A Review of the Australian SME Lending Landscape: Structural Funding Gap Bodes Well for Ongoing ADI Disintermediation and the Rise of Non-Bank Lenders

June 2024

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Key Points

1. SME[1] lending – Supply and demand imbalance causing funding gap for non-bank lenders

- Australian banks have largely retreated from all types of lending bar residential mortgages due, in large part, to Basel III and risk-weighted asset impositions, leading to reduced supply from ADIs.
- To fill the void, a host of SME lending originators have emerged, many providing niche lending options with tech-enabled processes and non-traditional funding sources.
- Traditional mortgage brokers and originators have been diversifying their business models in record numbers, providing origination services in an increasingly multifaceted SME lending environment and thus expanding the whole SME lending ecosystem ex-ADIs.

2. Notable growth runway for SME private credit lenders

- SME lending volumes continue to grow at a solid clip, notwithstanding sectoral idiosyncratic issues and macro headwinds. The mismatch of demand over supply is substantial, providing plenty of opportunities for SME lenders that have scalable deal sourcing and quality-focused underwriting.
- The non-bank SME lending segment is but a drop in the ocean, spelling strong growth opportunities moving forward given various tailwinds

3. Divergent lending structures for investors offer varying risk-reward propositions, but a focus on investment structure is key

- There are two very different ways to access the SME private debt sector: direct lending to medium enterprises or SME lending warehouse vehicles. We believe the emergence of divergent lending and funding models reflects the growing sophistication and scale of non-bank lenders. However, the risk-reward emanating from these are not homogenous. We believe warehouse-based SME funds will become an increasingly important source of funds for third-party SME originators.
- Warehouse structures remain our preferred exposure to the SME lending sector for a number of reasons that we explore in detail later in the report.

Introduction

A confluence of dynamics, including accelerated innovations, is leading to an increase in demand for SME lending from non-bank lenders. There has been a decline in the velocity and availability of money through traditional banking channels (ADIs) as the latter have retreated to residential mortgages on the back of the profitability of mandated risk-weighted asset/capital requirements.

Concurrently and consequently, there has been a proliferation of targeted and niche non-bank SME lending originators, covering everything from medical centre finance and childcare centre operating lease finance to legal disbursement finance. Responding to this proliferation of lending options, a record number of traditional real estate brokers have diversified their business models to provide origination services to prospective SME borrowers on what has evolved to become a far more tailored and product-specific SME lending market (source: MFAA | Data provides insights on broking industry). Finally, tapping into these evolving dynamics, the rising investor demand for private debt and not simply for the traditional mainstay of CRE lending, and the attractive risk-return potential, has seen the increasing proliferation of SME-specific private debt funds across both direct lending and non-direct lending structures as well as liquid/semi-liquid managed products. In addition, we have observed a rapid exposure drift from traditional fixed-income managers to asset-backed securities and warehouse-type structures, offering leverage to the rapidly growing SME lending market.

In the Reserve Bank of Australia's (RBA) Financial Stability Review report in 2023, the RBA noted that non-bank SME lending recorded 25% growth on a 6-month annualised basis in 1H2023, the fastest rate of growth in more than a decade. Furthermore in 2023, industry surveys show that more SMEs started switching to non-bank sources to fund new growth as the government's COVID stimulus wound down in 2022, and this momentum continued with ADIs tightening SME lending as

[1] Unless otherwise specified, the analysis in this study uses APRA's definition of SMEs as businesses with turnover of less than $50 million. This ensures that the business-level analysis of SME access to finance using the Business Longitudinal Analysis Data Environment is undertaken on a consistent basis to APRA's aggregate statistics on lending to SMEs.

interest rates increased. Surveys have also indicated that 80% of SMEs now maintain secondary lending relationships as lender loyalty declines (ScotPac SME Growth Index October 2023).

The writing on the wall is well and truly evident. For better or worse, ADIs have retreated to residential mortgages, and a resultant vacuum creates unmet funding gaps – excess demand over supply of opportunities. We acknowledge that with the 'mortgage wars' and the banks strategically effectively shooting themselves in their collective feet, the likes of National Australia Bank (NAB) are starting to push back on business lending. But you can't push back against an insurmountable force that has evolved to include a proliferation of niche/specialised and tailored borrowing options hitherto previously not provided by banks even to prime and quality borrowers.

We note the expanding role of SME private credit funds in the non-bank origination space. The rise of SME private credit funds is from a low base, but the structural tailwinds underpin a long runway of growth for these lenders. We believe SME lending could become the fastest-growing private debt lending segment over the medium term. The tide is changing with rapid ADI disintermediation and debanking mega-trends. These mega-trends offer opportunities for adept and well-structured players with a focus on quality and origination scale.

SME Lending Market Size – Systemwide

The total SME lending market includes all participants – banks (ADIs) and non-bank lenders. The latter can, in turn, be distinguished by 3 main categories based on funding sources:

1. Non-bank lenders that source funds from asset-backed securities and pre-term out warehouse markets
2. Private credit fund managers that source funding from wholesale and retail investors
3. Non-bank originators that largely source funding from private investors

We have not included any volume-related data in relation to the latter as it is not possible to gain any publicly available data on this very private category.

The Australian SME sector has recorded a 9.4% compound average growth rate since 2019, growing to $631BN by February 2024. This level of outstanding obligations comprises $168BN for 'Small' businesses and $463BN for 'Medium' businesses (see Exhibit 1).

Historically, the major banks dominated lending in the sector, but their market share has declined materially over the last 10 years. It is estimated that for ADIs/ banks, business loans as a share of all loans have fallen by approximately 50% between 1988 and 2019. This level of retreat has only accelerated in the last few years due to ongoing risk-weighted asset issues (aka Basel III) applicable to the banks and the focus on residential mortgages. This notwithstanding that we are witnessing some renewed focus from banks like NAB on business lending following the 'mortgage wars' and consequent NIM compression (historically contrary to how NIM typically increases in a rising interest rate environment). Also, the government-backed SME loan schemes provide some context to the rising activity of the banks and overall SME lending volume in 2022/23.

Within this context, there has been the emergence of non-bank originators and SME private credit funds, some of which are also fund originators, typically via warehouse structures. The SME private credit funds typically access capital from 2 different sources – private investors through evergreen funds and/or pre-term evergreen warehouses. The former is more an emerging category, and the latter has been a mainstay of the Australian asset-backed market for many years, with aged and curated loan books in pre-term warehouses 'graduating' to the listed asset-backed market.

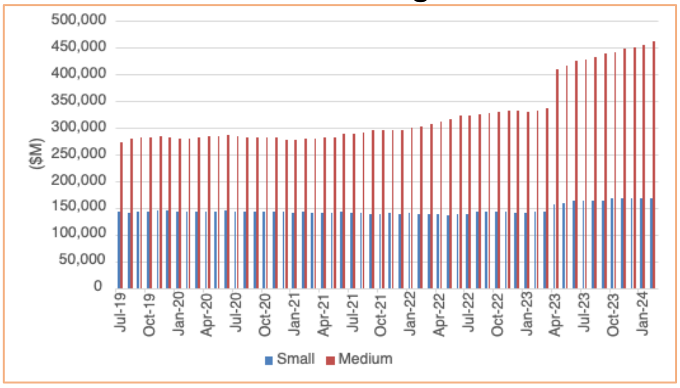
The listed asset-backed market totalled $9.2BN in December 2023, and we estimate the pre-term-out asset-backed warehouse market is roughly the same size. It totals to approximately $18BN, and the vast majority is issued by non-bank lenders, with Westpac Bank and Macquarie Bank divesting their auto loans businesses. In terms of SME private debt vehicles in Australia open to retail and/or wholesale investors, we estimate the total FUM to be approximately $3BN. In other words, non-bank lenders account for approximately 3.3% of the total SME lending market based on the universe of SME private credit funds tracked by Foresight Analytics and Ratings.

