Private Lending

"Underwriting" = Risk Evaluation

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Introduction

Private lending is a growing form of investment among family office and HNW investors as they seek greater returns on their fixed-income investments (debentures, notes and bonds).

The good news for private investor-lenders is that finding these investment opportunities isn't difficult. More stringent federal banking regulations, along with 30 years of commercial bank consolidations across the U.S., have significantly diminished the ability and overall willingness of commercial banks to make loans to small to medium companies ("SMB"). Banks are still making real estate loans. But smaller service businesses and many other business sectors can't get a bank loan from their local banker.

Local branch bankers, the bank's representatives who actually know SMB borrowers, now have much more limited influence on the bank's decision process for making the loan. The "underwriting department" within regional and larger banks (where the up or down decision is really made on a given loan application) is typically hundreds or even thousands of miles away from the borrower's location.

So, there are over 30,000,000 SMBs (99.9% of U.S. businesses) which have limited access to commercial bank financing and no access to the corporate bond markets. SMBs, therefore, are compelled to explore alternative sources of financing, in particular, the private capital market.

Private Lending as an Investment

Given the above, lending opportunities for private investors are virtually unlimited and at interest rates that are typically 3X or more than comparable maturity corporate bonds.

The returns available to investors from private lending are relatively "inelastic" in that they do not typically fall lock-step with the broader bond markets' price and yield changes. Therefore, the "alpha," the incremental yield available through this form of investment, can be consistently attractive – even more so during these times of historically low interest rates..

But there's no "free lunch." These loan investments represent a higher risk of default by the borrower. So, it is critical that a well-reasoned and thorough credit analysis precede each loan decision. by the private lender.

Family offices and individuals participating in this private lending activity need to understand the many facets of extending credit or, at least, be supported by someone who is experienced in this arena.

Borrower Analysis and The “Three C’s”

The “three C’s” offer a time-tested framework for evaluating the borrowers they lend to:

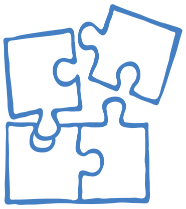
- **Capacity** – Determining the borrower’s ability to pay the loan’s interest and principal by analyzing the historical and projected operating cash flow and whether it’s sufficient to meet the loan’s “debt service” requirements. This includes a review of any other obligations of the borrower that might interfere with the loan’s repayment.

- **Collateral** – The borrower’s Assets (property, inventory, other “fungible” items) which could be sold, if necessary, to raise cash to repay the loan.

- **Character** – A critical determination about the personal integrity of the borrower and their personal commitment to repaying the loan.

Major Investment Considerations

Expanding on the three C's, the overall loan investment analysis should include:



1. **Borrower Background** – Information about the borrower, which should include their industry, their historical business performance, credit history, and a review of the people who own and manage the business.

2. **Borrower Financial Analysis** – An analysis of various financial ratios which pertain to the overall leverage of the borrower, its ability to pay the scheduled interest and principal payments associated with the loan, as well as the availability of any collateral or guarantees for use as a secondary source of loan repayment.

3. **Note Offering Terms** – Specific terms of the loan (or note), including the total borrowed amount, interest rate, maturity, principal repayment terms and other terms affecting investors' return on investment.

4. **Credit Support** – What, if anything, is available as a secondary source of repayment for the loan if, ultimately, the "full faith and credit" of the borrower is not sufficient? Smaller private borrowers commonly offer personal guarantees and collateral to provide additional sources of repayment.

⑤ **Representations & Conditions (Covenants)** – These items provide the foundation for the loans and include affirmations by borrowers that they will or will not do certain things necessary to make the debts binding obligations enforceable in court, if necessary.

⑥ **Relative Return Considerations** – There are virtually unlimited investment opportunities, even among those that provide "current income." How does the projected return of this loan compare when considering its risk and the investment's illiquidity, (i.e., the inability to get out of the investment before its maturity)?

Private Lending Evaluation Guideline

The following identifies the major categories for debt investment analysis as well as pertinent sub-categories.

Borrower Considerations	Required Answer
Is the industry well established?	Yes or No
Borrower's segment of the industry?	Yes or No
Borrower's business history	Years
Borrower's historical profitability	Yes, Sometimes or No
Borrower's credit history	Yes or No, Good or Bad
Senior management's industry experience	Years
Senior management in current role	Years
Senior management's personal credit history	Good or Bad

Borrower Financial Analysis	
Current level of indebtedness	$
Total debt-to-equity ratio	%
EBITDA Maintenance	$
Interest reserve	$ (X month's interest)
Borrowing base (Collateral value / loan principal)	% (100%)

Note Offering Terms	
Loan amount	$
Interest rate	%
Maturity	Years
Repayment schedule (amortization)	Bullet/amortization schedule
Warrant or other yield complement?	%
Total IRR Expectation	%
Repayment schedule (amortization)	Bullet/amortization schedule
Prepayment option	Yes or No

Credit Support	Required Answer
Seniority	Senior or Subordinated
Credit enhancement	Yes or No
Guarantees?	Yes or No
Can Guarantor repay the Note?	Yes or No
Is the Guarantee more about commitment?	Yes or No
Collateral	Yes or No
Type of Collateral	Type
Third-party valuation available?	Yes or No
Easily liquidated?	Yes or No
Perishable?	Yes or No
Increases in value over time?	Yes or No
Is it mobile?	Yes or No
Require maintenance?	Yes or No
Can it be secured and protected?	Yes or No
UCC filing?	Yes or No

Representations & Conditions (The list below is not all-inclusive; appropriately experienced legal counsel should be consulted.)	
Standard Reps & Warranties in Place?	Yes or No
Due diligence complete?	Yes or No
Financial Covenants	Yes or No
Collateral coverage	%
Fixed-charge coverage ratio	%
Total debt to total capitalization (leverage test)	%
Affirmative Covenants	Yes or No
Notifications to Lenders	Yes or No
Landlord cooperation	Yes or No

Representations & Conditions, cont'd	
Negative Covenants	Yes or No
Additional indebtedness limitation	Yes or No
Additional lease limitation	Yes or No
Interest reserve	Yes or No
Distribution to shareholder limitation	Yes or No
Shareholder loan prohibition	Yes or No
Other	Yes or No

Relative Return Considerations	
Comparable maturity U.S. Treasury Note Yield	%
Comparable maturity A-rated bond yields	%
Current High-Yield Bond Returns	%
Note IRR Multiple relative to High Yield	
Equity return range for issuer	% to %
Other private lending return range	% to %

Conclusion

The returns available to investors from private lending are relatively "inelastic" in that they do not typically fall lock-step with the broader bond markets' price and yield changes. Therefore, the "alpha," the incremental yield available through this form of investment, can be consistently attractive – even more so during these times of historically low interest rates.

But, as learned in an Econ 101 class, "there is no free lunch." Private loans typically involve much greater risk, likelihood of default, and potential for loss. Without applying an analysis as suggested by the above, losses can easily outstrip the incremental interest income that a portfolio of private loans potentially generates. However, such analyses may not be enough to prevent losses that are a result of factors outside of a borrower's control, such as changes in regulations, the imposition of tariffs, or "Force Majeure" Events.

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