ARES

In the Gaps

Ares Alternative Credit Newsletter

FALL 2023

Curb Your Enthusiasm

> **"A great many people think they are thinking when they are merely rearranging their prejudices."**
> **William James**

One February morning, Steve, Paul and Denton excitedly set out for a day of backcountry skiing in Utah's famous Wasatch mountains. The three men were highly-skilled, conscientious mountaineers and skiers; they were also well-equipped for their adventure with safety gear, including transponders.

Two hours into their journey, they encountered another group of skiers embarking on the same adventure. After stopping to compare notes about the best routes through the mountains, the two groups parted ways. The three men opted for a higher route through a sparsely-wooded trail called Gobbler's Knob. The other party chose a lower route, citing foggy conditions at higher altitudes and two feet of new snow that had fallen the previous day.

Not an hour later, an avalanche broke loose about 100 yards above Steve, Paul and Denton, burying them under several feet of snow. The other group of skiers heard the avalanche and soon arrived on the scene. Using transceivers, they located the three men. Paul and Denton were uninjured and had been able to dig their heads out of the snow. Steve, however, was injured and unable to do the same; tragically, he died before the men could reach him.

In the aftermath, Paul and Denton faced serious criticism about their risk assessments and fateful decisions. A close friend, Ian McCammon, decided to apply his training as a mountaineer, wilderness instructor and mechanical engineer to understand the accident. Ian studied more than 700 deadly avalanches, systematically cataloging their risk factors. He also gathered information on over 1,300 victims to assess each party's makeup, level of expertise, and other relevant information.

Ian published his findings in a paper entitled, "*Evidence of Heuristic Traps in Recreational Avalanche Accidents*." It is widely regarded as the gold standard in backcountry training and risk management. He writes, "*When most of us think of decision making, we imagine a process where we review relevant information, weigh alternatives, then decide. There's no doubt that we are capable of making some decisions this way, but this requires time and mental energy – resources that are in short supply in a busy and complex world.*"

Whether we're assessing avalanche risk or credit risk, research has shown that the human mind is limited to only four variables at a time. After that, we are mostly just guessing. To handle greater complexity, we rely on heuristics – *mental shortcuts* – the springs from which conventional wisdom flows. In doing so, we become vulnerable to cognitive biases which can be insidious and blind us to risk.

As we have met with investors across the world over the past few months, we sense a great deal of polarization. We believe that at least some of this polarization can be blamed on the mixed signals we are all trying to decipher. It is a busy and complex market environment chock full of heuristic traps.

Much of the market feels optimistic, mystified by those who see storm clouds on the horizon. The rest of the market feels very nervous, mystified by the market's blithe disregard of those storm clouds. While these opposing views tend to be strongly held and thoughtfully articulated, they almost certainly do not lead to the same investment outcomes.

We think it's time to *Curb Your Enthusiasm* for either view and ask some introspective questions: Does our view of risk or market opportunity rely too heavily on heuristics or conventional wisdom? Have we looked for cognitive biases in our modeling assumptions and investment processes? In the words of William James, "*A great many people think they are thinking when they are merely rearranging their prejudices.*"

In this edition of *In the Gaps*, we revisit the big world of consumer lending. There are dimensions to this rapidly changing sector that deserve more attention than they are getting. We dive into fintech lending, an industry grappling with a new capital paradigm. Finally, we spotlight a sector in which we've been active for years but has only recently started to garner broad attention: fund finance.

We are especially grateful for the team's contributions this quarter amid a frenetic pace of investment activity. We are also so very pleased to introduce you to this quarter's charity spotlight: Interactive Research & Development ("IRD"), a charity that operates health programs in 15 countries throughout Asia, Africa, and South America today. Please take a moment to get to know them.

Drugs, Liquor and Leverage

Consumers and households have sure been in the headlines a lot lately. However, we think far too much focus has been on household *spending* and not nearly enough on household *debt*.

As we noted previously, consumer spending is **not** a leading indicator for recessionary and market risks. That's a great example of where conventional wisdom is just wrong. The *no-recession-is-coming-because-household-spending-remains-strong* crowd is ignoring every recession for the past fifty years that saw *increasing* consumer spending right up until the economic downturn.

> **"Three things ruin people: drugs, liquor and leverage."**
>
> **Charlie Munger**

Household credit performance indicators are where all the interesting action really is. Household credit is nonetheless a multi-faceted beast that eats heuristics for breakfast. One must buckle in, peel back the layers, and go inside the data to truly understand where economic stresses are emerging... and where they are not.

Consumer Credit: A Tale of Many Cities

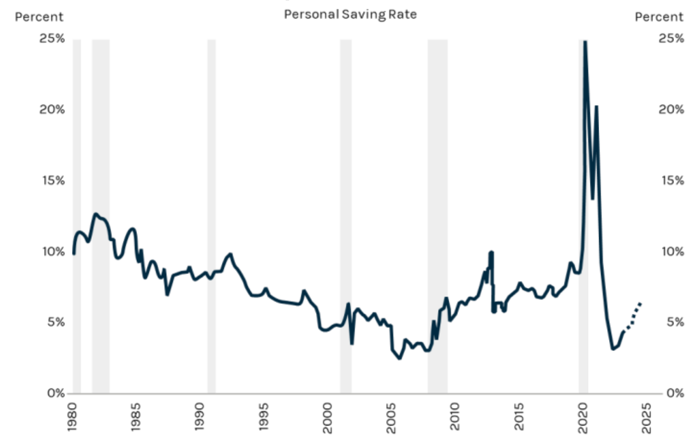
While we could fill dozens of pages with data and observations on consumer credit, we are instead going to focus on two particular facets that we believe are the source of misperceptions or heuristic traps.

1. **Borrower cohorts**
2. **Payment priority**

We will start with borrower cohorts. By breaking households into smaller groups sharing similar credit characteristics, a clearer picture emerges that helps explain some of the mixed signals which appear in more generalized analyses.

As previously noted, fiscal stimulus during the pandemic largely turned into excess savings, which ignited excess spending and inflation. Today, the household savings rate (chart below) is at its lowest level since the Global Financial Crisis ("GFC"), (3.8%) and roughly half the pre-pandemic 10-year average of 7.4%.[1]

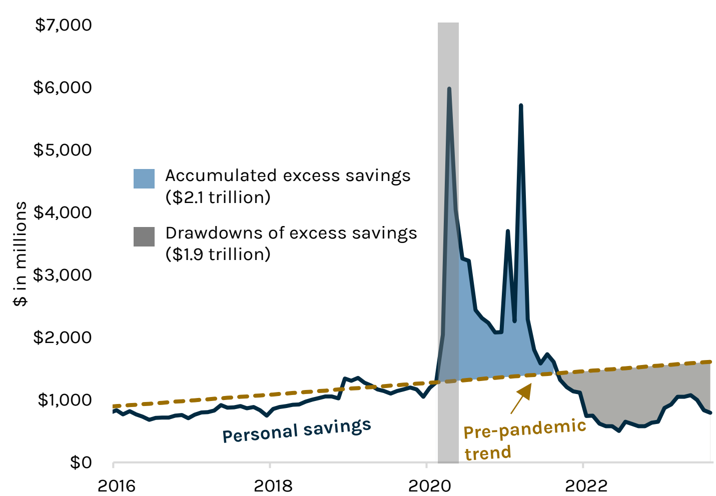
Personal Saving Rate as a Percentage of Disposable Income



Source: Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Federal Reserve Board, University of Michigan, The Conference Board, U.S. Federal Reserve Bank, Goldman Sachs Global Investment Research, IRS.

At this point, virtually all of that excess savings has been depleted (chart below). The bottom 75% of households exhausted it many months ago. The top quartile is still working at it. Poor equity market performance in 2022 then propelled a decline in overall household net worth from its peak in 2021.

