

Asset Based Lending:

Attractive Investment Opportunities
During the Credit Crisis and Beyond



White Paper

Asset Based Lending: Attractive Investment Opportunity during the Credit Crisis and Beyond

The investment management world has been turned upside down in 2008 as the credit crunch and the effects of the associated deleveraging have shaken the financial system to its core. The far reaching effects have left their mark on nearly every asset class in the investment universe. There have been few safe havens for investors looking for stable places to put money to work. Asset based lending has been a quiet pocket of growth for the investment management space. Amidst all of the turmoil in the markets, ABLs have been outperforming other, more popular, finance strategies. This white paper will discuss the opportunity that ABL strategies can present to investors looking for growth during these turbulent and challenging times.

Specifically, it will:

- Review the fundamentals of asset based lending
- Evaluate the performance of hedge funds during the credit crisis
- Explore how ABLs have become the new growth opportunity for savvy investors
- Discuss the outlook for ABL funds in 2009

Overview of the ABL asset class

Asset based loans are secured, over-collateralized borrowing arrangements made to middle market companies, in most instances secured by an interest in an asset on the borrower's balance sheet. The assets pledged as collateral can be intangible assets such as receivables, intellectual property or equity ownership in another company, or they may be tangible assets such as inventory, equipment and property. The value of the asset pledged as security is usually worth 30-40% more than the amount of money the lender extends, thus providing protection in the form of over-collateralization in the case of default.

ABL fund strategy gives the investor exposure to off-market loans where the primary risk characteristics are much different than for investment strategies that invest in public equity and debt securities. Funds specializing in asset based loans often focus on one specific collateral asset-type that they lend against that represents the lender's core competency.

The absence of publicly floated securities and thus daily marks differentiates ABL funds from other types of funds. ABL funds generally hold their loans to maturity,

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or until they are refinanced which allows the fund to carry the investments at cost on their books. This accounting practice allows ABL funds to avoid the volatility other strategies face due to the daily mark to market of liquid securities. Returns are generated by current yield, in the form of coupon interest on an ABL fund's portfolio of loans. In addition, returns are realized from any capital gains from loans called or repurchased by the borrower above par and any losses taken on impaired loans, or loans written off or sold at a loss. Generally, with sound due diligence and diversification, an ABL fund will consistently earn mid-teens annual returns that are achieved primarily from current yield on the portfolio.

Because legal documentation on debt and equity securities of the large public companies is standardized by the SEC, strategies that invest in stocks and bonds tend to primarily focus their investment assessment on valuation of the underlying company and price risk of the actual security. In addition to making sound credit determinations, ABL investing requires a significant amount of legal due diligence regarding verifying documentation, as well as structuring appropriate legal protection of the underlying assets.

Because ABL funds must create their own investments, rather than buying pre-existing ones off a regulated exchange or an over-the-counter market, there is a large emphasis on the legal documentation of each loan in an ABL fund. Specifically the collateral must be clearly designated as well as the fund's ownership ranking on the asset. The path of recourse in the case of default must also be clearly defined so that the fund can seize and liquidate the collateral if necessary. And, since the funds are lending to smaller, less known companies, tight legal protection is important to an ABL strategy. Because these companies are generally middle market, attractive risk adjusted returns can be realized by penetrating the space with an accurate pricing model, conservative loan-to-value ratio's, and strong legal documentation.

ABL funds have recently come into focus as traditional commercial banks have been handicapped by overly aggressive underwriting of residential and commercial mortgage loans (another form of asset based loans) that were held on their balance sheet. As the collateral quality of the assets degraded, houses and commercial buildings in this case, asset write downs have inhibited commercial banks' ability to extend credit to their core base of customers, which are typically middle market businesses. Unable to fulfill the demand for credit, small and mid-sized businesses have turned to alternative sources of funding, such as ABL funds. While ABL firms do not provide the large suite of products most banks offer, they

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can deliver a lending product that is tailored to suit the needs of these middle market companies in search of financing to help them maintain growth. ABL funds and other specialty lenders are able to find opportunity where the banks are not able to extend credit. Because ABL funds tend to focus on specific industries, and underwrite only certain collateral assets, they are able to achieve better risk adjusted pricing for their clients. Additionally, the recent turmoil in the equity and credit markets has caused significant redemptions from the traditional hedge funds strategies. These funds are flowing into the ABL space as the strategy has been able to weather the recent credit crisis in relatively good fashion.

