VICTORY PARK

CAPITAL

# VPC Specialty Lending Investments PLC

## Yearly Letter – Fourth Quarter 2018

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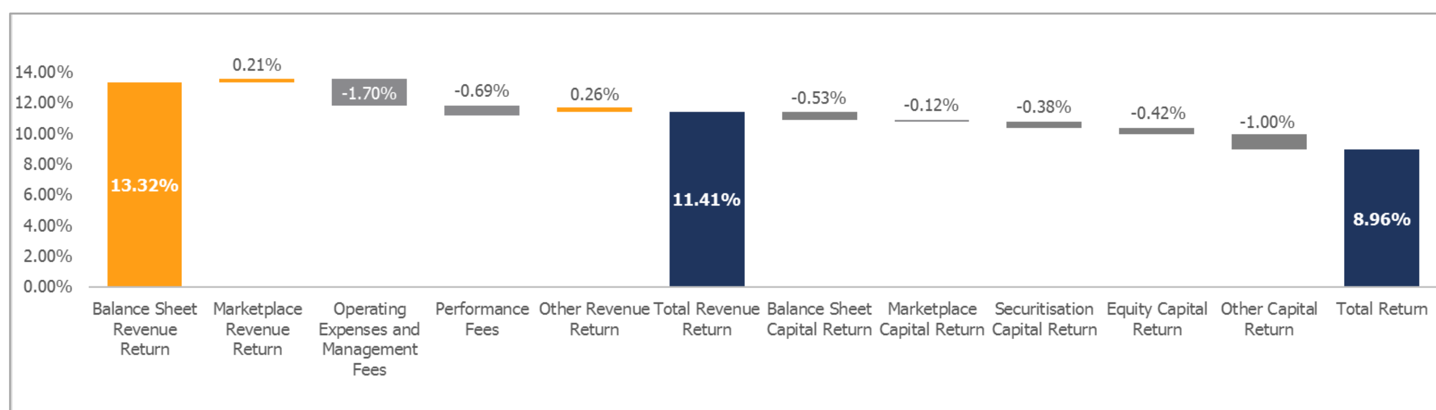
## Year in Review

VPC Specialty Lending Investments PLC ("VSL" or the "Company") finished the year with a total net revenue return of 11.41% and a total NAV (cum income) return of 8.96%. Both of these figures are records for the Company and reflect the results of a portfolio fully transitioned into primarily balance sheet investments. Capital returns of -2.45% were driven by a few factors, including the losses early in the year from the remaining marketplace loans and securitizations, from a drop in the stock price of the Company's equity position in Elevate Credit, Inc ("Elevate") (NYSE: ELVT) and from the cost of the hedging program for the Company which is included in "other capital" below.

Overall, the portfolio delivered strong credit performance and we do not see signs of a broad-based weakening in credit fundamentals at the underlying portfolio companies in which the Company is invested, despite the market volatility we saw across most asset classes during the fourth quarter of 2018. Below is a bridge from gross revenue return from the balance sheet investments to the total NAV (cum income) return over 2018:

