As the winner of Private Debt Investor’s Americas Speciality Finance Lender of the Year award, for the second time, Atalaya Capital Management committed around $1.6 billion across 43 transactions in just the first nine months of 2023.

Encompassing direct credit facilities, asset and portfolio acquisitions and platform investments, nearly 90 percent of the firm’s transactions in 2023 were with repeat partners.

Atalaya’s new white paper, Asset-Based Finance: Sizing the Next Generation of Private Credit, sets out the opportunities in the fast-growing asset-based finance (ABF) market. Founder and CIO Ivan Zinn answers questions on Atalaya’s market outlook.

Q You describe asset-based finance as the next generation of private credit. Why should LPs care about this market?

We believe investors should care because the market is large, less competitive than corporate direct lending and diversifies their existing portfolio.

Sponsor-driven corporate direct lending outside the banks has become synonymous with private credit, as the non-bank share of M&A financing has gone up from approximately 5 percent in 2010-14 to above 50 percent today. While corporate direct lending may have put private credit on the map, we believe the next generation of private credit will be the asset-based finance market.

Today, we estimate the US public and private asset-based finance market stands at around $7 trillion versus the comparable number for corporate of $13 trillion. We see the overall ABF market growing quickly due to a range of factors and we think investors are currently underallocated to this asset class.

Asset-based finance has several benefits that investors should care about, relative to corporate direct lending. First, it offers diversification. The underlying collateral pools are typically backed by tens of thousands of underlying consumer or small business loans.
that are less correlated to corporate direct loans.

Second, asset-based investments typically feature self-amortising assets – assets that naturally pay back interest and principal monthly or quarterly – that reduce risk and the reliance on the capital markets for an exit. Finally, because ABF typically requires specialised sourcing (direct vs sponsor), underwriting (backed by data science) and specialised servicing, there are fewer competitors addressing the market opportunity.

**How big is the asset-based finance market today and how big could it get?**

We see the potential for this large and growing market to reach $9 trillion over the next five years. The market today is about evenly split between consumer and commercial financing, with $3.4 trillion and $3.7 trillion, respectively.

It is worth noting that definitions of the market vary, depending on whether or not various real estate and mortgage financing activities are included. We choose to exclude real estate and mortgage financing to focus on the heart of today's private ABF opportunity. Inclusion of residential mortgage financing would create an approximately $20 trillion addressable total market.

At the moment, we believe private ABF markets represent a modest $350 billion of today's $7 trillion overall ABF market. Approximately $100 billion sits in high-yield asset-based finance within vehicles such as commingled funds, business development companies, interval funds and separately managed accounts.

Another significant component, totalling around $250 billion, consists of predominantly investment grade asset-based finance held by insurance companies. Taken together, private ABF accounts for approximately 5 percent of the overall ABF market.

If asset-based finance penetrates the total market in a similar way to corporate direct lending, then the private ABF market potential over the next several years is over $900 billion by our estimates, or more than 2.5 times where it is today. Importantly, we think ABF is a small allocation today for US investors with the potential to be a 2-5 percent allocation, as compared to corporate direct lending which averages approximately 6 percent today.

**What is driving growth of the market?**

The overall asset-based finance opportunity is growing for reasons on both the supply and demand sides. On the supply side, since the GFC, there has been a steady push to remove risk from the banking system, which continues today. Banks are on a ‘risk weighted’ diet, which means many speciality finance assets are not attractive for their return on equity. They may be exiting portfolios or entire lines of business.

As a result, non-bank providers of capital to consumers, small businesses, equipment providers and companies have grown and increasingly taken share from banks. Separately, securitisation is one leg of the financing stool for a speciality finance lender. Two key events in the last five years – covid and 2022 rate increases – reminded speciality finance originators of credit that they can’t rely upon securitisation as the only financing tool.

Additionally, we see factors such as financial technology driving the development of more sophisticated and flexible credit products outside of banks, thereby growing the overall market. So, the need for capital is growing while banks are retreating.

On the demand side, investors are seeking assets that are complementary and less correlated to direct lending which also can generate attractive returns and, we argue, a superior risk profile. The private market ABF opportunity is growing quickly because investors typically have little or no allocation to it. We believe that allocations will grow to a core allocation of between 2-5 percent of portfolios, taking a greater share of the overall private credit bucket.

**Why are the banks retrenching from this market?**

Bank retrenchment started post-GFC, as regulation such as Dodd-Frank in the US and Basel in Europe sought to reduce bank risk. The first wave of non-bank growth was in the corporate direct lending world, which evolved from a small market post-2008 into a more than $1 trillion market today as market participants (sponsors) realised the benefits of not relying upon banks or syndications.

Meanwhile, banks were restricted from many transactions considered too leveraged by virtue of a regulatorily imposed leverage multiple. As private corporate credit has matured, private ABF is the next asset class for private capital to replace retreating bank capital.

The SVB-related regional bank crisis in 2023 caused even more scrutiny from regulators. With Basel III and other regulatory overhauls, banks are struggling with increasing complexity and re-evaluating which businesses are core. Given this backdrop, we anticipate that banks will continue to slim down risk, which we call the “RWA diet”. This diet will see them shedding non-core portfolios and businesses.

**Which other areas of opportunity do you see opening up in the year ahead?**

The same themes that drive our excitement for ABF are present in several other areas. For example, we like situations where banks or non-banks have structural reasons to exit. This dynamic resulted in what we believe was the largest private credit secondary last year, which we led, to buy a $1 billion portfolio from Wells Fargo. Like private ABF, we believe we are at the earliest stages of growth in credit secondaries. Real estate is still early, but we expect opportunity in the coming years, driven by deterioration in credit performance.