White Paper | May 2024

NEUBERGER | BERMAN

PETER STERLING
Managing Director,
Head of Specialty Finance

SACHIN PATEL
Managing Director,
Specialty Finance

Specialty Finance: High-Yielding, Short-Duration and Uncorrelated Private Credit

Over the past 15 years, many institutional investors have steadily built their allocations to private debt, seeking yield in the attractive lending opportunities left as banks shored up their capital ratios in the wake of the Global Financial Crisis. Today, many of those portfolios are large enough that investors are looking to diversify them.

In this paper, we propose "specialty finance", also known as private asset-backed or asset-based lending, as a potential solution. It offers exposure away from the private equity-sponsored corporate credit risk that accounts for the bulk of private debt portfolios. We believe it can also offer abundant higher-yielding opportunities with shorter duration—under two years, in contrast to the four to seven years common for private credit maturities and private debt funds. We also believe that bespoke structuring of these privately placed investments can add attractive downside protection and further diversification benefits.

Executive Summary

What Is "Specialty Finance"?

- Finance markets have disaggregated and disintermediated, often enabled by new technology.
- New, tailored finance products and new loan originators have proliferated, requiring new backing from the capital markets.
- The risk profiles of these new products differ meaningfully from those of traditional private corporate debt.

Structuring and Credit Enhancement

- Market participants can negotiate structures with loan originators who take equity-like first-loss exposure beneath them and bespoke covenants that are more favorable to investors.
- This provides downside protection and further diversification from macroeconomic risks.

A Market That Has Seen Limited Institutional Competition

- Sourcing and structuring transactions is operationally demanding and, in our view, depends on an appropriately resourced and dedicated team with extensive industry networks and experience; as with Neuberger Berman's Specialty Finance team, this would ideally include senior operatives with hands-on experience with the specialty finance companies and alternative lenders that have originated many of the opportunities in the asset class.
- This limits competition for transactions, adding a final point of differentiation and complementarity next to traditional private debt strategies.

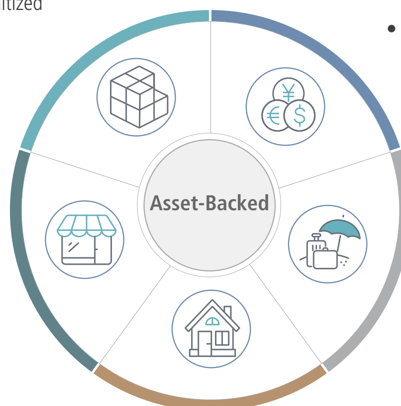
What Is "Specialty Finance"?

The markets underlying specialty finance, or asset-based lending, have developed and broadened rapidly over the past decade.

Large corporations have always needed services like trade finance, inventory finance and asset finance. Agri-businesses have always financed their operations with loans secured against next season's produce. Consumers have been taking out credit cards, mortgages and auto loans for decades. Specialty finance providers have moved into these services as banks have scaled down their presence since the Global Financial Crisis.

They have also been active throughout the modern finance ecosystem, which extends well beyond these vanilla products; indeed, in many cases they have shaped this modern ecosystem. Homeowners no longer automatically add to their mortgage to finance home improvements: a tailored loan can be arranged instead. If you're adding solar panels to your roof, why not secure the financing against the receivables that you'll sell back to the power grid? Consumers don't always get out their credit cards to pay for goods or services: cellphones can be leased rather than purchased; sellers offer various buy-now-pay-later (BNPL) and other payment-spreading options.

FIGURE 1. THE DIVERSITY OF SPECIALTY FINANCE MARKETS AND THEIR RECEIVABLES



Supply Chain Modernization

- Finance the agriculture industry through loans to farmers against crop values
- Inventory financing for companies with commoditized raw materials or merchandise

Payments and Loans

- Opportunities to finance credit card receivables, especially in the near-prime, historically under-banked population
- "Buy now, pay later" has become an increasingly popular way to purchase everything from Pelotons to groceries

Travel and Entertainment

- Travel point-of-sale loans allow consumers to get instant financing decisions on their next airline or cruise purchase
- Television and movie libraries are increasingly being bundled and licensed to media companies fighting for content
- Music royalties give investors a steady stream of cash flows

Small Businesses and Merchants

- Small business loans are increasingly coming from companies like Square, who require outside investor capital
- Merchant cash advances allow merchants to manage business liquidity while giving investors a short-term contractual receivable

Real Asset Financing

- Increasingly diversified from traditional mortgages: data center, residential solar panels, fiber networks, cell towers
- Auto loans, leases and rentals

Source: Neuberger Berman. For illustrative purposes only. Illustrative examples are not representative of actual investments.

