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

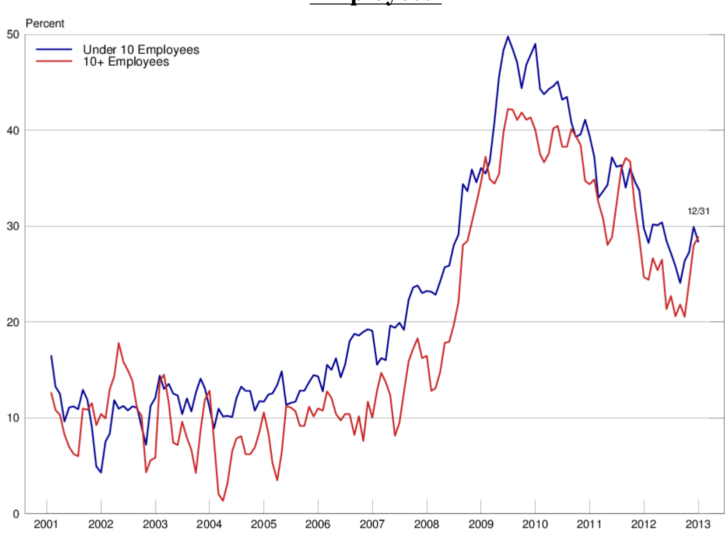
The Current State of US Lending (Q3:2014)

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. Our Q2 2014 white paper, "The Current State of US Lending" like this one, focused primarily on lower-middle market borrowers; we concluded, in summary that these borrowers will remain challenged to gain access to the desired amount of leverage to achieve their growth objectives. We are frequently asked why traditional commercial banks will not - or cannot - provide adequate growth capital for lower-middle market businesses, even if underwritten and priced appropriately. In this update, we will examine the regulatory, political and historical forces at the source of this change in the market. We believe this trend among commercial banks was brought on in large part - and by design - through regulatory reform and will continue. We further believe that sophisticated, alternative capital will absorb a lot of demand, and long-term, this is good for the lower-middle market.

The Current State of US Lending

As we discussed in our last white paper, in contrast to the common perception that funds for lower-middle market borrowers are widely available, our observations and experiences suggest this is not the case. Traditional commercial banks have significantly restricted credit relative to pre-2008/2009 credit crisis levels, and are consequently losing ground quickly in lower-middle market lending. The following data suggest that the percentage of firms reporting credit is harder to get relative to the prior three months went from an average of approximately 10% between 2001 and 2008, to 40%+ during the credit crisis, and currently hovers around 30%.

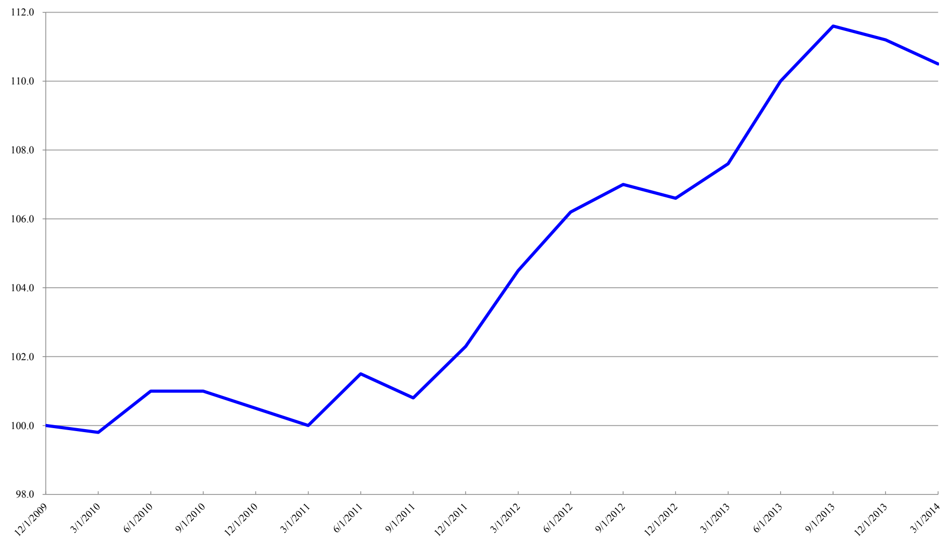
Net % of Firms Reporting Credit Harder to Get Compared to 3 Months Ago, by # of Employees[1]



[1] National Federation of Independent Businesses (NFIB), "Survey, Small Business Economic Trends Data", January 2014.

Picking up the slack, increasingly, are non-traditional, typically un-regulated capital sources. The emergence of these sources has not been rapid enough however to compensate entirely for the significant reduction of lower-middle market credit on the part of commercial banks. Strikingly, this dynamic has evolved alongside a rebound in credit quality among lower-middle market companies back to normal, or near-normal levels. Highlighting this is the Experian/Moody's Analytics Small Business Credit Index, which measures credit quality for firms with 100 or fewer workers. While falling 0.7 points in Q1 2014 to 110.5, the index is still up markedly since its initiation in 2010.

