Direct Lending: A Compelling Alternative For The Prudent Investor

Yield and Protection In A Low and Rising Interest Rate Climate

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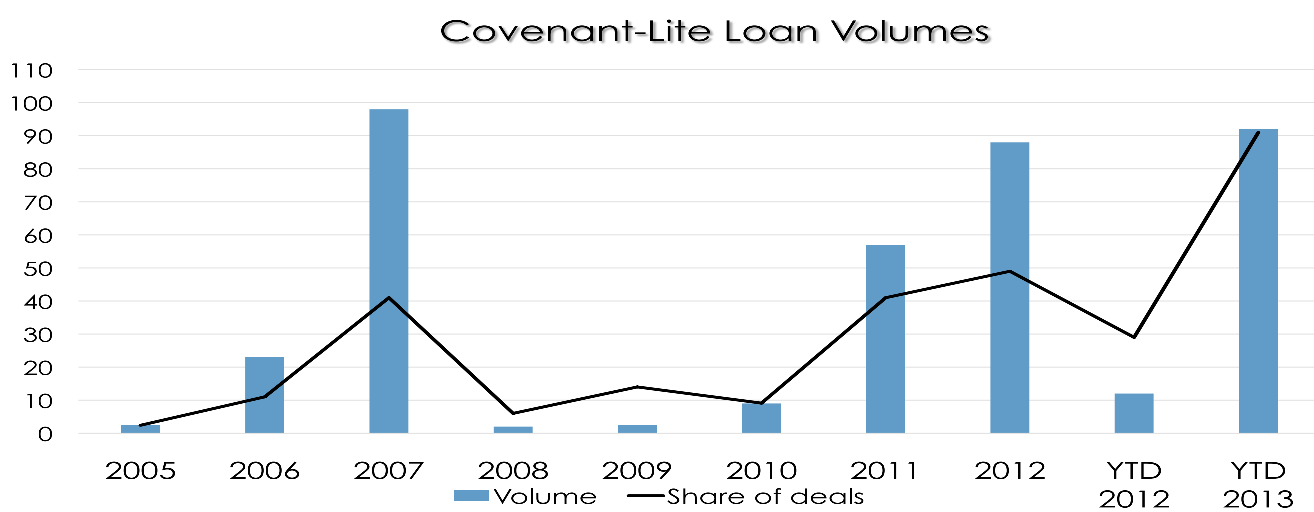
In the current investment environment, where fixed income has become a source of principal risk with negligible returns, investors and wealth managers are increasingly on the lookout for solutions, scouring the fixed-income universe seeking yield and protection.

Many investors have sought high-yield bonds as an alternative. As such, high yield bonds have enjoyed significant gains over the past few years, but credit spreads have reached relatively compressed levels and although default rates do not appear to threaten expected returns, there is indication that the high-yield market has become a bit frothy as evidenced by the increase in "covenant-lite" loans. U.S. "cov-lite" loan volume hit $83.6 billion over 82 deals in 2014, up 41 percent from the same period in 2013 ($59.4 billion over 68 deals), according to data tracker Dealogic. In an analysis of covenant-lite leveraged loan issuance, 2007 was the highest year ever at $74.2 billion, and last year (2013) the total was 106.3 billion! Such a move could indicate problems and defaults on the horizon, particularly if the economy has underlying fragility.



For investors wary of high-yield bonds but yield-focused, an overlooked and undiscovered opportunity is direct lending. Direct lending has many qualities investors want – shorter durations and yield premiums in excess of 400 basis points over comparable corporate bonds. In fact, the typical direct lending coupon ranges from 8% - 15% with a 4-year term.

The tighter banking regulatory environment has resulted in less willingness on the part of traditional financial institutions to lend to small and medium-sized businesses. These businesses are increasingly turning to non-bank providers such as private investment funds for financing of essential assets (Cap-Ex).

The strong, growing demand by small and middle-market businesses presents a real opportunity for wealth managers, individual investors and family offices prudently seeking yield in a low/no interest/rising rate environment. While short-term yields of 8%-15% would suggest more risk, if properly structured, monitored and collateralized, direct lending transactions are in fact, low-risk investments, supported by real assets or revenue-producing agreements.

