EXPERT Q&A

Niche asset-based speciality finance offers attractive yield for well-managed risk, according to CJ Wei, managing director in private credit at Northleaf Capital Partners

An emerging opportunity

Q How should investors think about the broad spectrum of opportunities within asset-based speciality finance?

Asset-based speciality finance (ABSF) is an established and integral segment of the financial markets, providing liquidity and funding for many aspects of the economy. Asset-based loans are predominantly collateralised by vast pools of cashflow-generating financial or hard assets, for example, receivables, royalties, or physical assets such as buildings or equipment.

This market is commonly segmented into three verticals: consumer, commercial and niche assets. Each offers investors unique and diversified exposure as part of a broader private credit portfolio.

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Consumer and commercial-based assets represent a large segment of the market and primarily include categories such as credit card receivables, unsecured consumer lending and equipment financing, among others. Given greater homogeneity in the underlying credit characteristics, consumer and commercial assets tend to be well financed by the banking system and conventional sources of institutional capital.

At Northleaf, our focus is primarily on low-correlation niche assets, including music royalties, commercial legal assets, healthcare receivables and specialised forms of factoring. Investment diligence and structuring for these assets require a high degree of specialisation, and therefore they tend to be less covered by traditional capital sources. The inherent complexity creates natural barriers to entry and favourable supply-demand dynamics for the smaller subset of institutional lenders active in this space.

A debt-orientated ABSF strategy can be particularly attractive for investors as part of a broader credit portfolio, offering the potential for yield enhancement, significant collateral coverage, borrower alignment and robust lender protections.

Q What does low correlation mean in practice and how does it contribute to downside management?

Low correlation is really a key value driver of ABSF, providing investors with diversification benefits that strengthen their portfolios.

Managers describe low correlation in different ways. At Northleaf, we're focused on selecting assets and subsectors with demand drivers and credit risk that are largely uninfluenced by the broader macro and market environment. Our credit thesis is predicated on collateralisation by highly diversified portfolios where asset verticals (and individual assets within each vertical) demonstrate idiosyncratic performance characteristics.

Music royalties, healthcare receivables and commercial legal assets generally have uncorrelated demand drivers, counterparties and credit risk profiles. Music royalty performance, for example, is largely driven by streaming volumes tied to modern music consumption patterns.

Healthcare receivables, on the other hand, crystalise value upon settlement from investment-grade insurance payors. As for commercial legal assets, case outcomes and associated settlement proceeds are largely uninfluenced by unemployment, GDP or interest rates. Rather, credit outcomes are influenced by the case-specific merits supporting the underlying claims.

> *"Debt investments within ABSF can offer strong cash yield with well-managed risk through diversified collateral pools and strong lender protection"*

Asset-based lending can provide strong downside-protected investments when you combine highly diversified portfolios with conservative structures, significant asset coverage, borrower alignment and lender-protective covenant protection. ABSF asset performance and valuations are typically very stable and, unlike public fixed income, private ABSF investments are not traded and not valued on a daily basis, which can mute the mark-to-market volatility within an investor's portfolio.

Q What is the lending versus asset ownership or equity opportunity in speciality finance?

Debt investments within ABSF can offer strong cash yield with well-managed risk through diversified collateral pools and strong lender protections. Debt is serviced by the cashflows generated by these assets, so the credit risk is largely based on the composition and quality of the underlying portfolio rather than the credit risk of the originator.

On the other hand, asset ownership or equity investments can provide for upside if assets outperform, but can be more sensitive to asset performance, valuation changes and duration risk, which may introduce inherent volatility to the range of potential investment outcomes.

Given the customized nature of financing solutions within this space, it is also possible to structure investments with attractive contractual yield, downside management and profit participation as assets generate cashflows.

Q What are the key structural features of debt instruments in this space?

ABSF debt investments include a number of key structural benefits from significant asset coverage and wide-ranging financial and asset covenants. We typically negotiate a handful of financial covenants and a range of eligibility criteria and concentration limits that govern our borrowing base, ensuring a high level of collateral diversification.

In addition, lenders are generally successful in securing call protections and granular reporting packages that allow for real-time monitoring and a high degree of information access.

Finally, most debt investments are loans into a special purpose vehicle, which is created to isolate financial risk, provide for bankruptcy remoteness and is created for the single purpose of warehousing collateral assets. Such a structure provides for lenders to have bank account controls for ease and efficiency of collateral enforcement in the event of underperformance.

Q Finally, what types of origination platforms does Northleaf typically partner with?

There are a few key attributes that we look for in an origination platform. First, we look to partner with platforms that have demonstrated consistency in their ability to sustain originations of high-quality assets.

Second, we're focused on platforms based in developed economies with established and stable regulatory regimes, namely common law legal systems in North America, Western Europe (including the UK) and Australia.

Thirdly, companies with internal underwriting and risk management systems that are rigorous and auditable, with the ability to sustain scale. And finally, Northleaf typically partners with experienced teams that offer strong alignment.

Overall, our view is that this asset class is still in its early innings. The opportunity set remains robust and we see a healthy pipeline. ■