Asset-Based Credit (ABC): Easy As 1-2-3

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Asset-based credit (ABC) represents the next phase in the evolution of private credit markets. But what is ABC really all about? While the space can appear intimidating, we think asset-based credit is a powerful tool for private credit allocators that's particularly worthy of consideration today.

In particular, we believe asset-based credit—which touches everything from how we make purchases, commute, pay for education, and much more—will be a strong source of favorable risk-adjusted returns in credit markets over the coming decade. At over $30T in size, the vast nature and relative complexity of the ABC market creates significant opportunities for experienced and scaled managers to exploit inefficiencies.

Additionally, asset-based credit provides investors exposure to an array of cash flows derived from a wide range of asset types, thereby offering attractive diversification to existing, "EBITDA-heavy" private and public credit allocations. The collateralization of ABC portfolios by diversified, front-loaded contractual cash flows from pools of underlying assets (auto, student, mortgage, and other loans) stands in contrast to corporate lending, which relies on the ability of a single operating company to service its debts via coupon payments and a large terminal maturity.

An Overview of Asset-Based Credit:

Asset-based credit is the financial fuel that powers millions of consumer, business, and other "main street economy" transactions every day.[1] This includes providing credit to finance families' mortgages, consumers' purchases, business' inventory, new home construction and development, and many more activities (see Exhibit 1). ABC thus empowers a wide range of stakeholders by providing debt capital to some of the largest segments of the global economy.

The loans provided in asset-based credit are supported by the contractual cash flows from diversified pools of assets—such as mortgages, consumer loans, or payments receivable—that are then used for debt service (which amortizes over time) and pledged as collateral against the value of the loan (see Exhibit 2 – next page). This differs from corporate direct lending, where a lender's collateral is a claim on a company's enterprise value and recourse against a borrower's other assets.

As with many parts of the private credit ecosystem, the growth of non-bank and specialty asset-based lending is in part a product of traditional banks pulling back from much of their conventional lending activity as a result of both market disruptions and increased regulatory constraints. This has left significant financing gaps that far exceed the sizable opportunity that already exists in private direct lending markets today.

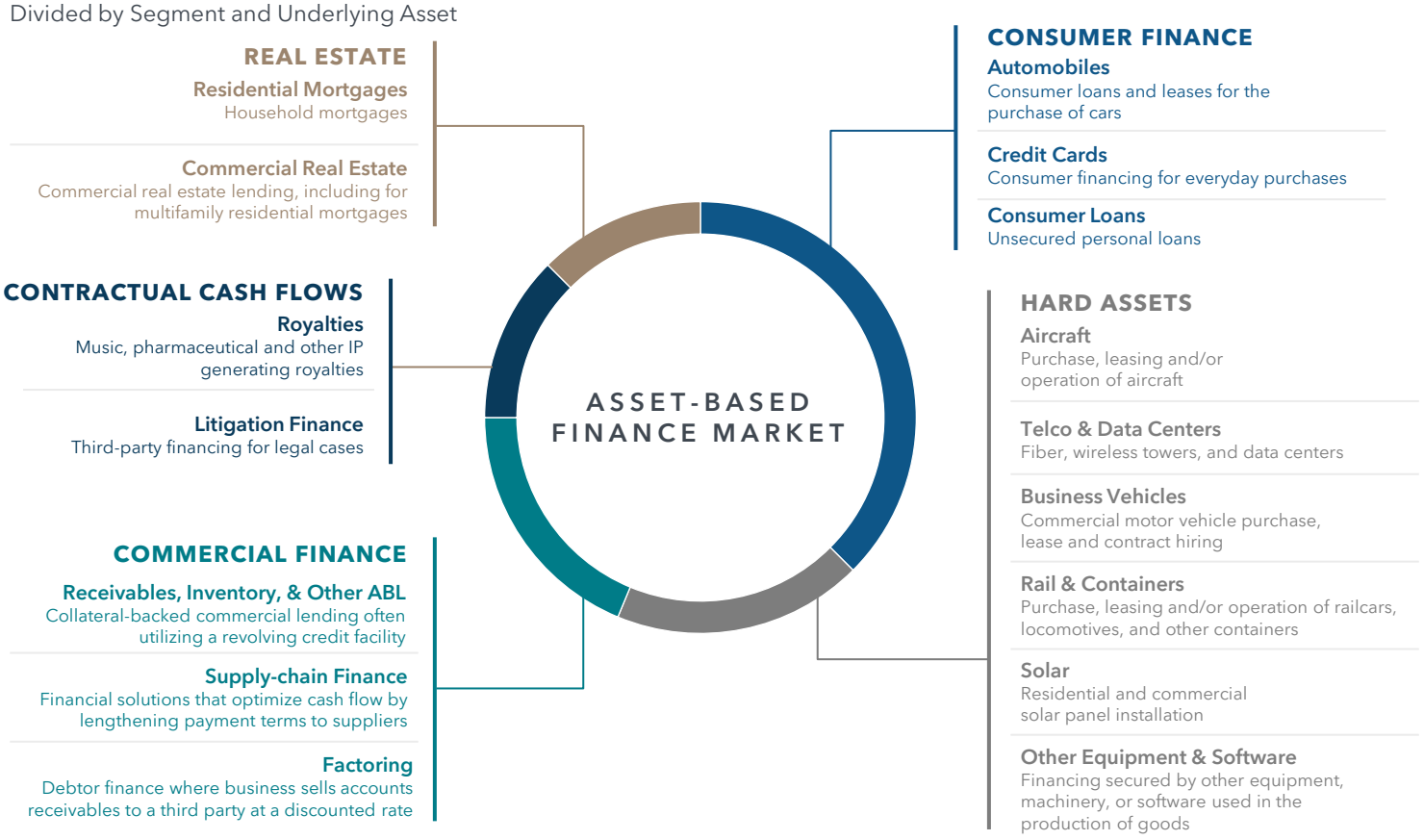
The 1-2-3 of the ABC Opportunity:

#1. A Natural Evolution in Private Credit

Asset-based credit represents the next phase in the evolution of private credit markets. But at the moment investors have yet to fully appreciate this opportunity, in our view, and remain significantly underallocated.

The broad shift in lending away from banks is hardly a new phenomenon and has been underway for decades. With the increased focus on private credit in recent years, banks' lending as a share of total borrowing in

Exhibit 1: An Overview Of The Asset-Based Credit Market
Divided by Segment and Underlying Asset



Note: 1. Asset-based finance is defined here to include consumer finance, hard assets, commercial finance, contractual cash flows, and real estate. Specialty finance is often used to refer to this group without the inclusion of real estate. Source: Oliver Wyman analysis, TPG.

Exhibit 2: A Comparison Of The Key Features Of Asset-Based Credit And Corporate Direct Lending

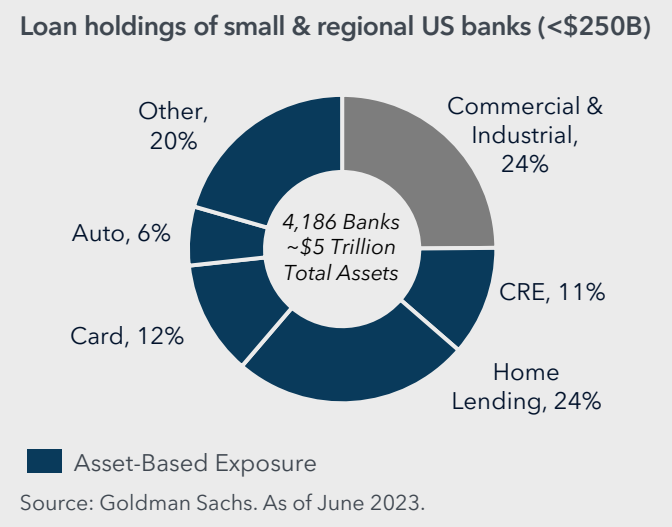
Feature	Asset-Based Credit	Corporate Direct Lending
Borrower Base	Loan pools made up of dozens or hundreds of underlying borrowers	Middle market businesses
Collateral	Hard assets (e.g. homes, equipment, cars) or financial (e.g. student loan w/ parent guarantee)	Corporate enterprise value
Credit Assumptions	Underwriting to loss-adjusted yield	Underwriting to zero-loss
Cash Flows	Self-amortizing over time	Bullet payment at maturity
Spread Premium	Estimated 300 – 600bps over public market comparables	Estimated 100 – 250bps over public market comparables

Source: TPG.

the US has been steadily declining for more than 50 years (from 60% in 1970 to 35% 2023).

