Alternative Lending

Risk Analysis

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Alternative Lending Risk Analysis

Introduction

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Characterizing ourselves as risk-averse, conservative, chickenhearted, and worry-warts is quite accurate. However, we still seek a return on our investments. This yin-yang balance is what has made us believers in alternative lending as an investment, but only by way of a diversified approach.

While the projected 8 – 10% yield is attractive, we hope the attached summary slides, which explicate our views on default risk in five loan/investment segments will give you comfort with this space.

Alternative Lending Risk Analysis

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Consumer Lending - Unsecured

- **Correlation to Economic Cycles**
  - Highly correlated to unemployment rate
  - Analogous to credit card lending
- **Loan Default Risk and/or Collateral Impairment**
  - Risk of rising defaults if lower credit borrowers become unemployed
- **Sub-Manager Mitigating Factors**
  - Investment or Loan structure: “big data” analytics are used to evaluate borrower credit worthiness. Lending platform loans are of higher credit quality than credit card loans
  - Hedging: observably undertaken by increasing average credit quality (from cash flow turnover) as unemployment rises
  - Return vs. default risk: rising defaults buffered by high interest rates charged to borrower
- **Sector Historical Experience:** see appendix A for sector experience using credit card debt as a proxy
- **Sub-Manager Historical Experience:** Lending Club loans originated in 2008 and 2009 delivered positive net returns of 2.3% and 5.3% respectively, notwithstanding unemployment spiking

Alternative Lending Risk Analysis

Consumer Lending - Secured

- **Correlation to Economic Cycles**
  - Uncorrelated to unemployment
  - Mild correlation to macro factors given idiosyncratic nature of the loans and borrower profiles
- **Loan Default Risk and/or Collateral Impairment**
  - Low risk of default due to tangible asset collateralization
  - Collateral value may depreciate in economic downturn
- **Sub-Manager Mitigating Factors**
  - Investment or Loan structure:
    - Low LTVs of 15% - 40% to cover 60% - 85% asset depreciation
    - Lender maintains possession of collateral when possible
  - Hedging: conservative collateral valuations
  - Return vs. default risk: low default risk allows for modest leverage to increase returns
- **Sector Historical Experience:** varies by niche, generally low defaults due to high collateralization
- **Sub-Manager Historical Experience:** no defaults, lower base yields than unsecured consumer loans

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Small Business

- **Correlation to Economic Cycles**
  - Small business loans are highly correlated to economic cycles due to decreased cash flows as demand falls and sales decrease
  - Smaller borrowers have superior performance over larger borrowers
- **Loan Default Risk and/or Collateral Impairment**
  - Low risk of default: defensive loan structuring
  - Modest risk of asset impairment: collateral varies from hard assets to company equity
- **Sub-Manager Mitigating Factors**
  - Investment or Loan structure: Typically structured to put lender in a senior secured position with negative covenants to prioritize borrower payments, cash controls, and often a personal guarantee.
    - Negative covenants include additional equity upside in the case of late payments
  - Hedging: short duration of six – 18 months
  - Return vs. default risk: high returns with a low default rate
- **Sector Historical Experience:** see appendix B for third party data on historical default rates
- **Sub-Manager Historical Experience:** generally low default rates through careful monitoring and restructuring of defaulted loans. On an asset-weighted basis, most defaults in small business portfolios have had 100%+ recoveries

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Real Estate

- **Correlation to Economic Cycles**
  - Residential loans are correlated to unemployment
  - Treasury-rate sensitive
- **Loan Default Risk and/or Collateral Impairment**
  - Low risk of default: highly collateralized
  - Risk of collateral impairment: real estate values can be cyclical
- **Sub-Manager Mitigating Factors**
  - Investment or Loan Structure:
    - 40% - 60% LTVs
    - Third-party valuation of underlying property
  - Hedging: short duration of one to three years
  - Return vs. default risk: moderate returns with a low default rate allows for modest leverage
- **Sector Historical Experience:** see appendix C for sector default data
- **Sub-Manager Historical Experience:**
  - Favorable actual data: 0.84% average monthly return from 2008 to 2009
  - No defaults during the recession

