Hunting Dog Capital
One Maritime Plaza
Suite 825
San Francisco, CA
94111
www.hdcap.com

Chris Allick
415.277.2292
chris@hdcap.com

Todd Blankfort
415.277.2293
todd@hdcap.com

Rob Kiesel
203.542.0922
rob@hdcap.com

Hunting Dog Capital LLC and its affiliates create uncommon lending solutions for all types of domestic companies regardless of industry or location.

The Current State of Lending in the U.S. – Its Impact on Businesses and Individuals and Timing to a Recovery

By:

Chris Allick, Todd Blankfort and Rob Kiesel

Background and Synopsis

Hunting Dog Capital is a privately-held, California-based investment firm that has been originating and servicing senior-secured term loans since 2006. We invest in direct lending opportunities nationally and have had the chance to analyze a large number of small, public and private company opportunities that span a wide range of industries. We have used firsthand experience to develop our perspective on what is truly occurring in today's lending market for small and mid-sized companies. What we observe contrasts with many articles that suggest that money is available from commercial banks for small businesses.

The purpose of this paper is to retrace some of the steps that led to the financial crisis of 2008 and review several factors that have created the challenging circumstances that currently exist for both borrowers and lenders. In addition, we review a few specific situations that highlight why the current environment is good from a private lender's perspective. Our conclusion discusses some of the fundamental changes that are necessary for things to get back to normal and why we believe this may take much longer than one might think.

We believe we are in the midst of a unique set of circumstances that have created an unprecedented opportunity as a non-traditional, unregulated lender to small and mid-sized companies. There are multiple factors that we consider to determine if it is a loan we want to fund, but the following are the key considerations:

- The borrower's tangible asset portfolio is a multiple of the principal amount of the loan
- The borrower's cash flow is sufficient to support a monthly cash pay coupon in the mid to high teens
- The equity value of the underlying business is a multiple of the total debt and the operations of the business have exhibited a stable to positive trend over the last several quarters

Some of our observations about the current market environment include the following:

- The attitudes of most borrowers about the prospects of improved profitability from increasing revenue is materially lower than in 2007
- Most prospective borrowers that have stabilized the financial condition of their businesses are still inclined to reduce operating expenses or invest in the maintenance of equipment already in place instead of hiring employees or investing in new capital expenditures in an effort to keep their businesses stable
- Most prospective borrowers do not believe that there will be a reversion back to a more "normal" relationship between commercial banks and themselves anytime in the foreseeable future

- Disintermediation between larger banks and smaller borrowers has resulted in significantly less available credit to companies that were considered highly "bankable" three years ago
  - FDIC-regulated institutional lenders continue to reduce the amount of their lending activity, particularly to small businesses with EBITDA less than $15 million, despite seeing an increase in their deposit bases
- The impact of the lack of credit is impairing businesses and will continue to hurt their ability and desire to hire additional employees

For a private lender, the current environment, compared to 2006 or 2007, is extraordinary:

- The volume of opportunities that fit our basic criteria is greater
- The average loan size is up from approximately $5 million to $20 million
- The collateral coverage is materially higher
- The businesses tend to be more stable than expected
- The terms are more favorable with less pushback from borrowers

Current State of the Banking Environment

Many books have already been published attempting to analyze the factors that led to the financial calamity in 2008. Needless to say, there are untold perspectives and explanations of why many icons of the financial services industry closed their doors. At the risk of oversimplification, we see the following: after more than a decade of Fed-induced, artificially cheap money, in an effort to stimulate national economic growth through home ownership, the merry-go-round came to a very sudden halt. Extreme liquidity at every level of the financial system had its day of reckoning. This excessive liquidity allowed trillions of dollars of complex, synthetic securities in the form of CLOs, mortgage-backed securities and credit-default swaps to enter the system that were inappropriately priced for their inherent risk. At the first indication that liquidity was no longer going to increase, signaled by the Fed taking short-term rates to zero, the sparks began to fly. Financial institutions that held these securities realized they were both over levered and had overvalued their assets. Hedge funds that were using leverage to enhance their returns to investors found themselves with no credit availability while holding considerable amounts of illiquid securities. Millions of homeowners found themselves with their primary asset worth less than their first mortgage and furthermore, most had drawn on their home equity lines.

