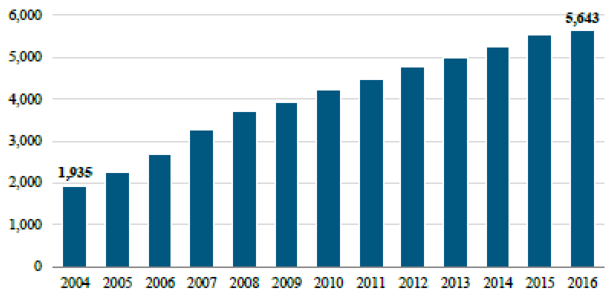
DIRECT LENDING – A GROWING ASSET CLASS

Investment Insight | Series II

In a series of articles we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. We have started the series with structured credit in September and continue with "Series II" about direct lending, which we believe will take an even more important role for institutional investors going forward. As long as interest rate levels in developed countries remain at historical depressed levels the asset class offers an outstanding risk/reward ratio as compared to traditional "safe haven" assets. **Direct or private loans give access to attractive and stable yield income at the expense to lock up the capital for in average 5-8 years.**

Chart 1: Middle market companies owned by PE firms



Source: S&P / Angelo Gordon

Direct lending – An attractive alternative

In a world of historical low interest rates and (very) high debt burdens combined with an economic outlook that foresees only moderate global GDP growth, it is a fair assumption that structural inflation pressure should remain tame – at the minimum for the next few years to come. Moreover, central banks responded to the lackluster economic growth with the introduction of new creative measures and actions to push key rates in some cases to the lowest levels ever. Even when we anticipate that the FED will soon start to normalize its interest rate policy and lift the yield curve, the income generation from "safe" bonds such as high quality investment grade or US Treasuries bonds will remain meagre. The situation gets even worse when we turn to European or Japanese bonds, earning in many instances negative yields. In this environment, private debt appears like a "yield island" offering an average yield of 7-8% p.a. for senior secured loans of well backed small and medium sized companies (middle market). This alternative investment opportunity gained popularity and has attracted an increasing number of institutional investors.

Chart 1 on the left hand gives an example to demonstrate the rapidly growing number of small and medium sized companies (SME's) tapping the private market for their borrowing needs. **Non-bank lenders are increasingly an alternative to the traditional bank lending as the regulatory burden for commercial banks has steadily increased since the financial crisis**. Chart 2 below illustrates well that investors can ask for an incremental yield for smaller loans as compared to the large syndicated loan market. The additional loan spread between SME's and large corporate loans from 2010 to 2015 was 155 bps higher.

Chart 2: Average yield for middle market loans

Source: S&P Capital IQ LCD / Angelo Gordon

Positive supply demand dynamics

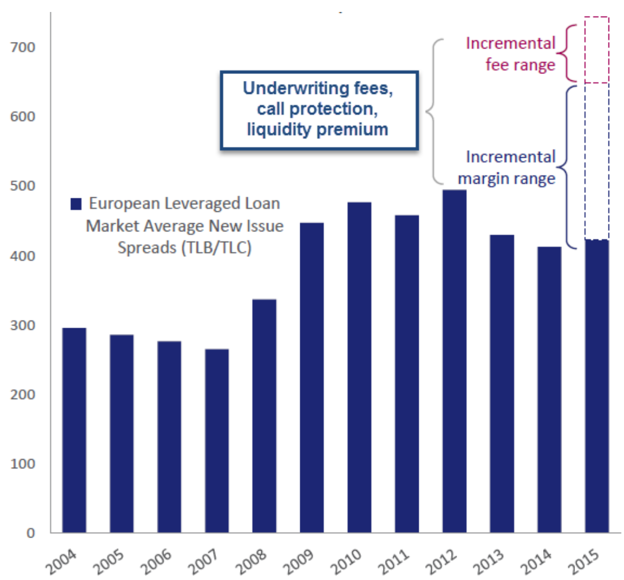
Banks are incentivized to reduce their balance sheets because of the new regulatory environment post the financial crisis. It is in many instances not any more efficient for them to hold exposure to SME's as the required capital costs by the regulator are too high. This leaves increasingly room for alternative lenders to step in and provide the lending.

While the private lending market is already established in the U.S. it is a relatively new market in Europe, which got a boost over the last 24 months. While some SME's are too small to tap the syndicated market and feel forced to enter the private lending market, the larger middle market companies like the speed, sophistication and flexibility of alternative lenders and are therefore willing to pay a premium versus the traditional market.

Attractive yields

The nature of deals structured has led in the past to high absolute and relative returns. Importantly, not only are the private lenders able to ask for a higher yield compensation (see chart 2), but they are also able to negotiate for "upfront fees" and call protection, what helps to increase the total target return for an investor as it is documented in chart 3.

Chart 3: Incremental fees enhance the target return

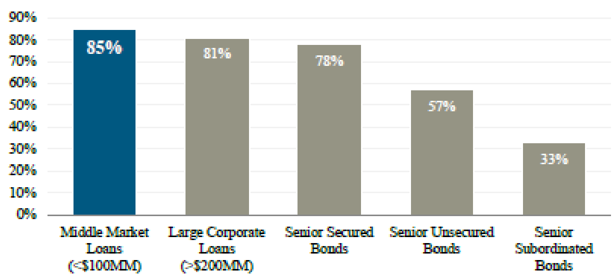


Source: S&P Capital IQ LCD / Bluebay / Alpinum Investment Management

Lower loss rates lead to lower risk profile

Historical analysis shows that experienced private debt lenders suffer lower default- & loss rates as compared to the "public" syndicated market. On average, **directly originated middle market senior secured debt offers not only a higher yield, but has on average also a lower leverage employed** than large corporate syndicated loans, what leads to higher recovery rates (see chart 4 below).

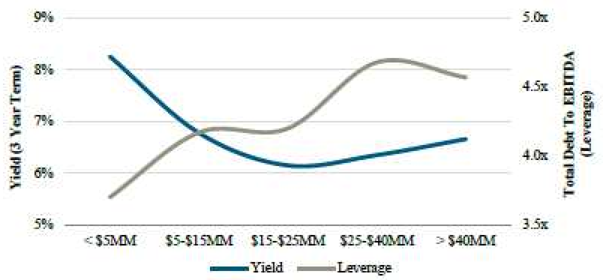
Chart 4: Average historical Recovery Rates



Source: S&P / Angelo Gordon

Chart 5 below illustrates well the fact that smaller credits are on average more conservatively financed. More equity within the capital structure does not only lead to **lower leverage ratios**, but also to **lower loss rates** (combination of low default rates & high recovery rates).

Chart 5: Middle market loans are more conservative



Source: Thomson Reuters / Angelo Gordont

Diversification and experience matters

Private debt as an asset class is growing rapidly and accounts today for **more than 2'000 funds** with an aggregate value of more than USD 140 bn. We have already been successfully investing in illiquid credit for many years and have also exposure in direct lending funds. Besides experience and superior selection skills of the funds' management teams, **portfolio diversification** is an absolute necessity in running a successful long term private loan portfolio. A **diligent underwriting process** with **strong covenants** in the documentation and an **effective loan monitoring process are other key success factors**.

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Contact Information:
Alpinum Investment Management AG
Talstrasse 82
CH-8001 Zurich
Tel: +41 43 888 79 30
Fax: +41 43 888 79 31
alpinumim.com