

Four Opportunities that are More Compelling Today than Middle Market Direct Lending

April 2015

If asset growth confers status, then middle market direct lending should be considered today's institutional darling. In 2014, direct lending funds accounted for nearly half of total assets raised across all private debt strategies.ⁱ Growth appears to be unabated: Preqin estimates that 72% of investors who are planning to allocate to private debt in 2015 expect to do so by investing in direct lending.ⁱⁱ However, expected returns are lower today than at any point since the Global Financial Crisis ("GFC") and leverage levels are notably higher. Then why are investors continuing to allocate to the space? Are there no other opportunities with a similar liquidity profile that are as compelling?

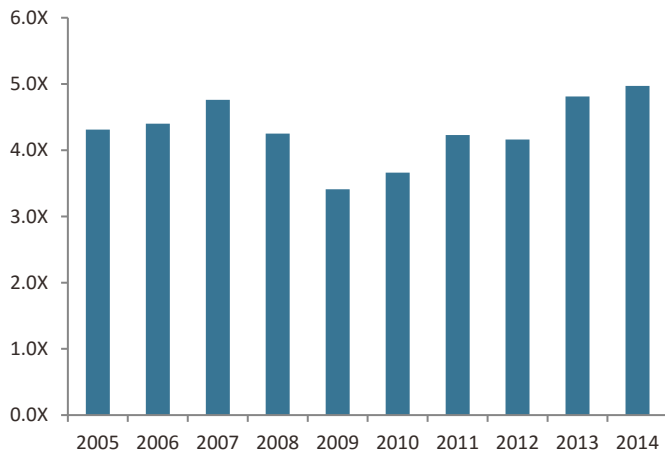
As specialists in private credit – a diverse market encompassing consumer lending, commercial and residential real estate-related finance and corporate lending – Silver Creek believes that many other alternative yield opportunities are more compelling today than direct lending. In this paper we have highlighted four strategies that, like direct lending, capitalize on regulatory change and seek to capture an illiquidity premium but are less crowded and currently can offer higher expected returns. The alternative strategies that we outline below are: 1) peer-to-peer lending; 2) consumer insolvencies; 3) risk transfer; and 4) specialty finance.

The private credit market is much broader than direct lending. We hope to illustrate some of its breadth in this paper, and also outline actionable strategies that are attractive today.

Middle Market Direct Lending Today

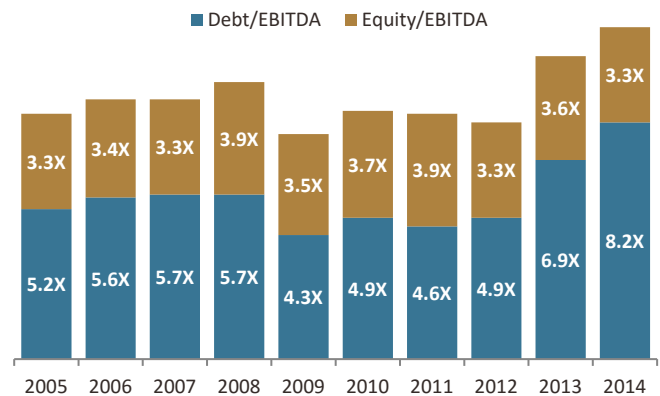
The case for middle market direct lending is straightforward, easy to articulate and likely familiar to most readers. To quickly revisit, middle market direct lending is an "originate and hold to maturity or refinance" strategy where the loans are difficult or unable to be traded. Middle market companies typically have less than \$50 million in EBITDA and many direct lending managers are focused on providing financing for an acquisition or some other type of transaction involving a private equity sponsor. While offering limited upside,

Exhibit 1- Middle Market Debt/EBITDA



Source: S&P Capital/LCD

Exhibit 2 - Leverage Buyout Multiples



Source: Pitchbook

middle market loans can generate a consistent yield with an incremental premium received for illiquidity. Other key positive attributes include: favorable historical default and recovery rates floating rate features, capital structure seniority and restrictive covenants.ⁱⁱⁱ

The opportunity became more compelling for institutional investors following the GFC as many of the historical providers of capital to this space (including regional banks) faced higher costs of capital associated with regulatory change. (If you are interested in a deeper explanation of the case for middle market direct lending as well as the nuances of its effective implementation, please contact us or visit our website at www.silvercreekcapital.com for a copy of an earlier Silver Creek whitepaper, “Middle Market Direct Lending: Accretive diversification.....but only if structured appropriately”).

