Blackstone

BXCI Insights

Asset Based Finance: The Oldest "New" Industry in Finance

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Overview

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A fast-growing area of credit,[1] asset based finance, or "ABF" as it is more commonly known, is often considered a relatively new asset class. In fact, with its roots in the asset-backed securities ("ABS") market, this asset class is the latest iteration of a form of financing which not only has been around for decades, but which is integral to a healthy economy. The ABF market finances physical and financial assets across the real economy, reaching across segments that directly impact all our daily lives as consumers—from where we live, to how we spend our money and get our data.

The evolution of the ABF market has taken place alongside the long-term structural shift towards private and alternative assets. Private credit managers have taken an ever-growing role in partnering with banks to provide financing to the real asset sectors encompassed by ABF. At the same time, institutional and individual investors are looking to diversify their fixed income portfolios driving demand for private credit assets, including ABF.

We believe the secular shift to private capital is only in its early innings. Higher base rates, the shift from banks to private lenders and the proliferation of strategies to access private credit will drive further expansion, opening up a highly scalable and rapidly growing $25 trillion+ opportunity for private credit lenders.[2] Within ABF specifically, robust demand for capital underpins a potential $12 trillion+ addressable market opportunity across several high-conviction sectors.[3]

For this latest piece in our Credit Insights series, we sit down with Robert Horn, who heads up the global infrastructure and asset based credit strategy at Blackstone Credit and Insurance ("BXCI"), to help unpack the ABF market, the opportunity ahead, and how we approach the asset class at BXCI.

In this piece we explore:

1 **What is ABF and how the market has evolved.**

2 **The characteristics of ABF that may benefit a fixed income portfolio.**

3 **BXCI's approach to ABF and the benefits of being a scaled manager.**

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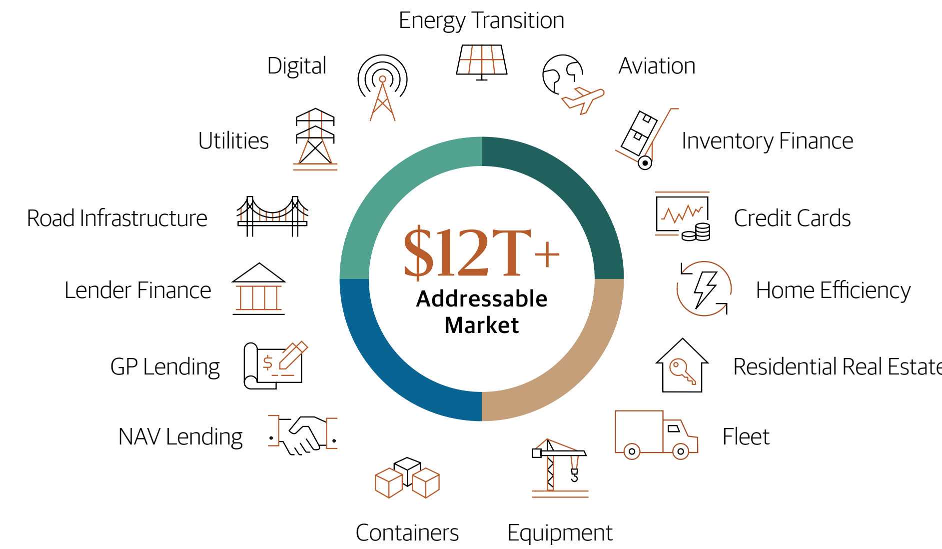
Proliferation of Private ABF Investible Asset Classes Drives Expansion[4]



Q: ABF means a lot of things to different people; can you break down what ABF is and how it has evolved over time?

ABF involves using a pool of cash-flow generating assets—hard assets, loans, or contractual cash flows—as collateral to raise debt to finance a broad spectrum of the real economy. These underlying asset-based income streams can take many forms, including digital infrastructure, energy transition and home improvement loans. In some cases, these assets are securitized into multiple tranches of debt and/or equity with various payment priorities and risk and return profiles.

