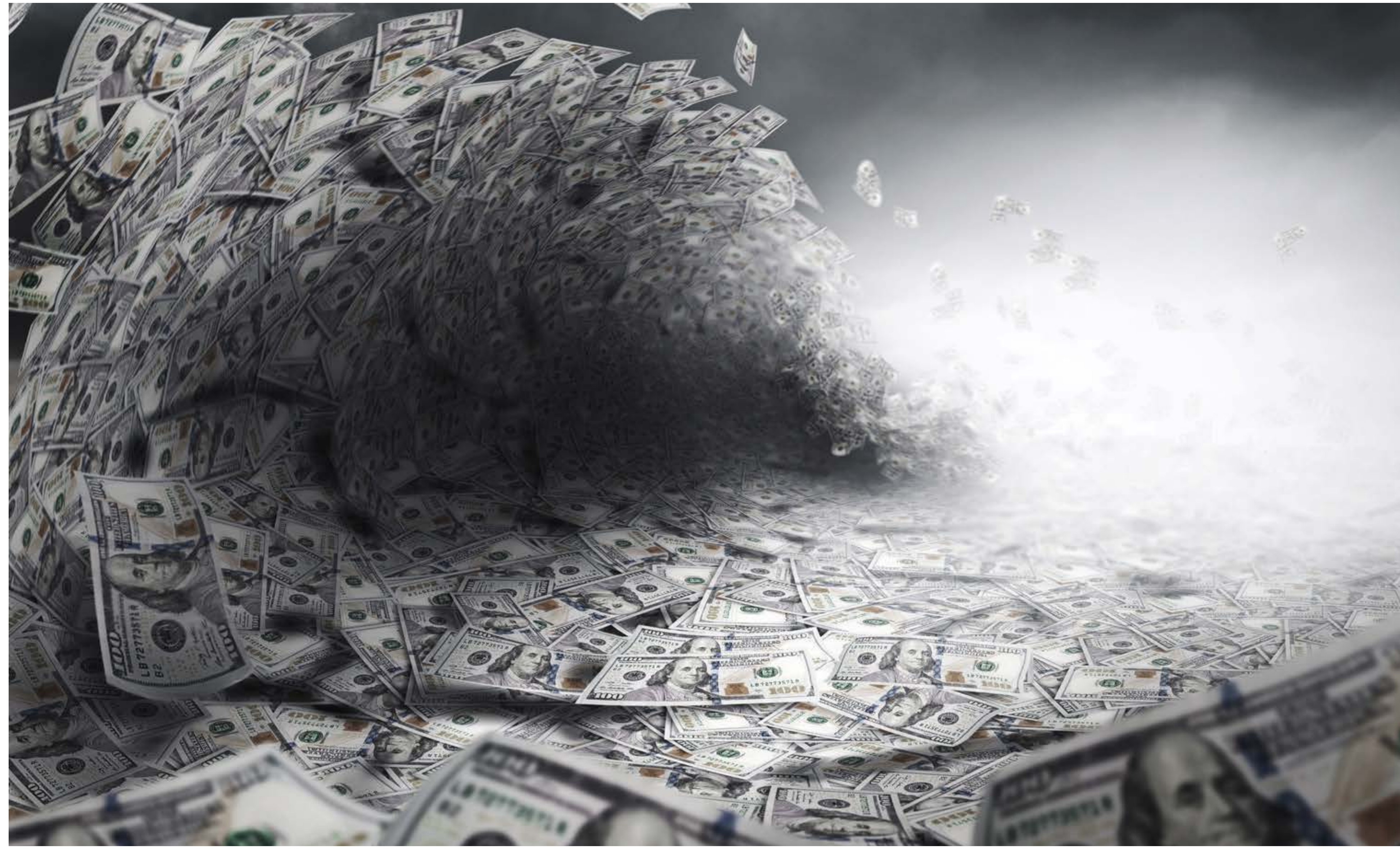
Riding the wave

Asset-backed finance (ABF) has been the success story of the year. *Kathryn Gaw* looks at the current ABF landscape and asks where the asset class goes from here



TO SAY THAT ASSET-backed financing (ABF) is a rapidly growing market would be an understatement. According to KKR research, by the end of 2022 the ABF asset class was 67 per cent bigger than in 2006 and 15 per cent bigger than it was in 2020. KKR expects the market to grow from its current size of $5.2tn (£4.1tn), to $7.7tn by 2027. Goldman Sachs believes the ABF market is already worth more than $15tn.

