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The case for asset-based finance

Alternative investments

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- Private asset-based finance is a maturing asset class in the fast-growing private credit space.
- Managers engage in pooled lending secured by contractual cash flows from a variety of assets, including consumer loans, residential and commercial mortgages, hard assets, and specialty finance.
- We think ABF has the potential to bring diversification benefits and enhanced investor safeguards to a portfolio, as well as attractive risk-adjusted returns. But the wide performance dispersion among managers warrants critical manager selection.

Introduction

Private credit is one of the fastest-growing segments of global markets. At the end of 2023, the space accounted for USD 1.7tr of assets under management (Preqin). Stricter regulation and higher capital requirements for banks spurred this growth, and we expect this to continue over the years ahead.

While direct lending is the more wellknown strategy in the space, it is neither the biggest part of private credit markets nor the only potential opportunity. The private asset-based finance (ABF) market, which engages in lending against contractual cash flows of various assets, represents about USD 5tr overall. Importantly, we expect additional bank regulation (including on smaller banks) to follow from the US regional bank crisis in 2023, providing a further boost to non-bank asset-backed lenders.

In this primer, we explore asset-based finance, particularly provided through private markets. As many investors may not be familiar with this asset class, we aim to describe what it is, and the diverse pool of assets it includes. We also describe the potential benefits of adding asset-based finance to a portfolio that private investors may have overlooked, given the dominance of institutional investors in this field, as well as the risks investors should pay attention to.

What is private ABF?

Private asset-based finance (ABF) refers to private credit managers engaging in pooled lending secured by contractual cash flows from a variety of assets, including consumer loans, residential and commercial mortgages, hard assets, and specialty finance. Loans are often privately originated, and these cash flows generate the bulk of returns for investors, reflecting a cross-section of the "real" economy.

How is this different from ABS?

Asset-backed finance falls into two broad categories: publicly traded structured finance (ABS) and private asset-based finance. While both markets exhibit overlaps in terms of sector exposure and position on the capital structure, ABS is generally more liquid and benefits from a secondary market. Private ABF, meanwhile, involves the side of the market that is privately originated, negotiated, and tailored to specific capital needs. Another difference is that private ABF non-bank lenders provide capital to borrowers, who, even if creditworthy, may find it difficult to access financing through banks. The more niche and esoteric the collateral, the more it suits private asset-based lending.

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Market and economic drivers
ABF caters to the needs of borrowers and investors, creating a dynamic supply and demand in the financial markets. Borrowers leverage ABF to raise capital efficiently, improving their balance sheets and ratios, and fast and efficient access to capital, thereby increasing the supply of such assets. Meanwhile, the demand side is driven by investors drawn to ABF's favorable structure, predictable and front-loaded cash flows, and potential for higher yields, which offer a diversified investment avenue. This mutual attraction enhances market breadth and depth, ensuring a steady supply of capital for borrowers and resilient demand from investors.

Figure 1: ABF investment universe

Source: UBS

Loan types in the private ABF universe
ABF managers give investors access to a mix of publicly and privately sourced loans, beyond the exposure to corporate loans available in the private credit market. The areas differ in their collateral, loan duration, structuring and yields can be broadly defined as below:

- *Consumer finance* includes pools of consumer debt. These debts are typically small and diversified, encompassing various types of consumer loans. Consumers often borrow to finance larger acquisitions or investments such as cars, home improvement loans, or higher education via student loans. These can be accessed as whole loans or pooled and purchased through asset-backed securities. The value of the underlying assets provides a layer of credit protection in this case. Depending on the type, loan durations vary from a few months to several years. For instance, prime automobile loans have maturities from 36 to 72 months with an average unlevered yield of ~6–8%.
- *Residential mortgages*, which can include whole loan household mortgages or securitized products of pooled residential mortgages. This segment generally provides predictable cash flows, with property serving as collateral. Investors in this segment may also have exposure to:
  - non-qualified mortgages, often written to self-employed borrowers, for example, who cannot provide employer certificates as a proof of income;
  - residential transition loans for large renovation projects, which are often used for “fix and flip” transactions involving buying, improving, and then selling a property at a higher price;
  - Single-family rental loans, which are meant for investment properties that will be rented out to tenants as opposed to home loans for owner-occupied properties.

Loans in this category typically have a weighted average life of 4–8 years, with current unlevered yields in the 6–12% range.