This is a story of disaggregation and disintermediation—of financing moving away from banks and into non-finance companies, of trilateral borrower-lender-seller relationships becoming bilateral borrower-seller relationships—all enabled by technology and the growing willingness of capital markets to assume the risk. A typical example would be a specialty financing company working with a manufacturer of high-end consumer goods to provide interest-free BNPL options. It works for the manufacturer and the financing company because it raises sales; and because it raises sales, the financing company can afford to offer the capital markets a near- or even sub-prime rate, even as the underlying loans are made to super-prime creditors.

The similarities make specialty finance a natural complement to private debt, in our view. Both are private lending markets that have developed along with the disintermediation of banking since the Global Financial Crisis, but with clear differences in the underlying credit exposures. These can bring diversification to private lending portfolios that now represent substantial portions of many investors' credit allocations.

Figure 2 outlines the key differences between the typical underlying specialty finance and private debt loan. The borrowers are more diverse, the maturities are shorter and the amortization schedules more frequent. Longer-duration assets such as student loans, 25-year mortgages and aircraft leases are an important part of the market, but the majority is much shorter. Film financing, to take another example, does not imply the equity-like risk of financing a new production, but rather lending to a film production company secured against the cash flows generated by finished films already licensed to streaming services.

This makes specialty finance a highly cash-generative, "self-liquidating" asset class, which both lowers the risk of lending to higher-yielding borrowers, relative to other types of private credit, and increases an investor's flexibility to adjust the risk profile of a portfolio in line with the changing opportunity set. Relative to the typical quarterly repayment schedules for traditional private debt, the monthly repayments associated with most specialty finance assets give investors a real-time view into the evolution of payment rates and delinquencies, potentially enhancing their insight into that opportunity set.

FIGURE 2. HOW UNDERLYING SPECIALTY FINANCE LOANS COMPLEMENT TRADITIONAL PRIVATE DEBT

	Typical Asset-Backed Finance Investment	Typical Corporate Direct Lending Investment
Borrower Credit & Backing	Diversified assets, contractual cash flows, ring-fenced or bankruptcy remote assets	Corporate entity and subsidiaries
Key Investment Metrics	Asset coverage ratio, amortization schedule	EBITDA, EBITDA margin, leverage multiple, revenue growth
Amortization Schedule	Monthly principal + interest payment – self-amortizing	Quarterly interest-only payments, with lump-sum principal at maturity, often through refinancing
Underlying Asset Duration	Short term (1.5 years)	Long term (2 – 4 years)
Remedies in Default Scenario	Negotiation; if fails, enforce lien on and sell assets	Negotiation; if fails, become creditor in distressed re-organization or bankruptcy proceedings
Portfolio Diversity	Diversified across asset classes (media, small business, corporate, real estate, etc.)	Diversified across GICS sector (industrials, information technology, healthcare, etc.)

Source: Neuberger Berman. For illustrative purposes only. Illustrative examples are not representative of actual investments. This material is based on Neuberger Berman's market observations and analysis, such views and opinions are subject to change and there is no guarantee that any will prove to be accurate or that industry experts would agree.

But this is just the surface of the diversification benefits that specialty finance can bring. It is a bespoke structured-credit asset class, and both the tailoring and the structuring provide additional layers of diversification.

