Insight INVESTMENT

A BRIDGE TO HIGHER QUALITY PRIVATE DEBT

OCTOBER 2018

> **Insight believes that bridge lending can offer higher credit quality exposure than other private debt markets such as middle-market lending.**

Part of BNY MELLON

EXECUTIVE SUMMARY

- Bridge lending is a form of short-dated temporary finance (typically secured against property) provided to a borrower before they can source a more permanent (and typically less costly) financing arrangement
- In our view, investors have the potential to receive illiquidity and complexity premia of **approximately 250bp to 450bp** pa[1] above corporate bonds with a comparable credit rating
- Credit risk for senior investors is typically, based on our internal methodology, AA or A quality
- In our view, the assets offer institutional investors stronger structural protections than corporate bonds and higher credit quality relative to many private lending markets
- The main markets are in the US and UK, where market growth is rebounding from post-crisis lows
- Loans are made bilaterally with terms of six months to one year, with institutional lending facilities up to four years
- Loan-to-value (LTV) ratios are around 60% (effectively lower when seniority is taken into account), meaning property prices need to fall 40% before the borrower may be at risk of a capital loss. Loan-on-loan structures offer further credit enhancement[2]
- We believe that bridge lending can play a key role in:
  - Secured finance investment strategies
  - Multi-credit portfolios including cashflow-driven investment solutions

[1] Manager makes no assurances that premia will be achieved. Past performance is not indicative of future results.
[2] Insight, as of August 2018.

A BRIDGE TO HIGHER QUALITY PRIVATE DEBT

BRIDGE LENDING EXPLAINED

Bridge lending (sometimes known as 'fix and flip' loans in the US) is a form of financing provided for a short-term period (often six months to a year) with fast execution. They are 'temporary' financing solutions, facilitated to a borrower while it secures a lower cost 'permanent' arrangement such as a mortgage[3].

Borrowers use bridge loans to purchase residential and small commercial properties. They are often used:

- as finance for one property purchase while the borrower completes the sale of another
- for purchasing properties at auction before a full mortgage agreement can be arranged
- for property development or refurbishment, for the purposes of lease or resale where mortgage financing is unavailable for incomplete properties
- to fund businesses' working capital needs, such as for invoices or large tax bills[4]

The borrower's exit strategy is a major factor in the deal's credit quality, although the lending is typically secured against the underlying property and subject to protective covenants.

In the US and the UK, loans collateralized by owner-occupied properties are regulated and those secured against investment properties are not. Generally speaking, unregulated loans typically provide institutional investors with greater enforcement capability. The vast majority of bridge lending is in the unregulated segment of the market.

BRIDGE LENDING MARKETS ARE GROWING GLOBALLY

Origins and post-crisis decline of bridge lending

Bridge lending emerged in both the US and the UK in the 1960s. In the US, following the post-war boom, 'hard money' loans (a form of bridge loan typically extended by private lenders in distressed circumstances), became relatively common until the economic turmoil of the 1970s and 1980s. During this time in the UK, bridge lending was a niche market due to tight regulatory restrictions on banks and building societies. It was largely served by banks, solicitors and accountants and limited to London and Manchester.

After widespread financial deregulation in 1980s, bridge lending grew materially in popularity. Up until the 2008 global financial crisis, global bridge lending was mostly provided by large banks and speciality lenders. Given the wide availability of credit, it was often only riskier borrowers that resorted to bridge lending.

As the 2008 US subprime crisis inflicted pain on lenders and borrowers, it shone a light on loose real estate lending practices and bridge lending unfairly developed a poor reputation. Lenders retrenched from the market as their business models became challenged: banks faced regulatory considerations and a rising cost of capital, while speciality lenders also struggled to maintain their own funding lines. Demand for borrowing was also challenged as housing markets faltered in many of the developed western economies.

