

SENIOR SECURED DIRECT LENDING

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Executive Summary

Senior secured direct lending represents an attractive investment opportunity in the current market environment. This is being driven by the imbalance between low supply of capital for middle market corporate borrowers and high demand from these companies. The dearth of available credit from traditional lenders in the space has created a favorable situation for investors. Funds with both capital to invest and the proper investment fund structure can utilize strong credit skills to seek total annualized gross returns of 9-15%; this is accomplished by investing in a diversified portfolio of self-originated, senior secured corporate loans. The senior secured nature of the investment offers significant downside protection to the investor. The returns in this segment of the market are at a significant spread to those available to investors focused on large, liquid credit issues. This investment opportunity is consistent with NEPC's current view that investors with a long-term horizon and the ability to invest in longer lock-up vehicles can benefit from a premium that accrues to illiquid and complex investments. This investment can be utilized in the context of an opportunistic credit allocation, a client's hedge fund sleeve, or within a broader fixed income portfolio.

The direct lending strategy involves new par loan origination rather than the purchase of loans or debt in the secondary corporate debt or loan market at a discount. It is currently available within investment vehicles that exhibit elements of a hedge fund structure, but with longer lock-ups (3-5 years) than the typical hedge fund, and has similarities with both hedge fund and private

equity distressed strategies. Lock-ups are shorter than the typical private equity vehicle, and are followed by higher levels of liquidity to the investor.

This paper endeavors to walk the reader through the characteristics of loans made to corporate entities, summarize the market opportunity at hand, explain the analysis performed by managers in this space, outline the key risks of the strategy, and, finally, provide specific recommendations for investing in direct lending given the present market environment.

THE STRATEGY OFFERS THE DOWNSIDE PROTECTION ASSOCIATED WITH A SENIOR SECURED LOAN

Direct Lending Characteristics

Corporate loans and bonds are typically arranged by banks and syndicated to a broad group of investors. Private direct lending instead involves a limited number of investors that structure terms of a transaction directly with a middle-market or small corporate borrower. There is generally a limited public market for these loans; they are usually refinanced prior to maturity or held to maturity by one or a relatively small number of investors. Senior secured private debt securities are arranged in the form of term loans and revolving credit facilities. Lenders in the space have historically been principal finance groups or proprietary desks within commercial/investment banks, specialty finance companies, financing arms of indus-

trial corporations, traditional asset management firms, and hedge funds.

The senior secured direct lending strategy offers the downside protection associated with a senior secured loan. In the current environment, the strategy has upside potential approaching that of mezzanine investing and other equity-like approaches. The senior position in a borrower's capital structure, however, typically allows a lender to have priority of return as well as control over any restructuring process, asset sale, or capital raise. These loans can also be structured to

THESE LOANS CAN ALSO BE STRUCTURED WITH EQUITY "KICKERS" THAT HAVE HISTORICALLY GENERATED MATERIAL INCREMENTAL RETURN

include equity "kickers" that have historically generated material incremental return. This equity participation can take the form of options, warrants, cash flow sharing or other participation features. Not all investors, however, pursue equity participation.

Private loans offer either a fixed or variable coupon payment due either monthly or quarterly, typically with a "LIBOR-plus" floating rate structure (LIBOR refers to the London Interbank offer rate, a commonly used risk-free rate). The term of the loan tends to be in the 24-60 month range.

From the perspective of the borrower, senior secured financing is attractive because it does not require the company to give up significant equity ownership or control of their business. Instead, the loan is backed by collateral such as property, plant, equipment, inventory, receivables, or trade claims. Access to credit by the corporate borrower is a function of the nature of such collateral, the health of their business, as well as the type of business and, to a significant extent, the condition of the capital markets and point in the economic cycle.

Senior secured private loans allow a company to monetize its assets, providing financing for:

- refinancing
- acquisitions
- debt consolidation
- equipment purchase/lease
- growth
- bridge loan
- bankruptcy/reorganization
- rescue financing/out of court restructuring

Direct lending is a strategy that is currently available in the form of an investment vehicle with elements of a hedge fund structure but with longer lock-ups (3-5 years) than the typical hedge fund. Lock-ups are shorter than the typical private equity vehicle, and are followed by higher levels of liquidity to the investor.