Aggregate Personal Savings Pre & Post-Pandemic



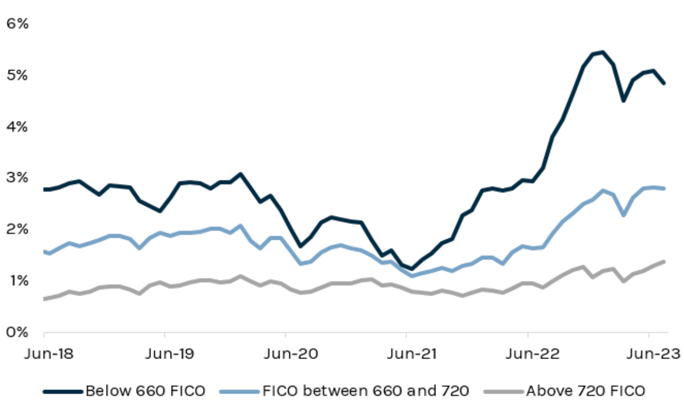
Source: Bureau of Economic Analysis and authors' calculations.

[1] Source: Bureau of Economic Analysis, July 2023.

The impact on consumer credit performance of this swing in savings varies considerably by borrower cohort. The following set of charts shows credit performance broken down by FICO score and age. There should be no surprises when comparing performance by credit score and age. What *should* jump off the page is how differently these various cohorts have performed over the past 18 months or so, coinciding with the spending of excess savings.

The chart below plots serious delinquencies ("DQ") – more than 60 days past due – on unsecured credit (think: credit cards) by credit score cohort. Notice the performance convergence in mid-2021 and the unusually wide dispersion today.

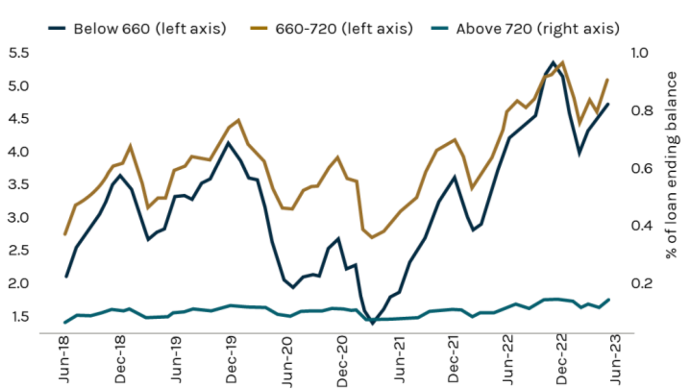
Unsecured Consumer 60+ day DQ, by FICO



Source: Citi Research, August 2023.

Looking at the same type of delinquency data, but focused exclusively on auto loans, reveals some important cohort performance differences compared to credit cards. Near-prime consumers, defined in the data as those with FICO scores between 660 and 720, are performing largely in line with subprime borrowers.

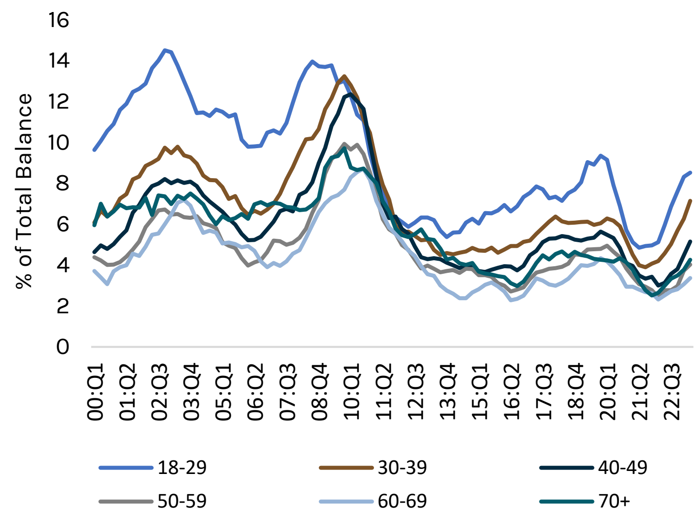
Auto Loan 60+ Day DQ, By FICO



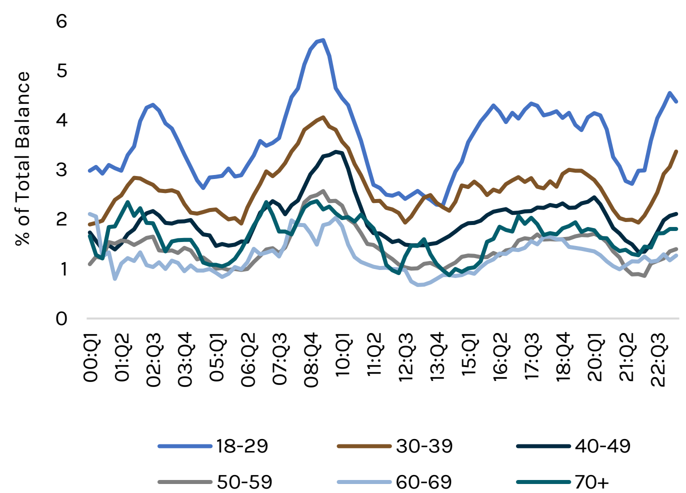
Source: Citi Research, August 2023.

Finally, when looking across age cohorts (regardless of FICO scores), notable differences emerge between credit cards and auto loans. Some cohorts are approaching delinquency rates we have not seen since the GFC.

Credit Card Performance by Borrower Age



Auto Loan Performance by Borrower Age



Source: Citi Research, August 2023.

We should probably take this opportunity to dispel another example of where conventional wisdom is just wrong: credit scores and household income are <u>not</u> correlated (here is some [research](#) on that topic).

While the above charts merely scratch the surface of insights gleaned through borrower cohort analysis, they reinforce how important it is to dig into the data and resist the temptation to extrapolate (a heuristic trap) or assume that what was true in the past is still true today.

Let's turn now to a facet of consumer credit performance that is, in our opinion, not getting nearly enough attention: **payment priority**. When consumers sit at their kitchen tables to pay the bills, some of those bills will reliably get paid first… and others last. In consumer lending, we call that the *household payment priority waterfall*.

Lenders and investors alike pay close attention to where certain obligations land in that payment priority waterfall. Because, even among those highest-priority obligations, *relative* placement in that waterfall can make a huge difference in credit performance during stressful economic periods.

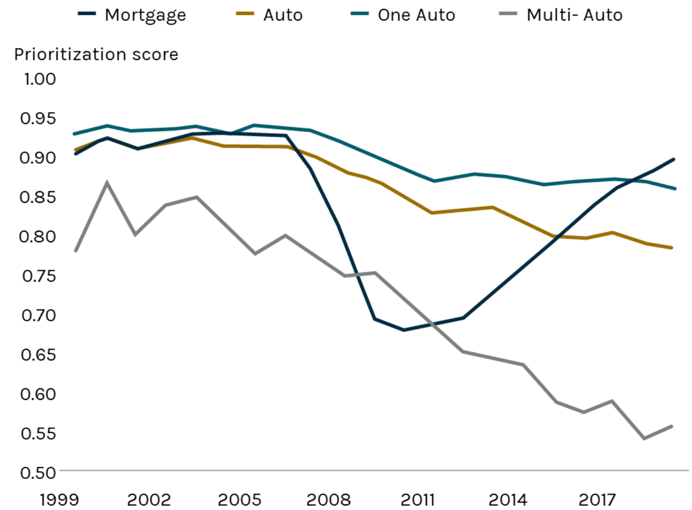
One of the best examples of this occurred during the GFC among subprime consumers who had borrowed money to purchase homes and cars. During the GFC, the tendency was for these individuals to prioritize their car payments over their mortgages.

The resulting performance difference between *subprime auto* and *subprime mortgages* was stark. Where subprime mortgage securitizations suffered devastating losses, subprime auto securitizations avoided even a rating downgrade. Consequently, conventional wisdom places auto loan payments near the very top of household waterfalls.

But is it still true? If not, what are the potential credit performance implications, and how might that vary today by borrower cohort (per the above)? The following charts point to shifting payment priorities; that re-prioritization has big implications on credit performance.