Contrary to some beliefs, ABF isn't that new at all. In fact, we like to think of ABF as the oldest "new" industry in finance. Private ABF is rooted in the more familiar public ABS market, which evolved out of the mortgage-backed securities ("MBS") market in the 1980s.[5] Public ABS are structured by securities broker dealers, who distribute them broadly to investors who can then trade them in the secondary market with varying degrees of liquidity. Private ABF transactions, by contrast, are directly originated, negotiated, and structured by investment managers who have relationships with asset originators, corporations and sponsors. As a result, private ABF can be tailored to specific risk and return criteria of investors and to the solution a company is seeking. From a borrower perspective, ABF allows companies to use their assets as collateral to secure funding, free up space on their balance sheet, and diversify financing sources.[i] And when working with private credit lenders, borrowers can access additional attributes, including speed of close, flexibility in structure, certainty of terms and confidentiality.

Historically, banks were the main originators and lenders in the ABS space, but the previous model where banks warehoused asset-based risk on their balance sheets with a view to securitize in the public market is changing fast. Regulatory, liquidity and capital constraints have made it harder for banks to finance many of their previous lending activities, leading them to prioritize asset classes with the highest return on capital. Industry estimates suggest that the ~20% increase to capital ratio minimums at large banks eliminated ~$130 billion in excess capital across those institutions. Capital that would otherwise have supported ~$1.5 trillion of new loan growth will instead reduce risk-adjusted leverage.[6,7]

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i. Diversification does not ensure a profit nor protect against losses.

In this long-term, secular, and accelerating shift towards private credit, the banking sector is evolving towards a partnership model with alternative asset managers, such as Blackstone, extending capital solutions to clients. At the same time, investors are increasingly leaning into the opportunity given the additional yield available on these low-risk assets.[8]

Effectively, what's happening is an innovative re-allocation of where these assets are held, moving from bank balance sheets (with a view towards distribution), to the end accounts, who want to hold these assets against their long-duration obligations. We like to think of it as being in the storage business; we are effectively underwriting these loans with a view to owning them for our clients, over the long term.

We consider this a win-win for banks and lenders, allowing the former to continue originating assets and serving their customers, while providing our clients with high-quality loans. Private credit lenders have received more than 70% of the net increase in global financial asset funding from bank balance sheets since 2015,[9] and we believe there is a highly scalable and rapidly growing opportunity ahead as we continue to work together. Importantly, these combined trends ensure the flow of credit to the real economy.

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Q: Talk us through some of the characteristics of ABF that can benefit a fixed income portfolio

We don't think it's a coincidence that the ABF market has moved into focus at this moment. Higher base rates have resulted in historically high all-in yields on private assets.[10] Private ABF offers an attractive illiquidity spread premium relative to similarly rated corporate credit, as well as more liquid public ABS, which can trade at tight spreads when demand for credit is robust as it is now.[11]

Investors can receive the economic benefit offered by private ABF transactions which are directly originated, negotiated and structured, helping eliminate the friction costs and inefficiencies associated with the bank structuring and syndication process.

We have seen that investors are increasingly willing to give up some balance sheet liquidity for that premium. We believe any perceived liquidity risk is partially mitigated by the high free cash flow of ABF investments,[ii] which provides consistent amortization and an ongoing return of capital through the life of the investment, and in many cases, increasing overcollateralization through the life of the investment.[12] Self-amortization offers a different cash flow profile compared to the interest-only, bullet structure for corporate credit instruments.

We believe an allocation to private ABF can improve the risk-return profile of a portfolio relative to more conventional fixed income portfolios by providing diversification,[iii] lower correlation and reduced volatility to traditional corporate credit.[13]

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ii. Risk Management seeks to mitigate risk but does not reduce or eliminate risk and does not protect against losses.
iii. Diversification does not ensure a profit nor protect against losses.

Private ABF provides a different risk profile versus public corporate bonds with underlying performance tied largely to tangible assets rather than to corporate earnings.

The structure of ABF transactions, which are typically backed by collateral pools of hundreds or even thousands of assets, can mitigate individual credit risk. Further, the breadth of sectors that ABF covers provides diversification[iv] across industries and sub-sectors of the real economy.

