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Attractive portfolio finance opportunities for liquidity providers – driven by bank disruption and frozen M&A market

MANDATUM
ASSET MANAGEMENT

ABSTRACT

At a time when the broader economy is facing significant turmoil, the landscape of private financing is undergoing substantial transformation. One subcategory of private debt, portfolio financing, has gained a lot of traction in recent years. Portfolio financing, which entails providing capital secured by diversified portfolios of assets, such as consumer loans, aircrafts, royalties, fund NAVs[1] and corporate receivables, offers investors exposure to a wide range of assets with front-loaded cash flows. These typically exhibit a lower correlation with traditional corporate assets like bonds and equity. This white paper explores two critical themes within portfolio financing – asset-based finance and fund finance – both of which present attractive risk-reward profiles forward. Driven by the disintermediation of traditional banking and frozen exit market in private equity, we foresee strong demand for innovative private debt solutions in these categories. However, this demand is met with a limited supply, as the pace of development has outpaced capital raising efforts.

First, following the global financial crisis and the implementation of Basel III, which imposed stricter capital requirements on banks, many forms of lending have become less profitable for bank equity. The initial waves of banking disintermediation were seen in asset classes subject to higher capital requirements, such as non-performing loans (NPLs) and middle-market leveraged buyout lending, the latter being a key driver behind the rise of direct lending. Today we are seeing increasingly diversified loan portfolios from the banking sector, such as auto loans, credit cards and student loans. Geographically, the more fragmented European market has lagged behind the U.S. in terms of disintermediation. However, since 2010, there has been a measurable decline in the banking sector's share of lending in Europe as well. In this transformation, agile private debt funds are emerging as key enablers despite serving only 5% of today's addressable market[2]. The total private asset-based finance market is projected to grow at approximately 8% p.a. reaching $8tn by 2027[3], equivalent to roughly $600bn in annual growth. This compares to only $190bn in new capital raised across private debt subsegments during the record-breaking year of 2023[4].

Second, increased geopolitical tensions and rapidly increased interest rates in early 2022 resulted in a 20% decline in valuations for new leveraged buyouts between the 2021 peak and 2023. As private equity funds aim to achieve their target IRRs[1], the gap between buyers and sellers remains significant – resulting in exit activity reaching near ten-year lows in 2023. Decreased exit activity has resulted in lower distributions for private equity fund investors and increased allocations in illiquid asset classes. To free up liquidity, fund investors have increasingly sought alternative solutions, with fund finance providers – such as secondary stake buyers and preferred equity providers – emerging as viable options. However, as exits remain constrained, private equity investment hold periods are lengthening necessitating follow-on investments in existing portfolio companies to support valuations targets. To finance these investments, funds that have already called most of their capital are increasingly turning into NAV financing, which refers to the lending against the diversified portfolio of private equity assets. As these portfolios are typically well diversified across sectors, at a mature sage in their harvest period, and subject to conservative LTVs ratios of 20-25% with strong sponsor alignment, the downside risk for achieving returns exceeding 10% is well mitigated.

Overall, we see portfolio financing emerging as the next growth segment within private debt. Given the substantial expansion of the addressable market, this opportunity is unlikely to diminish in the coming years. Interesting standalone risk-reward profile coupled with clear diversification benefits to otherwise single corporate lending focused private debt allocation makes us positive about the future of this asset class. Scale and broad mandates make it possible for selected managers with sufficient recourses to pursue the best relative value opportunities across the cycles.

1) NAV = Net Asset Value, IRR = Internal Rate of Return, LTV = Loan To Value. 2) Source: Oliver Wyman. Private Credit's Golden Moment And The Resurgence Of Banks. 3) Source: KKR. The Expansion of Asset-Based Finance. 4) Source: McKinsey. Global Private Markets Review 2024 | McKinsey.

1. How is portfolio finance defined?

Portfolio finance refers to all financing solutions provided for diversified portfolios of assets, rather than direct financing to individual corporations.

- Portfolios consist of diversified pools of assets, such as consumer loans, mortgages, aircrafts, royalties, receivables, and more.
- Many sub-segments have traditionally been served by banks but tightening capital requirements have led to alternative asset managers increasingly taking market share.
- Deals can be executed through case-by-case origination, acquiring existing portfolios, or leveraging an in-house origination platform.
- The cash flow profile of these portfolios is typically more front-loaded than that of direct corporate loans, due to amortisation.