Market Opportunity

Deal Size

Prior to the recent credit crisis, public leveraged loan deal sizes grew substantially as lenders favored the liquidity of larger deals and banks preferred larger transactions that could be syndicated and sold into the market. According to *Standard & Poor's Leveraged Commentary and Data*, the average size of public leveraged credit transactions increased from approximately \$250 million to over \$800 million between 2002 and 2008. This trend left middle-market companies, which tend to require smaller deal sizes, with fewer traditional financing options. As a result, the private credit market grew considerably in size and scope during those years, concomitant with the growth of the public credit markets. Today, deal sizes for senior secured private loans issued by investment funds tend to be in the \$20 to \$100m range, depending on whether the loan is made by a single investor or shared by multiple entities (broadly syndicated deals can be substantially larger but these are not as common today).

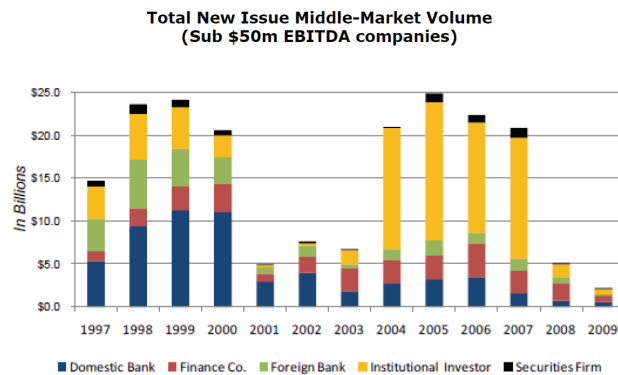
Target companies

While private lending funds have historically targeted borrowers encompassing a broader range of earnings, middle-market companies in the \$5 to \$50 million EBITDA are currently the most common borrowers in this category. Indeed, as seen



in the historical chart of middle-market lending volume (Figure 1), since late 2007 companies with less than \$50 million in EBITDA have had significant difficulty obtaining loans, creating tremendous opportunities for new entrants into that segment. Companies with EBITDA in excess of \$50 million have tended to be able to access the high yield market, which is currently active.

Figure 1



Source: Standard & Poor's Leveraged Commentary and Data

THE RELATIVE ABSENCE OF COMPETITION SHOULD ALLOW DIRECT LENDERS TO CAPTURE GREATER DEAL FLOW

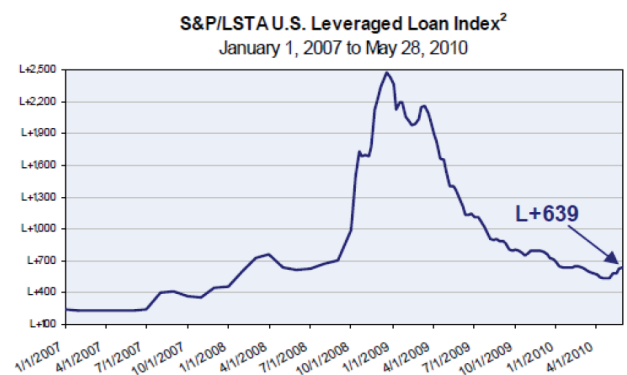
Lending terms

Today, senior secured direct lenders find themselves in an attractive position as declining leverage multiples, favorable loan terms, reduced loan-to-value (LTV) ratios, higher relative interest rates (spreads) and increased equity upside participations have improved the risk/reward profile of direct lending. The relative absence of competition as a result of the diminishment of the traditional lenders in the space should allow direct lending providers to capture greater deal flow and be very selective in making investments.

Secondary market yield spreads (spreads on loans that have already been issued, as opposed to new deals) in leveraged loans reached historically high levels during early 2009 as a result of deleveraging in the system, though spreads have tightened

dramatically from March 2009 to today (Figure 2). As primary lending activity returns to markets, credit spreads for new issuance have necessarily increased. This, in turn, has led to higher spreads for private deals. It is worth noting that in the frenzy and "thirst for yield" associated with the period between 2006 and 2007, yield spreads on privately originated loans had reached very tight levels, as low as LIBOR+200 (though LIBOR was higher at that time). In contrast, today's spread ranges on senior secured first lien deals are currently in the LIBOR plus 600 to 1000 range, while second lien deals are in the LIBOR plus 800 to 1500 range. These spreads are materially higher than the levels currently seen in the broader loan market, as shown below.

