SILVER CREEK
CAPITAL MANAGEMENT

VIEWPOINT

Middle Market Direct Lending:
Accretive diversification.....but only if structured appropriately

September 2013

With traditional fixed income returns negative year-to-date, investors understand that something must be done. However, investing with a single manager who holds perhaps twenty loans that do not trade is not the solution. Unfortunately, that is what some institutional investors are doing when investing in middle market direct lending, an area that has seen significant recent in-flows.

The purpose of this paper is to outline why mid-market direct lending can provide accretive diversification and be part of the answer, but only if structured appropriately. We also introduce a more attractive solution: broader private credit.

Revisiting the Case for Middle Market Direct Lending

Investors have been talking about how low interest rates have been for years and how worried they are about what happens when rates rise. However, most investors have not done anything and have been handsomely compensated for waiting. Given the recent uptick in interest rates – roughly 100 basis points on the 10 year US Treasury from May to June and a steady upward march since then[i] – investors have seen their traditional fixed income portfolios generate negative returns and are recognizing that the time for waiting is likely over.

Although the following data are moving targets and will be immediately outdated at time of printing, the below graph puts numbers around what investors conceptually already know: the significant negative asymmetry in the U.S. Treasury market. If rates continue upward, investors could experience negative double digit returns. The prospects in traditional corporate bond markets are directionally similar as credit spreads do not provide enough cushion to ameliorate losses from rises in interest rates.

Some investors have been looking to leveraged loans as a solution to the rate asymmetry problem. Given that the coupon payments on bank loans reset with moves in interest rates, leveraged loans help to address one of the key risks associated with fixed rate instruments. The seniority in the capital stack has contributed to the historically low loss rates of the asset class, which is another positive attribute that investors favor. But the modest return potential – broadly syndicated loans currently are returning approximately 5% on a loss-adjusted yield to maturity basis[ii] – are causing investors to consider less liquid options including middle market direct lending.

The case for mid-market direct lending is compelling: low default rates[iii] high recovery rates[iv], limited interest rate sensitivity and significant upside potential relative to broadly syndicated loans. And the investment thesis – i.e., the why and why now – is fairly easy to articulate and understand because it is a classic supply/demand argument. Middle market companies (those with less than $75 million in EBITDA) are too small and therefore unable to access traditional capital markets. Historically, these companies have turned to specialty finance companies, regional banks, business development companies, collateralized loan obligations and special investment vehicle structures to provide capital. Many of these entities did not survive the 2008 financial crisis or did survive in a significantly altered state, and while capital has returned to the space it has not done so in enough scale to meaningfully compress spreads.

Illustrative return statistics as of June 2013

	Spread (bps)	Spread After Loss (bps)	Loss Adj. Yield to Maturity
High-Yield Bonds	480[a]	248[c]	3.8%[d]
Leveraged Loans	494[b]	373[c]	5.1%[d]
Direct Lending	700 – 1000+	575-875+	8% -11%[e]

[a] **Source: Merrill Lynch High Yield Master II OAS (Government)**

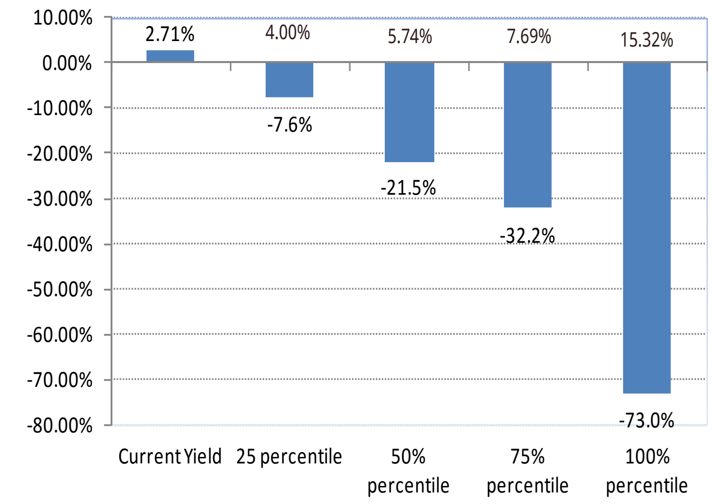
[b] **Source: LCD Quarterly 2013 Q1**

[c] **Altman Kuehne Report: High yield default % is the arithmetic average of 1985 – 2010. Recovery % for leveraged loans and high-yield bonds from the same report. Default % of Leveraged loans is the arithmetic average as per Silver Creek analysis of S&P LCD data from 3/2000 to 3/2013. Direct lending statistics are based on our understanding of our managers' experience.**

