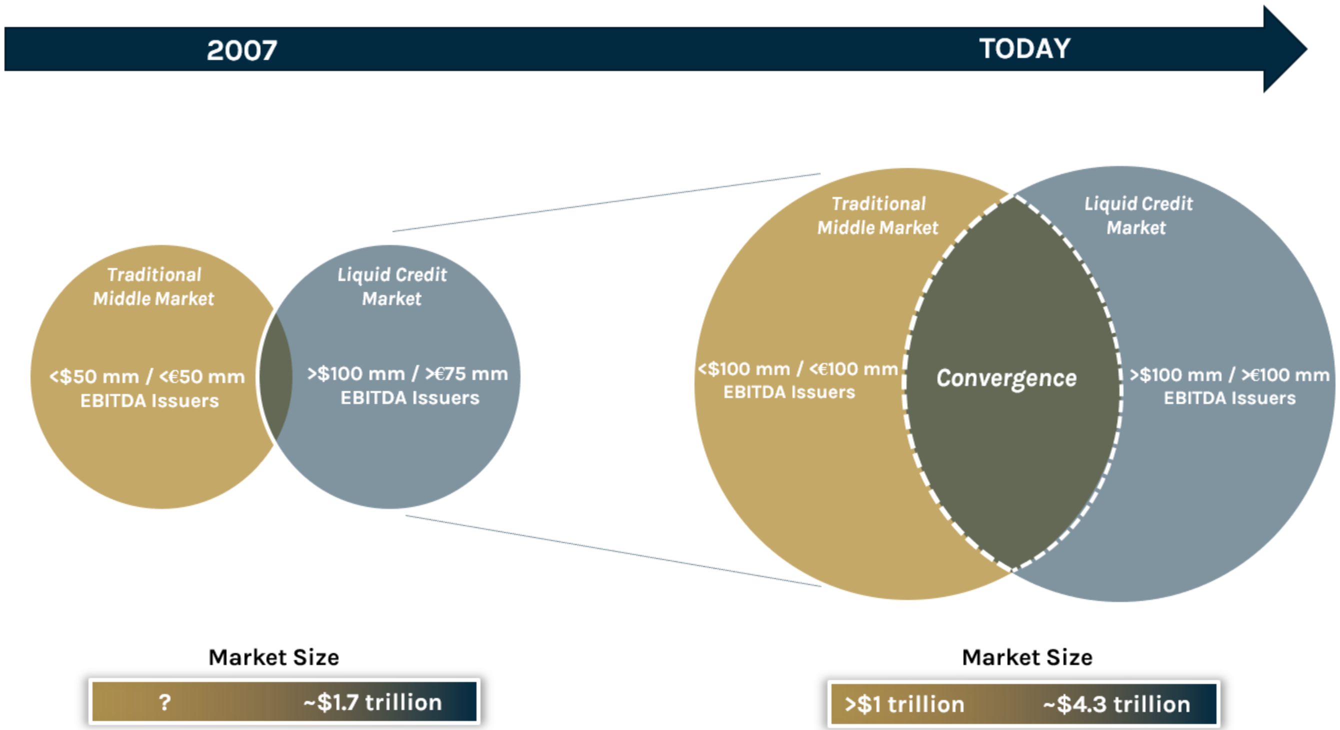
Potential Benefits of a Dual Allocation to Liquid Credit & Corporate Direct Lending

- ✓ Maximize Market Opportunity Set
- ✓ Complementary Exposures
- ✓ Information and Economic Advantages
- ✓ Capitalize on Dislocations across Cycles

Market Opportunity from Converging Markets

Today, many allocators are well-versed in the structural and regulatory dynamics that have led to the growth in syndicated loans and corporate direct lending markets. These structural shifts, along with the subsequent maturation of the private credit markets broadly, has resulted in a growing convergence between the liquid credit and corporate direct lending markets as larger middle market companies effectively "graduate" into the liquid credit universe. To capitalize on this dynamic, the ability to play in both markets is critical. Combined, these markets represent over ***$5.3 trillion*** of global opportunities,[3,4] and we believe Ares' expertise in both liquid credit and corporate direct lending is a differentiator that allows us to simultaneously and competitively participate in the largest public market deals, while serving borrowers seeking a solution from direct lenders of scale.

FIGURE 1: Over the last decade, the traditional middle market and liquid credit market have grown significantly, and we believe we are well-positioned to capitalize in both traditional markets as well as where these markets converge[3,4]



Note: For illustrative purposes only.