// Borrowers use bridge loans to purchase residential and small commercial properties //

[3] These bridge lending transactions are not to be confused with 'equity bridge loans' that are provided to companies for leveraged buyout and general M&A purposes. [4] This is currently the least common use of bridge finance.

Post-crisis re-emergence

Against the backdrop of a supply-constrained housing market, construction recovered in regions such as the US and UK. Improving economic trends including, in some cases, record-low unemployment rates, helped contribute to a recovery in demand for bridge lending.

Given tighter regulatory lending standards, including rules-based bank-lending restrictions and the removal of pre-crisis excesses such as self-certified mortgages, there was a marked increase in the credit quality of prospective borrowers. The greater availability of affordability checks and due diligence on borrowers helped lower costs for lenders and many were able to step into the gap left by the banking sector. Lenders were also able to demand more favorable terms. Given less exuberance around real estate markets, lending was written at substantially more conservative LTV ratios.

Global bridge lending activity is accelerating

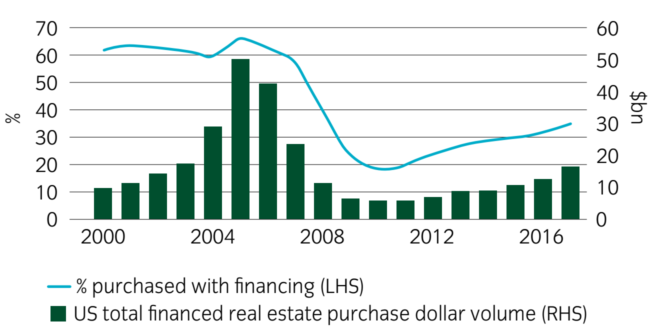
In the US, market fragmentation saw large banks retreat but regional banks continued to operate, as they commonly tend to finance local building projects. Favorable legislation, particularly the federal Community Reinvestment Act (CRA) of 1977 (including its post-crisis amendments) essentially offers goodwill incentives for financing for smaller projects, which has helped keep smaller banks active. Over the last two to three years, as the economic cycle has matured, more specialist lenders have been entering the market.

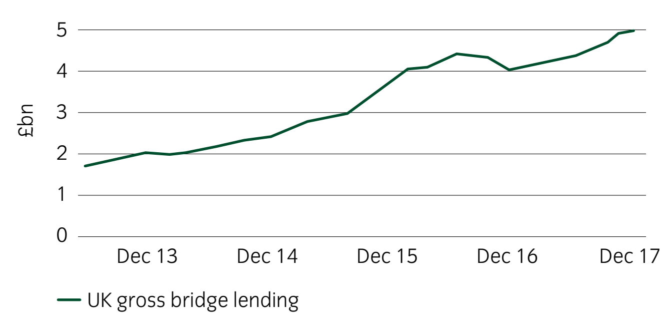
In the UK, the market was relatively slow to rebound. The first post-crisis lenders were largely funded by capital from high-net-worth individuals. Over the last three years, however, the market has become more institutionalized with larger bridge lenders and challenger banks now serving around 75%[5] of the market, with the more niche areas served by smaller independent lenders.

Market activity is now hitting post-financial crisis highs. In the US, the total value of financed bridge loans was $16.1bn in 2017, up 27% from a year earlier. In the UK, the bridge finance market reached £5bn in 2017, a 24% year-on-year rise (Figure 1).

