Asset-Based Finance: Private Credit's Key Diversifier

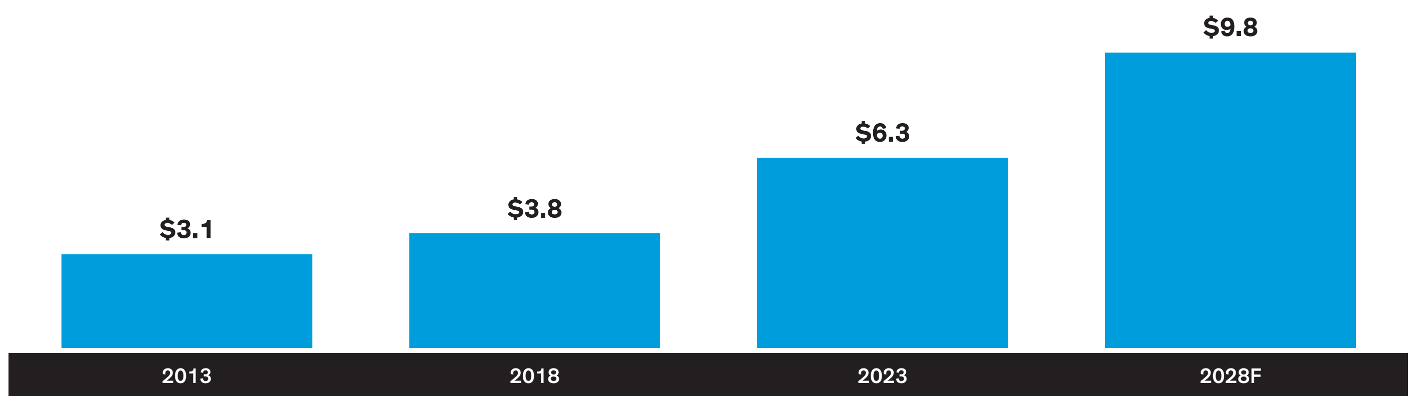
Amidst increased regulation in the wake of the Global Financial Crisis (GFC), AB CarVal believes there has been a systemic shift in global financing markets as banks have curbed their lending activities across various segments of the real economy, presenting an opportunity for private credit managers. Over the past 15 years, this bank disintermediation has been most apparent in the growth of direct lending, though we believe this extends far beyond corporate lending.

Asset-Based Finance (ABF), also commonly referred to as specialty finance, is an asset class that underpins the funding requirements of the real economy, providing financing for residential and commercial property, cars, commercial equipment, credit cards, aircraft, individuals and small businesses. Investments span a breadth of non-corporate sectors from consumer to commercial, with underlying collateral types including financial (e.g., loans, leases, receivables) and/or real assets (e.g., residential/commercial properties, aircraft). While banks have been the primary source of capital in ABF markets, we see bank disintermediation creating an opportunity for private credit managers to play an increasingly important role. Today, it is estimated that non-bank ABF lending activities combine into a $6 trillion+ global market, exceeding the size of the direct lending ($1.2 trillion) and private equity ($6.1 trillion) markets[1]. Furthermore, we expect the private ABF market will continue to grow to nearly $10 trillion by 2028, spurred by further bank regulation in both the US and Europe.

Despite the scale of the asset class, ABF has remained under-represented in investor portfolios, which we attribute to (1) the breadth of the asset class and the limited number of private credit managers who are capable of navigating the opportunity set, and (2) unlike direct lending, a relative lack of visibility to banks' sustained withdrawal from the market since the GFC. Recently however, it appears that ABF is garnering increasing interest from investors as they recognize the attractive investment attributes and seek diversification from private corporate credit allocations.

FIGURE 1: $6.3 TRILLION GLOBAL SPECIALTY FINANCE MARKET

(Trillions)



Source: 2013 and 2018 data sourced from FSB Global Monitoring Report on Non-Bank Financial Intermediation 2023 and reflect EF2. 2023 and 2028 Forecast are sourced from Integer Advisors and are as of June 30, 2023.