We believe the innate benefits of deep relationships across both markets coupled with real-time information sharing and exchange of ideas is integral to differentiated due diligence and sourcing opportunities. In our experience, managers with the expertise and scale to participate in both middle market and syndicated transactions can potentially drive benefits inaccessible to monoline and/or smaller managers.

With bouts of volatility becoming shorter and more frequent, the ability to quickly source intelligence is a distinct advantage that generally only managers with broad market coverage can achieve. Managers with a presence in both markets can also benefit from scenarios where a company migrates from the corporate direct lending market to syndicated markets by leveraging prior diligence and established relationships with company management, leading to enhanced insights. That augmented due diligence can lead to stronger conviction, and in turn higher quality investment opportunities.

These insights can also lead to differentiated sourcing opportunities that can support both investors in private direct lending as well as liquid credit mandates. Managers with capabilities in both the public and private markets may have established relationships with the company, private equity sponsors and underwriting banks to communicate a more holistic financing solution. In such circumstances, credit managers with depth across both public and private markets can provide a solution with increased certainty of execution, at times in exchange for enhanced allocations and/or economics.

As corporate direct lending has continued to expand, borrowers and private equity sponsors are increasingly using the aforementioned synergies between the broadly syndicated and middle markets to enhance certainty of execution and optimize their cost of capital. We believe scale and incumbency remain key to navigating and capitalizing on the opportunity set across corporate credit.

Ares Credit Spotlight

The breadth and depth of the Ares credit platform facilitates early access to deal flow via relationships with over **600** U.S. financial sponsors and **2,700+** portfolio company investments, which provide powerful insights throughout the investment process. Ares has been investing in the leveraged finance markets since our inception in 1997, and our Direct Lending team has a 16-year history of investing across multiple market cycles. In addition to sponsor and company relationships, we believe our scale and market access results in a strong presence with the Street, leading to a differentiated opportunity set and a prominent voice when structuring financial solutions.

Compelling Complements: The Dual Allocation Advantage

In addition to the expansive and converging market opportunity across both corporate direct lending and liquid credit, we believe the asset classes' complementary characteristics provide several attractive qualities when combined. As illustrated in Figure 2, we have identified the various levers that can be pulled to achieve the dual allocation advantage and meaningful outperformance relative to traditional fixed income over the long-term.

FIGURE 2: Corporate direct lending and liquid credit have complementary characteristics that can be combined for portfolio optimization

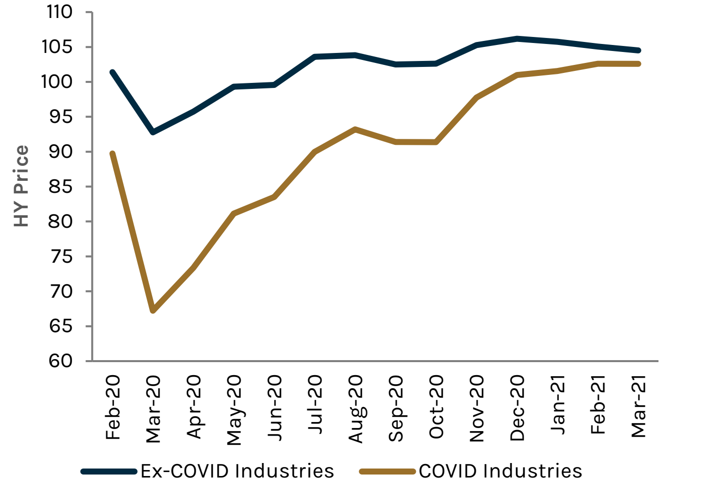
	Bank Loans	*High Yield Bonds*	*Direct Lending*	*Dual Allocation Advantage*
Liquidity	Liquid		Illiquid	*Capitalize on Dislocations*
Typical Issuer Size	>$100mm EBITDA		<$100mm EBITDA	*Diversification*
Primary Source	Varies		Majority Financial Sponsor	*Diversification*
Volatility	Moderate		Low	*Risk Efficient*
Sector Orientation	Varies		Defensive / Varies	*Diversification*
Approximate Fees	Fees retained by investment banks OR 0.5% – 2% OID provided to investors		Retains fees including structuring, closing, etc. (2% - 5%)	*Enhanced Yield*
Secured	Yes	Varies	Yes	*Risk Efficient*
Rate Sensitivity	Low	Moderate	Low	*Risk Efficient*
Est. Return[5]	5 - 7%		7 - 15%	*Enhanced Yield*

For illustrative purpose only Source: Ares, as of March 31, 2021. Diversification does not assure profit or protect against market loss.