The Disintermediation/De-leveraging Story

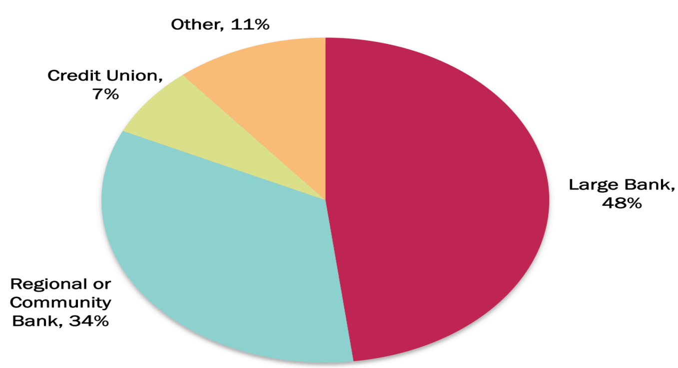
Despite the Fed increasing its balance sheet, there has not been a corresponding surge in bank lending. The current bank lending environment, while somewhat healed since 2008, continues to be muted, and loan growth remains weak compared to previous recoveries. On the demand side, a significant percentage of banks report experiencing stronger demand for commercial and industrial loans from firms of all sizes. To explain the reported increase in loan demand, many banks cite a wide range of customers' financing needs, particularly those related to investment in plant or equipment, accounts receivable, inventories, or mergers or acquisitions.

In addition, since the financial crisis, banking regulations have been tightened in order to reduce the risk of another system failure. The myriad of inter- and intra-national regulations has incentivized banks to reduce their holdings of risky assets and exacerbated the financing needs of smaller companies. The Basel III and Dodd-Frank regulations are the most prominent examples of a raft of regulatory actions designed to reduce the riskiness of banks. The increased regulation makes it more expensive and difficult for banks to lend and they have responded by planning to reduce future lending to the private sector and by attempting to sell off existing lending arrangements as syndicated loans, direct loans or Collateralized Loan Obligations, (CLOs). For a company seeking capital, the alternative to borrowing from a bank is to access the capital markets by issuing securities such as bonds or syndicated loans. Many larger companies can arrange bond issues and have numerous willing lenders. Disintermediation presents neither a significant challenge for them, nor a new opportunity for investors.

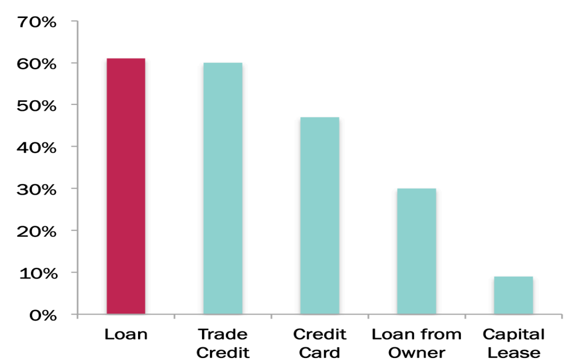
BANK LOANS ARE A MAJOR SOURCE OF CAPITAL FOR SMALL FIRMS

- Small firms lack access to debt and equity capital markets and the greater variability of small firm profits makes retained earnings a much less reliable source of capital