1 Source: Preqin and S&P Global Market Intelligence. Represents AUM excluding dry powder. As of June 2023.

A Diversified and Credit-Remote Profile

- ABF involves the purchase, origination or financing of a variety of credit assets sourced through specialist lenders, which encompass everyday financing activities critical to a functioning modern global economy. The core segments of the asset class can be broken out into consumer, residential and commercial as per *figure 2* below.
- ABF consists of a broad range of sectors within each of the segments, providing significant diversity inter-sector and opportunities to assess relative value at different points in an economic cycle.
- At a more granular level, ABF investments often comprise pools of hundreds if not thousands of underlying collateral assets or loans, each with contractual cash flows, providing investors with significant intra-asset diversification across borrower and credit profiles.
- Furthermore, in addition to the diversified cash-flowing profile of the underlying collateral, ABF investments often possess a number of structural features that can mitigate risk and importantly differ from corporate direct lending:
    - **Credit remote—**loans are typically made with a haircut to the underlying asset's value or contractual cash flows, therefore offering credit support from investment inception which together with strong borrower profiles and low default rates deliver a protected credit profile.
    - **Fully amortizing asset profile—**principal is returned over the life of the investment as opposed to waiting for a realization event (e.g., company sale or refinance) with a corporate loan. As a result, investments automatically de-risk over time.
    - **Lender protections—**bespoke structural protections, asset security and covenant packages across each investment provide enhanced credit support.
    - **Inflation hedge—**investments are often secured by tangible assets which typically increase in value during inflationary periods, providing downside protection. Most ABF loans are floating-rate which provide natural protection against inflation.
- ABF underlying asset pricing is not normally subject to traded market forces and is therefore not directly correlated to overall risk asset price direction.
- The result of ABF's distinct characteristics is a differentiated return profile that may exhibit low correlation with other core asset classes (*Figure 3, page 3*).

FIGURE 2: ABF INVESTMENT OPPORTUNITIES

Consumer	Residential	Commercial	Esoteric
Unsecured Consumer Loans	Specialist Residential Mortgages	CRE Senior & Mezz Lending	Music Royalties
Auto Loans	Bridge/Development Loans	Leasing and Factoring	Drug Royalties
Credit Card Receivables	Re-performing Mortgage Loans (RPLs)	Equipment Finiancing	Litigation Finance
Student Loans	Second Lien Mortgage/Home Equity Loans	Trade Finance	Life Settlements
Home Improvement Loans	Buy-to-Let Mortgages (BTL)	Small Business Loans	Reinsurance
		Transportation Finance	