The chart below is based on large surveys and performance data spanning a wide spectrum of consumers. It captures the degree to which these priorities have been shifting. While the underlying drivers of these shifts are important and interesting, we will not drill into them here. Note, however, the general downward trend in auto loan priority, and especially for loans on second or third vehicles. Mortgages have only very recently, and for the first time, occupied that all-important top spot.

Debt Payment Prioritization by Year



Source: New York Fed Consumer Credit Panel/Equifax.

Note: The prioritization score reflects the probability that a loan of a given type will be repaid relative to consumer debt (credit card loans, consumer finance, retail trade). Mortgage loans include home equity revolving, home equity investment, and first mortgage loans.

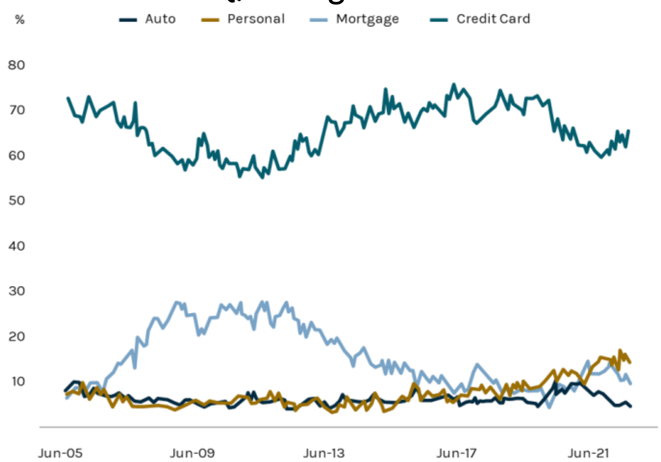
Looking through the other end of the telescope, we can perceive shifting payment priorities through an analysis called "First to DQ." The graphs below answer the question: which financial obligations are "first" to become delinquent when financial pressures mount. The charts are good visualizations of household payment priorities and how they have evolved over time. We would emphasize how significantly priorities vary by both borrower FICO and loan type.

Take a look at **mortgage payment** priority since the GFC. There is a clear trend across all credit quality cohorts of increasing priority. Admittedly, some of this is due to tighter underwriting standards for mortgages following the GFC, which included higher down payment and stricter debt-to-income requirements. More recently, however, as home values have appreciated so significantly, there is a stronger financial incentive to prioritize mortgage payments over other forms of household debt.

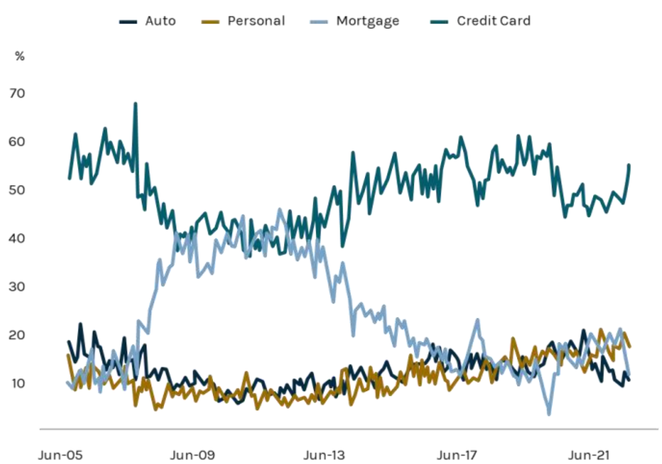
On the flip side, **credit card and personal loan payment** priorities have declined, as shown in their upward trajectories on the graphs. Borrowers in these credit products have been more impacted by higher interest rates. Looser underwriting standards and easy access to non-bank consumer lenders in recent years also contributed to an increase in overall household credit card and personal loan debt.

As discussed above, **auto loans** have historically enjoyed high payment priority – albeit that priority looks meaningfully different today than during the GFC. That prioritization may have taken another leg down for certain borrowers in the past year based on recent performance data.

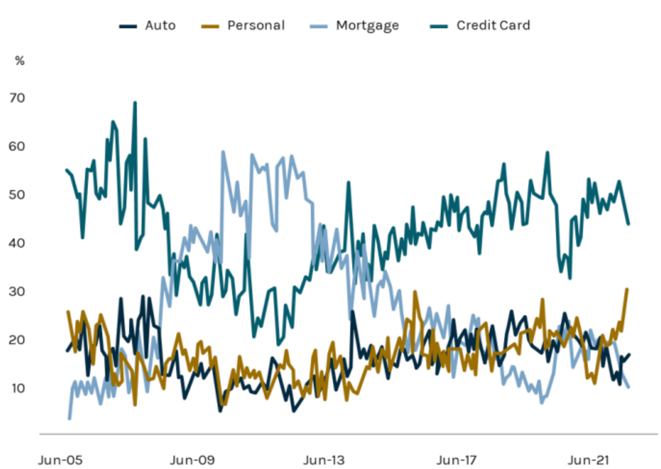
First To DQ, Vantage Score Below 660



First To DQ, Vantage Score 660-720



First To DQ, Vantage Score Above 720



Source: Citi Research, August 2023.

Back to School (or at least paying for it)

The "situation" developing in the U.S. student loan market is something we recommend watching closely. It is a fiasco of such staggering proportions that only politics could create it. It matters not whether you have a direct exposure to it, as its impact will be felt to one degree or another across the whole of consumer lending.

At the risk of sounding too cynical, it has become a giant social, political, and financial experiment in incentives and unintended consequences. Let's start with a short recap of what has happened and who is involved.

Some 45 million adults in the U.S. attended college, borrowed the money to pay for it directly or indirectly from the U.S. government, and still have an outstanding balance to repay. Unlike other consumer debt, the government heavily subsidized interest rates to encourage education (an important goal, to be sure); however, borrower risk is no different than for other types of consumer debt.

During the pandemic, the government made a number of accommodations to these borrowers. Interest stopped accruing (temporarily set at 0%) and payments were deferred. This was called the student loan "freeze." The freeze substantially increased discretionary spending and excess savings, now largely depleted, for student loan borrowers.

The freeze was so politically popular in some circles that certain politicians entertained making it quasi-permanent, including an outright forgiveness of student loan debt. This not only sparked debate about fairness and the root causes of inflation in higher education but also introduced an expectation among many borrowers that they may not have to ultimately repay their debt.

As of September, the freeze has now *mostly* ended. Interest accruals have recommenced; however, most borrowers can opt to defer making payments for another year without being deemed delinquent.

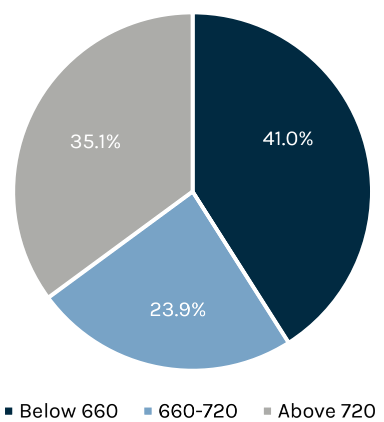
The unintended consequences can be captured in some truly shocking statistics that reflect the current state of borrower behavior, expectations and awareness. Never before have we seen statistics like this for any other cohort of borrower or credit obligation.

- Close to 90% of borrowers are currently not making any payments on their student loan debt.

- Fully 80% of student loan borrowers *expect* loan *forgiveness*.
- Nearly 50% of these borrowers are *unaware* or *unprepared* for the restart of student loan repayments.

Who are these borrowers? They span in age from 24 to over 65. They have other consumer debts, like credit cards, auto loans, mortgages, and personal loans. The large majority fall into the subprime and near-prime credit quality categories (pie chart below).

