When Specialty Finance Meets Silicon Valley Innovation

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Anu Rajakumar: The alternative credit industry continues to grow and evolve according to data provider, Preqin, total assets under management among private lenders is at $1.5 trillion, slightly overtaking the $1.4 trillion market for leveraged loans. Specialty Finance strategies offer access to high-quality deals, backed with strong partnerships, and can be particularly attractive for investors seeking to generate attractive current income via short-duration transactions.

But what types of investments does Specialty Finance strategies actually make? Where are allocators finding the most attractive opportunities and what are the major risks to be aware of? My name is Anu Rajakumar, and today I'm pleased to welcome back Peter Sterling, Head of Specialty Finance, to discuss why this area of the investment opportunity set looks particularly promising. Peter, thank you for joining me today.

Peter Sterling: Thanks for having me back, Anu. Great to see you.

Anu: Great to see you too. All right, so to kick off this episode, Peter, give us an overview of what exactly Specialty Finance means and how can it serve as a complement to other credit exposures?

Peter: I think there's a lot of different ways that people define Specialty Finance, and maybe an easy way to think about it is, in the world of private credit, you have lending that's focused on corporate lending, and you almost have everything else. So, one way to describe it would be all things asset backed or receivables backed. And within that space, there's more specific strategies that focus on short duration, long duration. There are strategies that focus on different sectors from the spectrum of aircraft to real estate, to invoice finance to consumer lending, commercial lending. So, we think of it as a mix of sectors' duration and credit quality, but the common theme is that it's all asset-backed and typically receivables financing.

Anu: Okay, terrific. That's a great umbrella term, but why don't you tell us now, how do **you** define it in the term of what you actually do?

Peter: We're mostly focused on short duration, and our three primary verticals are consumer, commercial, and other asset-backed, loans. Within those categories to give you a couple of examples, consumers are pretty wide category. We mostly look at things like credit cards, auto loans, consumer unsecured loans, point of sale. The commercial category has a lot of small business loans. And when we say small business, we mean very small. So, a loan in that space might be anywhere from $10,000 to $100,000. Within asset-backed, you can see a lot of inventory, finance, invoice finance, typically a couple of thousand dollars per loan. So common theme is really low balance, short duration, average portfolio, weighted average life might be a year or two.

Anu: Now you mentioned within the consumer, you know, credit cards, loans, et cetera, you know, something that we've been seeing is the potential for the consumer, certainly in the US to be coming to a point of exhaustion, and that's what a lot of the headlines say. Now I'm curious in your seat, do you get similar information or what kind of information are you getting? And does it contrast what we're seeing in the headlines?

Peter: Sure. So, I think on the information side, it's pretty interesting because there's a massive bifurcation now between what we read about in the newspapers and what we're seeing on the servicing files. So, we try to do a good job of summarizing all that information and forming insights into what's actually happening on the ground.

So our best guess is that a lot of the negative headlines you may have read about are really referring to vintages from year, year and a half ago and so sometimes you'll see things where auto delinquencies are up, and when you dig in, you'll see that they're up a couple of basis points or maybe they're off of artificial lows from the pandemic when there was a lot of stimulus money.

So, I think it's important to take a broader, longer perspective and look at it, and then also take a look at what's the real-time information. And as far as we could tell, there's a lot more we could dive into in terms of how different segments are performing, but to us, it looks like we're closer to seeing the light at the end of the tunnel than really worrying about going into a much broader recession.

I think a lot of the pain that you've heard about from the papers has been fixed to some degree by tightening on the part of a lot of the lenders, whether it's a FinTech company, a bank, an ABS issuer, a lot of companies have tightened their standards the last year, year and a half, and that's led to lower volumes and higher credit quality. So that all bears out when you actually look at what's happening real-time.

Anu: Now, Peter, let me just ask you, the opportunities that you're seeing in this area of Specialty Finance that you really play in, are these new opportunities, or are these opportunities that have transformed from something else, previously?

Peter: Most of the opportunities are actually pretty vanilla. It's really just that they're being offered to asset managers for the first time, but a lot of the products have been around for a long time. So, the most easy example is talking about credit cards, which have been around since the 1950s, but there's various originators today for one reason or another who want to partner with asset managers like us. So, we would definitely say that's not a new product.