- *Commercial mortgages* include pools of commercial real estate loans, which can offer downside protection compared to exposure to single properties. The assets underpinning these pools include commercial property types like multifamily buildings, offices, healthcare facilities, or hotels.
- *Hard assets* are structures that are secured by cash flows coming from loans or leases against physical assets. Loan types are varied, ranging from fleet leasing against rental cars or aircraft, shipping loans, and special equipment used, for example, in agriculture or manufacturing, through to infrastructure assets like fiber networks, telecom hardware, and solar plants. Hard assets are typically essential for a business to operate and have substantial value. Investments in hard assets typically have an average loan life of 3–4 years and unlevered yields in the range of 7–12% depending on the asset type.
- *Specialty finance* includes lending against specific assets like inventory, equipment, receivables, or real estate to offer credit to smaller and medium-sized companies, but also contractual cash flows coming from intellectual property, such as music royalties. Specialty finance requires strong collateral protection for the pledged assets to be revenue generating and/or essential for borrower operations. These features provide greater confidence and compensation to investors for the additional credit risks borne in lending to small- and middle-market companies. Specialty finance loans typically have a weighted average life of 2–4 years, with current unlevered yields in the 6–12% range.

Investor benefits

ABF offers investors several features that may be appealing additions to an investment strategy, whether they are looking for differentiated sources of return beyond traditional assets classes, ways to reduce swings in their portfolio, or to improve liquidity (ease of access to funds).

First, ABF offers **better investor protections** than traditional lending, which can come in the form

- *Bankruptcy remoteness* through special purpose vehicles (SPVs) to separate from the lending entity, distancing investor's money from the entity's financial status and isolating assets and liabilities in case of a sponsor's bankruptcy.
- C*ontractual cashflows and over-covered borrowings* bring stability. While traditional corporate debt relies on borrower creditworthiness, ABF derives its protection from the front-loaded cash flows, and often "overcollateralization" of the underlying asset pool. For instance, auto loan-backed debt uses consumer payments and vehicles as extra collateral, enabling loss recovery through collateral liquidation in defaults.
- *Strong covenants and asset triggers*, which include, debt service, leverage, collateral quality tests, tied to metrics like cash, capital, or EBITDA. Additionally, asset triggers are in place to react to loan pool deterioration, potentially requiring extra collateral or cash retention, thereby de-risking the loan. Also, third-party trustees monitor segregated bank accounts, ensuring compliance and reducing fraud or mismanagement.

Secondly, ABF offers **diversification benefits** for the following reasons:

- *Diversity of underlying assets:* the versatile pool of loans, leases, or receivables from various borrowers or lessees, reducing individual default risks. The wide range of payers, from cardholders to airlines, ensures ABF performance isn't heavily reliant on any single entity.
- *ABF holds in-built interest rate hedge* properties, as underlying assets are often priced off floating-interest rates. Coupons are also adjusted periodically in line with short-term interest rates. This characteristic makes ABF particularly valuable in scenarios of high interest rates or high inflation.
- *Intrinsic diversity enhances ABF's stability,* offering potential resilience in economic uncertainty and volatility, underscoring the importance of skilled management in maximizing returns and mitigating risks.

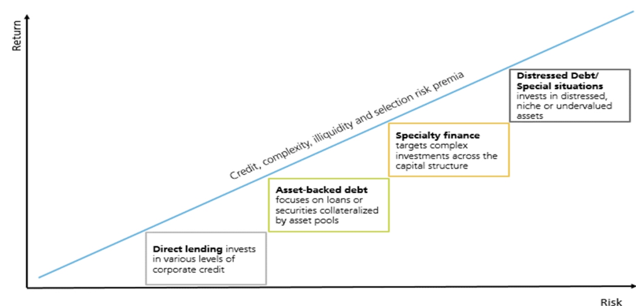
Finally, ABF can **dampen liquidity and interest rate risks** as it employs matched duration funding and amortization, aligning with collateral loan durations. Additionally, the portfolio's weighted average life (WAL) is typically 1-5 years, indicating lower credit risk due to the shorter duration of outstanding principal.

Performance

Providing definitive private asset performance is challenging. It is especially so for private asset-based finance, given the diversity and bespoke nature of deals as earlier outlined. Nevertheless, we can provide some general observations.

Average annualized returns of ABF funds typically range from 6% to more than 15%. We judge these returns, when adjusted for risks, to be attractive—thanks to the pooling of diversified assets, use of credit enhancements like overcollateralization, and strong contractual covenants to insulate investors.