As we will posit in this report, the inherent growth potential for the non-bank SME lending sector is extremely high and is magnified by coming off a relatively low market share base. We believe this potential is based on a combination of factors, including but not limited to the retreat of the banks; the substantial proliferation of originators lending in a vast array of SME debt verticals; the growth of private debt managers as a source of funding for SME lending origination, tied with growing investor knowledge and interest in the private debt sector; and the attractive premia paid to such investors.

Systemwide SME Lending – Value vs Volumes

Exhibit 1 below highlights the systemwide level of lending to the Australian SME sector as published by the RBA and distinguished by 'Small' and 'Medium' enterprises. As noted above, the total volume of Australian SME lending has recorded a 9.4% CAGR since 2019, growing to $631BN by February 2024, comprising $168BN for 'Small' businesses and $463BN for 'Medium' businesses. Tied into this, the volume of total debt outstanding is shown in Exhibits 5 and 6 below, which illustrate new lending based on a monthly time series as published by the Australian Bureau of Statistics (ABS).

Ex. 1: Total SME Lending Time Series



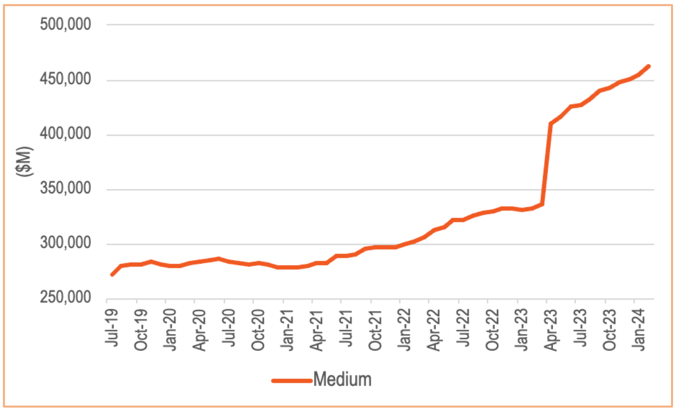
Source: RBA, Foresight Analytics and Ratings

Ex. 2: Total SME Lending ($BN)

Cat.	2019	2020	2021	2022	2023	CAGR
Small	144.4	142.2	138.8	140.0	168.4	3.5%
Medium	281.5	278.5	296.6	332.9	450.8	12.0%
Total	425.9	420.6	435.5	472.9	619.2	9.4%
% YoY Change		9.9%	3.5%	8.6%	30.9%	

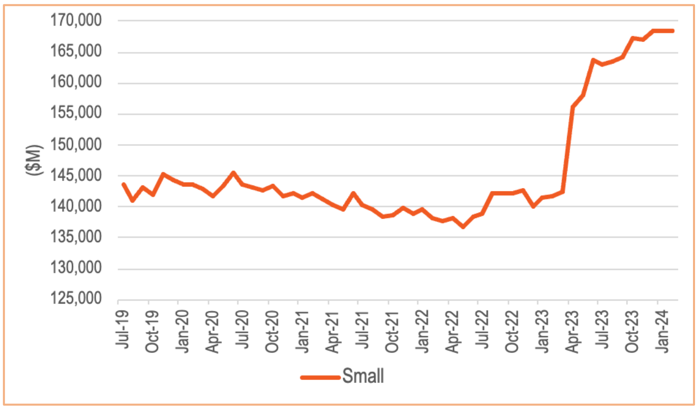
Source: RBA, Foresight Analytics and Ratings

Ex. 3: Total SME Time Series – Medium



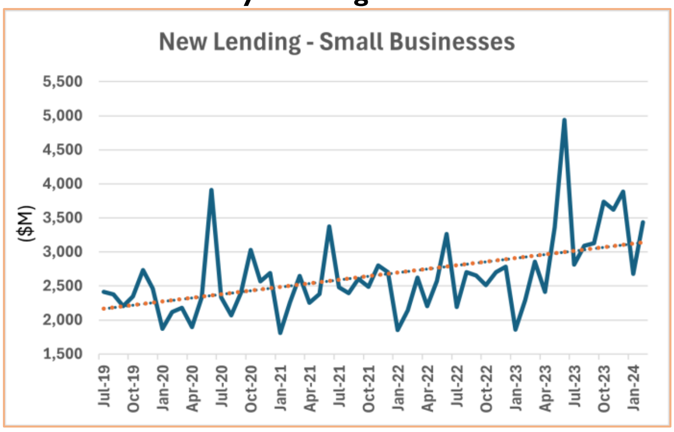
Source: RBA, Foresight Analytics and Ratings

Ex. 4: Total SME Time Series – Small



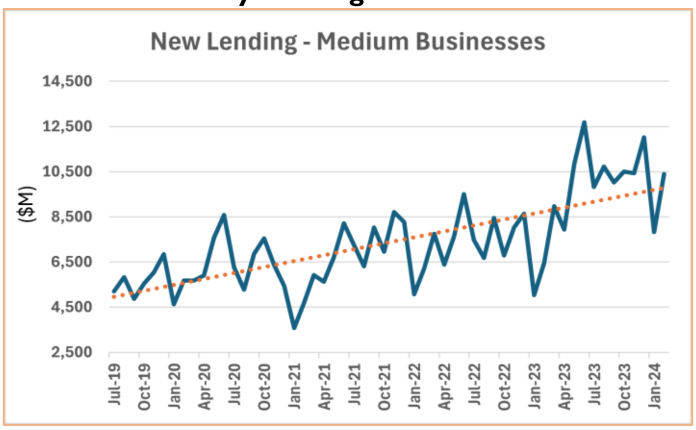
Source: Moody's, Foresight Analytics and Ratings

Ex 5: Monthly Lending Volumes – Small



Source: ABS, Excluding Property-Related Purchases

Ex 6: Monthly Lending Volumes – Medium

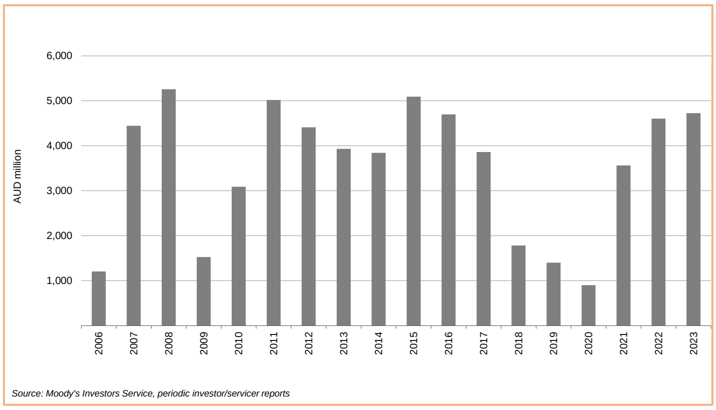


Source: ABS, Excluding Property-Related Purchases

Non-Bank Asset-Backed Securities and Private Warehouse/Pre-Term-Out Market Landscape

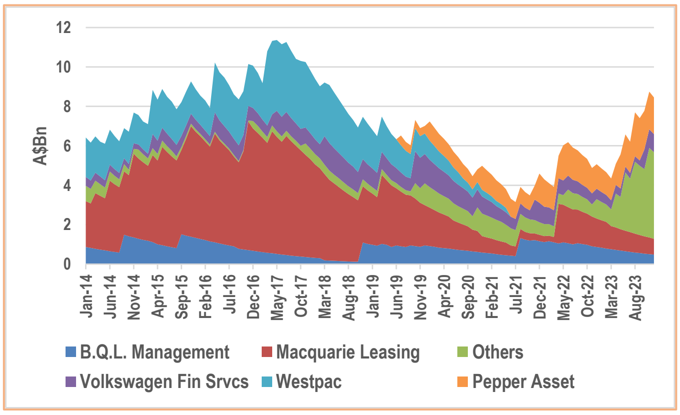
The asset-backed securitisation and pre-term-out market (private warehouse) has and remains the largest non-banking SME lending segment in Australia. We estimate current volumes to be approximately $18BN. While banks such as Macquarie Bank and Westpac Bank have historically been large participants in asset-backed issuances, both have now exited the market, selling their auto financing businesses to non-bank lenders. This is evident in Exhibit 8.