Unfortunately, the daily affairs of businesses, homeowners and regulated and unregulated financial service businesses did not slow down, they hit a wall. Unemployment levels rose and the repercussions were disastrous. Personal net worths were slashed, consumer confidence plummeted, business and personal bankruptcies skyrocketed and at the brink of a financial meltdown, the Federal Government stepped in. In an effort to restore confidence in the financial system, immediate and longer-term measures were taken to allow the Federal Government to control the financial future of many businesses or see to it that certain businesses directly linked to the complex securities mess were effectively shut down. What made matters worse was the uncovering of massive fraud operations that had grown to unprecedented levels. Danny Pang, Bernie Madoff and Tom Petters were only a few of the billion dollar plus Ponzi schemes.

Restoration of the public's confidence required unprecedented measures, more dramatic than anything since The Depression. This effort led to the Congressional acceptance of the approximately 2,300 page Dodd-Frank Wall Street Reform and Consumer Protection Act, or H.R. 4173, signed into law on July 21, 2010. Not only did this legislation touch upon Wall Street and the commercial banking system, it also had massive proposed changes for hedge and private investment funds and the Federal Government itself,

by creating the Financial Stability and Oversight Council, the Office of Financial Research and the Consumer Financial Protection Bureau, all with enforcement power over every financial institution. Although the Dodd-Frank legislation was voluminous, the procedure manual necessary to explain implementation and enforcement would be an estimated 5,000 pages long. This is at the heart of our current predicament.

The ability of an individual, bank or hedge fund manager to dissect this legislation, guess which parts will be implemented, estimate how long this will take and evaluate the impact is virtually impossible. Of the 387 proposed changes, only a handful has been enacted. Adding further to the uncertainty, of those enacted, several already have Congressional support to be repealed. In fact, regulators have missed all 26 deadlines supposed to be met by April 2011. We moved over the course of approximately one year from a sense of financial panic to an unprecedented level of uncertainty and it looks as if the Dodd-Frank legislation, which was intended to regulate nearly every aspect of the American financial system, may never provide the reforms it set up to impose.

This uncertainty in the regulatory environment has created a challenging environment for the banking sector. Deposit bases continue to increase, while lending continues to decrease. Commercial banks continue to be closed at their fastest pace in over a decade. The Trouble Asset Relief Program, or TARP, under the Emergency Economic Stabilization Act of 2008, supposedly bridged the gap in time necessary for financial institutions to make the appropriate adjustments to account for “troubled assets” and determine the appropriate capital to maintain a stable balance sheet. For many banks, liquidation was the only solution. There were hundreds of regional and community banks whose roots were making loans to local, small businesses, but during the decade of cheap money, the traditional commercial-lending model turned to real estate-related activities for better returns. Many of those overweight in real estate exposure are no longer in business. We believe that the use of TARP funds by the survivors falls into two categories:

1. Banks that augmented their surplus capital funds and intended to manage down to a smaller balance sheet with improved operating margins to repay TARP funds, and
2. Banks that used the money to increase loan loss reserves with the intent of selling loans at or above the write-down price and using the proceeds to repay TARP

The first group seems to have fared fairly well. Interesting enough, even with historically low deposit rates, deposits have continued to increase. With reasonable leverage and the ability to borrow at the Fed window, it is possible to generate 50-75 bps of risk-free spread by buying short-term Treasuries and continue to fire loan officers who are not doing very much. It is a good way to stay in business while waiting to determine the full impact of the changes to the regulatory environment.

