CANADIAN
ASSOCIATION OF
ALTERNATIVE
STRATEGIES
& ASSETS

THE CASE FOR PRIVATE LENDING

How to bring diversity and greater returns to your fixed-income strategy

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Foreword

Since the global financial crisis, private lending has become an increasingly prevalent part of institutional and retail portfolios across Canada, as investors seeking high-yielding investments continue to face low interest rates and compressed credit spreads on corporate debt versus comparable-term federal and provincial offerings.

In this publication, we provide an overview of private lending and some of the most common forms that it takes. Our goal is to provide enough information so that investors and their advisors develop a better understanding of this important fixed-income strategy.

We would like to thank the CAASA Fund Investment Risk Methodology (FIRM) Group, the CAASA Private Lending Group, and each of our sponsors for their important contributions to this work.

James Burron, CAIA
President, CAASA

An Introduction to Private Lending

Over the past decade, private lending — the origination of loans by non-bank lenders that are packaged into investment vehicles for institutional and retail investors — has exploded globally as an alternative fixed-income strategy. In the process, it has given greater choice to borrowers who otherwise are underserved by traditional lenders. At the same time, private debt has also emerged as an effective strategy to help investors increase diversification within their fixed-income strategies. It does this by giving them access to a broad range of lending opportunities, thus lowering their overall risk.

Across Canada, private lending has become an important component of institutional and retail portfolios thanks to the high and relatively stable yield it provides. Underscoring the point, the Canada Pension Plan Investment Board, one of the leading proponents of alternative investment strategies globally, has allocated 8.5 percent of its total assets to alternative fixed-income strategies, of which 5 percent is allocated to private debt.

Of course, private lending isn't a new concept. The earliest examples of it date back 3,000 years to Mesopotamia. And yet, it wasn't until the global financial crisis of 2007 to 2008 that private lending really started to gain momentum as an asset class. That's because following the crisis, the regulatory environment tightened considerably across Canada, the United States, and the rest of the world, leading banks to become far more cautious.

As a result, many chartered banks moved away from lending to small- and medium-sized companies, leaving a substantial market gap in their wake. Seeing an opportunity to fill that void, private lenders have since stepped in with a view to extending much-needed capital to Canadian businesses and households, while creating a lucrative income stream for investors.

As an alternative fixed-income strategy, private lending has some advantages compared to traditional fixed income, including:

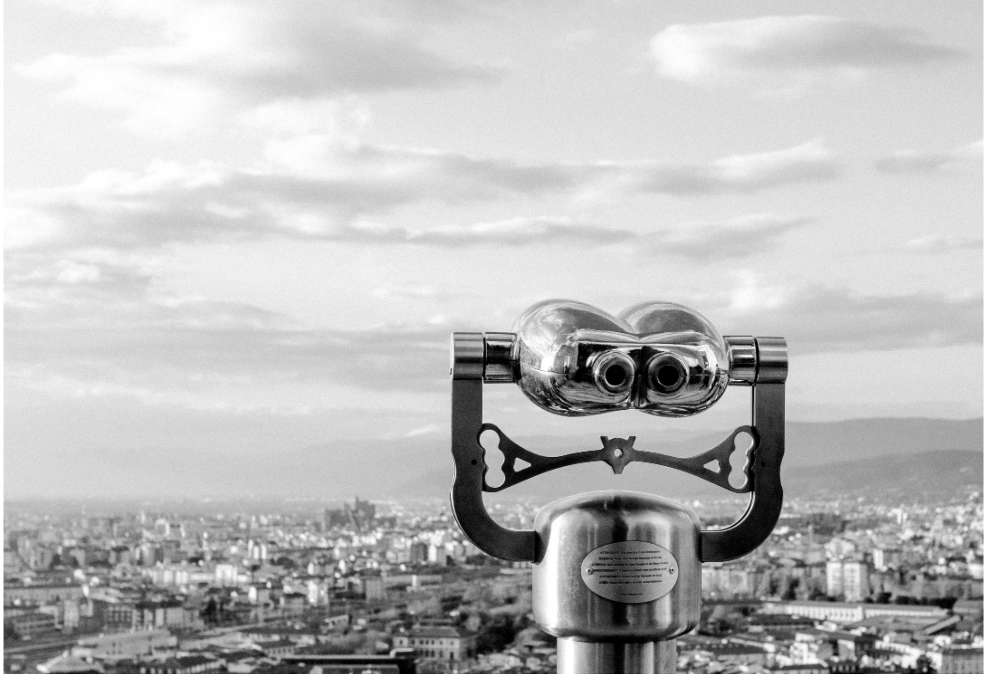
- Higher yields than fixed-income of comparable risk due to both an illiquidity premium as well as market inefficiencies
- Lower default and loss rates than fixed-income of comparable risk due to stronger covenants and lender oversight
- Low correlation with public markets
- Predictable and reliable source of current income
- Diversification of sources of risk and return
- Lower interest rate risk for private floating rate debt
- Shorter loan durations
- For venture debt and mid-market lending, there's an equity backstop from sponsors (i.e., venture capital or private equity firms)