■ Core □ Opportunistic

Source: AB CarVal

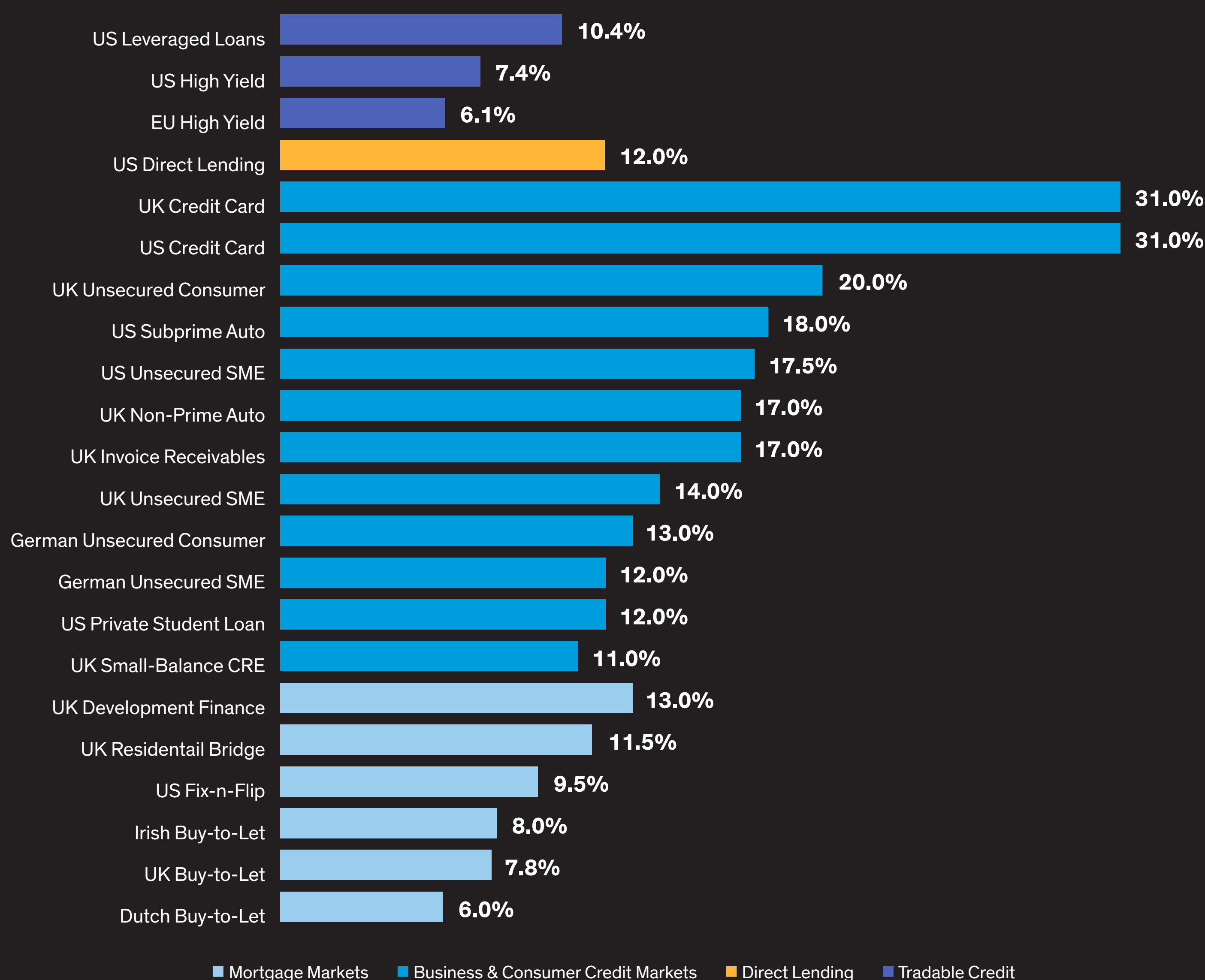
FIGURE 3: CROSS-MARKET CORRELATIONS OF ABF ANNUAL RETURNS

	Private Debt	Direct Lending	Private Equity	Leveraged Loans	High Yield Bonds	S&P 500	ABF
Private Debt	—	0.71	0.68	0.48	0.42	0.67	−0.14
Direct Lending	0.71	—	0.38	0.61	0.67	0.48	0.23
Private Equity	0.68	0.38	—	0.13	0.29	0.65	0.10
Leveraged Loans	0.48	0.61	0.13	—	0.90	0.63	−0.03
High Yield Bonds	0.42	0.67	0.29	0.90	—	0.71	0.22
S&P 500	0.67	0.48	0.65	0.63	0.71	—	−0.03
ABF	−0.14	0.23	0.10	−0.03	0.22	−0.03	—
Average Correlation	0.47	0.52	0.37	0.45	0.54	0.52	0.06

Source: Private Debt—Preqin Private Debt Private Capital Quarterly Index, Direct Lending—Cliffwater Direct Lending Index (CDLI), Private Equity—Preqin Private Equity Private Capital Quarterly Index, Leveraged Loans—Morningstar LSTA US Leveraged Loan Index, HY Bonds—ICE BofA US HY Index. ABF—AB CarVal's ABF composite track record. Reflects correlations of returns from 2010-2023.

ABF Yields Reflect an Illiquidity Premium

Relative to traded credit such as high yield bonds and leveraged loans, underlying ABF asset markets offer an appreciable yield premium, with relatively few exceptions. This can be thought of as premiums for illiquidity and/or complexity, in effect compensating investors for the non-vanilla formats of such private investments. Specialty loan pricing is also typically reflective of the supply/demand imbalance for alternative finance in the given market, rather than any risk asset market technicals or sentiment. Loan yields can be especially significant in liberal credit regimes with lightly regulated lending segments.



Source: ABF yields sourced from Integer Advisors and are indicative as of December 31, 2023. U.S. Leveraged Loans reflects YTM of the Morningstar LSTA US Leveraged Loan Index, U.S. and EU High Yield reflect ICE BofA High Yield Index Effective Yield (US and European, respectively), Direct Lending reflects the yield of the Cliffwater Direct Lending Index (CDLI) all as of December 31, 2023.