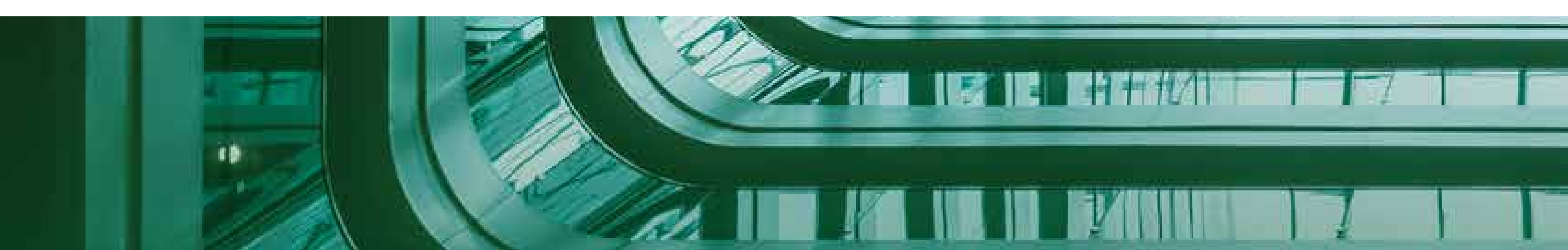
Other regions, such as Europe and Australia, have less developed bridge finance markets, even though they have large residential and consumer asset-backed securities (ABS) markets. Unlike the US or the UK, legal frameworks tend to be more tilted towards customers in Europe and can be less creditor-friendly. The regulatory frameworks also differ across jurisdictions, making portfolios of attractive deals across the continent less available. Over time, these markets may yet develop, and so investors may find opportunities within them.

Figure 1: US and UK bridge loan markets are on the rise[6]





[5] Source: Ernst and Young, Bridging Market Study 2018. [6] US data: Attom Data Solutions, as of April 2018. UK data: West One, as of August 2018.



BRIDGE LOANS OFFER COMPELLING COMPLEXITY AND ILLIQUIDITY PREMIA

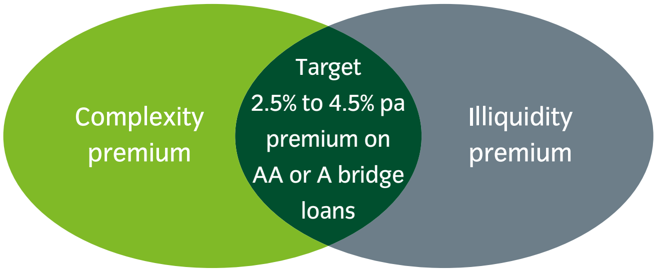
Bridge loans could offer potential returns in the region of 300 to 500bp pa above cash rates for AA or A quality credit risks[7]. In the US market, lenders could also uniquely benefit from the ability of borrowers to achieve ready refinancing from the large agencies, Fannie Mae and Freddie Mac. The transactions could potentially benefit from structural protections.

Private bridge loans have the potential to offer a compelling complexity and illiquidity premium over comparable corporate bonds. For AA-rated risks, US corporate debt offers an average asset swap spread of 43bp[8]. In the UK, the respective spread is 41bp[8]. This generally equates to a premium above 2.5% pa and sometimes above 4.5% pa.

Relative value versus riskier alternative credit

In our view, the structural and credit protections on bridge loans compare favorably with higher-risk alternative credit assets. For example, the higher-quality end of the middle-market lending market can offer 5% to 8% pa but expose investors to B-rated credit ratings, 5-year to 7-year tenors, often-relaxed leverage ratios and typically lower-quality structural protections (such as weaker covenant protection, lower levels of security and credit enhancement)[9].

Figure 2: Bridge lending complexity and illiquidity premium[10]



BRIDGE LENDERS CAN BENEFIT FROM HIGH CREDIT QUALITY AND STRUCTURAL PROTECTIONS

Low LTV rates protect against the potential for property market falls

In the case that investor confidence in their housing market proves misplaced, investors have a number of structural protections against worst-case scenarios.

Bridge loans are secured against the underlying real estate or a portfolio of real estate at LTV ratios of approximately 60%. This means the underlying property loan would need to fall by 40%[9] over the (usually 12-month) loan term before the lender is at risk of a capital loss. Bridge loans are also a senior debt obligation, which can reduce the effective LTV further. For comparison, in both the US and UK, the maximum housing-market drawdowns during the global financial crisis were just shy of 19% peak-to-trough[11].

