White Oak
Global Advisors, LLC

Highlights:

Introduction to Private Debt and Direct Lending

Types of Loans in the Marketplace

Competitive Landscape

Pricing Risk

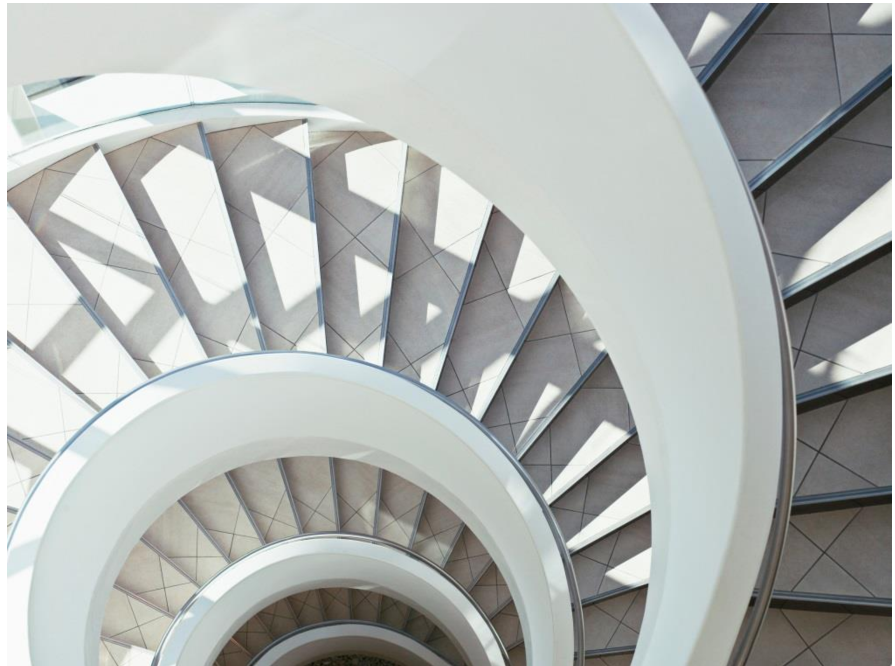
Infrastructure, Fees and Tax Considerations

Qualifying Default Rates in Private Debt

Tools to Compare Lending Managers

Private Debt Market Outlook – 2015

White Oak Global Advisors



Private Debt Market Outlook – 2015

Summary

- The U.S. economy continues to show signs of improvement, and demand for financing from middle-market borrowers is increasing. The primary driver for additional demand for financing is growth in U.S. GDP fueled by continued economic expansion, along with lower oil prices, unemployment and interest rates.
- Banks continue to face significant regulatory pressure; risk-based capital charges for non-rated loans and tier 1 capital ratio increases (of 25% or more by 2018) will make it increasingly challenging for banks to provide middle-market loans efficiently. In addition to facing a stricter regulatory environment, banks are confronting earnings challenges and have had to sell legacy loan positions and eliminate their proprietary trading activities. The end result is a limited ability for banks to commit capital. Direct lending has emerged as a structural replacement for banks in the viewpoint of borrowers (one recent study shows that 50% of borrowers seeking a bank loan are rejected).
- Private debt has grown significantly as an asset class with an institutional endorsement from investors seeking a fixed income alternative to enhance their portfolio yields.
- Although approximately 150 new entrants have entered the lending space (60 U.S. direct lenders, 40 U.S. BDCs and 50 European direct lenders) in the past five years (December 31, 2009 – 2014), the number of U.S. banks has shrunk by approximately 1,219 (6,855 banks vs. 5,636) during this same period, resulting in fewer lenders.
- Institutional investors continue to question the best place to put direct lending in their asset allocations (e.g., Private Equity, Fixed Income, Opportunistic Credit, or Absolute Return).
- Direct lending is here to stay and provides a steady fixed income rate of return when compared to publicly-traded corporate bonds. The speed and flexibility offered by non-bank lenders provides for a viable and efficient alternative for borrowers conducting business in a competitive landscape.
- The private lending market is large and highly fragmented; as such, it is difficult to label this market as "frothy," "a great time to invest"… or not. Frothiness is better characterized by how well a direct lending manager prices the risk of individual loans and how a basket of loans performs overall in a portfolio during a predefined time period.

- Comparing direct lending managers is difficult. This paper attempts to dissect the market into various categories so that the reader can best determine how to quantify risk, have the tools to compare managers and measure risk-adjusted returns for lending portfolios.

The objective of this paper is to provide an overview of the current corporate direct lending market. Beginning by defining the market, it will then provide a real time overview of how to measure risk and highlight approaches for analyzing direct lending opportunities.

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Application of Private Debt or Direct Lending

Private debt, or direct lending, is an investment strategy for providing debt to support the financing objectives and requirements of businesses. These objectives typically fall into the following categories:

- working capital needs;
- refinancing of existing debt;
- capital expenditures;
- acquisitions or other growth objectives;
- restructurings or special situations; and
- dividend recapitalizations.

Direct lending is neither a novelty nor a new business. Banks' core competency for multiple centuries has been to borrow money from deposit holders (or their federal government), leverage their balance sheets, and lend it to businesses, individuals or commercial and residential properties. Some people like to characterize direct lending as either a new paradigm or "disruptive," whereas in reality, it is a plain old staple in how businesses have functioned for a very long time. The major difference is that instead of banks lending this capital to companies, there is a transformation happening in which non-traditional lenders are stepping into this role.

The reason that this opportunity exists is that there are businesses that are growing and need financing, while at the same time banks have shrunk their lending balance sheets. This paper will focus on commercial lending to businesses, and not to lending against real estate assets. It is important to note that real estate lending accounts for over 60% of the aggregate lending balance sheet for banks, whereas the focus of this paper will be on the remaining 40%. The markets for both commercial real estate loans and home mortgages are more developed because these products are easier to underwrite and more homogeneous. In contrast, corporate loans have many more unique variables to consider and are more difficult to underwrite.

In order to understand the attributes of direct lending, it is important to understand why this strategy makes sense and the types of lending products that are available in the marketplace.

Differentiating Loans by Type

1. Term Lending

Many businesses require a term loan for a period of time between one and ten years. Such a loan may be amortized during the life of the loan (amortizing loan), or it may be paid as a bullet (full principal) when the loan matures. Most direct lending firms focus on originating or structuring term loans that are three to seven years in duration. If a manager is adept at building models and formulating projections three years out into the future, that represents 100% of the term for a three-year loan, but less than 43% of the term for a seven-year loan. In other words, in a shorter term loan, the manager will have visibility into the financial health of the borrower for a greater portion of that loan's term. Direct Lenders can "de-risk" a term loan either through amortizing the loan (straight-line or other financial formula) or through cash flow

sweeps (e.g., requiring periodic prepayments equal to 50% of the borrower's excess cash flow).

Note: 80% – 90% of direct lending managers focus on term lending, and 80% or more of those managers focus on term lending to sponsored companies that are backed by a private equity sponsor.

2. Asset-based Loans (ABL)

Asset-based lending is another business that has historically been provided by banks. Companies that have shipped their goods or services to their customers and are then waiting to be repaid (typically within 30, 60 or 90 days) often borrow money from a bank or direct lending institution based on some level of advance rate of their receivables pool. The collateral is usually "cash receivables" or a percentage of the liquidation value of the inventory. Some industry professionals call these types of loans "revolvers" because they revolve every 30, 60 or 90 days, i.e., the Direct Lender provides the cash to the borrower based on an advance rate; within 90 days the payment is received from the counterparty and paid to the lender; then the loan revolves again so that the Direct Lender provides the another similar or identical loan for the next 90 day cycle.

Note: Asset-based Loans continue to be serviced by banks at low interest rates to borrowers because they are shorter in duration, and because they are backed by cash receivables, the banks face a lower capital charge from these types of loans.

