

Private Credit Investing: 2012

Introduction

“When life gives you lemons, make lemonade.”

We’re not sure who first coined this phrase, but it certainly applies to private credit investing, as the credit crisis of 2008-2009 continues to provide opportunities in this segment of the overall debt market. Since 2008, we have seen volatile stock markets, low yields on bonds, and a general uncertainty in the market lead many investors and institutions to increase allocations to private credit. Most have been handsomely rewarded.

Public Credit vs. Private Credit

To begin, it is important to understand the various forms of credit investing. In public credit, which most are familiar with, loans and bonds are generally arranged by banks, then often syndicated to a larger number of investors, and ultimately available to purchase on the secondary market in a bid/ask format. Bond mutual funds, bond ETFs, hedge funds, pension funds, and individuals can then purchase such securities via a broker according to the quoted price. This market is fairly efficient with thousands, if not millions, of participants.

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Public credit markets tend to focus almost exclusively on providing credit to companies (or governments) via bonds or the syndicated loan market. Credit areas such as receivables factoring, asset based lending, equipment leasing, consumer debt, and others are virtually non-existent in the public credit domain, other than via securitized vehicles which can add additional risks and volatility.

Public credit markets also focus on the larger transactions, typically lending to companies with over \$500 million in revenue. Hence, when an investor purchases a corporate bond fund or ETF, he or she is typically buying a basket of loans in large companies that were originally syndicated by banks and are now available at a quoted price via a broker to everyone from Bill Gross at PIMCO to the \$5,000 individual investor with an online trading account. Such securities are easy to buy, very liquid, easily accessed by millions of investors, and have several banks, brokers, market makers, etc. taking out their fees along the way. Even if the investor is participating in a new issue bond or note, such securities are typically only issued to investors by large companies and purchased primarily by institutions willing to accept extremely low yields in exchange for liquidity (e.g. IBM was able to issue \$1.5 billion in three-year notes to investors in 2010 with a 1% coupon). Higher yields can be achieved in the high-yield market, but with significantly more risk.

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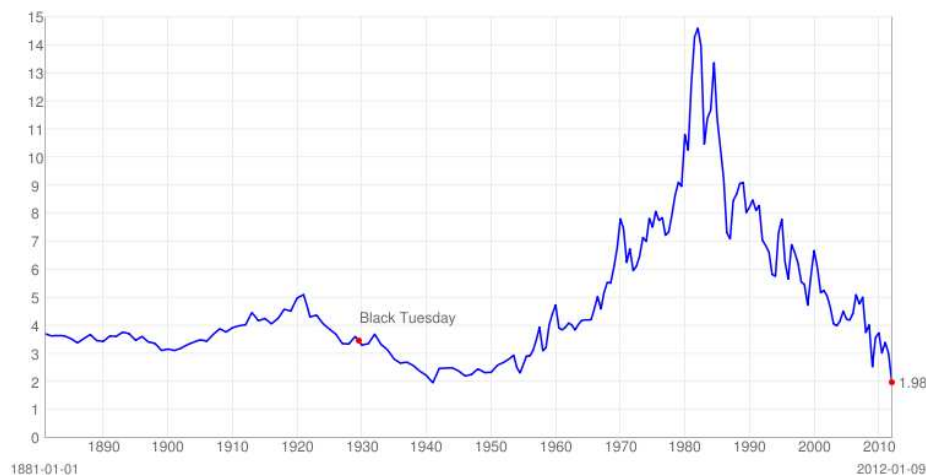
One additional problem is that bond and traded institutional bank debt markets are almost entirely driven by two non-controllable and difficult-to-predict factors: (1) public sentiments and (2) interest rates. As a result, obtaining useful diversification in a bond or traded institutional bank debt portfolio is difficult. Most bond portfolios seek large numbers of positions to protect against credit risk, which isn't generally the substantive issue. This approach overlooks the fact that the entire bond portfolio may likely be greatly impacted by changes in public sentiments or interest rates during the hold period.