An Evolving Market Opportunity

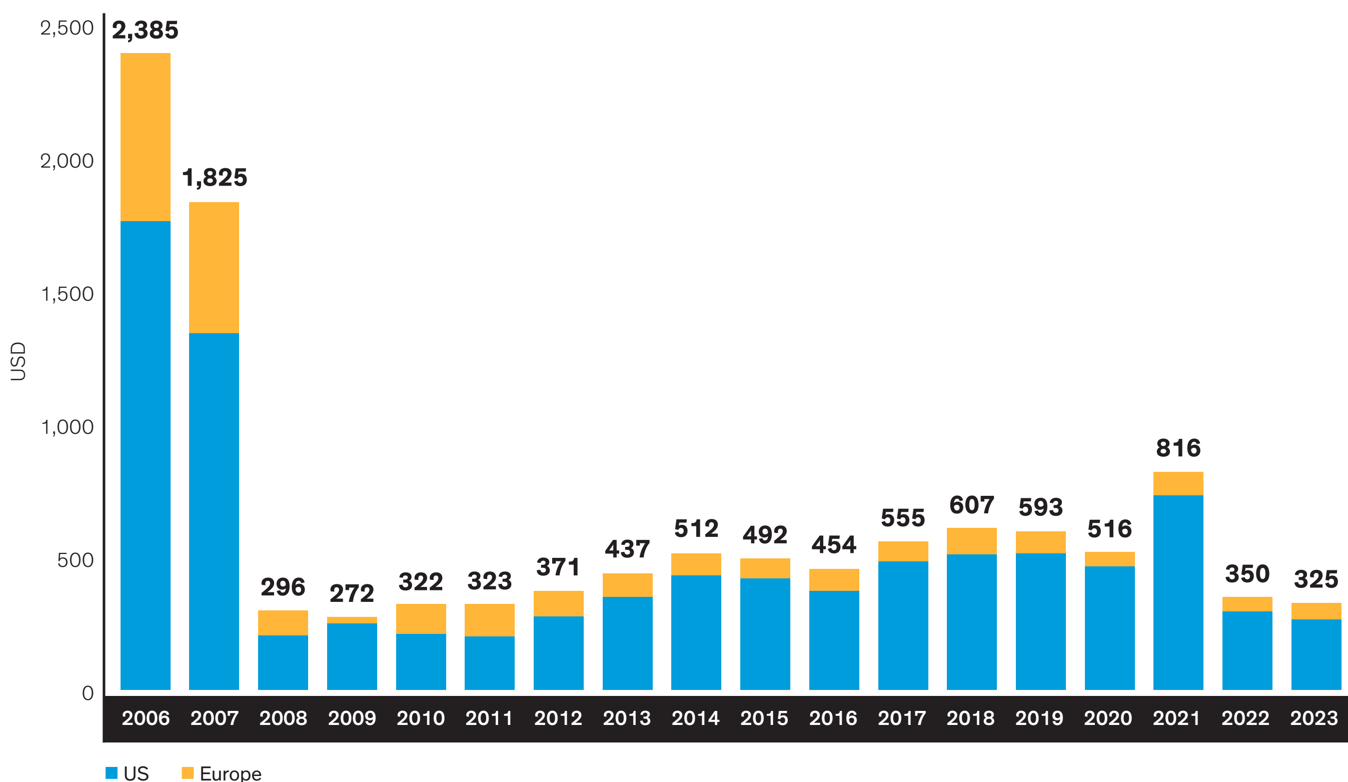
Historic Growth Driven by Systemic Change

Examining the evolution of the ABF market, we believe the key inflection point occurred in the aftermath of the GFC. Central banks across the major developed economies provided historic levels of support to the banking sector to prevent market collapse. This primarily took the form of quantitative easing, which provided swathes of liquidity via the purchase of asset-backed securities (ABS) and other bonds. A consequence of this support was stricter oversight of the banking sector in the form of tougher risk, capital and liquidity requirements under numerous policy-maker initiatives to include Dodd-Frank in the US and the Capital Requirements Directive (CRD) in the EU; in particular, levying higher capital charges on lending to consumers and small-to-midsize businesses. The natural reaction by banks was to focus their lending activity on their strongest customer relationships and deepest/safest asset classes, leaving huge numbers of creditworthy borrowers in a credit vacuum. This dynamic was a key driver for growth in the ABF market as talented lending teams gradually left the banks to create a new cohort of asset-focused specialist lenders in an attempt to fill the market void. Separately, it's important to note that technological advances were also paving the way for the growth of a non-bank lending market, as these nimble financing businesses were often able to more easily embrace new systems than the traditional banking sector.