3. Equipment Financings

Direct Lenders may also lend against specific collateral (e.g., hospital equipment such as CT scanning machines, aircraft, or other valuable machinery). These loans are usually provided at a discount to the collateral value (similar to the concept of an advance rate in an ABL loan), and they are also typically amortized in advance of the depreciable life of the collateral. Another point to bear in mind when comparing direct lending managers is that the EBITDA metrics of the borrowers are essentially irrelevant for borrowers receiving equipment financings (just as they are for borrowers receiving ABL loans).

Note. Direct Lenders can lend to specific equipment (for example, a single 737 jet) or to a diverse pools of assets (such as all the equipment that comprises a hospital).

4. Special Situations Lending

Many investors misinterpret special situations as distressed lending, predatory lending or part of a direct lending manager's loan-to-own strategy. Such characterizations may be true in part, but usually the loan is simply for a unique circumstance. Following are several examples of the types of circumstances that may constitute "special situations":

a. the borrower needs additional liquidity on a bridge basis to make a fast acquisition;

b. the company needs a short-term loan to bridge it to a high yield offering or IPO;

c. the business was in either an in court or out-of-court restructuring, has now emerged with a more rationalized capital structure and needs fresh capital that primes the previous lenders in seniority (debtor-in-possession ("DIP") financing or rescue financing); or

d. the loan itself is a non-traditional deal structure (e.g., complicated collateral package, government guarantees, intra-transfer financings).

5. Trade Finance

Trade Finance is a close cousin to ABL with the primary difference being that one of the counterparties (i.e., either the borrower or the party on the other side of the transaction who received the product/service and now has a payable to the borrower) is based outside of the borrower's jurisdiction. For example, in a situation where the borrower is a pre-paid phone card company based in Mexico who ships and sells pre-paid cards to Walmart in the U.S., the receivable is coming from a strong, creditworthy U.S. counterparty, and the underwriting is based on the credit quality of the payable.

Note: Historically, many of the leading providers of trade finance were European banks, who have significantly reduced their trade financing business due to the increase in bank solvency-related issues.

6. Bank Loans

Some direct lending managers promote their senior syndicated bank loans as direct lending funds, but they are actually quite different. Given the strict and expensive lending environment that banks face, many of them have opted to leverage their strength in originating into a high margin servicing business. Banks originate larger "bank loans" that are typically rated by a rating agency (thereby giving them a lower balance sheet capital charge), and the banks typically keep the higher quality loans for the benefit of their own balance sheets. Lesser quality bank loans are originated by a bank, and the bank collects the upfront points but sells the yield and risk off its balance sheet to institutional investors. The bank will receive a syndication fee from their leveraged finance division, and it will also continue to service the loan and receive a quarterly or annual loan servicing fee. Syndicated bank loans thus provide an interesting comparison to direct lending.

Direct Lending for Institutional Consideration

A savvy investor may well ask if it is worth the investigation, research and effort to create a new asset class in his portfolio for direct lending. If so, should the allocation come from fixed-income, equities or private equity? In White Oak's informal survey of over 100 institutional limited partners who have direct lending in their portfolios, it emerged that the top three reasons for them deciding to pursue this emerging asset class were:

1. "We need yield, we need yield now and we need help." Direct lending provides attractive risk-adjusted yields.

2. "We need to protect our portfolio from rising interest rates and negative mark-to-

market valuations in our fixed income portfolios." This is not a trivial concern.

3. "Direct lending mitigates the J-curve in our private equity portfolios by having a faster investment period and providing current yield."

Many institutional investors ponder why a business cannot raise debt financing from a bank or the highly fluid publicly traded credit markets – are private loan providers actually "lenders of last resort?"

There are two explanations:

- It is likely that a potential borrower has already applied to a bank or banks and been rejected for a bank loan. The fact that a company is not bankable is not necessarily due to poor credit fundamentals for the underlying borrower, but is more due to the fact that a bank has only so much risk-based capital available to underwrite and hold this type of risk. Loans that are not approved, upsized or refinanced should not be deemed "loans of last resort."
- Not every company would like to receive public financing and would rather keep their financial information private and away from their competition. Most private business owners prefer to pay a relatively higher loan interest rate and protect their financials from the public domain, including their peers and competitors.

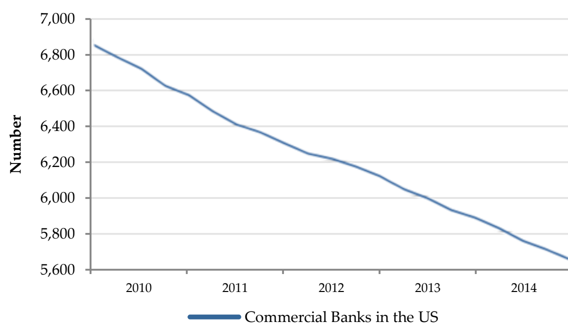
There have been many recent articles that highlight the rationale for why banks are structurally constrained from providing non-rated loans. Assuming that today's current regulatory environment disadvantages banks in making non-rated loans, has this circumstance invited too many entrants, as a result of which yields have compressed? Asked another way, are investors being adequately compensated for the risks associated with private loans? The answer is neither black nor white; rather it is 200,000 shades in between since there are that many small to middle-market businesses in the U.S. It is a fallacy to paint an entire major industry (lending) that is the back-bone of the U.S. economy with the same brush. Individual loans are all unique, and some may be priced in a "frothy" way; yet it is inaccurate to describe the overall lending market as frothy. These individual loans do not trade as an "'index," and they are not tracked holistically, by their place in the capital structure, liquidity, or by any measure of riskiness.

One may categorically state that private equity sponsors have been net sellers of their levered portfolio companies in 2014 (given the high valuations), that private loans are being repaid, and that there is a lot of direct lending capital chasing fewer sponsored deals at a time when the sponsors have slowed down their investment programs or have had to resort to additional leverage to juice up their multiples.

One can also state that banks have shrunk their balance sheets by 30% over the past seven years, and companies that used to borrow from banks are getting turned down for loans. Let's restate this key point: banks have absolutely shrunk their balance sheets by 30%; Dodd Frank has significantly impaired the ability of investment banks to

hold directly originated loans on their balance sheets, and banks are now facing continued pressure to increase their tier 1 ratios and reduce their exposure to high capital charging investment activities, which includes lending to non-rated loans.

COMMERCIAL BANKS IN THE U.S.



Source: Federal Financial Institutions Examination Council (US)

Defining the Size of the Lending Market

Most direct lending managers claim that they lend money to "middle-market" companies. Since there is no set definition for the term "middle-market," and given how large both mid-cap and large-cap companies have become, one could argue that direct lending managers lend money to both small and middle-market companies. The reason most direct lending managers are reluctant to categorize their borrowers as "small" is that "small" could be deemed to be more "risky" and could be mistaken to include a loan to the local gas station owner vs. a loan to a small-cap firm with a US$250 million market value. In this paper, the market is divided into three categories:

- **Small middle-market** (referred to as SMEs): companies with revenues between US$10 million and $500 million;
- **Middle-market:** companies with revenues between $500 million and $2.0 billion; and
- **Large middle-market:** companies with revenues between $2.0 billion and $7.0 billion.

The SME segment is a significant driver of the U.S. economy, encompassing approximately 200,000 companies with revenues between $10 million and $2 billion.[1] These companies collectively employ 78 million people, or 65% of the 120 million-strong U.S. work force.[2] White Oak estimates that there is approximately $1.5 – $2.0 trillion of outstanding debt in this market segment and that less than 20% of these companies are sponsored. Many are technology-oriented or have some unique asset that is attractive to an external equity provider. Non-sponsored companies tend to be smaller, or the owner sees high potential growth rate for the enterprise and does not want to dilute his/her ownership. These entrepreneurs appreciate the value of meeting their capital needs through a private loan that will typically be used for capital expenditures and other growth initiatives.

[1] http://www.middlemarketcenter.org/

[2] United States. Census Bureau. Washington: GPO, 2007. Print.

