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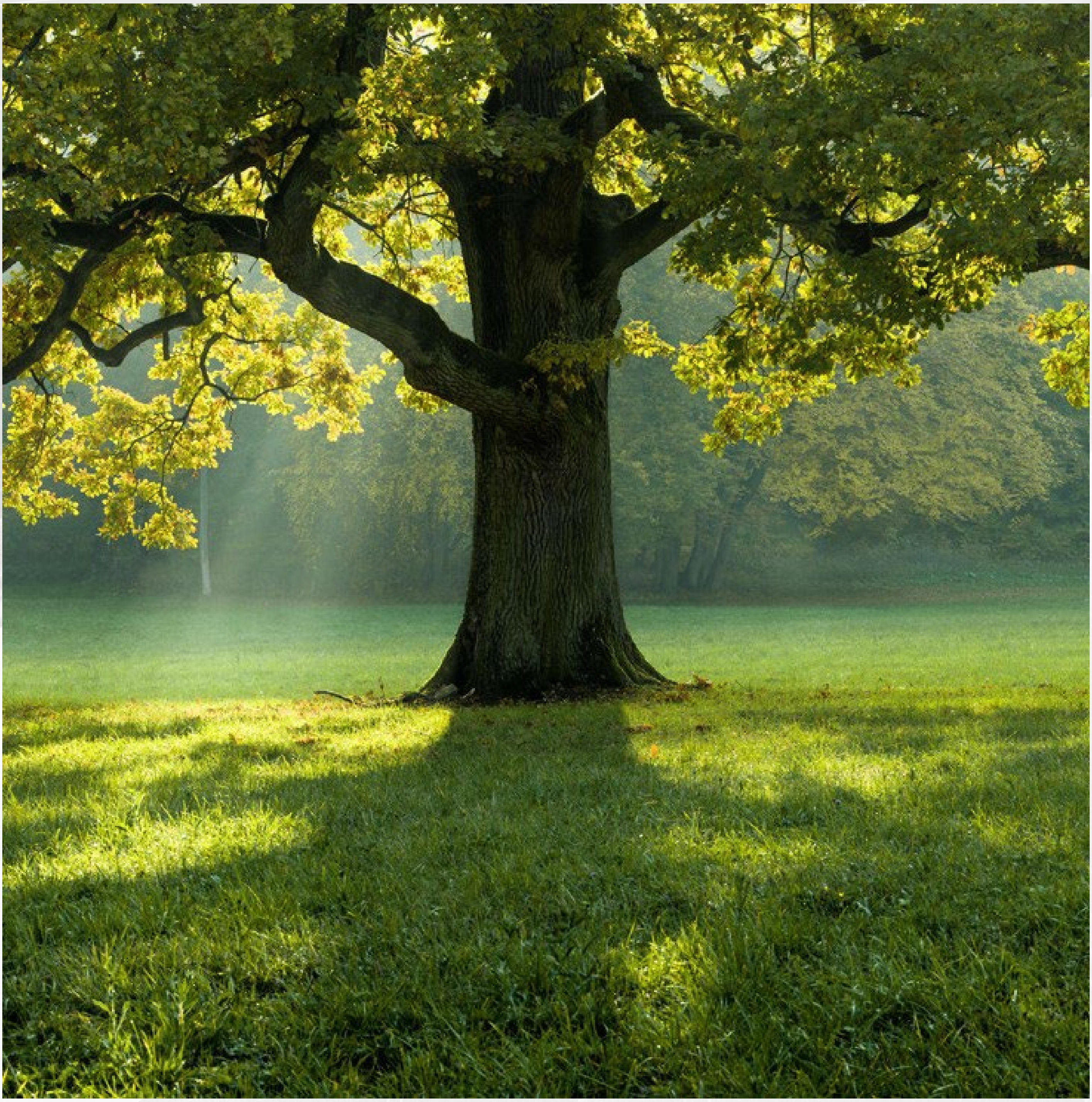

Asset-Based Clarity (*Finally*)

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Asset-Based Clarity

Traditional, sponsor-led, secured lending products lost some momentum in 2023 and 2024, given several factors:

- high valuations;
- a saturation of competing lending products;
- the extinguishment of a limited supply of "low hanging fruit" PE-led deals;
- the high-interest rate environment (base rates rose from 30bps to 5.30%, and currently rest at 4.30%, with the two-year forward curve showing 3.90%).[1]

Consequently, many sponsored private credit managers have tried to revive their businesses by launching "new" "Asset-Based" or "AB" funds with the dual goals of diversifying institutional investors' allocations to private credit, while introducing "new" capabilities that highlight their strength in originations.