That said, previous waves of disintermediation have had less impact on asset-based credit markets, and ABC remains a staple of bank balance sheets. More than 75% of the loan holdings of both the largest banks and smaller regional banks in the US are comprised of non-corporate credit (see Exhibit 3).

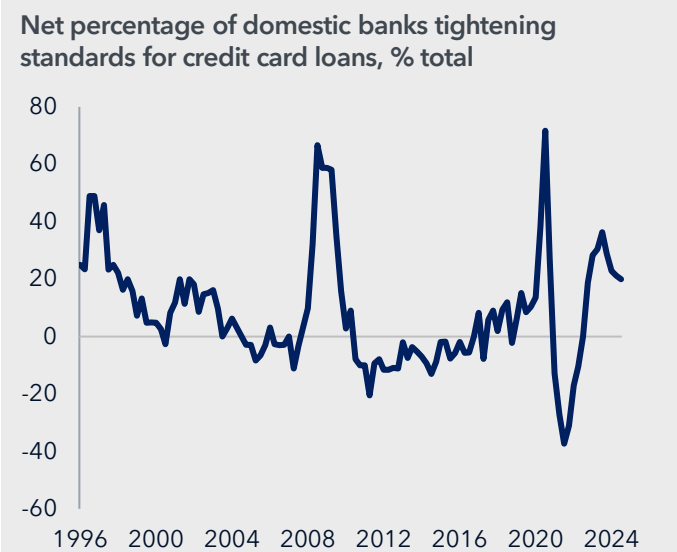
Exhibit 3: ABC Is A Staple of Banks' Balance Sheets



Source: Goldman Sachs. As of June 2023.

With lending standards continuing to remain tight across the US banking sector (see Exhibit 4), there's a meaningful opportunity for much of this ABC lending activity to continue to migrate away from the traditional banks, as we've already seen play out in full force in the corporate credit space with the rapid growth of private market direct lending.

Exhibit 4: US Bank Consumer Lending Standards Remain Fairly Tight



Source: Board of Governors of the Federal Reserve System (US).

#2. A Favorable Structure and Return Profile

In addition to representing a sizable investment opportunity, asset-based credit can also offer highly advantageous structures and return profiles. In contrast to corporate credit, ABC exposures often have a "self-liquidating" profile where a majority of the cash flows are generated early in the life of the loan pool.

As a result, ABC debt often amortizes fairly quickly as the underlying loans that support it are paid off, which generates more front-loaded cash flows, shorter average duration, and lower long-term tail risk as a lender relative to corporate credit (see Exhibit 5).

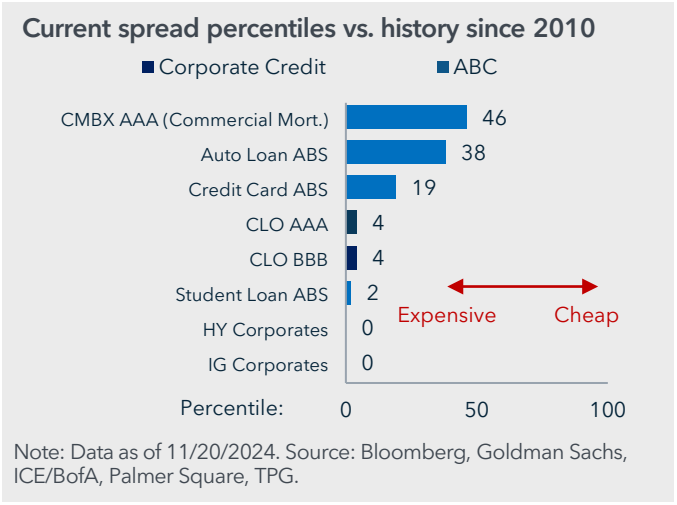
Unlike corporate lending, investors aren't exposed to rollover or refinancing risk in ABC. Asset-based credit also isn't subject to so-called liability management exercises ("LMEs"), whereby a company modifies its existing debt, that have become common in corporate credit and can erode value for some creditors.

ABC structures often include covenants—such as debt coverage, collateral quality, and leverage tests—to protect lenders against any deterioration in borrower quality. To take one example, any deterioration in the collateral backing an ABC facility, such as a fall in house values, would require borrowers to post additional collateral to de-risk the loan pool.

