KEYNOTE INTERVIEW

The hunt for 'underserved and underloved' assets

Asset-based finance is seen in some quarters as a strategy well suited to the times, thanks to the downside protection provided by collateral and bespoke investment structures. Daniel Pietrzak and Matthieu Boulanger discuss how KKR is approaching the space

In the wake of the covid-19 outbreak, investors are carefully scrutinising how the landscape has changed for different strategies. Many observers feel that private asset-based finance is well placed to prosper.

However, with so many different sub-strategies falling under the ABF umbrella, it's a complex investment area.

Private Debt Investor caught up with KKR partners Daniel Pietrzak and Matthieu Boulanger to understand more about the market and how the firm has chosen to approach it.

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Q What's the broad attraction of asset-based finance?

Daniel Pietrzak: We view private asset-based finance as a strategy that supports a diversified portfolio. It's generally uncorrelated to other investments and the market, which we estimate to be $4.5 trillion (growing to $7 trillion in five years) is probably 10 times that of the assets under management in the direct lending market, so opportunities are abundant. The asset class also has favourable secular and cyclical tailwinds and, in an environment where rates are low, you can get collateral-based credit opportunities that produce double-digit returns and attractive current income.

Matthieu Boulanger: Since the onset of the covid-19 pandemic, we've been focusing on the more resilient sub-categories of what is a very broad universe. There is also a good and consistent illiquidity premium versus the public market and high barriers to entry around it.

Q What explains KKR's approach to ABF?

DP: We've consciously chosen to be diversified. We think about ABF as a global team operating across a range of different underlying asset types and sectors. The simplest definition is that we acquire or lend against a diversified pool of financial or hard assets. This is not a space where we're taking a lot of singular credit risk. We are looking more at pools of assets – either by acquiring them or building platforms to source them.

We're trying to find lending themes and sectors that we consider 'underserved' and probably 'underloved' by the market and where we can come in and fill a void. Typically, we partner with banks or tap capital markets for financing to lower the cost of capital. We also work hard to improve the overall borrower experience.

MB: We think private ABF has already matured significantly but we continue to see further growth. You have organic forces assisting the sector – growing populations, younger demographics and people who are more comfortable with credit than prior generations, as well as being tech-savvy – and that has allowed technology platforms to develop. Fintech organisations are more customer-friendly in terms of the credit solutions they provide and have the ability to do credit scoring and approvals relatively quickly. So, you have these two trends of the asset class growing overall and people keen to find an alternative to the banks.

Q What are the risks in ABF investing and what are the keys to managing those risks?

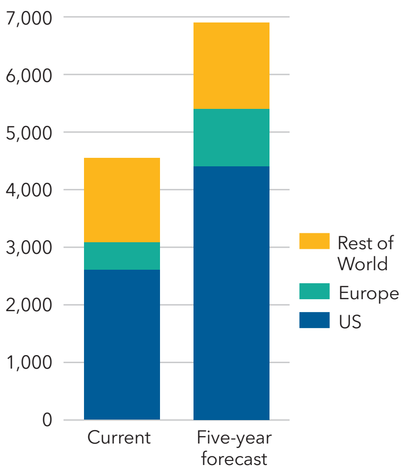
MB: The fundamental one is credit risk. Once an opportunity is identified, investors need to examine how the underlying loans behave in different scenarios through granular, bottom-up modelling. The second is structuring – that is negotiating the optimal structure to sustain macroeconomic and financial cycles. The third risk is scale and deployment – once you've identified the opportunity and are looking at either buying assets or originating portfolios of loans. If we don't find someone in the market executing the way we want, we establish a speciality lending platform to capture that specific market opportunity. The risk is whether we can scale it. This degree of control is a strong form of risk management, in addition to things we negotiate like portfolio governance rights, put rights and defined events of default.

Q Where do you see the value in consumer and mortgage finance?

DP: This is the biggest segment for us in our ABF strategy and there is no perfect way to categorise it. We set investments up in a lot of different ways based on how we think about the risk. We are modelling large portfolios of assets in the consumer and mortgage space and it's a different risk exercise compared with backing hard assets or SME loans. Overall, we like the macro-drivers, including the demographic trends, behind the segment.

We've been very active in US housing, where we see demographic trends driving strong household formation that is confronting a constrained housing supply. We have not wanted to be in the traditional 30-year mortgage market, so instead we have got behind residential transitional bridge loans. These are also known as 'fix and flip' loans and they're used by developers to purchase homes in desirable areas, perform light refurbishment, and sell (or 'flip') them at attractive gains. The market is large, with annual originations of $20 billion to $25 billion, and regionally fragmented across the US.

Although the US will see a substantial rise in the use of asset-backed finance, growth will remain less pronounced elsewhere ($bn)



Sources: KKR Credit and Integer Advisors' estimates, Financial Stability Board, central banks, national statistical offices, industry securitisation data

We chose to access it by starting a company called Toorak Capital in 2016. Today, Toorak is one of the largest operators and has originated $4.6 billion in loans. These have short, 12- to 18-month lives and high single-digit yields, or mid-teens when levered, so we feel like we're taking housing risk but doing it in a way that's very different from a regular 30-year mortgage. I think housing has probably been the largest theme we've had.

