VICTORY PARK

CAPITAL

# VPC Specialty Lending Investments PLC

## Quarterly Letter – First Quarter 2020

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## Quarterly Review

VPC Specialty Lending Investments PLC ("VSL" or the "Company") completed the first quarter with a quarterly NAV (Cum Income) return of -2.62%. Revenue returns were 3.39% (2.62p), driven by continued performance of the Company's balance sheet investments, and capital returns were -6.01% which reflect what is hoped will be one-time loss reserve adjustments to incorporate the potential economic changes from the COVID-19 crisis as well as reductions in valuations of our venture equity portfolio, where we utilise public market comparables to estimate fair value. Equity valuations accounted for -3.02% during the quarter, to reflect unrealised valuation adjustments resulting from general market deterioration as a result of the COVID-19 pandemic in addition to the decline in Elevate's (NYSE: ELVT) stock price which is marked to market monthly. Our equity portfolio has been a strong performer for us in recent years and we remain bullish on the long-term prospects of these investments. The equity portfolio remains well diversified with investments in 25 portfolio companies across several geographies and the Company's venture equity investments as a whole remain in an unrealised gain position after these adjustments.

## Top Ten Positions

Set forth below is a summary of the top ten positions, excluding equity exposure, held by the Company as at 31 March 2020:

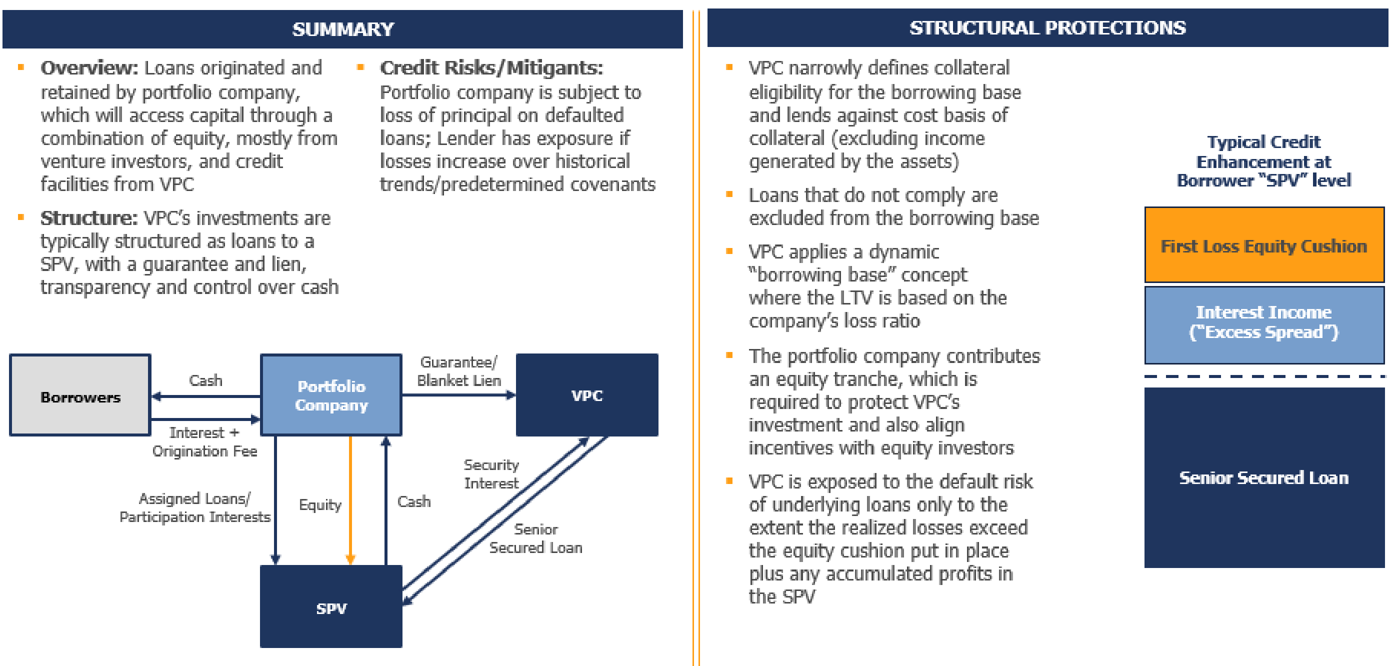
| Investment | Country | % of NAV | Gearing |
|---|---|---|---|
| Applied Data Finance, LLC | United States | 17.32% | NO |
| Elevate Credit, Inc. | United States | 13.23% | YES |
| Caribbean Financial Group Holdings, L.P. | Latin America | 12.32% | NO |
| West Creek Financial LLC | United States | 6.48% | NO |
| ATA KS Holdings, LLC | United States | 5.47% | NO |
| Deinde Group, LLC | United States | 4.20% | NO |
| NCP Holdings, LP | United States | 3.05% | NO |
| LendUp, Inc. | United States | 2.44% | NO |
| Counsel Financial Holdings LLC | United States | 2.39% | NO |
| Avant, Inc. | United States | 2.26% | YES |

