

SFA Research Feature

Harnessing the Potential in Private Asset-Based Finance

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Introduction

Private structured credit – also known as private asset-based finance (Private ABF) – is garnering significant attention these days with issuers seeking to diversify their capital sources, banks reducing their lending capacity and alternative investors raising capital. These developments are encouraging new investors to enter the market, each bringing varying degrees of experience and expertise.

Investors looking to launch a Private ABF strategy to capitalize on evolving financial opportunities are pursuing diverse approaches. Some opt to recruit senior leadership or teams, while others choose to purchase platforms. Another frequent tactic is to expand an existing publicly-traded Asset-Backed Securities (Traded ABS) investment team to include a private investing strategy. We look at the merits and considerations of launching a Private ABF strategy alongside a Traded ABS business, as it has the potential to broaden the pool of capital providers in the market, ultimately benefiting consumers and businesses.

What is Private Asset-Based Finance? How does it differ from Traded Asset-Backed Securities?

Private ABF are tailored, privately originated, credit solutions with an asset pool component, covering transactions that involve asset sales and asset financings, and negotiated by investment managers. For decades, Private ABF has served as an alternative financing source to Traded ABS, which are purchased either through a public (S-1) offering or a 144(a) private placement issuance. Private ABF has historically played a significant role in evaluating new structures and asset classes and providing customized financing solutions for unique situations. It has evolved into an efficient and viable financing source for a variety of assets and has grown to be a significant component of the structured credit market. Based on analysis of consumer and credit volumes, fund-raising and bank activity, global Private ABF [issuance](#) is estimated to have increased from \$4.5 trillion in 2020 to over [\\$5 trillion](#) at the end of 2022, as issuers, who originate the underlying assets in the pool, have relied more heavily on Private ABF to diversify their funding sources during periods of market volatility and to supplement bank financing as financial institutions retreat from the market.

Private ABF has many similarities to Traded ABS and therefore a significant knowledge overlap exists between Traded ABS and Private ABF investors, as shown in the table below. As one investor noted, “Both teams are in the business of managing risk,” and have similar objectives on portfolio construction and diversification. For purposes of this comparison, a Traded ABS investor will purchase CUSIP-ABS bonds either on the primary or secondary market, tend to hold them until maturity (rather than frequently trade the bonds) and does not make any markets in the ABS bonds.

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Existing Overlap Between Private ABF and Traded ABS Investing

		Private ABF	Traded ABS
Security	Involving a pool of assets with contractual cashflows, such as leases, loans or receivables	✓	✓
Hard Asset Protection	May be secured by real estate, autos, equipment	✓	✓
Non-Recourse	<ul style="list-style-type: none"> Source of repayment is only from the assets with no other party providing support Assets are segregated from corporate performance and are “bankruptcy remote” 	✓	✓
Priority	Lender has priority over a specific pool of assets before any other corporate debtors	✓	✓
Structure	Key structural features include payment waterfall, performance triggers, termination events	✓	✓
Servicer	The originator or another third-party services the assets	✓	✓
Rated	Rating agency may issue a rating based on established criteria for the specific asset class	✓	✓

However, differences between the two strategies exist and need to be acknowledged when transitioning a Traded ABS investment team to a private strategy. The table below details a few variances between the two strategies:

Differences Between Private ABF and Traded ABS Investing

	Private ABF	Traded ABS
Product	Many different forms, such as loans, TRS, repos, credit-linked notes (CLNs), and securities	Securities format with ISIN/CUSIPs
Distribution	Bilateral transactions between a limited number of parties, frequently arranged without an intermediary	Notes are widely distributed to several investors through a third-party arranger via a book-running/auction process
Liquidity	Usually a “buy-and-hold” strategy	Given the standardization of information, the ABS bonds are fairly liquid and are actively traded in the secondary market
Asset Pool	Revolving or “blind” pool of assets to be originated	Typically a static pool of existing assets
Structure	Bespoke structure and documentation negotiated between parties based on parties’ risk-return profiles	Standardized structure which usually replicates previous structure, adjusted for different asset compositions
Information	<p>Information is obtained after both parties sign a non-disclosure agreement (NDA), which permits parties to exchange information and will include (among other items):</p> <ul style="list-style-type: none"> Detailed historical data tapes Originator/servicer financials Management’s performance projections Policies, such as underwriting and servicing <p>An NDA also allows investors to do a thorough initial and annual diligence with the issuer, which may include an on-site visit, learning about their operations and meeting with other employees</p>	<ul style="list-style-type: none"> Information is fairly standardized across issuers and asset classes and includes (i) offering memorandum, (ii) data files accessed through Intex and (iii) after closing, monthly reports prepared by a third-party, such as a trustee All investors receive the same information so that there is no inside knowledge to affect the buy/sell or pricing decisions
Financial Restructuring	Given the direct relationship between the investor and the issuer, the investor will actively participate in any financial restructuring of the private transaction and possibly the issuer’s balance sheet	The structure and broad distribution limit investors’ accessibility to restructure exposure caused by originator’s performance issues
Reporting	Customized monthly (or more frequent) report based on parties’ data requirements	Monthly trustee report in standard format