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Trade Finance

- **Correlation to Economic Cycles**
  - Uncorrelated – market size expands and contracts as global trade does, but individual loans are only modestly affected
- **Loan Default Risk and/or Collateral Impairment**
  - Low risk of default due to transaction necessity
  - Moderate risk of cross-border buyer defaults
- **Sub-Manager Mitigating Factors**
  - Investment or Loan Structure: 75% average LTV
  - Hedging:
    - Very short duration of three to nine months
    - Futures contracts can lock in collateral value, protecting against collateral impairment should buyer default
  - Return vs. Default Risk: moderate return with a low default rate allows for modest leverage
- **Sector Historical Experience:** see appendix D for historic trade data
- **Sub-Manager Historical Experience:**
  - Favorable actual data: 0.75% average monthly return from 2008 to 2009
  - No defaults during the recession

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Life Settlements

- **Correlation to Economic Cycles**
  - Mortality of insured unrelated to economic activity
  - Correlated to life expectancies – rising longevities increases transaction costs (i.e., more monthly premium payments)
- **Loan Default Risk and/or Collateral Impairment**
  - No risk of default
  - Moderate risk of insolvency – investor must continue paying premiums to maintain the policy
  - Small risk of flawed policy purchases given re-regulation of industry

Alternative Lending Risk Analysis

Life Settlements (cont.)

- **Sub-Manager Mitigating Factors**
  - **Investment or Loan Structure:**
    - Strategy does not use leverage, which would increase cash flow risk
    - Average insured is 85 years old, with a 65-month life expectancy
    - All policies purchased after two-year period of insurance company contestability has ended
    - Next-of-kin agreement documents that the policy seller was aware of his or her actions – decreases risk of inheritance litigation
    - Guaranteed buyback by sub-manager of any flawed policy purchases, backed by significant proprietary capital
    - Third-party quality actuarial analysis & portfolio valuation
  - **Hedging:**
    - Credit facility and cash reserves allowing for 18 months of premium payments without new capital inflows or realized death benefits
    - Nearly 1,000 policies in the portfolio diversification allowing application of the "law of large numbers"
  - **Return vs. Default Risk:** high return with controlled risk of insolvency, policy contestation or litigation