Amid the continued resilience of the US economy, credit spreads across the market have reached historic tights as the expectation for a "soft landing" has taken hold. Investment Grade (IG) and High Yield (HY) corporate credit spreads have never traded at more expensive levels (i.e., tighter spreads) since 2010 (see Exhibit 6).

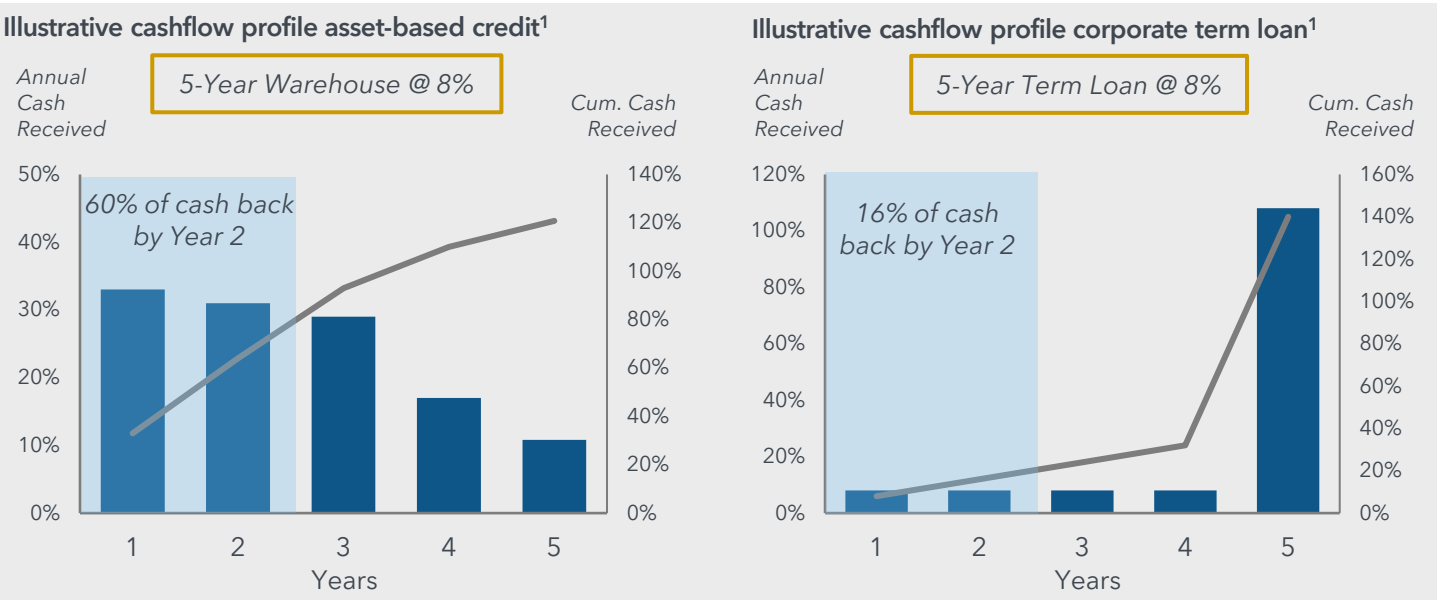
This has left asset-based credit as one of the few pockets across public credit markets with remaining relative value, at least at the index level, in our view. At the same time, the substantial variety across ABC markets, which encompass many different asset types and public as well as private market opportunities,

Exhibit 6: ABC Offer Strong Relative Value Today



Note: Data as of 11/20/2024. Source: Bloomberg, Goldman Sachs, ICE/BofA, Palmer Square, TPG.

Exhibit 5: Asset-Based Credit and Corporate Direct Lending Have Distinct and Complementary Cash Flow Profiles



1. Illustrative cashflows are purely hypothetical and provided for illustrative purposes. There can be no assurance that the strategy will achieve its objective or avoid significant losses.
Source: TPG Angelo Gordon. Reflects views and observations as of September 2024.

means that investors can pick and choose where to play strategically based on a number of considerations, including spreads, underlying fundamental credit quality, technical supply/demand dynamics and more. As an example, a particularly strong opportunity exists in home equity lines of credit or "HELOCs" given near record-high overall home equity value across the US economy and the lock-in effect from higher mortgage rates (see callout box on next page).