Ex. 7: Asset-Backed Issuance by Year



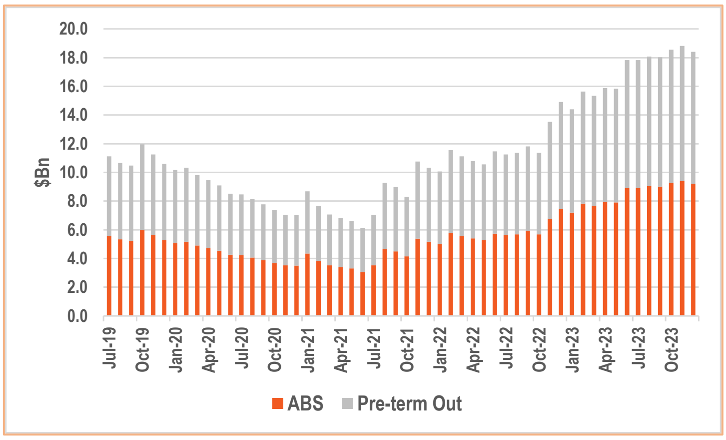
Source: Moody's, Foresight Analytics and Ratings

Ex. 8: Asset-backed Securities – Demise of the Banks



Source: Fitch, Foresight Analytics and Ratings

Ex.9: Private Warehouse + Asset-Backed Securities



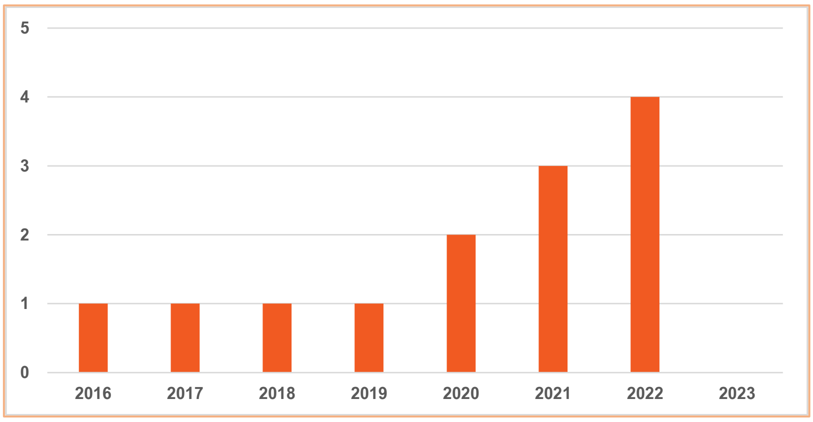
Source: Moody's, Foresight Analytics and Ratings

Foresight Australian SME Private Credit Fund Universe

The Foresight SME private credit fund (SME PCF) universe represents about $3BN in aggregate AUM across 15 managers that invest directly in the Australian SME lending market. The managers' funds relate to those open to either retail and/or wholesale investors. It excludes private warehouses issued by some managers that are, in terms of capital sourcing represented by institutional investors such as traditional fixed-income bond managers or superannuation funds. These come under our definition of 'pre-term-out warehouses' or private warehouses and are included in the asset-backed category volumes above.

Based on the cross-sectional analysis of the SME PCF universe researched by Foresight, the SME PCF landscape is a relatively concentrated market with a long tail. The top 5 players represent approximately 58% of the total market size of the Australian-domiciled fund managers. The number of SME funds established over the last couple of years is demonstrated in the Exhibit 10.

Exhibit. 10: SME Funds – No. Issued by Year



Source: Foresight Analytics and Ratings

Divergent Structures Reflect Heterogeneous Risks and Return Expectations

While these funds lend in the SME market, there are some very divergent structures in play. In effect, we would classify these mandates into 2 types, as depicted in Exhibit 11.

Exhibit 11 – SME PCF Structures and Intrinsic Risks

SME PCF Structures	Direct Lending	Indirect Lending (Peer-to-Peer)
Target Market	Small/medium businesses	Non-bank originators
Source of Credit Risk	Borrower default under bilateral terms	Warehouse owner operating risk, third-party underwriting process failure, end borrower default
Concentration of Idiosyncratic Risk	Very high (typically <20 names)	Moderate (typically 100+)
Systematic Risk	Moderate (floating - base + spread) Medium duration (18-36 months)	Moderate (floating - base + spread) Short duration (12 months)
Security Backing/Credit Enhancements	Low (equity buffer, director guarantees, PPSR, charge)	High (originator buffer, equity buffer, junior and senior tranche)
Expected Risk Premium (Above Cash)	High to very high	Moderate to high

Source: Foresight Analytics & Ratings

A deeper analysis of these SME PCF structures reveals that the expected risk-reward equation for these vehicles is materially different from idiosyncratic and systematic risk perspectives. The volatility of returns and other statistics like Sharpe Ratios are not the relevant yardsticks for judging intrinsic risks. The true economic risk embedded in these PCFs is loss-given-default (LGD). In other words, the downside volatility in a stressed situation, triggered by either an economic event, a company-specific event or a combination of both. A laser-sharp focus on these economic risks will allow investors and analysts to ensure an appropriate reward is offered for the level of risks being taken.

Under the indirect lending segment, warehouse strategies invariably provide highly diversified exposure by number of loans. The non-bank originator or warehouse owner provides a first loss equity note to protect fund investors and provide, at the very least, a junior and senior note tranche offering. In addition, the portfolios are typically short or very short in duration, limiting economic and interest rate cycle risk. Warehouse vehicles represent a securitised note investment structure, providing consequent protections to investors over and above the collateral applicable to each loan. In short, the structure provides multiple layers of protection to investors and is intrinsically less risky than a concentrated direct lending vehicle.

The direct lending mandates below typically provide circa $3-10M loans to medium-sized entities or participation in large loans via a lending club. In Australia, these mandates invariably have highly concentrated loan portfolios, with the total number of loans generally numbering between 10 and 15. They are typically medium-duration loans (1-3 years) and are floating-rate over this medium-term loan duration. Therefore, the economic and interest rate cycle risks (systematic risks) are materially higher. By virtue of the concentrated portfolio, there is a high degree of borrower idiosyncratic risk for the lender and for investors in that fund. Foresight Analytics and Ratings has also pointed out that many domestic direct lenders lack the work-out expertise necessary to manage a loan in technical or full default. We note that the returns profile of direct-lending SME PCFs needs to be higher to compensate for the risks taken.

The Australian SME Funding Gap – A Structural Imbalance

As we've already discussed, non-bank SME lenders have the opportunity for continued growth for a myriad of reasons: structural and regulatory changes in the banking sector leading to a withdrawal of ADIs from the SME sector; the service proposition of non-bank lenders due in part to technological superiority; the focus on specific niche sub-segment verticals; the increase in the source of funds from investors; and, importantly in the context of these factors, the segment is coming from a low base in terms of overall market share.