Structuring and Credit Enhancement

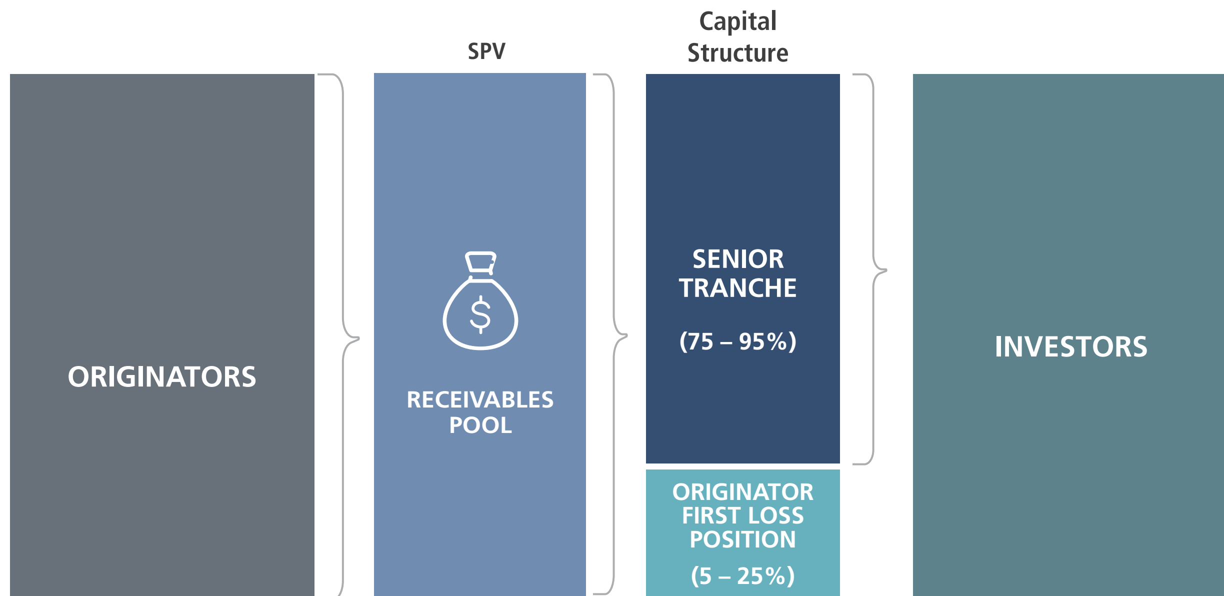
"Bespoke" means exactly that: there are no limits on the way transactions can be negotiated and structured. Here we will describe two examples that place the investor in a senior position to the loan originator, illustrated in figure 3.

In the first example, the originator (such as the BNPL provider that partners with a retailer) places its loans into a bankruptcy-remote special purpose vehicle (SPV). It generally retains between 5% and 25% of the value of the loans as equity on its own balance sheet and finances the rest by borrowing from a specialty finance investor for a contractual fixed or floating-rate coupon. The receivables are paid into the SPV and the coupon amount is then passed on to the specialty finance lender, with the residual cash flows passing to the originator. As such, the originator occupies the first-loss position in the structure and the specialty finance lender is senior (or sometimes a provider of mezzanine finance, with a bank lender in the senior position).

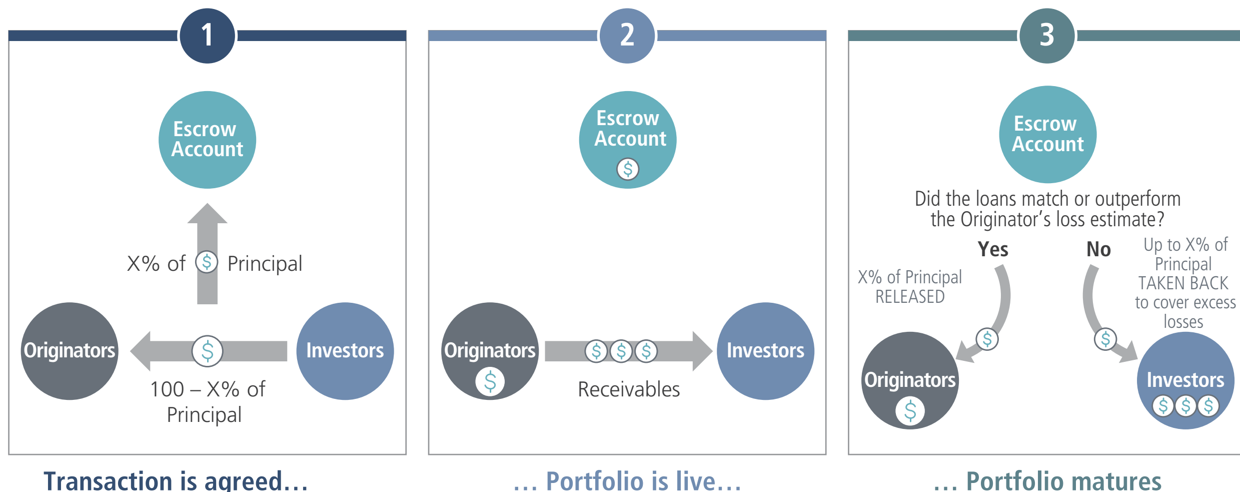
In the second example, the investor and originator agree on a par value for the loan portfolio, but the investor makes a lower upfront payment to the originator while depositing the remaining amount in escrow. The amount deposited in escrow would be enough to cover an agreed multiple of the originator's modeled loss estimate for the loan portfolio—say, an additional 5% of the principal amount to cover twice an estimated loss of 5%. If, once the loans have all matured, losses are exactly in line with the originator's estimate and the investor therefore earns their target interest yield, the money is released to the originator, bringing their payment to 100% of the par value agreed at inception. However, if losses exceed the originator's estimate, the investor takes back enough of the money to cover those excess losses, bringing their principal back to par and their realized yield back into line with their target yield. This effectively makes the investor senior to the originator: with 5% in escrow, it's only at the point where excess losses exceed 5% of the agreed par value that the investor becomes exposed, alongside the originator, to further loss. Put another way, loss rates would need to double before investors lose a cent of interest, let alone principal.