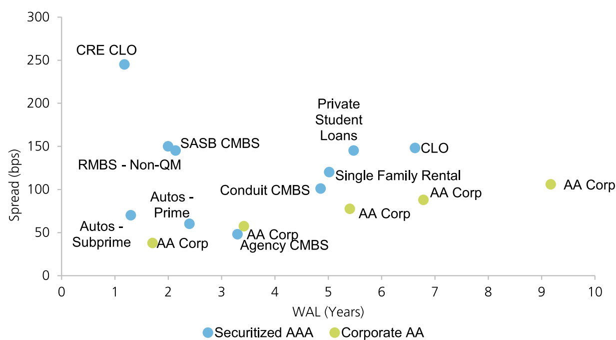
Figure 2: Private credit domain



Source: UBS

The primary driver of returns is income. Many managers pay out income streams of between 4% and 10% per year. ABF returns primarily come from the interest and principal payments on the underlying asset classes, such as loans, leases, receivables or royalties. The diversity of these assets often allows for higher yields compared to traditional fixed-income securities. We show the spread landscape in Figure 3 below. On average, ABF can deliver annual returns between 50 and 300 basis points larger than other types of similarly rated debt.

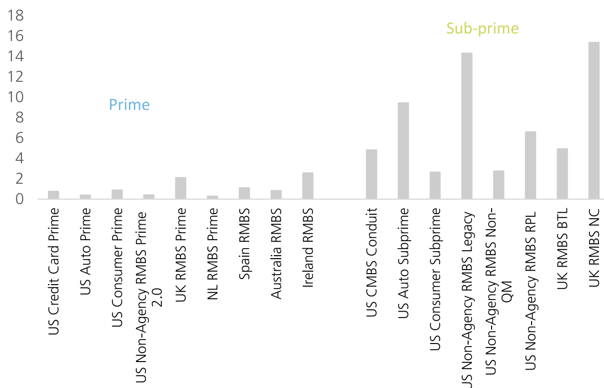
Figure 3: Credit spread vs. weighted avg life, AAA securitized and AA corp. FI



Source: : Goldman Sachs, UBS, as of February 2024

Defaults and delinquencies also drive ABF returns. Here the outlook is mixed, as shown in Figure 4. While prime ABS sectors continue to show strength, delinquencies in non-prime areas have increased, particularly in the mortgage and auto loan sectors. This reflects broader economic challenges and financial pressures faced by lower-income (and higher credit-risk borrowers). However, we note that overall pricing and returns for this diverse sector should contain default risks for well-diversified ABF investors.

Figure 4: Delinquency varies across sectors (in % of all collateral balance)



Source: Citigroup Inc., UBS, as of February 2024

Investors may wonder how borrowing affects returns. Many ABF strategies do use leverage to amplify returns on their underlying assets. This includes using borrowed funds to invest in a larger or more diverse pool of assets to find higher return opportunities or diversify exposures.

Using leverage increases the risk of returns falling in a slower growth or higher interest rate environment. Returns in leveraged assets will also be more sensitive to investor sentiment and risk appetite than unlevered ones.

ABF in your portfolio

ABF offers a distinct role in investment portfolios through its diversification potential, especially in fixed income portfolios that are often concentrated in corporate and alternative debt. The strategies' diverse pool of underlying assets across different credit profiles and geographic regions provides lower volatility and/or moderate correlation with other asset classes. As shown in table 1, ABF has an average long-term correlation of 0.48 to US corporate debt and 0.58 to private direct lending. Additionally, the stable, collateral-based cash flows generated by ABF are particularly beneficial in times of macroeconomic volatility and economic uncertainty offering an effective hedge against inflation and adding resilience to portfolios.

Table 1: Long-term correlation matrix across various asset classes

	US Equities	US IG	US Loans	US High Yield	Direct Lending	ABF
US Equities	-	0.39	0.59	0.67	0.57	0.54
US IG	0.39	-	0.33	0.52	0.22	0.48
US Loans	0.59	0.33	-	0.78	0.70	0.68
US High Yield	0.67	0.52	0.78	-	0.65	0.69
Direct Lending	0.57	0.22	0.70	0.65	-	0.58
ABF	0.54	0.48	0.68	0.69	0.58	-
Avg Correlation	**0.55**	**0.39**	**0.62**	**0.66**	**0.54**	**0.59**

Source: S&P 500 Index, Bloomberg US Corporate TR Index, LSTA Leveraged Loan Index, BofA US High Yield, Cliffwater Direct Lending Index, ICE BofA US ABS & CMBS Index to proxy for ABF returns, UBS, as of February 2024

Managers can address non-performing assets to mitigate investor losses and enhance recoveries through active management, particularly in sectors like residential real estate, consumer, and small business lending. The broad scope of ABF allows for active returns through the breadth of the various investment approaches and asset classes. This, coupled with the significant skill disparity in private asset management, presents broader opportunities for managers to achieve superior potential returns and effectively manage risks while positively impacting investor outcomes. As such, the need to choose seasoned investment managers with proven track records in a specific part of the ABF market—including through different business cycles—is key, in our view.

