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ASSET-BASED PRIVATE CREDIT MOVES INTO THE SPOTLIGHT

Asset allocators in search of differentiated returns are turning a laser eye on asset-based finance, one of the most rapidly growing segments in the private credit markets. Asset-based private credit, which is typically secured by hard assets as collateral, covers a wide range of financing for commercial credit, residential mortgages, specialty equipment and infrastructure. The diversity — and granularity — of asset-based finance strategies can offer allocators new sources of uncorrelated return, downside protection and an income stream.

Asset-based private credit can complement a traditional fixed income or direct lending allocation as it generates income derived directly from assets, as opposed to the cash flow of a company, which is typical in traditional lending strategies. Asset-based finance typically provides downside protection and should introduce less volatility than enterprise value cash-flow lending. Private credit specialists at **Bay Point Advisors, LCM Partners** and **Monroe Capital** unpack the underlying drivers of this asset class, the segments and regions where private capital is being deployed and the key manager attributes needed for origination and execution.

P&I: What's drawing institutional allocators to asset-based finance?

"Private credit has principally grown as a by-product of the forceful central bank intervention that occurred both during and post the global financial crisis. The lowering of rates, in some markets to sub-zero, forced traditional 60-40 investors and those with long-term liabilities, like pension funds and insurance companies, to look at alternatives," said Paul Burdell, chief executive officer of London-based LCM Partners. "So, in a nutshell, institutional investors saw that the grass was actually greener in what was then considered to be an unconventional asset class, and as such, private credit became conventional by virtue of the huge support it received."

With strong inflows into private credit, particularly direct lending, investors and their consultants have now turned their attention to differentiated segments that deliver strong risk-adjusted returns whilst also providing downside protection. "Private equity was a pathfinder to widen the aperture for investors in terms of investing in closed ended funds," Burdell said. "Many also invested in private credit in one form or another. The only difference now, with asset-based finance, is you're often able to directly compare your investment with public asset-backed securities. And historically, private asset-based lending has been able to deliver attractive spreads over publicly traded comparables."

"Many investors are looking to enhance their traditional cash flow direct-lending exposures and for a different income-based strategy within private credit," said Aaron Peck, managing director, co-head of alternative credit solutions at Chicago-based Monroe Capital. "Alternative credit tends to be uncorrelated and generates returns in excess of other credit products."

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—PAUL BURDELL, LCM PARTNERS

Peck added that the current economic environment is also drawing investor interest to the asset class. "During periods of market dislocation due to economic uncertainty, asset-based opportunities usually increase as an alternative means for borrowers to raise capital," he said. "The opportunity set grows because borrowers look to other markets to find ways to raise capital. Many LPs recognize that opportunity set and are finding that attractive given uncertain underlying market fundamentals."

P&I: What are some underlying drivers that make the asset class compelling?

Since the global financial crisis, the bank pullback from lending has persisted, and the situation was exacerbated more recently by the 2023 regional bank meltdown in the U.S. "Regional banks are basically not lending anymore. This pullback in the commercial bank market is creating significant opportunities for private asset-based lenders," Peck said. "Companies and asset owners have had to look elsewhere for capital solutions which has provided a tailwind for asset-based private credit managers."

"What's really driving current origination is what we call the 'need for speed,'" said Charles Andros, founding partner, president and chief investment officer of Bay Point Advisors, based in Atlanta. "For example, private real estate and private equity investors have experienced a dramatic decline in

distributions over the past 18 to 24 months, but they still need to fund capital calls or start new projects. They need the capital quickly, and the length of time it takes for a bank to process a traditional loan just isn't workable."

What's more, lower interest rates will make more cash available in the banking system, which should translate into tighter spreads between fixed income and high yield, a move that will benefit private credit, Andros said. "I do think that all in all, the growth of private credit has taken the need out of public investment grade and high yield."

P&I: What aspects of deal size, regions and sectors illustrate the range of opportunities?

The granularity of asset-based financing needs and solutions has meant that lenders can differentiate across niche or specialized areas by market or deal size, geography and economic sector — as they seek to deliver improved alpha for their institutional clients.

Monroe Capital, which focuses on the middle market across private credit, has identified major economic trends underpinning its strategies. "Three emergent themes are likely to persist," said Peck. "First, the expansion of computing power requiring a different level of digital infrastructure and power generation for artificial intelligence is creating opportunities to finance various digital assets, including data center construction, existing data center conversions and digital equipment, such as GPU chips. Second, given the shortage of affordable housing in the U.S., lower interest rates could increase demand for ownership and rentals. That will boost financing for single-family homes for rent, multifamily apartments, and manufactured homes, areas that Monroe specializes in," he noted. "Third, an impending wave of refinancings of commercial real estate mortgages will face a gap that banks are unlikely to fill, which asset-based lenders can address."