FIGURE 3. TWO WAYS TO ACHIEVE SENIORITY IN A SPECIALTY FINANCE STRUCTURE

Tranching cash flows from a receivables pool, with loan originator in first-loss position



Whole receivables purchase, with agreed portion of principal held in escrow



Source: Neuberger Berman. For illustrative purposes only.

In addition to this senior position in the structure, the bespoke nature of the transactions allows the parties to negotiate collateral-performance and financial covenants. These covenants are generally more favorable to the investor than the equivalents in public-market asset-backed securities (ABS); for example, delinquency and default performance covenants tend to be set meaningfully closer to levels that have actually been seen, historically, and so are tailored for the more junior rather than the most senior lenders.

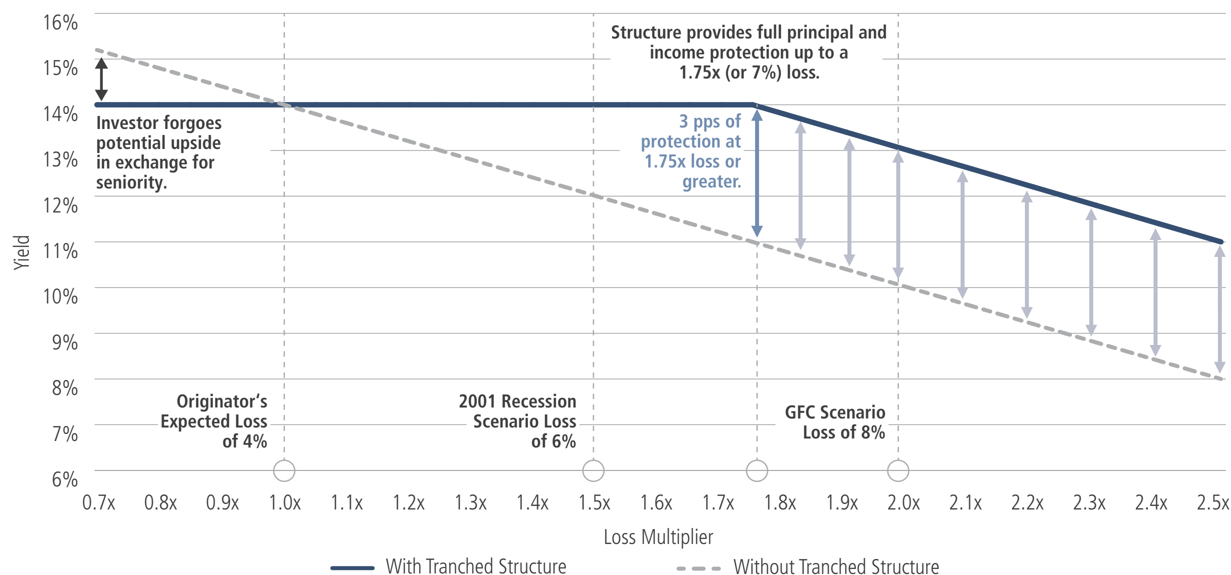
Without the credit enhancement inherent in the structuring, and the bespoke covenants, the investor would be fully exposed to the rising risk of defaults in environments where interest rates are rising and/or economic stresses are building—just like a traditional private corporate lender. With those features, specialty finance can bring significantly more downside protection and more diversification relative to a traditional private debt portfolio.

What does that mean in practice? We seek to illustrate this in figure 4.

In our illustration, the loan originator models a 4% loss rate for the portfolio, and on that basis, it targets paying a 14% contractual yield to the specialty finance investor, with 3% of the corresponding par value of the loans being deposited in escrow (equivalent to 0.75x the modelled loss rate).