As you have the advent of Silicon Valley and some companies that are more balance sheet light versus banks which have a depository base to fund a lot of the paper, right? Those types of companies need to find asset managers to help finance them. They do whole loan sales, but the actual core product is a loan, which has been around for a long time.

Now, with all that said, there has been some innovation, and we can talk more about some of the different products, but you see slight tweaks on some products. Like for example, you have point-of-sale loans, historically many people might not have been aware that they have used point-of-sale loans. So, sometimes people will ask us about, what is this new product? And we'll point out, have you ever taken out a loan when you bought a car, or did you pay with cash? And most people have gotten dealer financing and that's really a point-of-sale loan, also known as buy-now-pay-later to some degree, which has a stigma that you might be aware of.

So, within point-of-sale, some of the newer companies that have popped up, they're all looking for funding partners as they're not banks. And that's where the securitization markets come into play, but they also sell off balance sheets to companies like us. At the end of the day though, it's really a consumer unsecured loan that is backed by that consumer's credit score and their creditworthiness, which is no different than the credit card industry. It's just a term loan rather than a revolving card product.

Anu: Sure, absolutely. And because you mentioned it, I will ask a little bit more about innovation. What are some of the innovations that you're seeing within Specialty Finance today?

Peter: Some of the innovations we're seeing happening at the platform level are pretty profound. And, you know, maybe going back 5, 10 years ago, if you've been to your local small business, for example, going to a local coffee shop, most likely from a payments perspective, that coffee shop is doing the vast majority of its revenue through a payment system like, Square or Toast, maybe a PayPal. And those systems are unique in that they're a closed-loop ecosystem where the money is flowing directly through that system. The payments company, in this case, we'll talk about Square or Toast, is seeing the actual numbers come through and they have the ability to lend against that information. So, we would argue they have a very strong data advantage, and they also have a servicing advantage because the money's coming direct to them.

So those types of companies are partnering again with asset managers and it's not that the product is much different, it's just really the way that it's being delivered is different. And there's really no way that a traditional bank that at best might have a year or two of tax returns and maybe some lag bank account data, compete with a FinTech like those companies that have daily information on how much revenue did that coffee shop do yesterday. It's just as real-time as you can get.

So, I think that provides them with additional insights. From a cost-of-acquisition standpoint, it's free. You know, if you're a customer, you're going to get a little notification on the tablet saying you've pre-qualified for a loan versus, you know, when we get home today, you're probably going to have some mailers in your mailbox, where the company spent a lot of money to get you those mailers that you're going to throw out, so they can spend less money on that and therefore acquire potentially a better customer. So, I would actually put that in the more traditional innovation at this point, as it's now, you know, 10 years or so old. Going to the more frontier spectrum of FinTech, we're seeing companies that are figuring out ways for people to unlock equity in their homes. So, there's several companies that are called, equity unlocks, where people who predominantly have a lot of their net worth tied up in their home, their homes have appreciated, so they're home-rich and they're cash-poor.

There are several companies out there that offer ways for you to monetize your home without selling it and effectively fractionalizing a piece of the ownership in your home and offering that as a product. We've seen a couple of those companies now come to market and securitize that, with major institutions buying the securitized pieces.

So, it's still early, but we're seeing more institutional adoption there. So, there's really a spectrum of how innovative the asset manager wants to be and where they want to play on that. Again, we tend to be a little bit lagged in that innovation cycle for where we want to see companies develop before we're going to get involved, but there is a lot more even off the rails from that, that we haven't even talked about yet.

Anu: Yeah. That's very exciting. I actually didn't know that was, a thing. I'm going to have to look that up when I get home tonight.

Peter: Well, if you own too much home, we can give you a couple of phone numbers to call. Actually, phones wouldn't really be a thing, it would be more of a website.

Anu: That's great. No, that's very cool to hear. So, Peter, my question for you then, do you think that, you know, given the banking, crisis last year, do you think that we're going back at all? Do you think that some of these traditional banks are going to come back in and try and take market share for the space that you're playing in?

