Aura High Yield SME Fund

Private Credit Insights

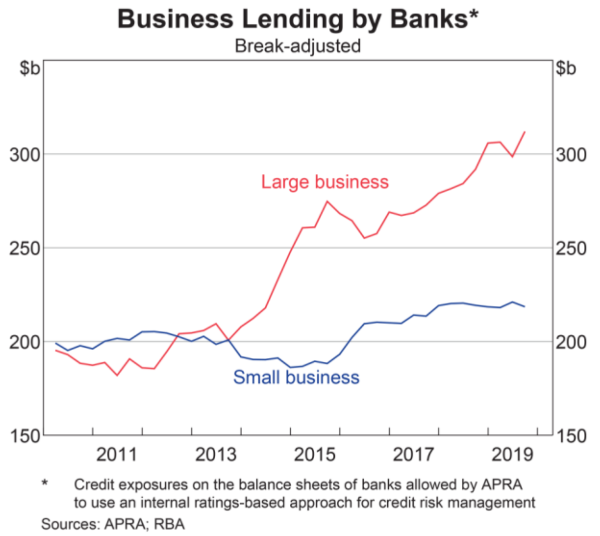
Reinforcement of the AHYSME Fund Thesis

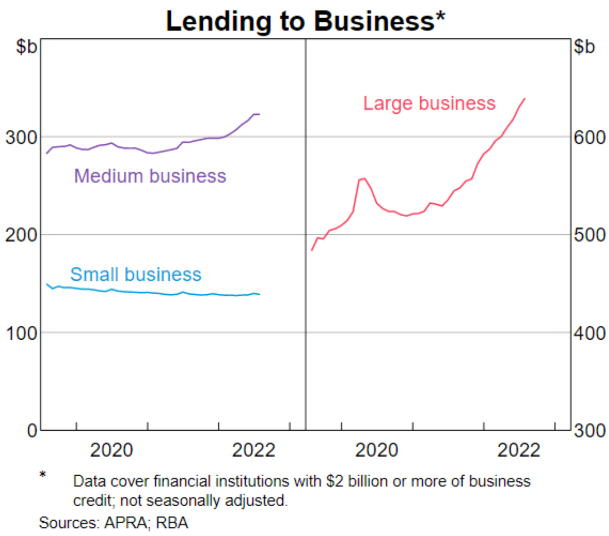
The AHYSME Fund was founded off the back of a very simple thesis, grounded in compelling data.

Product offerings to small businesses from banks no longer suit the requirements of small businesses and their owners. This can be traced back to a shift in the regulatory treatment of small business loans, which incentivised banks to push for hard property collateral usually in the form of the small business owner's primary residence and left little to no consideration for other forms of collateral, e.g., livestock, invoices owed to the borrower, and so on.

Combined with bank legacy systems, personnel, and ~~a~~ paperwork-heavy application assessment processes, this led to an inadequate service for small business borrowers.

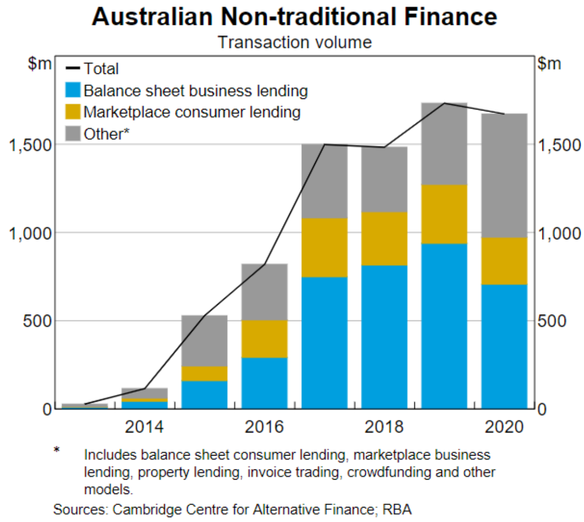
As a result, ADI bank business lending primarily shifted focus, instead focusing on large business borrowers, where regulatory capital treatment has been more favourable to banks and the loan sizes justified the onerous time spent. While this shift met the needs of large business borrowers, the quality of service offered to SME borrowers suffered.





Inevitably, this shift led to a funding gap in the SME sector, estimated at approximately $213.6 bn according to 2021 Judo SME Banking Insights Report [2].