Private credit is looking to take a share of the AB market, which is estimated to be close to $5 trillion[2] in size. A wide variety of credit products are now being marketed under the catch-all term, "AB," and they are as disparate to each other as apples are to coconuts.

Our objective is to explain and demystify the question, "What exactly is AB?"

We will articulate for you the varied product types that fall under the broader AB category, the return/risk profiles of these products, and their differing characteristics relating to execution, sourcing, originations, underwriting, portfolio, risk management, performance, and history.

First, it makes sense to clarify a few, key concepts. Some of the confusion that surrounds AB products may be by design; however, the main reason for the confusion is due to the fact that several of these terms sound similar, for example, "Asset-Based Lending," "Asset-Backed Lending," and "Asset-Backed" (Securities), all of which are often used interchangeably. To complicate things further, some investment managers market specialty finance strategies under the "AB" umbrella, as well.

Asset-Based Lending. Asset-Based Lending has historically fallen under traditional banking, with 15%-20% of bank balance sheets offering borrowing-based facilities. We estimate the ABL market to be close to $1 trillion, and non-bank lenders have less than 10% market share.

Rated single A to AAA, ABL loans typically result in a very low capital charge to a bank's balance sheet. Given their relatively low risk profile, Asset-Based Loans (ABL) represent one of the more conservative forms of bank-generated lending.

In fact, ABL is quite probably the oldest and most traditional lending product in the world, presumably invented by the Bank of Italy 600 years ago. Ironically, ABL is sometimes viewed as exotic or unique, while sponsored[3] lending is viewed as traditional or mainstream; yet, this could not be further from the case. This is a perception issue, and quite the opposite of what we believe to be true. Indeed, sponsored lending is not a bankable product, given its duration, covenants, leverage ratio, amortization features, and several other characteristics.

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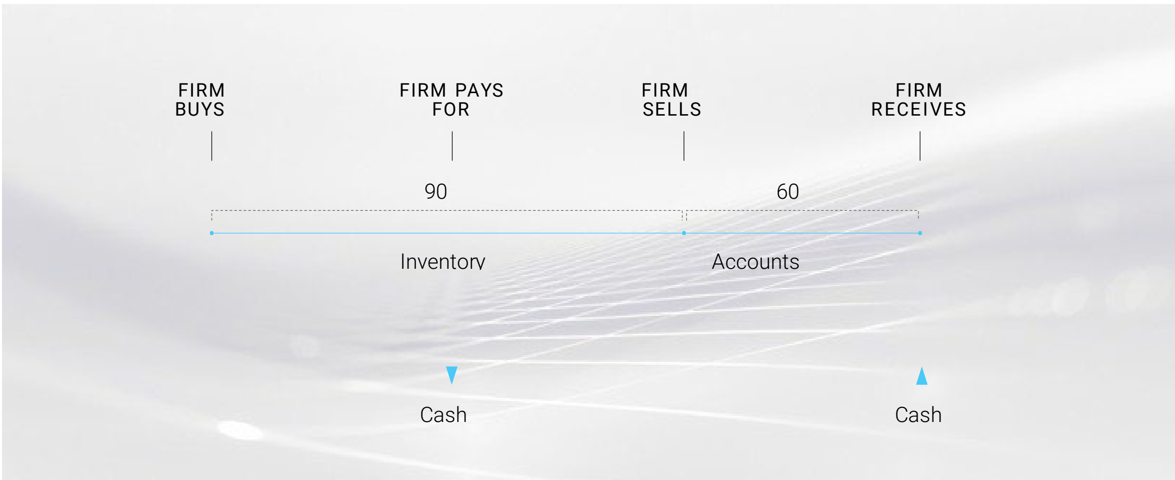
[1] Source: Bloomberg

[2] Source: https://www.oliverwyman.com/our-expertise/insights/2024/oct/private-credit-next-act-impact-on-banks-and-asset-managers.html

[3] White Oak views "sponsored" borrowers as those that generally are private equity-backed and private equity-controlled and that are subject to a broadly marketed process and in which the financial sponsor has access to committed capital at the institutional level.