Peter: No, not at all. I think that the banks are going to be really good at continuing to issue products that are really scalable, and big and, homogenous. So, prime consumer credit card, no problem. That will continue. I think if you go back in time, and you could make the same argument about way back when, when someone decided to sell a book online and now that same company sells food, and produce, and clothing, we're not going back to that non-existing, and just the same thing for calling a taxi versus hitting a button on your app to get a car to take you somewhere.

There's just no way you're going to go backwards. I mean, there's Moore's Law with technology taking over, and that will continue. I'm not a huge, technology advocate, to be clear. I'm not arguing for argument's sake there, but I just see more and more products that are more efficient. And at the end of the day, it's the same kind of underwriting. It's just faster, more efficient. I don't know why that would go backwards.

So, I think for a lot of us in this space, we're excited to be in this space because it's getting bigger and bigger rather than some of the old products that are shrinking every year. So, I don't know why that would change anytime soon. I'm excited to see where we go next.

Anu: You know, you mentioned the market's getting bigger and bigger, but do you expect at some point there'll be some consolidation as well, or do you think that there, the barriers of entry are high enough that there are going to be a set number of players, or do you think that there are going to be more and more players in the space and it'll be more fragmented?

Peter: Yeah. I'm not smart enough to know exactly where it's going to go, but I think it's really interesting. Just as one data point, if you look back to right before the GFC Lending Club and Prosper open in '07 to disrupt the banking industry, and I'm not sure if people are aware, but about a year ago, Lending Club officially became a bank, they merged with Radius Bank, so Lending Club is now a bank. They're just more online than offline.

So, I do think there will be some mergers and consolidations, and the shape of these originators may be different. And where do they fund the money with deposits, or fund managers, or the ABS markets? That will probably continue to evolve. The one constant is going to be that products that are very homogenous, very scalable, those are going to be great bank products, or the types of products that can be funded with deposits.

As you have newer products, more esoteric, things that don't scale well, that don't fit in a box, there's going to need to be people to underwrite those, understand them, understand which is good, which is bad, which doesn't have enough of a track record. And I think that's where you're going to continue to see innovation and people like us have an opportunity to invest.

Anu: Absolutely, now Peter, I want to talk about risks for a moment here as well. What are some of the challenges that you see that you and your team are facing right now, whether those are macro or micro? And what are you doing to kind mitigate some of those risks?

Peter: The biggest thing we could do to mitigate risk is try to take out the macro and beta risk. a portfolio that's constructed of different types of risk. So, for example, a portfolio of different sectors. a portfolio of different credit qualities. So near-prime, prime, super prime subprime. different durations.

And then structurally there is a way to structure deals where some are whole loans, some are credit facilities, a lot of them have a ton of covenants in them. So, the main goal is really to have idiosyncratic risk, which means that we're going to live or die by whether we did the underwrite properly for that particular deal.

The opposite would be just taking macro risk and saying, hey, we're in great shape. We think small businesses are going to do well, we think invoices are going to do well, we think consumers are going to do well, let's go- get along that." That's not the sort of risk that we want to take. We would like to have as close to zero correlation with the stock market, with the investment-grade bond market as possible, and the only way to do that is to have structures around your deals that will protect you in different markets.

Anu: Yeah. All right. Well, Peter, you know, I'm thrilled to have you today in the New York office where the Neuberger Berman headquarters are, but you and most of your team are based in Silicon Valley. How important is it to have a team on the ground kind of in this really innovative part of the country, would you say?

Peter: Most of the work that we're doing out there is making sure that we're in front of all the larger companies that are West Coast-based, and equally important, seeing all the venture capital firms. And in a way, having the headquarters here where we are in New York, we're able to easily cover the banking system. We can cover a lot of the private equity firms, but out West, the largest VCs that you'll see the Sequoias and Andreessen Horowitz's. They have very large portfolios and some of those companies are going to make it. some are not, but the ones that get later stage to Series C, Series D and they're really looking for that more mature $100 million-plus credit line, it's really important to have a relationship with them. And our world is very relationship-driven, just like direct lending. And if we can get the first call, we have some VCs we're really close with, some we don't know as well, but we're constantly trying to meet up with them on Sand Hill Road and Palo Alto, Menlo Park, and make sure that they know we're out there and that we're looking to work with their companies and help them grow.

