Secured Lending

Investment Insight | Series IV

In a series of articles, we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. So far we have discussed "Structured Credit", "Direct Lending" and "Indian Bonds". In series IV we introduce you to "Secured Lending".

While interest rates are at historical lows and valuations of most traditional asset classes have reached elevated levels, private and institutional investors are in search of alternative income sources to achieve their return goals. In this environment, we have identified within the "secured lending" asset class a very compelling strategy that **optimally combines the reach for an attractive yield with a very low risk of losing capital**. The following example briefly outlines the characteristics of this strategy we have been successfully implementing for our clients.

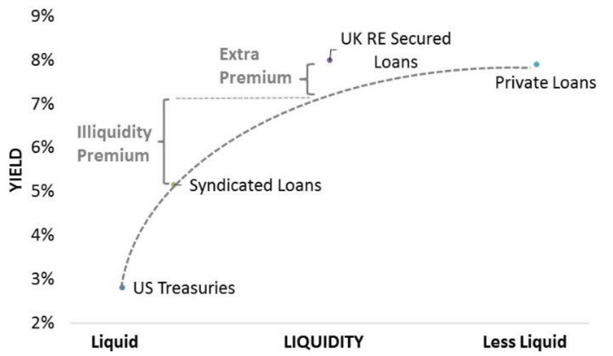
Secured lending in a nutshell

Generally, a "secured" loan is backed (or secured) by an asset. Hence, the borrower **pledges an asset** (i.e. in our example a property), **as collateral in favour of the loan**. In the event that the borrower defaults, the creditor takes possession of the asset and sells it to recover the amount originally lent to the borrower (via a mortgage repossession procedure to get the keys of the home). Besides real estate there are other assets that can be used as collateral. Most common are hard assets such as airplanes, cars, machineries, equipment, inventories or commodities. Liquid financial assets used are stocks, bonds or invoice receivables.

Sweet Spot in Secured Lending

Our focus in this investment insight is on **short term residential mortgage backed lending**. We believe this strategy represents the sweet spot within the secured lending market as it 1) generates a high income of ~8% p.a. 2) is backed by very strong collateral (homes with LTV* <65%) with extremely low historical loss rates, and 3) the maturity of the loans are short in nature at only 6-18 months. Hence, we can offer this strategy to investors in a relatively liquid format.

Earning an illiquidity and extra premium



The chart above illustrates the **unique risk-/return profile** of the strategy. An investor can structurally achieve an additional return, which we describe as illiquidity plus extra premium due to limited market capacity. We gain access to this asset class via a "clean", closed end fund structure with no asset-liability mismatch.

Short-term property lending market

Since the financial crisis 10 years ago stricter bank underwriting standards and requirements have resulted in more borrowers seeking short term finance via alternative lenders. Today the **short-term mortgage market** in the UK is estimated at **£4 bn annually**.
The loan approval times have increased, due to strengthened regulatory guidelines for traditional lenders (banks), leaving limited options to those who require urgent financing other than from the short-term market. Hence, borrowers are increasingly reliant on alternative lenders. To enable borrowers to conclude urgent property acquisitions (often at a discount), credit decisions have to be reached quickly. This creates an opportunity to earn a premium rate by providing speed, certainty of funding and the specialist services of alternative lenders.

Senior Secured Lending Strategy

Taking advantage of this unique investment opportunity requires very thorough processes and deep experience of the sector. Sourcing and underwriting standards are of key importance to effectively and continuously reach high income and low loss rates. We have identified a specialist with more than 10 years experience and an extensive history in the property and alternative lending market. So far the asset manager has completed over 2'100 loans with a value of over £1.4 billion of short-term finance. All the loans are backed by UK residential or commercial real estate. They have a very strong credit performance (less than 20 loans suffered a principal loss).

Please find on the right side an example that describes a typical project in the UK residential property market, to which we have gained exposure.

This niche lending market, where speed is key, an institutional infrastructure and risk management framework are very important and these have been developed steadily over the last twelve years. Dealing with hard money lending presumes focusing not only on the property itself but also on reviewing the borrower involved and the exits that have to be undertaken. Our portfolios have an average loan to value* (LTV) of 63%, whereas each loan has a maximum LTV of 75%, providing a lot of security even in a negative market. The duration range of financing is 6-24 months (average 12.5 months). This means that the liquidity for the end investor is also better than with other similar strategies such as private debt strategies.

Loan exits are achieved via property sales or long-term refinances, typically via buy-to let mortgages.

* A loan to value (LTV) ratio is a number that describes the size of a loan compared to the value of the property securing the loan. Lenders and others use the ratio to understand how risky a loan is, and it can be used for approving loans or requiring mortgage insurance. A higher LTV ratio suggests more risk because the assets behind the loan are less likely to pay off the loan as the LTV ratio increases.

Purchase of residential flat requiring refurbishment; exit planned as refinance via buy to let

Rationale: The borrower requires within a short time frame a loan to buy the property described below, which a "normal" bank is not able to provide within the tight time line. After the refurbishment, the borrower pays back the "expensive" bridge loan and replaces it with a "normal" mortgage via a commercial bank. The borrower keeps the property and rents it out in the market.

Loan Balance: £371'000 – South West England

- 2/3 bedroom converted flat on the second floor of a large Edwardian detached property in South West England
- Purpose of the loan is to purchase the flat, which the borrower plans to refurbish to a higher standard (expected Gross Development Value [GDV] of £ 595'000)
- Refurbishment project is being funded by the clients own funds
- The intended exit is to refinance on to a longer term buy to let mortgage via a commercial bank

The loan granted can be characterized as follows:

Loan to Value (LTV):	62.4%
Duration:	12 months
Yield:	11.2%
Security:	senior lien

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