Figure 2

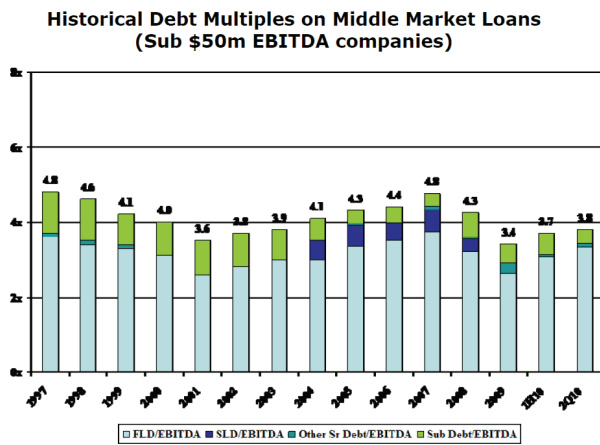


Source: Standard & Poor's Leveraged Commentary and Data

Collateral asset values have declined as a direct result of the recent credit crisis. Thus, direct lending firms are now able to finance assets at lower valuations than those seen in recent years. The current market environment also provides the opportunity for direct lenders to invest in assets at generally conservative LTV ratios. As illustrated in Figure 3, first lien debt/EBITDA multiples have fallen from an average of 4.8x in 2007 to an average of 3.8x in 2Q 2010, a decline of 21%. Though due to the economic environment the ability to anticipate what future EBITDA might be is challenging, this trend is positive for lenders. Furthermore, direct lenders have the ability to invest in new transactions with LTV ratios of 50% or less, down from the 60% to 80% range for deals originated during 2007. Such conservative LTV ratios help to limit downside risk and provide a larger margin of safety for investments in coming years. The caveat here is that estimates of

collateral values are subjective and also challenging; i.e. higher LTVs will result if more conservative collateral values are used.

Figure 3

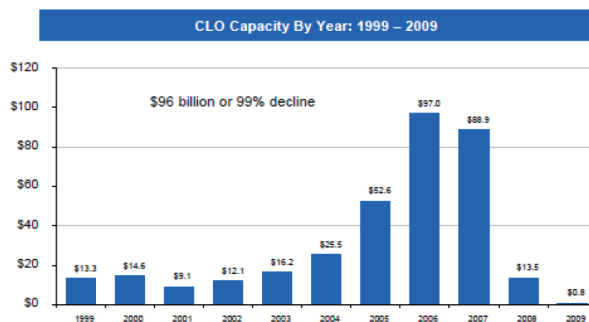


Source: Standard & Poor's Leveraged Commentary and Data

Loan Providers

While loan volume was robust through 2008, traditional sources of demand for middle market paper (i.e. providers of loans) have declined considerably since the onset of the credit crisis. Three key players in the space - collateralized loan obligation (CLO), commercial banks, and hedge funds - are substantially impaired in terms of their ability to originate loans. The collateralized loan obligation markets are weak, a significant development since, at their height, CLOs alone purchased more than 60% of leveraged loan supply. Figure 4 displays this trend.

Figure 4

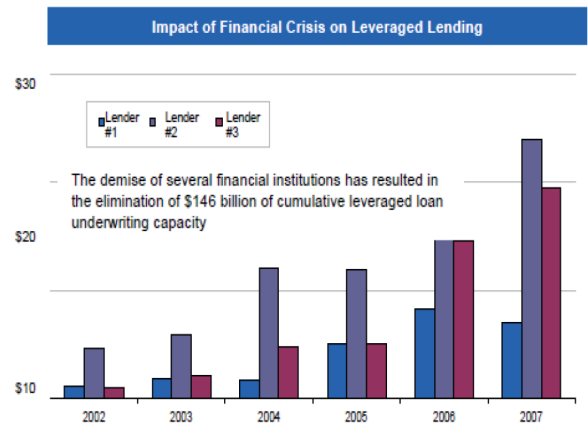


Source: Standard & Poor's Leveraged Commentary and Data, January 2010

Banks are now operating under significant scrutiny and are no longer able to provide the volume of capital to the market that they did in recent years. Large commercial finance companies such as CIT and GE Capital have been forced to shrink

their balance sheets (or have gone bankrupt) and are largely not providing new loans within this segment at the current time. The exit of three of the most sizeable lenders within this space has taken significant lending capacity out of the market, as shown in Figure 5.

