

5,500 years old & the next big thing – asset-based finance



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Private credit encompasses a dizzying array of strategies – from well-understood corporate direct lending to more esoteric music royalties, fund financing, litigation finance, and real estate credit. Direct lending remains the center of gravity. For allocators looking to build out large scale private credit portfolios, where to go after direct lending can be a challenge. We believe asset-based finance (“ABF”) is the answer – a truly scalable opportunity that focuses on income generation and capital preservation.

Private credit has been around for about 5,500 years by our count, and the original credit investments were ABF investments in the form of agricultural financing. But the breakneck growth and associated column inches are a more recent phenomenon. The market as we know it today developed in three stages.

Private Credit 1.0

In the 1990s and 2000s, middle market direct lending was generally controlled by the European investment banks and some of the mid-tier US Investment Banks. There were a handful of asset managers (Highbridge, Cerberus, Ares, Golub, and Antares) leading the initial salvos against the banks, but they represented a rounding error within the broader levered credit market. Then came the Global Financial Crisis (the “GFC”) in 2008.

Almost two decades on from the GFC, it’s easy to forget the extent of the chaos. The global financial system avoided collapse, but banks needed to shed distressed assets quickly. Asset managers began raising private equity-style drawdown funds to acquire and work out deeply distressed assets. This heralded the beginning of private credit 1.0.

In the years following the GFC, the introduction of Dodd Frank in 2010, the adoption of the leverage lending guidelines and the Volcker Rule in 2013, and the European sovereign debt crisis which went on for longer than we care to remember (2009-2014) set the stage for widespread bank disintermediation and Private Credit 2.0.

Private Credit 2.0

With traditional middle market banks finding it harder to do business, slowly, direct lenders transitioned from the lenders of last resort to sponsors’ first call. Every time the broadly syndicated market shut, direct lenders were there to support sponsors with capital – whether from Q1 2020 through Q1 2021 driven by the COVID-19 pandemic or 2H 2022 through 1H 2023 driven by the Fed interest rate hiking cycle.

This capital stability has largely cemented direct lending as the solution of choice for many sponsors. And in 2024, despite the broadly syndicated market being open, -84%ⁱ of leveraged buyouts were financed in the direct lending market. Sponsors seem to appreciate the convenience, the privacy and, most of all, the dependability of a private solution.

Private Credit 3.0

For allocators, overcoming the governance hurdles to build a private credit portfolio is no mean feat, particularly in a public pension context. Despite this, institutional adoption of private credit has continued apace as investors see the benefits it can bring to institutional portfolios. While direct lending typically forms the cornerstone of these portfolios, we believe asset-based finance can offer similar scalability and downside protection with limited correlation to existing corporate exposure.

The largest part of the ABF market involves lending against or purchasing loans to consumers. These loans can be either secured, as in residential mortgages and auto loans, or unsecured as with credit cards, installment loans, and leases. ABF finances everyday consumption by consumers and small businesses – the backbone of Main Street.

As banks have pulled back from originating these loans, non-bank finance companies have stepped in. Cash is inventory for non-bank lending platforms. Because they don’t have the benefit of bank deposits, non-bank originators have historically relied upon a combination of public securitization markets, bank-provided asset-based warehouse facilities, and programmatic asset sales to banks, credit unions, and insurance companies to replenish the cash inventory on which their businesses rely. As in corporate lending, a secular shift from public and bank solutions to private asset-based solutions is underway, driven by:

- The introduction of Current Expected Credit Losses (CECL) methodology in 2019 meant that banks must provision for loan losses at the initiation of each loan, rather than after a loss is incurred, which made it less profitable for banks to own ABF assets.
 - The 2022 rate hiking cycle temporarily closed the public ABS markets, and reduced banks’ willingness to provide committed warehouse financing.
 - The 2023 regional banking crisis caused a flight to quality (and to the money market) for bank deposits, hampering regional banks’ ability to create credit.
- These drivers are accelerating the growth of the private ABF opportunity set and have set up what we believe to be long-overdue private capital formation in the space.

Evaluating risk in ABF

Most people would agree that a company, with customers, products, and financial statements, is a safer credit bet than a typical consumer. A consumer can get fired, get sick. Life can be treacherous.

We agree that one consumer may be risky. Consumer credit portfolios, however, are typically highly diversified, comprising potentially millions of individual assets. This diversification generally reduces volatility in performance when assessed at the portfolio level. Successful ABF managers can delve into decades of historical performance data to assess how these assets will perform. Accessing and analyzing large, proprietary datasets is a key source of potential alpha given that relatively few managers can demonstrate true data science capabilities.

Risk management is also supported through transaction structures. ABF transactions typically amortize rapidly given the nature of the underlying assets, versus the bullet payments at maturity that are common in corporate credit. These amortizing cash flows generally drive shorter duration in ABF when compared with corporate credit and allow ABF investments to continue generating cash when the capital markets are closed as assets self-liquidate.

While diversification can limit performance volatility, structuring successful ABF transactions requires building in sufficient margin of safety to absorb increased losses in dire circumstances. ABF investments are generally structured to withstand GFC-like stresses, which speaks to the downside protection which investors expect from the strategy.

Takeaway for institutional investors

We estimate that private credit capital formation has grown to approximately \$2.5 trillionⁱⁱ, of which ABF represents -18%ⁱⁱⁱ, leaving meaningful room for growth. We expect demand to propagate for this type of capital and commensurate supply growth from institutional investors as familiarity with the asset class increases.

Estimated Corporate Credit Market^{iv}



Estimated Asset-Based Finance Market^v



Private Market sizing^{vi}

With the right partner, we believe asset-based finance has all the hallmarks of a core investment for institutional allocators:

- A large addressable market that allows allocators to invest in size
- Broad exposure across the US economy
- Consistent income generation
- Stable returns focused on downside protection
- Low of correlation with existing public and private markets exposure

In choosing a partner, we recommend investors look for:

- Direct sourcing – avoid “tourist” managers
- Track record of underwriting excellence including data science capabilities
- Scaled operational and capital markets efforts to ensure robust cash management and access to lowest cost financing

ⁱPitchbook LCD

ⁱⁱPrivate credit capital formation = Size of private markets in corporate credit (iv) + size of private markets in Asset-based Finance market (v)

ⁱⁱⁱ4% private markets exposure * \$11 trillion / private credit capital formation

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^{iv}With Intelligence, Private Debt Investor, Preqin, NAIC, Morgan Stanley Into the Great Unknown November 19, 2023, Private Equity International: Sizing the NAV finance market December 1, 2023, company websites, MSI research Q4 2023.