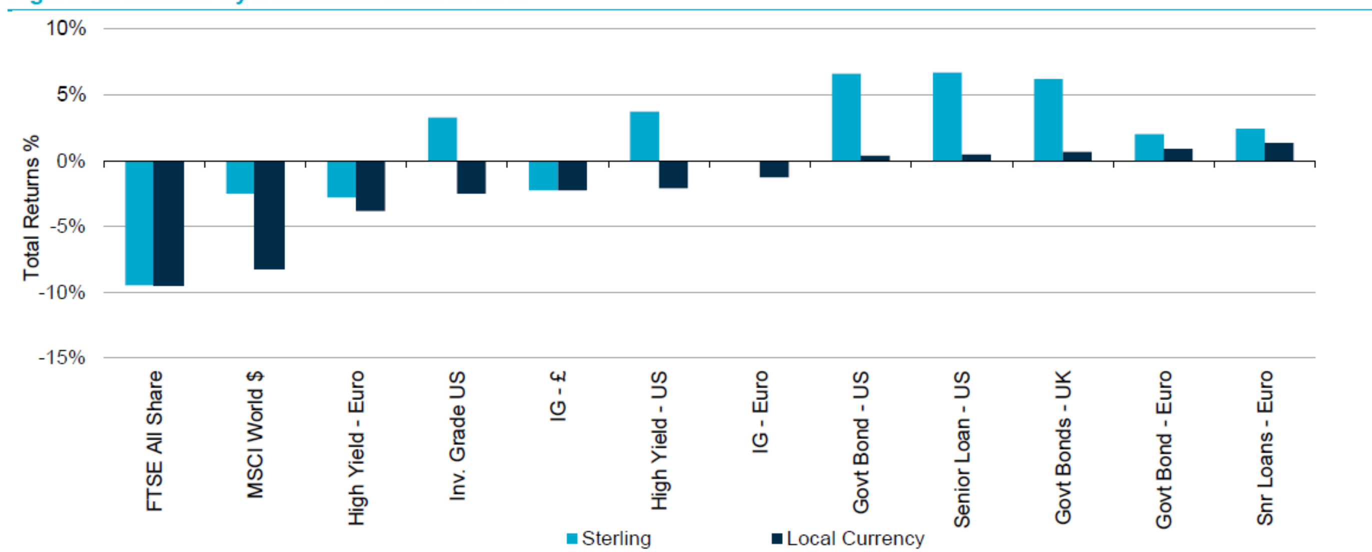
**1 January 2018 to 31 December 2018 Revenue, Capital and Total Return Profile**




Overall, we are pleased with the results from a NAV return perspective but remain disappointed by the discount that the stock continues to trade at to NAV. In order to address this, the Company continued to buy back shares and as of year-end, had purchased a total of 22,504,782 shares. We also continue to use 20% of our management fees to buy shares in the open market and to date, have purchased 2,200,217 shares, making sure our incentives are aligned with the shareholders. The Company's dividend was fully covered for the year by the revenue returns of the Company and as of year-end, the trailing twelve-month dividend yield was 10.16%[1].

[1] Calculated as the total dividends declared over the last twelve months, including the current reporting month, divided by the 31 December 2018 closing share price.

While we prefer to judge the Company on an absolute return basis, as seen below, when compared against other fixed income asset classes, the Company also delivered strong relative value returns.




## Top Ten Positions

Set forth below is a summary of the top ten positions, excluding equity exposure, held by the Company as at 31 December 2018[2].

| Investment | Country | Security Type | % of NAV | Gearing |
|---|---|---|---|---|
| Elevate Credit, Inc. | United States | Balance Sheet | 20.22% | YES |
| Caribbean Financial Group | Caribbean | Balance Sheet | 8.03% | NO |
| LendUp, Inc. | United States | Balance Sheet | 7.33% | NO |
| Fundbox Ltd. | United States | Balance Sheet | 7.24% | NO |
| Applied Data Finance, LLC | United States | Balance Sheet | 6.37% | NO |
| Oakam Ltd. | United Kingdom | Balance Sheet | 5.00% | NO |
| Borro Ltd. | United Kingdom | Balance Sheet | 4.95% | NO |
| NCP Holdings, LP | United States | Balance Sheet | 4.27% | NO |
| Avant, Inc. - Balance Sheet | United States | Balance Sheet | 3.73% | YES |
| FastCash | Caribbean | Balance Sheet | 3.01% | NO |

There has been some turnover in the Company's top ten positions compared to 31 December 2017 as the Company exited several positions throughout the year. We were swiftly able to reinvest the proceeds into new and existing deals. A few highlights are below:

- We continued to increase the Company's balance sheet investment in Elevate as Elevate scales its portfolio, but as previously discussed, we feel comfortable with this position being outsized compared to the Company's other investments because of our longstanding relationship with this company and their long record of outstanding credit performance;

[2] The summary includes a look-through of the Company's investment in VPC Offshore Unleveraged Private Debt Fund Feeder, L.P.