To fill this gap, the market witnessed the emergence of specialised, often tech-enabled non-bank lenders. These lenders tend to focus on a single niche, solving very specific funding needs and specialising in certain forms of security that the banks have been forced to overlook.



A non-exhaustive list of the niche security types of the lenders the AHYSME Fund works with include:

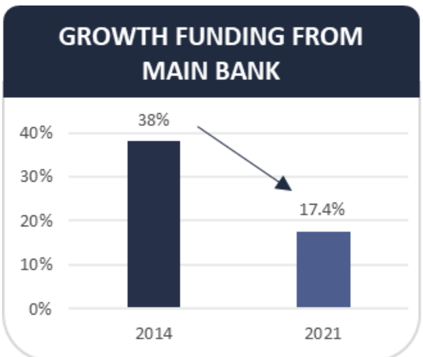
- Invoices owed to the borrower, further bolstered by an insurance overlay;
- Livestock which can appreciate in value as the animals fatten;
- Specific first ranking security over pieces of equipment/machinery; and
- Metropolitan property, although with streamlined application processes.

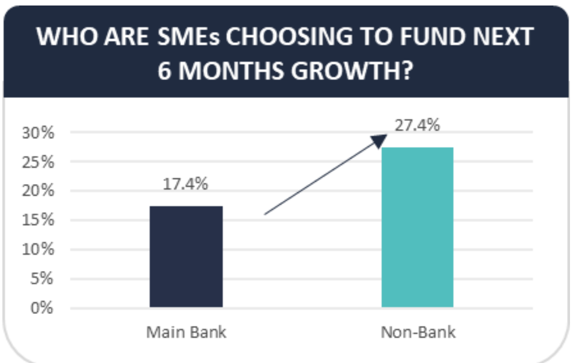
Many non-bank lenders utilise new technology, such as API plug ins designed to easily connect borrower bank accounts and run near instant analysis of the borrower, both upon application and on an ongoing basis. A combination of specialised solutions to specific funding problems and efficient, paperless, tech-driven analysis has poised non-bank lenders to both capture market share and earn attractive interest rates.

This line of thinking suggests that banks are not choosing to turn down SME borrowers and that SME borrowers are displaying a preference for the specialised offerings of non-bank lenders over the offerings of banks. A fine hypothesis, however, in need of supportive data.

Findings from the Australian Banking Associations Economic Report, September 2019 (3), demonstrated that while banks continued to approve small business loans at a steady rate of 94% over the five years to September 2019, actual approval volumes fell by 33% over the same five-year period, suggesting banks had seen a drop off in applications of approximately 33%.

Additionally, the Scottish Pacific Business Finance November 2020 SME Growth Index (4) found that the percentage of SMEs seeking growth funding from their main bank has fallen from 38% in 2014 to 17.4% at the time of survey. Meanwhile, 27.4% of SME respondents said they are seeking growth funding from non-bank lenders.





The findings of these two reports add weight to the conclusion that banks are not turning down SMEs, SMEs are turning down the banks in favour of non-bank lenders.

Where does the AHYSME Fund fit in?

A key difference between non-bank lenders and banks is how they obtain capital to fund their loan books. Banks enjoy Authorised Deposit-taking Institution (ADI) status within Australia. ADI status is, essentially, a license to issue term deposits, which accounts for a considerable portion of the capital used by banks to fund their loan books. Non-bank lenders must use alternate means to obtain capital. One method, which is the method the investment team of the AHYSME Fund specialise in, is called securitisation.

