PRIVATE CREDIT

MARKET COMMENTARY

February 2016

The Distressed Cycle goes round and round…round and round

An axiom in investing is that credit markets are cyclical. Range bound or "valuation rich" credit markets are followed by spread widening environments (i.e., bear markets) which set up for "opportunity rich" spread tightening regimes (i.e., bull markets)…and the cycle begins again. Corporate distressed follows this "opportunity plentiful/opportunity scarce" paradigm and opportunities were limited throughout much of 2014 and 2015. The environment, though, appears to be changing, while the European non-performing loan ("NPL") opportunity, a distressed strategy where the objective is to monetize a discount, continues to offer the potential for mid-teen returns. Taking a more holistic view towards credit, Silver Creek believes that we are on the cusp of a great distressed opportunity – one that combines opportunities in NPLs, corporate distressed, Business Development Company ("BDC") activism and structured credit. We explore these opportunities below and provide our thoughts on the broader private credit market.

Private Credit Market Commentary

NON-PERFORMING LOANS

In 2015 high yield posted its worst year since 2008, returning -4.66%.[1] Against this unfavorable credit backdrop, European NPL managers reported some of their best performance to-date. A Silver Creek manager who leads some of the largest transactions in the market posted a return over 16% for the year, while another of our managers focusing on smaller transactions returned over 10%. The strong performance highlighted that the primary drivers of NPL IRRs, forecasting of the net liquidation values or the time to resolution, are primarily idiosyncratic.

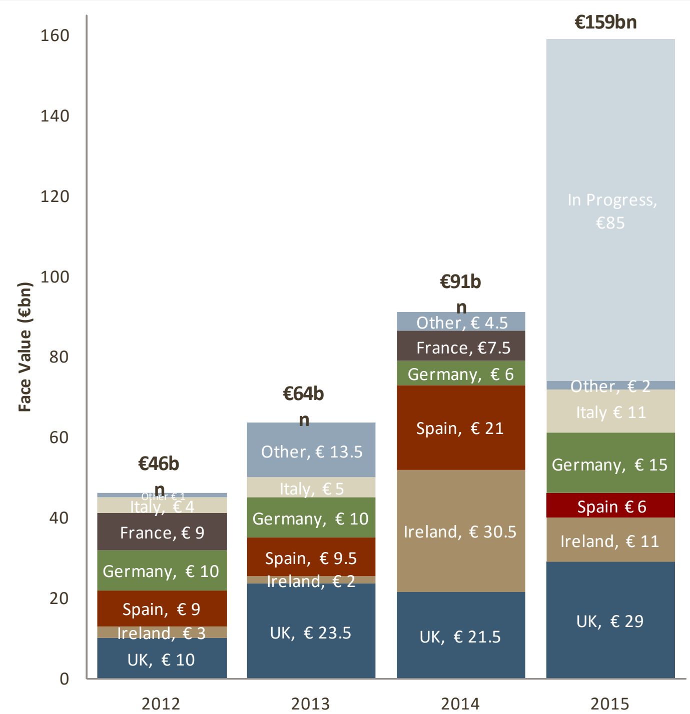
Market participants capitalized on robust transaction volumes. An estimated €159 billion of European NPLs were sold in 2015, representing a 2.5X increase from 2012 and the highest volume level to date.[2] Expectations are that transaction volumes will remain high in 2016 with approximately €80 billion in current commercial real estate loans sales (defined as live and planned sales) reported by Cushman & Wakefield as of January 2016.[3]

The composition of the opportunity continues to evolve, both in terms of geography and loan size. The major "bad banks" including Sareb and NAMA have worked through the majority of their large transactions. As a result, deal sizes are likely to become smaller and more granular going forward. Exhibit 1 shows that the U.K. and Ireland were two of the largest markets in 2014 and 2015 and will likely continue to have high levels of asset sales. However, the focus is shifting to Italy, the Netherlands and other less mature markets. Italy is a particular growth area as volumes of Italian CRE-backed loans increased 12.5X in 2015.[4] Expectations are that volumes will likely increase further given the recently announced state guarantee on NPLs held by Italian banks.

Pricing has become competitive in the more mature markets, while the potential for mid-teen returns exist in peripheral countries.