To be clear, while private lending is an excellent fixed-income strategy, it's not right for everyone. It has a number of drawbacks compared to traditional fixed income, including that it is:

- Relatively illiquid compared to bonds
- Often unrated, making it more difficult to classify relative risk levels compared to bonds
- Not well understood, which makes educating investors paramount

In this paper, we'll take a look at some of the most common types of private lending, including mortgages, venture debt, bridge financing, factoring, and mid-market lending. We'll then explain how private lending fits into a balanced portfolio and how to select the best strategy for your particular needs.

Ultimately, we'll make the case for why private lending is a great way to bring diversity and attractive yields to your fixed-income strategies.



A Look at the Different Types of Private Lending

There are a number of different forms of private lending that investors can access through funds and other managed products. The best known and most effective of these strategies include:

Mortgages

Private mortgages are the largest and most common form of private lending. Most often, they're extended to individuals to aid in the purchase of single-family homes. Typically, those individuals are entrepreneurs who've had a hard time securing a traditional mortgage because lenders can't verify their income or they're paying themselves too low of a salary and therefore appear less attractive. In some cases, private mortgages are also granted to commercial developers. In such instances, they are preferred not because traditional banks won't lend to developers, but rather because they're more tailored to developers' requirements and can be secured much faster.

Importantly, private mortgages shouldn't be confused with subprime lending. On the contrary, high-quality borrowers are turning to private mortgages for very specific reasons. In fact, private mortgages work on the same principles as those issued by chartered financial institutions, but with a few key differences.

Specifically, they:

- Typically have higher interest rates
- May require the payment of up-front fees to the lender
- May not be first-ranking mortgages
- Will likely be more lenient on the payment coverage ratios or in the calculation of those ratios, as well as the use of credit scoring in its determination
- Are ineligible for Canada Mortgage and Housing Corporation (CMHC) insurance

As an asset class, private mortgages make sense because people generally understand and appreciate them. Investors are also attracted to the fact that while the risk is involved, the underlying asset is real estate, which has value. However, it's important to be aware of several specific considerations, including the potential for manager and operational risk, the fact that they're tied to the fluctuating real estate market, and the inherent reinvestment risk since the loans are constantly rolling over.

Nevertheless, at a time when there's a great deal of downward pressure on bonds, and equity markets are experiencing immense volatility, alternatives like mortgages can be a very attractive option.

"In the private space, managerial and operational risk are the greatest by far. When you look around and see what has derailed many firms, it's things like conflict of interest, lack of transparency, and governance that have been the key detractors. That's why it's important for investors to understand how a firm is licensed, whether it has a board of governors, and who its major investors are. Be sure to also get a feel for the firm's process, ethics, and procedures. They matter more than the yield or return."