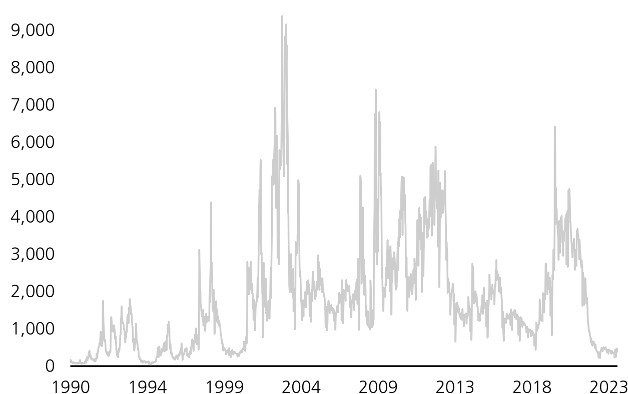
Key risks

ABF offers attractive yields and diversification, but investors should be aware of the challenges like illiquidity and complexity, and risks to successfully navigate this landscape.

- **Credit risk and collateral quality** are key risks in ABF, as they directly affect its performance and risk-return profile. Fluctuations in the value and quality of underlying assets, such as loans and leases, and related delinquencies, significantly impact ABF. During the GFC for example, poor collateral quality in mortgage-backed securities resulted in mass delinquencies and major losses.
- **Economic factors** also play a pivotal role. Broader economic shifts or changes in consumer behavior, like a recession or higher unemployment, can cause higher default rates on loans in ABF facilities, resulting in greater credit losses for investors.
- Given the bespoke and idiosyncratic nature of the asset class, **concentration risk** is a concern when the asset pool lacks diversity. If an ABF is heavily concentrated in one type of asset or sector, it's more vulnerable to economic shifts. This highlights the importance of strategic portfolio construction and risk management in ABF investments.
- The private ABF market is typically **less liquid** than other types of credit debt, such as corporate bonds, making it harder to sell at a fair price, especially in market stress.
- ABF can carry **prepayment risk** and **extension risk**. Particularly in consumer mortgage loans, early repayments driven by lower rates and refinancings can force reinvestment at less favorable rates and impact investor return. On the other hand, higher interest rates can slow loan prepayments, extending investment periods at lower rates and increasing mortgage durations.

Figure 5: MBA mortgage refinance index in the United States

An indication of the refinancing activities on US consumer mortgages



Source: Mortgage Bankers Association, UBS, as of February 2024

- **Regulatory changes** can also significantly impact ABF's risk-return profile, warranting ongoing diligence from managers and investor flexibility.
- Lastly, **performance dispersion among ABF managers** varies widely due to differences in expertise, risk management strategies, and asset selection and diversification. Some managers invest broadly across sub-asset classes, while others specialize in areas more sensitive to economic cycles. This dispersion, combined with managers' ability to navigate market shifts, operational efficiency, and use of leverage, leads to a broad range of potential returns. Investors and managers should conduct extensive due diligence to optimize long-term success and mitigate risks.

Appendix – ABF in detail

I. How managers access ABF

As ABF covers multiple sectors, successful management requires expertise on both asset level and instrument creation. Managers need to be able to maintain or improve control over the underlying assets, while building flexible structures that can navigate shifting macro- and microeconomic conditions. Specialist expertise may be crucial for certain types of ABF assets, given that each category has its own characteristics.

Practically, gaining exposure can take different shapes or forms across the following categories:

Whole loans, which can include exposures made to residential mortgage or consumer borrowers. Both bank and non-bank lenders can originate pooled loans, which can then be either tranched or untranched and include a specific collateral profile.

Public securitizations trade on public markets, requiring periodic reporting. These assets are generally described as public ABS. While ABS provides investors with generally liquid instruments with different layers of risk and return, buyers may have limited control over pricing and terms.

Private ABF is a market where instruments are negotiated bilaterally, including private securitizations or bridge financing requiring structuring expertise and in-depth knowledge of the assets involved on the lender's side. This expertise helps setting up loan terms, covenants and collateral on one hand, and offers borrowers flexibility on the other. This flexibility, however, comes at a premium for borrowers over public ABF.

Access to specialized loan origination platforms through partnership or ownership. Managers can source loans through originators and servicers, or in some cases seek to gain direct control and exposure to proprietary deal flows by gaining ownership of said originators. The benefits of this practice include:

- Gaining preferential rights and participating in originator platform expansion. Preferential rights can include rights of first refusal on originated loans or debt securitization.
- Reducing the number of intermediary parties.
- Performing direct due diligence and maintaining oversight and control of credit documentation, which helps lower risks.

