

DEMANDS OF REAL ECONOMY UNDERPIN ASSET-BASED LENDING

Asset-based lending — a subset of asset-based finance — continues to attract institutional allocators for its diversification, downside protection and attractive risk-adjusted returns. The interest persists even as some other areas of private credit are faced with tightening supply-demand dynamics driven by creeping weakness in economies around the world. While the massive asset class has proved its mettle through boom and bust economic cycles, today investors need to carefully navigate areas of the real economy that exhibit compelling borrower dynamics and robust loan structures. Working with experienced asset managers that have strong origination pipelines and workout capabilities is key.

In this strategy Q&A, James Sackett, a principal at AB CarVal, and Jim Moore, head of private placements and asset-based finance at Barings, describe what's driving market dynamics and investible opportunities in the current macroeconomic environment, emphasize the importance of risk management and shed light on what the future holds for the asset class.

Pensions & Investments: As institutions broaden their allocations to private credit, what's drawing them to asset-based lending?

The interest in asset-based finance is being driven by a few key factors. First, "it's the sheer size of the opportunity," said Moore at Barings. "Whether it's a narrow subsegment or the broadest possible universe, asset-based finance represents a massive opportunity. The second is the secular growth trends at play across residential, consumer and commercial asset finance. Finally, it's the breadth of potential risk-adjusted return profiles for investors, which range from triple-A down to equity."

Underpinning those reasons is the structural shift after the global financial crisis, when banks pulled back from the market due to regulatory requirements and both traditional and specialty asset managers stepped in to fill the void. "The opportunity set in this space has been driven — on an ongoing basis post financial crisis — by the retrenchment of the banks away from a lot of real economy lending," said Sackett at AB CarVal. "What was a \$1 trillion market back in 2010 is now a \$6 trillion to \$7 trillion market that is estimated to reach about \$10 trillion by 2028."¹

On the demand side, broader market dynamics — highly valued equities, tight public fixed-income markets and liquidity challenges in private equity — are pushing institutional investors to seek other avenues for uncorrelated returns and downside protection, such as asset-based finance.

"I think investors are looking to private credit to get more stable, front-ended cash flow solutions to their portfolios," Sackett said. "At a time when equities are flying high and public credit is tight," asset-based lending offers strong net yield potential and the granularity of underlying portfolios, he added. "We're typically talking about portfolios of loans or assets in the hundreds or thousands, or sometimes even tens of thousands. That granularity and downside protection are particularly compelling for investors in what

is a very noncorrelated asset class."

Moore added that interest in the asset class is particularly strong from insurance companies seeking excess yield for liability manufacturing, as well as pension funds looking to "layer asset-based finance and other private investment-grade strategies into traditional core and core-plus allocations" to pick up spread. For all investor types, the ability to dial up or down the risk profile of an asset-based finance deal is compelling. There is a "wide range of institutions and wealth channels looking to complement or supplement their existing middle-market direct lending allocations through a low double-B and high single-B or equivalent noncorporate, collateral-backed exposure," Moore explained. "Investors may also choose to invest in the junior part of the stack and seek out more double-digit returns for the additional risk."

P&I: How would you compare ABL to corporate lending and other private credit segments, and where does it best fit within an institutional portfolio?

As a broad asset class, asset-based lending covers different sectors and lending structures, and it can offer very different risk profiles. That said, certain distinct characteristics set it apart from other forms of private credit.

The broader term "asset-based finance" can be broken down into hard assets and financial assets across a variety of sectors," Moore pointed out. "We divide the opportunity into three main segments — residential (e.g., residential mortgages), consumer (e.g., credit cards, small business loans) and commercial asset finance (e.g., equipment finance and digital infrastructure)." From an investor's perspective, the asset class should be considered in terms of the investment goals that it can help achieve. "It really depends on what the investor is looking to achieve. Is it volume, diversification or yield?"



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“For example, if I already have corporate risk in direct lending or private placement investment-grade risk or public corporates, I’m probably looking at asset-based finance from a diversification perspective. Therefore, I may target segments like residential, consumer and parts of commercial that don’t have an underlying corporate risk,” Moore said. “If my objective is excess yield, then I’m going to look at the full opportunity set.”

Institutional investors’ search for robust diversification using strategies such as asset-based lending has become even more important, given that today they are turning more toward private assets relative to challenging public markets, Sackett said. “It diversifies their private credit book in a way that’s compelling,” he said. “And at this point in time, most investors are trying to grow that private credit book relative to pretty tight public markets.

Asset-backed lending “is highly uncorrelated because of the structured nature of the underlying portfolios,” he said. “When we compare it to direct lending, or the equities markets or other infrastructure-type debt, there’s a low level of correlation. I believe that is particularly attractive to investors who are currently using direct lending as their predominant allocation to private credit.”