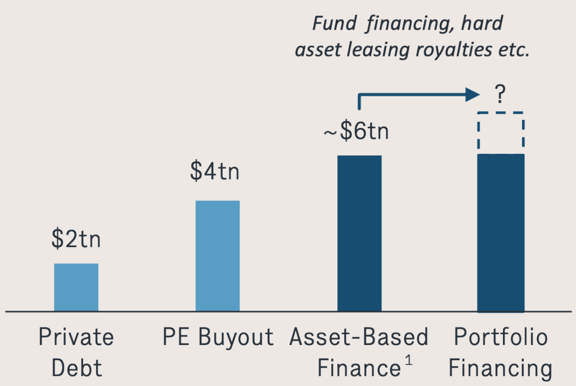
Large, diversified, and growing opportunity set driven by disruption

While alternative investing is typically associated with asset classes such as private equity, real estate and direct lending, one should not overlook one of the largest, if not the largest, areas of private financing — portfolio finance.

As shown in Graph 2, there is roughly estimated USD 6 trillion opportunity in areas of private consumer and commercial credit, shown in Graph 3, which have traditionally been served by banks. The shift away from banking sector has been driven by the increased regulation affecting banks' capital efficiency. However, competitive positioning in this space requires substantial investment and research capacity, which are currently held by only a handful of players.

2. Size of the opportunity set

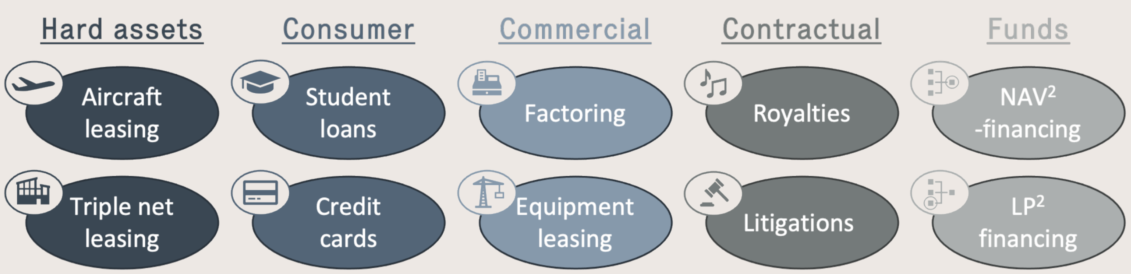
Market size estimates of global private asset classes in 2023, USDtn



Source: McKinsey Global Private Markets Review 2024, KKR[1]

These more traditional forms of financing, on which our economy has been build, have been complemented by innovative solutions for e.g., intellectual property owners and closed-ended fund investors. Especially fund financing has gained popularity in recent years as reduced M&A activity has affected distributions and fundraising. All in all, the traditional asset-based finance is projected to grow at ~8% p.a. until 2027[1], while e.g., NAV lending[2] could grow by as much as ~20%[3] p.a. by 2030.

3. Examples of portfolio financing



Source: Mandatum

1) Asset-Based Finance: Private financial assets originated and held by non-banks globally, related to household and business credit. Source: The Expansion of Asset-Based Finance, 2/2025. 2) NAV = Net Asset Value. LP = Limited Partner, i.e., fund investor. 3) 17 Capital (Alternative Credit Investor). Source: NAV finance: Behind the headlines - Alternative Credit Investor, 2/2025.

DISINTERMEDIATION OF BANKING RELIES ON PRIVATE ALTERNATIVES (1/3)

Flexibility of banks has been harmed by the regulators' hunt for systematic risk

After the global financial crisis in 2008, regulators sought to reduce systemic risk in the banking sector. One of the most significant reforms, Basel III, introduced the following: 1) an increased minimum CET1[1] ratio requirement from 2% to 4.5%; 2) guidelines to match the duration of assets and liabilities; 3) Standardised risk-weighted asset (RWA) calculations. While Basel III was introduced already in 2010, its implementation was only finalised in 2022.

Basel III impacted banks' ability to operate outside their core deposits-and-loans banking model, as other activities have become capital-intensive (Graph 4). To adapt, banks have shifted their focus to regulatory risks. This is especially evident in non-performing loans (NPLs), which require substantial capital reserves to be held against. As a result, banks have increasingly offloaded NPLs (Graph 5) to entities such as debt collectors, marking the first wave of banking disintermediation. The second wave was characterised by the rise of direct lending in small and mid-sized leveraged buyout (LBO) financing. Moreover, maturity of these assets usually do not align well with banks' short-term liabilities, such as deposits.