Credit Scores of Student Loan Borrowers Not Making Payments



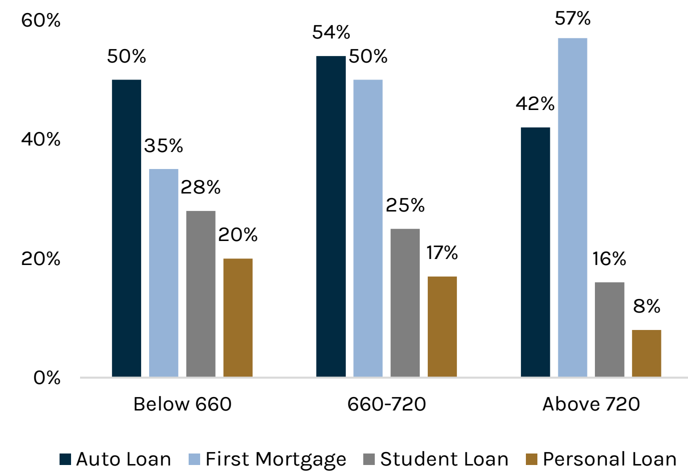
Source: Citi Research, Equifax Analytic Dataset, June 2023.

From what we have already seen above, we know this is the same borrower profile that is already feeling financial strain from inflation, higher borrowing rates, and the depletion of savings.

Their monthly student loan payments will generally range from $100-400. For most, this will represent approximately 20% of their discretionary household income. Whatever the impact on student loan credit performance, the resumption of payments alone will have a meaningful impact on the performance of other consumer credit. Ultimately, that is why it matters.

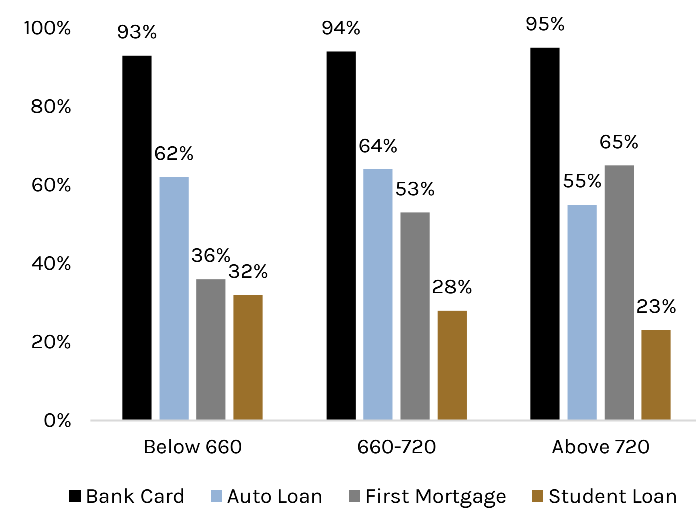
Where student loan payments will land in household payment priorities will vary considerably by borrower cohort. To identify the sectors most exposed to reprioritization, we evaluated borrower overlap among student loans and other types of borrowing (charts below).

Percentage of Credit Card Borrowers with Other Consumer Debt



Source: Citi Research, Equifax Analytic Dataset, July 2023.

Percentage of Unsecured Consumer Loan Borrowers with Other Consumer Debt



Source: Citi Research, Equifax Analytic Dataset, July 2023.

Many student loan borrowers, and especially those who are younger with lower incomes, will soon find themselves even more financially strained.

Coupled with the trend that unsecured consumer and credit card obligations have declined in household payment priority relative to others, we believe that subprime unsecured consumer and subprime credit card debt will be most impacted by the reprioritization of their payment waterfalls.

Fintech Fizzles

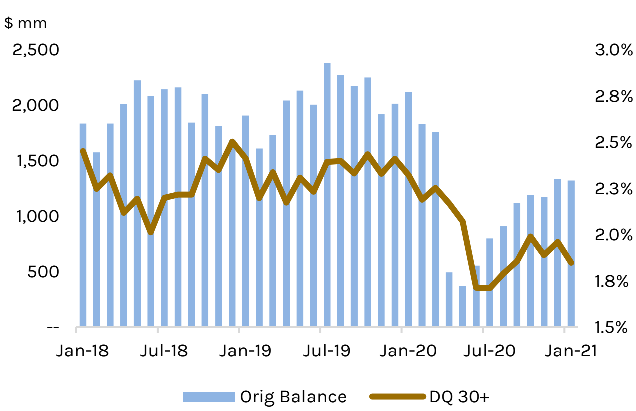
To paraphrase (abusively) Ross Perot during the 1992 U.S. presidential election, "*that giant sucking sound you are hearing is the sound of capital leaving the fintech lending industry.*"

After a period of rapid expansion fueled by an abundance of capital and liquidity, and few barriers to entry, the fintech lending industry is now facing consolidation and restructuring. The root cause is, ultimately, a problem of capital and business models that, in our opinion, never made sense. They nonetheless persisted in an abundant capital environment where investors weren't terribly fussed about silly things like positive earnings and free cash flow.

During the past four years, the fintech lending industry went for a wild ride: from feast to famine… back to feast… and then to famine again. What follows is the (short version) story of that ride, where we think this industry is going, and the potential implications for alternative credit investors.

The **first phase** (feast to famine) describes the immediate economic impact of the pandemic. Origination volumes dropped precipitously at first. Governments imposed payment deferral mandates on many types of consumer and small business lending, forcing lenders to stop collecting for a time. This led to an improvement of delinquency rates, even though payments weren't actually being made (chart below).

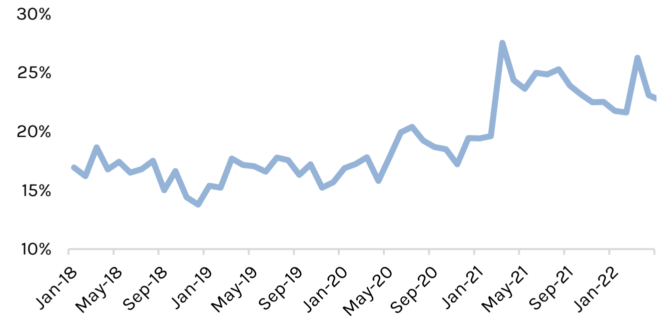
Origination Volumes vs. Delinquencies



Source: dv01.

The **second phase** (famine to feast) arrived later in 2020 with the onset of massive fiscal and monetary stimulus. The implications on fintech lenders were two-fold. First, loan repayment rates jumped in early 2021. Second, fintech lenders struggled to raise capital fast enough to replace the loans being repaid with new loan originations. The combination resulted in loan portfolios shrinking meaningfully.

Loan Prepayment Rates

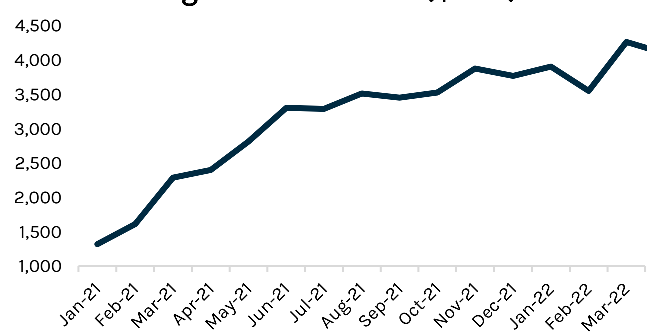


Source: dv01.

Even as households were repaying debt, they were also flush with excess savings. Those extra dollars landed in checking and savings accounts. Banks struggled to keep pace with these inflows in terms of their own loan origination and investment activity. The impact of large amounts of deposit inflows was particularly acute at smaller banks and credit unions.

As the universe hates a vacuum, banks' excess deposits found fintech lenders' capital deficits very quickly. The arrangements largely took the form of "programmatic flow purchases," where fintech lenders would originate loans and banks would purchase those loans at a healthy premium, committing in advance to a certain volume of these loan purchases over the coming year. Originations *tripled* between January and December 2021.

