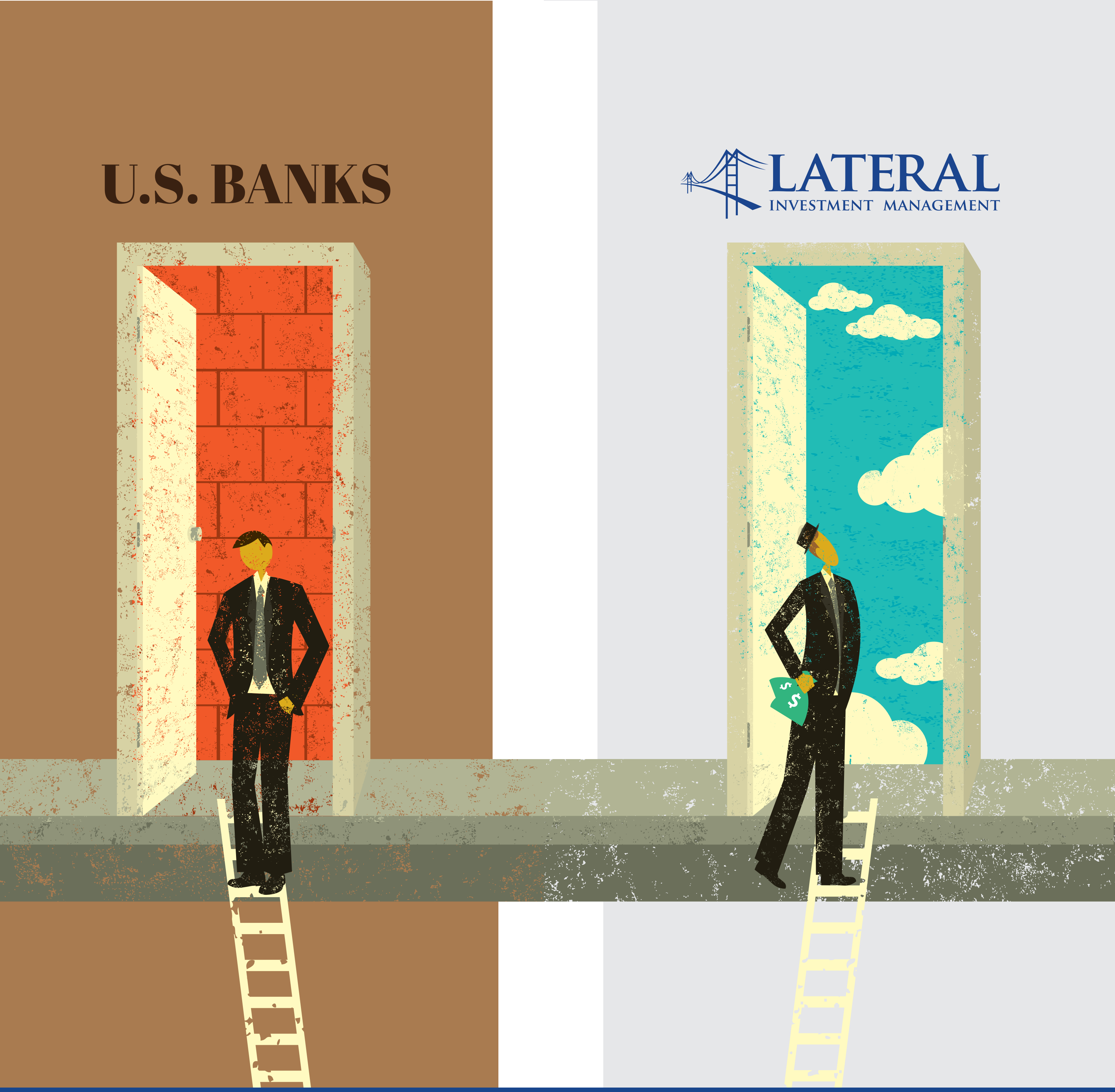


WHY BANKS WON'T LEND TO NON-SPONSORED U.S. COMPANIES

Attractive Yield Opportunities in the U.S. Middle Market

WHY BANKS WON'T LEND TO NON-SPONSORED U.S. COMPANIES*

By Richard de Silva and Kenneth Masters

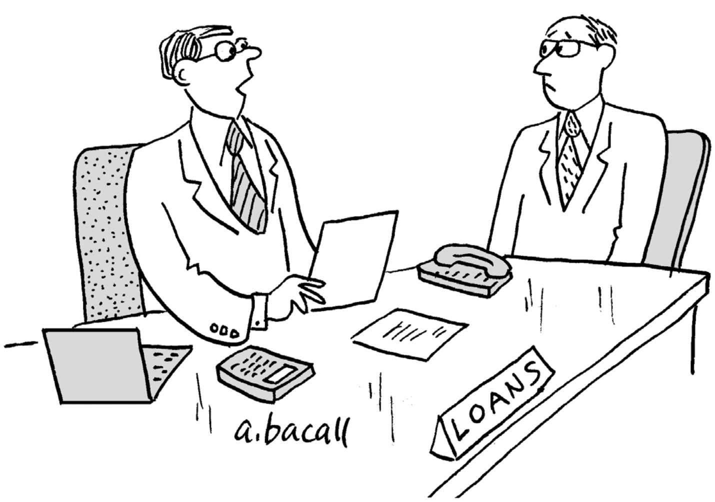
Capital is cheap almost everywhere except for the heartland of the American economy: independent U.S. companies with less than $100 million in revenue ("lower middle market" companies).

If you're a growing mid-sized manufacturer or service provider in the U.S., banks don't want you anymore. Banks today want to lend to big companies with publicly rated debt or to companies owned by private equity firms. If you're independent or family owned, banks won't lend you enough cash to take advantage of the emerging growth opportunities in the economy.

This is at least part of the reason why the U.S. economy has recovered so slowly since the 2007 recession. Large public companies like General Motors and Apple are sitting on piles of cash and still raising more with cheap debt. "Upper middle market" firms ($100MM to $1B in revenues) including private equity-backed companies have raised billions of dollars in far riskier high-yield public debt at only marginally higher rates and with minimal "covenant light" restrictions. But paradoxically, many of the suppliers to these companies can't get financing.

Unlike large cap and upper middle market companies, lower middle market companies are too small for the public debt markets and can't get the bank financing they need for working capital or for capital expenditures to keep up with growth. This dislocation in the availability of capital creates an exciting long-term structural opportunity to invest in the most fundamentally strong, stable and surprisingly, one of the most under-served markets in the world: the U.S. lower middle market.

U.S. BANKS AVOID FINANCING INDEPENDENT, MIDDLE MARKET FIRMS



"We are prepared to make you a loan, but first you have to prove that you really don't need it."

If you're a growing mid-sized manufacturer or service provider in the U.S., banks don't want you anymore.

*"Non-sponsored companies" refers to firms that are independent, owner-operated or family-owned businesses that have not been financed by a private-equity firm.

THE END OF THE BANK AS WE KNOW IT

Banks today are hamstrung by regulations enacted after the 2007 recession in the name of reducing overall risk in the banking industry. Just how significant were the regulatory changes? They have changed the banking industry structurally in three ways and the results are unprecedented and far-reaching.