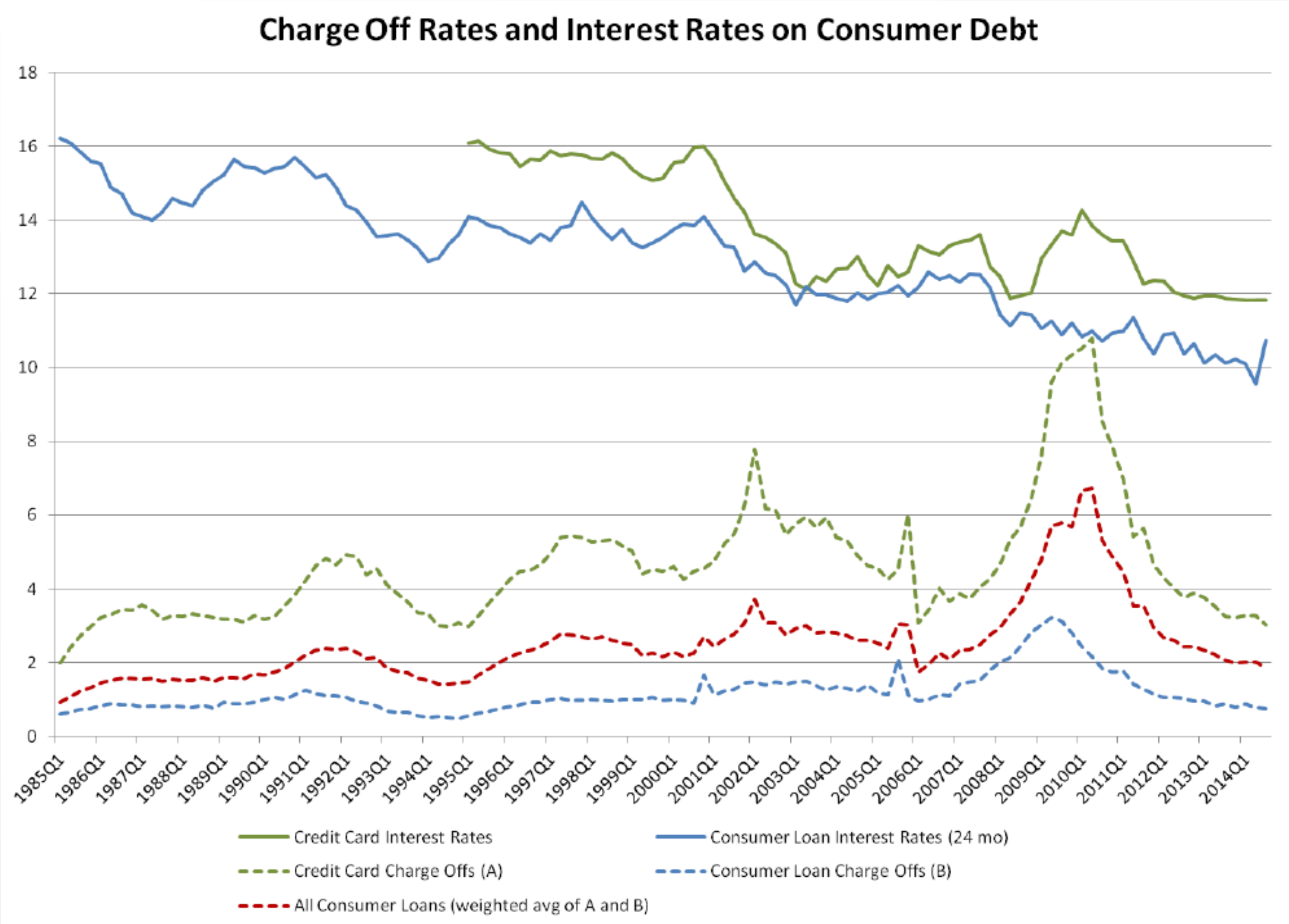
Alternative Lending Risk Analysis

Life Settlements (cont.)

- **Sector Historical Experience:**
  - Between late 2008 and early 2009 some life expectancy providers revised their life expectancy estimates upwards by 25% - 30%, reflecting the growth in experiential data available to underwriters. Today, adjustments are more frequent, avoiding substantial moves
  - Persistent high unemployment after 2008 increased the number of policyholders considering life settlements. Investor capital was unable to meet the rise in demand.
  - Rising unemployment leads to the need for alternative income, including the sale of life policies, increasing consumer demand
- **Sub-Manager Historical Experience:**
  - Sub-manager Monte Carlo simulations on actual holdings after a 20% life expectancy extension showed an estimated annualized net return of 6.0% with 1.8% annualized standard deviation and a 20% life expectancy extension
    - 97% of simulations showed net annualized returns in the range of 4.7% to 11.9%, with zero simulations showing negative gross returns
    - Historical annual net returns have ranged from 7.6% to 11.3%, with only four down months totaling (1.7%)

Appendix A:
Consumer Unsecured Debt – History of Positive Returns

- **Marketplace-originated consumer debt is similar to credit card debt, but with higher average credit scores**
- **Credit card debt has been profitable over multiple credit cycles, including 2008 and 2009**



Source: Federal Reserve G.19 Consumer Credit Report, February 2015

Appendix B:
Small Business Defaults in 2008 and 2009

- **Small business defaults rose to 5% - 6% between 2008 and 2009. Gross yields of 10% - 22% at the sub-manager level can absorb increased defaults without principal impairment.**