Figure 5



Source: Standard & Poor's Leveraged Commentary and Data, January 2010

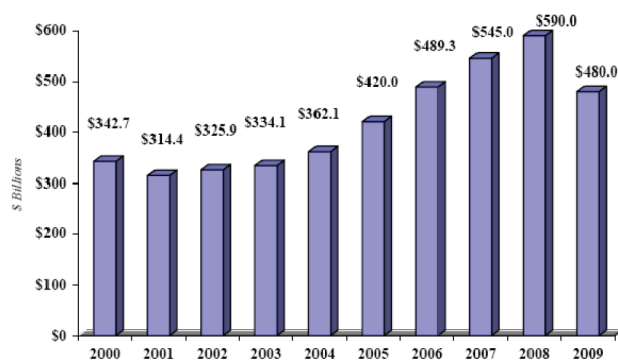
Similarly, hedge funds have lost significant investment capital and access to leverage. Smaller hedge funds, which tend to focus on the \$5 million to \$50 million EBITDA range mentioned earlier, have had significant problems with investor redemptions as they found themselves with an asset-liability mismatch. Many large multi-strategy hedge funds, which were substantial players in the space, have closed their direct lending arms and migrated back to more liquid strategies. This weakened demand picture further bolsters the need for new entrants to the origination market and has led to more attractive lending terms for investors.

Broader Asset-Based Lending Supply Trends

Despite the fact that smaller companies are disadvantaged in the current environment, the broader asset-based lending industry remains viable, continuing to provide financing to businesses. Indeed, the health of the industry is vital to that of the overall economy. According to the Commercial Finance Association (CFA), asset-based loans reported significant growth in 2008 despite the turmoil in the public credit markets. The U.S. asset-based lending industry grew by 8% in 2008 to \$590 billion in total loans outstanding marking the seventh consecutive year of supply growth (Figure 6).



Figure 6-ABL Industry Growth



Source: Commercial Finance Association Annual Asset-Based Lending and Factoring Survey, 2009; May 17, 2010 Non-Member Edition

Analysis Performed in the Evaluation of Direct Lending Opportunities

In order to implement and mitigate the risks of the Direct Lending strategy, it is important for a direct lending manager to have several critical capabilities. Though this is not an exhaustive list, it highlights some of the key components of a successful direct lending fund. The overall theme is that the infrastructure and team must be consistent with the level of diligence required to evaluate both existing portfolio companies as well as new deals.

Credit and Fundamental Analysis

Credit analysis involves an assessment of the creditworthiness of a business, including a variety of financial analysis techniques, such as ratio and trend analysis and a detailed analysis of cash flows. It also includes the examination of collateral and other sources of repayment as well as credit history and management ability. Fundamental analysis is related to credit analysis techniques, considering both quantitative and qualitative factors. It involves an analysis of a company's financial statements, management, and its competitors and markets with the goal of making financial forecasts and determining current intrinsic and potential future value.

Legal and Structural Analysis

Legal and structural analysis is as important as credit work. Key attributes associated with this include the presence of experienced bankruptcy attorneys on staff, who can mitigate the structural risk associated with the loans through careful underwriting and documentation. An example of

this is making sure that liens on the underlying collateral are perfected. Workout experience is also highly desirable.

Loan Sourcing

Sourcing can occur through a variety of avenues including private equity or leveraged buyout firms, investment banks, bankruptcy attorneys, restructuring firms, contacts in industry, and directly through companies in need of financing. It is preferable if a fund has a variety of sources for deals rather than relying on just one or two. An important element of the sourcing approach is how individuals within the firm who are charged with sourcing deals are paid and incentivized. Another is whether these same individuals are involved with the loan throughout its life while on the fund's books or whether they source the deals and then move on to the next deal.

Independent Collateral Appraisal and Monitoring

The presence of a third party who appraises and monitors the collateral underlying a loan is very important. The objective is to determine a range of potential collateral values: a fair market value, an orderly liquidation value, and a distressed market value. Without this element, a fund may find itself surprised to find out in the case of default and attempted recovery that the collateral is worth less than what was expected.

Portfolio Valuation

Independent, third party pricing and frequent portfolio auditing (every quarter is ideal) are critical due to the fact that the loans are generally not publicly traded and lack price discovery.

Strategy Risks and Portfolio Considerations

The direct lending strategy generally offers an investor low to moderate volatility and steady returns with low correlation to public capital markets (important to note, however, that the low correlation is at least partly a function of the lesser price discovery associated with direct loans). Direct loans do not typically depend on the existence of robust merger and acquisition or public equity markets (particularly if sourced outside of the leveraged buyout channel) and favorable returns on direct lending investments can be

achieved even if these markets remain challenged for some time. Also, regular cash flows associated with the strategy can serve to mitigate the “J curve” effect in a private equity portfolio.

