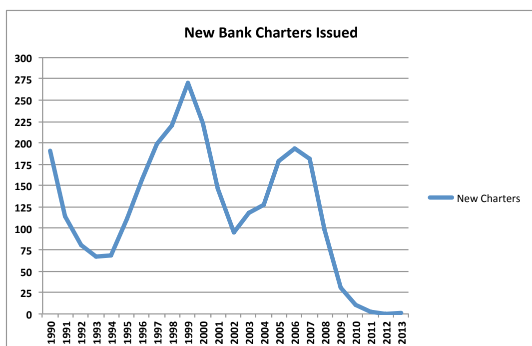
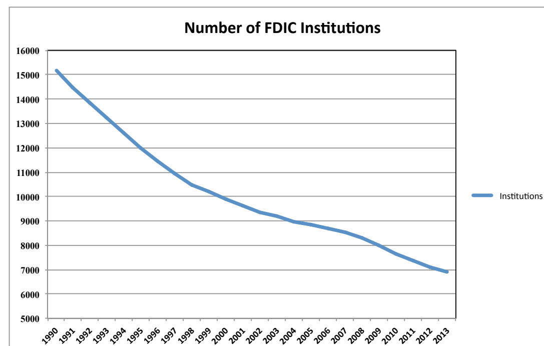
On the surface, the U.S economy looks significantly better compared to a few years ago. A combination of Quantitative Easing by the Federal Reserve, gradual improvement in the U.S. economy as measured by GDP, improvement in the official rate of unemployment, rising home prices and restored profitability for the banking sector as a whole has left U.S. banks flush with capital. It is quite notable that the total outstanding Commercial & Industrial ("C&I) loan volume is approximately back to historical highs. What is not apparent is the unlevel playing field for banks and companies. Big banks and large companies are fully enjoying the benefits of this recovery. Small lenders and small companies are not.

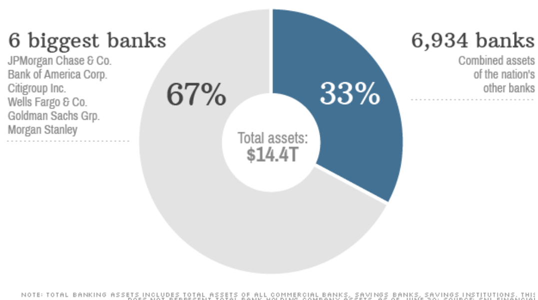
We believe that because of the growth of the largest banks and consolidation among the smaller lenders, in addition to stricter regulation, a disproportionate amount of the C&I lending is going to larger companies with EBITDA in excess of $25 million:

- Tally of US banks sinks to record low – According to the Federal Deposit Insurance Corporation ("FDIC"), the number of federally-insured banks dipped to 6,891 during 2013, which is the lowest level since 1934 when the government began keeping track
  - The US had over 18,000 banks in 1985, according to FDIC data
  - More than 1,400 banks disappeared in past five years





- Too big to fail (or not) – The six largest US banks (Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley and Wells Fargo) now have approximately 67% of all US assets, according the SNL Financial. This equates to approximately $9.6 trillion, which is an increase of approximately 37% from five years ago



According to the FDIC, 42% of all loans outstanding by US banks come from the five largest banks. As of June 30, 2013, Bank of America had the largest portfolio of C&I loans of approximately $228.7 billion, which is a year-over-year increase of almost 24%. In contrast, the largest community bank's portfolio was approximately $375 million, which is a year-over-year increase of almost 9%, according to *The American Banker*. Furthermore, for the twelve months ending September 2013, according to SNL Financial, the median loan-growth rate for banks with assets less than $100 million that service smaller borrowers was approximately 2%, which is well behind the 3.4-7.0% growth for banks with assets up to $10 billion. According to data by *Thomason Reuters*, banks issued 73% of middle market loans last year, down from 81% in 2012, with the balance originated by the shadow banking system.

Consolidation has also compounded the problem for many small borrowers in other ways. For example, as banks have grown, it is not uncommon for a borrower to be informed that they are too small and unprofitable for the bank to continue the relationship, especially, if there has been an historical technical default or covenant breach. These companies often have their credit lines restricted with excess cash swept to amortize the loan. Finally, as C&I

lending has increased, it appears that increased competition from the large banks has compressed yields while the amount of leverage (and therefore risk) has increased:

- Average spread of new-issue pricing for B+/B credits has decreased approximately 459 bps in January 2013 to approximately 434 bps in January 2014 (*Source: TM Capital Q4:2013 Leveraged Finance Report*)
- Leverage through first-lien debt of 3.4x and 3.9x in January 2013 and January 2014, respectively (*Source: TM Capital Q4:2013 Leveraged Finance Report*)
    - Total debt/EBITDA of 4.6x and 5.0x in January 2013 and January 2014, respectively

As a result, lower-middle market borrowers remain challenged to gain access to the desired amount of leverage to achieve their growth objectives. We believe that the inability of lower middle-market borrowers to access adequate capital to grow their businesses has important implication for the US economy and investors. Larger companies have access to capital on increasingly more favorable terms and pricing. But what are they doing with the capital? Instead of hiring, we believe many firms are investing in software and other productivity-enhancing technologies that will enable them to largely refrain from hiring or worse, trim employees to reduce expenses. According to the most recent information available from the US Census Bureau, over 98% of Americans work for companies with less than 100 employees. If these companies are unable to develop their businesses and stay competitive, they too could begin to shed employees. Therefore, it is extremely important for the broader economy that these small employers be able to access the resources necessary to be successful.