Hedge Fund Strategies and the Credit Crisis

The old adage about hedge funds is that, of all the investment strategies, hedge funds are the ones ideally suited to perform regardless of the direction of the market. However, these are unusual times. Along with individual issues at the strategy level, hedge funds have had to deal with the systematic risks arising from the failure of Lehman Brothers, the backlog of unsettled contracts in the \$62 trillion credit default swap market, the seizure of the short term lending markets, and unpredictable government intervention into securities oversight.

Long/Short Equity Funds: These funds generally employ a strategy of buying stocks in which they feel they have an edge, and shorting stocks against their longs as either a hedge (relative value) or as a general exposure hedge. These funds often end up being short vast quantities of ETF's to lower their net exposure and count on the outperformance of their long positions over the ETF short positions to generate positive performance. The effect of the short positions is to dampen the volatility of returns when the market drops.

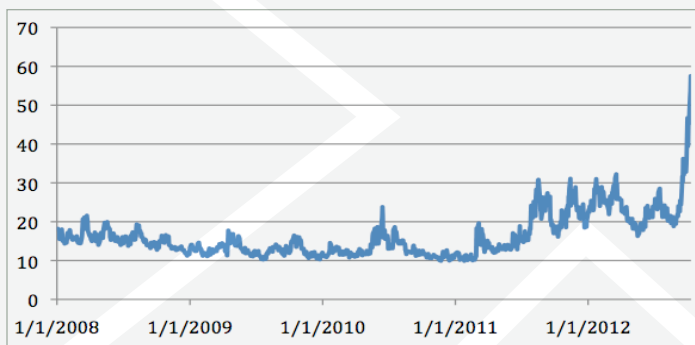
Two important phenomenon have emerged over the past few months that have made the long/short strategy a difficult one to employ. First, the massive upswing in volatility has caused traditional correlations to break down (see Figure 1, VIX Index). Funds tend to rely on historical correlations between stocks when devising a hedging strategy. When these correlations break down as volatility rises, the stocks tend not to perform as they normally do. Second, the pack mentality of hedge funds can oftentimes lead popular stocks to be overcrowded and thus more volatile as the funds trade in and out.

The government's recent intervention on short sales has also thrown this strategy into disarray. The daily volatility and government intervention has led some of the

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largest and most successful hedge funds to relegate themselves to the sidelines. The rapid altering of trading rules by the government has inhibited some funds from having the conviction to put any new positions on since they cannot hedge them properly. Additionally, the lack of credit at prime broker banks makes it difficult for these funds to borrow on margin. Adding leverage to a fund is a very common method of increasing returns when the market is stable.

Figure 1: VIX Index
Increased volatility challenge long/short strategy



Convertible Arbitrage Funds: Convert-Arb funds make money by buying the convertible bonds of companies while simultaneously shorting the equity of the company. The funds continued to perform until the increased volatility in the marketplace increased the value of the equity option embedded in convertible bonds. Nonetheless, the rise of volatility made effectively hedging the bonds increasingly difficult and intervention on short sales by the government has effectively closed this strategy.

Levered Credit Funds: Levered Credit funds are often directionally long (i.e. not fully hedged) and typically invest in corporate fixed income securities such as bank debt, term loans and bonds. These positions are often levered between one to five times depending on the aggressiveness of the investment manager. Levered Credit funds have performed poorly in this environment. As credit spreads widened dramatically, these funds took severe mark downs on their holdings. These marks often caused margin calls at their banks, which led to more panic selling and even worse marks. The inability to borrow, and the illiquidity that has beset the space has made this strategy very difficult to employ.

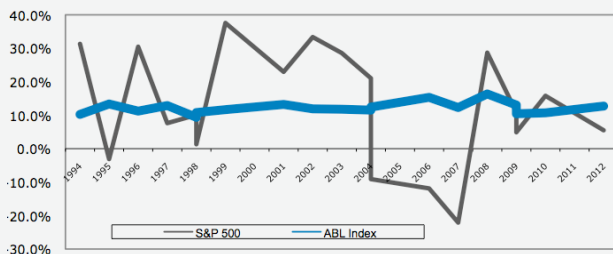
Asset Based Lending: Growth Opportunity Amidst The Worst Financial Crisis of the Century

Asset Based Lending Funds: ABL funds have fared remarkably well during this challenging period for a number of reasons. ABL funds generally invest in middle market companies at the senior secured level. This fundamental investment strategy provides several key benefits:

- There is no mark to market on the loans. Unless there is a clear impairment of the company or the collateral in the security package, the position will remain marked at cost, while earning coupons.
- ABL loans are generally over-collateralized by 30-40%. This low loan-to-value ratio gives the funds a significant amount of coverage and safety to recoup their capital should the company not be able to pay its coupons. The loans typically carry a personal guarantee from the business owners as well.
- The funds generally carry no or very low levels of leverage. Because the middle market ABL space is disparate, ABL funds can generally achieve low teens yields on their loans, thus eliminating the need to borrow money in order to increase the return of a low yielding position.
- The investing terms of ABL funds often have long lock up periods and limited withdrawal allowances. This enables fund managers to put money to work for extended periods of time without having to worry about raising cash (selling a loan at a rushed price) to meet a withdrawal request.

The high asset coverage combined with the consistent rates at which the loans pay has enabled the ABL space to consistently produce returns in the low teens with extremely low volatility as compared to the equity market. Figures 2 and 3 show that the ABL Index has outperformed the S&P 500 since 1989 on an absolute and risk adjusted basis (as measured by the Sharpe Ratio).

Figure 2: S&P vs. ABL Index



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Accounts receivable offer high absolute returns, low volatility, short-term duration, low correlation and high asset coverage.

Figure 3: Relative Performance of S&P vs. ABL Index Since 1989

	ABL INDEX	S&P 500
Annualized Return	12.2%	11.6%
Standard deviation	1.3%	13.5%
Sharpe Ratio	7.1	0.7
R-Squared (w/S&P)	1.6%	100.0%
Capital Structure	Secured	Equity
Capital Structure Rank	High	Lowest
Loss/Default Ratio	0.03%	2.7%

Recent performance

Month	ABL Index	S&P 500
August-08	0.70%	1.45%
September	-0.07%	-8.91%
October	0.78%	-16.80%

These favorable characteristics have made ABL funds standout performers over recent times as well. ABL funds have continued to perform well, even over the past two months (September and October 2008) as the equity and credit markets have experienced record volatility and extremely weak performance.

The break down in correlations and the rapid rise in counterparty risk brought on by the credit crisis has hurt historically stable strategies such as statistical arbitrage and convertible arbitrage that are popular alternative strategies in the hedge fund space. Dependence on leverage and a lack of liquidity has also badly impaired any funds holding general corporate credit or asset back securities. Correlation breakdown in the ETF and CDS markets has broken the long short equity hedge funds ability to control exposure and risk through hedging. Additionally, the government's abrupt rules on short selling have thrown equity long short funds into disarray. These market and systematic realized risks have had negligible effect on the ABL space.

The Rise of the ABL Marketplace: Outlook for 2009

Over recent years, asset based lending has continued to evolve, becoming more widely accepted as a mainstream financing option. The current credit crisis con-

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tinues to constrain banks' ability to lend while they work to repair their balance sheets, and has highlighted the considerable need for an alternative source of capital for middle market companies. ABLs have performed consistently and favorably for the past 20 years and show no signs of abating. Rather, they will only continue to increase in attractiveness and breed further utilization of the assets as mainstream tools in day-to-day financial management.

Given this change in landscape and the increasing demand for capital, interest in ABL funds will continue to grow as an attractive asset class. As a result, in 2009, ABL funds will play an increasingly vital role in the growth of middle market companies throughout the U.S. ABLs provide stable performance and attractive risk adjusted returns and are a good tool for corporate America to improve their business and financial performance. ABLs will no doubt further penetrate the investment management space for years to come.

The Receivables Exchange: The World's First Real-Time Centralized Marketplace for Receivables Finance

For many investors looking for a safe haven amidst the chaos, the centralized auction format of The Receivables Exchange will provide a platform to increase their scope of origination in a scalable and efficient manner. They will gain access to a broader scope of credit, industries and geographies, allowing them to dynamically shape and scale their portfolio based on their individual investment criteria. As the world's first real-time centralized electronic marketplace for receivables finance, The Receivables Exchange allows investors to diversify their investments and generate attractive returns through a new and stable asset class.

"The Receivables Exchange is a phenomenal idea that has hit the asset based finance industry by storm," said Michael Scanlon, Managing Director of HedgeCo. Net and Member of the Board for The Hedge Fund Association. "Through its centralized, transparent marketplace, it is transforming an industry that has long been based on one-to-one relationships, effectively making the sale of commercial receivables a completely transparent and globally competitive marketplace."

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