Origination Volumes ($mm)

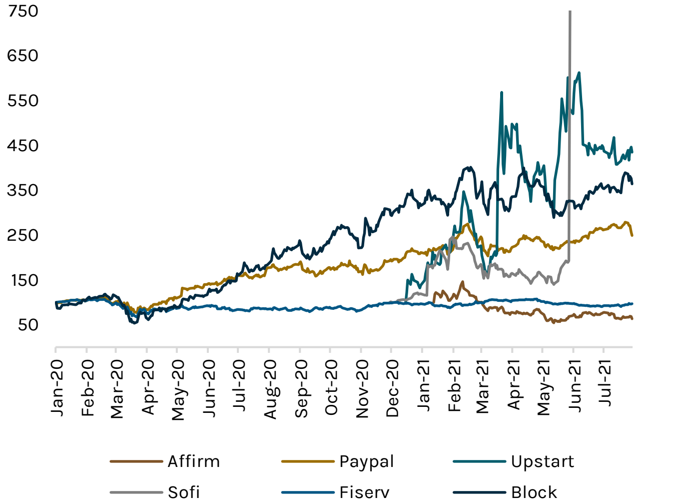


Source: dv01.

Fintech lenders typically booked a gain at the time each loan was sold to a bank and would typically also earn servicing fees over the life of the loan. This was a boon to certain fintech lenders as it provided a path toward scale and significant upfront earnings.

Valuations for many fintech lenders skyrocketed in 2021, encouraging many fintech sponsors to position their lending platforms for public listing… and motivating smaller platforms to grow as quickly as possible so they, too, could enjoy IPO glory.

Indexed Market Valuations of Public Fintechs

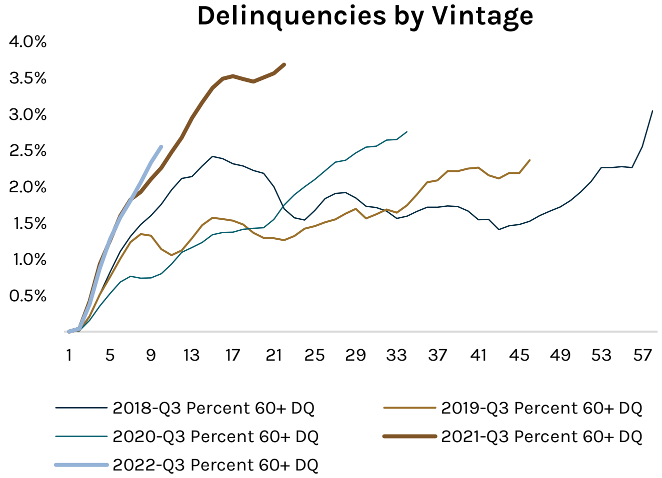


Source: S&P Capital IQ.

The **third phase** (final famine) arrived in the second half of 2022 when three developments coincided.

First, the credit performance of 2021 and 2022 vintage loan originations began to deteriorate much faster and more severely than expected. In some cases, loss rates were tracking toward levels not seen since the GFC. The graph below shows serious delinquency performance by vintage (quarter of origination). Readers of *In the Gaps* have heard this part of the story a few times already.

Delinquencies by Vintage

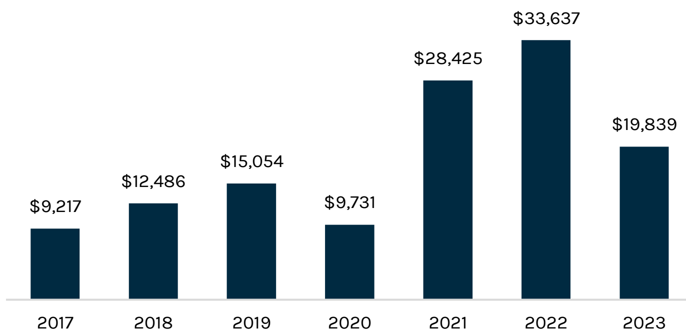


Source: dv01.

Second, banks responded to credit performance deterioration by decreasing flow buying activity and tightening credit. We detailed that phenomenon in last quarter's *In the Gaps* newsletter.

Third, inflation began to deplete excess savings and higher interest rates turned the tide of deposits from inflows into outflows. This further reduced banks' appetite for fintech originated loans.

Fintech Origination Volumes ($mm)



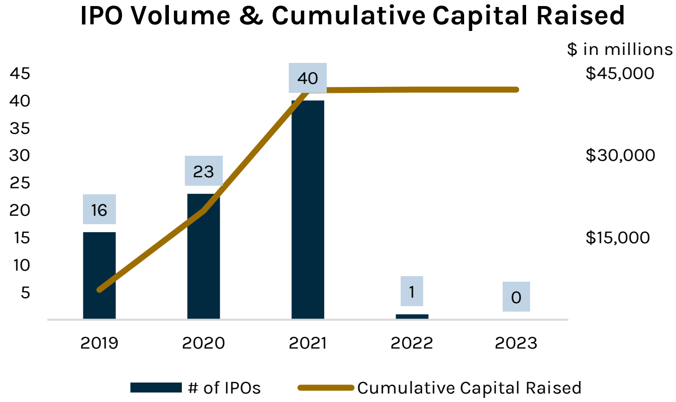
Source: Finsight.
This data is illustrative comprised of six representative lenders.

As we noted last quarter, loan origination volumes for many platforms who had been selling to banks and credit unions dropped by 50-80%. Valuations for many of these platforms were commensurately punished; fintech IPOs have basically evaporated.

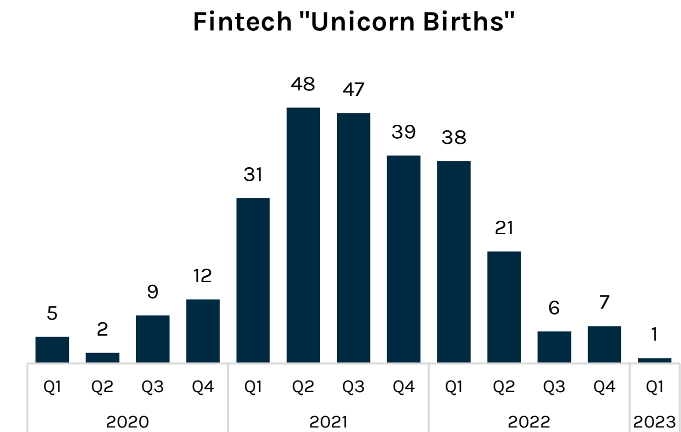
The following three charts do a good job showing the impact of these changes on valuations, IPO activity, and the emergence of new platforms. They also bring us to where the fintech lending industry stands today.

Public Fintech Stock Prices

Source: S&P Capital IQ.



Source: FT Partners, CEO Monthly Market Update & Analysis.



Source: CB Insights.

WHERE ARE WE HEADED?

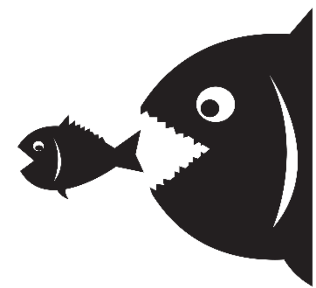
We think the fintech lending industry is about to undergo significant change; one might even use the term *transformation*. We wish to highlight two specific areas where new capital will be needed to facilitate change. These are areas where traditional markets, including banks, are unlikely to provide those capital solutions… and hence the two areas of opportunity for alternative credit investors.

Consolidation Capital

Most fintech lending platforms were never profitable in the first place. Now, with traditional capital sources (e.g., banks, venture capital, IPO market) pulling back from the space, many platforms are simply going to run out of capital and disappear. Younger, smaller, high-growth stage platforms are likely to be hit hardest.

The survivors will be compelled to accept capital at steep valuation haircuts. For example, Ramp recently raised $300mm at a $5.8bn valuation, representing a 28% drop from 2021. In 2022, Klarna raised $800mm at an $8.5bn valuation, representing an 85% drop from 2021.

In such an environment, we would certainly not expect to see many new entrants, given that access to new venture or traditional private equity capital is likely to be curtailed for an extended period as fintech-focused sponsors will need that capital to support and manage their existing portfolio.



We think growth in the industry will consolidate around the healthiest, well-capitalized fintech lenders. These platforms will face the age-old question of “buy vs. build” when they consider their growth options. With many struggling companies whose valuations have returned to earth, buying (vs. building) will likely be a more attractive path to growth and expansion into new product categories. For example, recently Marlette, a consumer lender, bought Till, a rental platform, and Upgrade, a consumer lender, bought Uplift, a buy now, pay later company.