Experian/Moody's Analytics Small Business Credit Index Q1 2014[2]



The question arises - why aren't these traditional commercial banks - which still possess the vast majority of the nation's underwriting expertise, as well as many of the historical borrower relationships - making more lucrative loans to lower-middle market companies? We believe the answers can be found both by examining the strength of the banks remaining subsequent to the credit crisis, and, more importantly, studying the regulatory reform environment, specifically the perception of that environment by the banks themselves.

In order to better understand the lower-middle market lending environment, we begin by examining the strength and number of banks now, relative to their pre-crisis levels, and in particular, small banks, a group heavily impacted by both the crisis, and by subsequent reform. The Federal Reserve Board published an in-depth analysis of this subject in a paper titled "Supervisor Ratings and the Contraction of Bank Lending to Small Businesses" in late 2012. The paper studied the relationship between changes in small C&I/commercial real estate ("CRE") loans and changes in small (<$5 billion of assets) banks' CAMELS ratings. CAMELS are components of the bank supervisors' rating system and stand for: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Ratings range from 1 to 5 with 1 (the highest) "represent[ing] the least supervisory concern3" and 5 (the lowest) "represent[ing] the greatest supervisory concern, indicating the most critically deficient level of performance[3]."

The simple conclusion: "small banks that experienced ratings downgrades during 2007-2010 exhibited significantly lower rates of growth in small C&I loans and small CRE loans outstanding compared with banks that maintained their ratings at healthy levels during the same period[4]."

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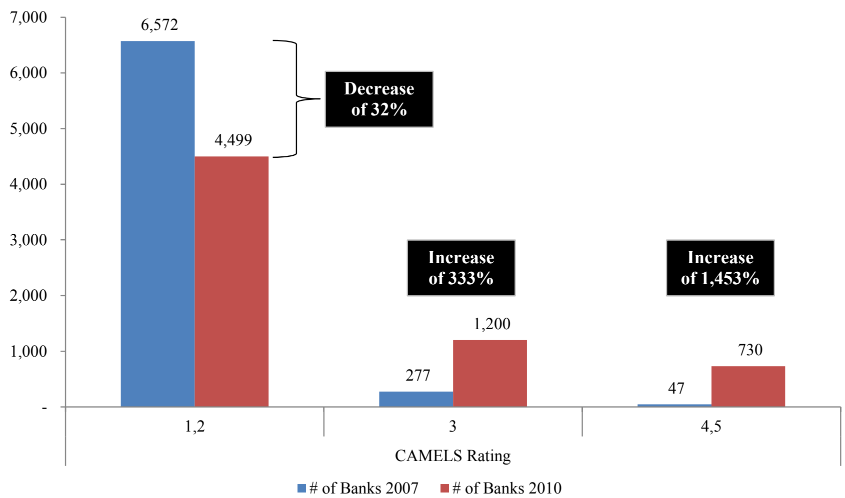
[2] Note: dates are shown as the beginning of the month of actual reporting, though measurements are for end-of-month.
[3] Comptroller of the Currency, "Bank Supervision Process, Comptroller's Handbook", September 2007, page 9.
[4] Elizabeth K. Kiser, Robin A. Prager, and Jason R. Scott, "Supervisor Ratings and the Contraction of Bank Lending to Small Businesses", Federal Reserve Board, 2012, page 2.

The downgrades - and failures - numbered in the thousands:

Distribution of CAMELS Ratings: 2007 to 2010 (Small Banks)



Any examination of the regulatory environment is set against this backdrop of significantly fewer, and significantly weaker small banks, as evidenced by the CAMELS ratings above.

Given the complexity of the regulatory environment, we first identify the regulations most influential on lending to the lower-middle market. These regulations are imposed by the Office of the Comptroller of the Currency (the "OCC") and the Federal Reserve Board. Though also a response to the credit crisis, the latest regulations serve to memorialize the Basel II and Basel III accords (recommended international banking regulations) as well as the relevant elements of the Dodd-Frank Act. The latest version of these regulations is laid out in the final rule on regulatory capital, a 983-page document released in October 2013 that outlines "risk-based and leverage capital requirements for banking organizations." The principal purpose of these regulations is to assure that banks - large and small - have sufficient capital to withstand potential losses in the assets they hold without harming their depositor bases or causing systemic problems similar to those seen in the 2008-2009 crisis. The primary mechanism to implement these limitations, simply put, is a minimum regulatory capital ratio, i.e., the minimum amount of capital required relative to the banks' risk-weighted assets. The final rule increased the minimum regulatory capital ratio - significantly and detrimentally, according to some. To understand the rules, and their impact, we must consider what constitutes an asset, how much "risk" is accorded individual assets (with "risk" being a topic of significant debate), and the amount and type of capital required to hold it. Perhaps, most importantly however, we must consider the perception of the regulations, and their evolution, by banks' management teams and stakeholders.