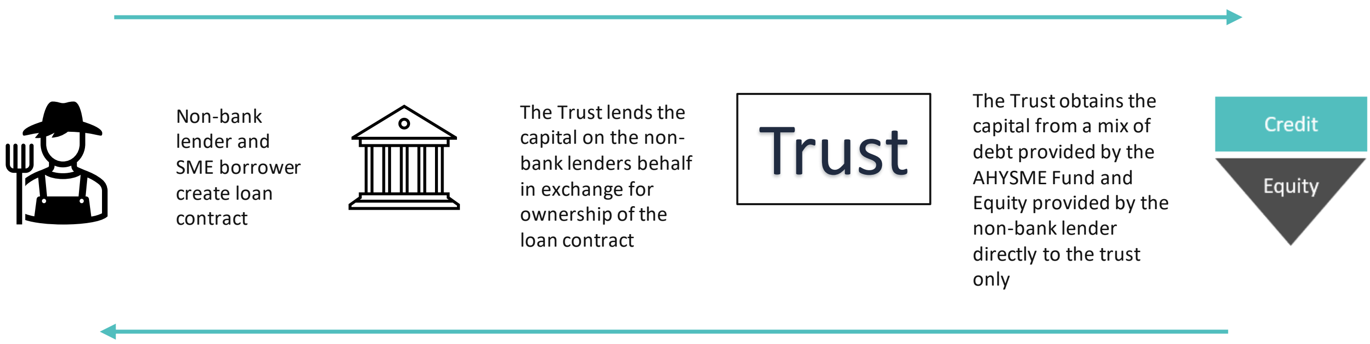
How does it work?

After completing in depth due diligence and approval from the Investment Committee, the AHYSME Fund will look to fund the loans only, not the lender at a corporate level. The loans which are funded must adhere to parameters and rules negotiated by the AHYSME Fund investment team. Furthermore, an LVR covenant in the funding stack must also be adhered to where the lender puts skin in the game via equity that is at risk before the investment from the AHYSME Fund.

In order to explore this concept, it is important to identify four parties:

1. The non-bank lender
2. The AHYSME Fund
3. The SME loan contracts originated by the non-bank lender
4. Independent, bankruptcy remote, trust.

The bankruptcy remote trust is key to understanding the funding method. The trust is the legal entity which owns the loan contracts, originated by the non-bank lender. It is referred to as "bankruptcy remote" because in the case that the non-bank lender becomes bankrupt, there is no recourse to the loans within the trust. The trust continues to have a legal right to the loans and can appoint a new party to step in and continue to service the existing loans.



Each month an independent trustee will conduct two key pieces of work:

1. Verify that the loans owned by the trust adhere to the parameters and rules negotiated by the AHYSME Fund's investment team.

These parameters include items such as concentration limits, maximum arrears levels, LVR of AHYSME Funds debt provided vs the equity provided by the non-bank lender etc.

If the trustee finds that the parameters have been breached, the AHYSME Fund investment team reserve the right to stop funding any new loans and let the loan book pay itself down and ultimately pay down the debt investment made by the AHYSME Fund, supported by the non-bank lenders equity contribution, which can be claimed only after the AHYSME Funds debt investment is repaid in full.

2. Calculate and direct the cash flows of the trust.

There are three primary cash flows. First, interest and fee revenue earned from the loan contracts (revenue) and second, interest owed to the AHYSME Fund on its debt investment, which is ultimately passed on to the investors in the Fund (expense). If there is insufficient income earned by the trust to cover the interest owed to the AHYSME Fund, the equity provided by the non-bank lender will be used to cover the expense.

The last cash flow is residual income flushed out of the trust and passed on to the non-bank lender (profit). The residual income is often referred to as NIM (Net Interest Margin) and forms the revenue of the non-bank lender. This form of financing and revenue generation creates a strong alignment of interest between non-bank lenders and the AHYSME Fund. If the loans go into arrears, or late payments, it is first the lender's revenue and then equity provided which suffer before any impact to the interest or capital of the AHYSME Fund. In order to maintain revenue and the equity contributed to the trust, non-bank lenders must write good quality loans, service well and minimise arrears.

The current environment

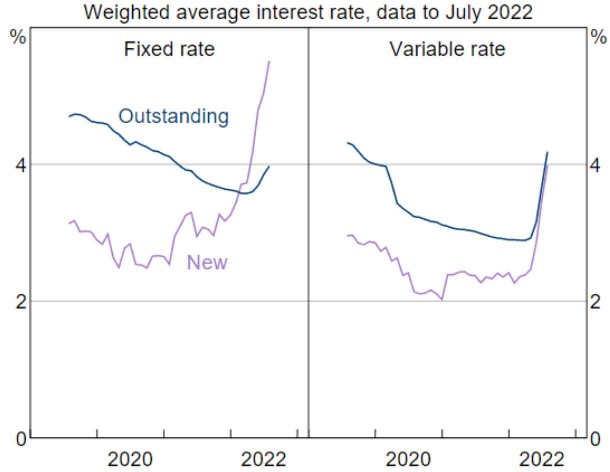
The interest rates earned by both banks and non-bank lenders alike are set to increase alongside the recent increases to the RBA Cash Rate.

