Värde Views: The Case for Asset Lending

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With credit spreads at historically tight levels and reliable sources of yield appearing elusive, we believe asset lending strategies offer the potential for consistent current income, solid absolute returns and strong downside protection secured by quality underlying collateral. Moreover, while traditional corporate credit exposures have grown in the portfolios of many asset owners, we believe asset lending can offer a better balance and diversification of sectors within a total portfolio.

WHAT IS ASSET LENDING?

Quite simply, asset lending is extending credit to a borrower where the credit instrument is supported by tangible assets (either real or financial) or contractual cash flows. Examples of real assets include commercial real estate, consumer housing, equipment and machinery, infrastructure and transportation assets. Financial assets generally consist of receivables from commercial borrowers and consumer loans in both secured and unsecured form. These assets both generate cash flow to service and ultimately repay the credit instrument and offer the necessary collateral to provide an important margin of safety.

To illustrate, suppose a lender extends a “vanilla” cash flow-based loan to a corporate entity. That corporate borrower will repay the loan with the cash it generates through its operating businesses as a whole.

In contrast, an asset-backed loan typically represents a secured claim on a specific set of the borrower’s assets, perhaps commercial real estate with tenants under contract, equipment critical to an operating business, or a diversified pool of financial assets. So, the likelihood of repayment of that asset-backed loan is improved by the tangible nature of the underlying asset and is tied more directly to the performance and cash flows of that collateral, rather than just the general operating performance of the business.

For example, a loan that is backed by credit card receivables will naturally have performance more closely tied to whether consumers in the pool are paying their credit card bills. In addition, the asset is not only the primary source of cash flows for repayment of the loan, but also constitutes specific collateral that can be taken in case the borrower defaults.

	Asset-Based Lending	Corporate / Cash Flow
Collateral	Financial assets and hard assets	Creditor in operating companies
Underlying value	Evaluate stability and performance over time	Subjective market and transaction multiples
Covenants	Clear performance-based and financial covenants	Increasingly covenant-lite structures
Default resolution	Control asset	Bankruptcy court / restructuring process

HOW CAN THE RELATIVE VALUE OF TODAY'S OPPORTUNITIES BE ASSESSED? WHERE DOES ASSET LENDING FIT INTO THAT ANALYSIS?

Our assessment of opportunities is informed by our investing activities and presence across a wide range of global public and private credit markets in many sectors and geographies. This expansive purview provides us with a sharp lens on relative value and the price of credit across markets. To assess relative value empirically, we look closely at returns relative to the risk of loss. We consider a variety of factors including loan-to-value, asset quality, economic sensitivity to underlying collateral value, and durability of cash flows.

We currently believe asset lending offers some of the best relative value we see across our investing platform. In several asset lending markets, we believe there is a persistent opportunity to lend at attractive spreads in structures which incorporate several important elements of downside protection. Although we're talking about the appeal of asset lending today and we appreciate that many asset owners are newer to the strategy, it is important to remember that many of these markets have existed for quite some time. Additionally, these markets are massive in scale and diversity, and therefore have meaningful recurring financing needs.

Furthermore, the private credit ecosystem has been underpinned by structural dynamics that are expected to shift \$5-\$6 trillion of assets to the nonbank sector over the next decade. The growth of private credit we have seen post-global financial crisis (the "GFC") only continues to accelerate, and we believe this trend will continue given the long-term dynamics at play and the simple fact that there is a shortage of available capital relative to demand.

WHAT GAVE RISE TO ASSET LENDING IN THE FIRST PLACE?

The asset lending opportunities we see today trace back to the secular trend of bank retrenchment, beginning with the over-extension of credit set in motion in the early 2000s and culminating with the aftereffects of the GFC. Prior to the GFC, banks and large non-bank finance companies represented the primary capital providers in asset lending markets, such as commercial real estate lending, homebuilding, trade finance, consumer finance and infrastructure finance. As a result of the GFC, most relevant non-bank finance companies either became banks to secure more stable funding and government support or went out of business.

In addition, post-GFC banking regulations generally increased capital requirements for banks to participate across a range of lending activities. These regulations increase the cost of pursuing certain business and hold other implications for how banks participate in the markets we discuss here. If the banks cannot pass on the higher cost of capital to the borrower (and often they cannot in competitive markets against alternative lenders, while simultaneously satisfying the constraints of these regulations), the result is typically a reduction in lending and securitization activities in some asset classes, divestment (or shuttering) of non-core business lines, and a consolidation of customer relationships.

