EXPERT Q&A

In an uncertain macroeconomic environment, it's business-as-usual for LCM Partners' asset-backed lending strategy, says Paul Burdell, co-founder and chief executive

Asset-backed lending: why partnerships work

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Q What areas of the European asset-backed market are you focused on?

We launched our Strategic Origination & Lending Opportunities (SOLO) strategy in 2018 to target segments of the European credit market within asset finance and real estate backed secured lending. The point of differentiation is granularity. We are, for instance, lending against small-ticket business critical equipment or providing residential property bridging loans and development finance, with the underlying asset values ranging from anything as little as €5,000 up to a maximum of around €5 million.

Our expertise lies at this end of the market because of our 23-plus years' experience of managing consumer and SME NPLs and it's where we find we're able to invest at attractive unleveraged yields. The banks typically don't like the small-ticket financing segment when the product lacks scale as they find it labour intensive and inefficient to manage; that's why the likes of Santander and Barclays publicly exited the UK asset finance market in 2019 and 2021, respectively.

The other area where we are seeing an increasing number of opportunities is in renewables, again in funding the more granular assets and service equipment rather than the larger ticket infrastructure itself. Having a product with positive ESG attributes wasn't our intention back in 2018 but ESG is obviously a topical subject with investors and so it's an undoubted positive that we are now offering an Article 8 product under the EU Sustainable Finance Disclosure Regulation (SFDR).

Q How scalable is the renewables opportunity?

We think it's huge, and what's more striking is the breadth of opportunities. People immediately think of the power generating assets such as solar panels or wind turbines but there's all the service equipment around the operations as well. To give an example, Europe is expected to install 116GW of new wind farms in the next four years, which is enough to power up to 116 million homes. To achieve this, engineers need physical access to the sites in large numbers and currently it's estimated there's a backlog of over 400 crew transfer vessels to meet demand for wind farm construction and maintenance. These are small-ticket boats (£3 million-£5 million [$5.6 million; €5.7million] in value) which are usually leased by the wind park owners for a five-year period. The banks tend to view the individual deal sizes as small, and often a boat yard may only manufacture five or six boats a year. Conversely, we're happy to embrace the granularity and we like the asset type given the favourable supply and demand dynamics.

Q You mention supply and demand dynamics, how are you navigating the current economic environment?

To date we've not experienced any losses, including during covid. However, covid wasn't the test everyone expected it to be and most GPs are holding up well this year, so the true test certainly lies ahead. Nonetheless, there's no doubt that an asset-backed strategy provides an additional layer of comfort in more difficult economic conditions.

Our modus operandi is to enter into long term (three-to-five year) exclusive origination partnerships and this won't change. These are relationships that take some time to establish but the expectation is that both parties are in it for the long haul, irrespective of changes in the economic environment. That is why we spend a lot of time on structuring, ensuring our partners are sufficiently incentivised whilst at the same time building in downside protection that preserves our base-case returns even in stressed default scenarios, such as those experienced during the global financial crisis.

We're clear with our partners from the outset about our eligibility criteria and the risk profile that's acceptable to us, putting in place back-ended profit-sharing arrangements and first loss pieces to make sure we align interests. We're five years into the strategy now with 15 origination partnerships up-and-running, and we're confident in the strength of these partnerships even through the coming downturn. With our focus on high-quality, asset-backed credits, it is largely a case of business-as-usual.

As an aside, one added benefit of the partnership model is that it also provides prospective investors with great transparency and visibility. New LPs know that the investments they're diligencing on the way in are likely to comprise a significant percentage of their deployment in the coming years. It tends to mean that they're fully engaged and want to get into the detail, which is exactly what you want as a GP.

Q Who are your partners and why do they want to work with LCM?

It's a good question because we're not the cheapest financing available. Our partners are typically established Original Equipment Manufacturers or experienced specialist originators that, for a variety of reasons, fall outside the remit of traditional bank financing. Some OEMs have their own captive finance or leasing arms to support their vendor finance programmes but these businesses can have capacity issues as they're typically subjected to the same regulatory and capital constraints as the banks.

Outside of the larger operators, most OEMs prefer to preserve their capital for research, development and production yet want the benefits of offering sales financing or a rental solution to their customers. In the case of the specialist originators, often they value the long-term nature of the capital and that we can offer flexibility that the banks can't; we're borderless, we're more creative with our financing solutions, we have operational and servicing capabilities that our partners can leverage, and we are much quicker and easier to deal with.

Q You say you're not the cheapest capital in the market, what yields are you trying to achieve?

It's a question we're getting asked a lot at the moment. Historically, we've targeted unleveraged yields of circa 9 percent, which we think is an attractive risk-adjusted return given the asset backing. Yields are definitely going up for new originations but the majority of our lending is fixed rate, with the real estate backed financing being short duration, typically between 12-18 months, and our leases between three-to-seven years.

Going forward, we're naturally able to hedge ourselves against increasing rates because of the granular, flow nature of our origination with many hundreds of new lends per quarter. Having said that, bank rates have moved materially in a short space of time and, like most in the private credit arena, we are playing catch up in terms of preserving our illiquidity premium versus public market comparables. That is starting to filter through and we expect more increases in the coming quarters.

Q What are your expectations for the next 12 months?

As is always the case in a downturn, we know our capital is going to get more popular and that can bring with it both risk and opportunity. I expect the next 12 months to be extremely busy for one thing. As mentioned earlier, we're really pleased with the partnerships we have in place today and they'll be the foundation of our asset-backed lending business going forward. There is going to be ample opportunity for us to add new partners, but we will be selective. We are clear about the asset types we want to target and how we'll structure those investments. And for each new originator that we do partner with, the expectation has to be that it's going to be a mutually beneficial multi-year relationship; that we're both in this for the long haul. ■