This is attractive for Private Credit investors as their returns are set to lift as inflation and rate hikes persist, helping to preserve the real return earned by investors.

The general risk of defaults within the SME sector remains in line with the long-term trend and has displayed a slight improvement since the pandemic. This has largely been supported by both a build up in cash holdings of Australian businesses as well as the ability to reprice their goods and services to maintain their margins over input costs and interest expenses.

SME Lending Rates

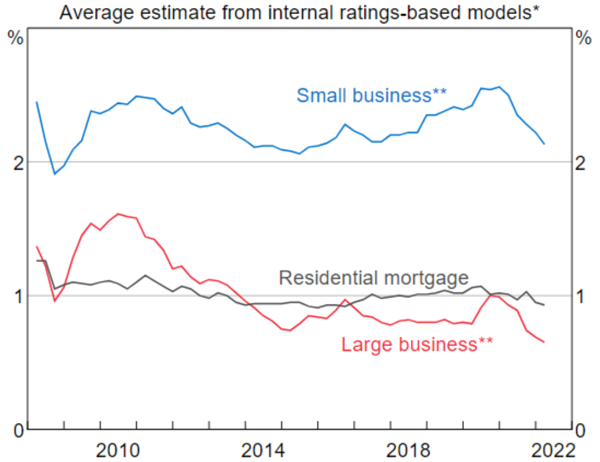
Weighted average interest rate, data to July 2022



Sources: APRA; RBA

Business Lending Default Probabilities

Average estimate from internal ratings-based models*



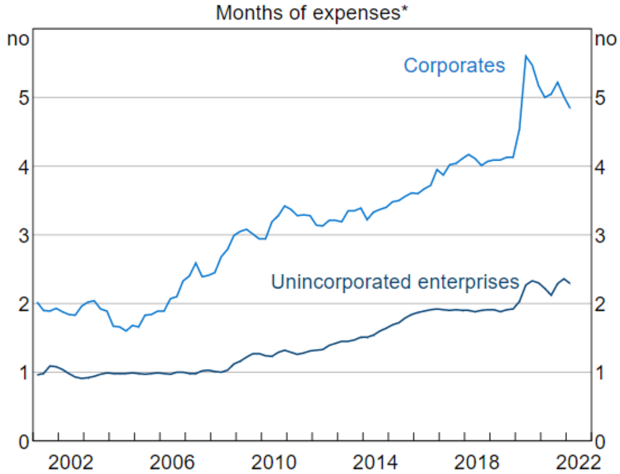
* On-balance sheet exposures of major banks.

** Small business is the SME retail and SME corporate categories in APRA's capital framework; large business is the corporate category.

Sources: APRA; RBA

Cash Holdings of Non-Financial Businesses

Months of expenses*



* Expenses estimated from the ABS Quarterly Business Indicators Survey.

Sources: ABS; RBA

There are a number of mitigants the AHYSME Fund investment team can utilise against risk in the underlying loans owned by a trust. These include the parameters, which include items such as the businesses credit scores and financial ratios of the SME borrowers, as well as the LVR for debt provided, i.e., the amount of lenders equity which must sit below and support the AHYSME Fund's debt investment.

Expanding opportunity for private credit investors

The investment team are of the view that the shift in SME debt funding from banks to non-bank lenders is still in its relative infancy. There is still some way to go and many specialised non-bank lenders to come in order to close the funding gap.

Private credit investors can gain access to this expanding asset class, curated by industry experts with a 5+ year track record* of maintaining a $1 NAV for, and paying income to, investors, at every monthly interval since inception, via the AHYSME Fund.

The investment team will continue to manage the AHYSME Fund and further diversify the portfolio in line with their two primary objectives. These are, in order, the preservation of capital and a risk adjusted return in line with our targets.

Until next week,

Brett Craig
Portfolio Manager and Director

* Past performance is not a reliable indicator of future performance.
[1] Source: Reserve Bank of Australia – The Current Climate for Small Business Finance, September 2022
[2] Source: Judo SME Banking Insights Report for 2021
[3] Source: Australian Banking Association Economic Report, September 2019
[4] Source: Scottish Pacific Nov 2020 SME Growth Index

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