How to Better Understand Lending Managers

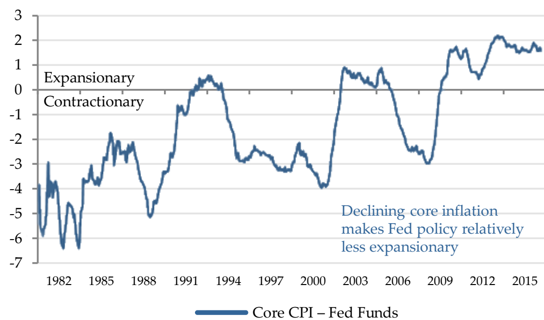
Institutional investors evaluating direct lending managers should keep in mind the following considerations:

- Each loan is unique, and how a manager sources, underwrites, structures risk mitigation (e.g., covenants), and prices the risk is dependent on:
  - the origination channel and the competitive landscape for how a particular loan was sourced;
  - the manager's risk tolerance and how creative a lending manager may be in mitigating risk through the credit's structure;
  - the underwriting skill set of the manager; and
  - exposure to circumstantial events; sometimes it is difficult to underwrite to shocks to the system, regulatory changes, or volatility in commodities pricing, and not all risks can be mitigated all of the time.
- Loan qualities generally are not static. Both private and public credits become more or less risky over the tenor of the loan because they are dynamic. One single contract may be the tipping point for a loan to be deemed "safe" versus "risky."
- Private loan managers should command a higher yield than an equivalently priced risk in the publicly traded market (due to the lack of liquidity for the loan; in other words, there is an illiquidity premium). The better arbitrage is to receive an illiquidity premium and achieve a better credit rating relative to a publicly traded loan. If institutional investors are unable to receive a net illiquidity premium (after paying management fees) that is 100 to 400 basis points higher than an equivalent publicly traded loan or bond, then the investor is buying beta. Beta may not be a bad strategy in an environment in which spreads may widen (i.e., inflationary) since it offsets the mark-to-mark risk that will be experienced in publicly traded credit markets. The best deal in the market is to find private loans that provide such an illiquidity premium where the beta trade is also part of the package.
- Lastly, there will always be banks, bankers, direct lending managers and all other types of investors that "get it wrong" and do not price risk appropriately in any market condition (deflation, stagflation or even inflation). Just because a manager is unable to price risk appropriately because they are fishing in an overcrowded pond does not mean that it is the only pond out there. Nor does it mean that the manager made the right decision not to return the funds or fully deploy the allocated capital.

Like any market, private loans are demand- and supply-driven. The better the economy, the more the need for financing growth accelerates. On the other hand, if the economy enters a down-cycle, banks may become more restrictive in their lending capital base, and borrowers will face less availability for bank loans. Therefore, there is

no perfect time to lend money; this is an ongoing business dynamic occurring all the time. Loan maturities come due from both healthy loans and challenged credits during all market conditions and cycles.

LOWER INFLATION TIGHTENS FED POLICY



Source: Evercore ISI

When inflation accelerates and LIBOR-based credit prices rise, yields become more attractive, and more investors reallocate their portfolios to take advantage of the higher yields. Of course, as new investors allocate to credit to take advantage of increasing rates, then spreads get tighter again. If the economy falters and less capital is circulating in the economy and banks continue to de-lever, the bond and loan price spreads widen, and investors may be worried about the economy and the rest of the world, thus deeming private loans to be more "risky," and because these are loans to middle-market companies, there is a false perception that these loans may lose more value relative to larger and more stable companies. This is not always the case. Being smaller and more nimble allows many middle-market businesses to adjust to evolving market conditions more efficiently and to be in a better position than a slow-moving, larger corporation.

When the economy slows down, over-levered companies may deteriorate in credit quality or go into default, no matter what the size of the company is.

There is no "right," "wrong" or "optimal" time to lend capital to middle-market businesses. Some institutional investors may deem a period in which the U.S. economy is contracting to be a good time to go into direct lending because the yields (and the risk) are higher. It is very difficult to "win-over" either institutional investor psychology or the powerful media with its influence on investor sentiment. **The bottom line is that good loans that are priced appropriately to their unique risks, and not overly levered, can be made in any market environment; good credit underwriting, manager selection and portfolio diversification are the key metrics to consider at all times.**

Lender Profiling / Tools to Evaluate Managers

Many investors like to put managers and the types of loans they underwrite into categories, thinking that one category may be more or less attractive or risky than another (e.g., large sponsored deals vs. smaller middle-market unsponsored deals; or cash flow loans vs. asset based loans).

Here are some of the categories that institutional investors use to profile managers, regardless of the size of the companies in which they invest:

“All over the debt capital structure” loans
Asset based Loans (ABL)
Cash-flow loans
Debtor-in-possession and rescue financing loans
Distressed or special situation loans
Equipment Loans
Mezzanine loans
Middle-market sponsored loans
Senior-secured loans
Senior-secured subordinated
Syndicated loans
Unitranche loans

Institutional investors with varying degrees of sophistication in the lending markets need to cut through the noise and make good risk-adjusted investment decisions on managers and the types of loans they underwrite. If there are twenty managers that reiterate that sponsored deals are safer than non-sponsored deals, or if there are twenty managers that reiterate that sponsored loans are overly leveraged, with no covenants and priced too tight, who is right?

Adding to the mix of pitches, institutional investors are also seeing validating presentations that make a compelling case that the world will end and that the economy is on the edge of a cliff; thus, the best product is a ten year fund with a 4 – 5 year investment period that is ready to invest when Armageddon Day arrives. All these presentations can be quite compelling to an investor. After all, the supposed advent of Armageddon and Doomsday are powerful arguments!

Some of the most successful investors in our era, including Peter Lynch, the “Wizard of Omaha” and George Soros, follow a consistent theme: that is, to stick to the fundamentals and remember that the clock does strike twelve twice a day, most of the time. What are the right fundamentals for credit? Let’s look at two basic categories, optimal and sub-optimal:

Optimal	**Sub-optimal**
1st Lien senior secured loans	Junior lien loans (2nd lien, subordinated, or mezzanine)
Low leverage ratio (multiple on EBITDA to be 4x or less)	High leverage ratio (multiple on EBITDA to be 4x or more)
Tight financial covenants	Covenant light or limited financial covenants
Shorter duration loans with amortization or cash flow sweeps (5 years or less)	Longer duration loans with a bullet payment upon maturity (5 years or more)
Conservative loan to value or orderly liquidation value	Aggressive loan to value or orderly liquidation value
Original credit underwriting	Reliance on 3rd party data room
Pricing risk appropriately and providing an illiquidity premium	Being in a highly competitive process and being a price taker
Directly originated loans	Syndicated loans or Club deals

The above metrics can be a road map to evaluate the riskiness of a borrower, regardless of size, sponsorship or the mix of loans that a manager has developed in their previous portfolios.

These optimal credit metrics have not changed for centuries and will be the gravitational force for what all credit managers ultimately want: a loan that gets repaid. This back-to-basics approach is simple and rational.

Some of the other credit considerations for evaluating managers include:

Illiquidity Premium

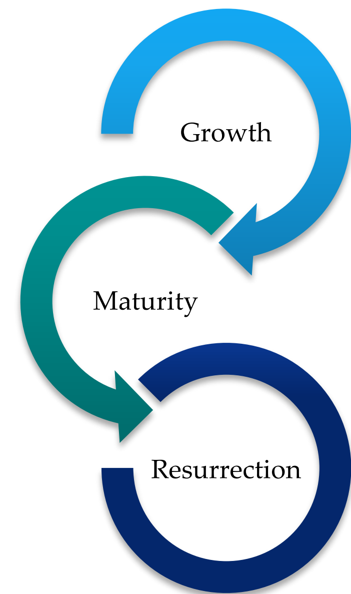
Is the manager providing an illiquidity premium for locking up capital for a period of time? If today one were to buy a publicly traded low-rated bond (S&P rating of CCC), the interest rate for this type of bond pays anywhere between 8 to 10%, generally. If the private loan manager is asking the investor to lock up their capital for a 6- to 8-year period, there should be an illiquidity premium after management and performance fees, and the amount of that premium should depend upon the risk differential between that CCC rating and the credit rating that the private loan would have if it were rated. For example, if the private loan manager underwrites a (private) B-rated loan at 8%, and the CCC loan is paying also 8%, and then after management fees and performance fees the private loan return drops to 6.75%, the investor needs to realize that they are giving up liquidity for that 6.75% return for a period of time; for the sake of this example, let's assume six years. This giving up of liquidity is both a blessing and a curse: the curse is that there is negative illiquidity premium, and the blessing is that if spreads widen, the publicly-traded CCC loan can have a negative carry as compared to the private loan which will not be subject to that same level of volatility.