The substantial drop off in bank originated ABF loans is demonstrated by non-corporate ABS issuance pre- and post-GFC. While market dynamics dictated that origination levels were lower across the market in the immediate fallout from the GFC, materially lower issuance levels since, we believe, have been in large part due to the surge in private capital flows as the new source of funding for specialist lenders, aside from tightening of the securitization regulatory regime that served to marginalize market activity. Private credit managers, like AB CarVal, have played an important role in the growth of ABF by providing capital solutions to these specialist lenders to support their originations; in doing so, securitization is now typically used selectively as a complementary funding tool as opposed to the primary mechanism of financing as seen pre-GFC.

FIGURE 4: US & EUROPEAN NEW ABS ISSUANCE

(Billions)



Source: SIFMA, AFME and other trade associations

Today's Market Dynamics Accelerate Growth

While we believe systemic change in the regulatory and capital landscape combined with technological advances create a compelling long-term ABF investment case alone, recent events have materially accelerated the growth rate and scale of the opportunity set:

- The swift increase in global interest rates has encouraged banks to further tighten lending criteria in anticipation of affordability issues and falling asset values. Banks have also cut back from new lending and exited select origination lines in favor of focusing on core asset classes, such as owner-occupied residential mortgages. As we reach the end of the interest rate hiking cycle, we expect it will take banks much longer to retrace these steps and loosen credit criteria, especially with uncertainty over the global macroeconomic outlook.
- Specific to the US banking sector, interest rate increases have led to mark-to-market losses on some regional banks' asset portfolios; in most cases these assets are held as unhedged positions on their balance sheets, which when combined with recent customer deposit flight has resulted in severe liquidity issues and potentially meaningful credit losses.
- Diminishing commercial real estate asset valuations reflect the shift from a historically low interest rate environment, and account for meaningfully higher financing costs over the life of these assets. While valuations vary meaningfully between sectors, geographies, and asset quality, barring a few exceptions, valuation declines average ~30%[2] from their peak. This has placed substantial pressure on loan-to-value ratios and covenant levels (especially Debt Service covenants), which as a result make it challenging for banks to hold these loan assets. Solutions involve either an equity injection from asset owners or equivalent capital relief exercise (SRT), or seeking other solutions (e.g., refinancing, gap-financing) through specialist lenders.
    - It is notable that there is ~$2.8 trillion in commercial real estate loans sitting on bank balance sheets that are expected to mature between now and 2027[3]; this comes at a time when banks are not well-positioned to lend and may struggle to keep pace with refinancing needs.
- The elevated interest rate environment is creating asset and financing dislocations across other asset classes resulting in what we believe to be compelling investment opportunities for private credit managers.
- Divestment by the first generation of private investors (i.e., 2015–2017) may also present interesting opportunities to invest and scale up established, mature ABF platforms.

As a result of these events, many banks are now seeking strategic partnerships with private credit managers, like AB CarVal, to provide ABF capital solutions for assets currently held on balance sheet as well as future originations, thereby protecting their key customer relationships. This includes carve outs of current portfolios and strategic joint ventures for new origination utilizing established bank infrastructure and relationships. We view this as a near- to medium-term accelerant of the private ABF opportunity set.

