SILVER CREEK
CAPITAL MANAGEMENT

PRIVATE CREDIT
MARKET UPDATE

APRIL 2017

Overview

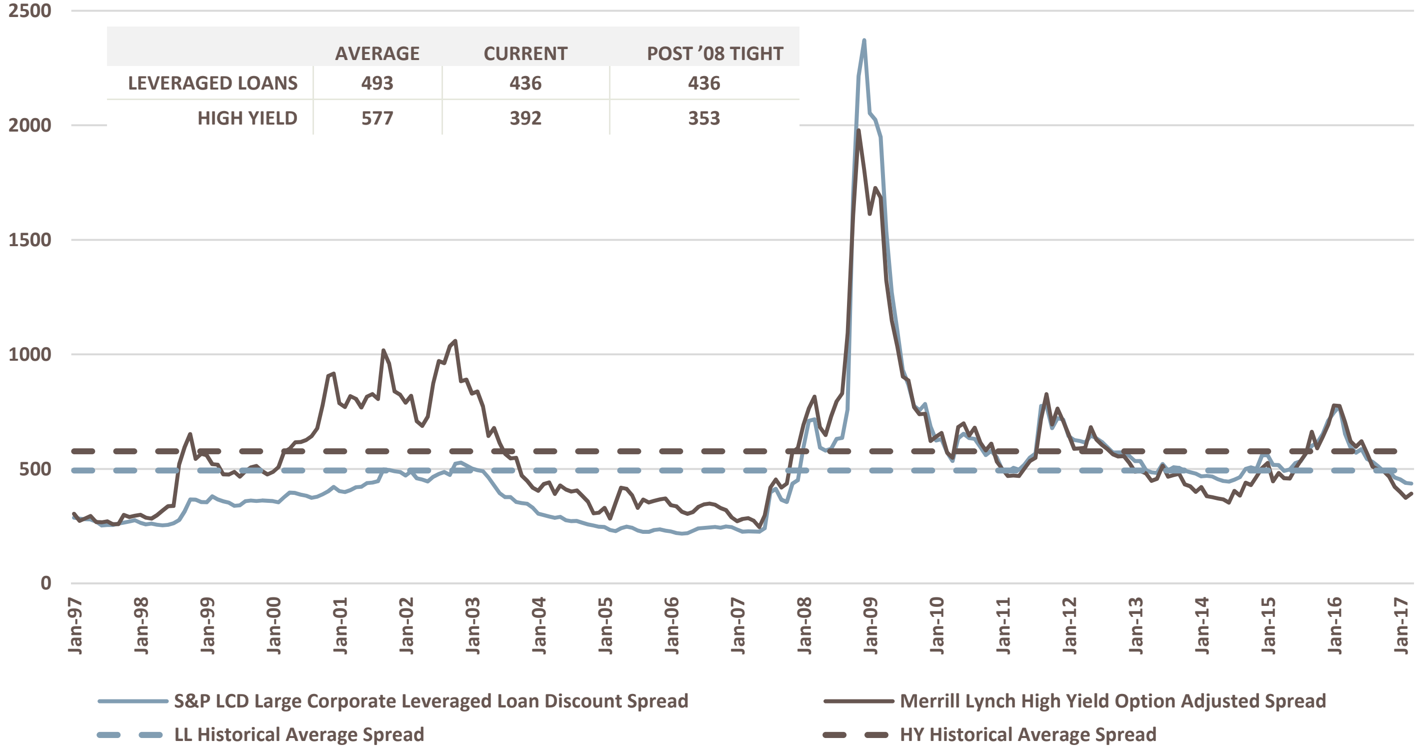
Many investors today think that "perceived risk does not reflect actual risk" in the credit markets. To be sure, many core sectors of the liquid and illiquid credit markets are not opportunistically priced today. However, that does not necessarily mean there is nothing to do in the space. We believe the key is to find well compensated pockets in the private credit markets with idiosyncratic risks where you are typically senior and exits are achieved organically through contractual terms, restructurings, or activism-driven cash flows versus market pricing. So even with the most negative and cautious investors, there are still interesting investments to make which can be highly accretive to overall portfolios. The other "caution" signal is the fact that the U.S. economy is enjoying one of the longest periods it has ever seen without a recession (defined by one quarter of negative GDP growth). This does not necessarily mean that a recession is imminent, but it is prudent to stay out of those credit sectors which are highly correlated to continued GDP growth. Additionally, investors are keeping an eye on interest rates where, contrary to the Fed's moves away from stimulus, Treasury yields have declined subsequent to the rate increase late last year. Despite the Treasury markets' somewhat contradictory reaction to the first rate increase since the crisis, investors remain concerned with the potential impact of rate increases on their portfolios and should remain cautious with strategies that are impacted by rising rates.