- The Company's position in Borro Ltd. decreased throughout the year as there were partial paydowns with proceeds of both portfolio realisations and asset sales as well as the previously disclosed IFRS 9 reserve on this investment. The investment remains on non-accrual status[3]; and
- As discussed in the Company's November 2018 monthly report, we initiated a new position in both the debt and equity of Caribbean Financial Group. Caribbean Financial Group has a nearly 40-year history of strong credit performance and profitability through multiple credit cycles. At the time of closing, Caribbean Financial Group's Last Twelve Months ("LTM") November 2018 Adjusted EBITDA was $76.2 million. Pro forma for the Company's new capital structure following the acquisition, LTM November 2018 interest coverage was approximately 2.5x.

## Structuring Advantage Versus Other Credit Products

The Company's portfolio benefits from its composition of primarily floating rate senior secured loans, backed by pools of loans with short underlying duration and minimal leverage of 0.16x on a look-through basis for the Company. The benefits of this can be seen when comparing the Company's portfolio to other credit products such as Collateralised Loan Obligations ("CLO's"), which saw significantly increased volatility during the fourth quarter of 2018. Most of the 2016-2018 vintage CLO's are made up of primarily covenant-lite loans with a duration of four to five years and up to 15x look-through leverage for the equity holder. In fact, according to JP Morgan, 82% of leveraged loans originated in 2018 were covenant-lite, up from 12% in 2010[4], even as issuance has exploded from US$157 billion to US$435 billion in 2018[5]. While CLO's have historically exhibited strong underlying performance, their behaviour in the next cycle might look very different than the prior cycle due to the overall weakening of investor protections. It is also worth noting that when you add large amounts of leverage even small changes in performance could have a big effect.

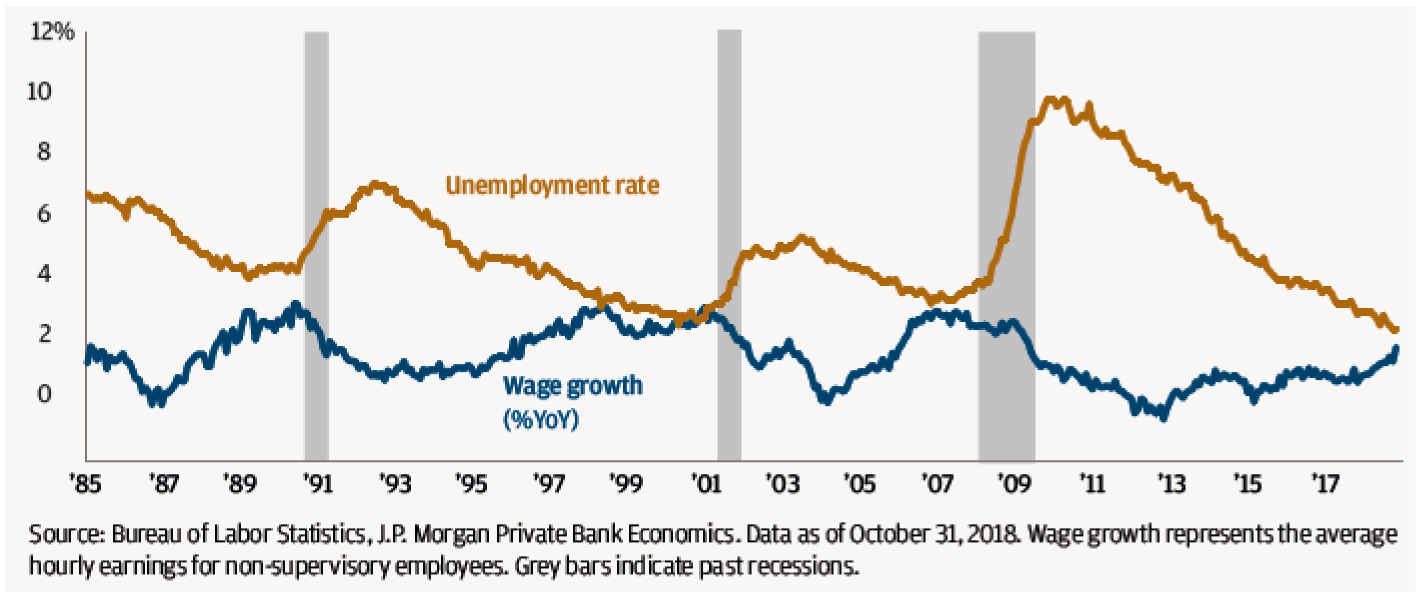
In contrast, VPC has continued to structure investments with tight covenant packages designed for downside protection in a variety of credit environments. VPC is able to do this because we operate in niche markets and do not participate in broadly syndicated deals, allowing us to control the exact make up the Company's portfolio and dictate the terms of investments. These structural protections combined with a disciplined and rigorous credit and diligence process, we believe, is the best form of risk management. We believe that remaining disciplined in our underwriting approach will result in success through multiple credit cycles. We continue to build a strong team, with sourcing and structuring focus, as our investment approach requires a higher touch than simply receiving allocations of broadly syndicated deals.