Vikram Rajagopalan
VP of Retail Sales and National Accounts
Trez Capital

Venture debt

Venture debt is a popular form of niche private lending to technology companies — mainly software as a service (SaaS) businesses. The venture debt market has grown out of the inability of traditional lenders to provide loans to technology companies, which generally don't have the attributes that traditional lenders seek, namely tangible assets for collateral such as real estate, plant and equipment, or positive EBITDA.

Software companies use venture debt in a variety of ways, including as working capital, growth capital, bridge financing (to an equity round), and for acquisition financing. Founders opt for venture debt to defer an equity financing or as partial replacement for equity financing to reduce the overall cost of capital, reduce dilution, and retain majority control of their business longer than they would using equity alone. While the cost of venture debt to the borrower is typically in the teens, most borrowers are happy to borrow at these rates because it is typically less than half the cost of equity financing.

For investors interested in venture debt as a private-lending strategy, there are several advantages to consider. These include:

- Low leverage to enterprise value
- An underserved market that is able to generate premium returns relative to risk
- Venture capital or private equity backing, which gives additional protection to lenders
- Inherent diversification in the underlying customer base of software companies, whose products are ubiquitous, serving companies of all sizes and across all industries
- Software companies generally tend to be resilient in economic downturns, as the service they provide is often mission-critical to the operations of their customers
- Finally, software companies have also benefited from, and are expected to continue to benefit from, the secular growth resulting from the shift of software from on-premises to the cloud, providing further durability to the revenues and growth of these borrowers

Of course, there are other considerations to keep in mind. The success of venture debt as a private-lending strategy hinges on the expert skills and relationships of the lender in selecting high-quality borrowers, actively monitoring these loans, and proactively mitigating potential sources of risk. In the hands of a highly skilled and proven manager, an investment in the venture debt segment can deliver outsized returns relative to risk and provide additional diversification to an alternative fixed-income strategy.

"Successful venture debt investing requires highly specialized skills and risk management capabilities. Espresso, over its ten-year operating history, has been fortunate to have built a team with deep expertise in tech investing. Additionally we have developed a proprietary data-driven loan underwriting and monitoring software platform, as well applying AI to credit scoring. We are big believers in using data science for continuous improvement of risk management."

Alkarim Jivraj
Chief Executive Officer
Espresso Capital

Bridge financing

In Canada, the banking industry is both highly concentrated and conservatively regulated. This means that commercial lending can take up to a year to secure since the decision-making process is complicated and multi-layered. Unfortunately, borrowers don't always have that kind of time. In many instances, healthy companies need to complete a transaction — say an acquisition — in as few as three to six weeks.

That's where bridge financing comes in. As its name suggests, it's a way to span the gap between when funds are needed and when they're received. That's because small, private lenders can be much more nimble than commercial lenders and offer short-term loans to meet mid-market companies' immediate needs until they're able to secure a traditional loan. Borrowers will pay a premium for a bridge loan (typically at more than double the interest rate), but are happy to do so since it's short term and means that they can execute their transaction without having to sacrifice equity in the business.

As a result, banks and bridge financing companies have established a symbiotic relationship where the banks are happy to refer their future borrowers to trusted lenders, whether they're larger organizations or hyper-regional family offices. Collectively, all of this means that bridge financing is a smart choice because it's a steady strategy that offers a strong rate of return relative to public fixed-income tools like bonds. Plus, it's a form of non-distressed credit and backed up by significant collateral, thus alleviating many potential investor concerns.

"Bridging Finance is a leader in the private debt investment space in Canada, specializing in non-distressed short-term bridge loans and accounts receivable financing (factoring). Bridging's borrowers are companies that are typically in a growth phase and referred by financial institutions where speed of execution is a primary consideration. There is always a defined exit, usually a financial institution, and always ample security against the loan."

David Sharpe
Chief Executive Officer
Bridging Finance Inc.

