PIMCO

Asset-Based Lending: Common Myths and Misconceptions Busted

Despite its growing popularity, asset-based lending (ABL) is frequently misunderstood. Below, we aim to dispel some of the most common myths and misconceptions that may be holding investors back from exploring this compelling investment opportunity.

MYTH 1: THE ASSET-BASED LENDING MARKET IS SMALL AND LIMITED

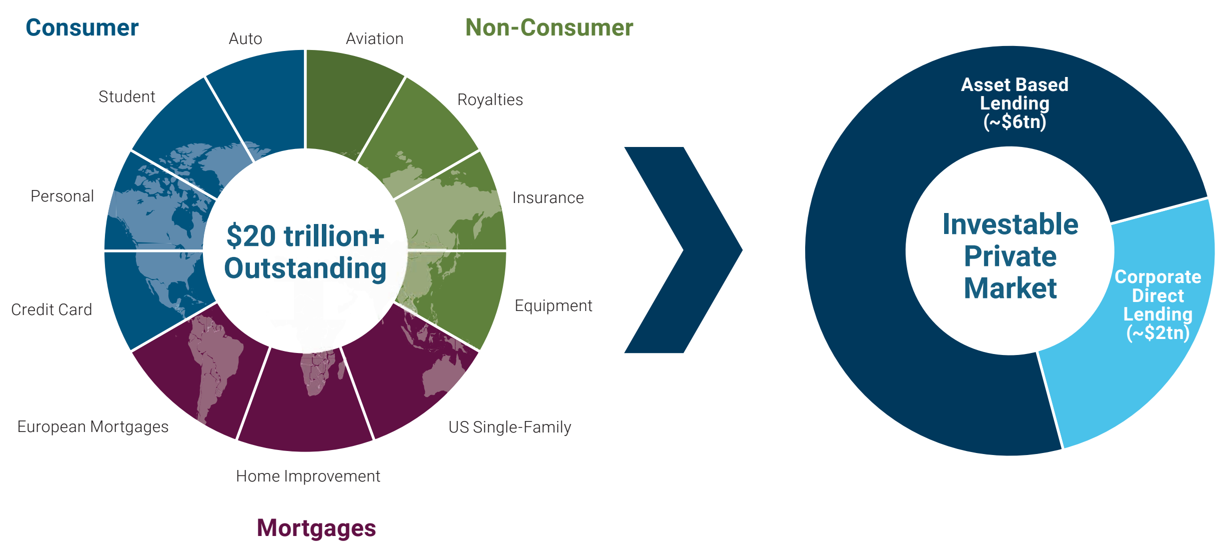
Reality: The ABL market encompasses a wide range of borrowers and collateral types. Since the global financial crisis (GFC), the market has grown significantly, reaching an estimated $20 trillion in the U.S., with a substantial portion being investable by private market players.

At PIMCO, we view ABL as a rapidly expanding opportunity set with attractive valuations compared with historical levels. We estimate the ABL market in the U.S. to be about $20 trillion, which is about 4x the size of the U.S. and European leveraged finance and private corporate direct lending markets. The figure includes total outstanding asset-backed credit and comprises both public securities (held by banks, originators, lenders) and private loan pools (held by investors like us).

Of the $20 trillion, approximately $12-$13 trillion are in residential mortgages, $3-$4 trillion in consumer credit (student loans, credit cards, auto loans), and $3-$4 trillion in other asset-backed categories (equipment leasing, aviation finance, etc). We estimate that about $6 trillion of the total ABL market is investable by private market players, similar to the proportion of corporate direct lending in relation to leveraged finance markets (direct lending, high yield, bank loans).

While banks remain active players, regulatory pressures have driven a steady migration of financing activity into a newer ecosystem dominated by specialty finance lenders with lower capital reserve requirements. We believe this is a persistent long-term change that will fuel opportunities for private lenders for decades to come.

Figure 1: The ABL Market is Vast and Diversified



As of 30 June 2024. SOURCE: PIMCO, FED Bank of New York. **For illustrative purposes only.**
Size of ABL private market is PIMCO's estimates. We estimate that approx. 25% of the $20T ABL opportunity set will be addressable by private capital.
The views and expectations expressed are those of PIMCO.

MYTH 2: ASSET-BASED LENDING IS COMPLICATED

Reality: At its core, asset-based lending is quite simple: it is a relatively high-quality fixed-income-like investment that finances the real economy and is typically backed by hard assets as collateral.

Most ABL assets have existed in public markets and on bank balance sheets for decades. However, regulatory restrictions stemming from the GFC have limited banks' ability to deploy capital and hold these loans on their balance sheets. As a result, these ABL assets are migrating away from the banking sector and into the hands of private lenders – similar to the trend that impacted corporate direct lending about 10 years ago.

ABL loans are essentially private fixed income assets, which aligns with PIMCO's fixed income expertise. ABL is a "high barrier to entry" sector where PIMCO has carved a niche, being one of the earlier entrants into private asset-based finance markets post-GFC. Today, we are one of the largest investors in this space with over US$170 billion deployed across private mortgage, consumer, and asset-backed sectors.

PIMCO's fixed income roots have enabled us to develop relationships with strong external partners to source and access origination at scale. We have built a far-reaching global network of sourcing channels, including 60+ origination partners (as of 31 December 2023), and have a long history of detailed loan-level underwriting, analytics, and downside risk management.

MYTH 3: ASSET-BASED LENDING IS RISKIER THAN CORPORATE DIRECT LENDING

Reality: In our view, ABL is not riskier than corporate direct lending. Many ABL investments are high-quality bank balance sheet assets that are now migrating into the hands of private lenders, not because banks no longer want to hold this credit, but because they simply cannot for regulatory and accounting reasons.

