Creative Solutions to Old Problems

In August 2022, First Eagle completed the acquisition of Napier Park Global Capital, a leading alternative credit manager active in a diverse range of global markets through credit vehicles, US and European collateralized loan obligations, and real assets. Managing Principal Jim O'Brien and Managing Principal and Chief Investment Officer Jon Dorfman share their initial experiences operating as part of First Eagle and their thoughts on alternative credit markets in 2023.

Q: How has your brief tenure at First Eagle gone so far?

Jim:

It’s been less than six months, but I would say that the experience has been an extraordinarily positive one for me and our colleagues at Napier Park. Admittedly, that was pretty much expected; once we began meeting with the senior team at First Eagle, it became clear that Napier Park and First Eagle have a very similar investment-driven culture, dedication to client outcomes and commitment to nurturing our employees. From a day-to-day perspective, little has changed for the Napier Park team and our clients. Jon and I continue to run the firm, and we operate autonomously under our own brand, maintaining our investment approach, business focus and client service.

Jon:

The reason that we engaged with First Eagle is that we felt Napier Park had gotten to a point in our company lifecycle when we needed to start investing in our client-facing infrastructure—including product development and management, client outreach and investor relations—if we wanted to execute our long-term business strategy. As we continue to move forward and markets become more interesting, we will need to expand from a market perspective as well. The transaction gave us the bandwidth to make investments over the next few years and to concentrate on how to best grow the business in a way that also enhances the solutions First Eagle offers to clients.
Jim:
The transaction also has been very positively received by our client base. There has been a lot of consolidation in the alternative credit space, and the fact that we participated in that consolidation did not come as a big surprise to most clients—they understood our need to invest in client infrastructure and expand our market breadth. Generally speaking, clients have appreciated our thoughtful approach to unlocking access to resources by partnering with a company like First Eagle. I’m sure that being part of a larger platform, with access to a bigger balance sheet and the stability all of that implies, was a source of comfort to some clients in the challenging environment of 2022.

Q:
Speaking of challenging environments, what was your experience in the credit markets in 2022?

Jim:
We came into 2022 expecting higher volatility and greater dispersion in the credit markets as fundamentals and technicals became more idiosyncratic. While we were right about direction, we underestimated the magnitude of the correction that lay ahead. Though the credit market was broadly lower during the year, higher-quality, shorter-duration assets delivered relative outperformance in the rising-rate environment.1

We invest in a broad range of floating-rate assets, which carry less interest rate risk than fixed-rate assets. They do have spread-duration risk, however, and 2022’s meaningful rate moves drove much of the repricing across global credit markets. Liquidity has been another challenge, as the violent and quick move in rates during the year has resulted in significant bid/offer widening.

A bright spot in the shift to higher base rates and wider credit spreads is that it allows managers to construct portfolios with the potential for much higher yields than were available a year ago without taking on additional credit risk. Yield as a meaningful contributor to total return is a benefit we haven’t had in a very long time, and it has the potential to initiate an asset allocation cycle across our markets and products.

Q:
Tell us about the Real Assets strategy. Are you seeing demand in the current environment?

Jon:
Given inflation pressures and the continued search for sources of uncorrelated yield, the number of conversations we had about the Real Assets platform escalated meaningfully in 2022. These assets tend to be long-lived, income generative, essential-use equipment with a focus on preserving residual value. Our platform provides diversified exposure to hard-to-access operational and developmental assets across three primary areas: railcars, aircraft and renewable energy. Meanwhile, the operators of these assets, who continue to provide the intensive day-to-day servicing, receive long-dated, non-dilutive, partnering capital to support their core businesses.

In contrast with many financial assets, hard assets historically have been more resilient during difficult macroeconomic periods, a trend that persisted amid the challenges of 2022. There are numerous reasons real assets continue to appear attractive in today’s economic and market environments. Based on equipment value and its potential to generate future income through operational usage, the price of real assets historically has been uncorrelated to financial markets and resilient to short-term volatility while also demonstrating a positive

1. Source: FactSet; data as of December 30, 2022.
sensitivity to rising interest and inflation rates. Further, the negotiated nature of these investments allows us to structure agreements specifically with capital preservation in mind. Finally, our recent focus on renewable energy assets may help support decarbonization and sustainability efforts.

Q: You both have a long history of investing in alternative credit. What have previous bouts of market volatility taught you?

Jim: As we refined our investment process over time, we've learned that periods of market volatility and uncertainty historically have been supportive of active management, and the dispersion among assets that often results allows our highly experienced credit research team to shine.

We've found that in our areas of investment, active management tends to be the exception rather than the rule; most managers tend to focus on upfront portfolio construction, and then it’s “set it and forget it” unless credit issues arise or liquidity is needed. At Napier Park, we tend to be very active. We continually look to optimize our exposures, moving risk profiles around in an effort to take advantage of opportunities as they emerge, facilitated by our institutional-grade infrastructure, creativity and decades of specialized expertise among our investment professionals. While Jon and I each have nearly 40 years behind us, you’ll find very seasoned professionals across the organization; our senior management team averages 33 years of experience in the industry and 18 years working together.