A second opportunity relates to the level of unmet demand from potential SME borrowers denied by the banks. That is, the SME funding gap. To be sure, many such borrowers would also be denied by non-bank lenders. Banks and specialist non-bank originators work on very different parameters, and we are not referring to borrower credit quality across prime and non-prime. It is reasonable to assume a portion of this unmet demand will be funded by non-bank lenders, subject to their lending standards. The degree of this estimated unmet demand relative to the existing FUM of non-bank lenders provides a guide to the opportunity set.

On that topic, in July 2019, UBS published an initiating coverage report in relation to the Prospa initial public offering (IPO), a non-bank lender. As part of that report, it estimated the level of unmet SME funding in the Australian market based on the retreat of the banks. Specifically, the analysis estimated the unmet SME funding opportunity at $240BN, consisting of $103BN in trade credit, $103BN to SME funding via business and personal credit cards and $34BN to SMEs currently utilising bank loans.

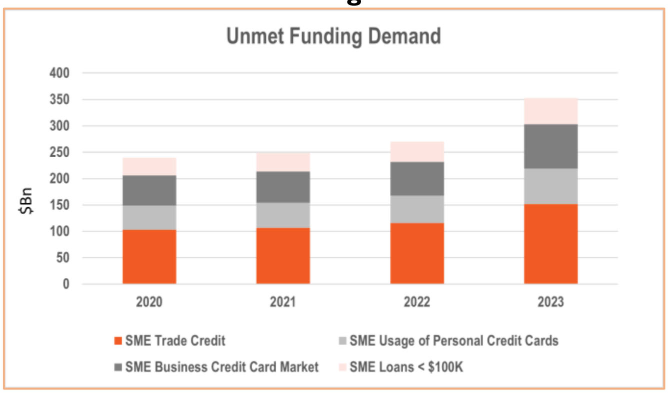
As we've already mentioned, this opportunity largely stems from structural and regulatory. More specifically, large banks have shied from SME credit due to the associated costs of assessing small loans to private companies and the increase in regulatory capital requirements, instead moving towards the more profitable residential lending sector.

The report also noted the following:

- Business loans as a share of all loans fell by around 50% between 1988 and 2019.
- While a third of SME loan applications are for working capital purposes, nearly 50% of unsuccessful loans are for amounts under $100,000. Small loans are assumed to relate primarily to working capital (see Exhibit 13 below).
- This has driven SMEs to utilise personal funds or venture capital (VC) to bridge funding gaps[2].

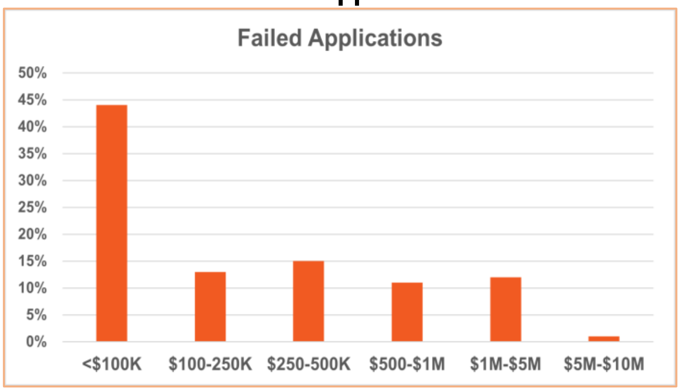
Utilising the baseline figures contained in that report, we have extrapolated the approximate unmet SME lending demand by the end of CY2023. These estimations are based on the annual SME lending growth levels as tracked by the RBA and as displayed in Exhibit 1 above. In short, utilising the annual growth rates of systemwide SME lending, the implication is that unmet SME lending sits at an approximate level of $350BN (see Exhibit 12 below).

Ex 12: Unmet SME Funding Demand



Source: UBS Prospa Initiating Coverage report 2019, Foresight Analytics

Ex 13: Failed SME Loan Applications



Source: UBS Prospa Initiating Coverage report 2019, Foresight Analytics

[2] Under the proposed taxation of unrealized capital gains, future funding for start-ups and small businesses may further increase demand for debt funding.

Australian SME Private Debt Tailwinds

Structural and cyclical tailwinds determine the growth trajectory in any investment sector. In Australia and other jurisdictions, the retreat of the banks/ADIs created a supply-side shock that is powering the emergence of non-bank SME lending. This has been magnified by the flexible, agile, rapid and responsive service offering enabled by technology and innovation.

Progressively, there has been a proliferation of non-bank lending options for SMEs, including medical centre finance, real estate vendor finance, research and development finance, royalty finance and legal disbursements finance, to name a few. With this proliferation in niche non-bank lenders, the industry has witnessed what were traditionally real estate mortgage brokers diversifying their business models into SME lending broking, facilitating growth in the non-bank SME lending segment.

Within this growing ecosystem has been the emergence of SME warehouse investment vehicles as a source of funding for select SME financing originators or fintech platforms. In turn, these private warehouses have gained increased investor traction based on attractive risk-adjusted returns, the growing sophistication of the Australian investor base and the search for yield from traditional bond investors. We discuss a number of these tailwinds below.

Basel III/Bank Capital and Liquidity Standards – A Mega-Force

The impact of Basel III on the growth of non-bank lending (i.e. private debt) cannot be overstated. It has changed Australian banks' lending practices in most segments other than the residential mortgage sector. The Basel III framework, introduced by the Basel Committee on Banking Supervision, aimed to strengthen the stability of the global banking system after the financial crisis of 2008. We discuss its key impacts in more detail below:

- Capital Adequacy Requirements – Basel III increased the minimum capital requirements for banks, including common equity Tier 1 (CET1) capital. Australian banks had to raise their capital levels to comply with these requirements. This made it more expensive for banks to lend to many segments, as they had to set aside more capital, potentially reducing the amount available for lending.

- Liquidity Standards – Basel III introduced liquidity requirements, including the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). These regulations required banks to hold sufficient high-quality liquid assets to meet short-term and long-term funding needs. Meeting these requirements may have influenced banks to prioritise larger, more liquid loans over SME lending, which is often seen as riskier when compared to exposure to large, publicly-rated corporations.

- Risk-Weighted Assets – Basel III introduced more risk-sensitive methods for calculating risk-weighted assets (RWA). While this aimed to make the capital requirements more reflective of the actual risks banks face, it made SME lending more capital-intensive, as both groups of loans are perceived to be riskier when compared to loans on residential mortgages. This has led to banks being more selective in their SME lending activities.

- Credit Assessment and Risk Management – Basel III emphasised the importance of robust credit assessment and risk management practices. Australian banks may have improved their credit assessment processes, leading to better-informed lending decisions in the SME sector. However, stricter risk management has also resulted in more conservative lending practices for both types of loans.

- Impact on Interest Rates and Loan Availability – The increased capital requirements and risk sensitivity have influenced interest rates for SME loans. Banks have charged higher interest rates to compensate for the capital costs, making borrowing more expensive for SMEs. Additionally, the availability of credit for SMEs has been affected as banks have reduced their exposure to the sector to manage capital and liquidity constraints.

- Alternative Funding Sources – In response to Basel III, some SMEs sought alternative funding sources, such as non-bank lenders, peer-to-peer lending platforms or equity financing. This has provided SMEs with more diverse financing options outside of traditional bank loans.

Superior Product/Service Proposition

There are a range of service and production value propositions that have also underpinned the strong growth in the private debt sector. The points below relate to the non-bank lenders in general, some of which seek funding via the securitisation markets (asset-backed/RMBS), while others offer private-debt managed funds to wholesale and retail investors.