Transformation Capital

It would be hard to overstate the financial impact that the pullback of flow buying from banks and credit unions has had on so many fintech lenders. Not only are origination volumes down significantly, but so are the associated gain-on-sale profits that boosted income and valuations. This has sent many fintech lenders scrambling to find new buyers.

However, this new cohort of flow buyers are demanding different terms than the banks did. This includes requirements that fintech lenders have real “skin in the game” in the form of risk sharing and loss protections. Shocking as it may sound, this is a new concept for many fintech lenders who became addicted to the “originate to sell” heydays of recent years during which banks typically required no risk sharing, no loss protections, and therefore no capital commitment on the part of fintech lenders.

Going forward, we expect that flow buyers will require a contribution of capital, loss protection, and other forms of economic and risk alignment. All of these require capital. Therefore, we expect fintech lending platforms will be looking for new partners who can provide strategic capital, or capital to buy loans, or both.

In fact, the VC and PE sponsors of many fintechs are rethinking business models and how they intend to support (or not) their portfolio companies. The emphasis today is more toward strategic rather than opportunistic decisions. Existing platforms must show a path to profitability if they expect to receive growth capital. Turns out positive earnings matter after all, and lender valuations tend to migrate back to book value (or perhaps a slight premium to book value). Go figure.

Sector Spotlight: Fund Finance

It's been hard to miss the headlines mentioning fund finance or NAV lending in recent months. The continued adoption of fund finance by asset managers in private equity, real estate, secondaries, infrastructure, credit, and other asset strategies, has been one of the biggest trends within alternative credit during the past few years.

Prior to the COVID pandemic, banks dominated the fund finance market. Most financing took the form of subscription lines. GPs used these facilities as working capital to more efficiently manage cash and capital calls from investors. Some managers effectively use subscription lines as a source of permitted leverage. Risk was mitigated through recourse against uncalled investor commitments.

NAV lending, or fund-level leverage explicitly against the net asset value of the fund, was historically uncommon. Because NAV loans do not benefit from recourse to uncalled LP commitments, only a handful of top-tier managers with fund documents that permit it, have had access to it. Even then, GPs' access to this kind of financing was largely limited to their key bank relationships. Smaller managers faced a significant premium, if they could access NAV financing at all.

In the last 36 months, this entire landscape has begun to transform. A big driver has been the recent emergence of regulatory and risk capital pressures, and new balance sheet restrictions facing banks in the U.S. and Europe. For the longest time, these were constraints with which European banks wrestled. That has since changed, and more recently U.S. banks are now also feeling the pinch. The impact has systematically reduced banks' overall capacity to lend to funds and has increased the overall cost of capital when they do it.

At the same time, we are seeing a dramatic increase in demand from funds. While we will detail below why demand has increased, the fact is that, today, there exists a structural need for fund financing capital, and for non-bank lenders to provide those capital solutions.

Given that, we felt it timely to share our insights into the dynamics that are driving opportunities across various types of borrowers, and the role that banks and non-bank lenders are likely to play going forward.

First, let's explain what we mean by fund finance, which we've separated into four distinct categories defined in the table below:

Term	Collateral	Typical Use of Proceeds
LP Stakes / Secondaries Fund NAV Financing	Loans collateralized by a portfolio of LP commitments	Portfolio acquisition financing, dividend recaps
Single Fund NAV Lending	Loans collateralized by the assets of a single fund	Distributions and follow-on investment financing
Subscription / Capital Call Finance	Uncalled capital commitments from LPs to a single fund	Cash and capital call management (ongoing leverage for some funds)
GP Financing	Management fee streams, co-invest amounts, carry pools, on-balance sheet investments, and other assets of a single GP	GP Commitment/co-invest financing, dividend recaps, succession planning, or other corporate proceeds

Unfortunately, there is no reliable way to measure the overall size of this market. The best information we have suggests that the broader NAV lending market is roughly $100 billion[2] in size. By way of comparison, the subscription line finance market is significantly larger at around $800 billion. For additional context, we peg global private markets' AUM at nearly $12 trillion with additional private capital dry powder of approximately $3 trillion.

These rough estimates suggest that the NAV lending market has a current market penetration of less than 1%. The more mature subscription line financing market has a market penetration of ~27%. Thus, it would appear that NAV lending has a lot of room to grow.

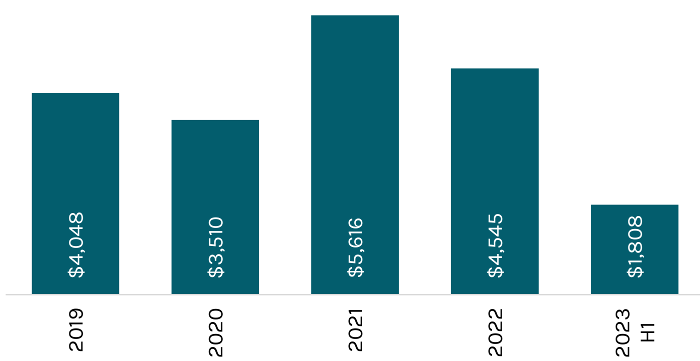
[2] Ares market observations.

Regardless of the amount of white space we might see today, the availability and source of capital in both subscription and NAV financing markets are undergoing significant change.

Outside of the long-term growth of private capital, which itself is a significant driver of fund finance, recent market volatility has been a clear catalyst for demand by GPs and LPs alike:

- *Rising rates*: today's elevated interest rate environment is imposing new cost pressures and limits on the availability of leverage at the portfolio company level.
- *Capital markets dislocation*: markets have become less reliable sources of capital to portfolio companies as market participants grapple with higher financing rates and the implications on valuation multiples.

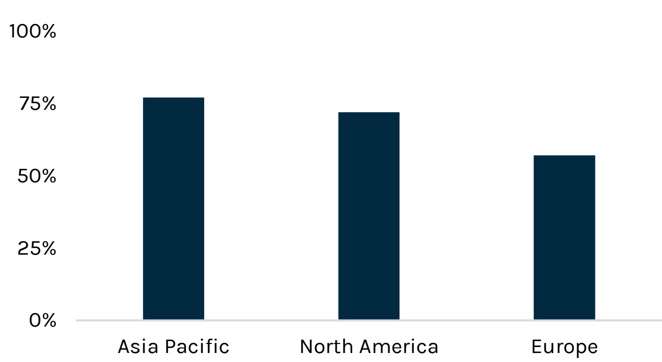
Global M&A Deal Value ($bn)



Source: PitchBook's Q2 2023 Global M&A Report.

- *M&A and IPO slowdown*: with capital markets dislocated, M&A and IPOs have slowed as investors acclimate to the higher rate environment.

Proportion of LPs Citing Lower Distributions Relative to 2022



Source: Capstone Partners.

- *Slowing distributions*: as the M&A market has slowed, funds have seen distributions to investors decelerate. We don't think we've spoken with a single LP who hasn't mentioned this as one of their bigger frustrations.
- *Complex fundraising environment*: large swings in valuations of public markets have forced LPs to reassess their allocation strategies, also known as the "denominator effect," with all the above factors also impacting liquidity management.

For GPs in the middle of their investment period, deployment periods are naturally extending, placing more reliance on the availability of capital in the subscription finance market to manage the working capital of the fund.

However, several banks have withdrawn from this market while others have pulled back having been impacted by exogenous events (e.g., the Russia/Ukraine war). Even banks with capital to deploy are reserving that capacity for only their most important clients (an increasingly common practice today).

On the borrower side, as demand for fund leverage has increased in the face of more limited bank activity, financing terms have evolved to better fit alternative credit capital providers. For example, loan duration has shortened and credit spreads have widened even as base rates remain elevated.

For GPs whose funds are in their harvesting period, asset realization delays continue to get longer, causing distributions to investors to slow. At the same time, GPs are facing decisions on portfolio add-ons, equity injections, and dividend recapitalizations… all of which require fresh capital.