Jon: While our flagship Opportunistic Credit strategy is intended to be an evergreen, all-weather portfolio over credit cycles, we also maintain a Credit Dislocation strategy that seeks to maximize absolute returns by taking advantage of periods of credit dislocation. The strategy operates on a contingent capital basis; that is, committed capital is deployed only when we believe the opportunity exists to build a portfolio that has the potential to generate our target return. When such circumstances emerge, we can act as a liquidity provider to stressed sellers.

For the Credit Dislocation strategy, we target non-investment grade performing assets; we’re buying mezzanine tranches and equity/first-loss tranches in things like collateralized loan obligations, asset-backed securities, mortgage-backed securities, privately arranged consumer and mortgage loans, commercial receivables and leasing. These tranches typically are the lowest rated within the securitization or are unrated, and offer the highest expected yield.

In our view, a performing asset that has lost value in a challenging market—if of good quality—is well positioned to continue generating positive cash flow for its owner even if its price remains depressed. The eventual return of market liquidity should act as a catalyst for price improvement in such credits while also driving spreads broadly tighter, encouraging new issuance and promoting the resumption of optimal market functionality.

Jim: The onset of Covid-19 is a good example of such a scenario. Asset prices fell sharply in March 2020 as the pandemic took hold, providing ample opportunities to acquire assets at steep discounts. Once the Fed stepped in, market conditions normalized and the prices of many once-troubled assets began to do the same. In these types of recoveries, it’s been our experience that higher-quality, shorter-duration assets often are the first to rebound while others lag; a nimble manager potentially can add value by taking profits from early-to-recover assets and directing the proceeds toward those yet to pick up a bid.
Q: What are you expecting for alternative credit markets in 2023?

Jim:
We believe the corporate earnings environment will be weaker in 2023, and marked by idiosyncratic risk-related events rather than a broad increase in defaults across companies and markets. Both corporations and consumers alike did an impressive job of managing their balance sheets and terming out liabilities, as evinced by the record-setting levels of refinancing activity in late 2020 and 2021. This should help mitigate the impacts of a slowdown in economic activity. We anticipate the first-order effects of economic slack will be seen in rating downgrades and then eventually through a higher but historically modest level of defaults, centered on corporates with weaker capital structures and operating in more cyclical industries. The continued strength of the US dollar may cause additional stress to corporations that generate meaningful revenue streams outside the US, which is not uncommon among investment grade issuers.

Jon:
The level of uncertainty is somewhat unsettling. There's too much exogenous risk, both geopolitical and economic. We have the war in Ukraine and signs of unrest among the Chinese population. Winter energy prices may push Europe closer to recession as financial conditions tighten, and the UK appears even further along that path. Questions still linger about the stability of global supply chains. The risk of policy error is quite high, in our view, given the extraordinary circumstances in which central bankers and politicians are operating. All of these factors are causing us to maintain a more reserved investing posture right now. That said, while I have no definitive prediction for our markets over the next six months, I’m comfortable investing with a two-year view in good credits at current price and yield levels. This is not to say the situation won’t get worse before it gets better—we may find ourselves investing more capital six or nine months from now, at even cheaper prices. But it all comes down to the quality of our credit work.
About the Authors

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Jon Dorfman is managing principal and chief investment officer of Napier Park, a First Eagle Investments Company. Jon became part of First Eagle in 2022 upon the firm’s acquisition of Napier Park Global Capital, a leading global alternative credit platform. Jon was previously co-CEO and CIO of Citi Capital Advisors, which he joined in 2007 when Citigroup acquired Carlton Hill Global Capital, the specialized asset management firm he co-founded in 2005. Previously, Jon spent 20 years in Morgan Stanley’s fixed income division in the US, Tokyo and London, holding numerous senior management positions including co-head of the global investment grade credit group and head of global credit derivative and asset swap trading group. An industry innovator, Jon served as an International Swaps and Derivatives Association committee member responsible for the first standardized credit default swap contract. Jon earned a BSE, magna cum laude, from the Wharton School of Business at the University of Pennsylvania.

Jim O’Brien

Managing Principal of Napier Park

Jim O’Brien is managing principal of Napier Park, a First Eagle Investments Company. Jim became part of First Eagle in 2022 upon the firm’s acquisition of Napier Park Global Capital, a leading global alternative credit platform. Jim was previously co-CEO of Citi Capital Advisors, which he joined in 2007 when Citigroup acquired Carlton Hill Global Capital, the specialized asset management firm he co-founded in 2005. Previously, Jim spent 19 years in Morgan Stanley’s fixed income division in the US and London, holding numerous senior management positions including co-head of the global corporate credit and global investment grade credit groups, and head of the global cash corporate trading, global credit research and European corporate bond and ABS trading groups. Earlier, Jim worked on Morgan Stanley’s US international sales and product management team. He began his career in the unit investment trust division of Merrill Lynch. Jim earned a BS in finance from Seton Hall University. He has been honored with service and humanitarian awards from StreetWise Partners, Team Walker, Inner City Education Foundation and Seton Hall University.
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