A foremost distinction is that transaction information in a Private ABF deal – such as pricing, structure, sometimes providers – is not publicly available on widely-used trading resources. Given that a confidentiality agreement restricts the disclosure of any information, any additional information received under a Private ABF confidentiality agreement is highly valuable. Having a direct dialogue with the issuer, reviewing policies, and understanding the issuer’s financial position allows the investor to assess platform and servicer risk at a level not accessible in a Traded ABS strategy. This capability proves especially valuable if an issuer encounters challenges. Unlike Traded ABS where an investor can quickly exit a position if they believe the issuer may be facing some challenges, such exits are not as readily available in Private ABF due to the limited liquidity of the secondary market. This in-depth, comprehensive view of an originator is critical for a buy-and-hold strategy, particularly when there is a long-term investment horizon.

This direct dialogue and in-depth view of an issuer allows the investor to assume a more active role in any financial restructuring of both the transaction and the issuer’s capital structure if performance deteriorates. The Private ABF investor also has multiple options at their disposal and can rely on its direct relationship with the issuer to structure a mutually beneficial solution. The confidential information provides the investor with critical information and insight to effectively protect their exposure and mitigate any potential losses. Additionally, the bilateral agreement negotiated between the issuer and the investor may be a more conservative structure than traded bonds which permits the investor to re-negotiate their debt before other creditors can act. This active restructuring role contrasts with Traded ABS positions in which investors have little expectations of directing any debt restructurings given the trustee’s role in exercising any remedies and a trader’s ability to sell the position.

In a Private ABF transaction, structure and terms are negotiated between the parties and are based on each party’s risk tolerance. While issuers strive for homogenous documentation across their various private financing transactions, differences exist because of the diverse nature of investors involved. For example, because Private ABF investments finance a “blind” pool of assets – meaning the assets will be generated over the life of the transaction – eligibility criteria and concentration limits may differ among private transactions due to each investor’s unique preferences for the pool they wish to finance. Additionally, anticipating future changes to underwriting criteria are critical as an investor wants to ensure that the assets’ risk profile that they are agreeing to finance today will be the same in the future. An investor wants to confirm that the asset quality is consistent with the original analysis and monitoring underwriting policy changes helps mitigate any potential deterioration in asset quality.

Benefits for a Traded ABS Team to Expand into a Private ABF Strategy

Issuer Benefits

- Expand capital sources
- Build on and expand existing ABS relationships
- Optimize private deal execution by reducing the "get-to-know-each other" phase
- Add new parties to ABS investor pool
- Facilitate ABS deals by working with investors who have deep knowledge of platform

Investor Benefits

- Resource efficiency - building a new strategy with individuals already familiar with internal processes
- Helps to create direct origination pipeline
- Minimize private transaction execution timing by working with originators whose ABS bonds have been bought

Financial Institution Benefits

- Expand relationship with existing clients into new products
- Investor is already on-boarded thus reducing KYC processes

The primary theme underlying the benefits outlined above is the importance of relationship building. Firstly, Traded ABS teams have already established issuer relationships, which can provide a foundation for initiating private transactions. Expanding into a private strategy would effectively leverage existing relationships, which are particularly important given that sourcing and origination directly involve the issuer. Secondly, expanding into a private strategy not only expands and deepens existing relationships among all parties involved but also allows for the development of new connections which may facilitate future ABS transactions. As one Private ABF investor explained, “Our goal is for our issuers utilizing Private ABF products to graduate to Traded ABS when we can buy their ABS bonds.” Expanding an existing team also facilitates the execution of a private transaction which, as detailed below, can be lengthy and complicated. The issuer’s business is already known to the investor and this knowledge can be incorporated into the structure at the beginning. For example, if an investor knows that an issuer tends to originate a small portion of its predominantly mid-FICO loan pool with low-FICO obligors, the investor can include this concentration in its initial analysis and terms.