While direct lending may be clean and simple to communicate, what is less widely discussed is the significant recent uptick in leverage at both loan and sponsor level. As shown above, leverage as measured by debt/EBITDA now eclipses pre-GFC levels (Exhibit 1) as do LBO multiples (Exhibit 2). During 2014, average debt/EBITDA ratios for middle market firms peaked at a record 5.2X, which is multiple turns greater than the low seen since 2009.^{iv} While leverage has increased, spreads have narrowed. Averaging 6.6%, first lien middle market loans as tracked by S&P Capital IQ LCD (“S&P”) are currently offering approximately a 60 basis point premium to broadly syndicated loans.^v Adding a 1% LIBOR floor and 1.5% of Original Issuer Discount, while assuming no credit losses and management fees of 1.5%, the expected returns are currently inside of 8%.

What also is likely overlooked in direct lending is a structural issue relating to the tails – the positions that for whatever reason (payment defaults, workouts, declines in business fundamentals)

cannot be refinanced. While the weighted average life of holdings in most direct lending funds is approximately 2 to 3 years, these tail positions often persist over the life of the fund (typically 5 to 7 years). This, in part, explains the return profile for lending funds – positive returns that are typically consistent with the average yield of the portfolio early in the life of the fund, followed by declining returns as the life of the fund extends. This profile explains, in part, why the average net returns of 2006 and 2007 vintage direct lending funds tracked by Preqin is 4.4%.^{vi}

With increasing leverage, lower expected returns and persistent tails, it begs the question: are investors currently getting paid enough to lock up their capital in sponsored-focused, U.S. direct lending strategies? As long-time investors in middle market direct lending, Silver Creek believes other opportunities are more attractive.

Opportunities More Compelling Than Direct Lending

Investment opportunities in private debt are broad and diverse, ranging anywhere from non-performing loans (“NPLs”) backed by Italian commercial real estate to U.S. student loans. While varying widely in terms of underlying collateral, strategies typically fall into two general categories: cash flow or distressed. The latter are value-oriented strategies such as NPLs or corporate restructurings. Value is typically created through servicing or workouts with the assets being purchased at a discount to intrinsic value. For purposes of this paper, these types of

strategies were not included for consideration as they have different risk profiles than direct lending. The focus instead is on the cash flow strategies. Below we detail four alternative yield strategies.

Peer-to-Peer Lending

Peer-to-peer lending (“P2P”) is a strategy that has received much media interest but is not widely used by institutional investors. Leveraging technology and targeting small loan sizes, P2P on-line platforms directly connect individual borrowers to lenders (both individuals and institutions), thereby reducing the costs associated with traditional bricks and mortar-based banks and credit card companies. Unlike banks, which fund loans through deposits, P2P platforms do not maintain a balance sheet or take credit risk. Still a nascent market, P2P platforms originated \$1.6 billion in loans in Q3 2014.^{vii}

P2P platforms appear to be attracting creditworthy borrowers, who have average FICO scores greater than 700 and average incomes in excess of \$70,000.^{viii} The primary purpose of most loans is debt consolidation, i.e., paying off balances from higher interest credit cards or debt refinancing.^{ix} Borrowers typically receive a 5-year fixed rate fully amortizing loan at rates lower than the average interest rate on credit cards and have an average loan balance of approximately \$7,000. A further comparison of the economics and credit quality of credit cards and P2P platforms is provided below (Exhibit 3).

