IDENTIFYING OPPORTUNITIES FOR CLIENTS IN ASSET-BASED LENDING

By now most wealth advisors are probably somewhat familiar with the value proposition of private credit – a strategy that has drawn increased attention over recent years on the premise of generating higher yields than public fixed income markets while providing strong downside protection.

The surge in private credit offerings in recent years has mainly centered around middle market direct lending strategies. Less attention has been paid to other opportunities within the private credit asset class, such as 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-Based Lending

In the broadest sense, private credit is debt originated or held by non-bank entities. Borrowers are often middle-market corporations, and exposure can be divided into two buckets: 1) cash-flow lending, in which repayment of debt comes from an operating company's cash flows, and 2) asset-based lending, in which repayment comes from cash flows generated by a particular asset, which serves as direct collateral.

Advisors may be less familiar with asset-based lending, so it's worthwhile to take a close look at its unique characteristics.

More Detailed Due Diligence

Asset-based lending opens the door for experienced 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.

Additionally, this deep analysis provides the ability to underwrite more accurately to a downside scenario. If a lender ends up owning the asset, odds are the market has sunk which will adversely affect recovery values.

However, asset-based 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.

Better Ability to Dictate Deal-Specific Terms

Asset-based lenders have a better ability to dictate terms and instill lender-friendly structural protections because they often have less competition and ample opportunity to specify and customize loan covenants. By contrast, traditional high-yield credit and leveraged loan terms are defined by an investment bank, who performs the underwriting of the debt that is syndicated out to a large group of investors in a fast process, that permits little time for deep, independent due diligence.

Lenders are often able to establish proactive monitoring mechanisms that grant real-time visibility into the performance of an asset, helping to ensure the borrower is financially healthy. Experienced asset-based lenders also often have the ability to impose detailed reporting requirements and may specify particular events of default.

Downside Protection

Asset-based 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 secured assets is an attractive option, given that a direct claim can expedite recovery in the event of a default.

Additionally, there are active markets for the most common underlying assets. If a lender ends up owning an asset after a borrower defaults, active markets support clearer price discovery and the potential for substantial recovery, further bolstering downside protection. Consider the planes which 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 security offered by a long-lasting, globally marketable asset.

A Strong Opportunity Set

Private credit has become a permanent feature of the lending landscape and continues to displace banks as a reliable source of capital. Yet many investors remain under-allocated to important segments of private credit. Investors should consider diversifying their private credit exposure into sub-strategies within asset-based lending which will complement more familiar strategies such as middle market direct lending. Yet, like all private credit, manager selection is critical — firms with proven expertise and deep credit research teams are best positioned to generate strong returns and avoid losses. Filtering through opportunities and conducting diligence on private assets is labor intensive and time-consuming — there are no shortcuts.

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