P&I: What factors are supporting the asset class as we look ahead to 2026, particularly in the current macro environment?

Both supply and demand are robust because of borrowers’ needs for private lending across key growth sectors of the economy and the funding capabilities of asset managers who are seeing strong institutional demand.

“Over the longer term, the resilient consumer is going to be a growth driver for the U.S., fueling demand for more consumer finance products, more purchases and more equipment that needs financing,” Moore said. “Take air travel as an example. There’s significant growth in air travel but a shortage of airplanes. To meet this demand, many more planes will need to be manufactured and, in turn, financed over a long period of time.”

Steady growth in the need for residential financing, both in the U.S. and Europe, is also supportive, according to Sackett. “Residential development in Europe is a huge area of growth, as we have a chronic housing shortage in places like Ireland, the Netherlands, the U.K. and Germany,” he said. “The fundamentals are driving the opportunity set, which we think will continue through not just the next year or two, but as a systemic opportunity.”

Moore pointed to both traditional infrastructure, such as transportation and energy, and newer digital infrastructure, like data centers, as long-term demand drivers for the asset class. “There are staggering numbers being thrown around for what we need to do in the U.S. to upgrade our core infrastructure, from energy generation to roads and airports,” he said. “Digital is no different. Whether it’s artificial intelligence, cell towers, data centers or fiber to the home, the numbers are staggering.”

But uneven growth numbers and the potential for inflation spikes can be a concern in asset-backed lending. Managers are keeping a close eye on potential impacts from macroeconomic trends so they can adjust portfolios if the need arises. “The macroeconomic story looks pretty grim across the developed nations,” Sackett said. “It’s a somewhat volatile situation where we expect some inflationary spikes, especially with the tariff uncertainty and slower growth. But that doesn’t stop the real economy.”

“What it means is we have to be more cognizant of the asset classes that are more protected, and what are the appropriate structures for lending,” he said. “If I’m focusing on granular, relatively short-duration assets, then I am able to adjust my underwriting criteria and risk assessment based on what’s happening in a particular country and consider all micro and macro factors to appropriately risk manage my origination.”

P&I: Which segments — such as consumer or business finance, tangible or intangible assets — present opportunity and why?

The opportunity set in asset-based lending can be divided by region, business, sector and even deal structure. Each approach has its benefits, depending on the allocator’s portfolio targets.

To start off, “it differs by jurisdiction. If I put the U.S. on the one side and Europe and the U.K. on the other, there are some more relatively attractive assets in each of those regions,” Sackett said. Starting with geographic differentiation is not uncommon because not only do economies operate at different points in the cycle, but supply and demand across regions are not often correlated.

“In the U.S., each sub-asset class has depth and volume, and the pricing visibility is clearer,” he added. “It often comes down to pricing and scale. Whereas in Europe, it is more of a developing market, where some of the asset financing is coming out of the banks and there is more differentiation in returns.”

“At the moment, some of the more specialized residential assets in Europe, where you have that supply-demand imbalance, are particularly compelling. That includes investing in mortgages,” Sackett said. “We also like the more asset-backed nature of consumer lending, so more auto lending and point-of-sale financing.”

In the U.S., on the other hand, opportunities are scalable. “We’re able to achieve structural downside protections, so we’re not exposed to meaningful movements in loss rates,” he said.

For Moore at Barings, asset-based finance offers a wide and evolving opportunity set. “We see opportunities across ABF segments, particularly those benefiting from strong secular growth trends,” he said. These include areas where originators with large financing programs are seeking to diversify funding sources away from traditional ABS or banks. “We also see opportunities in segments more exposed to bank retrenchment and in sectors

that require access to multiple end markets.”

Residential mortgages are one example. “We see potential in non-qualified mortgages, residential transition loans and second-lien home equity loans — areas outside typical bank underwriting but with solid credit profiles,” Moore noted. In commercial finance, aviation and equipment stand out, supported by structural tailwinds.

Broadening the lens, infrastructure and digital assets are emerging as significant growth areas. “With massive spending needed to upgrade U.S. infrastructure and meet digital and AI demand, private markets will play a critical role,” he said. While volatility is inevitable, Moore emphasized a long-term view: “There will be bumps in the road, but the underlying trends are supportive.”

P&I: What’s your risk-management process, and how do you approach potential defaults and workouts?

Asset-based lending can be complicated, with deals in different sectors and different business models. As such, it’s important that investors have a full understanding of a manager’s investment and risk-management process, and how they approach defaults and workouts.

AB CarVal has “over 30 investment professionals globally who focus on the asset-based financing market and specialists with a background in operating businesses, legal, data analytics, as well as financing, securitization and structured credit,” Sackett said. “We’re able to work with both the operation liabilities management and credit management of the underlying originators.”