We believe that one key consideration of the P2P strategy is mitigating the macroeconomic risk of an uptick in unemployment. While it is difficult to fully hedge this risk in a low cost and low basis risk manner, it is possible to dramatically shorten the duration via term financing and thereby change the nature of the downside risk from mild long term recession (which happens frequently) to a “not yet historically experienced” acute short term spike (which happens infrequently). Employing conservative assumptions (a 5-6% loss rate and no recoveries in the event of default) and term financing, the strategy is currently expected to return 18 to 22% gross over a weighted average life of 18 to 24 months.

In our view, the return profile of the P2P strategy is significantly more compelling than direct lending -- a higher expected return, a shorter average life, a less crowded strategy backed by solid collateral and a structure that mitigates one of the strategy’s biggest risks.

Consumer Insolvencies

A less widely known opportunity in the consumer credit space is consumer insolvency settlements. These settlements arise out of the personal bankruptcy process and most often relate to debt tied to credit card balances, car loans and other personal loans.

Under U.S. Chapter 13 bankruptcy, the debtor retains his property while working out a repayment plan (typically 3 to 5 years), at a reduced principal level. To qualify for this form of bankruptcy, debtors must demonstrate income and remain current on the new payments. Failure to do so results in the potential loss of one’s house and other property and as well as being held responsible for the pre-filing principal level plus any accrued default interest. This strong incentive to remain current on payments, coupled with the pre-identified ability and willingness to pay, makes the strategy notably different than consumer debt collection, which is sometimes confused with insolvency settlements.

Exhibit 3 - P2P versus Credit Card Comparison

	Credit Cards	P2P
FICO	<700	>700
Income	Typically not verified	Partially verified
Credit Migration	Negative	Positive
Structure	Revolver	Term Loan
Coupon	~18%	~7-32%
Origination Fee	None	Up to 5%

Source: Goldman Sachs, Silver Creek

The sellers of these payment plans are typically large money center banks. Despite the fact that the settlements are performing (cash-flowing but at a reduced paramount), banks are required to hold these loans at non-performing levels and are therefore motivated to sell. Banks do not seek to broadly communicate these non-core assets, and most transactions are negotiated and sourced through private networks. With the exception of the U.K. Individual Voluntary Agreement (“IVA”) market, the market outside of the U.S. is almost exclusively a negotiated market where discretion is highly valued.

In addition to being primarily a relationship-based market, specialized knowledge is required as each country has its own set

of laws, statutes and procedures for process where a debtor may apply to a debt discharge option (Restschuldbefreiung). During this phase a borrower cannot exit the plan – i.e., the concept of default does not apply. Returns vary across geographies. Mature markets such as the U.K. IVA market are currently offering returns in the high single digits, while in the U.S. Chapter 13 market, bankruptcy loans secured by residential real estate loans, are being priced at a projected IRR in the low teens with a two-year expected time frame for exit. Less developed European and Asian markets are offering unlevered returns upwards of 20%.

From a risk standpoint, the largest risk is a sharp spike in unemployment. The strategy has been tested in such an environment. When unemployment spiked from 4.6% to 10.0% from late 2007 through mid 2010, returns remained positive.^x As a self-liquidating asset, the receipt of cash flows almost immediately upon the purchase of the payment plans.

Although consumer insolvencies may one of the least understood strategies in the market, with strong cash flows and returns upwards of 20% in some regions, the strategy is, in our opinion, one of the most compelling alternative yield strategies available to investors today.