Investors can also secure deals with protections such as covenants. Examples include maintenance covenants that measure leverage during the life of the loan, forcing the issuer to enter discussions with lenders if the tests breach agreed thresholds. Robust protections like these can help provide diversification against public markets in which covenants have been declining. For example, we have witnessed that bank-loan issuers have been increasingly able to issue 'cov-lite' deals since the global financial crisis, with the share outstanding of cov-lite deals in the US loan market now close to 80% (up from 20% in 2007)[12] given what we believe to be strong demand for higher-yielding paper and increased purchasing activity from collateralized loan obligations (CLOs).

[7] Credit quality using Insight's internal private ratings methodology which is based upon the processes employed by the private ratings agencies. Manager makes no assurances that potential returns will be achieved. [8] Bank of America Merrill Lynch, as of July 2018. [9] Source: Insight, as of August 2018. [10] For illustrative purposes only. [11] FHFA US House Price Index and Halifax UK House Price Index,as of August 2018. [12] LCD, S&P Global Market Intelligence, as of August 2018.

Loan-on-loan structures can enhance structural protections

In our view, institutions could potentially find attractive opportunities to finance bridge loan portfolios in loan-on-loan format. Structures such as these have a number of similarities to public asset-backed security waterfall structures. They generally allow investors to finance portfolios of bridge loans by investing in structurally secured senior debt or more junior and loss-absorbing debt.

This typically involves extending loans secured against a diversified portfolio of bridge loans, originated by dedicated bridge-lending specialists.

Senior loan-on-loan structures have the potential to enhance the structural protections already provided by regular loans. They may allow investors to finance bridge loan portfolios in scale with additional credit enhancement (in addition to that provided by the low LTV rates). For example, if a structure provides a 70% attachment to a portfolio of loans originated at 70% LTVs, this could result in an average effective LTV of less than 50% (Figure 3).

ACCESSING THE MARKET THROUGH PRIVATE LENDING

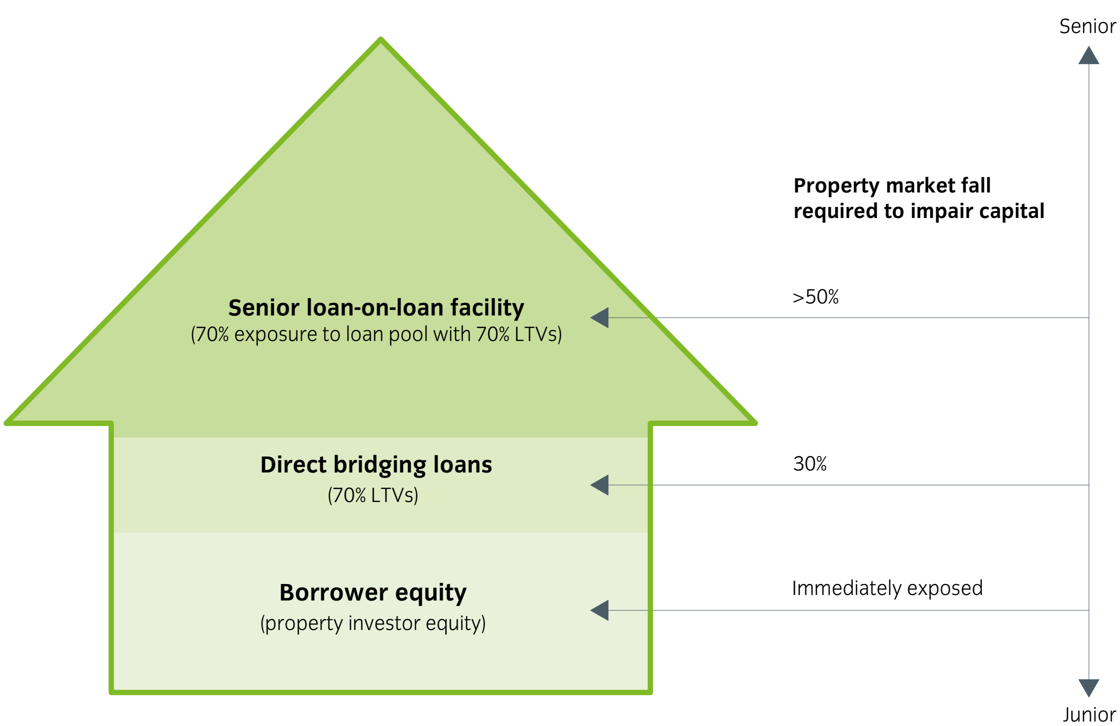
Public market access to bridge loans is in the embryonic stages