- Superior Technology, Superior Human Touch – With the emergence of new technologies (and being unencumbered by the old technology systems of the big banks), non-bank lenders have the ability to rapidly assess the creditworthiness of prospective borrowers. They are more efficient and more flexible than the big banks, providing prospective borrowers with a markedly quicker turn-around time on loan applications. Technology is complemented by human skills on both the credit and loan serviceability side, with the non-bank segment showing a very proactive and high-touch approach regarding the latter.

- Arrears Management is Critical to Non-bank Lenders – A non-bank lender's ability to fund itself is directly related to its arrears through its warehouse facilities and its securitisation transactions or, for those providing private-debt managed funds, its FUM prospects. Non-bank lenders are hugely focused on arrears because they directly impact the lender's effective cost of funding and FUM growth. This is not the case for the big banks (term deposit investors don't give a hoot about the bank's arrears, for example).

- Greater Flexibility has Led to More Rigorous Credit Assessment – On the whole, non-bank lenders have proven to be considerably more flexible when it comes to loan eligibility and loan terms. In turn, this flexibility and the higher complexity of the loans have necessitated a more detailed approach to credit assessment. In contrast, banks focus on standard prime residential mortgages with a cookie-cutter approach to credit assessment.

- Relationship-Driven – Borrowers tend to work more closely with their private debt lenders, and deals can be executed more quickly and with more certainty of pricing than with a large syndicate of lenders. The speed at which amendments were struck in the private debt markets as the pandemic unfolded highlighted the benefits of these relationships. Non-bank lenders know the quality, status and reputation of the borrowers, which are essential to mitigating credit risk and expediting loan approval times.

- Less Cyclically Driven – Banks typically tend to be very cyclically driven in terms of their economic outlook and their predilection to extend loans. This has been evident in the current economic environment, where bank lenders have once again partially retreated from SME lending.

Mortgage and Finance Brokers – Enablers of ADI Disintermediation

In 2023, while non-bank lending to SMEs increased 25% on an annualised basis according to the RBA, the non-bank share of lending to the housing sector declined for the first time in a decade, due in large part to the 'mortgage wars' the banks were engaged in. It is perhaps no coincidence then that in 2022, the number of mortgage and finance brokers that diversified their business models into non-bank lending offerings exceeded a record number of 6,000 as a result of SME demand for alternative funding and the increasing debt product choice.

As was noted in a professional brokerage publication, 'Small business owners can hardly be expected to keep up with the large range of lending products on offer themselves. Indeed, the lack of awareness among SMEs of the alternatives out there has been highlighted as a problem in past industry surveys. This is slowly changing as they come to rely more on finance brokers.' Historically, SMEs have relied upon an existing bank relationship or an accountant for referrals. This dynamic is fast changing and is enabling the growth of non-bank lenders as brokers and direct origination become the cost-effective proxy for ADI/bank branch network distribution.

Non-bank Originators – Enablers of ADI Disintermediation

Non-bank lender originators have moved well beyond the traditional realms also once occupied by banks – asset finance, insurance premium finance, invoice finance and business (cashflow) loans. Foresight Analytics and Ratings has circa 160 SME lending originators accounted for, and we are well aware that our list is far from comprehensive. Many originators provide SME lending facilities hitherto not provided by banks. Examples include medical centre finance, royalty finance, real estate vendor finance, childcare centre operating lease finance, payroll finance, bank guarantee finance, strata finance and research and development finance.

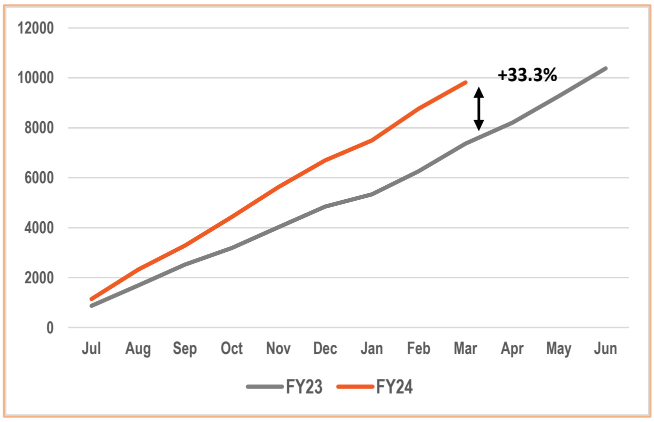
Many new originators are funded by founders and equity capital and, generally, family offices and high-net-worth investors. However, to the extent they grow their lending book, additional financing will be required. In our mind, this is where indirect and peer-to-peer lending SME private credit fund managers like Aura Private Credit can play a role, with the speciality financing verticals arguably being the most attractive from an overall portfolio diversification perspective.

Quality and Risk-Based Issues – It's About Downside Protection

For the SME lending sector, the economic and monetary cycle represents the most significant headwind. This headwind manifests itself in insolvencies and potential SME lending defaults. In this context, Exhibits 14 and 15 illustrate the current situation in Australia. It is well known that insolvencies are rising (Exhibit 14) and the sectors where they are most prevalent (Exhibit 15). What Exhibit 15 does not show is the long tail of sectors that have recorded very low insolvencies, i.e., there is a concentration of insolvencies and defaults in certain segments of the business. The point of these 2 charts is to highlight the flexibility required as an SME lender to be highly selective on quality and risk and to dynamically rotate as headwinds emerge.

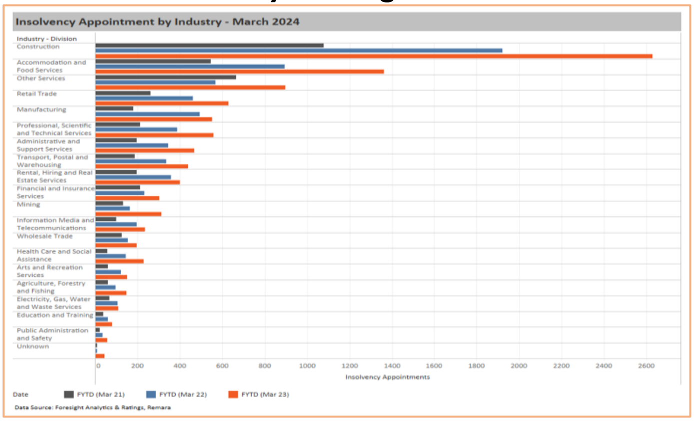
Exhibits 16 and 17 illustrate the 90+ day arrears level and net losses in the Australian asset-backed segment. We acknowledge that this sub-vertical of SME lending is dominated by auto loans, but Foresight knows that in undertaking research on SME warehouse funds, the first loss note levels are set accordingly. Below, we discuss the merits of the warehouse structure and why it is our preferred access vehicle for SME lending private debt.