The message from regulators and legislators to the banking industry is to take less risk. Increased regulation aimed at strengthening the financial system and building public confidence is likely to make shadow banking more profitable. In particular, the Volker rule and the risk-retention rule, designed to curb proprietary trading and improve underwriting standards by preventing large banks from securitizing pools of loans, will undoubtedly create room for new lenders and credit focused financial firms to operate outside of regulation. So, what is the size of the shadow banking system relative to traditional banks? According to the Federal Reserve Bank of New York, gross shadow liabilities, or the sum of total balance-sheet capacity allocated to shadow banking activities, is approximately $15 trillion. This is substantially less than the estimated $22 trillion in liabilities attributable to the shadow banking system in June 2007. Traditional bank liabilities, which were around $14 trillion in 2007, have continued to grow and recently surpassed the liabilities of the shadow banking system. Whereas before the crisis collateralized loan obligations ("CLO") that bought up middle-market loans helped to drive originations, non-CLO lenders with diverse institutional backing now make up a larger part of the market.

Market Implications for Borrowers
Making term loans to small companies will continue to be challenging for most banks. Inexpensive revolving credit facilities should be generally available especially in states that are experiencing solid economic growth. Small business owners are more likely to find term loans from an SBIC or through the SBA loan program. Other lower middle market companies that need growth capital or a loan that gives them the ability to grow will need to find alternative non-regulated lenders. Waiting for lending restrictions to loosen up is probably a flawed strategy. It will be years before there is any meaningful reversal of the Fed's Quantitative Easing program and even then it will be unlikely regulators will change their attitude toward banks taking risk. Small companies looking for leverage will be better served by private, unregulated sources for the foreseeable future.

Market Implications for Fixed Income Investors
Inevitably, interest rates will rise. Estimating how much rates will rise over the next few years is very challenging. There isn't enough evidence that the underlying economic stability is solid and sustainable. While the Fed has begun, and intends to continue, to taper, doing too much or moving too quickly can potentially create a significant market disruption. We've already seen market adjustments this year. Unless your time horizon is very long, buying floating rate securities with the intention of capturing the upturn in rates probably won't compensate you for the risk. Likewise there isn't enough yield in long-term bonds to be compensated for the risk. Owning short duration fixed rate investments is probably the best bet.

About Hunting Dog Capital
Since 2006 Hunting Dog Capital has created uncommon lending solutions for a wide variety of US based businesses. We use committed institutional capital to originate and service loans to public and private lower middle

market companies. Proceeds are used to facilitate acquisitions, refinance existing debt or for general corporate purposes that promote growth.

Here is a chart that compares the features of several financing options lower middle market companies may consider:

CAPITAL SOURCES USED BY MIDDLE-MARKET COMPANIES

	Hunting Dog	Senior Bank Loans	Mezzanine	Equity
Security	Secured	Secured	Subordinated	Unsecured
Position	Highest	Highest	Middle	Lowest
Covenants	Tailored to company's plan	Tight	Flexible	None
Term	1-5 yers	Short	Long term	Long term
Coupon	Fixed	Floating	Fixed	Dividend
Rate	Risk adjusted	LIBOR plus spread	Risk adjusted	Market adjusted
Equity Kicker	Warrants	None	Warrants	Shares
Control	No	No	Yes	Yes
Prepayment penalties	One year make-whole	Yes	Yes	No

A major differentiating factor in our lending strategy has to do with our emphasis on collateral value as opposed to cash flow. We look for situations where tangible collateral in liquidation will support a collateral coverage ratio ("CCR") of 1.1x or greater at closing. Our underwriting and diligence approach is more like an equity investor than a cash flow lender. With the right characteristics we will structure the loan with no amortization schedule and minimal prepayment penalties. This means the borrower can use cash that might otherwise be applied toward principal payments for general corporate purposes. This feature is quite valuable to equity holders that need growth capital but want to wait for several years before selling equity. The expected increase in equity value makes paying for a window to grow worthwhile.

We have tried to review the current market environment with facts that support the argument that conventional financing strategies are generally not available to small businesses and will not be for the foreseeable future. This implies that the market opportunity for lenders that can address the needs of this market segment are quite significant. If you would like to know more about Hunting Dog Capital, including additional research we conducted in preparation of this paper, please visit our website (www.hdcap.com) or contact Chris Allick by phone (415.277.2292) or by email (chris@hdcap.com)