Most Asset-Based lending products finance the working capital needs of a company and are structured as 1-to-3-year contracts (typically, they are 2-year contracts) that revolve every 30, 60, or 90 days. ABL are sometimes called "revolvers," and the premise behind ABL is to finance the timing gap between the delivery and payment for goods or services, by pledging collateral, receivables, or inventory to the lender for a brief period of time. As such, Asset-Based Loans are meant to solve for a company's 30 to 90 day timing problem between when: a) they fulfill a purchase order and ship their goods or render a service (think of a law firm or medical office), and b) when they collect the payment for these activities. Another way to look at it is, if everyone made payment immediately after a product was shipped or a service was rendered, the ABL product would not exist.

Figure 1: Illustration of An Asset-Based Loan



The appeal of Asset-Based Lending is simple: the credit underwriting is based on revenue, versus the bottom-line (EBITDA or cash flow). Traditional ABL products are borrowing base structures, since there is variability of sales and revenue throughout the day and month. Therefore, the ABL lender advances a discount on the cash receivables, using a discount rate (e.g., 20%) after taking an additional discount on what may be deemed an ineligibility criterion (e.g., 10%). Therefore, 100% of receivables, minus 10%, equals 90%, and an 80% advance rate on 90% equals a 72% advance rate as the "cap" of what the borrower may borrow against. The average borrowings are typically under 60% on "cash." This bears repeating: this species of financing represents 60% Loan to Value on "cash."

Also attractive, ABL lenders have control over a borrower's cash collections, which allows them to be repaid on the current assets they finance. Moreover, ABL lenders enjoy more insight into a borrower's business trends because they regularly receive updates on a borrower's cash collections and new sales via a borrowing base.

Banks have traditionally dominated the Asset-Based Lending marketplace. Historically, they have focused on investment grade borrowers and investment grade receivables. Non-traditional lenders have also entered the ABL marketplace -- examples include Wingspire (owned by Blue Owl), Encina (owned by Mass Mutual/Barings), MidCap (owned by Apollo), Ares Commercial Finance, and White Oak Commercial Finance. At White Oak, with over 150 professionals in ABL[1], we have 25[2] years of working history in the ABL space, with: (1) an on-balance

[1] As of 01/01/2025. Inclusive of Finacity Corp., an affiliated entity of White Oak Global Advisors (WOGA), White Oak Merchant Partners, an affiliated broker-dealer of WOGA, and the Financing Affiliates (as such term is defined in its Form ADV and which are owned by the WOGA funds/managed accounts). Employees of the affiliated entities and the Financing Affiliates are not employees of White Oak Global Advisors.

[2] Includes White Oak Commercial Finance's predecessor entity, Capital Business Credit, LLC.

sheet business that makes us the 5th largest factoring company in the U.S. and (2) an off-balance sheet business called Finacity, a White Oak Global Advisors company, which is one of the largest trade receivables securitization firms in the world. Through the latter, we process well over $200 billion of receivables, annually[1], and enjoy a 25-year[2] operating history with zero realized losses.

Banks and alternative lenders like White Oak may also finance a portion of the total inventory of a company at cost, in addition to financing only their receivables. For example, White Oak may lend 60% average advance rate on cash and 50% LTV on the cost of the inventory. This is a typical ABL bank-style arrangement.

Asset-Backed Lending. Meanwhile, Asset-Backed lending, which also shares the acronym "ABL," is typically a bank or finance product that lends against the fixed and moveable hard assets of a company (think of equipment financing or aircraft leasing). These financing solutions can be in the form of a 'financing' or a loan against the asset, while the company still owns the equipment. Alternatively, Asset-Backed loans can be in the form of a lease, whereby the financing company is the lessor (equity), and the lessor leases the equipment (back) to the lessee. Today, most companies generally prefer lease structures, because they entail a balance sheet-light structure (or can be off-balance sheet, altogether). Given their attractive structure, Asset-Backed loans have historically represented 10% of assets on the commercial & industrial side of the average bank's balance sheet.