[d] **Loss adjusted yield to maturity for high yield bonds and leveraged loans include 5yr swaps of 1.33% as of 6/10/13**

[e] **Loss adjusted yield to maturity for direct lending includes 5yr swaps of 1.33% as of 6/10/13 plus 2% of origination fees/Original Issue Discount amortized over a 5yr loan term**

Prospective Returns on 10-year Treasury



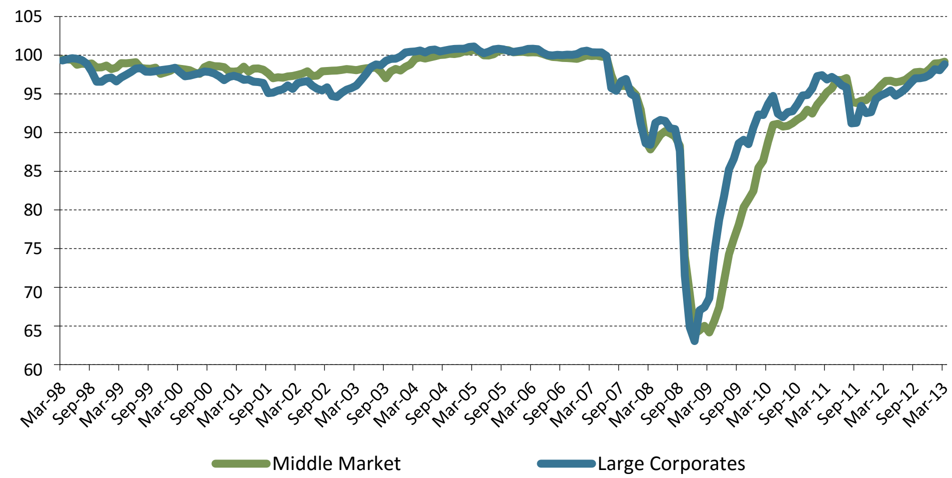
Source: Bloomberg; Silver Creek calculations; 10-year UST yield as of 8/27/13; prospective UST returns represent capital gain or loss incurred on a 10-year UST bond if yields jumped to yields jumped to levels consistent with the 25th, 50th, 75th and 100th percentile of their historical distribution, dating back to 1953.

As shown in the table below, directly originated mid-market loans command a yield premium of 300 to 600 basis points over broadly syndicated bank loans.

The spreads, while compelling, are not the sole reason investors are attracted to mid-market lending and they do not explain the seemingly counterintuitive lower default and loss rates relative to the broadly syndicated market. Contractual concessions in covenants are the second part of the story. One of the key features that mid-market loan originators are able to extract is contractual amortization and/or excess cash sweeps that force deleveraging. Broadly syndicated loans typically do not have this feature – i.e., they do not structurally de-risk over time. Leveraged loans also, on average, have more leverage (approximately 5-7X EBITDA versus 3-5X EBITDA for mid-market loans) and lower hard asset coverage. All of these features contribute to the lower loss rates for middle market loans. Finally, similar to leveraged loans, mid-market direct loans are an income strategy (i.e., the vast majority of total return is accrued from interest), and there are fees that accrue to investors (pre-payment penalties, covenant breach fees, warrants and PIKs[v]) that can add an additional 2 to 6% of incremental return annually.[vi] These fees are in addition to loss-adjusted yields of 8 to 11% as outlined below. We would highlight that the mid-market lending returns outlined below can be further enhanced through a modest degree of attractively-priced term financing.

The case for mid-market direct lending appears compelling, but investors may ask themselves whether they are getting paid enough to lock up their capital. We share detailed thoughts on vehicle structure and implementation below but believe the following graph provides an interesting perspective on that question. The significant sell-off during the 2008 financial crisis and subsequent sharp rebound clearly stand out and illustrate that investors who could maintain a buy-and-hold approach were well served versus monetizing the mark-to-market volatility. It begs the question: do traditional bank loans funds overstate their liquidity?

