E X P E R T Q & A

Given the diverse nature of the asset class, and the number of new asset-backed lending strategies coming to market, the importance of manager selection should not be underestimated, says Paul Burdell, co-founder and CEO at LCM Partners

Asset-backed lending: A heterogeneous asset class

Q Are you surprised by the increased interest in ABL strategies?

In a word: no, but given we launched our ABL strategy, Strategic Origination and Lending Opportunities (SOLO), back in 2018 you wouldn't expect me to respond in any other way. I think what has surprised me is the time it has taken to see this uptick in LP interest, but there are good reasons for this.

Post-global financial crisis, LPs searching for yield in a zero interest rate environment were forced to look more closely at alternative asset classes, including private debt, and by that I mean predominantly mid-market direct lending. For many, it was a move into uncharted territory with the asset class unproven and question marks over the sustainability of the opportunity set.

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Fast forward to today, direct lending has largely delivered from a return perspective and the majority of institutional investors now have a dedicated, standalone allocation to private debt. Yes, there will always be competition between the direct lenders and the banks but, in general, there's much more conviction among the investor community in the longevity of the opportunity set for private debt. Indeed, there used to be a healthy dose of scepticism about the extent to which regulation was constraining the banks but, with implementation of the final Basel 3 revised standards for bank capital requirements looming on the horizon, that mindset has changed.

So why has it taken until now for a greater number of LPs to deploy capital into ABL strategies? We've got to remember it remains a relatively niche strategy, reserved mainly for investors with established private debt portfolios looking to diversify their exposures.

Where we have differed from LPs is that we have had real conviction in the ABL opportunity set for some time. If we take the European asset finance market for example, a number of lenders exited some time ago – ING, GE Capital, Santander and Barclays to name only a few – so there has been demand for non-bank lending solutions for years.

Q Why have so many lenders exited the European asset finance market?

Without wanting to sound like a broken record, regulatory legislation has had a profound impact on bank behaviour. That's why we've seen loan sales in Europe in excess of €1.2 trillion since the global financial crisis.

In terms of asset finance more specifically, it's exactly the type of lending that banks don't want to do. Banks want to lend at scale into homogeneous asset types. While the European asset finance market is large with annual leasing volumes at c. €400 billion, demand comes from such a wide range of assets from larger ticket aviation, marine and industrial assets through to more granular agricultural equipment and wheeled assets. Moreover, leases are complex, covering a range of products including finance leases, secured loans, hire purchase arrangements and operating leases. It's hard to scale your deployment in similar asset types with comparable risk profiles.

On the flip side, that's what makes it such an attractive opportunity for non-bank lenders. We're able to be flexible in terms of the financing solutions we provide, and at the same time, embrace the operational complexity.

Q What is the opportunity set like in Europe?

I don't think the increased interest in ABL strategies is symptomatic of any improvement in the opportunity set. More funds are coming to market because managers realise the opportunities are scalable, and the LPs want to diversify away from EBITDA lending.

We've thought the space has offered compelling returns for years, and that remains the case today. One point that's important to note is that the majority of our lending is fixed rate over a term of up to seven years. One of the developments over the last two years that has pleased us is the extent to which yields have improved in line with interest rate rises, albeit with a bit of a lag. It means we're currently originating asset-backed loans and leases in the unleveraged 11-13 percent gross IRR range.

On the other side of the equation, we have always liked the defensive qualities of the asset class. If we use asset finance as an example again, studies have shown that leasing default rates and loss-given-default rates compare favourably with traditional bank SME lending, particularly during periods of market stress. This shouldn't be a surprise, especially if the focus is on leasing business critical assets with liquid secondary markets as we do.

"We're focused on the granular end of the market, which means we don't have high concentration risk in individual loans or underlying exposures"

Q Are you concerned about increased competition with more managers launching ABL strategies?

Not at all. The market is deep and there is such a diverse range of opportunities. What we have learned, though, is that with more strategies coming to market, it's increasingly important to clearly articulate your own investment strategy. ABL strategies can be complex, targeting a wide range of assets with differing risk-return profiles. That makes manager selection all the more challenging for allocators as you're rarely comparing apples with apples.

Q Given the wide range of opportunities, which areas are you most focused on?

SOLO targets investments across asset finance and secured real estate backed lending. Our USP or point of differentiation is that we're focused on the granular end of the market, which means we don't have high concentration risk in individual loans or underlying exposures.

With more than two decades of experience at the smaller ticket end of the SME loan and lease markets, we've developed a deep understanding of this segment of the industry, established long-standing relationships with key originators and gained broad operational experience, as well as considerable data and insight into borrower behaviour. It's where we've got a demonstrable edge, and we plan to stick to our knitting.

LP interest in investment strategies will always ebb and flow over time. We're fortunate to have SOLO at a time when ABL strategies appear to be in vogue. But we've been active at the granular end of the market for 25 years and expect to be here another 25 years. It's that experience and know-how that is integral to delivering returns over the long term. Pleasingly, allocators are taking note. ■