FIGURE 4. HOW STRUCTURING CAN PROVIDE DOWNSIDE PROTECTION

Yield for a hypothetical portfolio with a 4% modeled loss estimate, 3% of principal held in escrow and a 14% target yield, under various loss scenarios



Source: Neuberger Berman. This model is presented for illustrative purposes only as an overview of the theme described herein and is not representative of any actual opportunity or investment. Yield data is presented for illustrative purposes only and not as a suggestion, projection, or guarantee that any such returns will be realized or achieved or that an investment strategy will be successful. Yield represents the applicable contractual yield under the given loss scenarios. It is presented as a characteristic, and actual yield achieved may vary significantly. Yield does not take into account any applicable fees or expenses that investors would experience, which would reduce returns. The illustration shows an unlevered hypothetical portfolio.

If the investor took direct exposure to the underlying loan portfolio alongside the originator, without the seniority built into the negotiated structure, the yield would exhibit a linear relationship with the realized losses, as shown by the grey dotted line. If repayments turn out better than expected—let's say losses are 2.5% rather than 4%—the investor receives a bigger-than-expected annualized yield: 15.5% rather than 14%. But if any borrowers fail to pay, the investor loses out: if loan losses hit 6%, as they would have done in an equivalent portfolio during the 2001 recession, the investor's yield would drop to 12%; in a Global Financial Crisis scenario, the yield drops to 10%.

However, at a 14% yield on an expected loss of 4% with 3% of par value in escrow, the loan originator takes the first losses up to 7% of the underlying portfolio, or 1.75x its expected loss. That is a loss scenario equivalent to an event between the 2001 recession (1.5x) and the Global Financial Crisis (2.0x), and represents three percentage points of downside protection for the investor, relative to direct exposure to the underlying loans.

The investor, though, cannot receive any more than the par value agreed for the principal plus the agreed interest payments. Given that these values were negotiated based on the estimated portfolio losses modeled by the originator, the originator stands to benefit if losses come in lower than the estimated 4%. If losses amount to 2.5%, the additional 1.5 percentage points of yield the investor would have received had it taken exposure alongside the originator is instead taken as profit by the originator. We think this aligns the interests of originator and investor: once the originator has agreed on a par value and the corresponding level of yield on a particular expected loss, it is incentivized to limit realized losses via its credit analysis and selection.

A Market That Has Seen Limited Institutional Competition

Structures like these, which we believe properly align investor and originator, are typically bespoke and not widely available in asset-backed markets.

We think this underlines an important consideration when selecting an asset-management partner for specialty finance: an investment team's networks and relationships are critical not only for sourcing transactions and establishing exclusive deal flow, but for understanding underlying cash-flow risk profiles and using that understanding to achieve structures that are fair and aligned.

We believe investors should look for teams that can draw on diverse prior experience not only in investment banking and asset management, but in the fintech companies and other alternative lenders that originate so many of the opportunities in this asset class. That experience can help when it comes to due diligence on both loan originators and the portfolios of loans they offer for evaluation: we believe market participants that have worked in this industry, underwriting these kinds of loans, are better placed to assess the quality of those loans and the validity of the originator's loss modeling, and to structure and price a transaction appropriately.

Smaller asset managers may be better able to fill a dedicated strategy with the smaller, higher-yielding transactions that characterize the asset class, but it may be harder for smaller managers to support the dedicated, experienced team that we believe is necessary for appropriate due diligence and portfolio management, and they may lack the industry name recognition that originators often look for in their capital-markets partners. On the other hand, very large managers, investing from multi-strategy credit funds, at times struggle to execute and manage these highly technical and specialist transactions because they are often reluctant to make the required large upfront investment in data analytics and technology for such a small proportion of their portfolios.

That leaves an abundant opportunity set for larger specialist managers that can build and support a dedicated team and strategy, drawing upon their experience and networks in the broader private-markets ecosystem. Furthermore, we would argue that limited institutional competition for transactions represents another element of differentiation and diversification relative to other private markets.

This material is provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. The firm, its employees and advisory accounts may hold positions of any companies discussed. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types. References to third-party sites are for informational purposes only and do not imply any endorsement, approval, investigation, verification or monitoring by Neuberger Berman of any content or information contained within or accessible from such sites.

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

No part of this document may be reproduced in any manner without prior written permission of Neuberger Berman Europe Limited.

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-globalcommunications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

Z0499 05/24 1895913 ©2024 Neuberger Berman Group LLC. All rights reserved.

www.nb.com