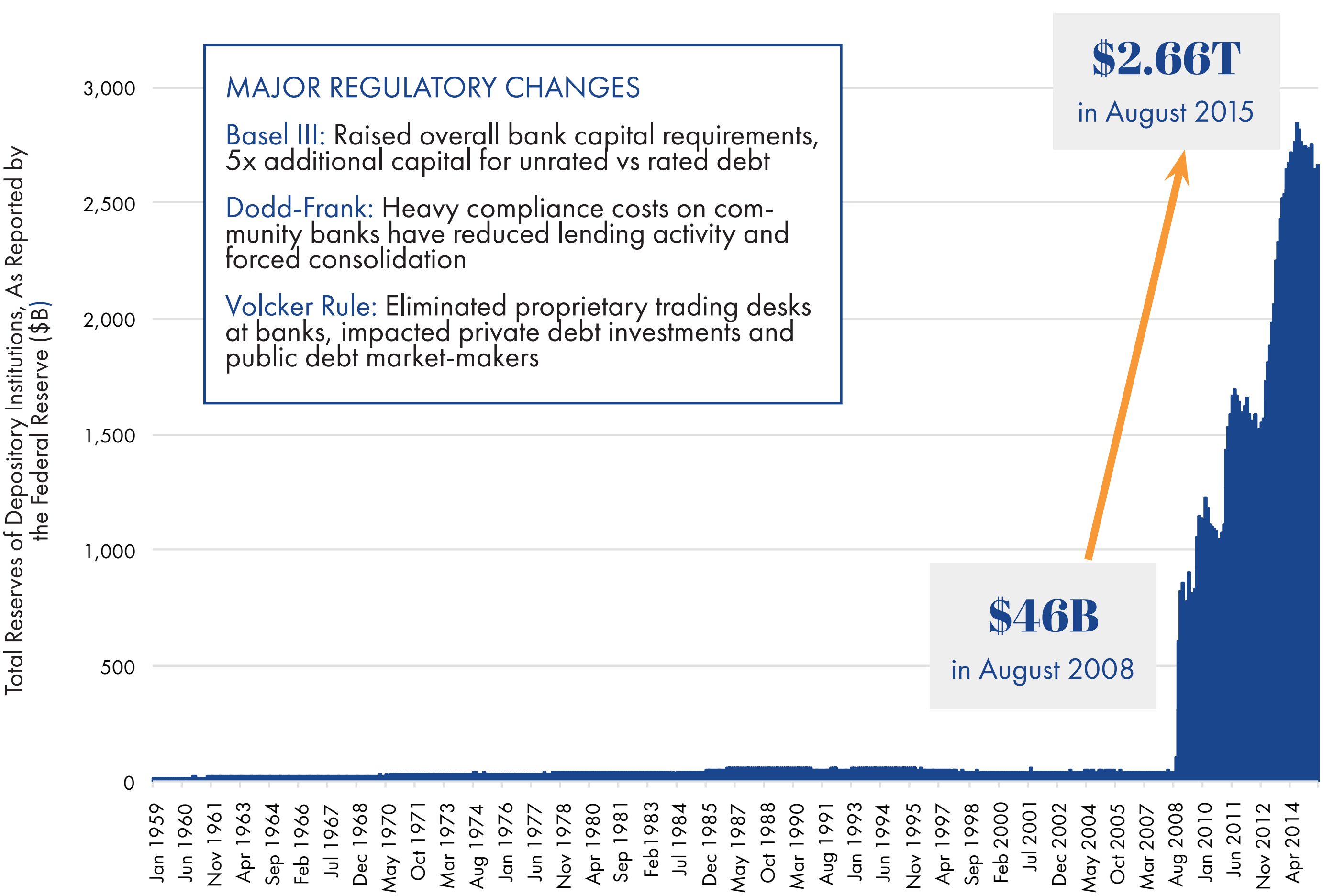
First, there has been a fundamental alteration of the U.S. bank's balance sheet economics. Second, regulation has dealt a death blow to community banks and local branch networks. Third, new regulation has largely eliminated trading operations within banks, which were big profit centers, but proved to be too risky and destabilizing to bank balance sheets.

The problem starts with the Basel III rules, which were adopted by the Federal Reserve in 2011. Basel III significantly strengthened bank capital requirements for "too big to fail" banks by increasing cash reserves and decreasing leverage. The unintended consequence of these rules is significantly reduced lending to lower middle market and small businesses.

Banks are now required to hold at least 8% of equity against risk-weighted assets. Prior to Basel III, it was only 2%. So how much money has come out of the banking system to fund reserves instead of loans? Bank reserves zoomed to $2.7 trillion in 2011 from just $46 billion in 2008.

U.S. BANK RESERVES HAVE BALLOONED TO ALMOST $3T

Massive and Unprecedented Contraction in Capacity for Lending



SOURCE: Federal Reserve Bank of St. Louis, FRED Economic Data

HOW TO BUY AMERICAN STRENGTH AND AVOID THE GLOBAL MAELSTROM

THE U.S. MIDDLE MARKET OPPORTUNITY

Despite recent volatility in the stock market, the U.S. economy is performing well in absolute terms and even better on a relative basis, given weakness in China and sluggishness in Europe. Real GDP growth, according to JP Morgan was robust at 3.8% in Q2. Unemployment dropped to 5.1% and job openings have grown by 21.7% this year versus a 14.3% decrease in the number of unemployed. The energy sector continues to be the most challenging, given the historically low price of oil and growing expectations of bond defaults (energy makes up 14% of the high yield bond market).