Lastly, we think private market ABC provides a few important advantages relative to public market securitizations. Alternatives managers can operate with tighter controls in terms of origination and deal flow, providing a strategic advantage in terms of overall portfolio construction. They can also offer both originators and investors more certainty of execution relative to the public market, as well as capital solutions style "problem solving" when financing gaps materialize.

#3. Diversification

The asset-backed credit market provides a natural diversifier to the predominant economic and credit risk exposures associated with corporate direct lending, which has been the fastest-growing segment of the private credit market in recent years. With ABC, investors can gain access to cash flows driven by different parts of the economy in assets such as consumer credit, residential mortgages, and equipment finance, to name just a few examples, with distinct fundamental drivers that are complementary to corporate lending.

Given this asset type diversity, ABC markets have historically been less correlated with corporate credit (see Exhibit 6). Over time, we believe mature private credit portfolios should be more representative of the broader range of credit exposures that exist across the economy, including greater allocations to ABC.

Conclusion:

Asset-based credit markets represent a fast-growing and target-rich portion of the rapidly evolving private credit landscape. ABC touches many of the most critical activities across the economy and can thereby enable investors to participate in and benefit from their continued growth.

As private credit markets continue to mature and grow, we believe there's a strong case for investors to consider adding allocations to ABC as a favorable source of risk-adjusted returns and diversification alongside corporate direct lending and other credit exposures.

Asset-Based Credit Provides Favorable Diversification Given Low Correlations With Corporate Credit

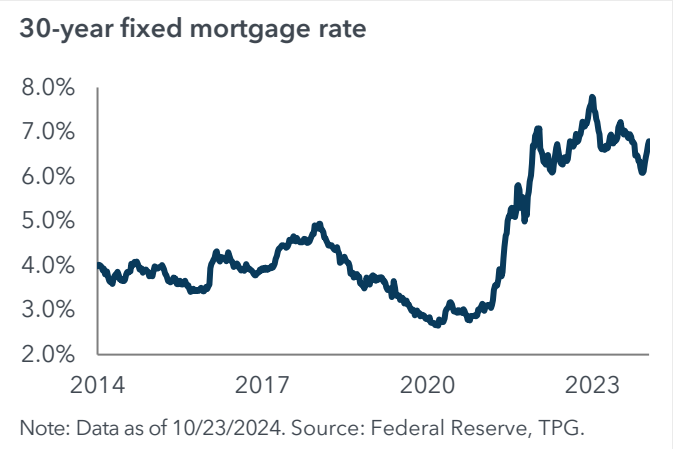
	Agency RMBS	*CMBX AAA*	*CMBX BBB*	*Auto Loan ABS*	*Credit Card ABS*	*Student Loan ABS*	*CDX IG*	*CDX HY*
Agency RMBS (Residential Mortgages)	-	0.34	0.89	0.71	0.54	0.57	0.35	0.69
CMBX AAA (Commercial Mortgages)	0.34	-	0.34	0.46	0.72	0.58	0.74	0.52
CMBX BBB (Commercial Mortgages)	0.89	0.34	-	0.85	0.59	0.80	0.45	0.81
Auto Loan ABS	0.71	0.46	0.85	-	0.84	0.90	0.65	0.92
Credit Card ABS	0.54	0.72	0.59	0.84	-	0.79	0.70	0.76
Student Loan ABS	0.57	0.58	0.80	0.90	0.79	-	0.76	0.88
CDX IG	0.35	0.74	0.45	0.65	0.70	0.76	-	0.84
CDX HY	0.69	0.52	0.81	0.92	0.76	0.88	0.84	-
Averge Correlation	0.58	0.53	0.68	0.76	0.70	0.76	0.64	0.77

Note: Correlations are based on asset-level returns between 1/25/2013 and 10/22/2024. Agency MBS (RMBS) based on CMM-CMS AAA spread, CMBS based on on-the-run CMBX17 AAA an CMBX BBB- indices, Auto Loan ABS based on AA-BBB spread, Credit Card ABS based on AA-BBB spread, Student Loan ABS based on AA-BBB spread, and IG and HY based on cash spreads. The average correlation for each listed asset class represents the average of its correlations with the other seven listed asset classes. Past cross-asset correlation relationships don't necessarily guarantee the same relationships will hold in the future.
Source: Bloomberg, Markit, Haver Analytics, ICE-BAML, Goldman Sachs GIR, TPG.

