Private Lending

"Underwriting" = Risk Evaluation

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Summary

The low interest rates offered from U.S. Treasury and public bond markets are increasing private lending among investors looking for greater returns on their fixed-income investments (debentures, notes and bonds).

Non-bank private lending has also grown. Smaller companies (the SMB's) – the nearly 200,000 that cannot access the public bond markets – must turn to other financing sources to fill the void left by U.S. commercial banks that have largely retreated from SMB lending since the early 1990's. Increased federal regulation and nationwide bank consolidations have nearly eliminated local underwriting – the process of evaluating the creditworthiness of a borrower. This critical step to loan approval is now being conducted hundreds or even thousands of miles away from the borrower's location.

Credit analysis, by any type of lender, remains an essential part of making a loan.

Participants in the expanding market – "direct private investment" – must appreciate the many facets of extending credit. It starts with determining the credit strength or weakness of the borrower. This "underwriting" process is a highly specialized skill within any lending institution. Individual lenders should acquire at least a basic understanding of credit analysis before they start investing in private notes.

This Carofin White Paper outlines the major considerations for evaluating both a corporate borrower's credit strength and the loan terms being offered for the related debt investment. The work sheet in the back will help guide less experienced investors' analyses in identifying factors to consider.

Major Underwriting Considerations

Primary areas for analysis include:

1. **Borrower Background** – Information about the borrower, which should include:

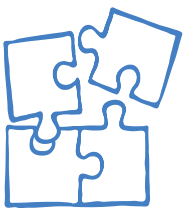
    -- Industry
    -- Business History and Performance
    -- Credit History
    -- Review of the Owners and Managers

2. **Borrower Financial Analysis** – An analysis of various financial ratios which pertain to the overall leverage (amount of debt on the balance sheet) 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:

    -- Total Borrowed Amount
    -- Interest Rate
    -- Maturity
    -- Principal Repayment Terms
    -- Other Terms Affecting Investor's 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? Personal guarantees and collateral are commonly offered by smaller private borrowers 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 do the projected returns of these loans compare when considering the risk and the investments' illiquidity, such as the inability to get out of the investments before their maturities? Unlike publicly offered securities, private placements generally do not offer investors the option to sell or redeem prior to maturity.

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.

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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	$
Debt service capacity (Fixed-charge coverage ratio)	% (100%)
Interest reserve	$ (X month's interest)
Borrowing base (Collateral value / loan principal)	% (100%)

Note Offering Terms	
Loan amount	$
Total debt to total capitalization (leverage test)	%
Interest rate	$
Equity warrant attached?	Yes or No
Warrant or other yield complement?	%
Total IRR Expectation	%
Maturity	Years
Repayment schedule (amortization)	Bullet/amortization schedule

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	%
Affirmative Covenants	Yes or No
Notifications Lo Lenders	Yes or No
Landlord cooperation	Yes or No
Lender indemnification	Yes or No

Representations & Conditions, cont'd	
Negative Covenants	Yes or No
Additional indebtedness limitation	Yes or No
Additional leas 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 (CCC-rated)	%
Note IRR Multiple relative to High Yield	
Equity return range for issuer	% to %
Other private lending return range	