On that point, many of these sectors are undergoing significant growth which opens up a vast pool of companies requiring private capital investment. We expect this growing need for private credit across the real economy to generate a consistent flow of transactions in which to invest capital.

ABF includes additional structural protections which help mitigate downside risk. These investments are typically senior in the capital structure, and highly cash flow generative. They are also backed by hard assets which provides an additional means to repay debt alongside cash flows.

A superior covenant package and triggers to trap or sweep cash flows to repay debt rather than distribute to equity, offer important structural and lender protections compared to public ABS, in our view.

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Key Features of Asset Based Finance vs. Public Credit
(For illustrative purposes only)

Key Features & Why They Matter	Private Asset Based Finance	Public ABS	Public IG Corporate Bonds	Syndicated Private Placements
Financial Covenants: Increased lender protections in case of deterioration in a borrower's financial health or collateral asset quality	✓	✓ Limited	✓ Limited	✓ Limited
Collateral Coverage: Ringfenced collateral for enhanced capital preservation	✓	✓ Limited		
Amortization: Return of principal and increasing overcollateralization	✓	✓		
Senior Secured: Priority in repayment	✓	✓ Limited, primarily for AAA tranches		Primarily corporate recourse
Privately Originated and Negotiated: Directly negotiated terms and structures with select originators/borrowers	✓			Bank agented and structured

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Q: How do we approach ABF at BXCI, and how do we leverage Blackstone's scale to source differentiated assets for investors?

At Blackstone, Asset Based Finance sits within Infrastructure & Asset Based Credit, a part of our $418 billion credit platform,[14] which also includes deep and longstanding franchises across private and liquid corporate credit, and real estate credit.[15] Our ABF strategy covers diverse opportunities across Physical Assets & Infrastructure, Consumer and Commercial Finance, Fund Finance, and Residential Loans.

In line with our broad approach at Blackstone, our ABF team seeks to identify key themes positioned to benefit from secular tailwinds within our sector focus areas and works to develop deep relationships, sourcing, and expertise within them.[v] Already the secular shift to private credit has led to a proliferation of investible asset classes across a wide range of asset types and real economy sectors. We estimate there is a $12 trillion+ addressable market opportunity across our high-conviction sectors,[16] from financing high-quality consumers and digital infrastructure, to data centers and energy transition, which will require large-scale capital to fuel the significant growth already underway.

Expanding into one such theme, we expect significant private credit growth in the digital infrastructure space as data centers experience historic growth driven by cloud adoption. Current expectations suggest roughly $2 trillion of capital expenditure needed globally to build and facilitate new data centers over the next five years.[17] The global macro cell tower market is expected to increase by $146 billion from 2024 to 2028, driven by 5G and fixed wireless deployment.[18] Power demand is expected to grow 40% over the next 10 years compared to minimal growth in the last decade, driving investment in new energy and energy transition infrastructure.[19] We believe this strong capital demand will create many private ABF opportunities in the years ahead.

Physical Assets & Infrastructure

Current Area of Focus:
- Digital Infrastructure
- Renewables and Energy Transition
- Transportation

Consumer Finance

Current Area of Focus:
- Home Improvement
- Credit Card
- Residential Solar
- Auto
- Secured HELOC Card

Commercial Finance

Current Area of Focus:
- Royalty Payments
- Equipment
- Fleet Lease
- Commercial and Industrial Solar

Fund Finance

Current Area of Focus:
- Lender Finance
- NAV Lending
- GP Lending

Residential Loans

Current Area of Focus:
- SFR Loans
- Bridge Loans
- Reperforming Loans
- Non-QM Loans





(See "Important Disclosure Information", including "Images").

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v. There can be no assurance that any Blackstone product or investment will achieve its objectives or avoid substantial losses.