Fragmented Universe

The lending universe is large and highly fragmented. White Oak estimates that there are 200,000 companies in the U.S. alone that have enterprise values between $10 million and $5.0 billion. There is a pyramid effect in these numbers where the larger companies comprise the top of the pyramid and the smaller businesses represent the base. Nevertheless, White Oak estimates that less than 20% of this constituent base of 200,000 businesses may have some level of sponsorship or parent; over 80% do not.

Dynamic Market & Dynamic Companies

Not only is the market highly fragmented, but direct lending managers and banks are lending to companies that are also dynamic and face varying continuous life cycle changes. One truism for lenders is that companies are never static: they are always going either up or down. "Big" can quickly become "small" and vice-versa; a healthy loan can become distressed; the senior lender can become an opportunistic private equity investor upon foreclosure; and small businesses can grow and prosper efficiently. Uber is a new kind of taxi service that did not exist four years ago and today has a market cap that exceeds US$20 billion, whereas Kodak, a company that had long



dominated an industry with one of the most recognizable brands globally with an elaborate balance sheet and capital structure was shattered within a year.

Some direct lending managers financed the production of the batteries for Tesla vehicles, and that loan may be performing better than the publicly traded bonds of Chrysler (what was assumed to be a large and stable company). One institutional investor decided not to invest with a particular manager because that manager made a loan in 2009 that was secured by the servers of a company that the investor wasn't familiar with – a company called Facebook. It was an equipment loan with rapid amortization and a parent guarantee; so why did the investor balk at the opportunity? Because it was a negative EBITDA technology company, and it was deemed to be too risky. A key takeaway is that a small and growing business can ultimately be a higher quality credit than a large, established borrower.

Default Rates

Banks have loss reserves for a reason. Direct lending managers, on the other hand, have no loss reserves, and no losses are ever acceptable. Institutional investors investing in direct lending funds of all types have to accept that losses do happen, however. So the question is not "if," but rather, "when, how much and what is the recovery rate?" A direct lending manager makes a loan to a company at a certain point in its evolution, and by the time the loan is repaid (early, at maturity or in default), that borrower is likely to be at a different point in its evolution or "lifecycle." Some of this may be attributed to economic fluctuations, regulatory changes, bad credit underwriting or simply an underperforming management team. Not only do businesses go through lifecycles, but they also orbit around a local and global economic cycle. Some small companies thrive in contracting markets while larger, over-levered companies may be brought to their knees regardless of whether the economic environment is experiencing inflation, deflation or stagflation.

So how should one evaluate a direct lending manager's loan loss record? Without market statistics or a benchmark, this is a difficult task. Looking to other markets in which statistics are available gives only a rough yardstick of comparable performance. Junk bonds have a historical default rate of approximately 5% with a 50% recovery rate (or 2.5%). Bank loans have a historical default rate of 70 basis points.

CHARGE-OFF RATES FOR BANK LOANS Q1 2004 – Q3 2014

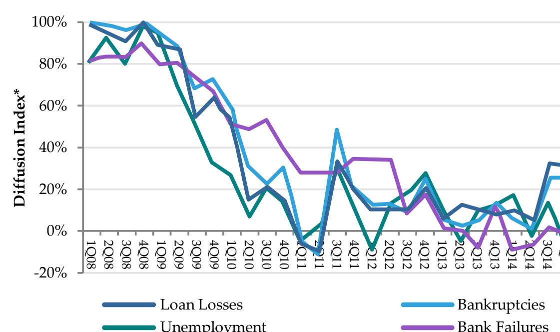
C&I are for all Commercial Bank Loans, and "Total Loans and Leases" includes Real Estate Loans:

All Banks	C&I loans	Total loans and leases
Q3 2014	0.19	0.46
Q2 2014	0.21	0.51
Q1 2014	0.24	0.55
Q4 2013	0.25	0.55
Q3 2013	0.26	0.62
Q2 2013	0.31	0.74
Q1 2013	0.37	0.86
Q4 2012	0.35	0.92
Q3 2012	0.46	1.22
Q2 2012	0.55	1.13
Q1 2012	0.57	1.21
Q4 2011	0.70	1.35
Q3 2011	0.72	1.55
Q2 2011	0.87	1.67
Q1 2011	1.13	1.96
Q4 2010	1.37	2.28
Q3 2010	1.67	2.52
Q2 2010	1.82	2.85
Q1 2010	1.96	2.97
Q4 2009	2.56	3.03
Q3 2009	2.48	2.86
Q2 2009	2.37	2.67
Q1 2009	1.80	2.05
Q4 2008	1.44	1.94

All Banks	C&I loans	Total loans and leases
Q4 2009	2.56	3.03
Q3 2009	2.48	2.86
Q2 2009	2.37	2.67
Q1 2009	1.80	2.05
Q4 2008	1.44	1.94
Q3 2008	0.95	1.56
Q2 2008	0.85	1.27
Q1 2008	0.69	0.99
Q4 2007	0.69	0.76
Q3 2007	0.44	0.60
Q2 2007	0.44	0.53
Q1 2007	0.39	0.52
Q4 2006	0.30	0.39
Q3 2006	0.31	0.44
Q2 2006	0.29	0.41
Q1 2006	0.25	0.39
Q4 2005	0.26	0.53
Q3 2005	0.23	0.59
Q2 2005	0.26	0.49
Q1 2005	0.30	0.53
Q4 2004	0.37	0.52
Q3 2004	0.43	0.54
Q2 2004	0.57	0.63
Q1 2004	0.77	0.70

LOAN LOSS, BANKRUPTCY, UNEMPLOYMENT & BANK FAILURE EXPECTATIONS

Next six months



*% of positive responses minus negative responses

Source: 2014 Phoenix Lending Survey

There are no general data, benchmarks or statistics available today that highlight the default rates and recovery rates for both banks and direct lending managers.

Theoretically, direct lending managers' loss rates should fall somewhere in between the available benchmarks for high yield and bank loans (i.e., somewhere between 0.70% and 2.50%). Of course, context is everything, and one has to ask: were the manager's losses generated in a loan portfolio that went through the economy's down-cycle or in a market when the sun has always been shining?

Some consultants have attempted to come up with their own analysis of loan loss rates for the managers they evaluate, but this requires a large number of data points over a long period of time. Other subjective considerations include whether managers self-report the populated data in a consultant survey only from their best funds or their most recent funds, whether they include their

SMAs and whether the loans they report were considered from inception.

	3Q2014			4Q2014		
	Up	Down	Same	Up	Down	Same
Corporate Lending	31%	10%	60%	32%	5%	63%
Middle-Market Lending	26%	7%	67%	34%	5%	61%
Small Business Lending	38%	14%	48%	37%	15%	49%
International Lending	19%	19%	62%	20%	20%	58%

"Expectations largely remained unchanged in 4Q 2014, as lenders expect a mild increase in corporate and middle market and a mild decrease in small business and international. Thirty percent of respondents view the entire lending universe as improving compared to Twenty-nine percent of respondents in the previous quarter. The overall lending diffusion index increased to twenty percent from sixteen percent in the prior quarter's survey. The domestic lending diffusion index rose as well this quarter, increasing five percentage points to twenty-six percent. The diffusion index for international lending maintained its diffusion index at zero percent."

Source: 2014 Phoenix Lending Survey

Brand Name Transactions and Access to Deals

Many direct lending managers highlight their unique access to certain "flashy" deals or to leading sponsors. Having access to the next mega-buyout and the exciting momentum this carries in presentations should be evaluated with caution. Some of these deals will ultimately be successful, while others have a much harder fall. Sticking to the principles of the credit, without getting caught up in headline deals, will yield the best results. Having 24 or 48 hours' advance look at J.P. Morgan's next $400 million deal does not give a real competitive advantage. If that deal were as attractive as it sounds, the J.P. Morgan investment bankers and structured finance professionals would have sold that loan to their best customer, the bank's own balance sheet.