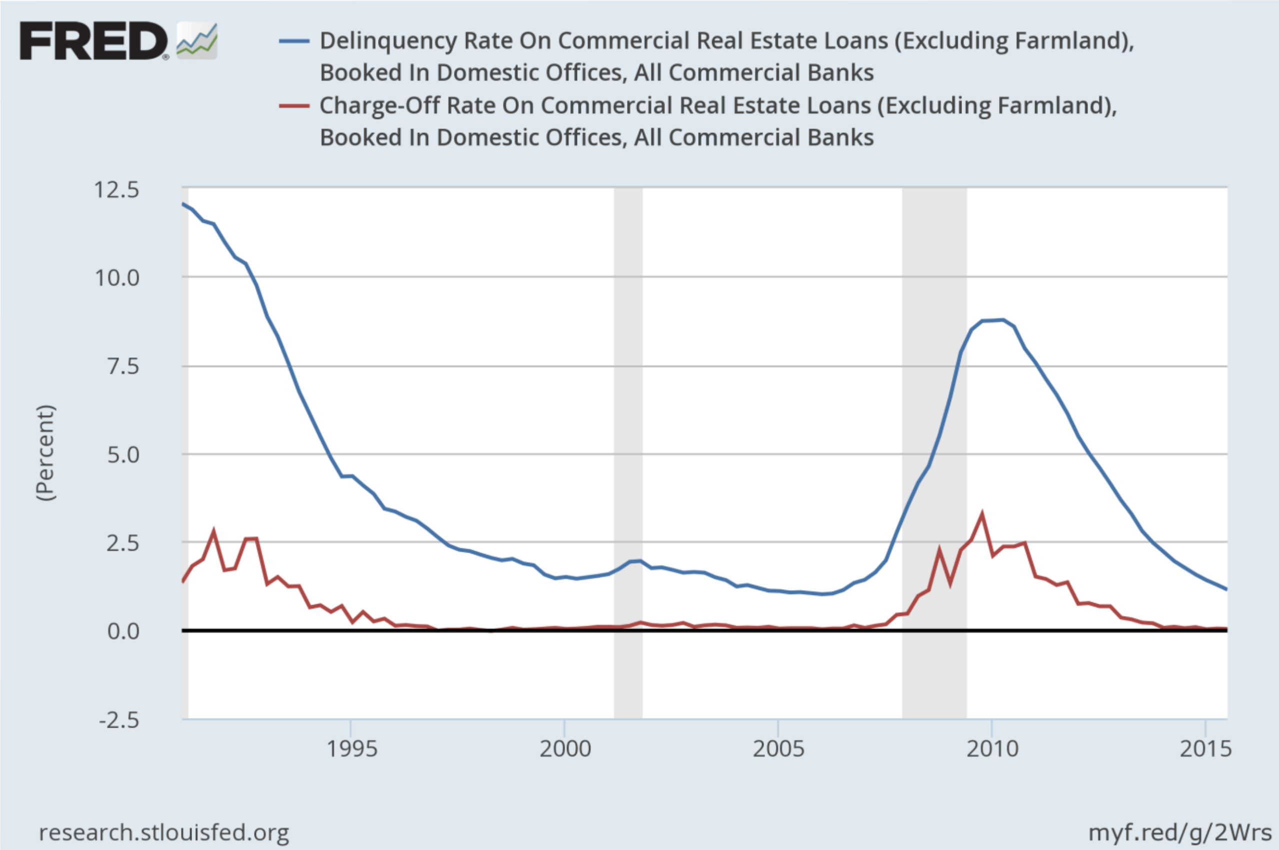
Industry	Historical Default Rates							
	2006	2007	2008	2009	2010	2011	2012	2013
Retail	3.0%	3.4%	4.6%	6.5%	4.9%	3.7%	2.0%	1.8%
Health Care	2.2%	4.1%	3.6%	3.7%	2.8%	1.9%	1.8%	1.4%
General	2.3%	3.5%	3.7%	5.0%	3.1%	2.0%	1.4%	1.3%
Transportation	2.9%	5.4%	7.8%	9.3%	5.8%	3.1%	2.1%	2.0%
Construction	2.3%	3.6%	5.5%	8.8%	6.7%	3.2%	2.0%	1.4%
Agriculture	2.3%	1.6%	1.8%	2.6%	2.6%	1.4%	1.0%	0.8%
All Industries	**2.5%**	**3.8%**	**4.7%**	**6.2%**	**4.2%**	**2.4%**	**1.7%**	**1.4%**
For Borrowers with an Exposure Less Than $2.5 Mil.								

Source: PayNet 2014Q1 Small Business Economic Outlook

PayNet maintains the largest database of small business loans, leases, and lines of credit, encompassing over 23 million contracts and more than $1.3 trillion in obligations