So, today, you have the intersection of two powerful dynamics creating the attractive relative value we see in asset lending and the rise of a new cohort of alternative lenders. First, meaningful capital gaps continue to persist in a number of markets, even while we are 15+ years removed from the GFC and the ensuing bank retrenchment it catalyzed. This is the supportive supply side dynamic of capital markets playing through. Second, several of the markets dependent on asset-centric lenders have continued to grow—this is the demand side dynamic playing through, also conferring advantage to alternative capital providers.

To bring these dynamics to life, consider U.S. homebuilding. Today, new housing starts are back to historic averages, and yet land acquisition development & construction loans are down nearly 60% since the GFC. This has led to a meaningful undersupply of finished, buildable lots and a very dynamic environment for homebuilders as demand for housing has increased.

WHAT DOES IT TAKE TO BE SUCCESSFUL IN THESE MARKETS AS A LENDER?

We cannot emphasize enough the importance of repeatable and scalable origination capabilities. By "origination," we mean activities across the full value chain of lending from the initial sourcing of a potential transaction, to structuring and funding it, all the way through to asset management and monitoring, which, depending on the asset class, may require expertise in everything from hard assets to data science.

From a sourcing standpoint, we have organized our own investing teams to draw from deep expertise in specific markets while allowing for flexibility and expansiveness across a range of asset classes – our investment professionals are deeply integrated into the fabric of their asset and geographic markets. As we cultivate these sourcing networks, we believe we build barriers to entry over time, through relationships, reputation and experience, that should offer us a more persistent opportunity set and deal flow. This flexibility in sourcing, coupled with strong oversight from senior leadership, ensures that our resources are allocated to the most compelling deals we see across our platform.

WHAT ARE THE KEYS TO SUCCESS TO UNDERWRITING THESE LOANS?

Unlike traditional cash flow-based private credit, expertise in the specific asset collateral is vital in the underwriting of an asset-backed loan since the performance of the underlying assets is a key driver of the ultimate quality and performance of the loan. The specialization required to navigate these investments effectively is less common in the marketplace, narrowing the competitive universe of lenders. We see this supply/demand imbalance play out across a number of the markets where we are currently active, and have been over Värde's history.

This supply/demand mismatch tends to tip the balance of power in favor of the lender who can understand and underwrite the assets and develop a custom financing structure for the borrower. There are several elements that a borrower might find important in a custom financing solution, from legal structure and key terms, through timing of execution, to the mix of collateral backing the financing, to name a few. As a lender in these markets, we are often able to negotiate robust covenants and other lender protections that would typically not be available in the more well-trodden corporate credit markets where pricing and terms are more competitive and influenced heavily by the capital markets.

While the specific terms of any loan agreement will vary by investment, these covenants can take a variety of forms, including control over the borrower's use of loan proceeds and capital expenditures, amortization requirements, leverage-related covenants, cash flow sweeps, dividend restrictions, and even corporate or personal guarantees that augment the support from the specific asset. Our team has deep experience in the types of assets we're underwriting in these strategies, having invested as both an owner and a lender. That perspective across the capital structure and as an operator gives us unique insights into how these assets work and can be optimized, and also into the needs of the current owners in today's environment. We have the credibility to approach potential partners with custom solutions designed to meet their needs, and the expertise to create attractive financing structures that we want to invest in.

The downside protection conferred by ease of access to specific collateral is another important structuring consideration. While our lending activities are not generally predicated on a desire to own the underlying collateral, clean and direct access to it is a critical feature in preserving principal in case events don't go according to plan. As previously noted, this underscores a key distinction from corporate cash flow-based lending, where lender recourse is generally to the operations of the business – typically a more complex equation.

A key component of recovering value in the case of asset lending is by ensuring clean, clear access to specific, tangible assets or contractual cash flows, ideally sidestepping the process of recovery from an operating business. In many instances, this can be accomplished by "ring-fencing" or segregating the assets into bankruptcy-remote entities.

WHAT DO YOU LOOK FOR IN ASSET LENDING OPPORTUNITIES?

As a starting point, we favor scalable markets where the need for capital is high, but the supply is relatively scarce. We also want to focus on markets that have a few key opportunity sets where we see the need for capital solutions, in sectors where we can identify tangible assets or contractual cash flows that we believe have the resiliency to hold their value.