Management Quality

Direct lending is a services business. As with any service provider, a direct lender is judged not only by its performance, but also by the quality of its people who deliver the service to its clients. A direct lender's clients fall into two categories: borrowers who need financing and investors who are seeking yield. When evaluating managers, it is not only absolutely critical to determine whether they are good investors, but also to evaluate whether they are good people. The lending business is both professional and personal, and as such, it has a closer feel to real estate investing (where each transaction is unique) than it does to investing in publicly traded equities. From the perspective of the borrower, if a private loan goes into default, the lender has various rights and remedies to

protect its investment, including the right to foreclose on the asset. This fact creates a "personal" relationship between the lender and the borrower and is similar to being in a predefined engagement with a stated term. "Gun slinging" direct lenders who use overly aggressive approaches to fluid situations may actually cause adverse consequences both for themselves as well as for the borrowers. As part of the due diligence process of evaluating direct lending managers, institutional investors need to feel good about the culture of the organization and the emotional maturity that a direct lender brings to bear in difficult situations. In this respect, an investor's "gut feeling" is the most important factor.

Infrastructure

Large banks today spend hundreds of millions of dollars patching their old legacy loan systems so that they function. With today's available technology, a direct lending manager can spend $5 – $8 million for a loan processing system that is the same, if not better, than the systems used by the largest banks in the world; plus, all of the data may be available in the Cloud. The key takeaway here is that the direct lending managers in this space need to have the requisite systems. Direct lending has the following technological requirements:

Loan administration and processing	Interest payment reconciliation	Cash processing: amortization, cash flow sweeps, delayed
Performance reporting	Calculating a NAV	Loan accounting engine
Middle-ware systems	ABL systems for daily advance rate monitoring and collections	Risk management and capital allocations

Smaller managers may perform many of these functions in Excel, and after a certain number of loans, this methodology will face limitations. Not until recently have there been systems offered by best-in-class service providers to streamline many of these functions for non-banks that lend money not from their corporate balance sheets, but rather through funds and separately managed account structures. The sophistication of the back- and middle-office of a manager will reveal a lot about where a particular lender is in their evolution.

Pricing risk

How does one price risk? This is the single most challenging and misunderstood aspect of direct lending. It can be based purely on fundamentals, or it can be based on market forces. Ultimately, it is driven by supply and demand. Price parity and pricing risk in direct lending is as much an art as it is a science. A mediocre or bad credit can suddenly become an attractive opportunity based on macro-related events or a single new contract. When evaluating managers, it is important to assess their track-record and

to look at the consistency of leverage ratio to yield, where the loans are in the capital structure (1st lien vs. 2nd lien) in relation to yield, and other fundamental credit risk attributes. Another way to determine pricing risk is to have a comparison to a benchmark (e.g., LCD plus a spread, or the bank loan market plus a spread). If a particular direct lending manager is pricing risk that is similar to a BB bank loan and is not accounting for an illiquidity premium on a relative basis, then perhaps the particular loan is not being priced appropriately. The pricing of direct loans may vary based on the size of the borrowers (small middle-market or SME, middle-market or large middle-market) and where the loan is in the capital structure of the borrower.

PRICING RANGE FOR 1ST LIEN SENIOR SECURED LOANS

Yield Attributes	SME or Small Middle-market	Middle-market	Large Middle-market
Up-front	1-3%	1-2%	1%
Coupon	8-12%	6-10%	4-8%
PIK/OID	1-3%	1-2%	None
Warrants	Sometimes	Rarely	Never
Target Gross Yield	10-13%	7-10%	5-8%

PRICING RANGE FOR 2ND LIEN OR JUNIOR LOANS

Yield Attributes	SME or Small Middle-market	Middle-market	Large Middle-market
Up-front	1-3%	1-2%	1%
Coupon	9-13%	7.5-11%	5-9%
PIK/OID	1-5%	1-4%	1-2%
Warrants	Sometimes	Rarely	Never
Target Gross Yield	11-14%	9-13%	6-9%

Management and Performance Fees

Direct lending managers used to have the same fee structures as mezzanine fund managers: a 2% management fee on committed capital and a 20% performance fee above a hurdle rate of 8%. In today's market there has been significant fee compression in the direct lending space, and the average management fees have come down significantly for two key reasons: (1) the entire investment management space has experienced fee compression and (2) there has been an advent of direct lending managers into the space that has created competition among managers that want to grab market share, thus further compressing fees.

What should institutional investors expect to pay? The results from White Oak's informal survey of over 100 institutional investors suggests that investors prefer that management fees be based on invested capital, not committed. The management fee ranges between 0.85% and 1.50% based on both the size of the commitment and the size of the manager, and the performance fee is typically approximately 15%. The hurdle rate for most direct lending managers is approximately 7.00% with a 100% catch-up. Some direct lending managers focus on investing in investment bank-originated clubbed syndicated loans where there may be one to eight managers who participate in the loan. In this type of investment strategy where a lot of the "heavy lifting" is done by the investment banks lower management fees may be merited.

Tax Considerations

Direct lending managers that utilize leverage to meet their portfolio return objectives are subject to tax on their unrelated business taxable income (commonly called "UBTI"), and the levered part of their return may be subject to tax withholding.

Non-U.S. investors in jurisdictions that do not have a favorable tax treaty with the United States are also subject to ECI (Effectively Connected Income) tax, and managers that originate their own (newly issued) loans are subject to this withholding. There are typically two ways to mitigate ECI: (1) a blocker structure in which there are both equity and debt tranches in the investment and the equity tranche is subject to tax and (2) a season-and-sell structure in which the newly originated loans are made through an onshore vehicle that owns the loans until they are deemed to be seasoned, at which time the loans are sold to an offshore vehicle. While this structure may mitigate 100% of the tax, it has been under increased scrutiny from the Internal Revenue Service. Because the season-and-sell approach is a tax "safe harbor," as opposed to a codified list of regulations under the Internal Revenue Code, the analysis conducted by the IRS is very fact-specific. If the tax authorities audit the structure or the fund, there is a risk that it may be subject to 100% withholding.

Performance and Valuation Methodology

Determining the investment performance information for direct lending managers in comparison for publicly traded fixed income investments is challenging. Why? In publicly traded fixed income markets, pricing is more efficient, and liquidity is higher. Most bond pricing comes from third parties and are deemed Level 1 in the liquidity spectrum. Bank loans and other types of fixed income securities that are either owned in a Reg D / Rule 144A offering or are closely held are deemed to be Level 2 securities, which means that while there may be a broker quote, the security is thinly traded. Private loans are Level 3 securities (which highlights their illiquidity) and have to be marked either by the manager's own internal valuation group to assess fair market value, or by an external third party valuation firm, or both (an internal mark and an external mark). The valuation policy of a firm will determine both the price volatility of the portfolio and whether the valuations are being made conservatively or aggressively. Most funds will engage a reputable auditing firm that will provide an additional set of eyes and bring another layer of objectivity to the valuations for private loans. The Securities and Exchange Commission (SEC) is providing further guidance to the auditing firms to provide more market-based pricing in determining the fair market value of a private loan. While it is difficult to select a perfect benchmark for private loans, managers may come up with their own "cocktail" blend of securities that may be utilized as a benchmark (e.g., the Bank Loan Index plus 200 basis points).