So, it's sort of a virtuous cycle to some degree that as we're doing more deal flow, just like in direct lending, we start doing more and more with certain VC's. And ironically, a lot of them are actually building out capital markets teams now just to handle all the-the debt financing. So, I think the concept of just popping over for a quick meeting is quite easy.

We're based in Redwood City, so not too far from a lot of them. And again, New York has been great for just having access to all the GPs that Neuberger Berman works with already on the private equity side. Within the pure platform, right, there's obviously Googles and Apples all the way down to PayPal, Square, Netflix, and we don't know who the next lender's going to be. Anyone that has data, you could argue, could be lending at some point. And a lot of people might be surprised to know that PayPal, Square, Intuit are some of the biggest small business lenders in the country today for small loans versus some of the banks that might have been the answer a decade or two ago.

Anu: And now you also have team members, I believe, who are based on the other side of the pond in London.

Anu: So, I'm just curious, what are some of your observations just given different geographical footprints, looking at this area that you are potentially investing in?

Peter: One thing we had to adjust to is that different countries have different consumer behavior or small business behavior, and sometimes it's a philosophical thing and other times there's actually government incentives and programs that help minimize defaults or cover defaults.

So we do have an office in London, and as we go through, even looking at differences between the UK and Germany and Eastern Europe, it's been interesting to really look at how different types of customers have performed, where the consumer is more, where the consumer is protected a bit more and we can really apply a relative value overlay and make sure that the yield we're getting in country X is justified versus what we could do here in North America.

Anu: That's great. Thank you very much. Well, Peter, I can't let you go today without asking you a quick bonus question. So, we've spoken about Specialty Finance today, and I'd like to know what your specialty is outside of your day job at Neuberger Berman.

Peter: Love bonus questions.

Anu: [laughs] Everyone does.

Peter: Well, I haven't really put this out to the universe, so maybe by saying it, it'll happen. I am a really slow runner and when I go jogging with friends, they get super annoyed, but I can kind of push along for a while, so I've had a goal my whole life of trying to do 100 miler and I did a marathon like 15 years ago in New York City. Most amazing marathon in the world.

Anu: Wow, yeah. Absolutely.

Peter: And I ran my first marathon, and I was just happy to finish, but I did have a goal breaking four hours, and I did four hours and seven seconds. So, then the next year I was like, I'm going to break four hours, so I ran it again and I didn't factor in that it was 70 degrees-

Anu: Oh, that's tough.

Peter: -in November instead 50, and I hit the wall early. So, I ran 4 hours and 30.

Anu: 30 seconds or 30 minutes?

Peter: 30 minutes.

Anu: Okay. [laughs]

Peter: So then in '04, I ran again saying, this is it. I trained and it was even hotter, and I was too pumped up, and I ran 4 hours, 55 minutes. So, I got really frustrated and I quit. And then three years later I said, there's one more try. I went out there and, everything lined up, had the right amount of pasta the night before, and I ran 3 hours, 59 and 31 seconds.

Anu: Wow.

Peter: And so that was one of the highlights of my life, and then after that, obviously when you're in a marathon for anyone who's done it, you know, the next day you swear off ever doing it again. So I have not run in 15 years, but on my bucket list is to run 100 miler, and I keep delaying it, and every year I get older, it's probably a lower probability of it, but I think by putting it out to the world, there's gotta be some increased chance that it actually happens, especially if Specialty Finance crushes it and I can spend my whole day training. So-

Anu: Wow. I like that.

Peter: -maybe one day.

Anu: Manifestation of, the goal, but that is very interesting to hear. Thank you.

Peter: Well, we'll see where it goes.

Anu: Thank you for sharing with that. No, but you shared a number of great insights today. You know, it seems like your team's ability to provide these, these unique financing solutions are really critical to the businesses and the consumers that you're partnering with, and of course, it, you know, seemingly offers the potential to unlock some really unique, market opportunities for investors. So, appreciate all of the comments that you shared today. Thank you for being here in New York with us today and, thanks for joining me again.

Peter: Well, it's great seeing you again. It was a lot of fun chatting and, hope to do it again soon.

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