Value covered

LibreMax Capital cio Greg Lippmann and ABS head Kevin Tyler outline the asset-based private credit opportunity set

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Q: How has the evolution of the banking system and regulatory environment over time shaped private credit markets?
GL: Before the global financial crisis (GFC), there were certain aggressive financial products which enabled consumers to become overleveraged, as well as light bank capital charges for investment bank holdings of structured products, which ultimately brought Lehman Brothers to default and spurred the Great Recession. Following the GFC, the government instituted a multitude of changes, including changes to bank participation in lending. The capital charge for securitised products increased significantly, as did the capital charge for deep mezzanine lending.

The tightening of capital requirements through the Dodd-Frank Act, now exacerbated by the Federal Reserve's aggressive rate-hiking cycle, has put the US banking system under considerable strain. This has led to reduced lending and diminished earnings power for banks.

In response, banks are strategically offloading assets, cutting back on consumer lending and engaging in credit risk transfer trades to minimise their risk exposure. As traditional banks retreat, a significant gap in credit supply is emerging. Private credit firms like LibreMax are stepping in to fill this void, particularly in sectors like specialty finance and commercial real estate, which are most affected by the pullback in traditional bank capital.

Q: How does the public credit market compare to the private credit market? Does investing in the former inform investing in the latter?
GL: Because of the aforementioned regulatory dynamics and the reticence to raise more capital on the part of the finance companies, private credit investors can get spreads that are well in excess of the spreads of the publicly traded reference security. When coupled with our team's ability to underwrite both the collateral and the originator to structure a transaction, we are able to identify extremely attractive private opportunities relative to the public counterparts – which we know well, as we are deeply involved in our public credit funds. These opportunities are illiquid and therefore require vehicles that can hold these types of assets.

KT: Not only are we getting at least a few hundred basis points more in spread than the public market equivalent, but private credit investments are also usually accompanied by a better collateral and structure package – such as lower leverage, stronger covenants, tighter triggers and cleaner collateral selection.

From a structural perspective, particularly these days, the dynamics have shifted quite dramatically towards lenders in the sense that public markets have become less reliable for borrowers over the last 18 months, given the rate and spread volatility. As such, in a lot of cases, companies are looking for customised solutions to provide them with certainty of execution, which

gives private credit players extra bargaining power. The pipeline today versus prior years is much more robust, with the ability to cherry pick opportunities.

Q: Why does LibreMax find today an opportune time to invest in asset-based private credit?

KT: Today we are seeing a myriad of opportunities to put capital to work in the specialty finance sector, where companies are struggling to access funding following a difficult fundraising environment in 2022 and 2023 and a tightening of lending standards across the board. A lot of specialty finance businesses that were on solid footing in a lower interest rate world were shaken in late 2021 and early 2022, when we started to see increasing credit losses in the subprime consumer cohort, driven by FICO score inflation, the fading of stimulus money and lax lending standards from the 2020-2021 period coming to roost. As those losses rolled through the system in tandem with the Fed's aggressive hiking cycle, many specialty finance companies focused on subprime borrowers struggled to raise capital - be it through public market ABS programmes or private market activities - leading to where we are today.

Since the events involving Silicon Valley Bank earlier this year, another growing theme where we have been focused is constrained bank balance sheets.

GL: We are also seeing a lot of opportunity on the residential side, particularly in second liens and lending against that, because of how high rates have risen and the amount of equity that people have in their homes. Historically, many individuals and families would have moved into new homes or executed some sort of cash-out refinancing. But with rates so high, a better way for homeowners to get cash out while staying in their homes is to take out a second mortgage.

Q: How do you view the outlook for asset-based private credit in the context of the current macroeconomic environment?

GL: The macro debate in the US has centred around three possible scenarios: a hard landing; no landing, where the Fed will have to keep raising rates; or a soft landing. We believe the third scenario is least likely, but if there is a soft landing to the economy, the assets underpinning our investments will perform well.

In the hard landing scenario, where we have a recession directly, we believe that our assets are going to bend, not break. We underwrite our collateral to significant stress scenarios; we assume losses are nearly double what our base case is, and we are still whole. We therefore trust in our private credit team to underwrite the originator, the collateral and structure appropriately, so that even in a recessionary environment, we could be value covered.

Conversely, should there be no recession, but rates stay high because the economy remains strong and inflation remains higher than forecasted, we would expect the collateral backing a lot of our loans to maintain value, as such an environment is generally positive for real assets. If the economy is strong, defaults and unemployment should remain low. Plus, we benefit from higher rates, given the floating rate nature of most of our positions.

KT: To Greg's earlier "stress scenarios" point, we underwrite our investments assuming a recession is coming shortly, and we seek to appropriately consider potential economic weakness. Generally speaking, we expect a full repayment of principal under stress scenarios. From a relative value perspective, when you consider the macro environment and compare the potential yield one can earn in an asset-based type of investment to the dividend yield in the S&P 500, we think private credit and its downside protection are quite attractive.

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