"Having that true experience, knowing how to deal with different market conditions, different asset classes and types, that's what an asset allocator should look for."

—CHARLES ANDROS, BAY POINT ADVISORS

Bay Point Advisors has carved out its specialty niche in the middle-market space, mostly in the southeast U.S. But it has been expanding its coverage area, Andros said. "As our brand has grown, demand for capital has expanded across the U.S.," he said. "In fact, we recently closed a transaction in Hawaii." The firm also tends to focus on the small- to mid-size space. "On the one hand, we stay below the mega-sized asset managers, at usually around $30 million. We've run deals above $50 million, but we've seen margins compress above that," he said. "On the other hand, we stay above the few million-dollar range. The key for us, regardless of size, is always securing a low loan-to-value ratio."

LCM Partners provides asset finance and secured real estate-backed funding predominantly in the U.K. and Europe. Within asset finance, the focus is on business-critical hard assets, such as crew transfer vessels that take workers to offshore wind farms, agricultural equipment, and search and rescue helicopters, Burdell said. "We concentrate on partnering with finance companies or manufacturers to provide point-of-sale financing in areas of the economy that banks are not really targeting." LCM looks for pockets of the market with favorable supply-and-demand dynamics — for instance, financing developers of smaller-scale residential housing projects in the U.K., which faces a building shortfall of about half of its home building needs over the next five years, he pointed out.

"We target high-quality customers across the width of our European footprint," Burdell said. "We're investors and not banks: We can favor those jurisdictions where rates are more favorable than others."

P&I: Where does asset-based private credit best fit within an institutional portfolio?

While asset-based finance typically sits under the umbrella of private credit, it can fit into a fixed-income bucket or a more specialized alternatives sleeve.

"It's a great complement to a fixed-income portfolio," Burdell said. "Asset-based lending belongs within private credit, but these investments are typically short duration and highly cash generative from the outset, so they exhibit characteristics appreciated by fixed-income investors, and we have seen some interest in our strategy from those fixed-income investors who can entertain closed-ended fund structures."

Andros said the asset-based strategies that Bay Point specializes in fit under the private credit umbrella, albeit in a more specialized exposure. "While our strategy is asset based, we don't typically rely on those assets to generate current cash flows. Instead, we focus on originating and servicing short-term, high-yield loans that are usually senior secured with low loan-to-value ratios," he said.

"Because of this approach, we believe a more precise term for what we do is asset-based direct lending. Ultimately, we believe our strategy is emerging in its own distinct bucket, in asset allocation or within an investor's credit allocation."

To achieve the full diversification benefits of private credit, investors should consider allocating across the range of segments, Andros said. "Allocators need to have a little bit of exposure to asset-based direct lenders like us, and then all the way up the spectrum to the more cash-flow direct credit-based lenders," he said. "That's why we think that it fits in every portfolio."

When Monroe Capital began raising capital 20 years ago, its strategies fell somewhere between institutional investors' public credit allocation and their private equity allocation, "and it was hard for them to know how to look at the segment," Peck said. Today, their asset-based strategies sit primarily within the private credit bucket. "They're seeing asset-based finance as a diversifier and a way to grow their private credit allocation without taking more of the same risk. Many investors see it as a way to generate higher return with more downside protection, which is an all-weather approach that is particularly attractive in a market like this."

P&I: What are the key risks that investors should keep in mind, and how do you navigate them?

Similar to most investment strategies, macro risks from a shifting interest rate cycle and a potential growth slowdown are a concern for asset-based finance. In addition, the unique, and sometimes complex, nature of asset-based financing also highlights idiosyncratic risks specific to each manager or deal.

With the Federal Reserve having embarked on a policy of lowering interest rates, consumers and businesses may increase borrowing. "As banks have more money, they're certainly going to try to make loans while they can," said Bay Point's Andros. "And that should loosen things up. For us, that means more competition for loans on the fringes. But all in all, we want that liquidity in the system, because it helps borrowers pay us back."

"The ultimate risk in asset-based private lending is a decline in the price of the asset," Andros said. Its book of business is short duration, typically between 12 and 24 months, which makes deflation a major risk. "That is our ultimate worry. We want a stable monetary policy with stable asset prices to loan against."