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At Barings, Moore's team focuses on balancing origination with the appropriate structure and risk management to deliver attractive returns relative to public investment grade or securitized loans "while at the same time focusing on capital preservation and downside protection," he said. Although every deal is different, "there's a key set of loan terms and protections that one needs to be familiar with when thinking about ABF, and it gets even more specialized in each segment. Collateral is tantamount. If you understand your collateral, from a risk perspective, you can play both offense and defense."

Given the complexity of this space, it is important for investors to understand whether a manager is sacrificing the quality of a deal or structure in exchange for higher potential returns. "We won't sacrifice quality for an extra 50 basis points or a bigger allocation," he said. "Where we might make adjustments is when we like the structure and collateral and we're still able to capture some excess premium."

While the asset-based finance market has grown significantly in recent years, loan defaults and workouts have been few and far between and largely idiosyncratic in nature. But that doesn't mean managers aren't ready to act when issues arise. "Workouts have been minimal over the long-term. As investors, we focus on active surveillance of data and review of early warning indicators so that when issues arise, we can work closely with sponsors and borrowers on a resolution with a goal of not having to go through an active workout or liquidation."

"Occasionally, situations may arise, where credits could run into trouble. This is why having resources in place to handle these situations is important. Our deal teams, who have deep knowledge of the borrower and terms, will partner with internal and external counsel, consultants and other specialists, and are always focused on collateral, capital preservation and finding alternatives to capture the return we anticipated at time of investment," Moore added.

"Our goal is to not have to go through workouts and liquidations. We'd much rather — and it's far more valuable — to catch some of those issues early and effectively restructure or reconstitute loans so they remain performing," AB CarVal's Sackett pointed out.

P&I: What qualities in an ABL manager are critical to delivering consistent performance?

Because of the breadth and depth of the asset-based lending market, many institutional investors work with an investment consultant to evaluate and identify managers that can deliver their investment goals. Either way, they need to have a solid understanding of a manager's process, from origination to workout.

"Allocators need to peel back the onion to understand what truly differentiates a manager's model," Moore said. "What are they bringing to the table that you're not already getting elsewhere?" For Barings, a key component is its origination pipeline, which provides access to an ongoing flow of investment opportunities.

Moore also emphasized the importance of taking a "deep and focused" approach to the market segments where a manager invests, versus a "thin and wide" coverage model. "We've built specialized teams and invested in talent and technology

within key verticals," Moore said. "That gives us the ability to tailor deal flow to investor preferences and return profiles."

Risk management is equally critical, he said. "Having a scalable, integrated data platform to manage risk, optimize returns and dictate origination is essential."

AB CarVal's Sackett emphasized that a manager's track record and duration are "absolutely crucial" to assessing risk management. "Look for a manager with a track record for 20, 30 years, not just the last five or 10 years," he said. "These asset classes are deep markets, and you have to understand what happens under certain situations in different countries." For example, Europe has different data sources and legal structures, and there are even distinct cultural and behavioral differences versus the U.S.

The manager "needs to have a business that has had consistent performance, but also an understanding of the liability side," he added. "The final piece is having people with a breadth of knowledge across different markets, so you aren't too concentrated."

At AB CarVal, the same team manages portfolios from start to finish, from underwriting until a loan is repaid. The value of such a structure is that "you take your learnings and you understand the asset class, but you also know each geography in detail and each asset class within that geography," Sackett said.

P&I: What's your outlook on asset-based spreads and yields against other segments of private credit and public fixed income over the next 12 to 18 months?

With relatively tight spreads across public fixed income and some private credit segments, will the asset-based finance markets also move in that same direction? Investors need to carefully consider market sector, region and specific exposures.

"Public fixed-income markets are very tight. And with a lot of capital focusing on private credit, spreads have come under a bit of pressure," Sackett said. "I believe the best relative value is likely to be seen in some subsegments of the asset-based market. It will differ by geography. You want to be paid for operational heft and complexity, as opposed to credit risk."

According to Barings' Moore, strong demand and limited supply have compressed spreads in private markets. "We've compressed a lot, and I think at the margin, spreads could compress a bit more," he said. "If volatility picks up, we could see a pullback in asset-based finance."

But that shift could ultimately benefit the asset class. Some investors may step back or move toward the relative safety of public markets. "You're going to see managers that jumped in without a history in ABF — those just getting comfortable with illiquidity — reduce risk and flock to liquidity," Moore said. "That will help rebalance the market from a supply-demand perspective."

¹Global Monitoring Report on Non-Bank Financial Intermediation, Financial Stability Board (2013, 2018 data); Integer Advisors (2023 and 2028 estimate).