Ex 14: Total Insolvencies Mar24 vs FY23



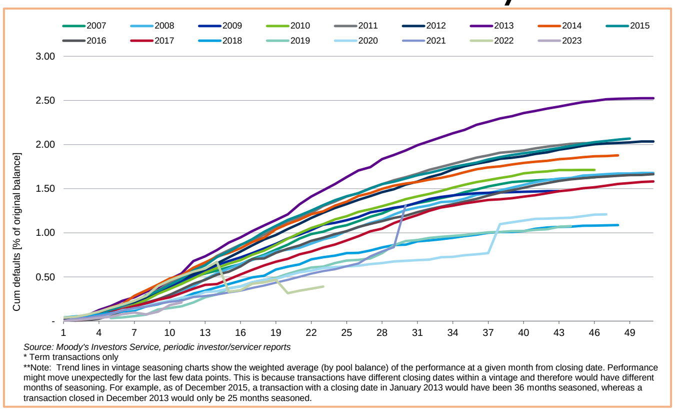
Source: ASIC, Foresight Analytics and Ratings

Ex 15: Insolvencies by Leading Sectors



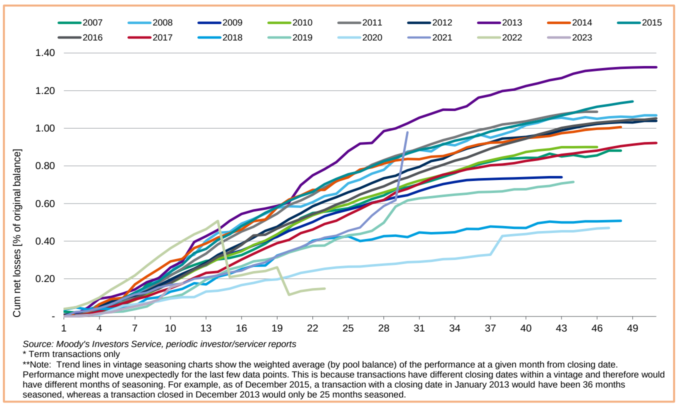
Source: ASIC, Foresight Analytics and Ratings

Ex 16: Asset-Backed Securities +90 Day Arrears



Source: Fitch Dinkum Report Q4 2023, Foresight Analytics

Ex 17: Asset-Backed Securities Net Losses



Source: Fitch Dinkum Report Q4 2023, Foresight Analytics

SME Warehouse Mechanics – Risk Management, Diversification and Scale

The casual observer may think that once a borrower in a portfolio either moves into or shows signs of heightened risk of delinquency, there is not much the private credit fund manager can do. But in the case of personal lending funds and SME warehouse structures, either the first loss provision (personal lending) or the first loss equity note (warehouse structures) can be dynamically managed to a degree (increased, for example) to mitigate any heightened risks. Furthermore, within an SME warehouse, the fund manager can tighten lending parameters and make tactical tilts away from certain borrower segments to address perceived heightened credit risk. Given the short-to-medium-term nature of most loans, these adjustments are made easily through term-outs and refinancings.

Below are the benefits of a warehouse investment vehicle relative to the direct lending investment vehicles for medium-sized enterprises:

- Substantially greater diversification by private credit lending strategy
- Substantially enhanced collateral protections by way of the securitisation structure of a warehouse facility (which has multiple layers of collateral protection)
- Additional investor protections over and above the original third-party loan book by the warehouse investment manager both tightening lending guidelines and providing another layer of lending oversight (risk management)
- Warehouse loan books are almost invariably short-duration, floating-interest-rate investments, thereby mitigating economic cycle risk and providing little to no interest rate risk. The short duration and revolving nature of a warehouse provide the investment manager 'ball control' over tactical tilts both by lender and by sector exposures, in contrast to the static pool (and longer duration) characteristics of RMBS and asset-backed securities.

SME Interest Rate Structure & Outlook

It's expected that the next RBA interest rate move will be a cut, but the timing of such a potential move differs significantly between what economists are predicting and what the bond markets are pricing in. Whatever the case, it is worth noting an easing monetary policy position is likely to improve the relative yield of SME lending.

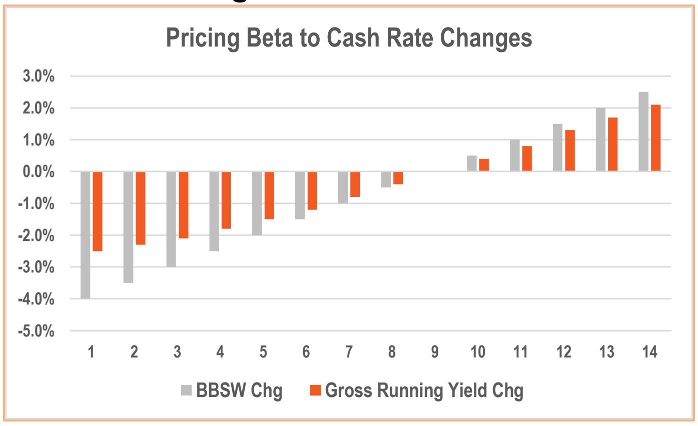
Generally, the short duration nature of SME lending interest rates on loans are typically locked in upon origination. However, the applicable rates over time reflect a spread plus a reference/market interest rate, such as the 3-month BBSW. 'Reference' is the operative word here – the relationship between the 2 rates is rarely perfectly correlated. SME lending rates have low 'beta' (sensitivity) to official cash rates, both in increasing and decreasing rate environments. Importantly however, the pricing structure by lenders results in an asymmetry of an up-rate beta exposure (being higher in a rising rate environment) and down-rate beta exposure (being lower in a declining rates environment). This type of pricing asymmetry is beneficial for SME PCF investors as the base rate sensitivity (beta) is more sticky than the public market securities (floating rate), which also use a base reference rate plus spread pricing.

Furthermore, SME lending rates tend to hit a floor in the latter environment. The historic returns performance of longer standing SME managed funds clearly illustrates this. In such an environment, the scarcity and risk premium override any official interest rate beta. This is in marked contrast to listed debt. On longer-dated SME loans, which are subject to a variable rate structure, a lender also has the ability to introduce interest rate floors. These are typically set at 100 basis points below the prevailing BBSW rate at the time of origination.

Additionally, over the monetary cycle of the last few years, some SME fund managers have switched from fixed to floating on longer duration lends – another lever that creates an upside asymmetry in relation to movements in base rates or official cash rates.

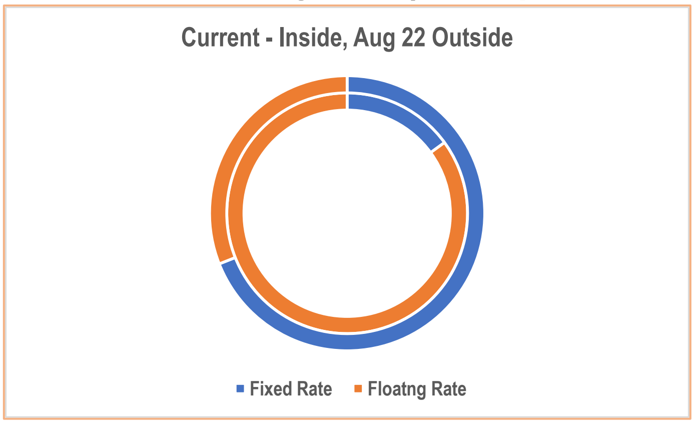
Exhibits 18 and 19 provide a real-world illustration of these dynamics, as undertaken by an SME warehouse-structured SME fund manager. We note that portfolios differ from manager to manager, but the important point here is the broader characteristics noted above. Exhibit 18 illustrates the net result in relation to interest rate changes. If BBSW increases by 2.5% from today, the fund return will increase by 2.1%. Conversely, if BBSW decreases by 4%, the fund return will only decrease by 2.5%. It's worth noting that in this case, several positions also include interest rate floors, typically set 1% below where the BBSW was when the transaction was priced. As Exhibit 18 illustrates, this particular manager also conducted a fund-wide exercise to move the majority of the facilities to floating rate, with currently 85% of the portfolio on the latter interest rate structure (inside ring of Exhibit 19 versus the outside ring, which indicates the August 2022 position).