Whatever its true value, there is no denying that its growth has been astronomical, thanks to a combination of demand for non-bank finance and investors' need for yield.

The rise of ABF began in the immediate aftermath of the global financial crisis, when new regulations led banks to pull back from non-mainstream lending activities or those requiring higher regulatory capital. This created the space for alternative capital providers to step in and plug the funding gap. ABF soon emerged as a financing solution that appealed to both borrowers and investors.

At its core, ABF is lending that is backed by collateral, and whose repayment comes directly from those secured or ring-fenced cash flows. Investors appreciate the extra layer of security that comes from the collateral; while borrowers appreciate the accessibility of ABF during a time when bank funding is extremely difficult to come by.

Today, around a third of this market is financed by non-bank lenders, according to Oliver Wyman data. Among those non-bank lenders are the alternative asset managers who have been honing their ABF skills over the years, and are now expanding their footprint in the market.

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In the year to date a wave of new ABF strategies and products have hit the market in response to soaring demand.

In January, the TCW Group established an ABF business supported by capital commitments of more than $1bn. Channel Capital Advisors launched a new asset-backed private credit strategy for borrowers in the "innovation economy". Ares Management announced a $1.5bn joint venture to fund prime new vehicle leases with Certified Automotive Lease Corp. Around the same time, SEC filings revealed that Pacific Investment Management Co (Pimco) had raised more than $2bn for its asset-based lending strategy over the summer months.

Meanwhile, in September the ABF-structured RoundShield Fund V closed with more than $1bn – around $150m above its target. The response to this fund was so strong that RoundShield is planning to a sixth iteration soon.

"Banks have shifted towards more mass market products like retail mortgages and retreated from more capital and operationally intensive speciality finance," says Toni McDermott, chief investment officer, credit and lending at Arrow Global.

"This has created an opportunity for those private credit providers with the necessary experience and operational capability to fill the gap."

According to Oaktree Capital's latest quarterly performing credit report, ABF is fast becoming the domain of alternative asset managers.

"As traditional lenders face further headwinds, we believe the next chapter in the private credit story is the migration of ABF toward alternative capital providers," said the report's authors Armen Panossian, co-chief executive and head of performing credit, and Danielle Poli, managing director and assistant portfolio manager at Oaktree.

"While the asset class isn't new – lending against contractual revenue streams has historically been a cornerstone of bank and insurance company activity – the fundamental transition lies in who now provides the capital."

Private credit fund managers certainly have the funds and the expertise to fill this financing gap. But expertise is the key word. As ABF becomes an ever more significant part of the private credit sector, the ability to manage the risk of asset depreciation and borrower defaults will become paramount.

"In order to properly manage what can be operationally intensive assets and mitigate the risks of possible covenant breaches or defaults

ALTERNATIVE CREDIT INVESTOR
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in the future, asset management should also be a key focus of any GP investing in ABF, and indeed of any LP evaluating managers in the space," says Hayley Stewart, director, investor relations at RoundShield.

Arrow's McDermott agrees, describing ABF as "granular and local, requiring operational capability, relationships and risk experience built up over many years."