## COVID-19 Update

As of this writing, we are eight weeks into what may be the worst economic and social crisis of our lifetimes and the data we have seen thus far gives us reason to be cautiously optimistic that the downside protection structured into our portfolio of balance sheet investments will remain resilient to the shocks we are seeing in the economy. We do not expect a "V" shaped recovery, but instead expect the global economy to remain depressed for an extended period, albeit with lockdowns easing gradually in the coming months. While the future remains uncertain, our investments have been structured conservatively in order to sustain a prolonged and sharp downturn in the economy and early indications have proven that the portfolio is well positioned to withstand the worst impacts of the crisis.

Our cautious optimism is based on the following factors addressed below:

- **Structure**: First and foremost, the Company's deals are structured with first loss cushions sitting below our debt position. Therefore, our balance sheet deals do not take a loss when delinquencies and charge offs increase at our portfolio companies, unless the entirety of the first loss capital is eroded (along with other additional credit enhancements). This aligns incentives and ensures that the portfolio company and its equity owners would take a complete loss before we experienced any loss on our balance sheet positions. At this point, all portfolio companies remain supportive of the respective credit facilities and are current on all interest payments. If this were to change, we would then seek to recover our capital by winding down the underlying loan portfolios and paying ourselves down over time.




- **Loan performance**: The majority of the underlying exposure in the fund is to the U.S. consumer. As of this writing, in early May while we have seen modest deterioration in loan performance, it is not as drastic as might have been expected six weeks ago when quarantines began. Further, all portfolio companies have revised underwriting criteria, the result of which is that originations have been significantly reduced if not completely stopped depending on the company. Given the short duration of the overall portfolio and reduction of originations, our portfolio companies have generated a significant amount of cash over the past eight weeks, which has either been repaid to the Company as a prepayment on the credit facility or remains at the portfolio company and is directly collateralising our investment. In total we have received USD $60 million of prepayments since the beginning of March, USD $25 million of which has been used to pay down part of our revolving credit facility with PacWest in April. We retain the right, but not the obligation, to redeploy this capital back to the portfolio companies on the same terms once the situation stabilises. We will only redeploy capital when we feel completely comfortable it will be used prudently and at good risk adjusted yields.

A few highlights below:

- **Payment Relief**: The earliest indicator of distress across all portfolios is the number of borrowers seeking payment relief. Portfolio companies can offer payment relief in many forms depending on the nature of the product, but this often includes payment deferral or forbearance, revised repayment plans or payment reductions, often resulting from a job loss. We have encouraged portfolio companies to offer fair and transparent options to borrowers both because of the number of individuals facing true hardship, but also because historical data suggests that such programs are the best way to maximise the ultimate collectability of debt. Specifically, borrowers that proactively reach out to seek such relief are demonstrating a willingness to pay in the future (once they regain the ability to pay), which can be a positive signal. In early April, we began to see an increase in the number of borrowers seeking hardship relief, though over the past several weeks that trend has slowed significantly and seems to be levelling off. While it varies by platform, the range of portfolio hardship relief is approximately 2%-12% across the consumer portfolios, which is consistent with broader industry data and compared to 0%-6% pre-COVID-19. While this represents a decrease in the credit quality of the portfolios, current trend levels suggest a less severe impact than many predicted and that the impact is likely to be manageable from the perspective of the Company's investments. Lastly, while we do not discount the possibility that these trends may still worsen, given the short duration of the underlying portfolios, time is on our side and each week that goes by without accelerating deterioration allows each of these investments to further de-risk and de-lever.
- **Borrower Delinquency and Payment Rates**: Aside from borrowers seeking payment relief, overall delinquency rates have remained relatively stable, if not decreasing, and as a result the overall payment rates on the underlying portfolios have continued to generate significant amounts of cash, reducing VPC's net portfolio exposures across the portfolio. Similar to modification trends, payment rates have improved in the second half of April compared to the beginning of the month. While we can only speculate on the cause, the unprecedented level of government support for individuals in the U.S. has likely played a role in stabilising the finances of the underlying borrowers.