PRIMARY FINANCIAL INSTITUTION FOR SMALL BUSINESSES



PERCENTAGE OF SMALL BUSINESSES USING VARIOUS SOURCES OF CAPITAL

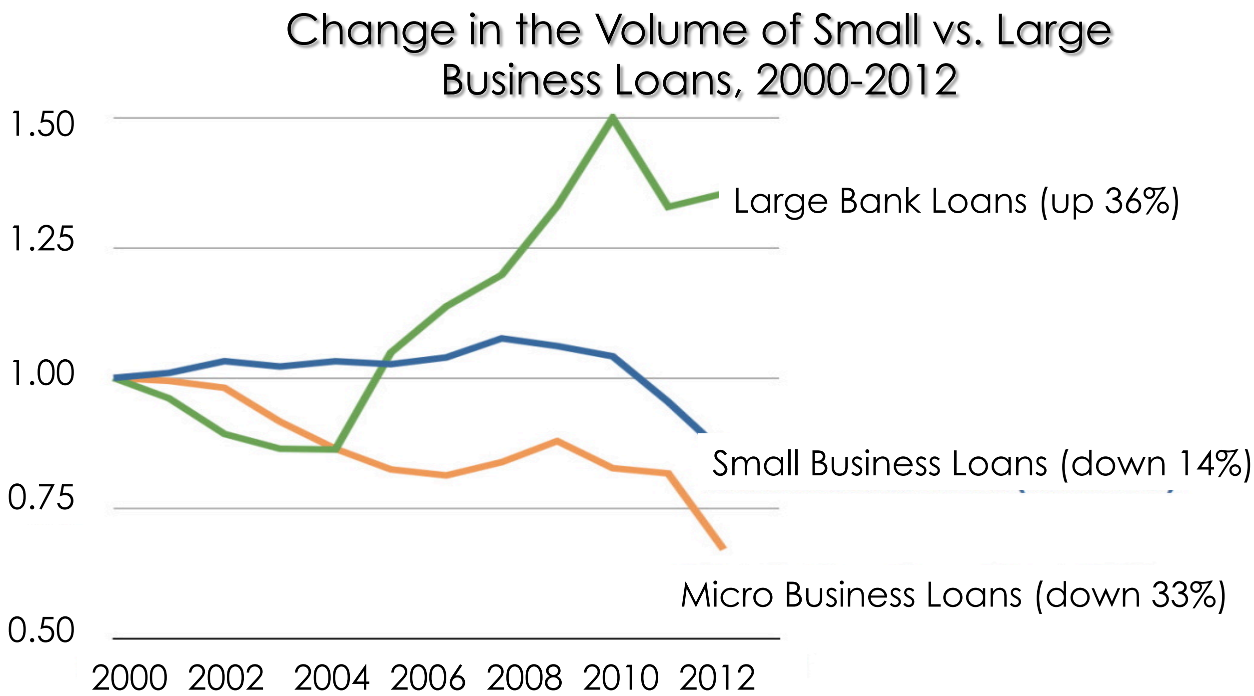


Source: National Federation of Independent Businesses, "Small Business, Credit Access, and a Lingering Recession", (January '12) and Federal Reserve's Survey of Small Business Finances (Released in '07)

This has created an opportunity for investors to lend directly to companies, something banks had previously been almost alone in doing. This creates an attractive supply-demand dynamic and the potential for attractive returns for prudent investors.

Widespread Cap-Ex Demand

With the economy returning to growth mode, the need for capital investment is not limited to companies that fit more stringent underwriting guidelines. Most small/mid-sized companies have few capital markets relationships and continue to have difficulty finding capital and financing growth. The pace at which these companies need to replenish older, less efficient assets will far outpace the rate at which banks can and will loosen credit criteria. Moreover, many smaller companies have stretched their physical assets far beyond normal replenishment cycles. After years of belt-tightening and cost-cutting, improving economic fundamentals offer these companies the best opportunity in years to invest in growth. Banks simply will not be able to meet the financing demand. This presents investors with a significant opportunity.



Source: Institute for Local Self-Reliance

A Compelling Opportunity But Who Will Be Able To Respond? Private Investor Funds: Meeting the Need

Today small-mid size business finance needs a new type of provider that can navigate this segments demand for specialized expertise. Leveraged balance sheets, complex capital structures and tight cash-flows require seasoned professionals with acumen and experience structuring transactions for these businesses. It also requires significant funding capacity so a provider can fund and hold transactions, as there will be few opportunities to syndicate.

The tightening of banking regulations around the world is providing investors access to opportunities that were previously the exclusive domain of banks. The opportunities created by banks' withdrawal from lending offers compelling potential returns and supply and demand dynamics. While many investors are aware that disintermediation/deleveraging is taking place, we believe that many remain confused about the scale and timing of the opportunity. The evidence shows that we are in the early innings of the game and a large opportunity set exists for discerning investors.

Investors are topically aware of this opportunity. However, many hold misconceptions about the asset class because of the opaque nature of the disintermediation/deleveraging process along with the unfamiliar and heterogenous nature of the assets involved. Moreover, few investors have had the opportunity to fully understand the practical characteristics of direct lending. Investors considering direct lending may not have a clear picture of the opportunity. The disintermediation/deleveraging process is not particularly transparent. However, we do not think the supply and demand imbalance that makes these investments attractive has eased. Generally, investors have not positioned themselves to meet this opportunity, and there are a limited number of appropriate and suitable vehicles available for qualified investors.

The objective of this paper is to provide details about the essential aspects of direct lending and explain how it might be incorporated into a portfolio.

Direct Lending: A Relationship More Than Just A Transaction.

The most attractive opportunities resulting from disintermediation/deleveraging are for direct lending to small and medium-sized companies, which have traditionally relied heavily on commercial and investment banking. The borrowing needs of these companies' are not large enough to make issuing bonds a viable option, but they still need funds. Direct lending means investment managers make loans to these companies on a one-to-one basis. These investments are likely to be illiquid, with no reliable secondary market but producing a "liquidity premium" in the form of higher coupon rates. Investors maybe attracted to direct lending because of the likely imbalance between the significant number of would-be borrowers, often with an inflexible demand for funds, and the small numbers of qualified and experienced lenders.

The direct lending market primarily consists of relatively small, non-public companies, and because there is little public information on issuers and no public market for direct lending arrangements there is a high degree of idiosyncratic behavior in structure and pricing. Because of their size and lack of information about the companies' credit risk, it takes time to acquire and process information, and subsequently monitor the enterprises' activities. Experienced relationship lenders have the process and expertise to extract benefits for themselves and investors, not only covering the additional costs associated with establishing and maintaining the relationships, but adding value in numerous ways.

Our view is that the stage is set for qualified investors to fill the "financing gap" and participate in especially favorable areas such as distressed real estate, mezzanine and lending for non-rated borrowers that cannot access capital from banks. From the perspective of an individual investor or family office, we consider the liquidity, expected returns and other characteristics of these securities and offer practical approaches as to how they might best be incorporated into a portfolio.