Detailed below we provide detail on some of the visible sectors of the private credit markets and then drill down into the sectors that we continue to believe are attractive.

GENERAL CREDIT MARKETS

To help frame up credit markets, we believe that it is worthwhile to discuss bank debt which is often the first step for institutional investors looking for alternative credit investments. We believe liquid credit and large syndicated credit is a challenging space today. Yields are uninteresting relative to other private credit categories. These loans are considered "safe" and yields have declined as massive capital flows have been seen from institutional investors. As you can see from the graph below, High Yield and Leveraged Loan spreads are well inside their historical average. Despite significant volatility in from the energy sector High Yield is rapidly approaching post crisis tights and Leveraged Loans are already there.

© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.



More recently, the technicals have favored the leveraged loan market where we continue to see strong demand from loan funds with increasing demand from the retail sector where funds have posted nine straight months of inflows. In fact, retail U.S. leveraged loan funds have added US$27.5B over the last year, of which US$12.3B is attributed to this year[ii]. Like-minded investors are shifting into floating rate assets ahead of rate increases and also some capital is being shifted from more risky trades into safer parts of the capital structure. There is also investor optimism that the relatively benign credit environment with relatively low defaults will continue. The new U.S. administration's positions which support small businesses and talk of tax breaks bode well for middle-market U.S. corporate. Many credit investors remain wary, however, as we are very late in the cycle and many fear rate increases may bring higher defaults. Regardless, we believe that most (if not all) liquid or quasi-liquid sectors of credit are not well-compensated risks. In contrast, we continue to identify sectors in the private credit markets where supply/demand factors are favorable. We detail these sections below.

CORPORATE DIRECT LENDING

It is our view that the private debt sector has become much more investable since the crisis of 2008. Unlike bank loans, the supply/demand factors related to direct lending remain favorable. Pre-crisis private lending in Europe and the U.S. was dominated by large financial institutions. Post crisis, large institutions have retreated to core businesses (e.g. mortgages). This, combined with new regulatory capital requirements, have opened the door to alternative lending structures. Private debt funds have grown dramatically as loans transition off financial institutions. However, although the overall private lending market demand remains robust, supply/demand continues to favor the lender. Managers we work with who have been in the business a long time report that strong market demand has kept premiums at historic highs and risk levels low. Some statistics on the sector are summarized below:

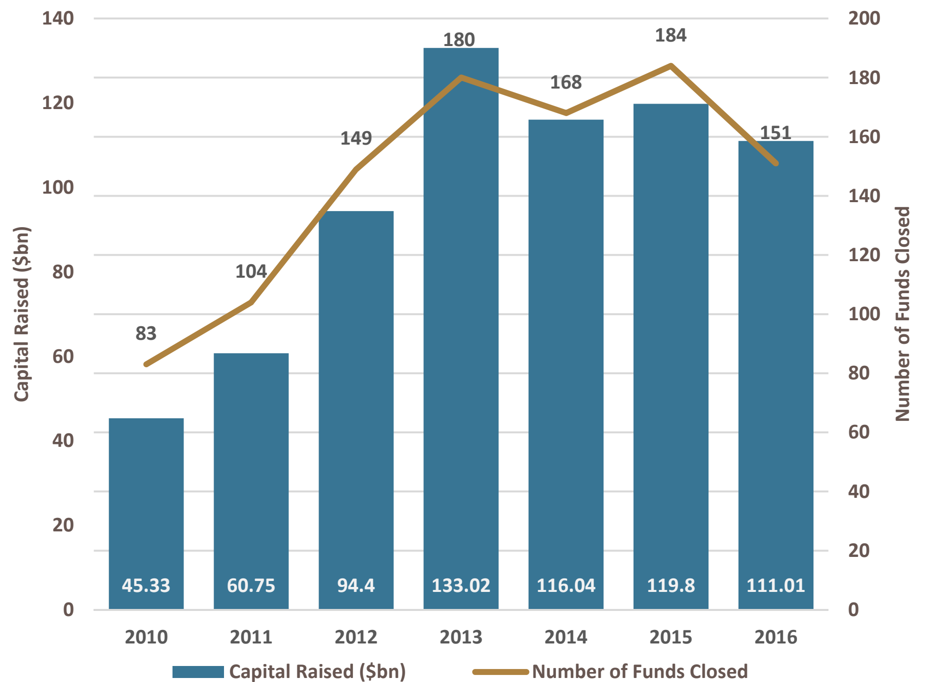
- The global private credit market is estimated to be US$560B, up from US$440B in 2015[iii]. The size of the market has nearly quadrupled since 2006[iv], which provides some data on how the "non-bank" direct lending sector has grown. This remains a small fraction of the overall private debt universe that continues to find a home on the balance sheets of banks, insurance companies, specialty finance companies like BDCs and more liquid funds.

© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.

- Investor appetite remains strong as recent surveys indicate investors' plans to continue increasing their allocations to the space. In a recent AIMA survey, over 91% of respondents expected to increase their allocation to private debt over the next 5 years[v].

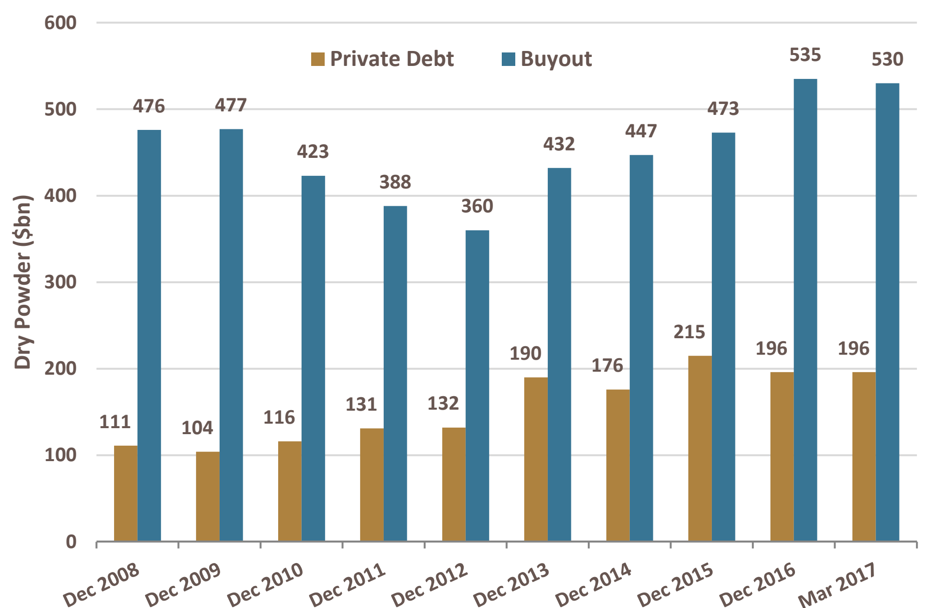
- Private debt managers raised US$111B across 151 funds in 2016, down approximately 7% from 2015[vi]. As of January 2017, there were 497 private credit funds in the market targeting US$244B[vii]. Approximately one-third of those funds are focused on distressed[viii].

- As of June 2016, there were 114 mid-market direct lending funds in the market targeting US$45B[ix], and there was US$65B in dry powder[x].



DIRECT LENDING IN THE UNITED STATES

The U.S. is a very active direct lending market today. As banks retreat from the business, there has been a steady pipeline of new entrants. This pipeline will likely be enhanced as a result of the roughly US$500B of middle market debt to U.S. companies maturing over the next 5 years[xi]. In addition to these maturities, there is approximately US$530B of dry powder in private equity buyout funds[xii]. "Sponsor" led financings are often attractive for private direct lenders because these loans are typically accompanied with large equity infusions. Additionally, equity sponsors are going after high equity returns so the terms on debt are not as important as the timing and certainty of execution. In short, many private equity sponsors are willing to provide secure collateral and pay high rates to get deals done. Adding new deals with refinancing, we estimate that approximately US$1T of direct loans will be made to mid-market companies over the next 5 years[xiii]. We believe that favorable supply/demand characteristics will likely be the norm for several years. Direct lending, in the right hands and done in a risk adverse manner, could be an 8%-11% ROE steady "net" business if structured appropriately. Many private credit investors believe they require higher returns, but it is our view that steady upper single digits is a highly accretive return. There are always multiple



© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.

direct lending firms in the market. Windows open and close with individual funds, but we have several decades of experience with multiple direct lending firms.