- **Strong points:** While there is no guarantee it will continue, some credit segments of the portfolio have held up particularly well at this point in the crisis relative to the broader impacts. In particular, we have seen consumers prioritising payments on debt associated with specific purchases, particularly where they have made a down payment on the purchase, such as with our point of sale financing companies (Sunbit, Cognical, West Creek). The legal lending platforms (ATA-KS Holdings LLC, Counsel Financial) have also been strong performers, which we expect will remain uncorrelated to the overall economy as the underlying loans are to law firms secured by highly diversified contingency fee receivables and other claims which are not dependent on economic growth.
- **Portfolio Company liquidity**: Portfolio company liquidity is a significant factor for ensuring that each portfolio company can meet its contractual obligations under the credit facility. In the vast majority of our balance sheet investments, (>93% of balance sheet exposure) we are secured not only by our direct portfolio collateral, but also by a guarantee from the portfolio company. This guarantee often includes additional

assets beyond those that are counted towards the borrowing base of the credit facility, including significant cash balances in excess of the cash required under the credit facility. Furthermore, in some instances, excess cash balances represent a significant percentage of the Company's investment exposure making it highly unlikely we would experience a loss regardless of underlying loan performance.

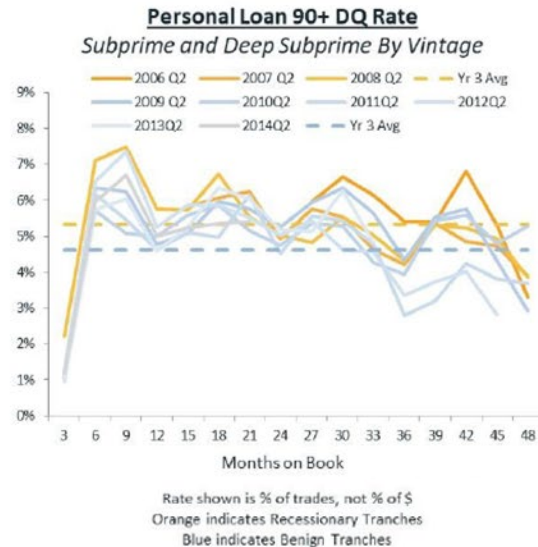
- **Sponsor support:** If we see a sustained downturn with losses beginning to approach the level of the financial crisis, the equity holders of a small number of our portfolio companies may need to support the business with more capital. In this instance if a sponsor chooses not to invest more capital we would then enforce our rights at which point we can decide to 1) operate the business as a going concern 2) attempt to raise equity from a new sponsor to recapitalise the business or 3) to wind down the portfolio and seek recovery on our secured debt. While we have structured our deals assuming a wind down, in all cases we would prefer that the portfolio company continue operating, assuming our position is adequately collateralised, and we are being compensated for the risk. Continuing operations is the best outcome for employees, customers, unsecured creditors and secured creditors alike. We have intentionally partnered with well capitalised sponsors to ensure in a scenario like this they would have the means (if not the intention) to support the business if necessary. Given the unprecedented situation that has developed in the past eight weeks, and while not necessary immediately, in certain cases we have begun having these discussions should an equity injection become more necessary in the coming months. While we do not consider equity support in any of our valuation scenarios, as of now we are optimistic that certain sponsors will likely be supportive of their platform companies should the situation worsen in the coming months in order to avert a portfolio liquidation.

## Expected Credit Losses

During March, we felt it was prudent to increase our estimate of expected credit losses on the Company's balance sheet investments by 2.55% (£6.9 million) to 4.33% of the Company's gross balance sheet investment portfolio, which reflects revised loss given default assumptions of loan performance over the next 12 months. Our accounting is the same standard used by commercial banks to determine the level of losses estimated to occur over a 12 month period depending on a range of scenarios. As of the date of this letter we have sustained no permanent losses of capital and all portfolio companies are current on interest payments, but given the unprecedented situation our valuations have been updated to account for the likelihood of a severe and sustained recession similar to the 2008 Financial Crisis. Given the high levels of credit support we have in the portfolio, historically in most cases we have not carried a loss reserve against most performing positions as the structural protections would be expected to absorb any foreseeable losses, even in times of stress. Given the current circumstances and ensuing uncertainty over what the next 12 months might look like, we have revised our modelling assumptions to reflect a 100% likelihood of a stress scenario, which assumes a significant level of incremental stress beyond the amounts witnessed thus far and comparable to loss rates on similar asset performance during the 2008 Financial Crisis. Our updated reserves reflect the possibility that some of these portfolio companies may default in the future under such adverse scenarios (hopefully this is not the case), and there is some probability we may not fully recover on the investment.

