Asset-based finance: private credit’s key diversifier

Private capital is increasingly being used to finance consumer spending. Banks are lending less to many areas of the real economy, including the most important one: consumers, who accounted for nearly 68% of US gross domestic product in the first quarter. For investors, we think this is an opportunity to boost return potential and diversify private credit portfolios.

By *James Sackett*

Disintermediation in the banking sector has been a constant since the global financial crisis forced banks to repair their balance sheets and comply with stricter regulations. These changes have helped drive the remarkable growth of direct middle market lending into a $ 1.5 trillion market, according to Preqin, and the foundation of most private credit allocations.

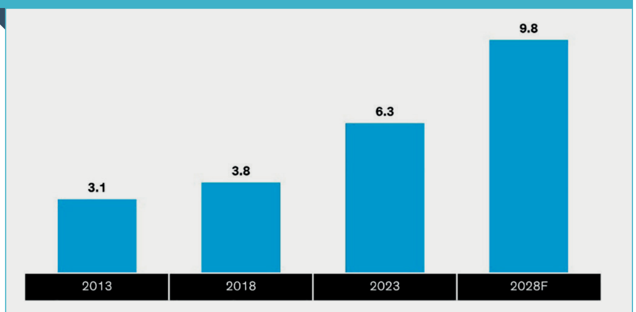
But it isn’t only corporate lending that banks are cutting back on these days. Over the past 15 years, US and European banks have sharply reduced lending to consumers and small businesses. The retrenchment has gathered speed since soaring interest rates increased deposit flight and mark-to-market losses on asset portfolios, notably at regional US banks.

Fuel for the real economy

Yet this broad form of consumer lending, known as asset-based finance, helps to power the real economy. At an estimated $ 6.3 trillion, the nonbank lending market is many times larger than the one for corporate direct lending, and it provides much of the financing for residential and commercial property, cars, credit cards, small business loans, commercial equipment and a variety of niche sectors, including revenue streams tied to intellectual property royalties.

Even so, asset-based finance has remained underrepresented in investor portfolios – a phenomenon we attribute to the breadth of the asset class and the limited number of private credit

FIGURE 1: SPECIALTY FINANCE’S RAPID GROWTH (IN USD TRILLIONS)



Source: Global Monitoring Report on Non-Bank Financial Intermediation, Financial Stability Board (2013, 2018 data); Integer Advisors (2023 and 2028 estimate); Preqin and S&P Global Representative AUM excludes dry powder.
As of June 30, 2023
Past performance and current analysis do not guarantee future results.

ILLUSTRATION: SHUTTERSTOCK

managers capable of navigating the opportunity set. That may soon change. According to one estimate, the size of the market – sometimes called specialty finance – will swell to almost $ 10 trillion by 2028 (Figure 1).

A diversifier for direct lending - and more

Asset-based finance involves the purchase, origination or financing of assets sourced through specialist lenders. There's a broad range of sectors within the core segments. Investments often comprise hundreds – and sometimes thousands – of underlying collateral assets or loans.

Along with a contractual cash flow that provides diversification across borrower and credit profiles, key characteristics include:

- **Fully amortizing asset profiles:** Principal is returned over the life of the investment.
- **A hedge against inflation:** Investments are often secured by tangible assets that increase in value when prices are rising.
- **Ample cushions:** Loans are typically made at a discount to underlying asset value or contractual cash flows.
- **Additional lender protections:** Transactions are directly originated, negotiated and structured to include important lender protections, including borrower covenants and requirements stipulating that originators hold a certain percentage of the loans they make and buy out any defaulted loans.

These features may also help to diversify exposure to other assets, both public and private. This includes direct lending to middle market companies and core public-market holdings such as high-yield corporate bonds and the S&P 500.

At the same time, asset-based finance assets offer an appreciable yield premium due to their limited liquidity and, in some cases, complex lending arrangements. Specialty loan pricing for auto loans and credit cards in the US and UK, for instance, is often above 20%. Yields on US direct lending, as measured by the Cliffwater Direct Lending Index, stood at about 12% at the start of the year, while public credit assets such as US and European high-yield debt hover between 6% and 7.5%.

Spanning the Atlantic

The way we see it, North America and Europe are the two largest and most accessible markets in the global opportunity set today. But understanding the nuances and specifics of each asset class in each jurisdiction is the key to success.

North America is the more mature market: it's bigger, deeper and more homogeneous. Data on underlying loan collateral are widely available, lending and legal frameworks are standardized, and specialty lenders are well established across the main asset classes, including autos, credit cards and private student loans.

The market in Europe, on the other hand, is more varied and smaller. Data quality varies. Legal regimes differ by country. We think this helps to explain why many private credit managers active in specialty finance focus on opportunities in the US and Canada.

We think inefficiencies create opportunities for managers with the experience, capabilities and relationships needed to navigate individual European markets. Sizable exposure to markets on both continents, in our view, can increase diversification and make it easier to uncover attractive relative value opportunities across a wider opportunity set.

Asset-based finance, in our view, stands today where corporate direct lending did a decade ago. We expect rapid and sustained growth to follow. With restrictive regulatory capital legislation putting banks on the back foot, specialist lenders should continue to grow and seek more scalable private credit financing solutions. For investors, we think it adds up to an increase in potential return and downside mitigation, and an opportunity to diversify their overall credit allocations. ■

James Sackett

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SUMMARY

Disintermediation in the banking sector has helped drive the remarkable growth of direct middle market lending.

Asset-based finance helps to power the real economy, but remains underrepresented in investors' portfolios.

Asset-based finance provides fully amortizing asset profiles, a hedge against inflation and ample cushions, among other lender protections.

Sizable exposure to markets in both North America and Europe can increase diversification and make it easier to uncover attractive relative value opportunities across a wider opportunity set.