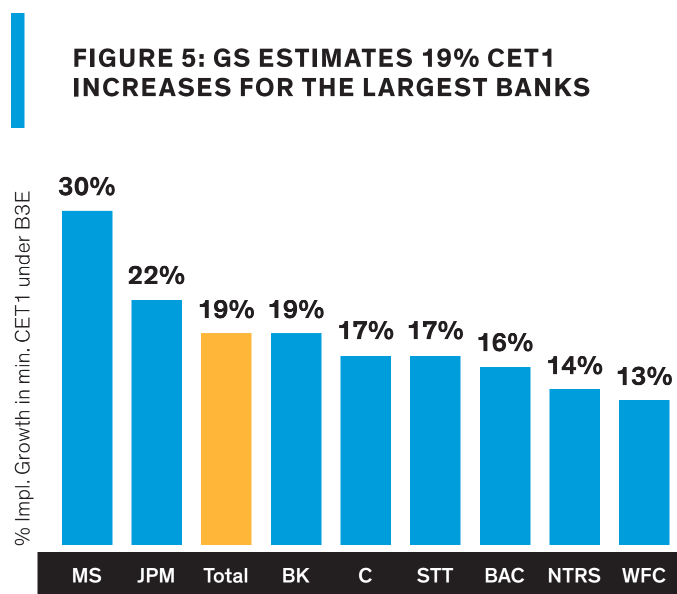
Concurrent with the more immediate growth catalysts, we believe the formalization of regulatory and capital legislation through the upcoming implementation of the Basel III reforms represents another long-term driver to the ABF opportunity.

The Regulatory Squeeze: Basel III Endgame

Pressure on banks' liquidity and their inability to extend credit in areas they have lent historically will likely be exacerbated by a regulatory squeeze driven by the implementation of the final components of the Basel III Agreement.

US Basel III includes proposed rules to strengthen capital requirements for large banks (those with total assets >$100 billion), some of which are in response to the recent banking turmoil in early 2023, with a three-year phase-in beginning in July 2025. One major component is a rewrite of the Risk Weighted Assets ("RWA") framework, which is estimated to result in a 23% increase in RWA[4]. Consequently, the largest banks will need to set aside additional high-quality regulatory capital, Common Equity Tier 1 ("CET1"), of an estimated 19% on average[5]. This dynamic is colloquially being described as the "Basel III Endgame."

FIGURE 5: GS ESTIMATES 19% CET1 INCREASES FOR THE LARGEST BANKS



Source: AB CarVal

2 Source: AB CarVal estimates
3 Source: Trepp; Morgan Stanley Research
4 Source: Goldman Sachs
5 Source: Goldman Sachs

Similar regulatory pressures will be felt in other global markets, especially Europe which has the second largest ABF market behind the US. A study by the European Banking Authority estimates that Basel III reforms will increase European banks' minimum Tier 1 capital requirement by a further 9% on average by 2028[6]. The updated capital requirements are more impactful for the sophisticated larger banks who, pre-Basel III, received preferential advanced capital treatment through the use of their own approved IRB models. The large differential in treatment between those internal models and the standardized approach (used by smaller less sophisticated banks) is being broadly removed with a floor level of capital no less than 72.5% of standardized approach.

This regulatory dynamic is expected to compound the existing secular trend of bank retrenchment in ABF, and as a result we expect an enduring global opportunity set in private ABF.

Market Overview: North America vs. Europe

Within the global opportunity set, the two most accessible markets are North America and Europe, both of which present compelling and distinct investment opportunities. Of the two, North America is the more mature market given its scale, depth, and homogenous nature. As a result, investment in this market is efficient due to data availability on the performance of underlying collateral as well as standardized lending and legal frameworks. These attractive features promote a high degree of competition among market participants, which is evidenced by established specialty lenders across all main asset classes and a handful of private credit managers with the capabilities to provide capital solutions.

In contrast, the European market is relatively smaller and heterogenous, with varying degrees of data quality and legal regimes that differ by country. These inefficiencies create opportunities for providers of capital solutions. The market's fragmented nature provides numerous entry points to capture relative value, and it is less competitive due to its complexity. This presents opportunities for private credit managers who have the necessary experience, capabilities, and relationships to successfully navigate these younger ABF markets.