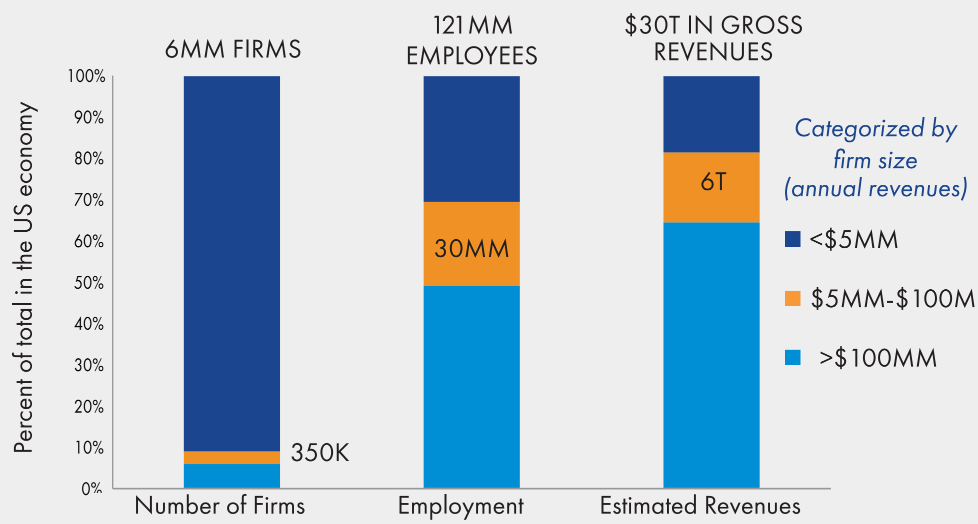
78%

of middle market U.S. companies are optimistic about the economy's impact on their business prospects

- American Express Sept. 2015 survey

THE LOWER MIDDLE MARKET IS A LARGE AND IMPORTANT SECTOR OF THE U.S. ECONOMY

350K firms, 25% of jobs, $6T in revenues



SOURCE: U.S. Census 2012

On a fundamental basis, the U.S. corporate sector (excluding energy) looks like a strong bet for the foreseeable future. Through Lateral's focus on U.S. middle market companies (we have reviewed more than 1,000 opportunities so far this year), we have interacted with numerous healthy and growing companies across industries (excluding energy) which are investing capex in growth and hiring to support new contracts. Most middle market companies are primarily exposed to the U.S. domestic market and have little exposure to Europe and China. Companies with $5MM-100MM in revenues (which is how we define the "lower middle market") have been the "engine" of the U.S. economy. This sector accounts for more than 350,000 firms and 25% of the jobs in the U.S. economy, nearly 30 million jobs.

Recent results from the middle market sector have been strong and point to continued economic momentum. 75% of middle market companies increased revenue growth in Q2 according to a recent survey – reporting an average of 6.6% year-over-year growth. In an American Express survey released in September, 78% of middle market U.S. companies are optimistic about the economy's impact on their business prospects. Nearly 90% plan to hire staff over the next few months.

For unrated debt, including loans to small and medium-sized businesses, banks must hold up to five times more in Tier 1 Capital than for rated public debt to larger companies. And for the biggest banks, which account for 95% of the industry, Basel III requires those institutions to maintain double the ratio of Tier 1 Capital to Total Exposure.

As a result, banks avoid unrated and bespoke middle market loans. Instead, they now focus heavily on the syndicated loan and public bond market, where the loans range from $100 million to $1 billion. Bank lending peaked in 2000 at $500 billion in quarterly volume and remains below that level today.

In contrast, corporate bond issuance has grown from $2 trillion quarterly in 2000 to $4.5 trillion quarterly this year. Banks prefer to lever their balance sheets five times more for readily available low-yield syndicated loans than reach for better risk-reward opportunities in the middle market.

