EXPERT Q&A

Music royalties, healthcare receivables and legal finance are all well-diversified, low-correlation investments suited to a range of market conditions. David Ross, CJ Wei, Jeff Perrin and Victoria Li of Northleaf Capital Partners explain why

Esoteric and niche: The benefits of low correlation

Q How do you define speciality finance at Northleaf and what does your strategy look like?

David Ross: Speciality finance is a broad segment of private credit, often defined differently by market participants. These types of investments are underpinned or collateralised by diversified pools of cashflow generating financial or hard assets. Many market participants are active within commercial and consumer categories, for example, consumer receivables, equipment financing or factoring.

While Northleaf invests selectively in commercial and consumer assets with protective structures and significant collateral coverage, our strategy is primarily focused on niche or esoteric assets that are highly diversified, with low correlation to the broader market. For example – music royalties, healthcare receivables and legal finance, all of which exhibit idiosyncratic credit outcomes that have low correlation to each other, to traditional fixed-income performance and to the broader economic environment.

Segments requiring asset specialisation and bespoke structuring tend to be less trafficked by generalist capital providers. Having high conviction in the investments we pursue is an important tenet of our strategy and this has led to a focused approach to asset coverage and selection.

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Q How would you describe the current market opportunity, and how is it impacted by macro events?

CJ Wei: Speciality finance is attractive through market cycles. From a borrower perspective, platforms require capital to scale and the demand drivers of these platforms are non-cyclical. From an investor perspective, speciality finance provides stable cash yield and downside protection.

The current market opportunity is particularly rich and compelling, especially for private capital. During periods of market volatility, as we saw in recent quarters, traditional capital sources (banks and public securitisation markets) pull back. This creates more opportunity for managers like Northleaf to lend on attractive risk-adjusted terms as borrowers look for flexible and customised financing solutions.

In the past year, we made several investments that could have been bank financed. But many borrowers are recognising the benefits of patient

Analysis

capital that can scale alongside their platforms, and the asset and structuring expertise that specialised managers can bring.

Q Thinking about specific asset verticals, where do you see the current tailwinds driving opportunity in music royalties?

CJW: Music royalties is a great example of a low correlation asset class where performance is uninfluenced by market volatility or broader economic cycles. Music consumption is inelastic and music royalties deliver very stable cashflows with an undercurrent of steady growth.

Streaming is anticipated to triple in size over the next 10 years and global music revenues are expected to double in that timeframe, driven by the proliferation of streaming platforms and new technology integration across gaming, home fitness and social media. The ecosystem is underpinned by a supportive regulatory framework that seeks to enhance music content rights, increase monetisation and streamline enforcement and collection.

However, from a monetisation and value perspective, not all music catalogues are created equal. Catalogues of seasoned content benefit from stable consumption trends, while newer content can provide opportunistic growth.

We typically look for diversified catalogues with income generated from a large, mature portfolio of copyright across a mix of songs, artists, genres and vintages; and it's always nice to see the resurgence of a classic, in the case of our catalogue, song "Won't Get Fooled Again" by The Who, which was released in the 1970s but gained a new generation of fans from recent placement in the movie *Top Gun: Maverick*.

DR: If you think about the publisher, writer or musician who owns the music copyright, they own an asset that generates cashflow well beyond their lifetime. The market has created an efficient mechanism for copyright owners to fully monetise that asset within their lifetime. The benefit of these transactions, including having the rights to their music content held by professional platforms that can unlock additional value, is very attractive to copyright owners.

Q What is driving investor appetite for speciality finance?

DR: There are typically two key factors or considerations that are highlighted by investors. First, investors feel that speciality finance is highly complementary to their existing credit allocations. The performance of these investments has low or no correlation to their direct lending exposure or traditional fixed-income portfolios. So, the addition of speciality finance investments helps to mute overall volatility and reduces correlation across the portfolio.

Secondly, speciality finance investments have attractive standalone risk and return characteristics, including high cash yield, diversified collateral coverage with concentration limits and a range of financial covenants. Downside risk is well managed, while investments typically deliver a mid-to-high teens gross return.