These reserves are calculated using a probability weighted estimate of losses that could reasonably be sustained if a portfolio company defaulted and we were forced to seek recovery by winding down the underlying collateral. Our loss reserves are based on the default performance on similar asset classes during the 2008 Financial Crisis and

include credit support from portfolio company assets we are secured by outside our direct borrowing base, as discussed above. These reserves also include operating reserves for the cost of winding down the portfolio including an estimate of legal and servicing costs that would occur in a downside. During the 2008 Financial Crisis peak loss rates on U.S. consumer credit ranged from 1.15x to 2.60x base case losses on a portfolio level based on the type of product and the credit quality of underlying debtor. We have used these historical data points to inform our current loss reserve estimates.




| | Benign Loss Level[1] | Recession Loss Level[2] | Recession Scalar |
|---|---|---|---|
| Prime and Superprime | 0.47% | 0.97% | 108% |
| Near Prime[3] | 2.27% | 3.19% | 41% |
| Subprime and Deep Subprime | 4.62% | 5.34% | 16% |

1. Avg 90+ DQ rate across benign vintages measured at MOB 25-36
2. Avg 90+ DQ rate across recession vintages measured at MOB 25-36
3. Near Prime chart included in Appendix 2

The change in our reserves reflects the immediacy of the onset of the current crisis as well as the increased likelihood of stress in the portfolios over the next 12 months, and we are making these changes to our loss reserves now with a view to expected additional stress to come. In the coming months, we will continue to modify these reserves as the situation develops and we receive additional information but we believe our downside scenario incorporates a significant level of stress that we have not yet seen within the portfolio. If the situation improves, we would then release these reserves over time.

## Risk Management Response

From early March we began to take a more active operational approach to working with and advising our portfolio companies' management teams through the crisis. The VPC risk team with direction from senior management is working with each individual portfolio investment team to develop a coordinated response across the entire portfolio. This includes daily internal meetings to address specific updates and issues as well as a full portfolio review twice a

week. With the benefit of some hindsight, we believe these initial steps along with the daily information we receive on the underlying portfolio have proven invaluable to properly manage the risks due to the current crisis.

A few specific steps we have taken are outlined below:

- **New Lending**

  The first and possibly most important step we took was to coordinate rapidly with portfolio companies to revise underwriting and originations strategies to ensure that any new originations were only being made to the most creditworthy customers. This resulted in a decrease of new originations of approximately 75-95% depending on the platform. Underwriting credit is fundamentally about using data signals to assess and price risk. Under the circumstances, it quickly became clear that the data sources that typically inform underwriting decisions (i.e., income and employment information, credit bureau data, etc.) were no longer providing relevant, accurate and timely signals and thus few lenders could adequately assess and price risk across any sector of the economy. Considering the short duration of the underlying loan portfolios, if a platform ceases new lending, cash begins to accumulate inside the SPV's quickly. As we anticipated this would happen, we waived prepayment penalties so that portfolio companies could repay our debt, therefore taking risk off for our investors and saving on interest expense for the portfolio company. In all cases we have retained the right to redeploy this capital on the same terms in the coming months if we feel it is appropriate. Since early March, we have received USD $60 million of prepayments on the Company's balance sheet investments, of which we have used 1) USD $25 million to pay down the PacWest credit facility (which we can redraw in the future) 2) made opportunistic investments into our Legal Finance strategy which is uncorrelated to the economic outlook and 3) the other proceeds we retained for new investment opportunities or to redeploy into existing portfolio companies. Additionally, in almost all cases (even after the paydowns) the cash levels within our SPVs have continued to grow, which we expect to continue in the coming weeks, ultimately de-risking our investments.

- **Data**

  In the normal course of our portfolio management process we receive a significant amount of data and reporting from our portfolio companies, including loan tapes and payment statistics directly from the servicing systems. Usually we require this information at least monthly and in some cases more frequently. In light of COVID-19, we increased our overall communication with portfolio companies as well as the frequency of obtaining additional detailed data and reporting. Our portfolio companies have been very cooperative in a collaborative effort to achieve the best outcome. We are currently analysing several gigabytes of data daily through our internal risk systems to identify trends that allow us to make timely decisions as the situation develops.

