Identifying Opportunities In Asset-Backed Lending

June 2023

Investors should consider diversifying their credit exposure with asset-backed lending strategies, which can offer diversification within a fixed income allocation, a potential inflation hedge, and downside protection with collateralized assets.

Many wealth advisors may be somewhat familiar with the value proposition of private credit – a strategy that has drawn increased attention over recent years for its potential to generate higher yields than public fixed income markets while providing downside protection. The surge in private credit offerings in recent years has mainly centered around direct lending strategies. Less attention has been paid to other opportunities within the private credit asset class, such as asset-backed (or asset-based) lending, that exhibit strong capital preservation characteristics and provide a complement to more familiar private credit strategies. These strategies – like aviation finance, first mortgage lending on commercial real estate, and equipment finance – can provide further diversification in a fixed income portfolio and often have greater visibility around the valuations of underlying assets.

A CLOSER LOOK AT ASSET-BACKED LENDING

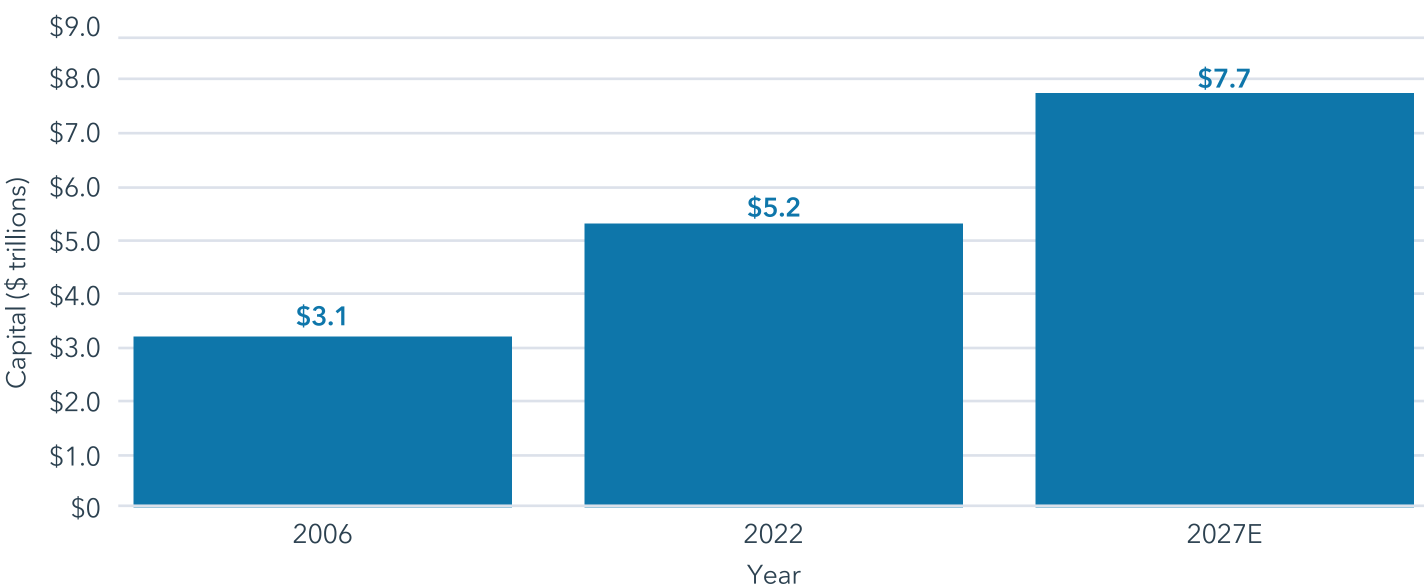
In the broadest sense, private credit is debt originated or held by non-bank entities. Borrowers are often small and medium-sized companies seeking a tailored financing solution that is not accessible to them in the public credit markets or through bank lenders, who are subject to strict regulations. Increasingly, large companies are borrowing from private credit managers due to their ability to offer speed, flexibility, and certainty of execution that traditional banks often cannot, particularly in challenging market conditions.