DIRECT LENDING IN EUROPE

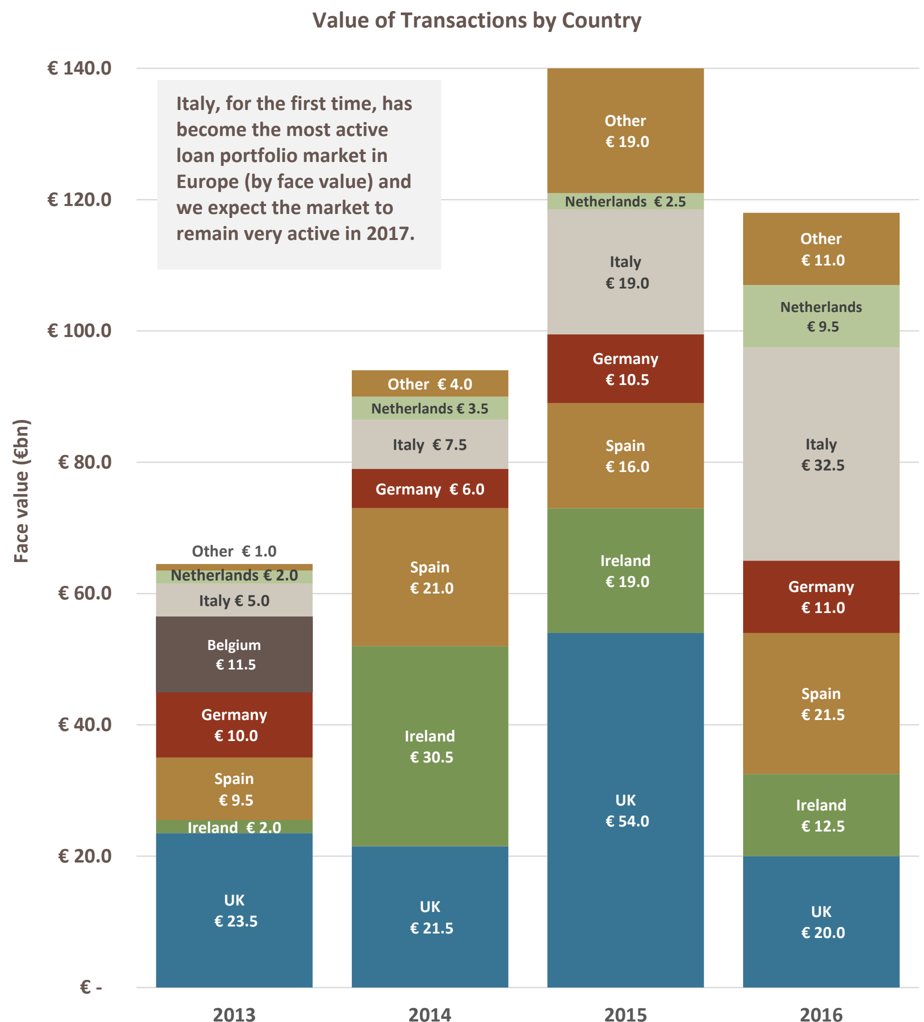
Europe is a much younger market for direct lending strategies and is therefore harder to pin down. In 2014, S&P estimated that European midsize companies would need roughly €2.8T to refinance existing loans and fund new economic activity before 2019[xiv]. The challenge is that the bulk of this activity (80%+) has historically been funded by European banks[xv]. Private lenders are relatively new to the space, but they are growing. In June 2016, the ECB published a report showing European bank loans outstanding to non-financial corporates dropping nearly 10% in the last 4 years, leaving a funding gap of roughly €400B[xvi]. Preqin estimates that just shy of US$40B had been raised by European direct lending funds from 2013 through December 2015[xvii].

We believe that the opportunity set must be approached differently in Europe than in the U.S. This is largely due to the fact that European banks absolutely dominated the private lending markets for a long period of time. The "sticker shock" of what direct lenders require can lead to adverse selection. We prefer to access the market with direct lending teams that we have worked with extensively in the past. Because Europe is a more nascent market, we believe that it is prudent to access the opportunity set with managers who really understand U.S. direct lending returns and risks. One needs to be compensated to make direct loans in Europe versus performing assets in the U.S. We are in discussion with a number of European lending groups and are executing various European lending strategies but primarily with teams based in the U.S.