There are many experienced third party loan valuation firms that direct lending managers use, including, but not limited to: Navigant Consulting, Houlihan Lokey, Duff & Phelps, and Lincoln International. These valuation

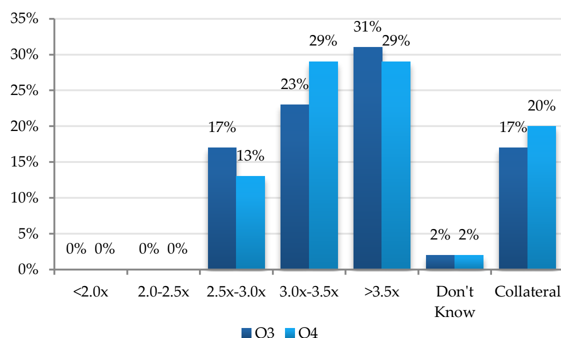
firms work with direct lending mangers on a per loan fee basis and provide an independent mark, typically on a quarterly basis.

Is Direct Lending Overcrowded?

The answer is not a binary yes or no, rather, it is a customized answer for each individually underwritten loan. If a particular loan is not priced appropriately for its risk – or the yield does not fully capture the credit risk — then that loan may be more risky than publicly traded debt, or when it is compared to another loan that has its own unique attributes.

In one particular deal where eight direct lenders are driving the yield lower and the leverage ratio higher for a $100 million loan, then one can certainly argue that direct lending is “hot” or overcrowded. There are other deals that are being done at a 1.25x leverage ratio yielding 11.5% for a 1.5 year $100 million term loan. The real answer is that the lending market is highly fragmented, and there are a lot of fish in the sea.

LENDERS’ HIGHEST MULTIPLE OF SENIOR DEBT TO EBITDA



Source: 2014 Phoenix Lending Survey

Some investors may decide not to participate in the direct lending market because it is over-crowded or it is a hot area. If banks could have printed presentation books and private placement memoranda and solicited institutional investors to invest in their balance sheets over the past two decades, perhaps this perception would have been different. The reality is that, yes, there is a disintermediation of banks happening today, and banks did raise a significant amount of money, mostly in the form of bond offerings and follow-on equity offerings. That is part of the reason that banks found themselves with balance sheets that were so much more highly levered than they are today.

This supply and demand imbalance has attracted new entrants to the market. The market is highly dynamic and fluid. Banks do not like to lend to dynamic businesses; they are not set up for this type of underwriting. The private credit markets are going through a structural change, and there is now more transparency for the performance of private loans – more than the banks have ever dared to share.

On a relative basis, direct lending is a very attractive market. One could ask, “Where else would you want to put your capital today?”

- Cap rates are compressed in real estate. In many markets the cap-rates are much lower than the borrowing costs.
- Private equity groups have been net sellers of their legacy investments and are having a difficult time making new investments.

- The stock market is at an all-time high, and growth rates are lower than their PE ratios.
- Credit market yields are super-tight.
- Commodities are on a high octane roller coaster ride.
- Europe is still in recovery and for some reason the Spanish 10-year bonds are yielding lower than the U.S. 10-year bonds.

Direct lending is topical, and the asset class continues to entice new entrants. The fundamental opportunity is, however, that banks now have to face a slower growth rate environment. If for example, due to the increase in tier 1 capital ratio requirements there is estimated to be $1 trillion that has to go into the capital reserves of the top 500 global banks, then 15 times $1 trillion is the amount by which banks would have been able to leverage that $1 trillion and loan to borrowers over time.

White Oak estimates that there is approximately $270 billion in direct lending today (including the private funds and BDCs). Will certain sponsored deals create a feeding frenzy among some direct lenders? Certainly. There are a lot of fish in this sea, and painting the entire direct lending space as "overly crowded" or spreads as "tight" are self-assuring statements. The U.S. economy is primed for lending, now and in the foreseeable future. The primary reason is that it has the right legal infrastructure – strong innovation creates opportunities for small and middle-market companies – and unfortunately it is a culture that thrives on credit. From a fundamental credit perspective, the reason that direct lending is not overcrowded is simply that there is an imbalance between supply and demand in the capital structures of both U.S. and global banks.

U.S. vs. European Direct Lending

The same macro fundamentals exist in Europe as they do in the U.S. with the big differences being that the U.S. has a much larger middle-market lending market with a more homogenous legal framework that is easy to understand, more user friendly to a lender looking to enforce its rights, and more efficient. For example, the more straightforward countries from a legal framework are places in which English Common Law is practiced: i.e., the U.K and Ireland. As a lender, it is relatively much more difficult to foreclose on assets in Italy, Spain, Greece and France. This legal or cultural framework makes the pricing of risk more difficult for direct lending managers.

Germany is the big unknown. Lenders recognize the breadth of the market opportunity in Germany, yet there have been very few European direct lenders that have successfully loaned money to German companies in any meaningful volume. White Oak analyzed the size of the borrowers in the German market and came to the realization that, unlike the U.S. where the size of borrowers is a slightly flattened bell curve, the German marketplace has a reverse bell curve in which there are many large companies and many small companies, but there is a much smaller middle-market.

The other notable concern related to lending to German- and Swiss-based borrowers is that under many Civil Law systems (as opposed to those founded on English Common Law) a lender is unable to secure a floating lien on a borrower's changing inventory. For example, a lender may be granted a lien on the inventory in a specific warehouse at the time of the loan, but as the inventory changes, the lender will not have a security interest in the replacement inventory. Unless the lender performs frequent inventory checks and perfects the security interest in the modified collateral, the replacement inventory will not be captured by the lien documents.

There has been a long-standing tendency away from private debt in Europe, and as a result, private debt is not as well established in Europe as it is in the U.S. This has presented an uphill battle for the lender that wants to serve the financing needs of businesses and price risk appropriately, but this attitude is slowly changing as bank financing is less readily available. The other market segmentation that is a differentiator between the U.S. and Europe is that there is a greater concentration of larger companies in Europe relative to their GDP, while the U.S. market has a much broader segment of middle-market businesses.

There are major uncertainties for the European economy and currency at this time. Many currency experts believe that the Euro will achieve parity with the U.S. Dollar. If this does in fact happen, it may be worthwhile to monitor the following European events:

- the Euro's situation (will it depreciate relative to the U.S. Dollar?);
- Germany's relationship with, and reliance on gas from, Russia (and the potential impact to the German economy);
- the potential for Greece to exit the Euro and the potential that might have on the rest of Europe; and
- Switzerland's currency and its potential ripple effects on the Euro.

There are certainly good opportunities in Europe and institutional investors should consider building diversified portfolios over time that include U.S. and European managers.

Definition of a Good Credit

The best definition of a good loan is one that gets repaid. Most credit managers will agree on the following credit metrics that make one loan better than another:

- Back to the basics: Good product and service offerings managed by an experienced management team.
- Loans that are on top of the capital structure (first lien loans), asset-based loans, or loans that have a direct lien on a particular asset (equipment financings) vs. second lien loans or mezzanine.
- Shorter duration loans will give the lender better visibility in the collateral values and cash flows of a business.
- Lower leverage ratios (conservative leverage ratios, being defined as the loan size relative to a multiple of its EBITDA, range from 1x to 4x; and more aggressive leverage ratios are 5x and up).

- Simplicity in the capital structure. Some companies will have a complicated capital structure: ABL, a senior lender, second lien, mezzanine, subordinated secured lenders, unsecured lenders and trade creditors.
- Borrowers that are less susceptible to economic shifts (e.g., consumer discretionary).
- Loans in which the lender can structure covenants and protections around the loan so that if the covenants are breached, the lender will have control rights over the appropriate course of action.
- Loans that are made to a diversified pool of cash receivables (that have a demonstrated track record of paying on time).

Whether to Lend to Private Equity Sponsored Portfolio Companies?

Historically, most of bank lending has been to non-sponsored businesses. In fact, out of approximately 350,000 small and middle-market businesses, White Oak estimates that less than 20% of them have some level of sponsorship (in other words, most of the loan volume conducted is to non-sponsored borrowers).

The untold truth about lending to sponsored businesses is that if private equity sponsors had a 100% hit rate on successes in their portfolio companies, then institutional investors would allocate 100% of their portfolios to this asset class. The reality is that typical sponsored portfolios will turn out 20 – 30% winners, 30 – 40% middle-of-the-fairway multiples, and 20 – 30% losers that the sponsor "will not back any further." Yes, you may have heard this for the first time: "Sponsors usually will not back their loser investments with additional capital or bail out the lender in dire times." A good way to verify this statement is to look at the track record of established mezzanine fund managers and determine default rates, recoveries and the percentage of their portfolios that the sponsors did not continue supporting.