Factoring

Factoring is a form of financing that companies can use to advance their cash flow cycle when they need funds to keep growing, but don't have assets that they can pledge for an asset-based loan or high enough revenue for a cash flow-based loan. In such cases, factoring can be an attractive option.

At its most basic, factoring is when a company sells its receivables to a lender in exchange for cash up front, less a fee to the factor for providing the capital and service. Such factoring facilities may be one-off transactions or, as in the case of high-volume but low working capital companies, be structured more as revolvers. In such cases, indebtedness is constantly paid off and drawn down in varying amounts depending on the needs of the borrower and up to a stated maximum amount. Companies typically use factoring for a period of 12 to 18 months until they can build up enough reserve capital.

"As an investor, we see factoring as a unique arbitrage opportunity that offers a great risk/reward scenario. When we purchase/factor receivables as a means of financing these businesses, we often get receivables with great credit quality; however, the rate we charge is more related to our client, the small/mid-sized business that has no other means of financing. This is the opportunity."

Robert Anton
Managing Director
Next Edge Capital

Mid-market lending

Mid-market lending is a loan provided to a private business for a specific term under which the borrower agrees to pay interest on the outstanding balance. In return for the capital, the borrower agrees to provide collateral and security for the loan and to meet a number of financial and non-financial covenants. Mid-market lending is an essential source of capital for companies that can be used to finance growth expansion, acquisitions, and capital restructuring. Meanwhile for investors, it can be used for a wide range of objectives including diversification, yield enhancement, and cash flow management.

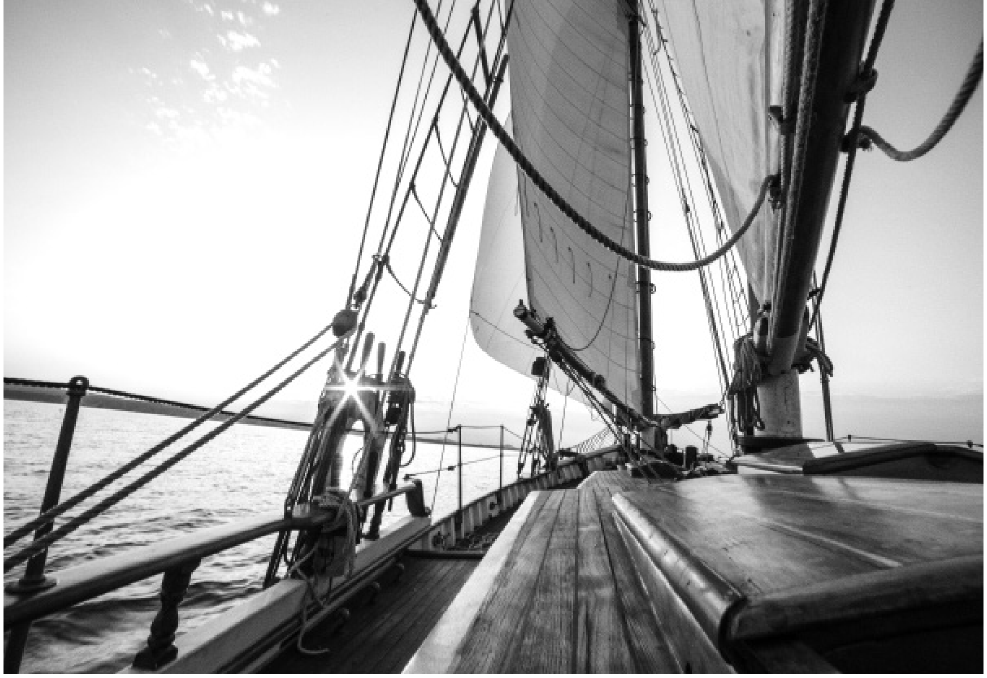
Importantly, unlike bank products, mid-market strategies can provide highly customized and flexible financing solutions for borrowers. Practically speaking, that means that borrowers are willing to pay higher rates for creative term financing that meets the unique needs of their business and is delivered by seasoned lending professionals.