We believe that the culture and processes that we have developed at VPC are key to generating the positive outcomes for the Company. Our culture promotes teamwork, such that every employee at VPC works as one team, directly benefitting VSL as it is invested alongside our private investment vehicles into our underlying portfolio companies. The collective teamwork of the entire firm produces our results, instead of one or two portfolio managers. This includes not only our investment team, but also our risk management and operations professionals, who are integral to our overall investment process.

[3] The Company stopped accruing interest in the accounts for the Borro investment when the initial IFRS 9 provision was made in January 2018
[4] Source: JPMorgan Leveraged Loan Index Cov-Lite Market Weight
[5] Source: Bank of America Merrill Lynch Cov-Lite Issuance data from S&P LCD

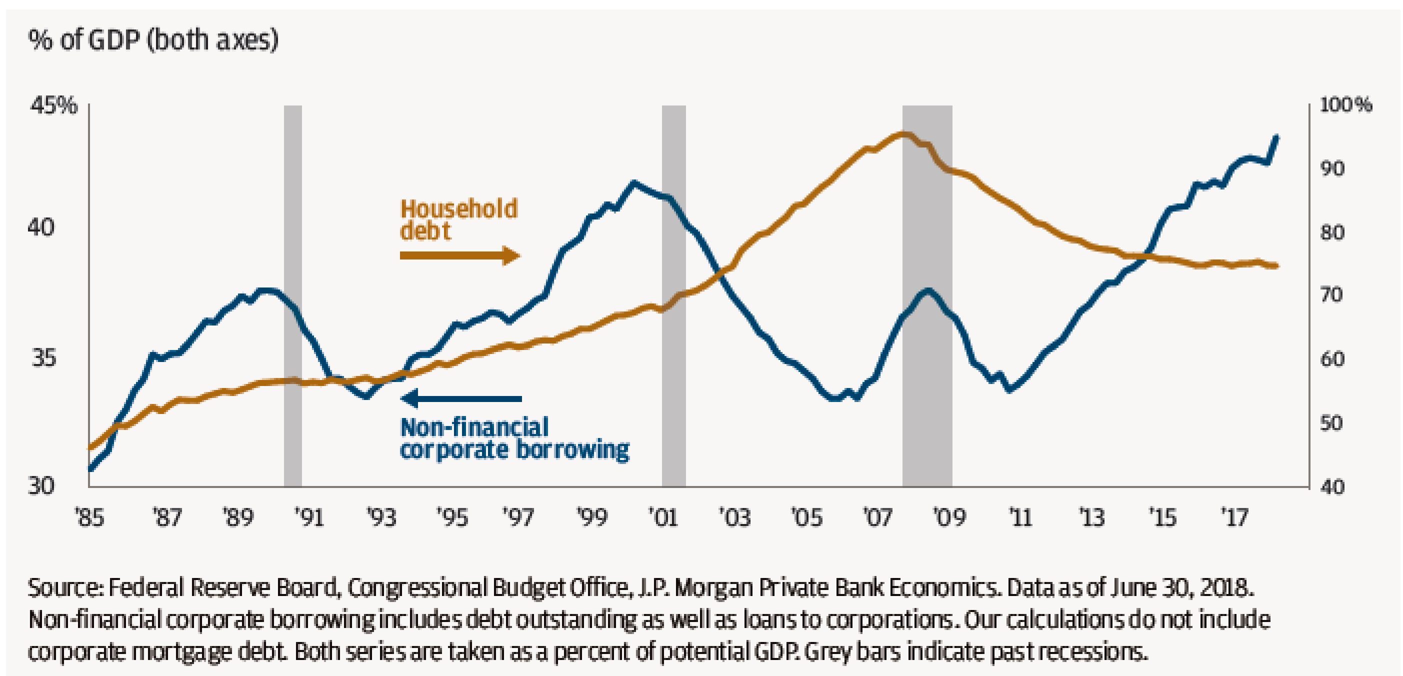
## Macro Update and Outlook

Overall, we are approaching 2019 in a broadly similar position as that to which we entered 2018. We are taking a conservative approach to credit, while also not being overly bearish on the position of the US consumer and small business market. In the US, the unemployment rate continued to reach new lows on the back of strong GDP growth and the effect of the 2017 tax cuts, ultimately flowing through to businesses. The tight labour market has put upward pressure on wages leading to an overall healthy outlook for consumers in 2019.




Source: Bureau of Labor Statistics, J.P. Morgan Private Bank Economics. Data as of October 31, 2018. Wage growth represents the average hourly earnings for non-supervisory employees. Grey bars indicate past recessions.

The same trend can be seen in overall household debt in the US, which has moderated and continued to decline as a percentage of GDP from its peak prior to the last recession. Corporate borrowing has increased significantly, which poses other risks to the economy. However, from an asset class standpoint, we reiterate our earlier point that this is most likely to have a larger negative effect on other areas of the credit markets than the Company's areas of exposure.




Source: Federal Reserve Board, Congressional Budget Office, J.P. Morgan Private Bank Economics. Data as of June 30, 2018. Non-financial corporate borrowing includes debt outstanding as well as loans to corporations. Our calculations do not include corporate mortgage debt. Both series are taken as a percent of potential GDP. Grey bars indicate past recessions.

Rising wages and the market volatility towards the end of 2018 have also led the Fed to pause on the rate hikes that defined much of 2018, which overall reduces the threat of a shock to the economy from rates rising too quickly. While this might marginally increase the inflation outlook over the medium-term, we do not see this as a significant risk to the Company's portfolio at this time.