There are a range of private credit strategies, but lender exposure can generally be divided into two buckets: 1) cash-flow lending, in which repayment of debt comes from an operating company's cash flows (e.g., direct lending, subordinated debt), and 2) asset-backed lending, in which repayment comes from cash flows generated by a particular asset, which serves as direct collateral.

A GROWING OPPORTUNITY SET

Global private asset-backed lending has grown 67% since 2006, and the market is expected to continue to grow from $5.2 trillion in 2022 to $7.7 trillion by 2027.[1] Much

Exhibit 1: Global Private Asset-Backed Lending Market



Source: KKR, Integer Advisors, as of October 31, 2022. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

of this growth can be attributed to the credit tightening of traditional bank lenders, driven by volatility in the banking system and post-Global Financial Crisis (GFC) regulation.

These factors contribute to a rising demand for private asset-backed lending, and opportunities for non-bank lenders to provide capital to creditworthy borrowers at attractive rates.

DETAILED DUE DILIGENCE

Asset-backed lending opens the door for specialized lenders to complete more detailed due diligence and underwrite loans based on their own thorough analyses and expertise with a specific asset type. In the commercial real estate space, for example, lenders have the flexibility to perform thorough evaluations of the property and tenants, and even survey the tenants to see what improvements may be required. This deep analysis allows lenders to more accurately assess, and only lend up to, the inherent value of the asset.

By contrast, traditional high-yield credit and leveraged loans are syndicated out by an investment bank to a large group of investors in a fast process, that permits little time for deep, independent due diligence.

Asset-backed lenders need highly specialized expertise and operational infrastructure to conduct proper due diligence, service loans, and manage assets in the event of foreclosure, which poses a significant barrier to entry.

TAILORED DEAL TERMS

Asset-backed lenders negotiate directly with companies seeking financing. Because they often have less competition and ample opportunity to specify and customize loan covenants, asset-backed lenders have a better ability to dictate terms and instill lender-friendly structural protections. For example, lenders are often able to establish proactive monitoring mechanisms and/or detailed reporting requirements that grant real-time visibility into the performance of an asset, helping to ensure the borrower is financially healthy.

Tailored, deal-specific terms in the private credit space are typically not available in the traditional high-yield credit and leveraged loan market, where pre-set terms are defined by an investment bank.

DOWNSIDE PROTECTION

Asset-backed lending inherently involves a direct claim on a physical asset, leaving lenders better protected in the event of borrower default. In the later stages of an economic cycle, lending against a senior-secured assets is an attractive option, given that a direct claim can expedite recovery in the event of a default. Moreover, the value of the collateral, particularly hard assets, generally rises with consumer prices, providing inflation protection.

Additionally, there are active secondary markets for the most common underlying assets. If a lender ends up owning an asset after a borrower defaults, liquid markets support clearer price discovery and the potential for substantial recovery, further bolstering downside protection. Consider aircraft assets that secure aviation loans: aircraft are durable, standardized assets with flexible uses, limited supply, and considerable residual value. Thousands of planes change hands every year in the secondary market – they are fungible assets that can be easily relocated. As such, investors in aviation debt benefit from the long-lasting, globally marketable asset.

CONCLUSION

Private credit has become a permanent feature of the lending landscape and continues to serve as a reliable alternative to banks as a source of capital. Yet many investors remain under-allocated to important segments of private credit. Investors should consider diversifying their credit exposure with asset-based lending strategies, which can offer diversification within a fixed income allocation, a potential inflation hedge, and downside protection with collateralized assets.

ENDNOTES

1. KKR, "Asset-Based Finance: A Fast-Growing Frontier in Private Credit," May 15, 2023.

iCapital®

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

www.icapital.com

North America
New York City
Princeton
Greenwich
Boston
Boca Raton
Toronto
Birmingham

Europe
Zurich
London
Lisbon

Asia
Hong Kong
Singapore