Beyond banks, many finance companies exist that focus on making Asset-Backed Loans, and some asset managers are investing in these companies. White Oak Global Advisors invests in AB finance companies, as well as makes direct Asset-Backed Loans and leases. Examples of other companies that lend in the equipment space are: Stonebriar (which is owned by Eldridge Industries), SLR Capital, Ansley Park (an affiliate of Ares), Marubeni Equipment Leasing, HC Mitsubishi, Post Road Equipment Finance (owned by Benefit Street), Capteris (owned by Apollo), and 46th Street Capital (owned by BlackRock).

Though lending against hard assets (movable or fixed) has traditionally been a bank business, given the long duration of the assets and the short duration of their liabilities, there has been increased scrutiny by bank regulators to drastically reduce banks' investments in Asset-Backed Loans. Furthermore, many strategic consulting companies (e.g., McKinsey, Bain, etc.) have advised corporates not to own their assets (e.g., not to be "balance sheet-heavy") -- in other words, to focus instead on investing their cash into product development, IP, IT, sales. Therefore, the preferred approach is to lease assets (not to own the equipment, but to lease it from a lessor).

In fact, most bank regulators and credit agencies believe that banks should not be the asset owners of machinery, trucks, and aircraft; rather, companies who are in those specific businesses should be in charge of the relevant equipment, with banks simply lending against these items.

Given how leasing products represent equity-like risk on banks' balance sheets, there is a tremendous opportunity to transfer the leasing structure from bank balance sheets to non-bank financing firms, such as White Oak. This allows banks to continue to sell their investments and offload their risk. The lease-factor rates are typically higher when base rates are higher, and it is therefore a strategic time to lock in higher, fixed rates, given we anticipate rates potentially going lower over the next few years.

By way of additional color, Asset-Backed Loans are fixed-rate (vs. floating rate), since companies need granularity into what their monthly payments will be, especially if the company is involved in a lease arrangement. Fixed rate loans perform better if they are underwritten in a high-interest rate environment, when the lease factor rates are

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[1] As of Q4 2024. The above information was provided independently by Finacity Corp. White Oak believes this data is accurate but did not verify the data.
[2] Includes White Oak Commercial Finance's predecessor entity, Capital Business Credit, LLC.

attractive; as rates eventually go down, the lessor is then receiving above-market rate returns. Of course, the reverse is also true: if one underwrites a lease in a low-interest rate environment and rates subsequently rise, the loan may underperform.

White Oak is affiliated with various Asset-Backed programs, including, but not limited to, aviation (White Oak Aviation) and equipment (White Oak Equipment Finance).

Asset-backed (Securities) or "AB." The Asset-Backed sector is getting a lot of attention these days. "Asset-Backed" is nothing more than formerly known ABS, and this is the product most asset managers are marketing today. Being represented as a collateral-backed (hence the word "assets") and a "safe" product, there is the implication that AB is backed by collateral, which is partly accurate, as it is backed by a plethora of small business or consumer loans that are bundled together. The good news is that there is a long history and myriad data behind these loans, which are often tranched and sold to various investors based on their risk/return appetite. We estimate this market to be in excess of $1 trillion, and non-banks have greater than 40% market share.

AB(S), otherwise known as Asset-Backed Securities, were popular prior to the Great Financial Crisis. However, it also goes without saying, that not all ABS survived the GFC of 2008, and it is perhaps for this association, that the new marketing message surrounding AB seems to have dropped the "S."

ABS presents a wide menu of securitizations including:

- Mortgages (residential or commercial)
- Consumer Finance
- Credit Cards
- Auto (prime, sub-prime)
- Home equity
- Credit Card
- Student Loans
- Some lease structures
- Housing contracts

More about the Asset-Backed Securities market. Historically, when banks started the AB originations markets, they did so by originating various Asset-Backed Securities, such as mortgages, auto-loans, and credit card financings; then, once they had scale, these products were either sold to the securitization markets (the buyers of old ABS have traditionally been institutional investors like pension plans and insurance companies), or to government-related companies, such as Freddie Mac, Fannie Mae, and Ginnie Mae.

An example of a common ABS product could be a loyalty credit card that is bank-sponsored. For example, an airline loyalty credit card might have an outstanding liability attached to it, whereby it is tranched, and the AAA tranche associated with it may be held on an insurance company's balance sheet, offering attractive, risk-adjusted spreads with an investment grade rating.