Ex 18: SME Pricing – Official Rate Beta



Source: Foresight Analytics and Ratings

Ex 19: Fixed vs Floating Rate Optionality



Source: Foresight Analytics and Ratings

Australian SME Lending Market Landscape

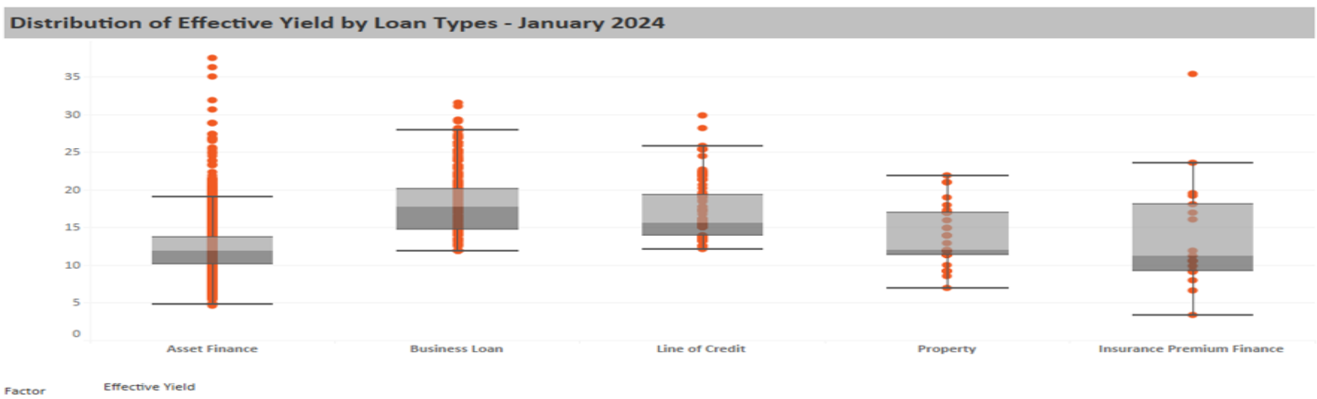
This section provides additional insights into SME lending sub-verticals.

We classify the SME sub-verticals as follows:

1. Asset Finance – This mostly reflects auto loans but can also include other lease or operating finance-type deals. These types of loans are asset-backed and are therefore secured.
2. Business Loan – This type of financing includes working capital or acquisition financing.
3. Insurance Premium – This type of finance includes lump-sum insurance premium funding for professionals (professional indemnity) or businesses (cyber risks).
4. Line of Credit – This is a revolving facility with an approved limit. Any interest is charged on the level of drawdown. There may be some fixed drawdown fees charged as well.
5. Property – This is secured lending for vendor financing. This doesn't include development or bridging finance.

Exhibit 20 provides the dispersion of pricing applied to these specific verticals of SME lending. The dataset reflects a large number of asset financing deals with a median interest rate of 12% and a positive skew around the median. It is interesting to note some outlier deals that may reflect short duration or high credit risk in this segment. Relative to other sub-verticals, asset financing has the greatest dispersion.

Ex 20: Distribution of Loan Pricing by SME Sub-Vertical



	Asset Finance	Business Loan	Insurance Premium Finance	Line of Credit	Property
Max	37	32	35	30	22
Average	12	18	14	17	14
Q1	14	20	18	19	17
Median	12	18	11	16	12
Q3	10	15	9	14	11
Min	5	12	3	12	7
Count	3,787	454	17	130	38

Factor Effective Yield

Data Source: Foresight Analytics & Ratings, Remara

The data set for business loan financing also reveals a positive skew but around a higher median of 18%. This may reflect higher risk, shorter duration or exposure to risker segments of the SME sectors.

Elsewhere, the median interest rate for insurance premium finance was 11%, line of credit 16% and property 12%. The dispersion of rates within property is relatively low and perhaps reflects lower risk, higher competitiveness, or a combination of both.

Ex 21: Distribution of Duration/Term by SME Loan Sub-Vertical

Distribution of Contract Term by Loan Types - January 2024

Factor Term

	Asset Finance	Business Loan	Insurance Premium Finance	Line of Credit	Property
Max	115	36	40	36	26
Average	56	33	13	36	15
Q1	60	36	10	36	18
Median	60	36	10	36	12
Q3	54	36	10	36	12
Min	12	6	5	24	6
Count	3,787	455	17	130	38

Factor Term

Data Source: Foresight Analytics & Ratings, Remara

The dataset in Exhibit 21 shows the duration of the loans. The asset financing vertical has a median term of 60 months (5 years) with a negative tail around this median. Business loans, on the other hand, have a median term of 36 months, followed by 10 months for insurance premium loans and 12 months for property loans.

Ex 22: Equifax Score Distribution by Lending Sub-Vertical

Distribution of Equifax Credit Score by Loan Types - January 2024

Factor Equifax Score

	Asset Finance	Business Loan	Insurance Premium Finance	Line of Credit	Property
Max	969	1,150	750	948	960
Average	477	652	590	641	650
Q1	647	694	641	676	695
Median	582	630	561	624	650
Q3	495	582	545	583	626
Min	0	484	487	0	0
Count	3,787	455	17	130	38

Factor Equifax Score

Data Source: Foresight Analytics & Ratings, Remara

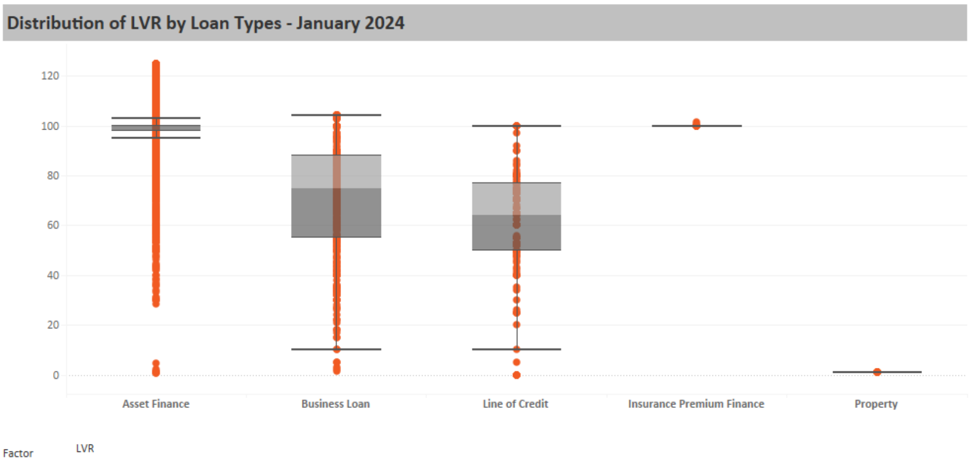
The dataset in Exhibit 22 shows the distribution of borrower quality as proxied by Equifax score. A high score denotes higher quality and lower risk.

Looking at the asset finance sub-vertical, we can see a positive skew around the median of 582. The first quartile is 647, while the third quartile is just below 500 (mid-point). The dispersion in the quality emphasises the need to be selective and high-quality focused. The median quality of business loans is higher than asset finance at 630. The insurance premium funding is very similar to asset finance, although the dispersion is more symmetric around the median. Line of credit and property both enjoy higher levels of quality than asset and business finance.

The borrower quality distribution for line of credit and property finance is consistent with more competitive pricing in these verticals.