On the political front, in the United States, with the House of Representatives moving to Democratic control, and a slew of candidates already entering the 2020 Presidential race, the more likely outcome is that very little happens legislatively for the next two years. Overall, the deregulatory position of the Trump administration has been a marginal positive for the Company's portfolio, but we are not opposed to intelligent and thoughtful regulation in consumer markets. We strongly believe that we are backing the best and most ethical players in the industry, but there is no doubt that there are bad actors that smart regulation helps eliminate.

In the UK the news obviously continues to be dominated by the ongoing Brexit negotiations. From a portfolio perspective the Company, we feel that it is fairly insulated to the impact of Brexit as the vast majority of the Company's credit exposure lies outside the UK, and most of the Company's risk lies in the margin requirements related to the Company's hedging program. With the closing of the Company's credit facility from CapSource, the Company now has a sufficient amount of revolver facility available such that the Company can sustain a further significant drop in the pound without affecting the Company's hedges. The cost of the hedges went up through the year as rates diverged between the US and the UK, but the floating rate nature of the Company's balance sheet deals helped offset a substantial portion of this.

## Stress Scenario Performance and Wind-down Analysis

Investors frequently ask how the Company's portfolio will perform during a recessionary environment. Our risk management team performs regular analysis to stress test individual company lending performance to determine what a downside scenario could look like at the portfolio level. The biggest risk mitigant in the downside scenarios is the first-loss protections that we structure into the Company's balance sheet investments, which ensures the portfolio company and their equity investors capital would have to be fully impaired before a balance sheet facility loses any interest income or principal invested. In the Company's recourse investments, this means the portfolio companies would also lose the cash and other assets that are outside of the borrowing base to cover the first-loss protections. We pride ourselves on our structural protections, risk management and portfolio monitoring as this is an important area of focus that we are constantly evaluating. Since most of the Company's portfolio companies are private, we are prohibited from sharing this analysis publicly, but there is macro data from the great recession that we would like to highlight below.