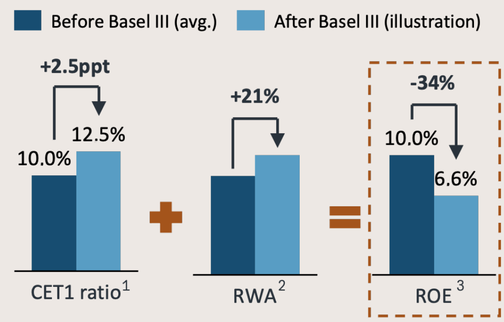
Furthermore, in the U.S., the Dodd-Frank Act (2010) introduced regulations that hindered lending to consumers and small- to mid-sized companies, which are at the core of regional banking. Moreover, increased requirements for data and compliance have created a need for scale, resulting in a reduction in the number of U.S. banks, leaving some segments unserved.

The Basel III "endgame" will reaccelerate the migration, which slowed during the Covid-19 period

Covid-19 temporarily stalled economic activity, resulting in government stimulus, which impacted the demand for private financing solutions. However, the upcoming Basel III "endgame", set to be implemented by 2028, is expected to increase the CET[1]s of the largest banks by another 19%[4]. As a result, disintermediation is likely to continue. One interesting niche is the extensive office exposure of U.S. regional banks in their lending, where we could see a wave of motivated selling in the near future.

4. Illustrative impact of Basel III on banks

Example of the impact of Basel III on bank profitability based on an average Group 1 bank in 2011, EURbn/%

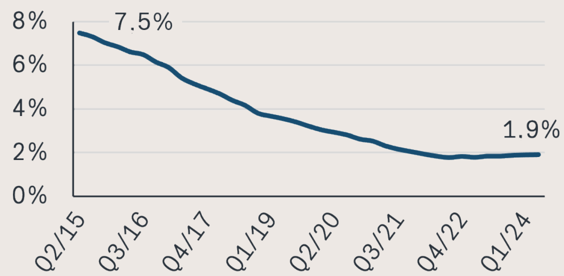


Estimated impact of Basel III on CET[1] ratio and risk-weighted assets in 2011 would have circa 3.4 percentage points negative impact on average return on equity of Group 1 banks

Source: ECB, BIS, EBA

5. NPL ratio of European banks

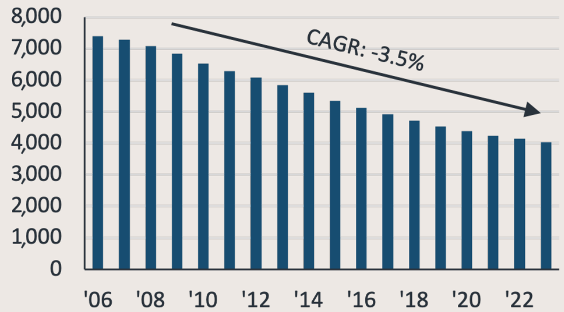
Non-performing loan ratio (% share of total assets) of European significant banks, Q2/2015–Q2/2024



Source: ECB

6. Number of US commercial banks

Number of commercial banks insured in the United States, 2006–2023



Source: Federal Deposit Insurance Corporation

1) CET1 ratio = Common equity Tier 1 capital in relation to RWA. Basel III introduced 2.5% higher minimum CET1 ratio. Pre-Basel III avg. CET1 ratio was ~10%. Common equity tier 1 capital consists of share capital and retained earnings. 2) RWA = Risk-weighted assets, i.e., regulatory balance of asset risk based on standardized calculations. European Banking Authority estimated circa 21% impact on RWA from Basel III, ceteris paribus. 3) Return on Equity, calculated as net income (stable in this model) in relation to CET1. Average ROE was 10% in 2011. 5) Goldman Sach

DISINTERMEDIATION OF BANKING RELIES ON PRIVATE ALTERNATIVES (2/3)

The non-banking sector is still evolving, particularly in Europe

Advancements in financial technology applications and the availability of reliable data have made it possible for private counterparties to underwrite complex portfolios, particularly in consumer and mortgage financing, thus providing a supply for the dried-up liquidity by banks.

As seen in Graph 7, Europe is clearly lagging in disintermediation, while in the U.S., the homogeneous environment and developed public capital markets have made it easier to find alternatives for banks. Europe has already taken steps toward reducing banks' importance, and agile private debt funds could be a viable solution for the heterogeneous Europe.

Attractive opportunities arising from limited supply against large demand

Growth of private asset-based finance (ABF) is expected to accelerate to 8% p.a. in the next few years (Graph 8)[2]. This translates into ~$600bn per year, which can be mirrored against the all-time-high private credit fundraising of $190bn in 2023[3]. Further, vast majority of capital was raised for direct lending funds – the largest ones already reaching sizes of $10–20bn. Private debt funds have estimated to hold only 5% market share in private ABF[4], leaving significant room for growth within the current addressable market.