The second group is not doing quite as well. Although spreads have dropped precipitously, finding a bid for bank debt that has experienced a technical or payment default in the last 24 months remains challenging. It appears that if there is a market price, it is lower than the existing mark, which means a further loss or coming up with more equity to hold the loan. The latter option poses the additional risk that a red flag goes up in the eyes of the regulators and the asset management practices of the bank will undergo additional scrutiny. As a result, we believe that considerable opportunities remain to refinance companies where the use of proceeds is primarily to take out existing bank debt at a meaningful discount. The following are two examples of loans we funded over the past year:

- *Midwest auto dealer and GM parts distributor* – Established in 1976 and based in Indianapolis, IN, the borrower is a new and used car dealer, recognized by General Motors as “one of its key dealers for the Chevrolet Brand.” In addition to new and used vehicle sales, the borrower is a leading GM wholesale parts distributor and has established one of the

largest and most technologically-advanced, full-service repair and collision centers in the Midwest. With its mix of parts, repairs and service, the company maintained profitability throughout the bankruptcy of General Motors and one of the harshest environments for the sale of new and used cars. Despite this, the company's then current lender (*recipient of approximately $3.4 billion of TARP funds*) agreed to a discount of approximately 68% of the face amount of the debt to exit the credit. The Hunting Dog Capital loan is secured by a mix of highly-liquid collateral along with additional real estate, which at closing was estimated to have an orderly liquidation value of approximately 1.6x the principal amount. The collateral, combined with an improving top line and a stable, high-margin repair and servicing business made this an attractive opportunity

- *Midwest downstream industrial waste water processing company* – Headquartered in Columbus, OH, the company is a technologically-advanced, leading processor of hazardous and non-hazardous wastewater utilizing a proprietary technology. The company operates three fully permitted centralized waste treatment facilities within the state of Ohio capable of processing over 140 million gallons of wastewater per year. The company had an opportunity to replace its incumbent lender and its affiliate (*recipient of approximately $1.4 billion of TARP funds*) at a discount of approximately 18%, with a significantly reduced loan amount. The loan is secured by cash, accounts receivable, machinery and equipment and real estate, which at closing was estimated to have an orderly liquidation value of approximately 2.0x the principal amount. Because of several recent and ongoing market changes (EPA investigations and forced closures at two of its competitors), the company has been and continues to attract numerous new customers and has materially increased its cash flow and profitability.

Implications for Businesses and Individuals

Businesses
Small and local businesses have never been more challenged. Most tend to be far too small for larger regional banks. Most business owners are hunkering down and controlling or reducing expenses as far as they can until sales growth is more certain. Most are unwilling to commit to new capital expenditures or hire new, full-time employees. Additionally, at the risk of losing customers because of lower quality of service, trying to maintain the course with less money and fewer people is the norm. The silver lining in this debacle is that business owners have discovered new levels of innovation and tested the extremes to which they can cut costs and still maintain a customer base. Many that have survived this far are enjoying the benefit of increased market share as a result of declining competition.

Individuals
Unemployment remains a significant problem in almost every sector of our economy. Underemployment is an even greater problem. It is estimated that at the beginning of 2011, one in five Americans were either unemployed or underemployed. We have never experienced a set of circumstances where the percentage of the population over 60 represents the fastest growing segment and the majority of unemployed skilled laborers are willing to accept any work for compensation materially lower than their current standard of living requires. Add to this, that your financial assets are worth a fraction of what you thought they were worth in 2008 and what you see is not a pretty picture. Underemployed individuals are typically less inclined to take risk and to the extent that they have savings, they are willing to accept sub-par rates of return in exchange for avoiding further losses. In other words, a two-year, federally-insured certificate of deposit at the local bank for a 2% APR is satisfactory.

How Long Will This Cycle Last?