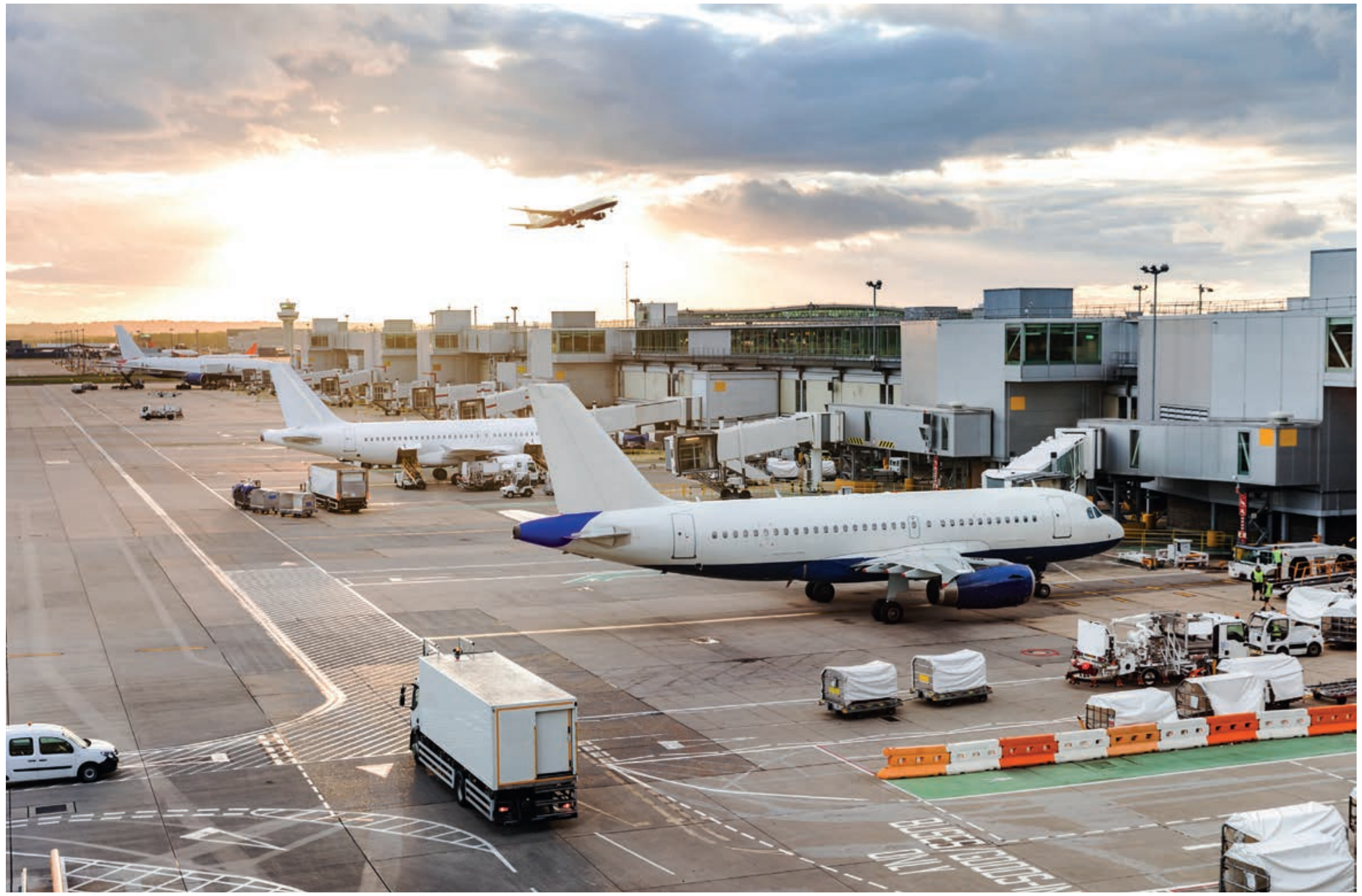
ABF is a very broad church, encompassing an endless range of assets which are being financed in increasingly creative ways. But the quality of an ABF loan can vary wildly depending on the nature of the underlying asset, and the ability of the fund manager to correctly price in the risk. This means that LPs are even more reliant than usual on the expertise of their GPs at a deal level.

"For LPs, the focus should be on selecting the right manager, considering experience and length of track record in the sector, as well as experience in enforcements and/or workouts to feel secure in the manager's capability to protect capital and deliver returns," says Stewart.

"Further, LPs should consider the risks of entering into ABF sub-categories that might be inherently too niche, and where returns might disappear with capital inflows."