Banks have historically been the largest originators of ABS, charging generous fees for originating and servicing the loans for which they had an interest in maintaining the customer relationship. However, many banks subsequently off-loaded the risk from their balance sheets to institutional investors, freeing up capital to originate additional loans and syndicate (charge) again. The ROE for banks is much higher for being an originator and servicer vs. holding onto the risk.

By way of a more recent example, one of the more successful transactions over the past few years has been

Apollo's acquisition of Atlas from the Credit Suisse Bank sale to UBS. Atlas is a large ABS securitization firm and is now under Apollo's ownership, originating (minimally directly and mostly through third parties) and syndicating the ABS risk to Apollo-affiliated and non-affiliated balance sheets. In fact, Apollo's affiliated insurance platforms, Athene and Athora, are some of the biggest buyers of ABS risk today.

In this sense, the role of the investment bank is being disintermediated and transferred to an asset manager model with a much higher multiple of enterprise value (18-25x FRE vs. a much lower non-recurring value for a pure play investment bank). In some cases, such divisions of banks came with the originations of such ABS loans, while others simply rely on the bank's branch network to make an auto loan to a person (for example); then based on credit or FICO scores, the bank will bundle all of these individual loans into risk ratings and use their own investment bank (the ABS desk), or hire an investment bank's ABS or securitization desk to sell this risk to investors in various tranches.

It is important to distinguish that AB is not really new paper at all; the difference is that the buyers of this risk are simply changing from one investor cluster to another. We estimate this market segment to be in excess of $3 trillion in AUM, and non-banks have < 45% share.

A question that arises is what will the traditional buyers of this ABS paper invest their capital in, now that fund managers are taking away investable opportunities from them? Either the risk will be repriced (lower), or they will have to find other paper. There are only so many limited customers that will need a mortgage, consumer loan, auto loan, etc. It is a finite market, and origination will not keep up with the quantum of capital that will be available for this product.

Finally, we have "Specialty Finance". In the event we haven't already confused you with all the Asset-Based, Asset-Backed, "ABS" terminology and acronyms… some asset managers also present specialty finance as "asset-backed."

Specialty finance is exactly what it is called. These securities have unique origination and underwriting parameters and derive from bespoke industries and niche sectors.

Examples of products. Catastrophe bonds and side-car loans assume tail risk from a re-insurance company's balance sheet, which is not traditional bank underwriting. Statistical models show there is a multiple standard deviation risk for triggering such tail risk; however, the underwriting may be more suitable for a specialty finance lender. Insurance lined securities or Catastrophe "Cat" Bonds represent more of a binary risk, and, in most cases, the investor is taking tail insurance from a single peril (for example: a fire in California).

Royalties. Royalties may include cash flows that come from movies/film libraries, music royalties, and FDA-approved tier 2 or 3 drugs. Royalty structures involve segregating certain assets and pools of contractual cash flows into special purpose vehicles, for example, 30 films that have been produced. The fees generated from licensing a library of films to various venues (i.e., pay-per-view, airlines, etc.) service the interest and loan balance. Once the debt investor gets their capital and interest fully repaid, the 30 films in the example then go back to the equity owner, and a new film library debt may be established. This example is also applicable to drug royalties, music, and sports franchises.

Equity/Mezzanine Investments to Other Lenders. Credit fund managers and specialty finance lenders may take an equity or mezzanine stake in other lending institutions. Unlike "Lender Finance," which often takes a senior position in lending institutions and funds, specialty finance lenders take a more junior tranche in these entities. Underlying investment structure may entail Asset-Based Loans, Asset-Backed Loans, credit card finance companies, mortgage finance companies, and a dozen more strategies and structures.

Conclusion. ABL and ABS are not new. In fact, most things in finance are not new. I recall ETFs being launched by Barclays de Zoete Wedd in the Channel Islands in the late 1980s and early 1990s to make its index investing tax-efficient for offshore clients (a fun bonus fact). ETFs are now a massive market. Each type of lending has a long history and the audience (investors, reporters, and managers), need clarity. ABL is actually "old school," traditional lending, and ABS is a securitization that offloads risk from mostly bank originations.

An abundance of private markets managers has and will continue to launch new secured finance strategies "in the AB/ABL/ABS/Specialty Finance zip code," and we hope that this short paper provides some light and guidance on how to maneuver through this AB universe. All these products have a place in a risk-adjusted institutional portfolio. We are grateful for your curiosity and welcome further questions regarding this complex "new" old product.

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