- **Collections/Modifications**

  We have also worked closely with our portfolio companies with regard to collection and borrower contact strategies. This includes: (a) ensuring companies have adequate resources to manage collections and servicing of the portfolio, including geographically redundant call centres and remote employee access, (b) developing fair and transparent hardship relief options (as referenced above) which allow the portfolio

companies to provide relief to borrowers facing difficulty, but also positioning the portfolio companies to maximise the collectability of those loans once borrowers regain the ability to make payments and (c) generally making sure that portfolio companies are employing best practices in servicing the portfolio. In certain instances, we have brought in external collections experts via a third-party consulting firm with deep expertise in consumer credit and collections to ensure portfolio companies further enhance collections capabilities. While the situation we are facing is novel, there have been many instances of natural disasters which disrupt regional economies and believe this historical data can provide insights regarding best practices, including:

- Borrowers ending modification in a crisis performed significantly better than borrowers that miss payments in normal times, which can be used to ascertain a lower bound expectation on collectability.
- Borrowers taking modifications during a crisis had almost half the losses of borrowers taking modifications during normal times.
- Borrowers who were not modified but became delinquent in a crisis had a similar propensity to roll to default as those populations did in a non-crisis. This supports the notion that taking a modification is a strong positive signal compared to simply not paying.

## New Investment Opportunities

We have spent the majority of our time the past two months managing the existing portfolio to minimise the risk COVID-19 poses to the portfolio, however, it has also become clear that the coming months will provide us with some of the best investment opportunities we have seen in years. As we have often stated in our past letters our market has become increasingly competitive in recent years, and we were happy to be refinanced from opportunities where others were willing to add more risk. The situation has now quickly reversed, and we believe that we are well positioned to capitalise on opportunities in the near future. In addition to redeployment opportunities into existing deals and any opportunities for extensions, amendment fees or pricing changes within our existing portfolio, below is a summary of a few opportunities we see ahead:

- **Secondary Market Opportunities:** The most actionable and near-term investment opportunities are in secondary market loan pools and in traded Asset Backed Securities (ABS) backed by pools of consumer and small business loans. There are billions of USD in public ABS deals backed by assets similar to our existing portfolios which have sold off materially since the onset of the crisis, in addition to direct purchases of loan pools at significant discounts. We see a large opportunity to invest in rated securities with significant asset cushions below them at yields ranging from 10% to 25%, depending on the underlying performance. Many of the deals (both securities and loan pools) are made up of assets originated by former portfolio companies or other originators where we know the management teams. Given our existing strong analytical capabilities and expertise in the asset classes we are uniquely positioned to capitalise on the opportunity. We have been actively analysing these deals and hope to make new investments in the coming months.
- **New balance sheet deals**: We believe our pricing power on new deals has increased significantly since the onset of the crisis and we expect this to be a lasting effect. In the past month alone we have received a number of interesting calls on new deals where pricing and structure expectations have changed dramatically from pre-COVID and we are pursuing a number of them as we speak. This includes several former portfolio companies we were refinanced from, which we now have the opportunity to finance again.

- **Legal Lending Strategy**: Over the last few years, VPC has applied its asset backed lending approach to non-correlated assets including legal sector investments backed by direct law firm loans and pools of law firm loans backed by contingency fee receivables and other assets, which are a different form of cash flow receivable. We believe these assets are not correlated to the overall economy as they are based on the outcomes of large-scale litigations and provide for some diversification to traditional consumer and small business loans. Similar to our specialty finance strategy, we do not pick individual litigations or contingency fees, but instead back strong management teams and lend at low LTVs against cross collateralised pools of receivables thereby reducing risk. This is a natural extension of our existing strategy and presents a good opportunity to invest with strong risk-adjusted returns. Our investments in ATA-KS Holdings, LLC (name is not disclosed due to confidentiality requirements) and Counsel Financial are two examples of investments in this strategy. The crisis has caused a pull back by some of our competitors and we continue to identify excellent non-correlated investment opportunities that we believe are a strong fit for the Company.

## Conclusion

While we will never be happy with a negative NAV return during a quarter, given the circumstances of the past two months we feel our conservative approach to credit makes our portfolio reasonably resilient to the extreme economic shock caused by the COVID-19 crisis. We view our updated expectations of credit losses to be conservative and we do not expect them to be recurring in this magnitude, although we will continue to update them based on new information and data we receive over time. Our revenue meanwhile has remained strong as our portfolio companies continue to make timely interest payments. As cash builds in the portfolio from de-risking we expect to be able to reinvest at very attractive risk adjusted yields. We are also optimistic that over time our equity portfolio will continue to drive strong IRR's as many of our high growth investments continue to meet or exceed our expectations at underwriting. Please feel free to reach out the team anytime if you have any additional questions or concerns.

Kind Regards,

The VPC Team

7 May 2020

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