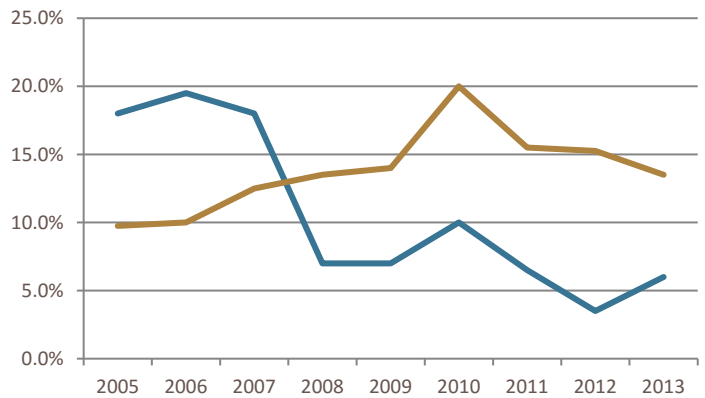
Risk Transfer

Few regions or sectors are as defined by regulatory change as the European banking system. European banks must balance the dual objectives of meeting regulatory requirements while improving profitability. The latter has been a persistent struggle for most large European money center banks since the cost of equity has remained above the return on equity since 2008 (Exhibit 4).^{xi}

Risk transfer transactions allow banks to address these dual objectives. By “transferring” rather than selling assets, banks do not risk alienating key clients, while creating more balance sheet capacity to pursue additional business. At the same time, the deals are structured to help banks meet the regulatory requirements in the bank’s jurisdiction. Deutsche Bank alone has executed 48 risk transfer transactions, totaling €63 billion.^{xii}

Risk transfer transactions can take many forms. Some are highly customized, bi-lateral agreements between a bank and an investment manager, while others are more open auction-driven transactions.

Exhibit 4 - European Banks Return on Equity vs. Cost of Equity



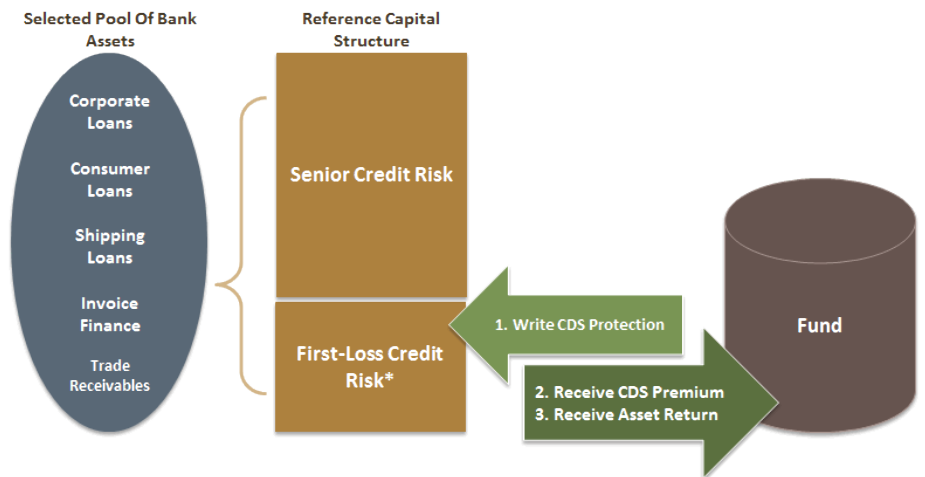
Source: Bloomberg

The specific structure (e.g., credit-linked note or a tri-party repo) and collateral (e.g., corporate loans or Italian salary assignment loans) varies by transaction. In all transactions, the potential for loss must be present (a regulatory requirement).

The investment manager to mitigate this loss by carefully specifying the collateral and, in some cases, having the right to substitute collateral subject to detailed guidelines. Returns for transactions vary based the underlying collateral and the transaction structure, though they typically range from L+6% to L+15%. Timing and the length of the transaction also varies, with some having final maturities of 5 to 7 years while others being significantly shorter.

Below we illustrate a sample transaction (Exhibit 5).

Exhibit 5 - Risk Transfer Sample Transaction



*Attachment/detachment point dependent on expected loss of the assets in the selected pool of banks assets. Senior risk is retained by the bank. The bank “buys protection” that covers the expected loss (and more) on the selected pool lowers capital charges, thereby improving bank capital ratios
Source: Silver Creek

In the Regulatory Spotlight sidebar, we highlight the Total Loss-Absorbing Capacity guideline, a measure is designed to avoid future bailouts of globally systemically important banks. Market participants believe that significant portfolio risk transfers will likely occur over the next 1 to 3 years to meet this new regulatory guideline.