Average Bid of Single B Leveraged Loans



Source: S&P Capital IQ

Implementation

Vehicle structure and manager selection in middle market direct lending is critical. Unfortunately, many investors who are new to the space appear to be utilizing a framework they learned in the context of liquid credit, not recognizing that origination-based strategies are fundamentally different than trading-oriented approaches. A different set of questions and a different level of analysis are required, which are more resource intensive and specialized.

While all fixed income strategies are about "avoiding mistakes" two of the key differences between liquid credit and mid-market direct lending relate to concentration and liquidity (or lack thereof). As investors know, traditional bank loan and high yield managers often construct portfolios with 1-2% positions and can trade out of positions if their assessment of a credit or a view on relative value changes. Mid-market lending portfolios are effectively the opposite – generally consisting of 20 to 30 loans that are held to maturity (or re-financed or otherwise retired). The level of concentration and illiquidity in mid-market direct lending makes loss avoidance paramount and, in turn, requires a due diligence process that emphasizes underwriting and loan level analysis. Instead of exclusively evaluating the three Ps -- people, process and price -- cash flow modeling and sensitivity analysis must be conducted. At Silver Creek we build iterative scenarios to see how impaired conditions must become before the portfolio generates a return of zero. In our analysis we account for a myriad of different factors which may include different types of loans (sale leaseback, revenue participation, contract monetization, etc), the strength of contractual covenants, whether the deals are "sponsor-backed," comparisons amongst different industries and comparisons amongst different underlying leverage levels.

The difference in analysis does not stop with conducting loan level analysis. Because direct lending managers are "asset managers" in the operating sense of the term both investment and operational resources are needed to understand how the manager receives payments, services its loans, monitors covenants and otherwise operates its origination business. Legal expertise is also required to understand the manager's workout expertise in situations where something goes wrong and a credit becomes impaired. Again, unlike in liquid credit, mid-market direct lending managers cannot trade out of problem credits.

The differences do not stop there. Performance-based analysis is difficult to perform in the context of mid-market lending, whereas liquid credit investors have a number of evaluation methods to choose from. Similarly, the risk management framework that applies to liquid strategies (namely, VaR) does not apply to mid-market lending. Trying to do a comparison of Internal Rates of Return (IRRs), even taking into account "vintage years," is challenging since the use of leverage at the fund level and other factors contribute to wide dispersions in expected returns. Analyzing defaults and losses is also of limited value as many of today's direct lending funds were launched post-crisis, in a market that has been largely benign. With the overall default rate for the industry near historic lows and dispersion between managers tight, everybody looks good. But there are many proverbial bodies in mid-market direct lending, and, unfortunately, an investor new to the space may not know where they are buried.

In hedge funds there are industry norms for terms and liquidity, for instance, 2% management fee, 20% incentive fee and quarterly liquidity with a 45-90 day notice period. No such conventions exist in mid- market lending. Investment periods range from two to five years with stated final maturities ranging from five to eight years with optional extensions, often at the general partner's discretion. For someone new to the asset class it is difficult to determine what favorable terms are, much less negotiate or create customized vehicles. At Silver Creek we have developed a number of creative implementation solutions including: seeding private lending structures and participating in the equity upside when the vehicle listed as a publicly traded business development company; investing directly in specialty finance companies; and negotiating the ability to terminate the investment period and effect immediate harvest or to otherwise modify the investment period. Someone new to mid-market direct lending likely would have little choice than to invest in a standardized, commingled fund and would probably have a difficult time comparing the myriad of different types of structures that are currently in the market.

Our comments to this point have been focused on manager selection, but we understand that things can go wrong regardless of thorough due diligence. If an investor allocates to a single manager with twenty loans that do not trade and one credit becomes impaired, what was supposed to be a conservative investment can become a headache.

Unfortunately, there is not much the investor can do at that point. But, when building a mid-market lending program, this concentration risk can be mitigated and managed through a multi-manager portfolio that combines managers with complementary approaches based on factors that may include loan type, industry, geography, etc. All of which sounds easy to do but portfolio construction, in our opinion, is the "secret sauce" to appropriately structuring a middle market direct lending program.