WHAT IS THE SIZE AND NATURE OF ASSET LENDING?

The term "specialty finance" broadly denotes consumer loans and small balance commercial credit. It can also encompass lending against more esoteric collateral with contractual cash flows, like royalties or long-term services contracts. These are deep markets that present a diversity of opportunity, which by our estimates total at least $3.5 trillion[1]. These markets are not only massive, but also growing well above GDP growth rates and therefore present us with a variety of durable asset lending opportunities. Consumer credit to us includes lending against or acquiring pools of consumer financial assets such as personal loans or loans secured by autos or other large ticket items. It also includes point-of-sale finance, which is one of the fastest growing segments of personal finance markets. Here, consumers receive financing for the purchase of goods or services directly from a retailer, whether online or in person, allowing them the convenience of paying over time. The merchant still receives its required payment at the time of purchase, and ready access to financing might even drive greater aggregate sales.

Commercial credit encompasses a variety of forms of lending to small businesses, including lending secured by tangible assets used by the business or contractual cash flows such as business contracts or financial assets. For example, some small businesses might borrow against or lease capital-intensive assets like equipment and machinery that are integral to their activities. Receivables factoring is another commercial finance product that allows a business to sell its accounts receivables at a small discount, receiving cash sooner than it could otherwise collect and compensating the lender via the purchase discount. This form of financing shortens the normal receivables collection timeline and can be a critical lifeline for a small business. The common denominator across these examples is that they demonstrate how commercial borrowers can use their assets flexibly to obtain financing, and a lender can have greater security by attaching a loan to identifiable assets.

CAN YOU DESCRIBE THE STRUCTURE OF THESE ASSET LENDING INVESTMENTS? WHAT ARE YOU FINANCING EXACTLY?

There are two primary ways to structure these financings. The first is what we commonly refer to as “lending to lenders.” In this structure, we are providing capital directly to a platform, typically a company providing small balance commercial or consumer loans, that has assets on its balance sheet. The platform may be looking to raise financing for growth or balance sheet efficiency, and can obtain greater flexibility to extend credit to its own end customers by partnering with us. Such a direct loan will likely feature a security pledge of the loans that the business is making, which typically represent large pools of diversified exposure. The capital Värde provides can also have security in the form of a direct guarantee that could be satisfied by other business-critical assets.

The second common financing structure in specialty finance is buying whole loans outright, or providing financing against these assets. Loans can be acquired either in bulk transactions as a diversified portfolio, or purchased over time, i.e. as a “forward flow.” In a forward flow arrangement, the lender agrees to buy pools of loans that the platform will make in the future in its normal course of business. The motivation for the platform is to free up balance sheet capacity in order to maintain its ability to originate more loans to its customers. In structuring a forward flow agreement, we can typically specify the credit underwriting criteria for loans we are willing to acquire and forgo the purchase of anything that falls outside of them. This ability to define the underwriting criteria is a key ex-ante risk mitigant. In many instances, the platform also provides first-loss capital into the structure, which means it will absorb all losses up to a certain point, if any.

Again, a key structural feature that should be evident in these examples is that the assets, not the borrower counterparty, generate the cash flows to repay the principal and interest of our credit instrument. This mitigates potential counterparty credit risk. The asset diversification often inherent in these investments is a crucial component of downside protection because it means that no single underlying asset can have a significant negative impact on the loan pool that collateralizes our credit instrument. There are often hundreds or even thousands of individual assets (in the case of small balance loans) forming the security backing a single investment, such as our loan to a platform, or in cases where we acquire a pool of assets. These individual loans are often self-amortizing, relatively shorter duration, and generate current income in the form of interest. The quickly amortizing nature of the loans means that proceeds can be reinvested into the creation of additional assets and compound returns.

About Värde Partners

Värde Partners is a leading global investment firm specializing in credit and credit-related assets. Founded in 1993, the firm has invested more than $100 billion across the credit quality and liquidity spectrum and currently manages $16 billion in assets. With local investment teams and partnerships in North America, Europe and Asia Pacific, Värde invests across private and public markets with a focus on real estate, asset-based finance and corporate credit. For more information, please visit www.varde.com.

Disclaimers

Footnotes

1. Source: Värde estimates.

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