EUROPEAN BANK DELEVERAGING

European bank deleveraging continues to be the most opportunistic sector of the private credit markets. The latest number from PwC is that there are €2.1T of non-core assets on European bank balance sheets, estimates are that roughly half of those non-core assets are non-performing even after several years of healthy dispositions[xviii]. Our experience is that NPL numbers are typically underestimated. NPLs remain a very attractive opportunity set with few "real" capital market buyers. Estimates from market surveys are that €1T will transact over the next 5 years[xix]. Sales in 2015 were €141B[xx]. Things were a bit slower in 2016 with only about €75B closed through Q3 but that is largely due to the mid-year-lull when deal flow came to a crawl following Brexit[xxi]. By the end of 2016, sales had picked up and there were an estimated €80B of deals in the market[xxii]. While some of those deals slid to 2017, in 2016 the market saw completed portfolio transactions of €118B[xxiii].

Thus far, we have seen the year-end pace continue into 2017. Although the short-term timing of these sales is uncertain, regulatory pressure is mounting (e.g. Basel 4) and NPLs



Source: PwC analysis. Note: Based on locations of the head office of the bank selling the assets.

© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.

have to transact in order to cleanse balance sheets. We believe that this remains the richest sector of the private credit market as it relates to returns. If one has a “purchase and drive to quick consensual work-out” strategy, the risk wrapper that NPLs carry is compelling on both an absolute and relative basis. Capital markets should continue to support low to mid-teen returns in this sector. To realize these returns, we believe that NPL investments should be made with the most experienced and deep teams rather than with more transient investors. NPL transactions are about solving problems for financial institutions. The best transactions are negotiated deals and not the visible auctions with multiple bidders. We are fortunate to have a deep relationship with the largest purchaser of European NPLs to date. We also have access to other managers where a jurisdictional focus or approach has value. We currently believe that NPLs will be the largest exposure in any new private credit portfolios that we construct in the future.

STRUCTURED CREDIT

As we discussed above, most of the securities in the broadly defined liquid or quasi-liquid structured credit sector are fully priced. Our focus in this sector remains on bank regulatory capital relief trades. Basel 4 will shift focus from capital ratios to harmonizing risk weightings and this will likely cause some interesting problems for banks. Regulators continue to press banks to deal with their NPLs, but more pressure is coming on performing loans. Banks’ approaches to risk weighting vary dramatically across Europe. Forcing banks to more conservative standards will force them to deal with capital issues. We see this as a great environment for RWA trades and we continue to see our platform managers execute structured trades, albeit episodically.

ASSET-BASED SPECIALTY FINANCE

Changes in regulatory capital requirements are also having significant impacts on other performing asset classes, including leasing, asset-based and secured lending. Private lending opportunities often create exposure to loan pools and assets similar to direct loan origination but at a lower attachment point. This creates credit support through excess collateral and excess spread. In many cases, these types of structures may have better credit support and yet still price in the low double digit yields. In order to produce double digit yields in more liquid or broadly syndicated corporate or asset backed securities, a significant amount of leverage is generally required. In this asset based strategy, managers can achieve excess yield simply by structuring and underwriting the securities privately and doing so without using leverage. Other opportunities include non-bank lenders providing financing backed by multiple collateral types to consumers and small to mid-sized businesses that cannot otherwise receive financing. Examples may include sub-prime auto loans/leasing, credit card, home improvement loans, student loans, payday cash advances, IVAs/ consumer insolvency, marketplace lending, equipment leasing, litigation finance, and royalty streams.

CAPITAL SOLUTIONS

Capital solutions strategies focus on providing companies with the ability to solve shorter term financing needs. These strategies may include bridge financings for mergers or acquisitions, rescue capital to refinance existing debt, or other areas of middle market lending that are more capacity constrained or sector specific. These strategies often take advantage of low levels of capital flow or the urgent need for capital to drive excess yields despite enjoying structural protections of senior debt investments. In our opinion, accessing these forms of excess yield without giving up structural protections is one of the most compelling private credit opportunities at this point in the cycle.

SUMMARY

Although we are not experiencing the unprecedented market environment of 2009, we believe that it remains a productive time to make private credit investments in the attractive sectors identified above. Given the rate risk in traditional liquid fixed income investments, particularly on a relative basis, private credit investments may offer some of the most attractive relative fixed income returns seen since the Global Financial Crisis.

© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.