We conclude this section with one more statistic: €80B. This represents the funding gap that exists between the expected sale proceeds from non-core assets that are expected to be sold (€200B on €500B face value) and the amount of capital that has been raised to purchase these assets (€120B equity plus leverage).[5] While becoming competitive, opportunities remain for the skillful manager.

Exhibit 1: Total NPL Sales by Geography

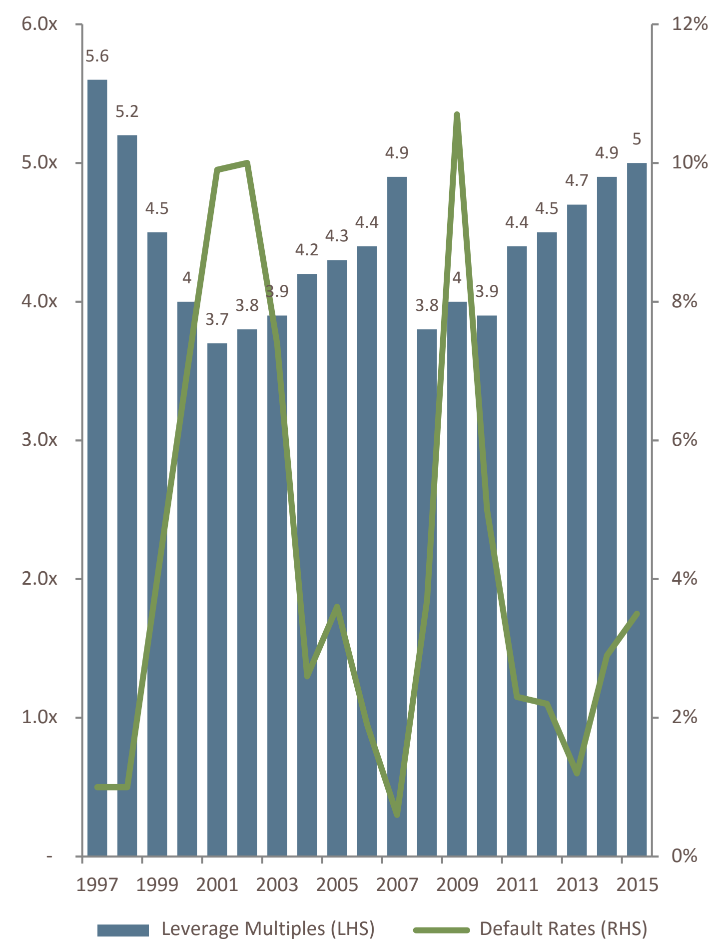


Source: PWC

DISTRESSED

Much like how the Iowa caucuses mark the start of the U.S. Presidential election year, deterioration in underwriting standards presages an uptick in defaults. Leverage multiples now exceed pre-Global Financial Crisis ("GFC") levels (Exhibit 2). The outstanding amount of CCC and lower credit, another closely watched metric, also ranks near 2008 levels ($227B in 2015; $232B in 2008).[6] Moreover, fallen angels, investment grade bonds that have slipped to non-investment grade, have also spiked to near GFC levels (Exhibit 3).

Exhibit 2 – Lever age Multiples and Default Rates



Source: S&P Capital IQ and BofAML. Leveraged loan multiples and default rate.

The spike in fallen angels highlights one of the structural changes in the market, namely the precipitous decline in broker inventory (Exhibit 4). Often attributed to the Volcker Rule, these significantly reduced inventories likely will continue to exacerbate volatility for “liquid” credit. Price changes are also expected to be more volatile given the low coupons of many bonds in the current cycle.

Distressed is not limited to corporates or the U.S. A few other notable opportunities include:

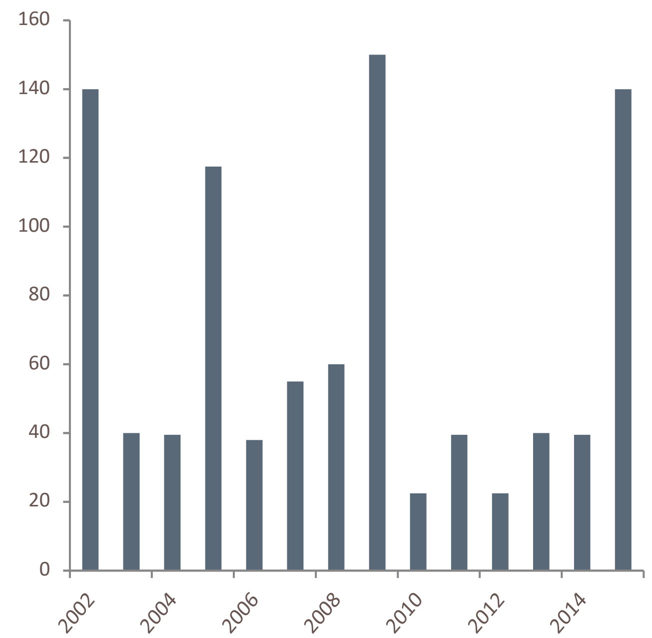
- Business Development Company (“BDC”) prices in mid-January 2016 implied that 60% of BDC loans will default, according to Wells Fargo. We find this highly unlikely as middle market defaults peaked at less than 10% in 2008.[7] However, we expect “BDC activism,” which draws attention to shareholder unfriendly activity, to continue. TPG Specialty Lending’s proposal to terminate the Investment Advisory Agreement between TICC and TICC Management is an example of such activity.

- A “wall of maturities” is looming in Europe – i.e., €35 billion in European high yield and bank debt maturing in 2016/2017 followed by a rapid acceleration in subsequent years.[8] This is against a backdrop of a decline of €562B of bank lending to European corporates over the past 5 years.[9]

- Market participants have described the U.S. and European Collateralized Loan Obligation (“CLO”) primary markets as “becoming dysfunctional.”[10] Approximately $1.28B has priced over the year-to-date (“YTD”) period ending February 8th, compared to over $7B over the same period last year (Exhibit 5). The YTD volatility, coupled with the risk-retention rules is making it difficult to price the equity component.

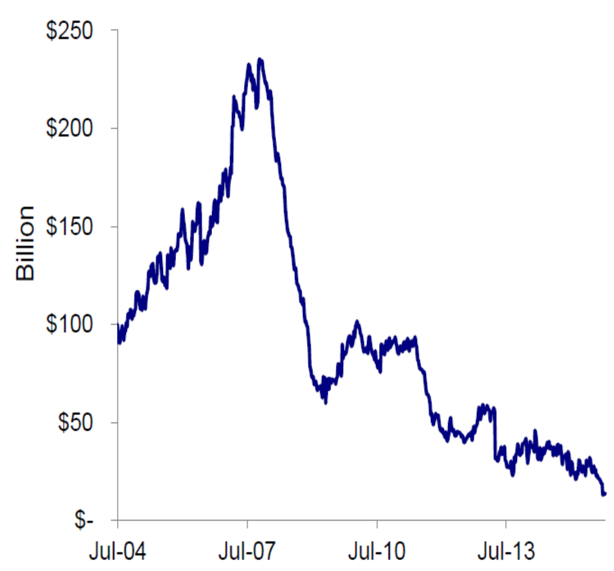
- We would be remiss if we did not include some discussion about energy when highlighting distressed opportunities. The turmoil of the energy and energy related sectors, which represents approximately 17.5% of the high yield market, is illustrated below inthe yield to worst comparison (Exhibit 6). We do not express a view on the direction of oil prices.