We are of the opinion that we are still in the early phases of a recovery from the downturn in 2008. The breath of the negative impact on individuals and businesses was so pervasive that recovery to a more normal business environment is years away. The supply of existing homes in the major markets of the Sun Belt states and California needs to be fully absorbed. Several sequential quarters of demand-driven sales growth will have to occur before smaller businesses will commit to new capital expenditures or the addition of new, full-time employees. Even with these factors in place, the availability of credit from commercial banks to small businesses will remain scarce. The prospect of higher taxes or mandatory health care benefits for employees will keep most businesses in a wait-and-see mode. The prospective burden of Federal regulation on banks needs to have clarity. An article from *The Wall Street Journal* on May 24, 2011 written by Professor Ronald McKinnon of Stanford University points out a critical problem with the current banking environment. He writes:

> *"Since July 2008, the stock of so called base money in the U.S. banking system has virtually tripled. As part of its rescue mission in the crisis and to drive interest rates down, the Fed has bought many nontraditional assets (e.g. mortgage-backed securities) as well as Treasuries. Yet these drastic actions have not stimulated new bank lending. The huge increase in base money is now lodged as excess reserves in large commercial banks.*
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> *In mid-2011, the supply of ordinary bank credit to firms and households continues to fall from what it had been in mid-2008. Although large corporate enterprises again have access to bond and equity financing, bank credit is the principal source of finance for working capital for small and medium-sized enterprises (SMEs) enabling them to purchase labor and other supplies. In cyclical upswings, SMEs have traditionally been the main engines for increasing employment, but not in the very weak upswing of 2010-11, where employment gains have been meager or nonexistent.*
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> *Why should zero interest rates be causing a credit constraint? After all, conventional thinking has it that the lower the interest the better the credit can expand. But this is only true when interest rates – particularly interbank interest rates – are comfortably above zero. Banks with good retail lending opportunities typically lend by opening lines to nonbank customers. But, these credit lines are open-ended in the sense that the commercial borrower can choose when -and by how much- he will actually draw on his credit line. This creates uncertainty for the bank in not knowing what its future cash position will be. An illiquid bank could be in trouble if its customers simultaneously decided to draw down their credit lines.*
>
> *If the retail bank has easy access to the wholesale interbank market, its liquidity is much improved. To cover unexpected liquidity shortfalls, it can borrow from banks with excess reserves with little or no credit checks. But, if the prevailing interbank lending rate is close to zero (as it is now), then large banks with surplus reserves become loath to part with them for a derisory yield. And smaller banks, which are collectively the biggest lenders to SMEs, cannot easily bid for funds at an interest rate significantly above the prevailing interest rate without inadvertently signaling that they might be in trouble. Indeed, counterparty risks in smaller banks remains substantial as almost 50 have failed so far this year."*

Professor McKinnon goes on to suggest that the current economic environment has many similarities to the stagflation experienced in the 1970's. The persistence of heightened bank counterparty risk is exacerbated by the "regulatory change overhang." As a result, we believe that the business environment like the current one will last at least another three to five years, if not longer.

While our lending strategy is designed to provide attractive, risk-adjusted returns regardless of market conditions, as an asset manager making direct, senior-secured loans to small businesses, we believe that there remains ample opportunity to prudently deploy significantly larger amounts of capital and achieve very attractive returns relative to the risk taken. We believe that our target market of businesses ignored, abandoned or underserved by commercial banks is growing, not shrinking. Our strategy is to generate unlevered cash returns in the low teens, net of fees and expenses by finding and servicing senior-secured term loans that are uncorrelated to the equity markets and are backed by tangible assets.

About Hunting Dog Capital LLC

Hunting Dog Capital LLC and its affiliates (www.hdcap.com) create uncommon lending solutions for all types of companies no matter where they are located or the industry. Whether it is a loan for an acquisition or a senior note for general corporate purposes, Hunting Dog Capital acts quickly to provide the required capital when it is most essential. HDC is a California licensed commercial lender.

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3. *Statistics at a Glance*, http://www.fdic.gov/bank/statistical/stats/2011mar/industry.html (June 2011)

Additional Reading:

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2. "Housing Market Holds Economy Back" – http://kondratieffwinter.blogspot.com/2011_01_01_archive.html
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