VSL is invested in numerous asset classes across the credit spectrum from prime to non-prime lenders including consumer, factoring and small business lending. However, through the Company's exposure to Elevate and other portfolio companies, it has a concentration of exposure in the non-prime consumer sector. While to most investors it seems counterintuitive, during the last recession this segment of consumer credit performed the strongest on a relative value basis.

To illustrate this point, below is an excerpt from an internal risk report that we produced to summarize the findings from our stress test analysis:

> *For nearly all the investments being reviewed, the primary driver of collateral value is the loss rates on the underlying loans or leases, measured by cumulative net loss, which considers the total principal losses between a given point in time and the final repayment on the portfolio. While many of the companies*

*and asset classes being reviewed do not have historical performance data going back to pre-2007, macro-economic data is available which can be used as a proxy for the specific asset classes being analysed. One of the most robust and relevant data sets available is from US consumer credit cards – which correlate highly with many of the assets being reviewed, and for which the available data serves as a useful benchmark[6]. Data from the Federal Reserve of Philadelphia[7] shows the following peak to trough increases in default rates in credit card receivables in the US from the benign credit environment of 2004-2006 through the credit crisis of 2009.*

| Risk Score | 2004-2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Peak-to-Trough Multiple |
|---|---|---|---|---|---|---|---|
| Sub Prime | 20.4 | 22.5 | 27.3 | 28.4 | 21.6 | 16.7 | 1.39 |
| Near Prime | 5.6 | 6.7 | 8.2 | 9.8 | 8.2 | 5.7 | 1.75 |
| Prime | 1.5 | 1.7 | 2.4 | 3.9 | 3.6 | 2.1 | 2.60 |

**Category by FICO    Sub-Prime 250-650    Near-Prime 650-710    Prime 710-770*

*As seen in the above table, default rates on sub-prime and near prime consumers (the most heavily represented segments in the VSL portfolio) increased by 1.39x-1.75x. Each portfolio was assessed based on this stress factor range, with emphasis on the more relevant classification (1.39x for sub-prime and 1.75x for near prime). Prime consumer losses increased by up to 2.60x during the same time – this stress factor was considered for portfolios with significant prime borrower exposure, though this represents a minority of the portfolio.*

It is also important to keep in mind that the analysis above is based on static pools of loans, and that the Company's balance sheet investments are dynamic in that the borrowing base is refreshed monthly, making the Company's portfolio less sensitive to individual vintages of loans. The portfolio is made up of both seasoned and more recent vintages, so if a borrower defaults and we are forced to step in and wind down the portfolio at the point of default, the diversity across the vintages should reduce the overall risk of the portfolio. Based on the above and also the work we have done on the Company's individual balance sheet investments, we feel very comfortable with the Company's exposure to the non-prime segment in general, and more specifically to the Company's subset of portfolio companies which we feel are best in class. For more information, we encourage investors to review the public filings of Elevate filed with the SEC, which provides granular details on their credit performance.

## Conclusion

In summary, we are pleased with the Company's record NAV (cum income) return for 2018. However, we recognize that to close the discount on the Company's stock price, investors expect consistent strong performance and a covered dividend. As such, both the performance and dividend of the Company remain as our primary focus heading into 2019, and we feel strongly about the positive outlook for our existing portfolio.

[6] Other asset classes with similarly robust data available include mortgages and auto loans, both of which are typically longer duration and heavily dependent upon the value of the secured collateral. As such, credit cards were deemed a better proxy for the VPC portfolio which is largely comprised of unsecured or "soft" secured receivables with terms of five years or less at origination.
[7] "Working Paper No. 15-08 Credit Risk Modelling in Segmented Portfolios: An Application to Credit Cards" – February 2015

Finally, while the Company had a record year in performance, we are very sorry to note the passing away of our Chairman, Andrew Adcock. Andrew was a man of great integrity and was a valued leader of the Company's board. His contribution to the Company was enormous, and we are grateful for the constructive manner in which he chaired the board. As previously announced, Kevin Ingram, an existing Non-Executive Director and Audit Chairman, will serve as interim Chairman until a permanent replacement is appointed.

Kind Regards,

The VPC Team

26 February 2019

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