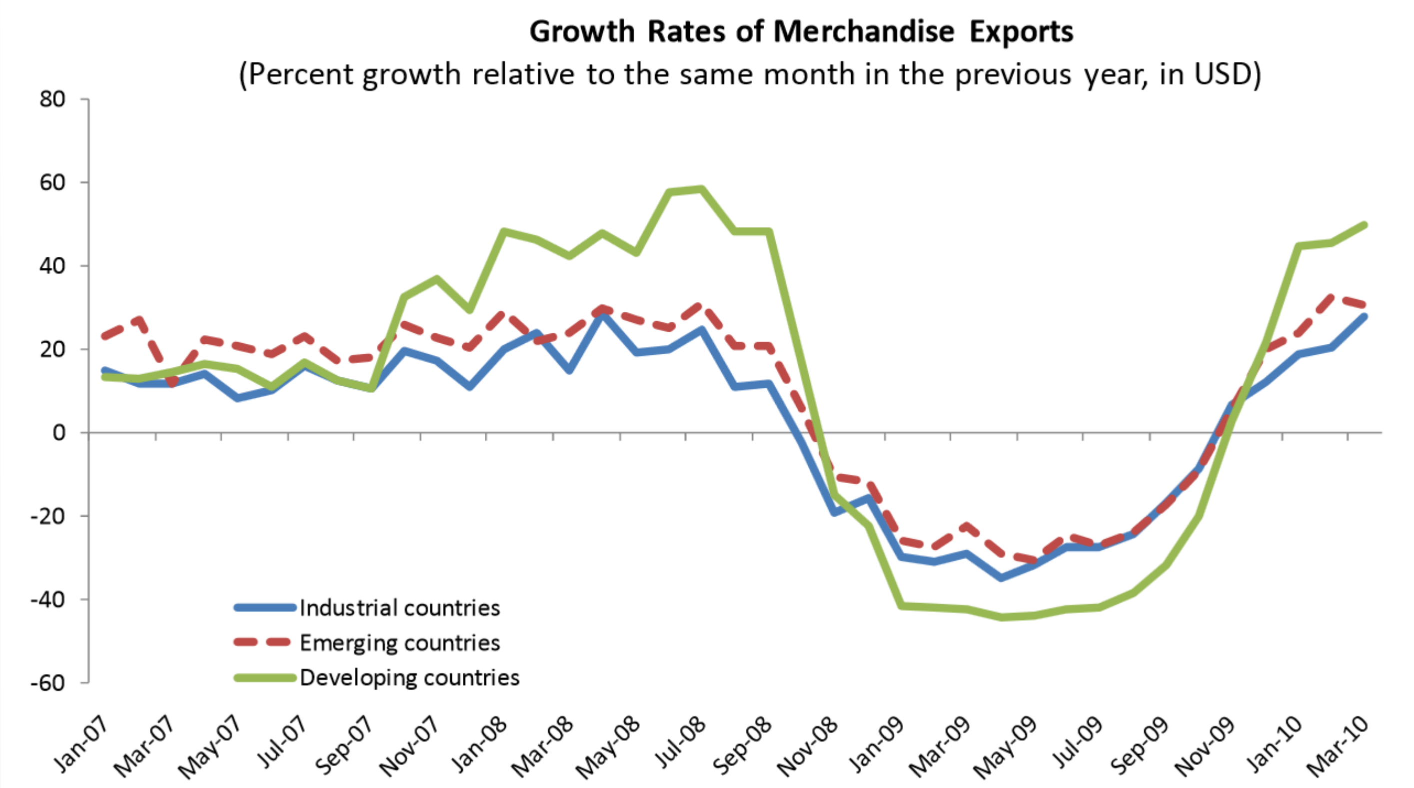
Appendix C:
Long-term history of commercial real estate lending

- **Commercial real estate loans experience a rapid increase in delinquencies in the "great recession", but charge-offs (the percent of principal impairment) remained relatively low due to high recoveries from collateral sales, despite weak housing markets**
- **Niche money managers with purpose built organizations can hedge the risk of rising charge-off rates through lower loan-to-value ratios and third-party valuations**



Appendix D:
Trade Finance – Recessionary Capacity

- **Though the "Great Recession" did not impact individual trade finance loans, export markets contracted leading to a dearth of opportunities to deploy capital**
- **Niche managers with lower target loan sizes can operate at a smaller scale than large banks that need to deploy large amounts of capital per loan to be profitable.**



Trade data on industrial, emerging, and developing countries are based on 31, 32, and 20 countries with a few exceptions: for Jan-10 data, 31, 31, and 19 countries are used respectively; for Feb-10 data 31, 29, and 18 countries are used respectively; for Mar-10 data 31, 28, and 15 countries are used respectively.
Source: IMF Staff calculations, Haver Analytics, WTO.