Bridge loans have never been securitized in investible off-balance sheet credit structures until very recently in the US mortgage-backed securities market. In March 2018, Angel Oak Capital issued a US$90m deal, believed to be the first to be backed by fix-and-flip loans[13]. Although we believe more deals are expected, ratings agencies currently have no agreed methodology for assigning ratings to them.

Investors need to access bridge finance exposure through private debt

Instead, we believe investors will find most opportunities in the private debt market. In our view, the asset class can offer a compelling risk/return trade-off that can complement an existing allocation to secured finance, as bridge loans currently offer an attractive relative value proposition against traditional corporate credit, other areas of secured finance and riskier alternative credit assets.

Figure 3: Institutional lenders are likely to find the best value in scale through loan-on-loan structures[14]



[13] Source: housingwire.com, as of March 2018. [14] For illustrative purposes only. Opinons are as of the date of the commentary and subject to change without notice. Manager assumes no responsibility to update such information.

CASE STUDY: BRIDGE LENDING IN PRACTICE[15]

Insight recently financed an established specialist bridge lender that had been active across the UK market (particularly London and the Midlands) for over 20 years, having written over £330m of loans. Insight was invited to participate in the financing as a senior co-lender on a pari-passu basis with a UK challenger bank. The financing came in excess of 400bp above Libor for an implied AA credit quality, and was supported by a comprehensive security package combined with a robust set of financial and collateral performance covenants, including a debenture and share charge over the borrower. When the loan was written, AA sterling corporate bond indices offered comparable asset swap spreads between 60bp and 70bp[16].

The loan's exposure was against a pool of UK property assets with a maximum weighted average LTV ratio of 65%, but given the seniority of the loan, at an advance rate of 75%, the effective weighted average LTV of Insight's lending facility was around 50%. Practically speaking this means that, in a worst-case scenario in which all the loans default, the UK property market would still need to fall in value by more than 50% for Insight's senior loan to begin suffering capital losses from debt recoveries[17].

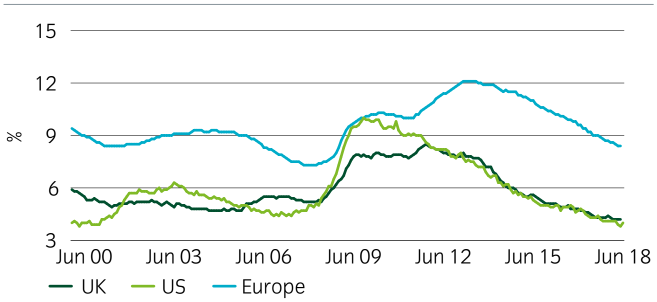
For context, a 50% fall is over double any UK house price drawdown on record[18]. The Bank of England's latest banking sector stress tests incorporate a residential property market drawdown of only 33%[19]. A hypothetical 50% fall could potentially be a systemic banking sector event inflicting severe pain on most risk asset classes. Even at this stressed level, in our view the loan withstands AA credit stress levels.

