THE SILCGROUP®

SILC Private Credit

Market Insights

August 2022

CODE R.E.D.

Resolve to Evolve or Dissolve

Living in times of volatility, risk and uncertainty, access to capital from the traditional banking channels has become more difficult than ever for projects, assets, business and commercial enterprises in Australia. As global economies and financial markets have experienced heightened levels of unpredictability and uneasiness, businesses have sought to de-risk their balance sheets and trading activities by diversifying their funding sources through various 'non-traditional' channels and structures.

On a global macro basis, Australia is seen as a favourable destination from a capital and investment perspective. Most notably, Australia's credentials include:

- **Consistent Economic Growth:** Sustained economic growth over the long-term; led by the growing service and resources sectors
- **Political Stability:** Low risk of political instability in the region
- **Highly Regulated Business Environment:** Well-regulated and transparent commercial environment
- **Strong Economic Credentials:** Ranked in the world's top 5 leading financial systems and capital markets by the World Economic Forum
- **Mature and Innovative Financial Markets:**
  - A leading pension fund market
  - The 4th largest pool of investment assets globally
  - The 2nd largest free-floating stock market in the Asia Pacific
  - Fast growing and liquid foreign exchange market
- **Strategic Location:** Located in the fast-growing Asia-Pacific region, there are time zone advantages, cultural affinity with Asia and American/European business environment
- **Low Sovereign Risk:** AAA rated by all 3 global rating agencies

Although the current Australian economic environment is supporting strong fundamentals for investment, including historically low-interest rates, strong unemployment figures, and stable GDP numbers, the major Australian trading banks have been scaling back their asset exposures predominately as a result of regulatory changes imposed by the Australian Prudential Regulation Authority (APRA) post the Global Financial Crisis (GFC), and more recently due to the Royal Banking Commission enquiry.

Amongst others, APRA is

- Limiting growth in lending secured by residential investment property;
- Requiring banks to hold more capital; and
- Reducing banks' exposure to property development and related transactions

The Team

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Koby is the Founder and Managing Director of The SILC Group. He is responsible for the overall management of the group's operations, strategy and business development.

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Liam is an Associate within the Capital Solutions team providing initial assessment of private credit transaction via the SILC Credit Fund, and leads ongoing communications with brokers and borrowers.

The flow-on effect from the Australian major trading banks has resulted in:

- Slower turn around to approve and settle loans
- A higher reluctance to take on 'new-to-bank' clients
- Tightening lending to property investors and foreign borrowers
- Greater aversion to construction risk
- Restricting lending covenants
- More conservative in testing serviceability and stress testing
- Lower Loan to Value Ratios (LVRs)
- Increased pre-sales requirements
- Limiting off-shore pre-sales proportions
- Increased equity requirements on new investment loans

This structural shift has heightened the level of interest from international investors in Australian based projects, assets, and sponsors, as well as domestic investors, are also seeking non-traditional investment opportunities particularly into the unlisted private 'Middle-Market'. This presents a clear opportunity for Australian companies, projects, and assets to access capital via alternative funding channels. At an institutional level, large corporates are able to solve their borrowing requirements through various global capital market structures and instruments. These same opportunities are now more readily available to businesses in the 'Middle-Market' in the form of Private Credit (usually termed Non-Bank Lenders), where capital is deployed on either a direct, syndicated or fund basis.

Some 'Middle-Market' companies are going further and are considering securitising assets/projects through undertaking fixed income issuance programs offering asset-backed debt paper into the marketplace. However, a more efficient and less costly way of raising debt can be through Private Credit Funds.

Private Credit Funds raise money from investors to provide loans to borrowers at a prevailing interest rate over a given term. Private Credit Funds have their credit criteria and risk/return appetites depending on their specific Fund mandate and objectives. These Non-Bank Lenders can provide loans on a first or second mortgage basis, with the appetite for first and second mortgage investments increasing as an investment asset class. Private Credit into the 'Middle-Market' is also more accommodating and flexible to the requirements of credible borrowers, which can provide for a competitive advantage to the sponsor or increase rates of returns.