The hard asset-backed nature of ABL markets tends to lead to lower credit spreads vs. private corporate markets that fund highly levered corporate balance sheets. In fact, we believe ABL and corporate direct lending are better together, as ABL complements and diversifies direct lending in 3 key ways:

Borrowers

Consumers, homeowners, aircraft leases, etc. reflect diversified, high-quality borrower bases distinct from corporate entities.

Collateral Type

ABL often has hard collateral pledged to the credit agreement to provide lenders with additional structural protections. Collateral types can range from single-family homes to aircraft to financial guarantees.

Cash Flow Profile

Unlike corporate direct lending, cash flows tend to be front-loaded and include both principal and interest. Amortizing investments self-liquidate and de-risk over time, as principal payments reduce the debt outstanding.

MYTH 4: SLOWER ECONOMIC GROWTH SPELLS TROUBLE FOR ABL

Reality: ABL is inherently credit-oriented and naturally will not be immune to an economic slowdown. However, we have positive views across many ABL sectors, including consumer lending, aviation finance and digital infrastructure, and have the flexibility to pivot to those with the strongest fundamentals.

For example, we believe the U.S. consumer remains incredibly resilient, particularly prime borrowers with high credit scores. U.S. consumers have been shielded from the effects of rising rates: job gains from a healthy labour market, wage increases, mostly fixed rate debt (almost 90% of U.S. mortgages are 30-year fixed rate), and falling inflation have all been tailwinds.

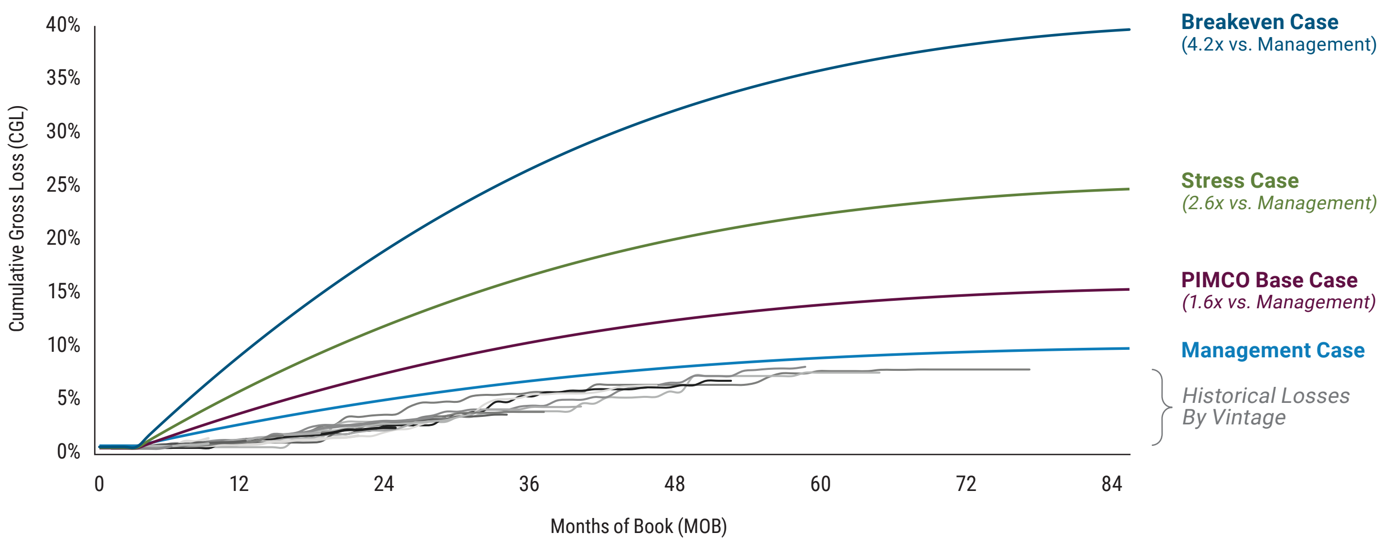
Simultaneously, we've observed a parallel shift in terms of tightened origination standards across our partners, leading to an overall uptick in credit quality, even as we conservatively increase our loss assumptions across soft- and hard-landing scenarios. This means loans backed by prime borrowers have improving fundamentals, better credit quality, and stricter underwriting standards.

Nevertheless, in light of slower economic growth ahead, we will continue to focus on up-in-quality borrowers (top quartiles, prime credit scores) and maintain extremely conservative underwriting assumptions to build in structural protections.

We rely on highly granular underwriting techniques driven by data analytics. Loan portfolios are accompanied by large data sets, which we use in stress tests across various assumptions and economic scenarios. Unlike underwriting a bilateral corporate loan, a conservative loss assumption is already built into base case returns for ABL loans.

Figure 2: ABL Investments Are Generally Underwritten on Lost-Adjusted Yields

Modeled Losses of a Hypothetical Consumer Loan Portfolio



PIMCO's loss assumptions scenarios

Base Case	Stress Case	Breakeven Case
Estimated using various inputs, including **historical performance and loss curves** from our proprietary database	Calibrated based on a **worst historical vintage performance**, peak losses observed during economic stress environments, and other inputs	Indicate the cumulative loss rates that lead to the first dollar principal loss on an investment

As of 30 June 2024. Source: PIMCO. **For illustrative purposes only.** The views and expectations expressed are those of PIMCO. Actual results may vary significantly from modeled results. There is no assurance that the opportunities identified above will materialize or that the proposed portfolio will achieve its investment objectives and provide any level of returns. **An investment in any PIMCO managed fund or portfolio entails a high degree of risk and investors could lose all or a portion of their investment.**

Important information

All data as of 30 June 2024 unless otherwise stated.

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