Collateral	Checklist for deal	Yes/no
Residential bridge loans	Contractual cashflows	Yes
	High quality	Yes
	Security, seniority and covenants	Yes
	Consistent with Insight's top-down fixed income and credit strategy views	Yes
	Attractive complexity and illiquidity premium above mainstream corporate debt	Yes

MARKET CONDITIONS ARE LIKELY TO SUPPORT CONTINUED GROWTH IN BRIDGE LENDING

In our view, global real estate markets generally look in good shape, particularly as unemployment rates globally are falling to historically low levels (Figure 4). In the UK, it is at the lowest since the 1970s and in the US, the lowest since the turn of the millennium. Despite this, economic growth is at or below potential across the developed world[20], a far cry from the over-heated nature of economies before the global financial crisis.

Figure 4: Falling unemployment indicates improving housing market health[21]



Rising rates reflect an improving global economy

Global monetary policy expansion appears to have reached its limits with most central banks now eyeing a normalization of policy. This activity (including the Federal Reserve's policy rate rises) is importantly being carried out gradually and is being driven by improving economic conditions, particularly as core inflation has remained benign even as spare capacity dwindles. We therefore do not expect housing markets to be materially impacted by changing monetary policy.

UK housing market looks likely to withstand Brexit risks

At the price levels generally targeted by development investors, risks such as the UK's decision to leave the European Union are not likely to have a major impact on the housing market, in our view. The overwhelming majority of residential property transactions in the UK occur at £300,000 and below. This is around 80% by count and 50% by value. Transactions above £1m account for just 1.6% of all deals by count but 13.5% by value.[22]

In our view, this indicates favorable demand dynamics for medium-to-lower priced housing as a result of low supply. It is at these price brackets where we expect the majority of bridge loans will be written. It's our opinon Brexit-related capital flight is likely to be more of a risk at larger price brackets.

[15] The information presented here is a representation/example to demonstrate the Insight's capabilities in bridge lending. It is for illustrative purposes only and should not be relied upon when making an investment decision. Past performance is not indicative of future results. Each account is individually managed, and could differ from what is presented herein. [16] Bank of America Merrill Lynch, February 2018. [17] The example is shown for illustrative purposes only. The Manager makes no assurances that similar results will be achieved. Each loan presents a unique set of facts and circumstances which may produce results that are unsuccessful. Past performance is not indicative of future results. [18] FHFA US House Price Index and Halifax UK House Price Index. [19] Bank of England, "Stress testing the UK banking system: key elements of the 2018 stress test", March 2018. [20] Source: OECD, as of July 2018. [21] Source: Bloomberg, as of August 2018. [22] Source: HM Revenue & Customs, as of 2014.

BARRIERS TO INVESTING IN THE BRIDGE LENDING MARKET

The additional potential return available in bridge lending compared to more liquid markets reflect a combination of a complexity premium and an illiquidity premium. This essentially puts the investments off-limits to all but specialist investors with the experience, expertise, resource and capability to invest in this area.

No off-the-shelf solutions for credit analysis

Bridge loans differ from corporate bond and liquid corporate credit markets in that there are no off-the-shelf solutions for analyzing them. Corporate credit investors can make use of tools such as broker research, Bloomberg terminal data and ratings agency credit assessments and research. ABS investors are also afforded tools such as Intex. However, private bridge lenders have no such tools available and therefore need to underwrite and perform detailed analysis on a transaction-by-transaction basis.

Relationships are key

Successful bridge lending requires deep relationships with other market participants. This includes borrowers, large and small banks (which may require co-investors) and speciality lenders (which, in themselves, may be looking for finance). Investors that lack a wide range of relationships across the entire market will likely miss out on the most potentially attractive opportunities. Large public and private debt investors are likely to have wide-ranging banking relationships, but they will also likely need relationships with private bridge lending specialists to access the full range of potential opportunities.