As with all types of investment classes, the rate of returns for a Private Credit Fund will vary depending on the terms and risks associated with the types of mortgages it invests. With that said, as depicted in Figure 1 above, the overall risk profile for Private Credit investments compared to other investment classes such as property and shares will generally be lower due to the increased security in the capital structure and the more stable cash-flows and returns

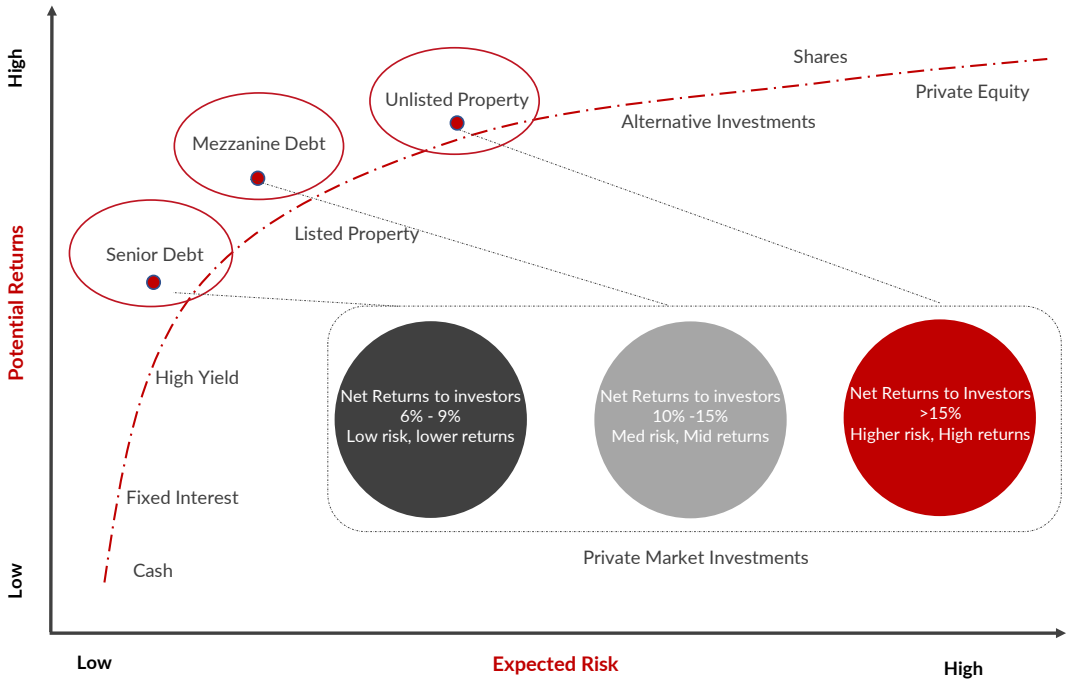

Figure 1. Investment Risk/Return Spectrum is not to scale and is intended to illustrate the ranked order of the expected risk for each class of asset. This chart is not based on actual data, is for demonstration purposes only, and is not intended as a guide for predicting future performances. As with all investments, private debt investments carry risks and should be considered on a case by case basis, taking into account your financial circumstances.

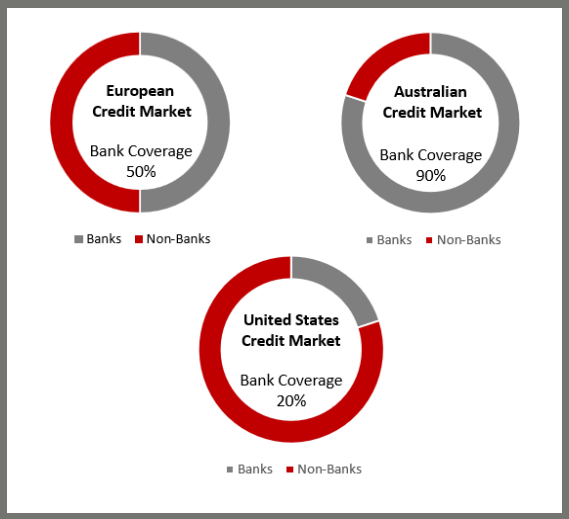

Figure 2: Moodys Investor Services, reported in The Economist, 23/2/2022

As can be seen in Figure 2 to the left, Non-Bank Lenders make up a substantial proportion of loans provided in the US and European markets, however, with the dominance of the major trading banks in Australia, Non-Bank Lenders historically made up a relatively small portion of the market. Given the structural regulatory changes and the sophistication and dislocation of corporate markets' demand not being met by capital supply, non- bank lending in Australia is poised to grow - just as they have in foreign markets.