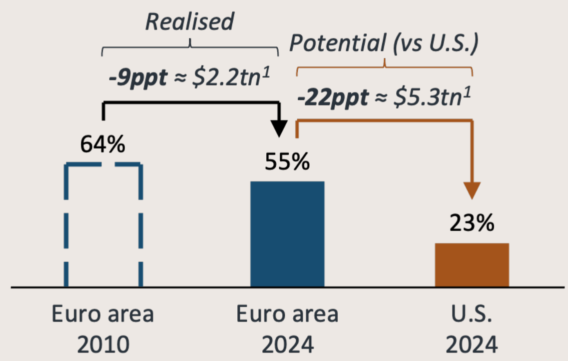
In addition, underwriting portfolios of thousands of loans requires significant capital and research capacity. These capabilities are still rare as the asset class is relatively new, which limits the number of suitable capital providers. As a result, the supply-demand balance is attractive for investors, which results in double-digit IRRs with limited downside risk due to the asset backing.

Front-loaded cash flow profile is unique for asset-based finance

In addition to attractive risk-reward profile, asset-based lending usually results in contractually front-loaded cash which both reduce the risk of the positions and enable solid capital distributions to investors also during less certain times – like the past few years. This provides valuable diversification benefits for private debt investors.

7. Banks' share of lending

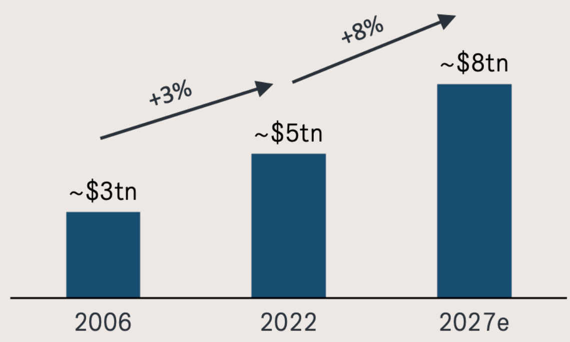
Share of private non-financial sector lending (%) by banks as a proportion of total in the Euro area and the U.S., 2010 and 2024



Source: Bank for International Settlements (BIS)

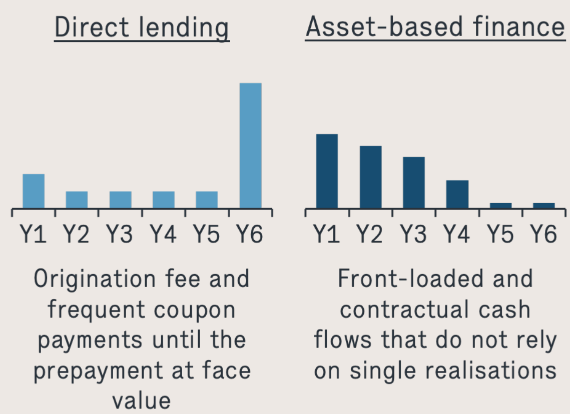
8. Private ABF opportunity set

Value of private financial assets originated and held by non-banks globally, related to household and business credit 2006–2027e, USDtn



Source: KKR2

9. Different cash flow profiles of direct lending and asset-based finance



1) Calculated as delta in banks' share of lending to private non-financial sector times the current total debt outstanding for European private non-financial sector. 2) KKR. Source: The Expansion of Asset-Based Finance. 3) McKinsey. Source: Global Private Markets Review 2024 | McKinsey. 4) Oliver Wyman. Source: Private Credit's Golden Moment And The Resurgence Of Banks.

DISINTERMEDIATION OF BANKING RELIES ON PRIVATE ALTERNATIVES (3/3)

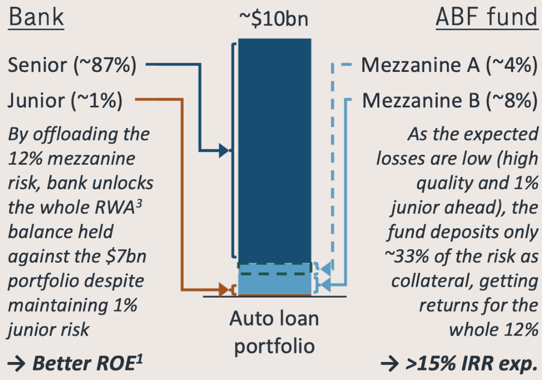
Case example 1: Win-win situation in the U.S. prime consumer auto credit space

Banks' balance sheets are increasingly driven by regulatory capital to enchase better returns for equity. Illustrative real-life example of so-called significant risk transfer in US prime consumer auto credit space effectively demonstrates the banks' motives to hand over attractive risk-return.