In summary, what we currently have in the public credit market is a very narrowly focused investment platform (large companies), easily accessed by millions (hence, very efficient), currently offering very low rates of returns (1-4% for non-“junk” status), with a relatively high potential for loss on long duration bonds if interest rates rise and the security cannot be held to maturity. An interesting quote by Jeremy Siegel, Wharton School finance professor, appeared in the Wall Street Journal on January 9, 2012. Professor Siegel states, *“The bond outlook is extraordinarily bad. Bonds are in vogue and overvalued, much as stocks were at the end of the 1990’s. After 30 favorable years of declining yields and rising prices, the best case for bonds over the next couple of decades is a return of zero after inflation – and more likely a negative outcome.”*

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Those who offer great “historical returns” as rationale for bond investing fail to make the case. The overwhelming driver behind returns of all types of bonds over the past 20 years has been a dramatic, long-term decline in interest rates. Although we believe interest rates could go even lower or stay flat for some time yet, we believe the public credit markets are in the last days of a secular bull market. As shown in the chart below, the public credit bull market began in the early 1980’s as the 10 year treasury yield began a long, unprecedented decline. The duration risk associated with bonds is greater the lower this curve goes as the long term propensity for rates to rise increases.

10 Year Treasury Rate



For the reasons discussed above, the public bond market, in our opinion, is currently a borrowers' market with very little upside for investors and actually quite a bit of downside due to interest rate risk, unless such securities are held to maturity, which still results in a very low return scenario.

Public bond fund investors seeking yield and security should consider the private credit markets, which may offer a better risk / return profile than public credit. Private credit investments are generally not "quoted" on a broad system or exchange and cannot typically be purchased via a broker. Private credit investments are typically privately negotiated investments secured by underlying collateral whereby the lender receives rights to a contractual stream of payments. Private credit investments include loans to companies, as is the focus of public credit, but private credit also includes various other segments of the credit market that are either too small or not easily syndicated and thus are not part of the larger, public credit market. Private credit includes investments in the following areas:

- New issue senior loans to middle market companies
- Secondary loan pool purchases
- Consumer and industrial loans
- Distressed debt
- Accounts receivable factoring
- Credit card charge-offs
- Equipment leasing
- Auto finance
- Bankruptcy claims
- Real estate debt

An unlevered, diversified portfolio of private credit investments can provide substantial yield to investors and still provide strong collateral and downside protection. Such investments offer low volatility and steady returns as most are based on contractual cash flows and held to maturity, as opposed to public bond funds and ETF's whose returns are significantly influenced by sentiment-driven price movements. In much of private credit, returns are made by investing in pre-determined, contractual streams of cash flow at an attractive price. Returns are primarily made on the buy and locked in. While all private credit investments (like all credit investments) do possess credit risk, many private credit investments have significant equity underneath them or underlying hard assets pledged as collateral, thus providing strong downside protection. If investments are properly selected and underwritten, returns can have low correlation to public stocks, bonds, real estate or commodity prices, notably because private credit investments rely on a stated stream of principal and interest payments, as opposed to market sentiments, interest rates, company or economic growth or other macroeconomic factors to achieve their return.

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Current Market Status: 2012

Current opportunities in private credit are robust for several reasons. First and foremost, many of the historical providers of private credit have been impacted by the financial crisis. These include small and regional banks, specialty finance companies, hedge funds, CLO's, and others. Before 2008, all of these sources of capital were very active providing or facilitating capital to private market borrowers. However, since the collapse of Bear Stearns and Lehman Brothers, there has been a significant reduction in the availability of capital for the private credit markets. Additionally, the number of FDIC insured commercial banks has declined by 40% since 1994 and larger banks have shifted products and services away from the middle market in favor of larger clients. Hence, capital in many areas of the private credit market has become scarce. Most private credit investments take advantage of this capital shortfall by demanding increased downside protection and higher interest rates. Investors can demand higher returns because the larger banks are simply not there anymore competing with their lower cost of capital.

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One of the largest enablers of capital to the middle market was the CLO market (collateralized loan obligation). These vehicles made thousands of loans to middle market companies which were pooled together, securitized, and sold off to investors. In essence, CLO's turned private middle market lending into a public credit vehicle (which lowers the cost of capital and returns to investors, and can increase risk). However, since 2008 the CLO market has declined considerably, creating a dearth of financing for middle market companies and niche users of credit capital. We see a prominent dividing line in the market, at approximately the \$50 million in EBITDA level. Solid companies with greater than \$50 million in earnings are generally able to find financing in the current market with relative ease, and companies below this threshold struggle as the public bond and CLO markets are not available, regional and community banks are still struggling and hampered by loan maturities and underwater real estate loans, and the larger banks want to serve bigger clients.

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In addition, many banks that were providing private credit in areas such as equipment leasing, receivables factoring, auto finance, consumer lending, etc. have curtailed or altogether eliminated their available capital for such activities, thereby creating opportunities in these smaller niche segments of the private credit markets.

2011 was a fantastic year for private credit, driven largely by uncertainty in the public markets which prevents banks and other financial institutions from expanding their lending footprint. We believe one of the best predictors of what the private credit markets will be like in 2012 is the level of

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uncertainty we expect to see in the broader financial markets. Market uncertainty leads to great private credit opportunities.