GPs are keen to demonstrate to their investors that they are able to navigate these challenges against a backdrop of a difficult fundraising environment. Having access to financing that enables these GPs to expedite distributions to investors can be particularly helpful where those same investors are being asked to commit to new vehicles. GPs may also require financing in order to pay management fees and fund expenses at times when the portfolio companies are not making distributions to the funds.

Finally, it should be noted that GPs are selective and sensitive in terms of selecting a financing partner to bring into their funds. A deep understanding of the underlying assets, alignment, lender reputation, and a strong lender/borrower relationship are significant factors in GPs' decisions about who they work with and on what terms.

Within this context of rising demand alongside a constrained supply of bank capital, we are excited to see how this market develops and expands, and we are pleased that this sector is garnering more attention from both GPs and LPs who appreciate the relative value these opportunities can present.

The Path Forward

> **"History tells us that all recessions have a default cycle but not all default cycles have a recession."**

I [Joel] have been reminiscing lately about the two summers I spent working in Alaska. My dad, a preacher, had taken a new job in Anchorage during my senior year of high school. As the youngest and last child still living at home, I stayed back in Boise, Idaho, with my mom to finish the school year. I had been to Anchorage only once before, in January of that same year. Alaska had introduced itself to me with a two-foot snowstorm.

Graduation day was a surreal experience: hanging out that night with all my friends, knowing that I would wake up the next morning to begin a 50-hour journey of 3,000 miles on the ALCAN highway… and would never see most of them ever again.

My cousin, Chris, who was a year older and one of my closest friends, joined me for both summers. That first summer, we worked doing landscaping and construction. The second summer, we worked at Sears, a popular department store at the time, selling lawn and garden equipment.

When we were not working, we were playing basketball late into the midnight sun… or fishing. I had grown up fishing during my years living in Oregon and Idaho and had done a lot of fishing with Chris. For Chris, fishing and hunting were a way of life; he is practically a fishing and hunting guide.

Alaska fishing is different – less a pastime, much more an occupation and passion. Given the richness of Alaska's wildlife and the vastness of the state, the choices between freshwater fishing and ocean fishing are just the beginning. The biggest passion is salmon fishing which itself spans four totally different types and runs. One can fish for trophy king salmon. One can engage in "legal snagging" of "reds" or sockeye salmon. There's the "dog run" or pink salmon fishing. Finally, and my personal favorite, fishing and eating silver salmon.

With each type, the fishing is different. Different runs, different areas, different hooks, different bait, different weeks, different regulations… and very different success rates. Also, everything is just *bigger* in Alaska. I remember the very first fish I caught which I thought was a "jack salmon" - a junior king salmon that you must release. However, when I reeled it into the net, I discovered it was actually a 24-inch rainbow trout. I had grown up catching 8-to-12-inch rainbows; I didn't even know they could get that big. Alaska is like that.

Markets this year have reminded me a lot of fishing in Alaska. Different runs, different areas, different weeks. Fishing in the right areas, with the right hook, at the right time, and with enough patience, has resulted in truly amazing opportunities, including a few trophy kings or giant rainbows.

Conversely, like Alaska, the markets are so vast that one can end up fishing in the wrong areas, at the wrong times, or with impatience. There are many with "fishing stories" this year about snapped lines, snagged lures, broken nets or (worse) swamped and sinking boats… due to poor risk assessments or inflexible capital (impeding relative value efforts).

As we have tried to emphasize throughout this edition, we think it's so important right now to check and recheck assumptions, to dig deep in the data, to overcommunicate, and to be diligent about assessing risk and relative value. The extreme bears and the extreme bulls share one thing in common: they are influenced by bias and emotion… and need to *curb their enthusiasm*.

The data clearly shows that we are in the early innings of a default cycle. As we have seen historically with default cycles, a small subset of industries or asset classes tends to bear the brunt of the stress and account for most of the losses; other parts of the market will be less impacted, if at all.

For example, within consumer lending, as we have highlighted earlier, large subsets of subprime and near prime consumers are clearly experiencing a default cycle. Conversely, prime and super prime consumers are as healthy as they have ever been.

Within insurance, there is stress in the property and casualty markets; catastrophe risk and auto insurance have been facing increasing liability payouts from natural disasters and inflation over the last three years. Conversely, annuity providers are enjoying some of their best years ever as higher rates and bank deposit flight have created inflows.

Within corporates, fundamental stresses are appearing within pockets of the healthcare industry; liquidity stresses are afflicting capital-intensive industries like infrastructure. Conversely, most other industries and companies have managed to grow both top and bottom lines despite higher costs of capital and inflationary pressures.

Within real estate, it is clear that commercial office may be the "subprime residential" market of this default cycle; those fundamental stresses only continue to become more acute within bank balance sheets and other owners. Conversely, multifamily and industrial are still very solid despite dealing with higher cap rates; even retail and hospitality are seeing some of their best performance in several years. Residential housing, despite higher mortgage rates and near historical low volumes of sales, continues to enjoy strong home values.

To us, all of this evidence suggests that the coming default cycle is materializing in a *normal* way. I personally still believe we are in for both a credit cycle and a recession given the impact of the steeply inverted curve and credit contraction.

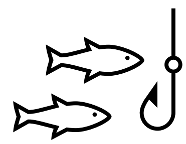
> **"Success means being very patient, but aggressive when it's time."**
> **Charlie Munger**

However, history tells us that all recessions have a default cycle, but not all default cycles have a recession. For example, in the late 1980s, we had Black Monday and the junk bond crisis, but no recession. In the late 1990s, we had Long Term Capital Management, Russian ruble crisis, the Asian financial crisis and the dotcom collapse, but no recession. In 2015, the energy sector experienced a default cycle which was a major event for fixed income and a few banks, but triggered no recession.

The extreme bull and bear advocates have been debating the likelihood of a soft landing or a hard landing, even as central banks fight the parasite of inflation while trying to not kill the host: economic growth. Default cycles are often combined with recessions, but when the constant debate is no recession, soft landing or hard landing, I do get truly confused by all-time high public price-to-earnings ratios and corporate option-adjusted spreads near tights.

As good as the relative value is in some markets, it is equally as bad in other parts of the market. Today, one thing is clear, the difference in relative value among asset classes and investments is as varied as the views on the underlying economies.

Regardless of individual views, there are and have recently been stresses, cracks and dislocations in different markets and asset classes. Regardless of a recession, credit cycles and default cycles are, by definition, cycles.



The ability to have the right type of scaled, flexible capital (fishing rod), with the right relative value lens to create your own opportunities (bait), and the breadth and ability to rotate across assets classes as the markets continue to change (best fishing spot) will lead to truly trophy investments.

We spoke last quarter about sitting on the edge of the water, patiently watching the ripples with a smile on our face. We have now set our hooks even as the fish continue to roll in at an increasing speed.

To quote one of my favorite lines from Charlie Munger, "Success means being very patient, but aggressive when it's time." It begins with preparation and process, but it ends with execution.

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Charity Spotlight

Ares is committed to investing in global health and education to help save lives and drive equality. Ares and the Team's portfolio managers have committed to donate a portion of carried interest profits for certain of the Team's flagship funds to global health and education charities. Given Ares' focus on investing with purpose, each quarter we will highlight a non-profit organization with a track record of delivering value per charitable dollar contributed. Note Ares is not endorsing the non-profit organization, nor has Ares donated to the highlighted charity at the time of this publication.

This edition, we are spotlighting Interactive Research & Development ("IRD"), an organization that we were introduced to through GiveWell (regular readers of *In the Gaps* will recognize GiveWell from prior charity spotlights).

We caught up with the leadership of IRD in recent months and were impressed with the team and the wide breadth of their programs, from tuberculosis screenings and childhood immunizations to mental health screenings and global surgery. Similar to other charities we have profiled in the past, IRD has showcased an ability to work effectively with government and institutional partners to develop, implement and scale interventions. The Team also appreciated IRD's heavy emphasis on research and technical expertise to prove out and maximize their impact.

