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Alternative Lending Loses Its Mojo + Italian Alt Lending (end of note)
By Alan Snyder

Alternative Lending Loses Its Mojo?
Lawrence Delevigne says so in a recent Reuters article entitled "Direct Lending Funds' Fading All-Weather Appeal." He posits:

1. Loan covenants looser
2. Rates down
3. More risk
4. Untested loan originators
5. Inexperienced investors
6. Too much leverage
7. Illiquidity

Almost every risk Lawrence notes can apply to any sizable financial market. But, there is a smattering of truth in each of his observations. Maybe, a better headline would have been:

"Direct Lending Grows Up"
The business has grown. Several years ago, Goldman Sachs suggested it was a $51 trillion global market. Growth continues through today as alternative lenders continue to take market share away from banks. Guess Goldman continues to be a believer with their own entrance into the market via Marcus.

Rates have come down, whether from competition within a particular sub-market or simply macroeconomic conditions in our country. Additionally, we are in passionate agreement with Lawrence that without careful selection, painstaking due diligence and a discerning evaluation of the loans and loan originators that bad outcomes and ugly surprises are ordained. High tide does raise all but the leakiest of ships and low tide exposes many flaws. Alternative lending remains compelling when well diversified and undertaken with traditional investment discipline. Discipline includes careful selection of loans identified by battle tested and experienced loan originators and sourced within the criteria defined by an agreed upon "buy box." Some specific thoughts follow.

Interest Rates and Portfolio Developments
Across the maturity spectrum, Treasury rates remain low. Inflation remains quiescent, seemingly driving this rate outcome though the Federal Reserve Board has modestly tightened and desires more. In general, alternative lending rates have declined. For example, bridge real estate loans with short duration have dropped from 10% – 11% to 8% – 8.5%. Small business lending rates have decreased as well but by less. The economy motors along in first gear without the long-anticipated "Trump Bump." However, worldwide growth is improving to provide some expectation that there may be spillover effects here in the future.

Late last year, we ruminated on this possible rate scenario and began laying down track to hedge against it. While earning approximately 250% of 10-Year Treasuries with a short duration (19 months) and a basically unlevered portfolio (6% leverage) is relatively attractive, we wanted to dig deeper. (See our generic alternative lending presentation and portfolio at www.shinnecock.com).

The result was to search out more direct lending in niche opportunities using Special Purpose Vehicle/Entity ("SPV/SPE") structures. We believe this will increase yields and counterintuitively, bolster downside protection. In sum, it means finding the opportunity, vetting it and putting in place the SPV/SPE legal structure. The SPV/SPE structure, which we can control, houses the sourced loans. To build these unique structures, we engaged legal counsel with specific expertise in this area, researched many third-party examples and sought to extract the best elements.

Concurrently with this legal research, we sought deal flow in bite-sizes with characteristics of uncommonly attractive interest rates, high collateralization (modest loan-to-value ratios), personal or corporate guarantees as appropriate, and additional downside protection from loan originator first-loss capital, whether from advance rates of less than 100% or by posting standby capital. This last item can be important because it means that the loan originator has meaningful "skin in the game." As a simple example, if a target loan of $100 were to be purchased by the SPV/SPE after meeting the selection criteria established by us, we would advance somewhere between 60% – 85% of the $100 and the originator funds the balance. Our net yield target varies from between 10% – 19% per annum, payable monthly. The originator keeps any yield from the loans in excess of what we are being paid.

If there are defaults in excess of anticipated or historical rates, we enjoy the cushion of overcollateralization, the protection of the "first-loss capital," any personal or corporate guarantees and the ability to sever the relationship with the originator yet retain their excess spread (difference between our coupon and the loan rate).

It all sounds peachy-dandy but demands much tire kicking. This month we closed on two high-end art loans, a solar panel receivable contract, and a motorcycle taxi receivable loan. We are exploring several specialty receivable transactions, a government employee small balance lending program collected by the employer, and a short-term bridge real estate lender.