As we look forward to 2012, we see several factors that point to a “status quo” situation with continued uncertainty in the market—a sort of one step forward, one step back routine. First and foremost is the European debt crisis. Even the chance of an unraveling European Union or collapse of the Euro is enough to create fear among U.S. financial institutions, seriously reducing private market credit capital availability. A close second to the EU crisis is the current unemployment rate and related issue of consumer spending. Unemployment remains above 8% and consumers’ stamina to keep the economy going is beginning to come into question. Finally, also adding to the uncertainty is the high level of underwater real estate still on the books of many financial institutions, particularly small and mid-size banks. At some point this debt is either (1) repaid or (2) written off. For many borrowers, option (1) simply does not exist. For these reasons, and others, we believe banks and the institutional providers of private credit will remain on their heels in 2012.

Illiquidity—An Advantage for Private Credit

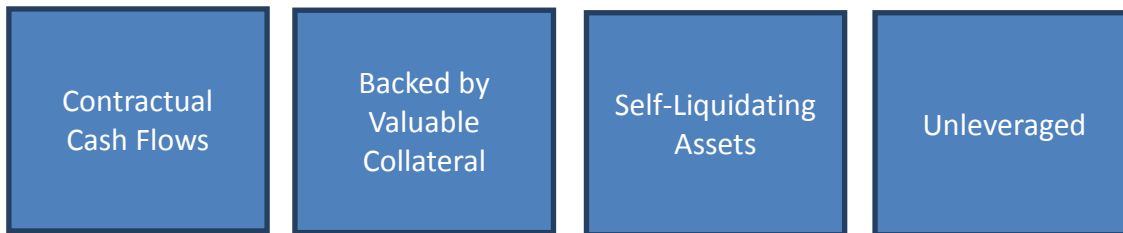
Private credit is less liquid than public credit as it is not quoted and bought/sold daily via brokers or exchanges, eliminating much of the eligible investor universe—a very positive condition for those who can invest in private credit. Investors who require daily liquidity often pay dearly for it by taking on more risk and getting lower yields than comparable private credit investments. Lack of daily trading prohibits allocations from certain pension funds and much of the world’s available credit capital (e.g., mutual funds, 401(k) plans, etc.). This condition forces the vast majority of the world’s available credit capital into (often unrewarding) mainstream credit investments. This is the very reason IBM could sell \$1.5 billion in 1% notes in 2010. IBM knew many institutional investors basically had no other choice. Investors not constrained by such parameters should ask themselves if the increased risk and lower return is worth the benefit of daily liquidity, as private credit strategies may offer investors higher yields and potentially less volatility and risk of loss.

“Investors who require daily liquidity often pay dearly for it by taking on more risk and getting lower yields than comparable private credit investments.”

The Future of Private Credit: Beyond 2012

The biggest risk to finding new, attractive private credit investment opportunities is an overheated economy, like we experienced prior to the recession. In 2005-2007, there were very few attractive private credit opportunities for private investors. Banks, hedge funds, BDC’s, captive finance arms, and others were lending to just about any company or individual with a heartbeat—and some without. Based on the factors discussed above, it appears there is ample runway for attractive private credit investing as we are likely several years away from an “overheated” U.S. economy. The subset of opportunities and those areas with capital shortages may shift, as we have seen in the last two years, but attractive opportunities are likely to be found.

We continue to believe a compelling opportunity exists to create an attractive portfolio of private market credit investments with the following characteristics:



Private credit investments, which are generally held to maturity and self-liquidating rather than held for sale, offer more predictability in returns than bond market investments which rely on trading movements. Returns are typically determined at the time of purchase. As a result, investments made today facilitate significant returns visibility, even if sentiments or interest rates change in the future. If the market for private credit investing becomes unattractive, new investments can be avoided and allocations curtailed without much impact on investments already made due to the contractual nature of the returns.

Conclusion

We believe the opportunity for investing in the private credit market continues to be very attractive, if investments are carefully selected and underwritten. The market opportunity in 2012 looks very similar to that of 2011, with minimal progress or improvements in those issues that would reduce uncertainty and entice banks to become more active in private credit lending, thereby driving down yields. As for the outlook beyond 2012, the future is always difficult to predict with any degree of certainty. However, when you see your unemployed neighbor borrowing 120% of the value of his home based only on his signature and no other collateral, you will know that attractive private credit investments have become difficult to find. Until then, drink lemonade.

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