Exhibit 3: Annual U.S. Fallen Angels



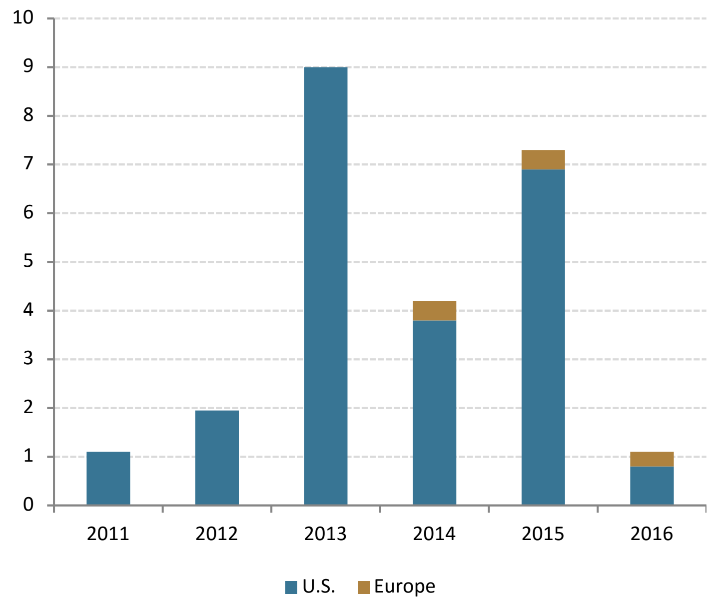
Source: JP Morgan

Exhibit 4: Broker/Dealer Inventory



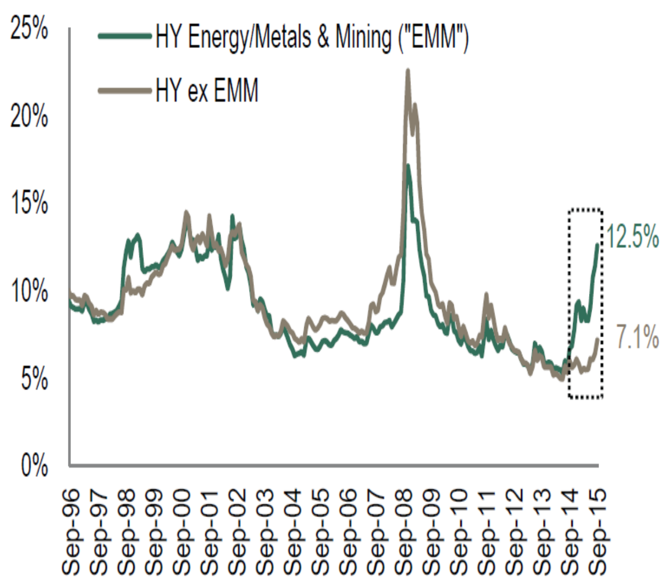
Source: New York Fed. As of October 2015.

Exhibit 5 – Global CLO Issuance YTD (as of Feb 8)



Source: S&P Capital IQ LCD

Exhibit 6 – Yield to Worst (With and Without Energy)



Source: Hotchkis &Wiley

Summary

In summary, distressed is cyclical with "opportunity scarce" environments followed by "opportunity plentiful" regimes. Recognizing the myriad of technical and structural pressures, Silver Creek believes global markets are on the cusp of a significant global distressed opportunity that is likely to extend beyond the "traditional" corporate distressed market. We look to capitalize on this by continuing to source and structure attractive idiosyncratic opportunities.

About the Author

Mary Bates is the Director of Credit Strategies at Silver Creek. Her responsibilities include underwriting and monitoring credit-focused strategies, authoring white papers and other market commentary 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.

Peter Duncan is a Portfolio Manager and Managing Director at Silver Creek. Mr. Duncan's responsibilities include serving as the Portfolio Manager for the firm's private credit offerings and serving as a member of the firm's Investment Committee. Mr. Duncan has over 18 years of direct investment experience in distressed and alternative assets. Mr. Duncan spent over six years with Fortress Investment Group, a leading global alternative asset manager where he was a Vice President on the private equity investment team. His roles at Fortress included a diverse array of investment experience on portfolio companies including; European distressed debt strategies, securitization businesses in the US and Europe, and the recapitalization and IPO of a leading German residential real-estate company. Prior to Fortress, Mr. Duncan worked with the Archon Group, a Goldman Sachs subsidiary, where he assisted in the underwriting, acquisition, financing, and workout of distressed real estate and distressed debt in Mexico, Brazil, Japan, Korea, and Thailand. He holds a B.A. in government from Harvard University.

About Silver Creek

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[1] BoA Merrill Lynch U.S. High Yield Master II Index
[2] PWC Portfolio Advisory Group, Q3 2015 Update
[3] Cushman & Wakefield, European Real Estate Loan Sales Market, Q4 2015
[4] Ibid.
[5] PWC, Ares
[6] As of November 30, 2015. Source: BoAML
[7] Wells Fargo Securities, Jonathan Bock, January 22,2016
[8] Barclays, January 2016
[9] As of June 2015. Source: RBS, July 2015
[10] S&P Capital IQ LCD, February 8, 2016
[11] Silver Creek Capital Management LLC (Silver Creek Capital") was organized in 1999 as the successor entity to offer other fund of fund products in addition to the original fund established by the founders of Silver Creek Capital in 1994. AUM includes unfunded commitments as of November 30, 2015.