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Everyone Wants Access to a New Private Asset Class. Here's How Apollo Helped Create One.

Apollo has grown its hybrid value strategy, a cross between debt and equity, to $13 billion in three years. That's because companies can get a lot of what private equity offers, without giving up control.

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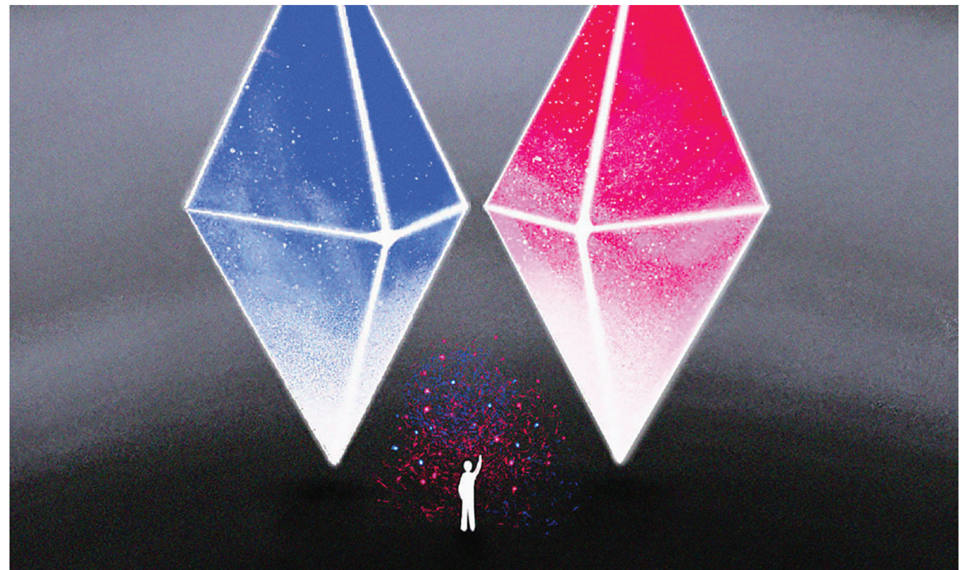

Illustration by II

When Dominic Bagnoli, executive chair and the former CEO of US Acute Care Solutions, started talking to a handful of private equity firms, health systems, and strategic buyers last September, he had two options. One was to sell the whole company or merge it with a strategic buyer. The other was to find a way to buy out private equity firm Welsh, Carson, Anderson & Stowe, which bought a 30 percent stake in the acute care service provider in 2015.

Bagnoli, an emergency medicine doctor who founded the physician-owned organization in 1992, wasn't used to giving up control. In fact, almost thirty years before he had formed the company around his fundamental belief that patients were far better off turning to a surgeon, who owned — and had control of — their practice, rather than trusting one who worked for someone else.

A few weeks after meeting with a group of potential buyers, Barclays investment banker Richard Landgarten convinced Bagnoli that he should meet with Apollo and hear them out. Bagnoli thought he would get a better deal from a strategic buyer, but Landgarten said that Jason Scheir, a partner and head of U.S. hybrid value at the private markets firm, had heard about US Acute Care's process and had something other than control equity in mind.

Scheir told Bagnoli that his company wouldn't have to give up control. And Apollo would still provide strategic growth advice and capital to do acquisitions and fund other long-term initiatives.

"It's hard to thread that needle to obtain the capital so you can deliver the care and service the health system expects and communities deserve, with the scale and efficiencies that will be required," Bagnoli said. "And remain in control, right? A lot of companies have tried to do that, and typically it's easier to throw your hands up and say we can't keep control anymore. But we have always been willing to bet on ourselves, so why change that now?"

Prior to closing the deal in February, and after months of Zoom calls, Bagnoli flew to New York and met Scheir and the team face to face for the first time. Under the agreement they reached, Apollo would invest up to $470 million in preferred equity and US Acute Care Solutions issued $375 million in bonds to refinance debt and buy out Welsh Carson. Shareholders got some liquidity, and the company got capital for its growth plans. Already it has made one acquisition.