Portfolio company risk can be addressed by investing in managers that build well diversified portfolios by corporate sector, size, and geography or investing in multiple managers with differing target markets. When compared to other strategies in an opportunistic or strategic credit allocation, the direct lending strategy offers a moderate expected time horizon, with appropriate fund-level lock-ups in the 36-60 month range.

The strategy is not without its risks, the key components of which can be boiled down to:

- default on interest payments
- non-repayment of principal
- recovery of value from the collateral underlying the loan below what the collateral value was deemed to be.

Any of these outcomes in portfolio companies would subtract from the expected 9-15% returns mentioned in more detail in the section below. Default, or more specifically non-performance, typically causes the largest negative impact on returns in this space. Positive equity participation outcomes, if applicable, would add to the base case. In addition, the strategy entails liquidity and pricing/valuation risk, as these loans may lack a secondary market (and therefore significant price discovery), as well as counterparty/fraud risk whereby a portfolio company could misrepresent material facts about its business.

Recommendations for Present Conditions

We have observed a wide range of yields available today to direct lenders with most loans falling somewhere between LIBOR 600 to 1000 for senior secured first lien deals while second lien deals are in the Libor plus 800 to 1500 range. The spread is a function of the size of the company, the nature of the business, the type of collateral, the sourcing avenue, and myriad other factors that can be toggled in order to arrive at the desired potential internal rate of return (IRR). Also available to lenders are origination and exit fees, which can range from 2-4% of the loan, as

well as in certain cases equity participation, which can materially impact total returns. Note that some funds will seek to obtain a higher coupon or other terms and forgo the equity participation. We are targeting potential gross total annualized returns over the coming cycle to fall within the 9-15% range in the current environment. Again, it should be understood that the type of company that is targeted and the manner in which the loan is structured will determine the target IRR, which could be higher or lower than our estimates below. This return range can be decomposed as follows.

Components of Direct Lending Returns	
Cash coupon	6-15%
PIK coupon	0-5%
Origination fees	2-3%
Equity participation	0-5%+
Expected Returns	9-15%

In the current environment, NEPC recommends seeking the general attributes below in a direct lending fund in an effort to maximize potential return and minimize risk (not an exhaustive list).

Recommended Attributes - Direct Lending Funds
• Demonstrably thorough underwriting and asset management process
• Majority senior secured, first-lien loans
• Loan terms in the 24-48 month range (short to moderate duration)
• Hard collateral coverage only
• Originate and hold approach (little trading), accept illiquidity premium
• Multiple sourcing avenues (avoid exclusively PE/LBO focused players)
• Small and middle market companies, EBITDA \$20-50 million ideal
• Focus on financial engineering, as opposed to operational turnarounds
• Private companies only or almost exclusively
• No portfolio leverage
• Loans to healthy companies only or good companies/bad balance sheet, avoid distressed, rescue, loan-to-own
• Invested across industries
• Moderately diversified portfolio, 30-50 names
• New fund with little or no capital deployed and few or no legacy issues in other funds
• Warrants obtained selectively when appropriate
• Origination fees going to the fund not to the manager
• Carefully matched assets and liabilities; i.e. proper vehicle structure
• Hold controlling stake in capital tranche (not minority) and/or be involved with like-minded investors when sharing deals
• Moderate LTV (40-60%) using conservative assumptions



Conclusion

For the reasons illustrated above, senior secured direct lending represents an attractive investment opportunity in the present market environment. The lack of credit available from traditional lenders has allowed investment funds to utilize their credit analysis skills to build portfolios of loans with total targeted annualized gross returns of 9-15%. Investors with a long-term horizon and the ability to invest in longer lock-up vehicles can benefit from the premium that today accrues to illiquid and complex investments. At NEPC, we can help clients structure an investment in the direct lending strategy as part of their opportunistic credit allocation, a hedge fund sleeve, or within their broader fixed income portfolio.

Sources

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- “Strategy Focus Report - Asset Based Lending Funds”, Hedgefund.net, April 2009.
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Disclaimer

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In addition, it is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds and private equity:

- Performance can be volatile and investors could lose all or a substantial portion of their investment
- Leverage and other speculative practices may increase the risk of loss
- Past performance may be revised due to the revaluation of investments
- These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
- These funds are not subject to the same regulatory requirements as registered investment vehicles
- Managers are not required to provide periodic pricing or valuation information to investors
- These funds may have complex tax structures and delays in distributing important tax information
- These funds often charge high fees
- Limited partnership agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager’s realm of expertise or contemplated investment strategy

