Asset-Backed Finance: A View Under the Hood

A conversation with Oaktree's Christopher Gray

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Asset-backed finance (ABF) is a form of private lending secured by pools of contractual assets, such as credit card payments, leases or mortgages, and ABF continues to grow in importance within the private credit universe. We spoke with Christopher Gray, Managing Director in Oaktree's ABF strategy, about how he and his team underwrite opportunities across various ABF sectors—like consumer loans—and how they think about the key differences between private ABF and public asset-backed securities (ABS), along with other nuances of the strategy.

Highlights:

1. Evaluating opportunities within consumer lending requires nuanced analysis of data and trends by experienced ABF managers.
2. One advantage of ABF is the ability to negotiate structural protections that help mitigate risk for lenders and investors.
3. Private ABF offers a spread premium over public ABS, adding to the appeal of the asset class.

Q: Consumer lending is a highly visible segment of the asset-backed finance market, yet the state of the consumer is under constant debate. Amid all the data, opinions and outlooks, how do you rationally evaluate consumer lending investments?

In order for us to lend against an asset, we need to understand how that asset is expected to perform and how it can perform in a downside. So macro data is the first useful high-level input—unemployment rate, personal savings rate, consumer spending rates—but that doesn't drive all consumer lending, and it's important to recognize that consumer lending is a very broad sector. There are different types of products from cell phones to auto loans to mortgages to credit cards, and there are different credits.

There's lending to high-quality super-prime borrowers, and then there's lending all the way through to deep sub-prime borrowers, and so I can't apply the same headlines to analyze all of these investments. A more nuanced analysis is really required to understand how these different products, and how these credits might perform in a variety of environments. You can't be overly reliant on the data. This is something we really stress at Oaktree.

Behind every consumer loan is an originator. The originator is the company that originates or creates the loan, so we look at those guys too. We have to overlay qualitative factors. How does this originator underwrite loans? How are they motivated or incentivized? Are they being aggressive—they're trying to grow, they're trying to take market share—or are they being conservative and they're more focused on making high-quality loans?

Q: When evaluating these opportunities, what factors give you confidence in stepping in as the lender?

When we underwrite consumer lending investments, we focus on two key elements: the product and the structure. On the product side, we target high-touch, essential-use items—such as cell phones, HVAC systems, and vehicles—that we believe borrowers will prioritize in what we refer to as the consumer priority of payments waterfall. In times of financial stress, we want to be invested in assets that consumers are most likely to defend.

We also prefer investments backed by some form of security, which can enhance recovery rates in the event of default. On the structural side, a common misconception is that we simply assess how assets are currently performing. In reality, we underwrite to a range of downside scenarios and design structures with built-in cushions to help protect against potential underperformance.

Q: Do you agree, then, that in private asset-backed finance, unlike the more syndicated markets, investors often have greater discretion in negotiating structural protections?

Yes, that's exactly right. In the public asset-backed securities (ABS) market, transactions are typically pre-structured by banks, reviewed by rating agencies, and shaped by legal counsel. By the time the deal reaches investors, the structure is largely set, and the focus is primarily on pricing.

In contrast, in the private ABF space, the process is more bespoke. We're often negotiating directly with the originator and legal counsel. Occasionally, a bank may be involved—particularly if they are providing senior financing—but the negotiation is typically bilateral between us and the originator.

This gives us the ability to shape the deal structure and build in downside protections that are often not available in traditional ABS deals.

Q: Let's talk about market dynamics. Is this another case of banks pulling back, creating space for alternative lenders?

That's certainly part of the story. There's tremendous scale in consumer lending across the spectrum: from large banks to regionals, credit unions and non-bank lenders. We've seen significant growth in non-banks and specialty finance companies offering products that go beyond what banks have traditionally provided.

Often, we find the most attractive relative value in segments that were previously well-trafficked but have seen lender retrenchment. Regional banks stepping back is a good example. Additionally, some lenders are still dealing with underperformance from the post-Covid period, particularly in 2021 and 2022. Others, especially asset-light non-bank lenders, may be struggling to place loans with buyers. In those situations, we're often able to negotiate better economics.

Q: Of course, consumer lending is only one part of the ABF universe. Are there other sectors worth highlighting?

Absolutely. One of the advantages we have at Oaktree is the ability to draw on expertise across the full range of ABF verticals. We're not limited to just one or two areas. Another major sector for us is equipment and transportation—this includes aircraft leasing and small- to mid-ticket business-critical equipment.

There's also infrastructure and energy, including digital infrastructure like data centers, fiber and AI-related assets. The U.S. is undergoing a massive capital expenditure cycle, and we're seeing opportunities to lend against cash-flowing assets in securitized structures that we find very attractive. Beyond that, there's real estate, and what we broadly refer to as "corporate," which can include pools of loans, receivables, or even royalties. The ABF universe is vast.

Q: You mentioned favoring essential-use assets in consumer lending. Is there a similar principle that guides your approach in the equipment space?

Yes, definitely. In equipment finance, we benefit from two key dynamics. First, the assets we lend against—whether small, mid-ticket or large-ticket (like aircraft) are typically business-critical. These are assets a company can't operate without. In some cases, the equipment is physically integrated into operations to the point where the business couldn't function without it.

Second, we've seen a notable pullback from regional and even large banks that once had dedicated equipment finance teams. That creates a gap in the market—one that allows us to lend against high-quality, business-essential assets in a space that's less competitive today.

Q: Asset-backed finance seems to offer a spread premium over public ABS markets. What's driving that premium today? Is it simply a liquidity premium, or is there more to it?

There are a few factors at play. ABS transactions are typically fully funded, based on a fixed pool of assets, and structured with ratings in mind. The deals are standardized, rated and tradable, all features that contribute to market efficiency but also create rigidity.

In contrast, ABF allows us to deliver bespoke solutions to originators. We can offer variable funding, forgo formal credit ratings, and build dynamic asset bases that adjust with the originator's needs. These flexibilities allow us to structure transactions that meet the needs of both parties while maintaining strong credit protections.

However, there are relatively few lenders in the private market with the scale, expertise, and structuring capabilities to offer these solutions. That scarcity of capital results in a spread premium—compensating us not only for reduced liquidity, but for the value of customization and the complexity we're underwriting.

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