The deal with Apollo illustrates how private credit is changing amid increased competition — and Apollo isn't the only firm to see the opportunity. Other private equity firms, including Blackstone, have started offering a new form of capital to companies that is somewhere between credit and private equity. In credit mar-

kets jargon, that means the deals are about 50 to 80 percent loan-to-value. It's a fundamental change in the industry, providing access to capital and a flexibility in deal making that doesn't require management teams and boards to give up control of their businesses.

Apollo's hybrid value business, created in 2018, grew out of two big changes the firm was facing.

From the private equity side, CEOs wanted access to capital to deleverage or expand factories, without having to sell control of their companies.

A chemical, financial, or media company, for example, would come to an Apollo partner, with whom they might have worked for a decade in building the business, and say that control wasn't on the table, but they wanted to structure a deal. Most of these special situations were turned away.

"At the time our platform was basically credit — gap — private equity," said Matt Michelini, the firm's co-head of hybrid value, speaking to *Institutional Investor* at Apollo's office in New York. "The problem is the PE people only had one tool in their tool kit, which is, 'Do you want to go private?'"

Meanwhile, Rob Ruberton, who serves as co-head alongside Michelini, said that Apollo's credit business was facing narrowing spreads and lower returns as direct lending started maturing as an asset class. Target returns for something like mezzanine went from 12 to 14 percent during the financial crisis to single digits.

"So what we started to do in our credit business was thinking about, what if I offer the borrower, not a debt security, but something more like equity; something structured more like a convert, or preferred, where there's still a decent coupon, but with some equity kickers to it," said Ruberton.

Ruberton and his team initially put some of these new securities in Apollo's higher return credit funds, but ultimately the firm needed to start a dedicated strategy.

A chief investment officer of an endowment, who has talked to the co-heads, said that from an allocator's perspective, one of the appeals of flexible investments like Apollo's is that managers get to do the types of deal that fit with what's happening in the larger economic world. In March and April of 2020, when the pandemic hit, investors could have bought some assets at fire-sale prices, but the opportunity was short lived as markets came back.

"Take distressed funds right now: Managers can't sit on all that cash they raised for too long, so they have to do deals whether there are good ones out there are not," the CIO said. "It's not a new problem, but there's got to be a solution to it."

Right now, with robust capital markets and high spending by governments and consumers, the strategy is a fit for CEOs looking for partners to help with growth. "Today companies are almost all playing offense," Michelini said. "Capital markets are feeling great; there's lots of spending, lots of M&A going on. But they don't want to issue straight equity — it's too dilutive. They're happy to do structured equity and bring in a partner to help navigate the growth."

The hybrid value unit's transaction with Albertsons Companies before it went public in late June 2020 was a growth play as grocers benefitted from people shut in their homes. Albertsons also needed to replace longtime private equity owner Cerberus Capital Management, which needed to return money to shareholders. Knowing profitability would go down at some point as lockdowns lifted, CEO Vivek Sankaran wanted Apollo's help with other growth ideas.

"They have been a fabulous board observer and investor in that they also understand how they can add value, like connecting us to the right people or bringing us a macroeconomic perspective. Yet at the same time, they know where their line ends as an investor and where our line begins as a management team," Sankaran told *II*.

As Ruberton explains it, hybrid value offers companies and investors an alternative to private equity.

"We can give you access to the same resources that you can get from a PE fund, but we don't need control of your board room," he said. For example, CEOs can get help to expand their sales forces, implement enterprise resource planning, and support HR departments, among other corporate resources. Investors, meanwhile, get some downside protection they wouldn't get in a PE fund. The Apollo team, for instance, cordoned off Albertsons' valuable real estate, in case the company hit trouble.

"From a management team's perspective, it's not really different from PE," Sankaran said. "I look at it as I have Apollo as a board observer and significant investor in the company. Yes, with preferred shares, I'm paying a slightly higher dividend on it for now, but that is likely temporary, as the preferred shares are likely to convert to common shares over time."

So far, the hybrid strategy is working. According to Apollo's most recent earnings, hybrid value had a gross internal rate of return of 29 percent and a net IRR of 23 percent. It's also working for Apollo, whose assets recently hit $13.1 billion, also announced in earnings.

But as the head of alternatives at a mid-size pension said, even though the strategy isn't "so far outside the box," it still doesn't have a natural home for some allocators.

"My response is this is why you should do it," Michelini said. "Because that viewpoint is shared by many LPs in the world, which means there isn't a lot of capital chasing this asset class."

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