As shown above, varying company size and potential source of new opportunities can enhance issuer diversification. Diversification can also be improved from an industry perspective, as illiquidity generally supports a bias towards defensive vs. cyclical industries given a lack of an active secondary market. From a risk perspective, allocating to both credit sectors will help mitigate duration while having a bias toward high-quality, secured assets. Additionally, an investor can realize enhanced yields and economic benefits such as original issue discounts ("OID") and structuring fees through an allocation to both asset classes. With an allocation to both liquid and illiquid credit, investors can participate in potential opportunistic trading gains throughout the cycle, while maintaining the defensive characteristics of directly originated assets. Certain factors, such as market liquidity, can be exploited in a complementary manner, too.

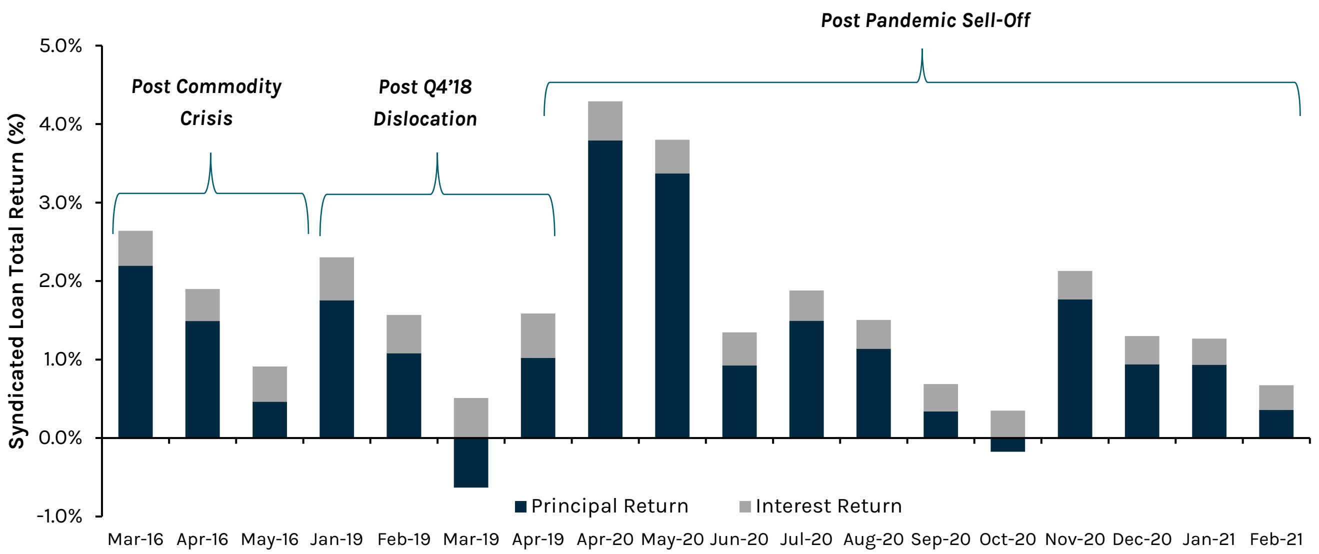
While volatility is often perceived as a negative quality in investor portfolios, nimble managers view such "air pockets" as meaningful investment opportunities, provided they have some degree of liquidity. The ability to take advantage of market liquidity is paramount to asset allocation, particularly in periods of dislocation. Drivers of market returns can vary over time in liquid credit, supporting the need to apply a dynamic approach that seeks to protect principal and generate attractive returns. The market environment since the onset of COVID-19 underscores the evolving dynamics in liquid credit. Initially post-dislocation, defensive sectors and higher credit quality investments drove returns as lockdown measures went into place and the "new normal" took shape. As seen in Figure 3, that dynamic has evolved since lockdown measures were first implemented, and sectors heavily impacted by COVID-19 subsequently drove spread tightening. Additionally, managers can use liquidity to take advantage of price discounts in the secondary market; as shown in Figure 4, price returns have often been the primary driver of total returns in the syndicated loan market post-dislocation.

FIGURE 3: Liquid credit conditions evolve as the "Reopening Trade" unfolds



For illustrative purposes only. Source: Ares, ICE BofA HY Indices. As of March 31, 2021.

FIGURE 4: Price appreciation can have a meaningful impact in liquid credit



For illustrative purposes only. Source: Credit Suisse Leveraged Loan Index. As of February 28, 2021.