Broader Opportunity Set

While investors have been actively allocating to mid-market direct lending we would be remiss if we did not introduce the broader private credit opportunity set. As previously mentioned, we view portfolio construction as the "secret sauce" and believe that a diversified broader private credit portfolio can provide returns in excess of those solely offered by mid-market direct lending strategies with similar liquidity. Said differently, for investors who are considering a concentrated allocation to direct lending through a structure with a 7 year final maturity, investors can build a diversified portfolio of private credit with a similar weighted average life, better downside protection and higher upside potential.

Private credit is a broad opportunity set that includes non-performing loans (NPLs), small balance commercial loans, consumer insolvency settlements, mortgage servicing rights, regulatory capital relief trades, aviation finance as well as other strategies. While some opportunities are structural (i.e., there is always a need), others will be attractively priced and available for purchase only at certain times. European NPLs currently are one such area. One of our NPL managers has invested over $1 billion of equity over the past 12 months, having been largely dormant in this geography for multiple years. Given the low dollar price at time of purchase, conservative return expectations, at the manager level, are in excess of 20% net of fees. (The manager has historically generated nearly a 40% gross IRR on NPL purchases since the late 1990s). NPLs are only one of many compelling opportunities that are currently available in the broader private credit market, an area that has been largely overlooked by institutional investors and other capital providers. In turn, it remains one the most attractive areas of the market – and one that offers a strong alternative to traditional fixed income.

Concluding Thoughts

Investors understand that the time for waiting is over and something must be done to address the significant negative asymmetry in their traditional fixed income portfolios. Some have looked to mid- market direct lending as part of the solution and for good reason: middle market loans offer low default rates, high recovery rates, limited interest rate sensitivity and significant upside potential to broadly syndicated loans. Investors new to the space, however, are failing to recognize the fundamental differences between origination-based strategies and trading-oriented approaches, and some may be investing with a single manager who holds perhaps twenty loans that do not trade.

As outlined in this paper, mid-market direct lending investments can be part of the answer to address the problems faced by traditional fixed income portfolios, but only if structured appropriately. A multi-manager approach that accounts for the nuances of origination strategies is critical to successful implementation. Moreover, for investors comfortable with the illiquidity of mid-market direct lending, a diversified, multi-manager private credit portfolio is an even better solution that we believe has the ability to offer better risk-adjusted returns than just mid-marketing lending investments with similar liquidity.

We welcome the opportunity to have discussions about how we can help investors implement a solution focused on middle market direct lending or private credit more broadly or how we could otherwise be a resource.

ABOUT THE AUTHOR

Mary Bates is the Director of Credit Strategies at Silver Creek. Her responsibilities include underwriting and monitoring credit-focused strategies and communicating Silver Creek's strategies externally. Prior to joining Silver Creek, Ms. Bates spent over eleven years at Hewitt EnnisKnupp (and the legacy EnnisKnupp & Associates) where she most recently served as a Senior Research Consultant on the Liquid Alternatives team, focused on credit-related hedge funds. While at HEK, Ms. Bates worked with some of the largest institutional plan sponsors in the industry on their hedge fund programs, advising on portfolio construction, manager selection and program design. She also was a key team member of the manager selection phase of the Public-Private Investment Program (PPIP) of Troubled Asset Relief Program (TARP). Prior to joining Hewitt EnnisKnupp, Ms. Bates began her career at Lehman Brothers in New York where she was an analyst on the emerging market debt desk. Ms. Bates holds a B.S. in Business Administration with a concentration in finance from Indiana University.

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[i] This represents the low (1.66% on May 1, 2013) to high (2.60% on June 25, 2013) change in the 10 year U.S. Treasury between May and June 2013. Source: U.S. Treasury.

[ii] Source: LCD Quarterly 2013 Q1.

[iii] Source: Bloomberg; Silver Creek calculations; 10-year UST yield as of 8/27/13; prospective UST returns represent capital gain or loss incurred on a 10-year UST bond if yields jumped to yields jumped to levels consistent with the 25th, 50th, 75th and 100th percentile of their historical distribution, dating back to 1953.

[iv] The recovery rate for loans less than $200 million over the past 20 years was 86.1% versus 81.0% for loans greater than $200 million. Source: Credit Pro

[v] Payment In Kind (PIKs) do no pay interest in cash, rather the coupon payment is deferred as new bonds are issued to pay the interest payments.

[vi] These represent Silver Creek estimates.