Expanding a Traded ABS team to a private strategy requires careful consideration of three key areas to facilitate a smooth transition and strategy launch:

Origination & Sourcing

The process of originating opportunities will shift to a different practice under a Private ABF strategy. Private transactions are frequently sourced directly from the issuer and not through an intermediary. If a Traded ABS team has relied mostly on arrangers to source ABS bond investments, then the team needs to shift to more direct marketing and relationship-building tactics with originators. These new relationships take time (and lots of travel) to build as the parties carefully evaluate each other, understand each other’s offerings and limitations, and develop solutions that are mutually beneficial.

Daily Cadence of Work

A Traded ABS team should understand that the rhythm of daily workflow will be different under a Private ABF business and should be prepared for a radical change to their work practices. Whereas a Traded ABS team is accustomed to trading on Bloomberg, reviewing trader lists, running deal models on Intex and monitoring trustee reports, the cadence of a Private ABF business is like project management. Issuers and investors are primarily responsible for the management of private deals (with some assistance from third parties), and, as such, the Private ABF team simultaneously manages multiple parties and workstreams to close and monitor a transaction.

A workday for a Private ABF team may be filled with reading legal documents, conference calls with external counsel, engaging third party providers (trustee, custodian, back-up servicer, etc.), internal meetings to brief stakeholders on progress, and multiple calls with issuers on data, practices, new business developments, etc. The team should be aware that it will be heavily involved in the documentation negotiations both during and after closing. Private ABF documentation addresses several business risks that the deal team needs to review. Additionally, private deals have several post-closing amendments to address changes in the risk or provisions that are not operationally efficient.

Due to the multiple workstreams that need to be completed, the execution timing to close a Private ABF transaction is much longer than for a Traded ABS deal where standardized milestones (15g filing, pricing, etc.) drive the closing timing. Investors should be aware that private deals will not progress at the same velocity as Traded ABS deals.

Data, Systems & Infrastructure

Due to the additional data and information provided in Private ABF transactions, investors have the components to develop a deeper view on historical collateral performance, issuer stability and asset projections than in Traded ABS, so long as the investor can process this additional material. Underwriting models and collateral analysis tools that are widely used for Traded ABS transactions may not be fully customizable for Private ABF transactions. Thus, the investor should ensure that they have the ability to process this information with either internally developed systems or third party-provided solutions. A few areas in which Private ABF data and its use differ from Traded ABS are as follows:

- **Loan-level data sets** are larger than public transactions with more data fields and history; the ability to process and analyze these large data sets in an efficient manner may be a key driver to a successful Private ABF strategy.
- **Underwriting models** may be different for each deal; a template that can be adjusted for each private transaction may be an efficient approach until enough deals are completed to build a library of models.
- **Performance reports** are customized to each parties' needs and correspond to unique transaction documentation; they may be daily, weekly, monthly, or quarterly; building and testing these reports may extend the execution timeline and require regular review and auditing for accuracy.

Finally, existing systems that record ABS securities with CUSIPs may not accurately book, track, and value a different product such as a loan or total return swap. A Private ABF team must ensure that existing systems and infrastructure are equipped to receive unique data feeds and can book different products to avoid time-consuming manual adjustments.

Conclusion

Utilizing the existing Traded ABS team for a Private ABF strategy presents a practical way to seize opportunities in the evolving Private ABF landscape. It leverages resources already within the organization, avoiding the need to hire new staff. Additionally, it provides employees with the chance to diversify their skills. However, transitioning a team requires careful consideration of potential downstream effects and acknowledgment of the significant changes in daily responsibilities. When an investment manager launches a Private ABF strategy alongside a Traded ABS business, they broaden the pool of capital providers in the market. This diversification benefits issuers by expanding their funding sources, investors by providing more capital options, and banks and service providers by increasing their customer base. Ultimately, having a team acquainted with both strategies empowers investors to adapt to market shifts adeptly.