As shown in Graph 12, the bank transferred a 12% mezzanine risk related to ~$10bn auto credit portfolio to an investor. As illustrated in Graph 10, the bank was able to release the entire Tier 1 capital held against the portfolio while retaining the first-loss junior risk of approximately 1%, which now represents the maximum realistic loss the bank will take. In doing so, the bank improved its return on equity, making the transaction attractive for itself as well.

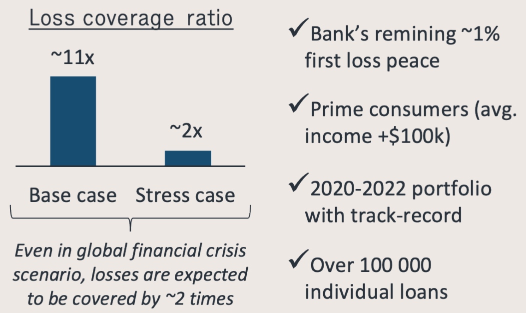
On the other side, due to the high quality of the portfolio and bank's junior tranche, the investor is required to hold only ~33% of its 12% mezzanine (i.e., 4% of the portfolio) as collateral, while yielding returns for the whole risk – this can result in >15% IRR. The investor's expected losses related to payment defaults are well covered by the returns, as the loss coverage ratio is ~2× even under a global financial crisis scenario, as shown in Graph 11. Overall, this win-win situation resulted in an attractive risk-reward opportunity for ABF fund investors.

10. Incentives for the bank and the fund

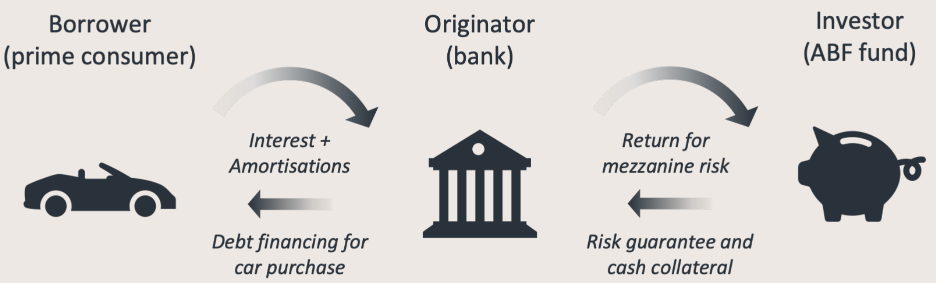


11. Expected loss coverage ratio

Loss coverage ratio = total income / total losses



12. Illustrative deal flow of the Significant Risk Transfer



1. "A" risk scored2 US prime consumers purchased cars using ~$10bn of combined credit from the nation-wide U.S. bank during Covid-19.

2. Bank's balance sheet is adversely affected by the new regulation. To release additional regulatory capital, bank sells part of the risk (~12% mezzanine) to an ABF fund who guarantees the risk.

3. Due to the low-risk profile of the portfolio, ABF fund is required to hand over only 4% cash collateral while having the return for the whole 12% risk. Bank continues to service the loan portfolio.

1) ROE = Return on equity. 2) Refers to particular threshold of personal credit scoring of US consumers called FICO. 3) RWA = Risk-weighted assets.

FROZEN M&A MARKET CREATES OPPORTUNITIES FOR LIQUIDITY PROVIDERS (1/3)

Higher cost of capital puts pressure on the valuations of existing portfolios

Following the geopolitical tensions and rapidly accelerating inflation in early 2022, interest rates rose from negative to clearly positive, as e.g., German 10y government bond peaked at 3.0%, the highest level since 2011. Coupled with uncertainty, the higher cost of capital drove S&P 500 to 25% decline in the first nine months of 2022. While the change was not as dramatic in the returns of illiquid assets, Graph 10 illustrates the decline in the valuations of new LBOs from 2021 to 2023, which corresponds to circa 20%.

Graph 14 illustrates the impact of interest rates on valuations by private equity (PE) investors seeking to maintain similar IRRs for new LBOs. While the base rate peaked, and valuations bottomed out in 2023 – as reflected in Graph 13 – we still see an approximate 9% decline in valuations from 2021 to 2024. Moreover, this does not consider the possibly higher IRR targets for new LBOs required to maintain the risk premium over the base rate nor the weaker current economic outlook compared to 2021.