The big benefit to the institutional investor and the managers that focus exclusively on sponsored loans is that since these loans are typically longer in duration (six to eight years), and as there are typically few, if any, covenants to breach, the problem loans will not appear for a long time and both the sponsor lender and the institutional investor can look great for many quarters, and even years, before they start to deteriorate. Be wary of private debt managers that show track records of their sponsored deals where not all the capital has been returned. Those stragglers may be the loans that the sponsors will not back any longer and that will need to be restructured.

Sponsor-focused direct lending managers also do not typically underwrite asset-based loans (ABL) or equipment financing loans. Please note that underwriting a loan that is based on a diversified pool of cash receivables (ABL) is a much easier process, and typically a more conservative credit, than making a term loan to a sponsored company.

Let's summarize the Pros and Cons of lending to sponsored vs. non-sponsored businesses:

The Pros include that underwriting is streamlined, and the private equity sponsor has an established data room that has most of the diligence information readily available. Another benefit is that the sponsor has a vested interest in improving the performance of the company with the hope of an exit within a 3- to 6-year time frame. Lastly, if the portfolio investment underperforms, there is presumably the potential for the private equity sponsor to invest additional fresh capital into the business to preserve the equity value.

The Cons include the following:

- Given the streamlined underwriting, the lender to the sponsored transaction has limited time and access to further diligence the borrower and at times has limited access to its management team.
- Most sponsors run a highly competitive process to find the lender that will provide them the longest duration loan, the least amount of covenant restrictions, the lowest yield and the highest amount of leverage possible. As illustrated in the Appendix, the majority of U.S.-based direct lending managers are focused on sponsored deals, so that most transactions have 5 to 10 lenders negotiating among themselves on these important credit attributes in order to win the deal. Claims to have special access to sponsors may sometimes be true, but the direct lending manager will not be performing their fiduciary duties unless they negotiate the most favorable terms possible for their investors.
- The universe for sponsored deals is much smaller than that for non-sponsored.
- In the event of a deterioration in the credit, there is absolutely no certainty that the sponsor will step up and provide additional capital. It is usually a binary outcome, and there are many factors that come into play when the sponsor is considering whether to make an additional infusion of equity, including: (a) if the sponsor believes that by making the incremental cash investment, he will realize an attractive multiple on the combined investment; (b) if the sponsor has any additional available cash; (c) if the sponsor has had some major homeruns in their portfolio, they may less motivated to invest more capital to maximize the returns; and (d) lastly, the culture, profile and relationship that a particular partner at the sponsor may have with the lender may all influence the ultimate outcome of a deteriorating investment circumstance.

Cash Flow Loans vs. Hard Asset Loans vs. a Combination

Most sponsored deals are cash flow loans and are evaluated as a multiple of EBITD or EBITDA. From what White Oak as observed in the marketplace, most of these loans are asset-light, with leverage ratios ranging between 3x and 8x (with a midpoint of 5.5x). For example, if a borrower has an EBITDA of $20 million at a 5.0x leverage ratio, the loan balance may go up to $100 million. White Oak estimates that most of the current private equity sponsored deals that are being done

today are being done between 5x and 7x EBITDA.

Non-sponsored cash flow loans are also underwritten primarily as a multiple of EBITDA, but the leverage ratio (or multiple) is typically more conservative and may be underwritten anywhere between 1x and 4x in today's pricing.

Hard asset loans may or may not have a sponsor and are typically underwritten as a percentage of the loan to the total value of the asset or business. For example, if a loan is made to a company with heavy infrastructure (property, plant and equipment) the analysis may be made on:

1. Loan to value (LTV)

If the collateral is appraised at $100 million and the LTV is 50%, then the loan balance may be $50 million. LTV is usually viewed by a lending manager as selling the asset based on current fair market values.

2. Loan to orderly liquidation value (OLV)

If the collateral has to be sold inside of six months, there is usually a discount applied to the collateral value and the loan to OLV will be at a higher ratio than the LTV. In the same example, if $100 million of assets has to be sold within six months then the value of the asset may be only $80 million, and a $50 million loan balance will make the loan to OLV 63%.

3. Forced liquidation value (FLV)

FLV applies if the asset has to be sold within 30 days (auction). FLV is the most conservative analysis as most investors would prefer not to sell anything at "fire sale" prices.

Some loans, whether they are sponsored or not, will be analyzed on a combination of leverage ratios and asset value testing (whether it is LTV, OLV or FLV). There is no perfect formula to make a certain leverage ratio combined with an asset value yield a good loan. There are many variables that go into this analysis, and each loan needs to be analyzed and stress-tested based on its own merits.

How to Evaluate Managers

Key takeaway: Be dogmatic and cynical. By concentrating due diligence efforts in the following areas, the institutional investor will better determine:

- Differentiation in origination channels.
- Track record (loan by loan from day one).
- Is the track-record time tested? Many portfolio managers have not experienced a full market cycle including the severe downturn that took place between 2008 and 2010.
- Credit underwriting (original work vs. reliance on others populating a data room).

- Getting paid for risk and illiquidity (why lock-up your capital for the same yield as a publicly traded bond?).
- Really understanding the types of loans being underwritten (ABL, term loans, equipment loans, sponsored loans, non-sponsored loans, special situation loans, etc.) and understanding the unique risks associated with each of these types.
- A good feel for the firm's culture and its people.
- Investment process and focus on risk management.
- Having meaningful portfolio management expertise (many new entrants have never actually managed the assets and liabilities of a fund previously).
- Remember that a leveraged direct lending fund is a double-edged sword.
- Direct lending is a heavy infrastructure business. Keep in mind a bank's infrastructure, and make sure that the institution has the technology systems, investment processes and loan administration services to perform these functions. Outsourcing doesn't solve all the internally required systems required to monitor, process, and administer the loan programs and the investment vehicles (e.g., a fund structure or an SMA).

Investment Implementation in Private Lending

Providing loans generally falls into the following steps:

- origination and sourcing;
- underwriting and due diligence;
- portfolio construction, risk management; and
- monitoring.

Origination and Sourcing:

Members of the origination team provide the core relationship between the lender and its borrowers. Due to the smaller size and broad geographical dispersion of borrowers, a successful origination team actively networks with local business brokers, boutique investment banks, and sometimes even commercial bankers. The primary task of the origination team is, however, to ensure that the borrowers' needs are aligned with the lender's investment mandate.

During times of capital scarcity, competition among lenders is limited, and they enjoy great latitude in structuring deal terms. When liquidity is abundant, a lender's ability to control deal terms tends to be diminished. It should be noted that the current size of borrowers' unmet capital needs far exceeds the capital available to them, which largely accounts for the stability of yield in the private debt market today.

Originating private loans directly with non-sponsored borrowers can be a time-consuming process, but it has distinct benefits. These include the ability to customize the loan, tailor covenant levels and achieve higher interest rates and fees that have low correlation with public market rates. By working directly with non-sponsored borrowers, the direct lender can negotiate terms that mutually benefit both parties, without interference from a sponsor who may ultimately be focused on the interests of a different set of investors. Sponsored loans, on the other hand, require far less effort by the originations team. Sourcing may be made from the following channels:

- Direct relationships with borrowers;
- Private equity sponsors;
- Investment banks and brokers;
- Traditional banks;
- Restructuring firms;
- Professional services firms: business advisors and legal, tax and audit firms; and
- Word of mouth.

Underwriting and Due Diligence:

Underwriting and due diligence is the second phase of the lending process and serves two purposes. First, it enables the lender to develop a deeper understanding of the borrower's business and its financial drivers. Second, it's when the lender determines the loan structure, particularly the covenants, that will provide optimal constraints on and oversight of the company, without being so onerous that insignificant deviations result in noncompliance. Sound commercial lending requires understanding both the macro issues – such as dominant industry trends – as well as the micro issues involving the borrower's specific advantages and challenges within that industry.