Strategy Snapshot: Home Equity Lines of Credit ("HELOCs"):

The outlook for one of the economy's most rate sensitive sectors—housing—is in large part a product of the outlook for mortgage rates. While mortgage rates have fallen from their peak in late 2023, they remain far above the ultra-low levels experienced over the past decade (see Exhibit 7). Moreover, since mortgage rates incorporate forward expectations for future Fed easing, it isn't immediately clear that we're likely to see much additional downside in 2025 absent unexpected rate cuts.

Exhibit 7: Mortgage Rates Remain Elevated Today



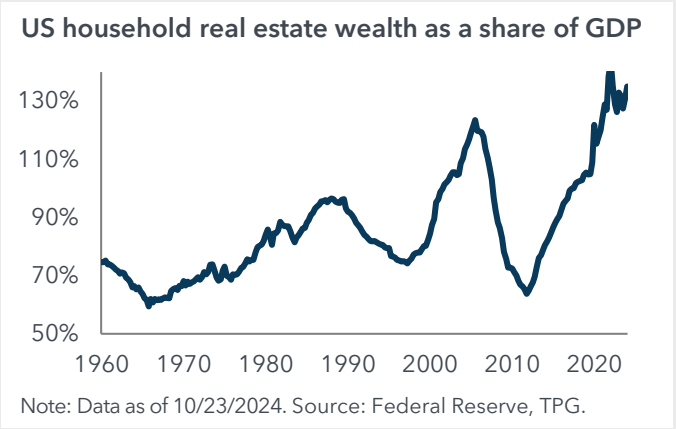
Note: Data as of 10/23/2024. Source: Federal Reserve, TPG.

One impact of recent high mortgage rates has been a significant increase in the financial cost of moving for existing homeowners—leading to the so-called "lock-in" effect, whereby homeowners have become reluctant to move due to the cost of having to prepay their existing mortgage and take on a new one at much higher rates. Around 85% of mortgage borrowers today have interest rates below those prevailing in the market.

At the same time, national home price appreciation has remained fairly strong, averaging around 3.5-4%, and total home equity is near all-time highs at around 135% of GDP (see Exhibit 7).

This combination of homeowners being locked into their existing homes and sustained home price appreciation has generated a strong incentive for households to tap home equity lines of credit (HELOCs) for things such as home improvement or other discretionary and non-discretionary spending.

Exhibit 8: US Home Equity Is Near All-Time Highs

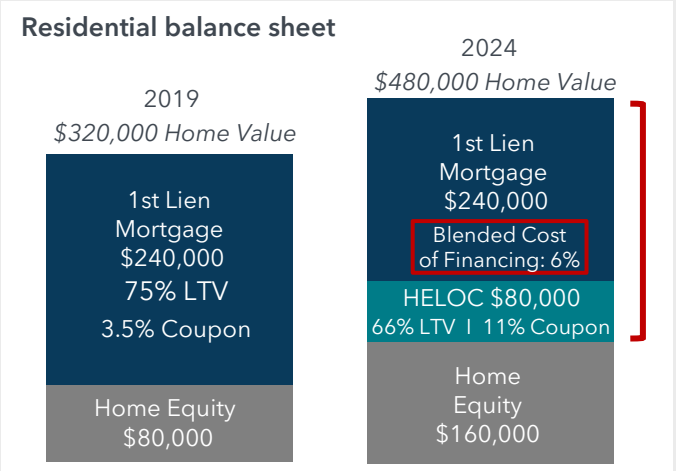


Note: Data as of 10/23/2024. Source: Federal Reserve, TPG.

HELOCs can provide a useful source of liquidity for households and, given they are secured in nature, their cost is often preferable for borrowers relative to paying significantly higher interest rates on unsecured consumer loans or credit cards.

As a lender, providing capital for HELOCs also has many attractive features. In particular, such transactions can provide high carry relative to a first-lien mortgage while also still affording a lender downside protection in the form of the collateral of the underlying home (see Exhibit 9).

Exhibit 9: A Snapshot of Home Equity Lines of Credit



Note: Strictly for illustrative purposes. Doesn't necessarily represent all loans made by TPG AG. Source: TPG.

The strong opportunity in home equity line of credit (HELOC) lending is a great example of the important role that ABC can play in helping to solve everyday household financing challenges while providing value to both the borrower and the lender.

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