Legal and tax requirements command time and investment

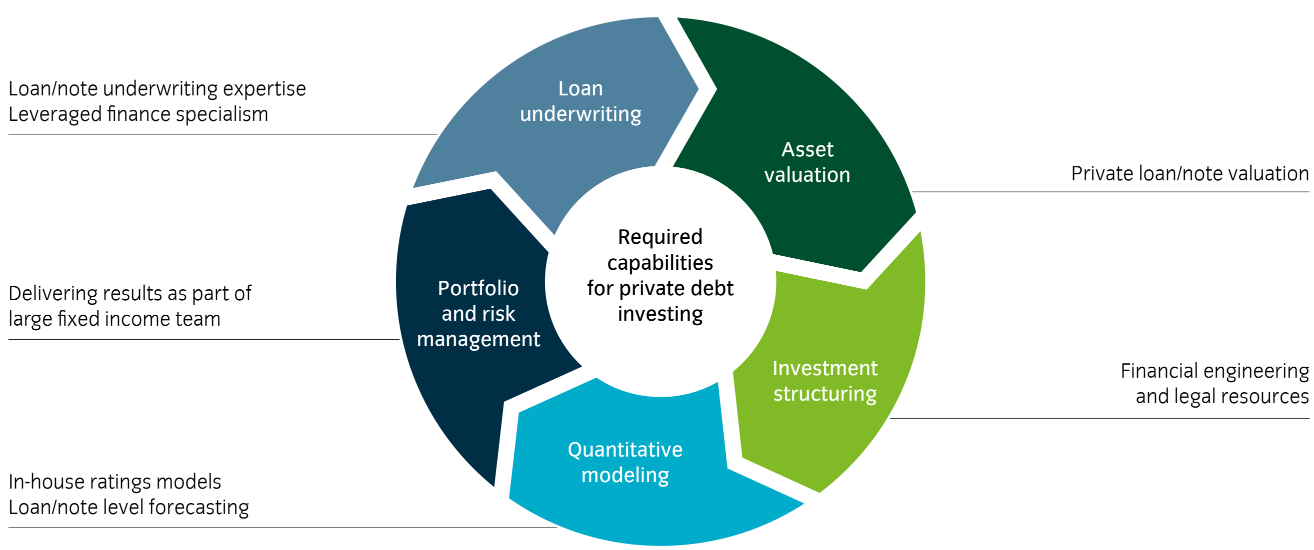
In our experience, setting up the necessary infrastructure to enter the bridge lending market in new jurisdictions can take a year or more. Complying with legal considerations and creating tax-efficient investment structures alone can require significant investment[23]. Investors that have already laid the groundwork will therefore be best-placed to take advantage of investment opportunities in the market.

Private lending requires substantial capabilities

To invest in private bridge loans, we believe that investors need access to the following capabilities in order to source, negotiate and structure, underwrite, value and carry out on-going risk management.

The capabilities that we believe are required for investors to successfully invest in the market are listed in Figure 5.

Figure 5: Capabilities required to engage in bridge lending[24]



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INCORPORATING BRIDGE LOANS INTO A PORTFOLIO

In our view, there are two potentially valuable applications of bridge loans in an institutional investor's portfolio:

Within a secured finance portfolio

We believe that bridge loans are a natural fit for inclusion in a wider portfolio of public and private secured finance assets, including residential, consumer, commercial real estate and secured corporate lending-based collateral.

Within a cashflow-driven investment (CDI) strategy

The prospects of attractive yield and credit spread premium available from the contractual cashflows also lend themselves to playing a valuable role at the short end of high-grade multi-credit CDI solutions.

A LOWER-RISK APPROACH TO SOLVING THE YIELD CONUNDRUM

In a world of low yields and narrow credit risk premia, many investors feel forced into higher-credit-risk asset classes to generate the income they require to meet their cash flow needs.

This often steers investors to high yield or lower-quality private debt markets. However, by substituting illiquidity and complexity premia for credit risk, investors may find the yields they desire in assets such as bridge loans, which offer secured, credit-enhanced cashflows and relatively short-dated exposures.

> By substituting illiquidity and complexity premia for credit risk, investors may find the yields they desire in assets such as bridge loans

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