Beginning with the assets themselves, each asset, or more simply, each loan is accorded some degree of risk, i.e., it is "weighted." Among the lowest-risk assets, according to the final rule, are "exposures to the U.S. government, its central bank, or a U.S. government agency" that are "unconditionally guaranteed." These assets are weighted with zero-percent risk, meaning they do not count as assets at all for which "high-quality" (i.e. loss-absorbing) capital must be held. Other exposures to U.S. government-related entities for which there are conditional guarantees carry higher risk weightings, while exposures to foreign sovereigns are risk weighted according to a number of factors, including whether the sovereign is a member of the OECD and the sovereign's country risk classification. Risk weights for foreign sovereigns range from zero to 150% of the asset. Still other assets are assigned various weights as well. It becomes apparent that simply calculating total risk-weighted assets on banks' books could prove a challenge, especially to smaller banks.

Corporate Exposures: relevant to understanding the funding environment for lower-middle market companies is understanding the regulations' risk weighting of banks' corporate exposure, all of which is uniformly weighted at 100%, and its definition, which is as follows:

> "exposure to a company that is not an exposure to a sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB [multilateral development bank], a depository institution, a foreign bank, a credit union, a PSE, a GSE, a residential mortgage exposure, a pre-sold construction loan, a statutory multifamily mortgage, a high-volatility commercial real estate (HVCRE) exposure, an equity exposure, or an unsettled transaction[5]."

Using corporate exposures as an example, we'll review the capital requirements at present vs. the old:

Capital Category	Adequately Capitalized	
	Prior	**New**
Common Equity, Tier 1	N/A	> 4.5%
Total Tier 1	> 4.0%	> 6.0%
Total Capital	> 8.0%	> 8.0%
Leverage Ratio	> 4.0%	> 4.0%

Put simply, in order to be "adequately capitalized," a bank must hold $8.00 of total capital, including $4.50 in common equity and $6.00 of total tier 1capital (new and increased requirements, respectively) for every $100 of corporate exposure, given that this exposure is "risk-weighted" at 100%. Several observations are in order:

1. Numerous studies by the agencies suggested the increased capital requirements would in fact NOT be difficult for most banks to meet, but the message to de-risk was clear, especially given the new common equity requirement. Small banks and community banks - the biggest lenders to the lower-middle market - were particularly vocal, however, in their aversion to the new capital requirements, claiming they put undue pressure on them as raising common equity and tier 1 capital is generally more difficult for small banks than for large ones.
2. The agencies maintained the 100% risk weighting for corporate exposures despite the fact they "understand that a 100-percent risk weight may overstate the credit risk associated with some high-quality bonds[6]." Maintaining this weighting may, in part, also be a function of Dodd-Frank's preclusion of the use of traditional credit ratings, given that the agencies could have changed the weightings along with all of the other changes made.

In addition to the increased risk-based capital requirements above, the final rule includes an incremental "capital conservation buffer" of 2.5% of total risk-weighted assets, all of which must be satisfied with common equity. Unless this buffer is met, bonuses and capital distributions will be limited, if not entirely prohibited, depending on the severity of shortfall. Bonus restrictions apply to banks' executives themselves and capital distributions apply broadly, including stock buy-backs, dividend programs, etc. These are serious penalties, the incurrence of which could ultimately lead to very negative consequences for individual executives (i.e., termination) as well as shareholders (significant reduction in equity values). Again, the message to de-risk is clear.

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[5] Office of the Comptroller of the Currency, Treasury; and the Board of Governors of the Federal Reserve System, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule", October 11, 2013, page 252.

[6] See footnote 5, page 254.

What is not clear however - and potentially most important to the analysis - is what is next from a regulatory and supervisory perspective. We believe that uncertainty in the evolution of regulation and supervision – perhaps more so than actual regulation and supervision itself - has caused, and will continue to cause traditional commercial banks to pare risk. This uncertainty is embodied in the evolution, and perception of three discrete frameworks, some very specific, and some much more nebulous and subject to interpretation:

1. **"Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework"** was published by The Bank for International Settlements in June 2004. It was nearly three and a half year later before U.S. regulators issued a final rule on Basel II's implementation. The regulations continued to be modified subsequently and the compliance date was delayed as a result of the financial crisis that began in 2007. Basel "II.5" and Basel III were already in the works at that point, and they were not memorialized in the U.S. until October 2013.
2. **The Dodd-Frank Wall Street Reform and Consumer Protection Act**, proposed by the Administration in June 2009, was signed into law approximately one year later. According to law firm, Davis Polk, since then approximately 45% of all rulemaking deadlines have been missed and approximately 24% of all rulemaking requirements have not even been proposed. Consequently, regulated entities can only guess what shape the ultimate rules will take.
3. **"Interagency Guidance on Leveraged Lending"** was issued by the Fed, FDIC and OCC in March 2013. This short memorandum has had far reaching impact, and is emblematic of an increasing tendency to regulate through guidance. Initially, regulated entities perceived the take-away was simply that leverage in excess of 6.0X EBITDA "raises concerns for most industries" and consequently would increase regulatory scrutiny. Increasingly however, regulated entities are concerned with the memo's guidance on underwriting standards and information systems, among other areas. Much of this guidance is open-ended, subject to significant interpretation, and hence, more worrisome for regulated entities hosting examiners reviewing their assets, procedures, systems and people.

In conclusion, while the number and strength of small banks has diminished subsequent to the crisis, and regulation is certainly more onerous than it was, it is the increased uncertainty in the regulatory environment, the ongoing "evolution" of regulation and the increasing tendency on the part of regulators to regulate through "guidance" as opposed to rules that has most impacted lower-middle market lending. We cannot quantify the impact of any of these trends, but bank behavior has changed markedly in the recent past:

- Traditional commercial banks of all sizes have turned inward, focusing heavily on compliance with Basel III, the Dodd-Frank Act and 2013's interagency guidance among other regulations, all with some degree of inefficiency given the evolving nature of the regulatory environment
- Banks are shedding employees focused on making new loans, and staffing up compliance departments
- Consequently, banks have made concerted efforts to focus on fewer, larger, more easily monitored credits, further distancing themselves from the lower-middle market

We view these trends and the changes in the regulatory framework as an opportunity, as do a growing number of fund managers. Globally, funds dedicated to private debt are expected to raise $105 billion in 2014, up from $97 billion in 2013 while, in a similar vein, business development companies grew tenfold between 2003 and 2013[7]. Though the regulatory agencies admit that regulations are imperfect, and in some cases possibly over-conservative (i.e., in the case of corporate exposures) the regulations are in

[7] *Private Debt Investor Magazine* as quoted by *The Economist*, "Shadow and Substance", May 10th -16th 2014.

large part having their intended consequence: the de-risking of traditional commercial banks, and transfer of that risk to more nimble parties. Many of these parties (including Hunting Dog Capital) use no leverage whatsoever, and absolutely none of them takes deposits.

About Hunting Dog Capital

Since 2006, Hunting Dog Capital LLC and its affiliates have created uncommon lending solutions for a wide variety of US-based companies. Backed by institutional capital, Hunting Dog loans are used by business owners and management to facilitate acquisitions, refinance existing debt or for general corporate purposes to enable growth. Typically:

- We lend to US-based public and private companies across industries
- All loans are senior-secured (first lien) with stated maturities ranging from two to five years
- Loans are in amounts of $5 million and up
- If we get comfortable with the underlying collateral, we will consider non-amortizing loans with bullet maturities
- Borrowers can prepay without penalty after the first year
- We act quickly to provide the required capital when it is most essential

One way we differentiate ourselves from other direct lenders to lower middle-market companies is by focusing on tangible assets instead of cash flow. If we get comfortable with the underlying collateral, typically a collateral coverage ratio ("CCR") of 1.1x or greater going in, we will do non-amortizing bullets. We believe our terms are especially attractive to businesses owners with substantial at-risk equity because they enable entrepreneurs to retain control, avoid or delay significant equity dilution and capture equity appreciation as the business grows. Instead of amortizing debt, management may use cash for working capital or additional growth objectives.

Stated maturities are typically two to five years with a one-year make-whole provision. After twelve months, our loan documents usually do not include a prepayment penalty, thus enabling the borrower to repay the loan sooner if a sale of the business is imminent or refinancing is an attractive option. Another characteristic of Hunting Dog loans is the way we tailor covenants to management's business plan and projections. While tight and designed to protect principle, covenants are not typically as restrictive as those found in term loans or revolvers from traditional banks. As a short-term capital provider, we believe this type of liquidity is essential for middle-market businesses to execute their plans and meet or exceed corporate objectives.

Available capital sources for middle-market companies can include senior term loans and revolvers from traditional banks, mezzanine lenders, and private equity sponsors. However, as mentioned above, the state of the current market may make financing from traditional sources more difficult to secure or at terms that are unappealing to the company. In addition, issuing equity or adding a mezzanine piece to the capital structure may not align with the owner's expectations for growth and control. Hunting Dog's direct lending strategy is unique and gives the borrower additional flexibility to operate the business.

To learn more about Hunting Dog Capital, please visit our website (www.hdcap.com) or contact Chris Allick by phone (415.277.2292) or by email (chris@hdcap.com).