However, short-term interest-rate fluctuations are not a big risk for the portfolio. "Changes in rates don't affect our balance sheet like they may affect a balance sheet that holds a lot of duration," Andros said. "That gets to the heart of what risk is and, in the end, know your collateral. That's the definition of all lending."

Monroe Capital's Peck believes lower interest rates won't change banks' calculus for lending, so asset-based finance will remain relatively unaffected. "Where you might see increased competition from banks is in larger deals. But in the middle market asset-based finance space, it's hard to imagine the largest banks dipping down into our market to compete."

When assessing risks specific to asset-based private credit, a critical issue is fully understanding the manager's approach, the dynamics of its area of specialization and its origination process.

"When you're an investor who is allocating capital to an asset-based finance manager, it starts and ends with the people," Peck said. "Who are you investing with? What do their benches look like? What does their track record look like? It really comes down to manager selection because the asset-based finance market is so varied from manager to manager, from situation to situation. It takes a specialized skillset, as structures are more complex, and it takes the right type of experience to execute successfully."

It's important to know how your manager is approaching a deal and what they expect to happen for that deal to be successful or unsuccessful.

—AARON PECK, MONROE CAPITAL

For LCM Partners, building long-term relationships with its deal partners and borrowers is a central focus. "We work with origination partners, and we want these to be long-term partnerships. So when we're establishing a partnership, we spend many months getting to know their product and customer base before we finalize an agreement," Burdell said. "We know the market. We know the borrower. We know the underlying asset, and we understand it."

As a lender, LCM Partners also delves into all the potential risks the borrower may face, so that it can act with a high level of confidence that the borrower will make its payments. "We provide point-of-sale financing, and so we can see and understand what the borrower is doing," he said. "We're not just portfolio managers, we're also operators. It's like being a trained mechanic when you're driving a car. You start hearing a funny noise in the engine compartment, you stop, lift up the hood to inspect the problem and thankfully, in most cases, you can probably fix it. If you can't, you probably know someone that can."

P&I: As manager selection is so important in this space, what manager capabilities are most important?

If one of the bigger issues in asset-based private credit is manager selection, allocators can ameliorate that risk by getting under the hood to truly understand loan covenants, deal terms and the manager's ability to recover if a borrower defaults.

"It's important to know how your manager is approaching a deal and what they expect to happen for that deal to be successful or unsuccessful," Peck said. "At Monroe, we assume the world is melting down tomorrow in every deal that we do in asset-based finance. As a result, we underwrite the deal to the worst-case scenario we believe we can predict. If that assumption materializes, how do we get out of the deal? If we can't answer that fundamental question, that's a deal we can't and won't close."

At LCM Partners, Burdell thinks about the firm's ultimate clients — pensioners — and what suffering an investment loss could mean. "It's as much about capital preservation as it is how much we make," he said. "So we've always targeted prime, good-quality customers. You can be a big multinational or a mom-and-pop business just around the corner, but a good quality customer is a good quality customer. That's critically important to us."

"On top of that, if you're investing in granular assets that are business critical and have liquid secondary markets, you've got additional lines of defense," he added.

The other key is understanding how a manager will respond to a default or potential loss. "In the event that something does go wrong, we're pretty confident in our ability to recover the loan," Burdell said. In a worse-case scenario, given the firm's portfolio of hard assets with conservative loan-to-value ratios, "there's a pretty good chance that we'll be able to sell that asset and not incur a loss."

For Andros at Bay Point, it comes down to the manager's experience through several economic cycles and understanding when market conditions are changing or when a borrower may be showing signs of stress. "Nobody's perfect. We have made mistakes, but we've learned from those mistakes," he said. "Having that true experience, knowing how to deal with different market conditions, different asset classes and types, that's what an asset allocator should look for."

Consistency is key. "A unique part of Bay Point is that we are probably the only firm that originates, services and collects about 98% of our paper," he said. "We have a lot of experience in the space."

P&I: What's an underappreciated fact about recent — or historical — performance of asset-based private credit?

"When looking across the private credit universe, annual loan losses of up to 90 basis points are fairly common," said Andros. "It's essentially baked into those strategies. However, our defaulted loans have earned our investors an average of 62 basis points annually. In other words, our gains from working out defaults have been greater than our net losses. That's not easy to achieve."

Investors may not know the full comparative picture of asset-based finance, said LCM Partners' Burdell. For example, "if we look at studies from the global financial crisis, net loss rates ranged between 0.2% and 0.5% for leasing, around one-third of the loss rate on equivalent traditional bank loans."

"So if you're lending against business-critical assets with liquid secondary markets, as with asset-based finance strategies, you get very strong defensive attributes."

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