Specialty Finance

Goldman Sachs recently published a study that estimates that U.S. banks risk losing \$1.6 trillion over the next 5 to 10 years through dis-intermediation to non-traditional lenders.^{xiii} Some of these assets will go to what we characterize as “specialty finance companies,” which are generally non-bank entities that provide origination, lending and other services traditionally provided by banks. Not being tied to a specific collateral type, these companies may be on-going business concerns or may be established for specific projects. Often the latter have multiple possibilities for monetization, including the sale of the platform, an IPO or the sale of the assets. Below we highlight the breadth of that continuum.

Non-QM Origination

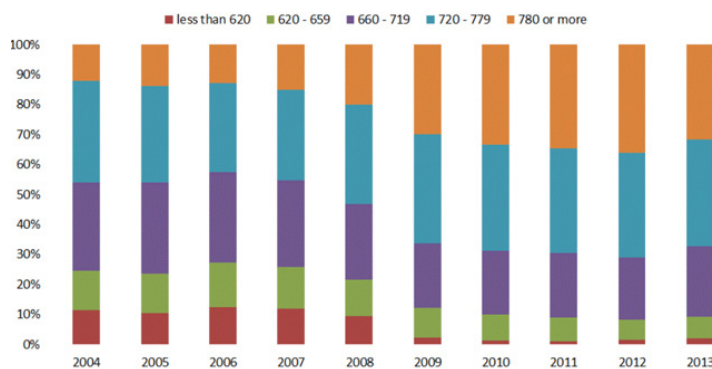
Following the GFC, few markets remained as stuck as the U.S. residential mortgage market. The non-qualified mortgage (“non-QM”) space – i.e., borrowers/mortgages that do not meeting conforming loan standards – in particular remains stymied with lower credit quality borrowers largely shut out of the mortgage market (Exhibit 6).

The non-QM market is re-emerging, albeit slowly and haltingly. Originations are occurring, creating opportunities to purchase whole loans. Warehouse financing opportunities which typically have duration of 1 to 2 years and expected returns of 8 to 15% are another way to access the market. While having a different risk profile than direct lending and, therefore, outside of the scope of this paper, opportunities also exist to take equity ownership positions in origination platforms and/or initiate an origination platform.

U.K. Solar

A discrete specialty finance opportunity recently arose in the U.K.’s solar power industry resulting from regulatory change in a subsidy program. This specific opportunity is no longer actionable but serves to illustrate “YieldCo” specialty finance opportunities.

Exhibit 6 – Mortgage Originations by Credit Quality Distribution



Source: Black Knight Financial Services

Regulatory Spotlight

Total Loss-Absorbing Capacity Guideline

In November 2014, the Financial Stability Board, an international body focused on promoting global financial stability, issued the Total Loss-Absorbing Capacity (“TLAC”) guideline to avoid future bailouts of the globally systemically important banks (“GSIBs”). Industry experts expect the guidance will apply to all large European banks under the “harmonization rules” associated with the European Central Bank’s Asset Quality Review.

Key TLAC Requirements

- i. GSIBs must hold a minimum TLAC capital of 20-25% of their risk-weighted capital by 2019. This increases the requirement (under Basel II) from approximately 8%.
- ii. TLAC capital must equal 6% of total adjusted assets.

Expected Impact

- i. JP Morgan estimates that the GSIBs will issue between €170 to €420 billion (combination of debt and equity) over the next 4 years to meet the requirement.
- ii. The cost of eligible debt instruments is expected to be potentially 30% more than current senior secured deb