Underwriting and performing due diligence on non-sponsored borrowers is resource-intensive. Detailed financial and operational modeling and analysis is the cornerstone of solid underwriting. Unlike publicly traded companies, SMEs and their management have limited publicly available information. In addition, unless a lender is devoted to a single, narrow industry segment, it may need to engage independent industry experts to provide important insights about the industry, company, collateral, management and their financial assumptions. Once a complete financial model has been constructed during the underwriting phase, it also provides the basis for constructing loan covenants and the guide for monitoring the company once the loan has been made.

The nature of covenants varies significantly based on the specific borrower, their type of business and the use of proceeds from the funds provided; but they usually include cash flow, revenue and EBITDA covenants. An astute lender uses these covenants as an early warning flag to signal that the borrower is not performing as expected and that therefore a more hands-on approach may be required.

Portfolio construction, risk management and monitoring:

Portfolio construction and risk management in private lending is significantly different than in the public market. The lack of liquidity, longer investment horizons and fewer market comparables make traditional risk management tools less relevant. The direct lending manager must approach portfolio construction and risk management by considering the position of a proposed loan within the larger portfolio and potential exit strategies to ensure:

1. Diversification exists across sectors.
2. Average loan duration is within target expectations.
3. Average portfolio loan to value (LTV – transaction leverage) is within target expectations.
4. Portfolio-level leverage, if any, is within applicable limits.
5. Fund usage or use of proceeds is clearly defined and able to be monitored and enforced.
6. Sound exit strategies are established prior to funding each loan investment.

In addition to ensuring a diversified portfolio, and that individual loans and the portfolio as a whole are in line with target expectations, an important, but frequently overlooked, risk in many direct lending portfolios is the use of leverage. This is particularly true for direct lending managers who emphasize sponsored transactions. As yield spreads in these deals have compressed, some managers have introduced portfolio-level leverage. While this can boost total return while all is going well, if setbacks occur such leverage is likely to be dangerous – and costly – for investors. As was observed during the most recent economic downturn, many funds with leverage failed completely.

Of all the risk management tools a direct lending manager has to work with, however, the most important is a carefully considered, predetermined exit strategy. This should always be established prior to funding any individual loan investment.

While the level of borrower oversight that occurs in the publicly-traded debt market varies considerably, private loans always require careful monitoring. Assuming strong and appropriate covenants were established prior to funding, reviewing quarterly financial statements with the borrower and frequent communication are necessary steps to ensure the borrower is adhering to the agreed upon plan. At its best, this monitoring not only provides the lender early warning signs that trouble may be developing, but also establishes a basis for trust between the parties that will enable them to work together on a mutually beneficial solution. During the loan's tenor a borrower may experience challenging periods, as well as unexpected growth opportunities. In either case, investors need an experienced direct lending manager that can make the right call and act quickly.

Conclusion

A secular trend in global banking regulation has constricted the traditional source of capital for borrowers. This unmet need has driven recent growth in the private debt market.

Whether investors view direct lending as an alternative investment or a supplement to fixed income, their interest in the private debt market grows from their search for yield. Understanding the differences among direct lending managers is key to finding the appropriate managers and products to meet individualized investment goals.

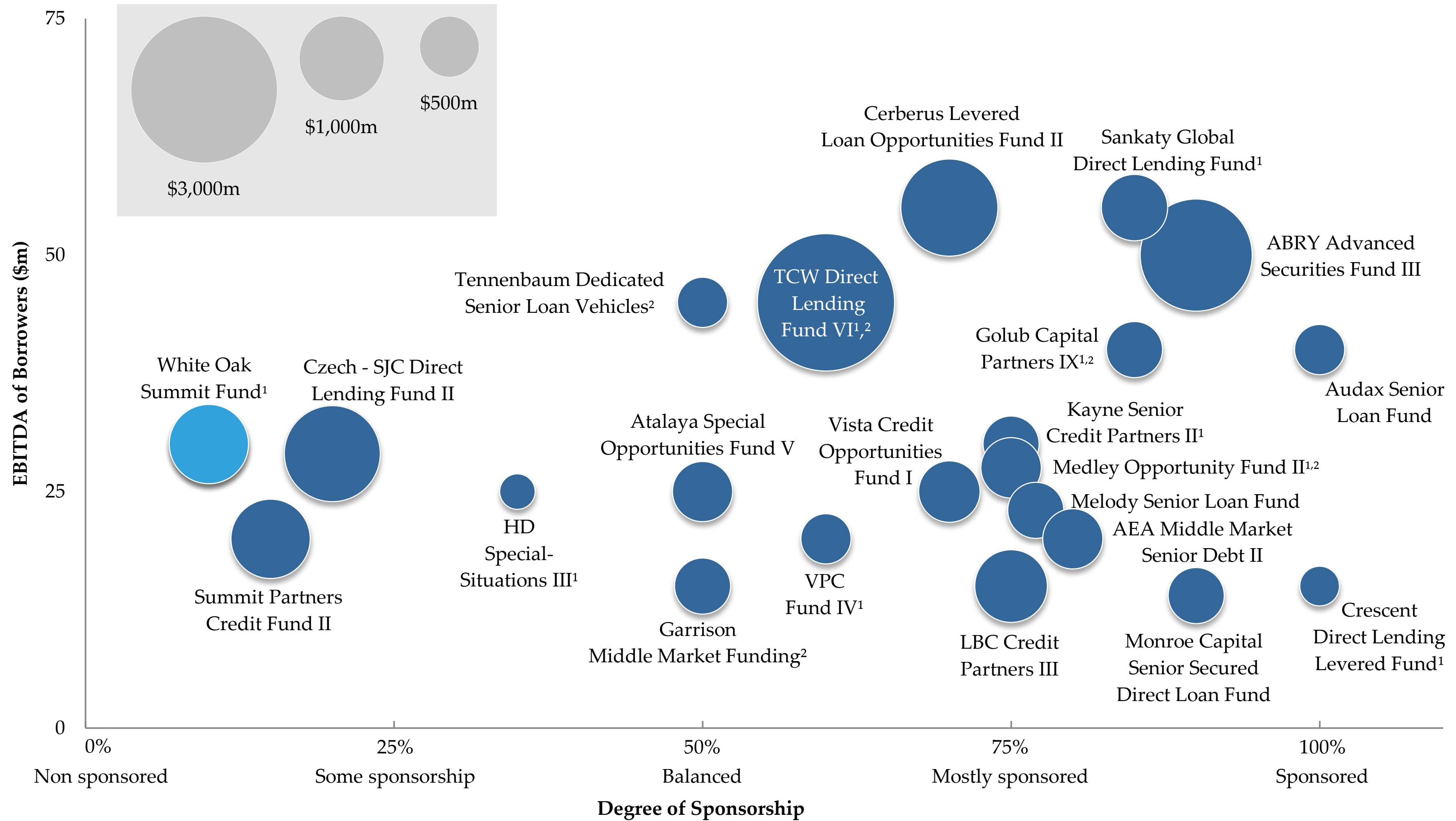
Given that banks have the longest track-record in lending, banks usually put loan loss reserves on individual loans or a portfolio of loans. Banks also have a work-out department for underperforming loans. The key takeaway is that both companies and loans will go through various lifecycles throughout their evolution. That is natural – don't get too bogged down in categories. Institutional investors should focus on credit metrics and credit risk, credit underwriting, portfolio construction, valuation methodology, avoiding conflicts and risk management (in no particular order).

Consider the following in your analysis:

- Assess if the manager has a disciplined approach to credit underwriting and pricing risk appropriately.
- Determine whether the manager has built a track-record where loans have been repaid consistently in their portfolios (remember the best loans are the ones that get repaid).
- Ask whether the investment team has a deep bench and a scalable infrastructure that supports this business.
- Look for a team that is experienced in work-outs and restructurings.

Appendix

SELECT U.S. SENIOR DIRECT LENDING FUND LANDSCAPE



Source: Preqin – December 2014, Campbell Lutyens

[1] Funds currently fundraising

[2] Managers of funds also managing direct lending BDCs