IMPORTANT DISCLOSURES

This document is for informational purposes only and does not constitute an offer or a solicitation of an offer to buy an interest in any fund (each, a "Fund") managed by Silver Creek Advisory Partners LLC and/or any affiliated management company thereof, including without limitation Silver Creek Capital Management LLC (collectively, "Silver Creek"). Offers are made only pursuant to the Confidential Offering Memorandum and the Subscription Documents of the Fund, which should be read in their entirety. Hedge fund investments may be speculative, highly leveraged, illiquid and subject to a substantial risk of loss, and as a result are not suitable for many investors. Funds are intended only for sophisticated investors who are able to assume the risks inherent in investment vehicles of this type and who meet the Funds' eligibility requirements. **No assurance can be given that any of the Funds will achieve their investment objective or any particular level of returns. An investor may lose money by investing in any of the Funds. Past results of Funds are not necessarily indicative of future performance, and performance may be volatile.**

All figures are unaudited estimates and are based on information from third-party sources that may be inaccurate or incomplete. Silver Creek does not necessarily have access to information from third-party managers to ensure the accuracy of the information presented, and any information received from third-party managers may be inaccurate or incomplete. Certain information presented is of a high-level, summary, condensed and aggregated nature, and is inherently limited, incomplete, and required the application of simplifications, generalizations and assumptions to produce. Individual reviews may vary due to Silver Creek's assessment of the risks and other factors associated with the underlying manager. Silver Creek expressly disclaims any representation or warranty as to the accuracy, completeness, availability or timeliness of the information presented. The information provided does not necessarily reflect the most up to date or current information available.

Any statements herein that are not based on historical fact, including without limitation, internal rate of return targets, return targets, future distributions and expected maturity dates, are forward-looking statements. The words "target", "project", "plan", "forecast", "anticipate", "estimate", "intend", "expect", "should", "believe" and similar expressions also identify forward-looking statements. Forward looking statements present Silver Creek's expectations, beliefs, plans and objectives regarding future financial performance, and assumptions or judgments concerning such performance. Although such statements are based on Silver Creek's current estimates and expectations, and known and/or currently available financial and economic data, forward-looking statements are inherently uncertain. There are a variety of factors that could cause business conditions and performance to differ materially and adversely from what is contained in our forward-looking statements. Silver Creek disclaims any obligation to update forward-looking statements. For a description of some of the factors that could cause actual results to differ from our forward-looking statements please refer to the "Risk Factors" in the fund's Confidential Offering Memorandum.

Silver Creek Capital Management LLC ("Silver Creek US") 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 US in 1994.

By accepting receipt of this document, you hereby agree and acknowledge that the information contained herein (the "Confidential Information") is strictly confidential and may not be reproduced or distributed in any manner. You agree to not disclose any Confidential Information to third parties, except as provided below. You may only disclose Confidential Information upon a good faith determination that such disclosure is required by judicial or other governmental order or as otherwise required by law, provided that you have given reasonable notice to and shall consult with counsel of Silver Creek prior to such disclosure and you shall comply with any applicable protective order or equivalent. You may disclose Confidential Information to your employees or legal and financial advisors on **a need-to-know basis.**

[i] **Leveraged loan spread information from S&P Global High End Middle Market Review Q1 2017. HY spread information from Bloomberg.**

[ii] **Thompson Reuters; Leveraged Loan Monthly – March 2017**

[iii] **Deloitte; Global Private Credit Market Growing Rapidly, According to ACC/Deloitte Survey; June 28, 2016**

[iv] **Brown Brothers Harriman / Preqin; Private Debt in 2015: Thinking Outside the Bank**

[v] **Deloitte; Financing The Economy 2016**

[vi] **Private Debt Investor; PDI Annual Fundraising Report 2016**

[vii] **ibid**

[viii] **ibid**

[ix] **Preqin; Q2 2016 Private Debt Fundraising Update**

[x] **ibid**

[xi] **Blackrock; Middle Market Debt: The Long View; July 2016**

[xii] **Preqin; Preqin Quarterly Update: Private Debt Q1 2017**

[xiii] **PwC; Portfolio Advisory Group Market Survey 2016**

[xiv] **Blackrock; Middle Market Debt: The Long View; July 2016**

[xv] **ibid**

[xvi] **ibid**

[xvii] **Preqin; 2016 Preqin Global Private Debt Report; Page 20**

[xviii] **PwC; Capitalizing on the Acceleration in Bank Restructuring; Q1 2016**

[xix] **ibid**

[xx] **PwC; Portfolio Advisory Group Market Survey 2016; Q1 2016**

[xxi] **PwC; Portfolio Advisory Group Market Update Q3 2016**

[xxii] **PwC; Portfolio Advisory Group Market Update Q4 2016**

[xxiii] **ibid**

© 2017 Silver Creek. All rights reserved. Contains forward looking statements. Please refer to important disclosures at the end of this document. CONFIDENTIAL.