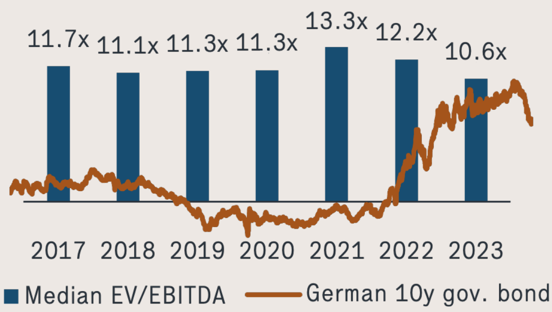
Exits close to ten-year lows and fundraising near to all-time high

If we assume, based on the November 2024 rates outlook, that new 2024 LBOs were made at 12.1× EV/EBITDA, sellers who bought in at 2021 valuations would make only 13.5% IRR compared to initial 17% base case (Graph 14). Further, GDP growth has been much slower than anticipated[1]. Factoring this, one can estimate only 8.0% IRRs for 2021 LBOs assuming EBITDA growth of 4% (vs. our 6.5% base case). As investors want to reach their target IRRs, sellers and buyers are hard to connect. As a result, PE exits are almost at ten-year lows — with only 2019 recording a slightly lower level (Graph 15). This trend could persist for some time, as deal values in the peak valuation year of 2021 were twice the ten-year average. Given a typical five-year PE holding period, most currently exited investments were initiated before 2021.

Simultaneously, PE capital raising grew by 146% between 2014–2021, after which the level has remained stable despite challenging market conditions (Graph 15). This puts pressure on distributions from previous vintages, as PE allocations are growing faster than anticipated by investors.

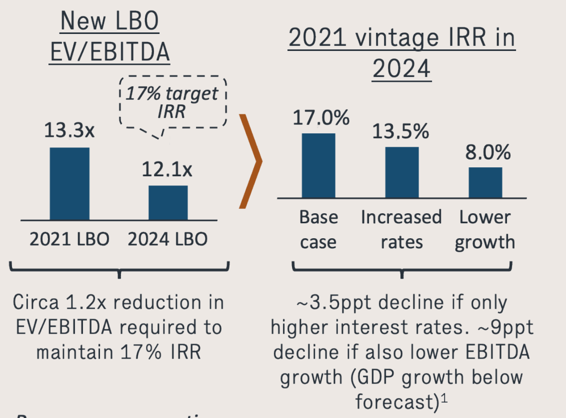
13. Buyout entry valuations and risk-free rate

VAnnual median EV/EBITDA of global LBOs. Daily yield of German 10y government bond, 1/2017–12/2023



Source: Pitchbook Global M&A Report, Bloomberg

14. Impact of interest rates on 2021 LBO IRR

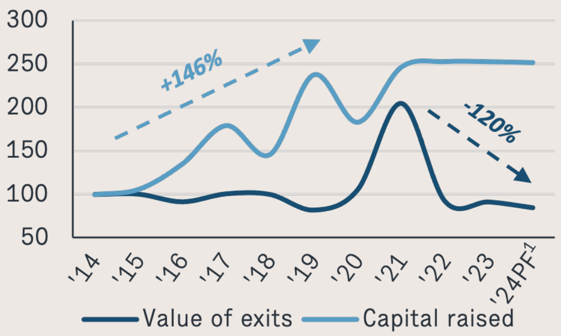


Base case assumptions:

- EBITDA growth : 6.5%
- Leverage: 5.5x EBITDA
- Interest (2021): 4.5% margin
- Interest (2024): 4.5% margin + Nov-24 Euribor curve
- Base case IRR: 17%
- Cash conversion: 70%
- Debt arrangement fee: 1.5%