COMMUNITY BANKS: AT RISK

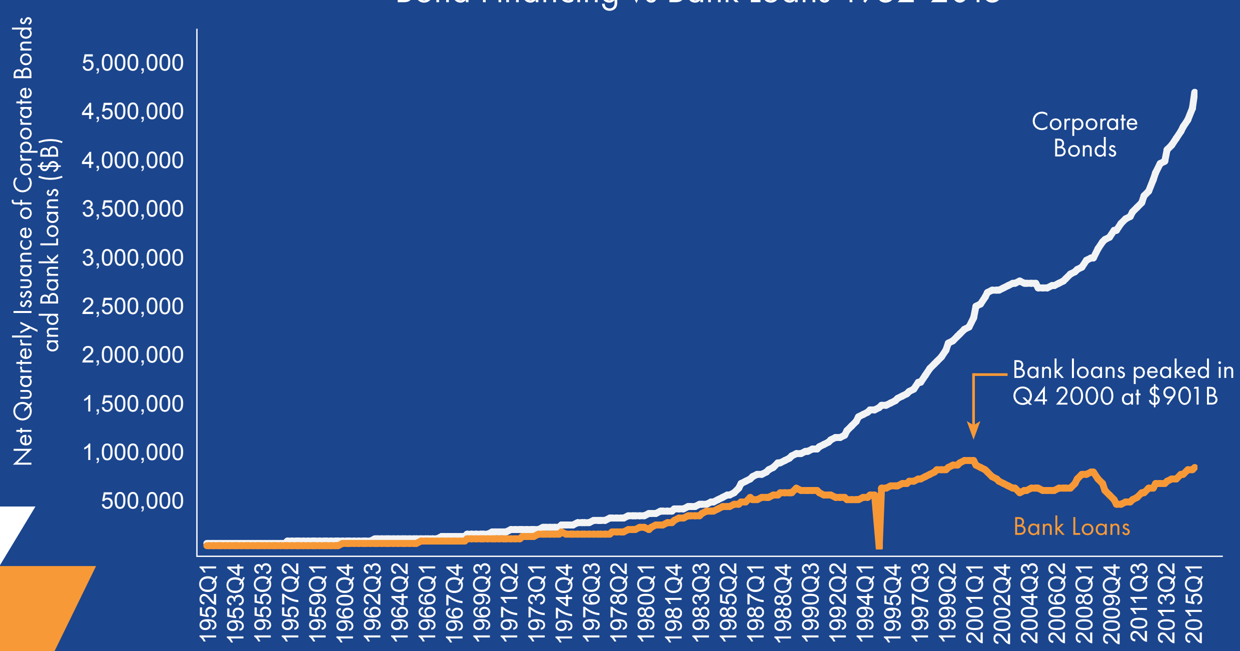
The local community bank is at risk of becoming an endangered creature as the number of banks in the US fell from 15,000 to 5,000 over the past 30 years. The shrinking number of institutions has been driven by consolidating branch networks, community bank failures and consumer mortgage origination. Adding to the problem is the Dodd-Frank legislation, which has put additional costs and compliance pressures on community banks forcing them to engage in further consolidation.

Finally, the Volcker rule, which was part of Dodd-Frank, prohibited banks from engaging in proprietary trading activity. This led to the dismantling of large proprietary trading desks at major banks, which engaged in both private equity and private debt activity.

TALE OF TWO CORPORATE DEBT MARKETS:

The corporate bond market has skyrocketed, while bank lending to businesses has languished

Bond Financing vs Bank Loans 1952-2015



SOURCE: Federal Reserve, Z.1 Statistical Release, Financial Accounts of the United States, updated September 18, 2015

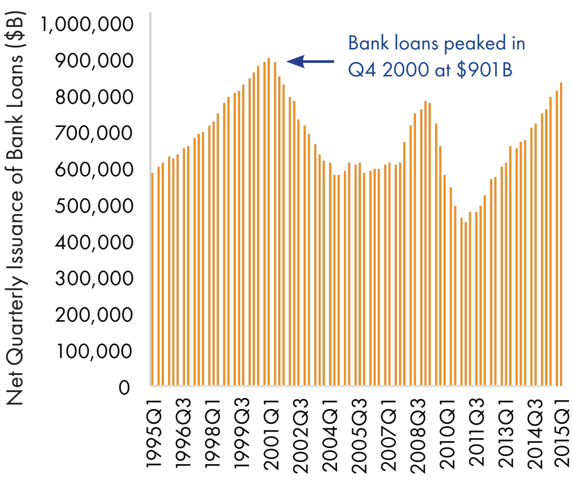
CONCLUSION

Banks are certainly less risky than they were in 2007 – with much higher reserve ratios and less speculative trading activity. That's good news – however, the banks' primary lending function to growing businesses has been dramatically reduced and middle market U.S. companies with less than $100 million in revenues are the collateral damage. This important segment of the U.S. economy has been structurally left behind by the U.S. banking system for the following reasons covered in this white paper:

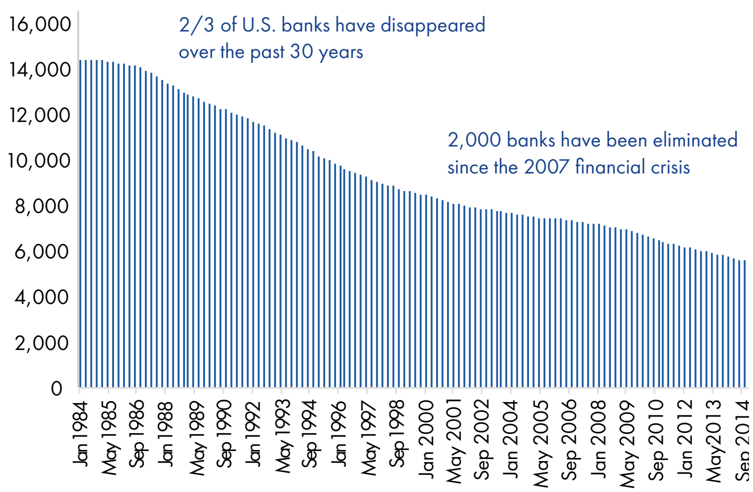
- The dislocation in the banking industry is structural because of consolidation of bank networks and community banks and deeply-rooted regulation which has changed the banking industry in unprecedented ways that disadvantage middle market companies.
- Even though capital is plentiful and inexpensive and covenants are light or non-existent for large companies, middle market firms have limited options for growth capital beyond small bank credit lines and selling a control stake to a private equity firm.
- The best middle market entrepreneurs want to control their own destinies and prefer to grow organically. They are often dilution-sensitive and have goals and ambitions that are incompatible with a private equity investor. Some may have assets that are difficult for a bank to value: a significant base of fixed assets or a large recurring base of contracted revenue. They may have specific capital needs that don't match well with homogeneous loan documents. Some of the best U.S. middle market companies just don't fit the template for lending by U.S. banks.

That's why we believe that non-bank lending to the most successful lower middle market U.S. companies is perhaps the most compelling risk-reward investment opportunity available today.

BANK LENDING FLAT FOR PAST 15 YEARS



NUMBER OF U.S. COMMERCIAL BANKS HAS SHARPLY DECREASED



SOURCE: FDIC Commercial Bank Reports, Changes in Number of Institutions: https://www2.fdic.gov/hsob/HSOBRpt.asp.
NOTE: Commercial Bank is defined as a banking institution in the U.S. operating under licenses issued by the Secretary of the Treasury or by state banking authorities and includes: national banks, state-chartered commercial banks, land and trust companies, private banks under state supervision, and industrial banks. The number of commercial banks is represented by the number distinct banking charters.
For details on the FDIC's definition: https://www2.fdic.gov/hsob/hsobnotes.asp.