GiveWell has also been engaged with IRD and was impressed with the organization's operational capacity in high-burden and populous geographies: IRD's willingness to prioritize the cost-effectiveness of their programs and the fact that IRD's leadership and staff are largely made up of individuals from the global South provides them important contextual knowledge that helps address and reduce blindspots.

HISTORY

In 2004, IRD was founded in Karachi, Pakistan by Aamir Khan, MD, PhD (founder and Executive Director) as a not-for-profit organization with a mission towards creating a space that enables innovations in health research.

Now headquartered in Singapore, IRD has since grown its global reach to 15 countries and implements numerous health programs throughout Asia, Africa, and South America, with plans to expand into the Middle East and operates with a $10mm+ budget, primarily funded by foundation grants. True to its origin, IRD continues to maintain a strong presence in Pakistan, with Bangladesh being its second largest focus.

IRD focuses on global health challenges and inequities related to mass screening and testing, treatment, and prevention of myriad indications and diseases (spanning historically high-focus infectious diseases to neglected or underfunded opportunities in non-communicable diseases like mental health).

Their broad array of interventions are encapsulated within several overarching program groups:

1. Maternal and Child Health
2. Infectious Diseases
3. Neglected Tropical Diseases
4. Non-communicable Diseases
5. Global Surgery
6. Water, Sanitation, and Hygiene ("WASH")

Importantly, despite the ~500 global employee base, IRD has continued to orient towards local program staff and maintains strong leadership teams within each locale as the organization expands its footprint.

Ultimately, ideation and the allocation of resources is local employee-driven and donor-driven. For each country IRD operates in, the focus is to find a person or group in the local country that is active in global health efforts. Success is often linked to the ideas that staff on-the-ground have, with IRD's centralized staff focusing on managing resources across the various geographies.

> **"Whether IRD operates a program directly or in partnership with the government depends on the program. Ultimately, it is impossible to operate large-scale programs without government involvement, so all programs are intended to be handed over to the local government. However, IRD typically operates independently when at a smaller scale or starting out with a new intervention."**
>
> **Aamir Khan, MD, PhD**
> *Founder / Executive Director*

IMPACT

The team discussed a few of IRD's numerous interventions and will highlight several programs we found particularly exciting.

Zindagi Mehfooz

One program area in which IRD has successfully developed a large-scale infrastructure is maternal care and childhood immunizations. Working in Pakastani communities with scarce resources, IRD piloted in 2017 *Zindagi Mehfooz* (translated to "Safe Life" in Urdu; or "ZM"), a phone-based immunization program that aimed to improve vaccination coverage, with seed funding from the United Nations Foundation.

According to IRD, ZM represents one of the largest electronic immunization registries in the world and is unparalleled in other large countries. ZM provided lottery-based cash transfers to caregivers to incentivize routine immunizations. **This has allowed them to successfully completed more than 107 million immunizations across 12 million+ children and women (9+ million children and 3+ million women)**. IRD successfully leveraged low-cost technology to improve immunization outcomes and in the process, learned to improve the efficacy of cash incentives in future pilot programs.

Mental Health

In addition to IRD's programs focused on infectious diseases (e.g., tuberculosis, HIV, malaria, COVID, etc.), the organization has also developed extensive programs focused on non-communicable diseases such as mental health that traditionally fall outside the scope of other organizations.

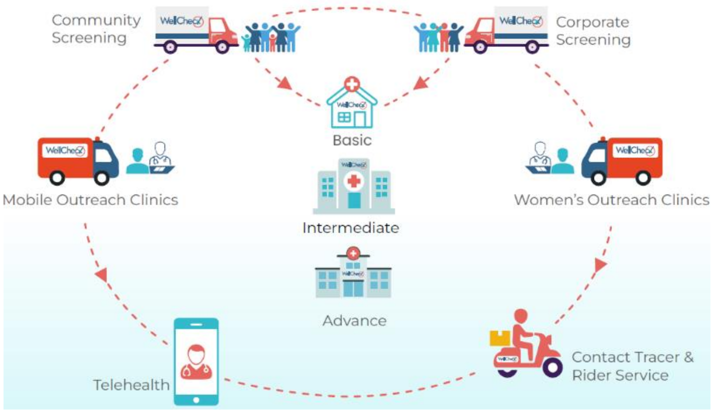
While mental illness is often linked to poverty and is prevalent in South Asian communities, it remains a taboo subject in many societies. IRD's mental health screening and counseling programs in Bangladesh, Pakistan, Philippines, and South America have resulted in **295,000+ mental health screenings, 40,000+ counseling sessions, and 15,000+ enrolled patients,** bringing attention and large-scale resources to affected individuals.

> **Depression affects 86 million people in Southeast Asia. The World Health Organization estimates that almost one-third of people suffering from depression worldwide live in South Asia.**
>
> **Borgen Project**
> *Non-profit focused on addressing global poverty*

WellCheck

WellCheck is IRD's holistic health and wellness program that was rolled out to integrate the organization's many individual screenings and treatments. This allows IRD to operate a large-scale screening program that is more geography-focused.

WellCheck's "Integrated Model of Service Delivery" (shown in the graphic below) describes a network of mobile vans operated in collaboration with local governments. The vans allow IRD to reach patients who lack the ability or resources to go to a hospital or clinic. To date, **7 million+ individuals have been screened for tuberculosis and 270,000+ individuals have been screened for mental health diseases. WellCheck also conducts rapid diagnoses tests for Hepatitis C (170,000+ tests to date) and COVID-19 (300,000+), alongside more comprehensive PCR tests (500,000+)**.



IRD works with and trains local governments in building out the local healthcare infrastructure. The goal is for local governments to eventually take over and fund these programs but in the interim, the not-for-profit organization continues to be intimately involved given the complexity of the models.

FOR ADDITIONAL INFORMATION, PLEASE VISIT IRD's WEBSITE.

KEY STATISTICS

- Immunizations in Pakistan through *Zindagi Mehfooz*: 107 million+
- Women and children enrolled in *Zindagi Mehfooz*: 12 million+
- *Zindagi Mehfooz* Clinics: 2,200+ immunization clinics, with 4,500+ vaccinators
- Mental Health Screenings: 295,000+
- Mental Health Counseling Sessions: 40,000+, with 15,000+ enrolled patients
- Global impact through WellCheck: 250,000+ students and 80,000+ corporate employees
- Targeted school-age children for treatment of intestinal work infections through the Pakistan Deworming Initiative: 17 million
- Awarded grants in the past 3 years: $84 million

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The outbreak of a novel and highly contagious form of coronavirus ("COVID-19"), which the World Health Organization has declared to constitute a pandemic, has resulted in numerous deaths, adversely impacted global commercial activity and contributed to significant volatility in certain equity and debt markets. The global impact of the outbreak is rapidly evolving, and many countries have reacted by instituting quarantines, prohibitions on travel and the closure of offices, businesses, schools, retail stores and other public venues. Businesses are also implementing similar precautionary measures. Such measures, as well as the general uncertainty surrounding the dangers and impact of COVID-19, are creating significant disruption in supply chains and economic activity and are having a particularly adverse impact on energy, transportation, hospitality, tourism, entertainment and other industries. The impact of COVID-19 has led to significant volatility and declines in the global financial markets and oil prices and it is uncertain how long this volatility will continue. As COVID-19 continues to spread, the potential impacts, including a global, regional or other economic recession, are increasingly uncertain and difficult to assess. Any public health emergency, including any outbreak of COVID-19 or other existing or new epidemic diseases, or the threat thereof, and the resulting financial and economic market uncertainty could have a significant adverse impact on the funds, the value of their investments and their portfolio companies. The information herein is as of the dates referenced, and not all of the effects, directly or indirectly, resulting from COVID-19 and/or the current market environment may be reflected herein. The full impact of COVID-19 and its ultimate potential effects on portfolio company performance and valuations is particularly uncertain and difficult to predict.

Graphs are shown for illustrative purposes only.

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