Leveraging the Power of the Blackstone Platform[vi]
Turning to asset sourcing and the power of the platform: One of our ABF strategy's core benefits as part of a large and diverse credit platform, as well as the world's largest alternative asset manager,[20] is scale. We believe this brings numerous advantages, from the Blackstone network effect, to positioning us as a partner of choice and supporting our proprietary relationships, to strengthening our origination funnel.

Underpinning all of this is access to the significant real-time proprietary data generated by our global portfolio. We believe access to this data puts us at the forefront of macroeconomic trends, and the insights we glean are integral to our decision-making processes and guide our high-conviction investment strategy. Our ABF team utilizes this data, including early reads on macro trends, to inform our investment focus, drive decisions on underlying credits and better analyze risk during the underwriting process.

> "Already, the secular shift to private credit has led to a proliferation of investible asset classes over the past five years, covering an increasingly wide range of asset classes across real economy sectors. We estimate there is a $12 trillion+ addressable market opportunity across the firm's high-conviction sectors."

The scale and breadth of capital available to our ABF strategy allows us to serve as a 'one-stop shop' and partner of choice, providing borrowers with comprehensive financing solutions. Our ability to play in size allows us to better compete for assets; BXCI can commit to deals that exceed $1 billion on our own, which we believe distinguishes us from most competitors.[21] We utilize our deep industry knowledge and structuring expertise to transact with speed and certainty during dynamic market environments, and provide private, off-balance sheet solutions to banks and other borrowers, including premier sponsors and asset originators.

Repeat business powers our pipeline of proprietary investment opportunities not broadly available in the market. We draw on our cross-platform and cross-team capabilities,[vii] experience, and expertise, leaning on our sponsor coverage infrastructure professionals to target digital infrastructure investments, and our residential real estate professionals with their deep data sets and expertise when lending to homeowning consumers.

We leverage relationships across the Blackstone network to seek to identify new opportunities; our global presence, and deep-rooted partnerships with bankers, sponsors, originators and advisors help us create a high-quality funnel of investment opportunities. We ramped up our efforts in forming balance sheet partnerships to provide supplemental capital and liquidity to banks when the Fed began tightening money supply in 2022, and today have worked to source differentiated, long-term origination channels in consumer loans and credit card receivables, among others.

The size of our capital markets financing needs across debt and equity positions us as one of the largest clients for banks, providing access to the differentiated opportunities that banks are working on across products and asset classes.[22]

We believe that the secular shift to private capital and the significant growth of sectors across the real-asset sectors ties in well with Blackstone's platform strength, and we're excited by the opportunity to continue to lean into ABF to build high quality, differentiated credit portfolios for our investors.

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vi. There can be no assurance that any Blackstone product or investment will achieve its objectives or avoid substantial losses.
vii. Subject to Blackstone's policies and procedures regarding information walls and the management of conflicts of interest.