MB: In addition to that, it's a case of finding asset classes that are probably a little underserved. We set up a lending business in the UK to address near-prime used-car financing, and we've been buying auto risk and student loan risk in the US. We've been a little bit more cautious over the last couple of years, and our underwriting has certainly been more defensive since the onset of covid-19. For example, we've stepped back a bit from near-prime unsecured consumer and auto lending. Maybe in a different underwriting environment on the other side of this pandemic crisis, we'll consider going back into those markets.

Q Hard assets cover so many different things, from homes to planes. How have you narrowed down the opportunity?

DP: Thematically, we avoid energy because of the commodity risk, which is impossible to manage. So, the first thing to say is we'd exclude the hard asset types that are associated with that sector. We're also not going to buy ships or mining equipment.

As I mentioned, we've tried to get fully behind the US housing theme. In the hard asset segment, it's why we're involved in a single-family rental platform called Home Partners of America. We think that with demographics changing due to the millennial generation you will see more people renting houses for a longer time before buying. In the current interest rate environment, total returns have improved as rental yields are flat-to-up but financing costs are down.

MB: We've also invested in aviation leasing, although that sector is probably the epicentre of the covid-19 storm. For the last 25 years, airline traffic volume has grown at twice the rate of GDP growth. You had more and more people flying, particularly from developing parts of the world. We underwrote the post-9/11 and financial crises as worst-case scenarios and it took two to three years for those assets to recover. So long as investors can wait it out and get to the other side they can still be in a good spot. Covid-19 is different and it might take twice as long to recover compared with those previous crises.

Q In SME finance, the approach appears very targeted. Could you describe it?

DP: We're never going to compete with banks head-on because that is a losing proposition for us. Banks are excellent at serving their customers and we're not going after their direct customer base.

What we do need to have is a bit of a different approach on financing that is outside banks' comfort zone. For example, when you look at financing homebuilders, we've done transactions in Ireland and the UK, where the banks have stepped back due to regulatory capital issues.

Housing was a major issue in Ireland and also in the UK outside of London during the financial crisis. As a result, developers there have been underserved by banks, so it's something we are really able to get behind now. Similarly, equipment leasing has been punitive for many banks and again the question was how do we step in and fill that void? But this is a smaller sector for us in many ways. We're not going to go after the 'regular way' SME lending facilities.

MB: Agreed. It's also important for us to distinguish between what we do in our traditional corporate direct lending funds and what we do in SME finance. In direct lending, it's cashflow-based and we tend to focus on much larger businesses, typically those with EBITDA of between $50 million and $100 million. In this sub-category of the ABF strategy, it's lending to small- and medium-sized corporates, and the downside protection lies in the collateral owned by the business, such as real estate or industrial equipment. It's a different approach: much more granular and diversified.

Q The contractual cashflows strategy also appears niche. Is assessing this opportunity different from hard assets?

DP: It's almost a catch-all bucket for other things and is probably the least correlated of the strategies. We've tried to find places where we can add value, maybe take advantage of mispriced asset classes or themes in the economy or financial services that probably need to evolve. For instance, we like the regulatory capital space, particularly during periods when financial institutions are stressed, but it needs to be the right kind of deal for us.

Life settlements is a space that has worried us historically from a reputational risk perspective. But we found a partner that is offering a strong economic benefit to its underlying consumers and we've implemented operational safeguards. So, it's the right transaction to be doing from the customer and investor points of view.

Q The non-performing loan mountain is presumably set to grow again, and investors may have an eye on the opportunity. What is your take on it?

MB: Our approach to NPLs has been about picking our spots. The opportunity set is not just about Southern Europe. It's lots of different countries with their own legal regimes with different expertise and local knowledge required. We own three platforms, with more than 1,000 employees across seven European countries, that are servicing around €50 billion of distressed loans.

DP: This gives us really good real-time intelligence into what is happening in a specific market. We've shied away from auctions to look mainly at bilateral transactions with banks, so we are able to negotiate a better deal and more appropriately price the risk.

Q You have different approaches to doing deals. How do you decide which is the most appropriate way of accessing a given opportunity?

DP: We set up our ABF operation to be flexible. We find the asset classes and long-term themes that we want to invest in by lending to companies, buying loan portfolios or potentially setting up lending platforms. So, we aim to access opportunities in the most efficient and economical way in order to access the best available risk-adjusted returns. That said, it's always easier for us to lend against existing themes and to borrowers that we know well; so, as our base of incumbent positions expands, our opportunity set scales alongside it.

Setting up a platform has the highest bar. We need to have the right reason to do it, which is usually because it's very difficult to get access to the market otherwise and this barrier to entry is why spreads are wider than they should be for the amount of risk. We set up the platform primarily to get the cashflow from the assets but also to hopefully create some equity value in the platform that provides an additional upside.

MB: In Europe, we're a little more inclined to set up lending platforms, whereas in the US we probably buy more loan portfolios because it's easier to gain access to them. We want to be positioned to find the best available risk-adjusted returns, whether it is by lending, buying loans or owning an interest in platforms. ■

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