While it may seem counterintuitive, direct lending managers can also utilize market liquidity to their advantage. In times of dislocation within the liquid markets, new issue volume can slow due to heightened uncertainty. During these periods, successful direct lending managers can fill the void by providing much needed liquidity to middle market companies, often with enhanced terms. In addition, structures can be more lender-friendly due to the reduced number of financing solutions available. Unfortunately, not all managers are positioned to take advantage of the opportunity. Managers with loose underwriting standards or limited infrastructure may be forced to look inward and address their existing portfolio, rather than deploy capital under preferential conditions.

As most evident during market dislocations, we believe prudent active managers can identify discounted "needle in the haystack" investment opportunities through rigorous bottom-up, fundamental analysis, active dialogue with the Street and quantitative resources.

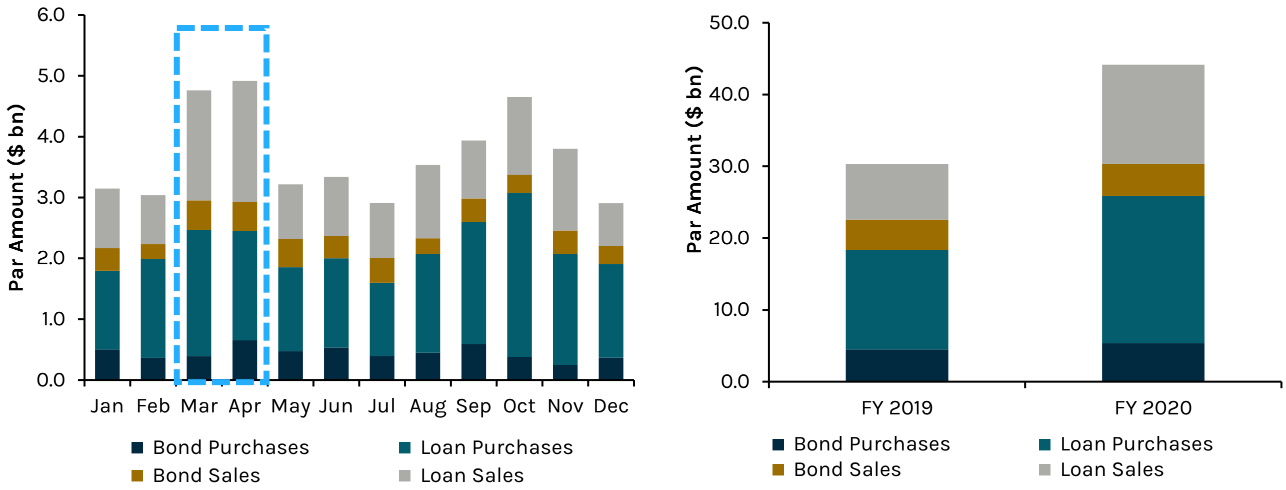
2020: Convergence in Action

In the wake of the initial COVID-19 crisis in March and April of last year, spreads in the liquid credit markets widened to levels not seen since the Global Financial Crisis. At a time when company fundamentals appeared to be quickly deteriorating, extensive due diligence, broad market coverage and enhanced insights were key to understanding the risks underpinning mispriced credits. In doing so, nimble credit managers were able to identify discounted opportunities in the secondary market. Less agile managers, due to having a more constrained investment strategy and/or not having the liquidity or cash available to deploy, were left standing on the sidelines.

Ares Liquid Credit Case Study

Ares remained active through the COVID-19 crisis, as we swiftly identified and executed on opportunities where assets were discounted and/or mispriced as a result of the dislocation. As the snapback occurred and relative value improved dramatically through March, we deployed cash into higher-rated segments of the market, favoring more defensive industries, while selectively adding risk in COVID-impacted sectors and large Fallen Angels that we believed would ultimately recover. In Q2'2020 and early Q3'2020, we continued to take advantage of discounted names that we believed were fundamentally resilient.

FIGURE 5: Ares Global Liquid Credit traded nearly $10bn during the peak of the COVID-19 crisis, and YoY trading volume increased by ~50%



For illustrative purposes only. Source: Ares, as of December 31, 2020.

As the broader economic recovery began to take shape, primary market opportunities began to flourish in private markets. While the economy was improving, uncertainty remained, creating a significant opportunity to integrate committed private capital alongside a liquid credit solution to support companies' financing needs. For managers positioned to capitalize on convergence, mid-2020 presented compelling investment opportunities in an otherwise limited new issue landscape.

Ares Angle[6] Case Study

As the economic recovery commenced, the Ares Credit Group financed a multi-branded restaurant chain seeking to grow their business through an acquisition. Ares Liquid Credit had been a long-time investor in the companies' syndicated deals, while Ares Direct Lending had a strong relationship with their financial sponsor. To help increase certainty of execution, Ares was approached to support the transaction through collaboration across our liquid and illiquid strategies. Utilizing our existing relationships with the company and sponsor, Ares was able to provide a significant commitment prior to launch in exchange for enhanced economics relative to the market.