15. Private Equity exit and fundraising value

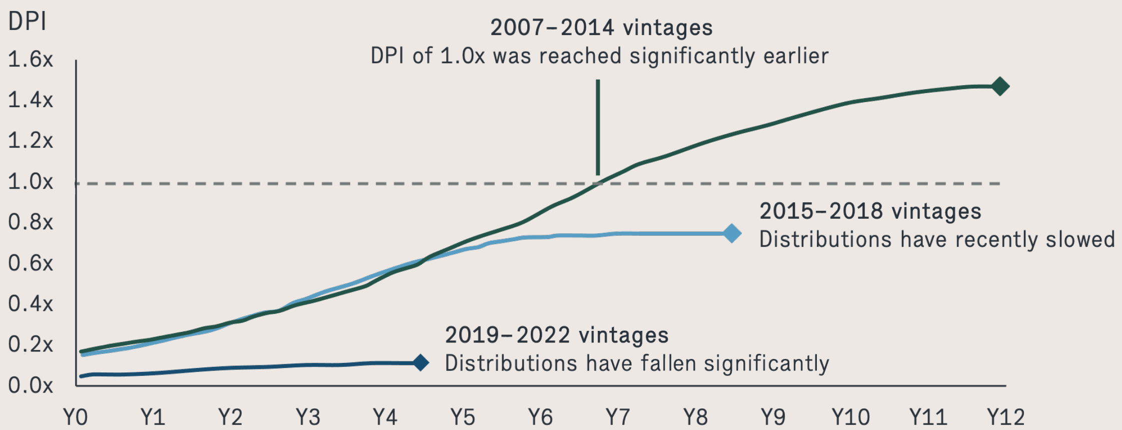
Indexed sum of values of US and European sponsor-backed exists and PE fundraising, 2014–2024PF[2], 2014 =100



Source: Pitchbook Global M&A Report

1) US GDP growth forecast 22'-23' was 3.4% p.a. vs. 2.2% p.a. realized. Source: Federal Reserve Bank of Atlanta. 2) 2024 pro forma is calculated as H2 2024 value times two.

16. Global average of distribution to paid-in capital ("DPI"): Private Equity



Source: Financial Times (Preqin)[3]

Slow M&A market puts pressure on the distributions of closed-ended funds

Reduced exits in the past few years have led to depressed distributions in recent vintages, which is evident in the slower PE DPI[1] generation shown in Graph 16. In addition, 2015–2018 vintages have seen a slowdown in distributions after tracing the longer-term trend over the first four years. This is not only a trend of private equity (PE), but also other illiquid asset classes are seeing similar type of dynamics. This has incentivised funds and their investors to seek other sources of capital to continue investing and secure liquidity.

Extended hold periods force PE funds to do follow-on investments above callable capital

As exits are not happening, PE funds are required to invest in the growth of their existing portfolio to achieve the IRR targets and NAV[1] marks. If the callable capital has already been invested, follow-on investments can be funded through a NAV facility, an example of which is provided on the next page.

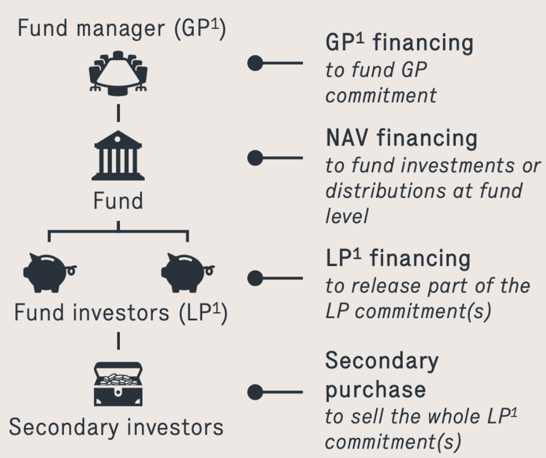
Fund financing can be structured at various levels and for multiple purposes

While fund financing and its many forms have not been invented in this cycle, the accelerated rise in demand for such solutions has been a trending subject for the past two years. Graph describes the landscape of fund financing throughout the fund value chain.

A General Partner (GP), can borrow money against, for example, the future management fees to fund larger GP commitments, which is typically favoured by investors, or to free up their capital to enchase their own returns.

Second, NAV[1] lending is done at fund level to either finance investments, or less frequently, to fund distributions. In NAV lending, the fund has a lending facility against the equity of one or several funds. Third, in need of liquidity, fund investors, called Limited Partners, can borrow against their commitments to free up capital. This serves as an alternative to the divestment of an LP stake to a secondary buyer, allowing the investor to retain the upside. On the other hand, secondary market can facilitate the liquidation of holdings and free up capital.

17. Levels of fund financing



1) DPI = Distribution to paid-in capital. LP = Limited Partner, i.e., fund investor. GP = General Partner, i.e., fund management company. NAV = Net Asset Value. 2) Source: Buyout executives say distributions are 'magic word' after exit slowdown, 4/2024.

Case example 2: Single fund NAV[1] lending

One of the most topical themes within fund financing is NAV lending. While the market was estimated to be only $100bn in size in 2020, the growth of approximately 20% p.a. would make it as large as a $700bn market in 2030.[2]

Graph 19 illustrates the single fund NAV lending structure where the facility has been guaranteed by the equity of the private equity fund. Against this equity, the fund management company has drawn the facility up to 15% of NAV, meaning the lender still has an 85% buffer against losses.