Appendix- Charts

Distribution of LVR by Loan Types

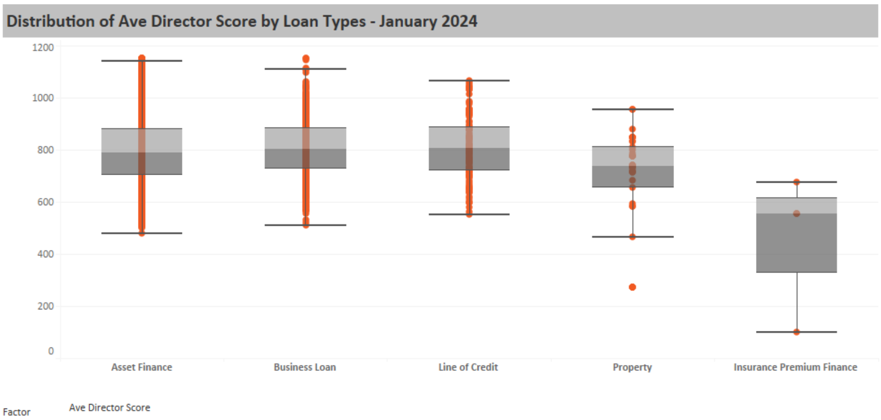


	Asset Finance	Business Loan	Insurance Premium Finance	Line of Credit	Property
Max	125	104	101	100	1
Average	96	72	100	60	1
Q1	100	88	100	77	1
Median	100	75	100	64	1
Q3	98	55	100	50	1
Min	1	1	100	0	1
Count	3,787	455	15	121	38

Factor LVR

Data Source: Foresight Analytics & Ratings, Remara

Distribution of Ave Director Score



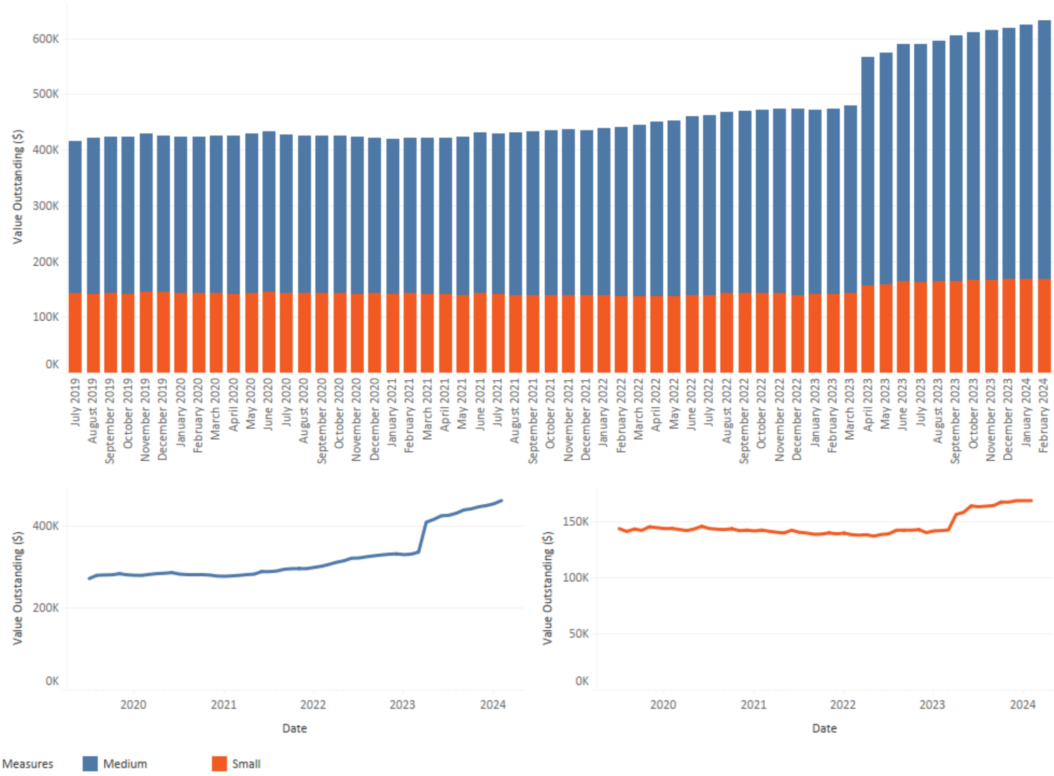
	Asset Finance	Business Loan	Insurance Premium Finance	Line of Credit	Property
Max	1,150	1,150	675	1,066	954
Average	794	810	471	807	691
Q1	879	881	584	886	808
Median	790	804	554	807	737
Q3	703	727	441	721	662
Min	478	511	100	550	273
Count	3,719	454	4	130	38

Factor Ave Director Score

Data Source: Foresight Analytics & Ratings, Remara

Total SME Lending

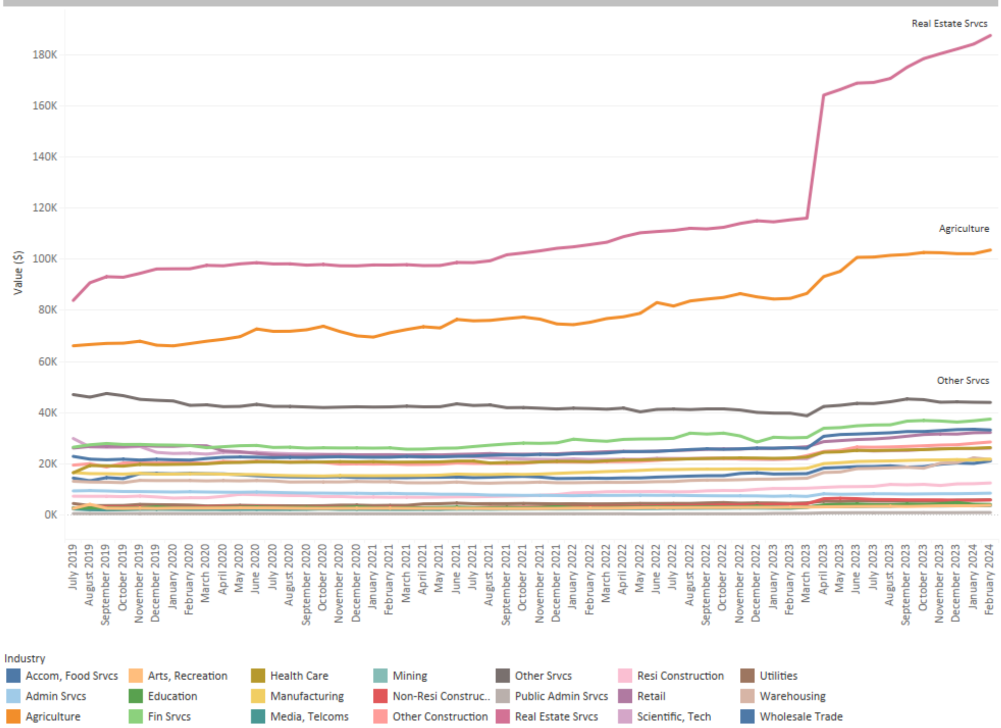
Total SME Lending: Value Outstanding - March 2024



Data Source: Foresight Analytics & Ratings, Remara

SME Lending by Industry

SME Lending by Industry: Value Outstanding - March 2024



Data Source: Foresight Analytics & Ratings, Remara

Appendix- Definitions

Acronyms	Definitions
ADI	Authorised Deposit Taking Institution
BBSW	Bank Bill Swap rate
BDD	Bad and Doubtful Debts
BN	Billion
CAGR	Compounded annual growth rate
CRE	Commercial Real Estate
FUM	Funds under management
LGD	Loss given default
LVR	Loan to Value ratio
MFAA	Mortgage Finance Association of Australia
NIM	Net Interest Margin
PCF	Private Credit Fund
RBA	Reserve Bank of Australia
RMBS	Residential mortgage backed securities
SME	Small and Medium Enterprises. Unless otherwise specified, the analysis in this study uses APRA's definition of SMEs as businesses with turnover of less than $50 million.
YoY	Year on year

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