Indicative of the work going into these transactions are the 16 separately negotiated documents and other paperwork needed to close our art finance transaction. In this one, we received prepaid interest for the one-year term of the loan at a double-digit rate with a loan-to-value ratio measured against the appraisal of 55%, a personal guarantee, and the art under the SPV's control. The docs:

1. Photograph of the art with bonded warehouse receipt
2. SPV operating agreement
3. Servicing agreement
4. Loan schedule
5. Investment guaranty
6. Note
7. Insurance certificate
8. Loan and security agreement
9. Origination agreement
10. U.C.C. filing
11. Wire confirmation
12. – 16. Miscellaneous documents

For diversification purposes, we entered into a second art loan with different collateral and borrower, yet similar terms.

Additionally, we closed on the motorcycle taxi transaction with a mid-double-digit interest rate, approximately 50% advance rate including first-loss capital in the receivables, and a secured interest in the motorcycles (an LTV of 50%). The expected duration is approximately six to eight months from the overcollateralization, with the opportunity to roll over the loan going forward. We were particularly mindful of these important protections because the loans are in Sub-Saharan Africa and do bear the currency risk of the Kenyan Shilling. Directly hedging the currency risk in this situation is overly costly. However, the baked-in deal protections should provide adequate cover against the historic currency fluctuations. Over the last ten years, the maximum peak-to-valley drawdown of the Shilling versus the dollar was 30% with a duration of 12 months until recovery. If this same decline were to occur while this loan was outstanding, there should be no loss of principal or yield. To further stress test the position, we assumed a 30% currency decline and a 150% increase in defaults over the expected case. If this were to occur, there would be no principal loss. While there are few guarantees in life, we became comfortable with this investment and its protections.

Are we infallible, prescient, above reproach and generally wonderful? Alas, no. However, we implore investors to employ a traditional duty-of-care mindset in all of their investments and only offer the above as examples of what may be achieved in alternative lending.

Italian Alt Lending

An Italian walked into a bank in New York City and asked for the loan officer. He told the loan officer that he was going to Italy on business for two weeks and needed to borrow $5,000 and that he was not a depositor of the bank.

The bank officer told him that the bank would need some form of security for the loan, so the Italian handed over the keys to a new Ferrari. The car was parked on the street in front of the bank.

The Italian produced the title and everything checked out. The loan officer agreed to hold the car as collateral for the loan and apologized for having to charge 12% interest.

Later, the bank's president and its officers all enjoyed a good laugh at the Italian for using a $250,000 Ferrari as collateral for a $5,000 loan. An employee of the bank then drove the Ferrari into the bank's underground garage and parked it.

Two weeks later, the Italian returns, repays the $5,000 and the interest, which comes to $23.07. The loan officer said, "Sir, we are very happy to have had your business, and this transaction has worked out very nicely, but we are a little puzzled. While you were away, we checked you out and found that you are a multimillionaire. What puzzles us is, why would you bother to borrow $5,000?"

The Italian replied: "Where else in New York City can I park my car for two weeks for only $23.07 and expect it to be there when I return?"

Ah, Italian alternative lending…. Bada bing!

Upcoming Events

See attached schedule of industry related events at which Shinnecock will be sharing more in-depth information and let us know if you'll be attending so we can look for you!

Upcoming Events

Shinnecock will be in attendance and/or speaking at the following events. We'd be happy to have you join us!

September 13-14, 2017 – New York
iGlobal Forum 8th Specialty Finance Summit
Panel Discussion: Managing Risk in the Online Marketplace Lending and Fintech's Impact on Specialty Financing
***Venue details to come
For information and registration: http://www.iglobalforum.com/spfinance8

September 17-19, 2017 – Dana Point
Context Summits West 2017 (We will have meeting suite #126)
Monarch Beach Resort
1 Monarch Beach Resort N., Dana Point, CA 92629
For information and registration: https://contextsummits.com/west/

November 12-14, 2017 – Austin
Context Summits Texas 2017
Fairmont Hotel/Austin Convention Center
Convention Center, 500 E. Cesar Chavez St., Austin, TX 78701
For information and registration: https://contextsummits.com/texas/

January 31 - February 2, 2018 – Miami Beach
Context Summits Miami 2017
Fontainebleau Hotel
4441 Collins Ave., Miami Beach, FL 33140
For information and registration: https://contextsummits.com/miami/