Although the data in Figure 2 are 5 years old, the trend continues and a clear opportunity exists for businesses, sponsors, projects and assets to diversify their capital and funding risk requirements, enhance credibility and scale their business operations.

From an investor's perspective, there is increased appetite to deploy credit/debt capital into the 'Middle-Market' which will give them a greater spread of investment assets, a higher level of security in the capital structure and more stable rates of return. This, combined with the opportunity for Middle-Market borrowers provides for a mutually beneficial outcome to both interest groups.

Historically, Australia has had high barriers to entry for foreign capital providers, namely due to:

Regulation
- Australia's tight regulations on various industry sectors including banking and financial services

Relationship
- Originating deals require relationships with market participants including sponsors, banks and advisory firms

Expertise
- High level of expertise is expected in negotiating and constructing transaction deals from both financial and legal perspectives

Knowledge
- Knowldge of the local Australia loan market and related industries
- Extensive due dilligence to understand specific businesses and its capital requirements

Currency Risk
- Cash-flows from investments are variable and difficult to hedge

However, given the structural shift in the banking and financial services sector in Australia, Non-Bank Lenders have a very strong present and sustained opportunity to invest capital in a highly regulated and regarded risk-adjusted return environment via domestic participants and strategic partners.

With this in mind, The SILC Group established the SILC Credit Fund which provides astute qualifying investors with exclusive opportunities to generate attractive returns through a range of quality alternative debt investments secured by real property or other forms of security as disclosed.

Investors have the unique flexibility of being able to either select specific investments from a range of individual asset-backed commercial loans with different levels of risk, reward and investment terms, or invest in portfolios of Senior Debt Loans or Junior Debt Loans selected and managed by The SILC Group.

All loan investment opportunities are assessed by an experienced team of credit specialists prior to being offered to investors and are assessed against a clearly defined credit policy and risk framework. This is complemented by the group's strong governance, risk management and compliance framework.

Based on financial and market conditions, targeted returns on a direct loan basis (Discrete Loan Units) have been in the range of:

- **1st mortgage loan investments:** RBA Cash Rate plus 5.0% to 8.5% p.a.*
- **2nd mortgage loan investments:** RBA Cash Rate plus 9.0% to 16.5% p.a.*

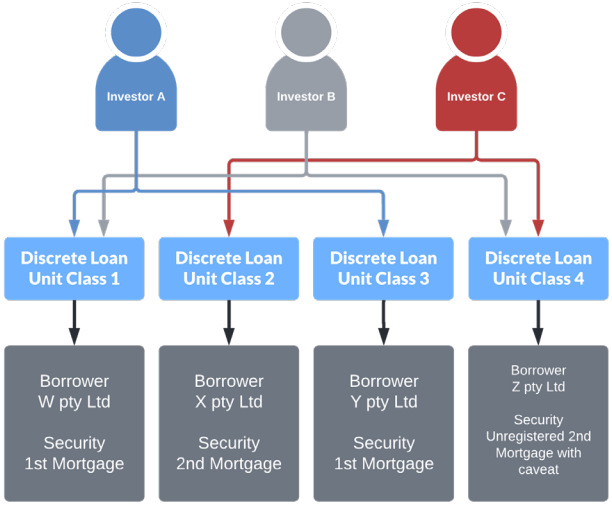

Figure 3. Self-directed investors investing in Discrete Loan Units via the SILC Credit Fund.

Figures 3 to the left demonstrates how a portfolio consisting of Discrete Loan Units respectively can be constructed.

* The target returns are not a promise or forecast of future returns

In an environment where there is a core and fundamental change in traditional capital to private capital in Australia, both borrowers and investors alike need to 'Resolve to Evolve or Dissolve' in order to stay ahead of the curve and not be limited, restricted, prohibited or constrained by the long-established investment and lending channels.

THE SILCGROUP®

The SILC Group is an Australian-based financial services firm that specialises in providing multi-faceted financial solutions to discerning wholesale and sophisticated clients.

Our team of experienced professionals has a deep understanding of the financial services market across a range of financial products, markets and structures. As an Australian Financial Services Licence (AFSL) and Australian Credit Licence (ACL) holder, The SILC Group can act as advisor, structurer, arranger, trustee and manager of investment assets to provide our clients with holistic tailored solutions.

We seek to be an alternative to mainstream channels by providing our clients with greater accessibility and enhanced choice across bntraditional and specialised financial products and services.

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