Incorporating Direct Lending Into A Diversified Portfolio

As the capital landscape for traditional lenders becomes more restrictive for small to medium businesses, analysis demonstrates that direct lending opportunities will persist for the next five to seven years.

A pooled fund of direct lending assets, rather than a segregated account, is likely the optimum means for an investor to gain the appropriate diversification and exposure. Diversification is important and a pooled fund structure allows an investor to diversify across a range of direct lending assets and avoid excessive concentration of issuer and other risks. Investors may prefer segregated accounts in other asset classes, but the benefit is limited in direct lending because those accounts do not easily accommodate individual clients constraints.

The method an investor uses to incorporate direct lending into a portfolio will partly depend upon their tolerance for adding illiquid assets. Currently, we believe that sacrificing liquidity provides investors with an attractive gain in expected return. Therefore, investors who can sacrifice liquidity without jeopardizing their ability to meet liabilities should do so. However, even investors whose allocation to illiquid assets is already as high as they feel comfortable with may improve their portfolios by re-allocating some of the illiquid portion of their portfolio to direct lending. Below we outline asset allocation changes we believe can improve expected returns and/or reduce risk.

Direct Lending As A "De-risking Strategy"

The performance of equity markets over the last few years provides investors with a number of challenges. The consensus is the markets going forward will not perform as robustly as they have. As such, to avoid the possibility of giving back gains, investors can maintain overall portfolio performance by "de-risking" the portfolio, moving out of equities and into other asset classes such as direct lending and opportunistic fixed income.

Direct Lending As A Replacement For High Yield Bonds

Even after recent increases, government bond yields are far below their historical range. This combination of low interest rates and tight credit spreads means that loans are competitive with high yield bonds on an absolute basis as well as adjusted for risk. Replacing high yield bonds with loans gives an investor a competitive yield, a superior position in the capital structure, and a floating coupon rather than a fixed one. The price of these advantages is a reduction in liquidity. In terms of spread to LIBOR, we currently see direct lending as being priced at least 120 bps higher than high yield, for a similar credit rating. Furthermore, the superior claim on capital in the event of default and the floating nature of the coupon help to reduce default risk and interest rate risk, respectively. The two main threats to investors' capital are thereby partially mitigated. We expect that the higher spread will persist for some time and that the liquidity premium for direct lending is unlikely to disappear. The spread advantage of loans over bonds will persist.

Switching From Other Illiquid Assets Into Direct Lending

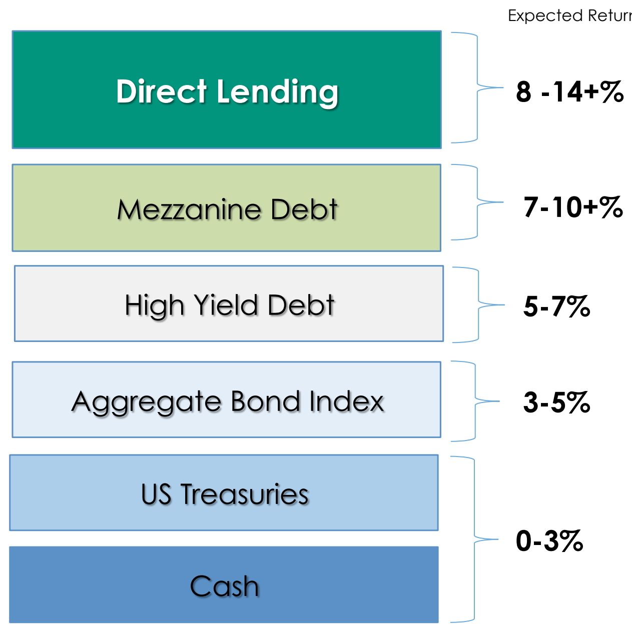
For investors who have already reached their maximum allocation to illiquid assets, we believe there may be advantages to partially switching from other illiquid assets into direct loans. Such changes would be subject to the schedule at which other illiquid allocations could be reduced, since these assets are by definition not readily realizable. Switching from private equity to direct lending would likely increase diversification, reduce total intra-portfolio correlation and increase liquidity by shortening lockup periods and reducing contingent commitments. Switching from hedge funds to direct lending could offer more security regarding expected returns.

Advantages of Direct Lending

- Designed to generate low volatility, uncorrelated, absolute returns emphasizing capital preservation and protection of principal
- Exposure to fixed income without the mark-to-market risk associated with the current public credit market
- A floating rate coupon with a floor protects the portfolio from rising interest rates
- Senior position in the borrower's capital structure allows the lender to be repaid ahead of all junior creditors

Risks of Direct Lending

- Fraud Risk – mitigated with extensive on and off site due diligence
- Valuation Risk – mitigated with conservative underwriting assumptions and monitoring the performance and value of the collateral on an ongoing basis



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