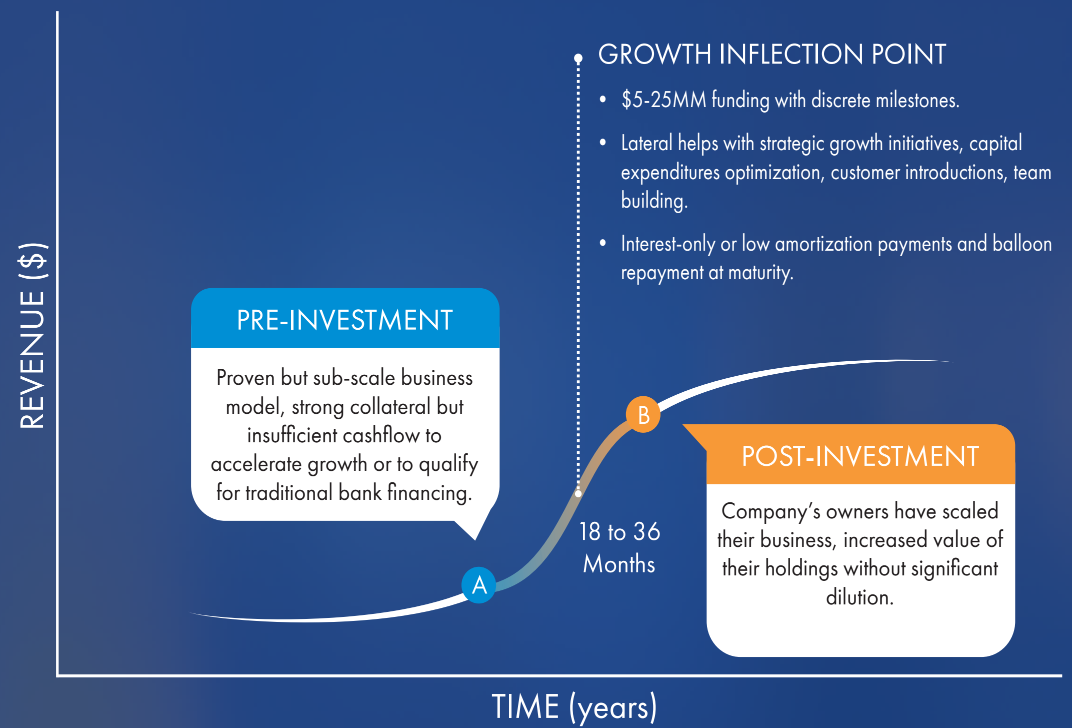
ABOUT
LATERAL INVESTMENT MANAGEMENT

Lateral Investment Management provides senior secured short-term financing to non-sponsored, lower middle-market businesses, with $10MM-100MM in trailing 12-month revenues. The Fund targets gross returns that are significantly higher than fixed income and private equity benchmarks, with low principal risk, low volatility, and low correlation to the public markets.

We believe this opportunity to generate superior returns results from long-term market disruptions in the U.S. banking system which have reduced access to growth capital for lower middle market companies. The demand for capital far outweighs the supply to this segment.

Lateral provides short-term credit financing to owner-operated or family-owned middle market companies as an alternative to the formulaic limits of bank debt or the dilution of private equity. The Fund is structured for downside protection, targeting a minimal loss rate while focusing on business building and exit management through value based underwriting and opportunistic exit strategies. The Fund targets attractive net unlevered returns and quarterly cash distributions. The Fund minimizes principal risk by investing in highly collateralized loan positions that are typically short in duration (36 months or less) and senior in the corporate structure to protect both principal and base returns.

- Collateral-based principal protection: The Fund is structured for downside protection, focusing on opportunities with 100-200% in collateral value at underwriting. Emphasis on asset-based industries and collateral in hard assets or contracted revenues.
- Senior secured debt: The loans are at the top of the capital structure and generate cash coupons of 12-16%.
- Event-driven "inflection point": Well-defined opportunity to accelerate growth by 50-100%. Lateral provides business building support and taps upside potential through 5-20% equity ownership stake in warrants.



THE AUTHORS

RICHARD DE SILVA

Managing Partner and Portfolio Manager

Richard de Silva, Managing Partner and Portfolio Manager, was previously a General Partner at Highland Capital Partners, a global venture capital firm with $3 billion in assets under management. De Silva joined Highland in 2003 and focused on growth investments. De Silva was a co-founder of IronPlanet, the $1 billion construction equipment marketplace and also has held operating roles at four other companies as CEO or co-founder. De Silva holds an A.B. from Harvard College, an M.Phil from Cambridge University and an M.B.A. from Harvard Business School.

Contact Richard at rd@lateralim.com

KENNETH MASTERS

Managing Partner and Chief Investment Officer

Kenneth Masters, Managing Partner and Chief Investment Officer was previously Co-Founder and Co-Portfolio Manager at White Oak Global Advisors, a middle market direct-lending firm based in San Francisco with reported assets under management of $1.5 billion. Masters served as Co-Portfolio Manager and Investment Committee Member at White Oak from June 2007 to December 2012. Masters was previously a Director at KKR Financial LLC, the credit arm of global private equity firm KKR, from November 2004 to August 2006. While at KKR, Masters assessed and underwrote more than $1 billion in loans to middle market companies across the insurance, media, pharmaceutical and other industries. Prior to KKR, Masters was a senior investment analyst for the High-Yield and Fixed Income Portfolio Group at Franklin Templeton. He received an M.B.A. from Harvard University, and a Bachelor of Science from Cornell University.

Contact Ken at ken@lateralim.com