FIGURE 6: MARKET OVERVIEW - NORTH AMERICA VS. EUROPE

	North America	Europe
Size	$3.6 trillion	$1.2 trillion
Key Geographies	2	20+
Legal Regime	**Relatively standardised:** • Creditor friendly	**Heterogenous:** • Creditor protections vary between jurisdictions and asset class • Structural protections required
Data Quality & Depth	**High quality:** • Homogenous, strong historical data	**Mixed and generally poor:** • Lack of historical data, no consistency between jurisdiction or asset class • Data cleansing & supplementation required
Capital Markets Penetration and Execution	**High:** • Multiple issuers across all major asset classes • Standard structures • Deep investor base • Consistent pricing	**Lower:** • Focussed on core asset classes in larger jurisdictions • Differentiated structures • Less competing supply and thinner investor base • Inconsistent pricing
Specialty Finance Lenders	**Highly competitive across key markets:** • Scaled businesses with origination often >$500 million p.a. • Pricing is a key driver of competition • Typically specialize in one asset class • More institutional and professional in structure	**Competitive in major markets/asset classes but many underserved niches** • Smaller businesses often <€100 million p.a. origination • Product features and innovation as well as price drive competition • Often young growth businesses which require support from private credit managers

Source: Integer Advisors and AB CarVal

6 Source: European Banking Authority

Navigating the ABF Market: Criteria for Successful Investment

ABF is a complex global market comprised of multiple asset classes and specialist lenders. There are thousands of protagonists across the sector with varying levels of expertise and capabilities. Understanding the nuances and specifics of each asset class in each jurisdiction is key to success and enables a proper assessment of relative value. Key factors which will drive a successful investment approach include:

- Detailed jurisdictional knowledge and experience (especially if investing in Europe), understanding market size and depth, legal framework, commercial dynamics, debtor behavior and culture, the servicing landscape, and various origination options
- Ability to source bilateral off-market transactions. Given the complex solution-based approach to transactions, it is more efficient to work with partners bilaterally to reach optimum solutions and create scalable opportunities that work for all parties. Established relationships with asset sellers and originators (i.e., specialist lenders) are critical.
- Selection of established operating partners in lending and servicing is key—how investors access the market to achieve desired exposures will be determinative of the success of an investment and strategy
- Due to direct access and the granular nature of the underlying assets, it is important to have the infrastructure and investment tools to assess performance and consumer behavior—this requires investment in technology, infrastructure, and people; data analytics plays a big role in this process. Furthermore, it requires an established and experienced asset management team integrated within the investment team
- Alignment with the asset originator is another integral factor, especially with respect to structuring the investment based on future performance—whether this be tiered fees, first loss protection, deferrals, a joint venture, etc.
- Provide a full breadth of structured finance and capital market solutions to solve for the best outcome in different situations, including being able to provide funding throughout the capital structure and operate in scale.
- Ability to assess and re-evaluate risk metrics over time; data analytic proficiency is a crucial factor when investing in granular asset portfolios.

As these factors detail, successful investment in the ABF market involves deep sector expertise, experience transacting across geographies, and the infrastructure in place to assess risk and performance of assets and portfolios over their lifetime. Delivering on this requires an established and seasoned private credit manager with a presence in local markets.

What characteristics do specialist lenders prioritize in a private credit partner?

- ✓ Excellence and reliability in execution
- ✓ Ability to provide flexible capital solutions, including whole loan or asset financing
- ✓ Significant scale, enabling room for growth ambitions
- ✓ Asset class expertise and track record of investing over multiple cycles, providing valuable insights
- ✓ Support in managing specialty lender liabilities

Conclusion

Amidst the backdrop of continued bank disintermediation and increased regulatory constraints, the private ABF market is poised to experience an acceleration in its growth trajectory, as specialist lenders increasingly seek private credit financing solutions. Given the scale of the ABF asset class and increasing investor interest, in our view private ABF is at a similar launch point to that of corporate direct lending a little over a decade ago, which preluded a substantial shift in non-investment grade corporate credit towards private direct lenders. To a meaningful extent, adoption of ABF as an asset class will be driven by investors seeking to diversify private credit allocations overweighted to corporate direct lending, in favor of ABF's credit and relative value superiority. However, investing in the asset class requires significant expertise and specialized infrastructure considering the complexity of navigating different collateral types, granular portfolios of numerous underlying assets, and various jurisdictions—especially in Europe.

ENDNOTES:

Per FSB, Economic Function 2 ("EF2") entities engage in loan provision that is typically dependent on short-term funding. Finance companies, the long-standing dominant EF2 entity type, often specialize in areas such as consumer finance, auto finance, retail mortgage provision, commercial property finance, and equipment finance. Entities engaged in these activities tend to either compete with banks or offer services in niche markets where banks are not active players, and often concentrate their lending activities in specific sectors due, in part, to expertise.

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