Originator control, however, requires in-depth knowledge of the assets on the loan platform and structuring expertise to fully realize the benefits of flexibility and potentially lower risks.

II. Securitization basics

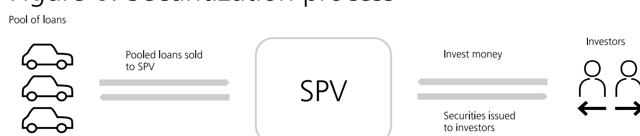
Securitization, at the simplest level, is a form of financial market repackaging. Essentially it is the process of transforming an asset into a marketable form.

ABF can include either securitized or unsecuritized collateral. In the cases where managers choose securitization, the following reasons help explain why:

1. Securitization reduces (dis) intermediation costs, which results in lower funding costs for borrowers and higher risk-adjusted returns for investors.
2. Investors have stronger legal claims on securitized assets.
3. Improvement in liquidity.
4. Lenders/banks can increase lending capacity.
5. Enables tailored investments, fitting investor preferences.
6. Offers risk reduction and diversification over single loans.

Securitization often starts with the creation of a special purpose vehicle (SPV) to create a separate legal entity and to isolate risks and offer protection against eventual bankruptcy proceedings. In this case, an SPV serves to isolate cashflows related to the collateral within a closed ecosystem, allowing investors to focus on the underlying cash flows and attributes of the collateral (see Fig. 6).

Figure 6: Securitization process



Source: UBS

The process of securitizing cash flows typically looks like this:

1. A loan originator and a borrowing party agree on a loan. For example, a car loan provider agrees on a loan to a consumer buying a car.
2. The loan is then purchased by a specialty finance manager and aggregated with other similar loans
3. The loans are structured, securitized and "warehoused" in an SPV with revolving credit lines.
4. Loans are then syndicated and priced according to ratings, and pre-sold to investors.
5. Finally, the pooled loans are then sold, for example as securities backed by car loans, to for example asset managers or insurance companies.

Lenders and capital owners can opt for securitization to help them focus on their main activities. The following participants benefit from this:

- *Lenders* who specialize in credit origination, lending and servicing to creditworthy borrowers. Securitization is less capital intensive for them compared to keeping loans on the balance sheet. There is also the potential for additional profits if loans are sold above par.
- *Investors* could gain access to forms of lending that were otherwise considered less investible and could see additional diversification in fixed income portfolios. They would also benefit from potentially higher yields than comparable securities with the potential advantages of relatively predictable cash flows, diversification, and increased liquidity.
- *Borrowers* potentially experience better credit terms and gain access to more innovative financial products as originators are less capital intensive.
- *The broader financial system* could benefit from a lower cost of capital through price discovery for credit risk, specialization between originators and capital owners, and see more efficient loan resolution

III. How does ABF differ from direct lending?
A key question that arises when discussing ABF is how this investment opportunity differs from private credit segments that investors may be more familiar with, like direct lending. The main differences can be found in the borrower type, sector exposure, and cash flows, allowing investors to diversify from typical private credit exposures in portfolios.

Table 2: How ABF differs from Direct lending

	ABF	Direct lending
Sector	Multi-sector	Corporate
Borrower type	- Consumers - Corporate borrowers - CRE operators - Home owners	Corporate borrowers, often PE-backed
Capital structure	Mainly senior secured	Mainly senior secured
Credit rating	Mixed, rated and unrated	Unrated
Rate structure	Floating and fixed	Floating
Maturity	Short (1-5 years)	3-5 years
Cashflow	Mixed: front and back-ended	back-end
Yield structure	Floating: SOFR+ spread + OID. For others, spread over public equivalent debt	SOFR + spread + OID

Source: UBS

IV. Sustainable investing in ABF
ABF is also increasingly a topic for sustainable investors, where we see underlying assets and the structure and originator as key considerations. Underlying assets can include (but are not limited to) commercial properties which support social/environmental outcomes (e.g. hospitals or education institutions); ABS that provide capital to companies that produce products with a sustainability thesis (e.g. renewable power or electric vehicles); and agency MBS that reach underserved populations. Sustainable ABF strategies are most likely to appear as a subset of a core sustainable fixed income strategy, as part of a thematic diversified strategy that includes labeled bonds, or as a standalone approach. Please refer to "Sustainable agency MBS and securitized products", published on 14 July 2023, for more insights on sustainable issuance in securitized products, reporting, and its proportion in portfolios.

Appendix

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