This is an incredibly specialised industry with a diverse array of assets underpinning each deal. This diversity makes it hard to compare like-for-like portfolio risk, so there are no shortcuts when it comes to investor due diligence. However, that same ability to diversify also adds to the appeal of ABF.

"We have been supporting GPs across auto loans, credit card receivables, trade receivables, mortgages, small- and medium-sized



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enterprise loans, equipment leases, aircraft leases, residential solar, litigation finance, maritime leases, royalties, and more," says Kanav Kalia, director at Oxane Partners. "Diversification has been the key theme across these portfolios."

"Diversity is important and not to get lulled to sleep by synthetic diversity," adds Kyle Asher, managing director and co-head, alternative credit solutions at Monroe Capital.

"You have to have diversity across asset classes and a number of different transactions. We're very much believers in diversity, and have to set up our business that way to ensure we can do a lot of different transactions because ultimately, sometimes there's just things you can't predict, no matter how much work you do and how much structuring you do, because it's real life and it's investing."

The legal complexity of structuring transactions and ensuring accurate valuation frameworks can be immense. This is particularly true in the European market, where ABF is still a relatively new concept. Unlike in the US, the banking systems and capital markets infrastructure in Europe are fragmented, so financing assets in Europe requires local language, market, regulatory, tax and legal expertise. But savvy fund managers can use these challenges to their advantage.

"This fragmentation and supply-demand fundamentals gives rise to opportunities which Arrow has positioned itself to capitalise on through longstanding ownership of local best-in-class lending and investment franchises," says McDermott. "The US market has a more unified landscape, which can simplify ABF transactions, making them more competitive."

As ABF has grown on both sides of the Atlantic, innovation has come to the fore. In order to set themselves apart, GPs are introducing new structures and covenants into their ABF deals, and moving into even more niche areas.

Channel Capital recently participated in an ABF funding round for FlapKap, an Abu Dhabi-based fintech which provides revenue-based finance and embedded finance solutions. In this particular ABF deal, the asset is the revenue.

"The underlying revenue contracts and flows are the principal form of repayment to fund investors," explains Walter Gontarek, chief executive and chairman of Channel Capital Advisors.

Gontarek believes that ABF should be "self liquidating" and so he is reluctant to sign off on loans secured against real assets such as yachts or cars, which could be difficult to locate and sell on in the case of a default.

"There are different types of collateral which would have different impact on the valuation of your ABF," he adds.

Meanwhile, Monroe's ABF business covers everything from equipment leasing, to media royalties, to real estate, and – more recently – asset covered transactions including digital infrastructure elements.

The recent influx of ABF-themed products and services suggests that we are only at the beginning of the ABF growth story. More and more borrowers are seeking out non-bank lending solutions, while investors are prioritising higher yields with better downside protection.

Even the notoriously risk-averse pension funds are starting to allocate into ABF strategies. In July, the California Public Employees' Retirement System committed more than $1bn to an asset-based finance strategy managed by Sixth Street Partners. Some industry experts now believe that pension funds represent the future of the segment.

"We're seeing interest from some of the larger pensions and more sophisticated investors," says Asher. "Some of that's driven by their advisors that tend to be a little bit more forward thinking. We're seeing significant interest from those types of folks."

"Institutional investors like insurance companies and pension funds are seeking to diversify their private credit exposure beyond corporate debt," adds Kalia.

"Private ABF allows investment managers to tailor portfolios based on risk and return profiles of investors."

ABF's appeal is obvious, but as it becomes a more significant pillar of the private credit sector, the asset class will face more scrutiny. Poor due diligence or a lack of specialised knowledge will eventually expose the bad managers, while the good managers will be able to harness the current momentum and carve out a lucrative space in the market.

"I think we're in the initial innings of the investor interest in the asset class," says Asher. "I think it's going to grow significantly from an institutional investor standpoint. I think it's going to be a large investor focus for probably the next seven or eight years and beyond."

As the asset class matures, it will continue to attract capital from a wider range of investors who will bring their own innovations and niche assets to the table. In a challenging financial landscape, ABF seems to have something to offer everyone. ■