Current market dynamics have certainly driven increased appetite as investors look at market volatility and valuations across public and private corporates and recognise the high yield, low correlation and downside protection attributes of speciality finance.

Clockwise from top left: CJ Wei, Jeff Perrin, David Ross, Victoria Li

Q What is Northleaf doing in healthcare receivables?

Jeff Perrin: We've done a number of healthcare receivables transactions over the better part of the past decade and know the space very well. These receivables often relate to medical expenses stemming from personal injury matters. We like this space because collateral is well diversified by claim type and geography, collections are stable and predictable and the end payors are typically well-capitalised insurance companies.

The credit risk here is also uncorrelated, driven mostly by personal injury settlements involving third-party liability. We look for platforms with established track records and deep origination channels across hundreds of healthcare providers or law firms. As a growing but niche sector, we have been able to structure customised capital solutions, often with profit participation, to generate outsized returns with consistent yield and downside protections. Some of the most attractive opportunities in our pipeline today are in this space.

> *"Investors feel that speciality finance is highly complementary to their existing credit allocations"*
>
> **DAVID ROSS**

Q What about legal finance – what are the challenges and opportunities there?

CJW: Global investments in legal assets have increased considerably in the last five years. There is broader recognition that legal finance is a critical part of the legal system's value chain – it transfers risk from plaintiffs (mostly corporates or law firms) to funders, and in so doing provides equitable access for meritorious claims. Australia, the UK and the US are the most mature markets for legal funding, though globally, more and more jurisdictions are creating supportive regulatory environments.

Legal finance is a niche that falls outside the lending focus of traditional capital providers, like banks. Given the specialisation required to assess cases and navigate the legal landscape, there are high barriers to entry for both operators and capital providers, creating a unique opportunity to generate attractive risk-adjusted returns.

Q What about the commercial/consumer space where many of your peers play? How does Northleaf think about those opportunities?

Victoria Li: Commercial and consumer finance have gone through a volatile three years with the impact of covid and an inflationary environment. But that has created more opportunities and attractive entry points for lenders. These segments are very large and encompass diverse assets with different return and risk profiles, so we think it is important to be highly targeted and focus on investments that align with our strategy.

While credit drivers may be more correlated to labour markets and the macro environment, we target asset segments and structures with attractive risk-mitigating features including short duration, high diversification and significant collateral coverage. This helps manage exposure through economic cycles.

On the commercial side, for example, we like factoring. These are discounted purchases of short-duration invoice receivables that facilitate working capital management for small and medium businesses. We look for situations involving high-quality payors/counterparties with cross-collateral enhancements. Meanwhile, we focus on disciplined platforms with a proven track record of lower-than-peer loss rates with low volatility by industry standards.

Another feature of asset investing, particularly in the commercial and consumer space, is that it benefits from rigorous statistical analysis and a data-driven approach. Historical borrower performance, which may include hundreds of thousands of underlying loans or receivables, is scrutinised and stratified to assess performance and risk drivers.

My background in advanced statistics is an advantage during underwriting for this type of asset. It provides for a deeper understanding of how assets will perform, what could potentially go wrong and how to structure around the risks.

Q Looking forward, how would you describe the outlook for speciality finance, and how do you see it developing?

DR: There is no doubt that speciality finance has grown at a good clip since the end of the global financial crisis and we expect that to continue. The accelerated adoption of technology is creating more sophisticated fintech platforms, with enhanced origination and risk management capabilities.

Naturally, we are cautious with new investments, given the current macro and market backdrop, but what remains particularly relevant is that speciality finance provides low correlation, diversification and enhanced yield within a broader fixed-income portfolio.

CJW: The opportunity is global and we are one of few players investing in North America, UK/Europe and Australia. There is a supply-demand imbalance for capital that favours speciality finance lenders and we continue to see attractive opportunities with the expertise and dedicated teams to support our global investment efforts. ■

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