Looking forward, we believe there is a wealth of opportunities to provide liquid and illiquid solutions to attractive companies for a differentiated primary market solution. Informational advantages and insights continue to play a role in credit selection in these markets. Thus, we believe investors who invest in managers with both liquid and illiquid credit capabilities have distinct investing advantages with opportunities for generating enhanced returns through cycles, but especially in periods of elevated volatility and significant credit dispersion.

Conclusion

Some may view allocating to liquid credit and corporate direct lending as a binary decision, exchanging liquidity for yield. However, we believe the convergence trend is here to stay and likely to be a growing source of differentiated risk-adjusted returns for the foreseeable future. We believe in-depth knowledge and experience in both markets, coupled with strong relationships with sponsors, borrowers and Street counterparties, are critical to having the edge required to maximize the opportunity set and unlock the economic benefits described above.

As demonstrated above, these asset classes have complementary qualities that can be exploited to efficiently manage exposures throughout the cycle, while building a portfolio that provides diversification and yield premium relative to traditional fixed income. Furthermore, an allocation to both liquid credit and corporate direct lending maximizes an investor's ability to take advantage of dislocations in both the secondary and primary markets.

Keys to Succeed in Liquid & Illiquid Credit Investing

- ✓ Scale & Local Market Presence
- ✓ Incumbency & Strong Company/Sponsor Relationships
- ✓ Track Record of Yield Generation & Principal Protection

While the scale and nature of investments may differ across direct lending and liquid credit, at Ares, we apply the same rigorous, fundamental analysis across our credit platform. We believe there are common traits critical to successful credit investing, and in our experience, there are few managers who possess these strengths in both asset classes. Specific to direct lending, managers with scale and expertise can steadily deploy capital through a large network of existing portfolio companies and private equity sponsor relationships. As one of the largest direct lending managers globally, Ares' expansive network allows us to be highly selective, consistent with our cycle-tested underwriting standards. As a result, we believe we are better positioned to protect investor capital. Within liquid credit, Ares utilizes our market access and experience across cycles to actively manage risk and rotate exposures while seeking to generate attractive total returns in varied market environments.

Through collaboration, we believe our deep knowledge, tenured history and relationships in both markets allow us to better take advantage of the growing convergence between illiquid and syndicated markets to enhance deal flow, due diligence and drive preferred economics for our investors. We believe our constant, organic exchange of ideas better informs decision-making across credit markets, and opportunities for our direct lending and liquid credit businesses are the ultimate manifestation of that. For our investors, this translates to opportunities for flexible, income-producing portfolios that can weather virtually any climate.

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Endnotes

1. Diversification does not assure profit or protect against market loss.
2. As of March 31, 2021. AUM amounts include funds managed by Ivy Hill Asset Management, L.P., a wholly owned portfolio company of Ares Capital Corporation and registered investment adviser.
3. As of March 31, 2021. Market Size for liquid credit markets is represented by the ICE BofA Global High Yield Index (HWOO), Credit Suisse Western European Leveraged Loan Index (hedged to USD) (CSWELLI) and Credit Suisse Leveraged Loan Index (CSLLI).
4. As of December 31, 2017. Market size for traditional middle market includes U.S. and European Direct Lending. Based on Ares' own calculations using information from Thomson Reuters, Deloitte, S&P Global Market Intelligence and Ares' observations, as discussed in *Opportunities in Global Direct Lending: A Historical and Prospective View of the U.S. and European Markets, April 2018.*
5. Source: Ares as of March 2021. Assumptions are based on Ares current estimates and subject to change.
6. Ares Angle case studies reflect investments where Ares, through cross-platform collaboration among different investment groups and the size of its investment platform, believes that it was able to source broadly syndicated loans and / or bonds with preferential economic terms and / or favorable allocations relative to the broader market. These investments generally include providing borrowers with early commitments to a transaction in exchange for Ares receiving premium economics for its capital committed. Ares does not provide arrangement or underwriting services as part of these transactions, and does not negotiate the terms of the financings. Selected case studies are shown for illustrative purposes only and not necessarily representative of all of the transactions of a given type or of investments generally and are intended to be illustrative of some of the types of investments that may be included in the investment strategy detailed in this presentation. They are not necessarily indicative of opportunities that may be available in the future. This information is neither an offer to sell, nor the solicitation of an offer to purchase, any security, the offer and/or sale of which can only be made by definitive offering documentation.