Mid-market lending is fixed rate and has maturities ranging from 2 to 10 years with primarily matching amortizations. Private lenders will only lend money to a borrower if the loan meets the agreed upon investment criteria of the fund. These criteria typically include a minimum credit quality, a target return, and diversification requirements with respect to maximum loan size and sector exposure.

Part of the appeal of mid-market loans is that they typically deliver superior risk-adjusted returns that are 200 basis points (2 percent) higher than comparable public bonds.

"The popularity of private debt continues to grow among investors seeking attractive risk-adjusted returns and lower volatility. With more private debt managers entering the market to meet this need, a range of new strategies have emerged which differ widely with respect to risk profile and investment complexity. When evaluating an investment in private debt, it's important to understand the risks and to assess the manager's track record."

Theresa Shutt
Chief Investment Officer
IAM Private Debt Group



Private Lending in Practice

Since the global financial crisis in 2008, yields from traditional fixed income have fallen significantly causing investors to look for ways to get better yields without taking excessive risks.

That's why it's important to remember the role that alternatives such as private lending can play in earning more consistent rates of return. Fundamentally, private lending allows investors to diversify the fixed income portion of their portfolio. By offering far more options than bonds or other forms of traditional public fixed income, private lending is a way to lower duration risk while generating better returns.

However, it's important to note that private lending has complexities. Anyone investing in this area needs to have a certain level of knowledge and financial sophistication. It's critical that you take the time to understand the nuances of any private lending strategy before investing.

Private lending investments can be very useful in constructing properly-diversified investment portfolios. Since the crisis and consequent overall drop in yields, many advisers have resorted to moving farther out the yield curve or have accepted lower credit quality in order to realize some reasonable level of income for their clients. Being further out the yield curve in itself can be risky, particularly if interest rates spike for some reason. Private lending allows that trend to be reversed and offers new alternatives for delivering the critical income sought.

Although alternative fixed income investments are often rated as higher risk, when mixed prudently together in a portfolio with traditional fixed income, overall portfolio risk can often be reduced. When using private lending in the fixed income allocation it is always prudent to use common sense by diversifying across different managers, industries, lending styles, economic and geographic

environments. It is important to avoid concentration risk with only one strategy or only one manager, diversification amongst private lending solutions is usually safer.

Once you have a short list of strategies and managers to consider, reach out to the product managers. In Canada, managers generally have an open-door policy and are willing to talk with you. Take advantage of this to build your comfort level with the product and the people running it. If you take the time to appropriately understand the various private lending strategies and have a short list of vetted options to consider, finding the right solutions for your particular needs will become much easier.

"As a discretionary portfolio manager for private clients we started (like many do) by using a base of only traditional fixed income. In 2009 we began adding various private lending strategies and have increased this to a substantial and meaningful allocation in all of our clients' portfolios. Since then, our clients have achieved better returns with a much smoother ride. This is important for retired clients who make up the majority of our business."

Cecil Baldry-White, CIM, CFP®
Chief Executive Officer
Alitis Investment Counsel Inc.

A Better Approach to Fixed Income

Over the course of just 10 years, private lending has emerged as a legitimate and increasingly important form of fixed-income investment. Today, there are numerous strategies including mortgages, venture debt, bridge financing, factoring, and mid-market lending that are designed to suit a wide range of risk appetites.

As we've seen, at a time of rising interest rates and uncertainty in equity markets, private lending brings stability and higher yields than found in traditional fixed-income products. Not only that, it's a great way to diversify portfolios, thereby creating greater security. Of course, before investing in any strategy, it's important to take the time to fully understand how it works.

We would like to thank the following CAASA members for helping to make this paper possible:

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About CAASA

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space as well as select individuals (such as those employed by investors) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active with 12 committees and working groups, organizing approximately 50 events each year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

For more information, please visit www.caasa.ca.