Source: ICG, JP Morgan, Nomura

Due to a variety of regulatory initiatives, the U.K. government created a solar subsidy several years ago. However, the amount of the subsidy did not take into account the possibility of a non-linear drop in the price of solar panels. of the subsidy did not take into account the possibility of a non-linear drop in the price of solar panels. The dramatic drop in panel prices caused the subsidy to become over-rich, prompting the U.K. regulator to sunset the program on March 31, 2015. Given the lead times

associated with permit approvals, this had the effect of freezing the existing pipeline of large ground mount solar projects. For those with a substantial pipeline of projects, they found themselves in a position of having a subsidy program that covered more than all of their costs with no further competition to drive up land prices. This gave them what amounts to something close to a principle-protected note that is both indexed to inflation and long U.K. power prices. The base case unlevered return for opportunity at the time of the transaction was in the high single digits and significantly higher with excellent term financing that was available at closing. The exit strategy for this high quality, scarce asset will likely be to float it as its own "YieldCo" or a sale to any number of potential public or private buyers. In the meantime, holding the asset and accruing the yield associated with it remains quite attractive.

Other Opportunities

As highlighted above, specialty finance opportunities are diverse and cover a broad range of collateral types. Other areas that can present unique opportunities include aircraft leasing (parts), shipping, manufactured housing and cell towers.

Summary

Institutional investors remain focused on middle market direct lending. While easy to understand, its return prospects of compressed spreads, increasing leverage, and persistent tails are not, in our opinion, compelling today as other alternatives. For similar lock-ups, more attractive alternative yield strategies are available.

The four strategies that are highlighted in this paper are representative of a much broader opportunity set in which Silver Creek has a history of investments for over 20 years.^{xiv} With regulatory reform in mind, we seek to identify opportunities to provide capital to less served market segments and more off-the-run strategies that require specialized knowledge to underwrite. These less crowded opportunities command attractive premiums while offering downside protection and accretive diversification to traditional asset classes. As an evolving and growing opportunity set, private credit is much broader than middle market direct lending with many attractive opportunities available to the discerning investor.

ABOUT THE AUTHOR

Mary Bates is the Director of Credit Strategies at Silver Creek. Her responsibilities include authoring white papers and other market commentary, underwriting and monitoring credit-focused strategies as well as developing the firm's relationships with consultants. Prior to joining Silver Creek, Ms. Bates spent over eleven years at Hewitt EnnisKnupp 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 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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About Silver Creek

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With a 20 year history and owned entirely by its employees and founders, Silver Creek has assembled a team of investment professionals to implement what it believes to be best practices in the pursuit of unique bespoke specialty finance strategies in a closed-end structure with shorter time horizons.^{xv}

Silver Creek manages assets of over \$5 billion with offices in Seattle and New York. The global investor base incorporates qualified individuals, pension funds, endowments, foundations, insurance companies, and other institutional entities. Silver Creek is registered with the United States Securities and Exchange Commission as an investment adviser.

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ⁱ Source: 2015 Preqin Global Private Debt Report

ⁱⁱ Source: Preqin Private Debt Online

ⁱⁱⁱ Source: S&P Leveraged Commentary & Data

^{iv} Source: S&P Capital IQ LCD Middle Market Review, Fourth Quarter 2014

^v Ibid

^{vi} Source: Preqin Private Debt Fund Performance Database

^{vii} Source: Goldman Sachs, “The Future of Finance: The Rise of the new Shadow Bank,” March 2015

^{viii} Source: Prosper

^{ix} Approximately 77% of P2P loans are used for debt refinancing (56.6%) or paying off credit cards (21.1%). Source: Goldman Sachs, “The Future of Finance: The Rise of the new Shadow Bank,” March 2015.

^x Source: Bureau of Labor Statistics, Labor Force Statistics from the Current Population Survey, February 2015

^{xi} Data represent median RoE and CoE for Erste, KBC, Danske, BNP, Credit Agricole, Societe Generale, Commerzbank, Deutsche Bank, Intesa, Unicredit, DNB, BBVA, Santander, Nordea, SEB, Handelsbanken, Swedbank, Credit Suisse, UBS, Barclays, HSBC, Lloyds, RBS, and Standard Chartered. Analysis by Chorus Capital.

^{xii} Source: Investment manager

^{xiii} Source: Goldman Sachs, “The Future of Finance: The Rise of the new Shadow Bank,” March 2015

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^{xv} Ibid.