Endnotes

1. Market has grown from $3.1 trillion in 2006 to $5.2 trillion in 2022. Source: Integer Advisors forecasts and KKR research estimates, as of October 31, 2022, which is the latest data available.
2. Market size based on BXCI's internal analysis on a combination of strategies including ABF, Infrastructure Credit, Private Placements, Real Estate Lending, Structured Credit and Direct Lending.
3. ABF addressable market based on BXCI's internal analysis on a combination of strategies including ABF, Infrastructure Credit, Private Placements, Real Estate Lending, and Structured Credit.
4. See Endnote 3.
5. The Rise and Fall of the ABS Market, Mario Cerrato, University of Glasgow and Structured Credit Investors, as of November 5, 2010.
6. The Federal Reserve: Assets and Liabilities of Commercial Banks in the United States, as of July 19, 2024.
7. Goldman Sachs Equity Research, as of July 28, 2023. (Based on Fed Reserve Capital Requirement Rule Proposal).
8. Blackstone Views and Beliefs, as of June 2024.
9. The Global Banking Annual Review 2023, The Great Banking Transition, McKinsey Panorama, as of October 2023.
10. BXCI Strategic Insurers Portfolio Data, as of 2Q24.
11. Spread over corporates at origination is calculated by subtracting the treasury rate and corporate index spread from the underwritten ABF investment book yield. The reference corporate index is determined based on mapped rating and weighted average life of investment. The corporate indices used are the Bloomberg US Corporate Investment Grade, ex-financials benchmark and the Bloomberg US Corporate High Yield, ex financials benchmark. Prior reporting calculated this metric by subtracting the swap rate (rather than treasuries) and corporate index based solely on mapped rating from the ABF investment book yield (without regard to weighted average life). We believe the updated methodology presents a more accurate measurement of spreads.
12. Blackstone Views and Beliefs, as of August 2024.
13. Based on Bloomberg BBB Corporate Return Index and JPM BBB ABS Return Index, as of October 2023.
14. AUM is a combined figure inclusive of Blackstone Credit & Insurance "BXCI" and Real Estate Debt businesses.
15. Private Corporate Credit includes funds and products in Capital Solutions and Credit Alpha strategies, and assets managed for certain strategic insurance partnerships, in addition to the strategies listed.
    - Infra and Asset Based Credit reflects assets under management attributable to infrastructure (sustainable resources and energy transition, energy drawdown funds, private placements, and Harvest Fund Advisors LLC) as well as asset-based finance. BXCI has a closed energy drawdown fund that has an investment program and objective substantially different from the investment program and objective of the Sustainable Resources funds (e.g., ESOF II, BGREEN III). All figures are subject to change.
    - Largest BDC based on publicly reported fair value of both traded and non-traded BDCs, as of December 31, 2023.
    - Largest Loan Manager, as of December 31, 2023. Evidenced by (i) the largest recipient of primary US loan allocations per LCD, (ii) the largest trader of US and European secondary loans, per S&P Global, (iii) the largest active US Loan ETF, per Morningstar and (iv) the largest global CLO manager, per Creditflux.
    - Largest private credit energy transition fund ever raised. Preqin, Pitchbook, and publicly available information as of August 5, 2023. BGREEN III commitments included in this figure are as of August 8, 2023, to reflect final closing amount. Analysis based on universe of private credit funds closed since 2006 with fund sizes of $7 billion or greater.
    - Largest real estate mezzanine debt fund based on BREDS IV fund size, per PERE historical fundraising data, as of December 31, 2023.
16. See Endnote 3.
17. Stephen Allen Schwarzman — Chairman and Chief Executive Officer of Blackstone, 2Q24 Earnings Call, as of July 18, 2024.
18. Technavio via PR Newswire, 5G Equipment Market size is set to grow by USD 146.95 billion from 2024-2028, Adoption of 5G networks for smart cities boost the market, Technavio, as of July 2, 2024.
19. Blackstone analysis, as of July 18, 2024.
20. Based on Blackstone analysis of company earnings presentations and calls, as of June 30, 2024 (or latest publicly available data published by Blackstone Credit & Insurance's peers).
21. Preqin, as of September 18, 2024. Reflects Private Credit Managers in North America only and latest publicly available data.
22. Reflects Blackstone Credit and Insurance views and beliefs, as of December 31, 2023. Credit positions reflect issuers and sponsors across all asset types within Private Corporate Credit, Liquid Corporate Credit, and Infrastructure & Asset Based Credit, excluding FX derivatives and LP interests.

Key Risk Factors

In considering any investment performance information contained in the Materials, **prospective investors should bear in mind that past or estimated performance do not predict future returns** and there can be no assurance that a Fund will achieve comparable results, implement its investment strategy, achieve its objectives or avoid substantial losses or that any expected returns will be met.

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Rating	Mapped Rating	RBC Change
AAA	AAA	0.16%
AA+	AA	0.27%
AA	AA	0.42%
AA-	AA	0.52%
A+	A	0.66%
A	A	0.82%
CM1	A	0.90%
A-	A	1.02%
BBB+	BBB	1.26%
BBB	BBB	1.52%
CM2	BBB	1.75%
BBB-	BBB	2.17%
BB+	BB	3.15%
BB	BB	4.54%
BB-	BB	6.02%
B+	B	7.39%
B	B	9.54%
B-	B	12.43%

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ADGM

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