On the other side of the equation, the facility can be used to fund either new investments or distributions, which help to achieve the target valuations or boost IRR and DPI, respectively. In the credit documentation, counterparties have agreed on the maximum LTV[1], typically ~20–25%.

18. Key differences between direct lending and NAV lending strategies

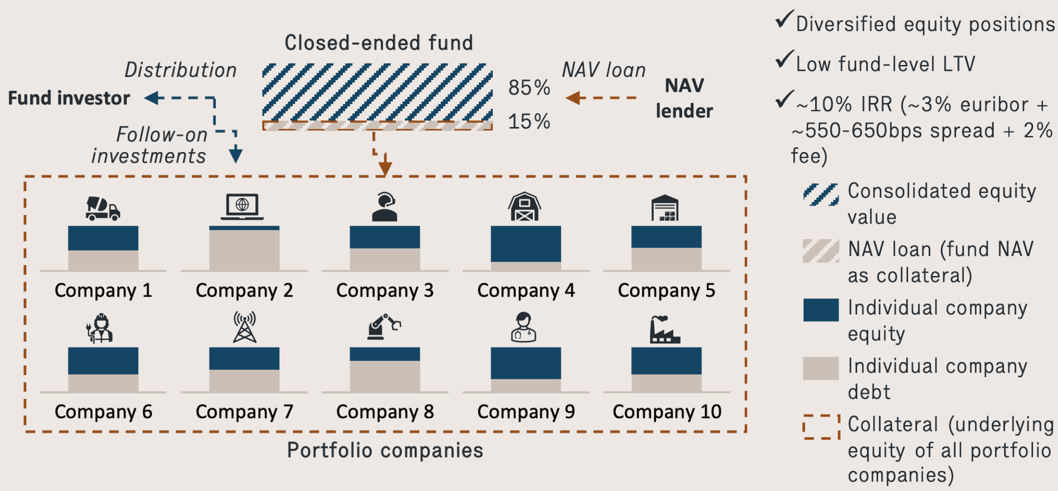
Key features	Direct lending strategy	Fund finance strategy
Diversification	Company level	Portfolio level
Entry point	Investment period	Value creation period
Covenants	Company level	Portfolio level (e.g., max LTV[1])
Sponsor alignment	One default is not a risk for the franchise	Portfolio default is a risk for the franchise

NAV lending offers clear diversification benefits despite underlying corporate risk

Graph 18 shows some significant differences between direct lending and NAV lending. First, fund financing diversifies risks across portfolios, not just individual corporates. Since underlying assets are also diversified across industries, the within-portfolio correlation is relatively low. Even though the underlying companies are usually highly leveraged, as part of the private equity financial engineering, the event in which the fund NAV declines by 85% and results in a loss for the NAV lender is unlikely. Against this risk, unlevered returns are attractive at ~10%, comprising typically of base rate, circa ~550–650 basis point spread, and two percent arrangement fee divided over roughly three-year hold period.

In addition, target funds are usually in their value creation period, so holdings can be underwritten at a mature stage – no significant execution risks compared to new investments. Furthermore, exits are much closer, providing earlier cash flows. Finally, fund lenders and sponsors are well-aligned, as a default in an otherwise performing portfolio does not pose a risk to the entire franchise, however a default of the whole portfolio certainly does.

19. Illustrative NAV lending structure



1) NAV = Net Asset Value, LTV = Loan to Value. 2) 17 Capital (Alternative Credit Investor). Source: NAV finance: Behind the headlines - Alternative Credit Investor.

SUMMARY

The private debt market has recently seen a rise in portfolio financing, such as asset-based finance and fund financing, which offer credit investors diversification benefits in the form of lower correlation and front-loaded cash flows. Banking disintermediation, accelerated by stricter regulations, has created demand for increasingly diverse private asset-based finance solutions that are both closer to people's lives – like consumer credit – and larger in size than the current private credit market. At the same time, the frozen M&A market and slow capital distributions from private equity funds have increased the demand for various fund financing solutions, such as NAV loans. As both markets have grown faster than the assets and capabilities raised by private debt funds, we see portfolio financing offering attractive risk-reward opportunities for investors. Mandatum's AM Private Debt program for professional investors allocates assets broadly across the private debt market, and we view portfolio financing as one of the most interesting themes in our program at the moment. However, we believe it is particularly important in the portfolio financing field to invest in broad mandates, capable of identifying attractive investment opportunities throughout market cycles.

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