THE GROWTH OF SPECIALTY FINANCE
THE NEXT FRONTIER OF PRIVATE CREDIT

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The Growth of Specialty Finance, the Next Frontier of Private Credit

For many in the world of alternative assets, the rise of private credit is nothing new. But while strategies such as direct lending and distressed debt continue to grow and attract financial news headlines, smaller, more complex strategies have also emerged as attractive investment opportunities. These niche strategies, collectively referred to as "specialty finance" or "asset-backed finance," generally focus on smaller loans to nonbank financial businesses with pools of esoteric assets as collateral. The intricacies of these investments mean that the loans would be difficult to securitize or trade in broader public markets. The success or failure of specialty finance strategies are typically unrelated to larger markets, which makes them particularly attractive opportunities for investors.

The assets themselves can be anything from music royalty profits, insurance money after a natural disaster, or even a future payout from a successful lawsuit. In this piece, we will consider a few key areas of specialty finance; Asset and Equipment Leasing, Insurance-Linked Securities, Life-Science/Music Royalties, and Litigation Finance, and look at the effects of their growth on human capital.

Asset and Equipment Leasing

One of the most common forms of asset-backed finance is asset/equipment leasing, where a firm owns and leases a pool of specialized physical assets, which can range from construction machinery to aircraft engines to restaurant equipment, etc. The strategy also often includes lending to small businesses who are looking to purchase these assets. While regional banks have traditionally been responsible for financing these goods, their larger retreat from lending over the last two years has provided space for new players.

Insurance Linked Securities

Insurance-linked securities are also a burgeoning area of specialty finance, but not without their own unique pros and cons. Insurance firms looking to reduce their exposure will often sell securities promising future income to investors. After the wildfires in Los Angeles earlier this year, many financial firms sought to realize their investments in catastrophe bonds and other insurance devices such as subrogation claims. But those efforts are receiving pushback from local California governments that seek to combat what they see as profiteering behavior after a tragedy.[1] Such specialty investments require evaluating the risks around not just the asset itself, but larger factors such as potential political opposition and reputational damage.

Life-Science and Musical Royalties

A particularly interesting area of specialty finance is royalty investing, where asset managers and other funds will purchase intellectual property rights to receive future income from pharmaceuticals and medical devices or songwriting credits, records, and performances. For small biotech companies, life-science royalty sales can provide much needed capital in a difficult and competitive fundraising market, allowing a firm to grow without taking on costly debt or greatly diluting their equity. Such investments require professionals with legal and subject matter expertise and the ability to stay ahead of regulatory and discrete market forces.

In the music royalty space, alternative asset managers such as Carlyle, Partners Group, and Blackstone have all done recent deals, purchasing song catalogs from artists such as Shakira, the Red Hot Chili Peppers, and Katy Perry. With the growth of streaming and internet platforms, older songs that go viral or are used in media can become sudden sources of great profit. For big asset management firms whose overall portfolios are often linked to larger market trends, royalties offer isolated and uncorrelated returns.

[1] Bloomberg, "Hedge Funds Are Hunting Deals in Risks Too Big for Insurers

Litigation Finance

Within specialty finance, litigation finance is another prime area of growth. This strategy is where financial firms fund legal fees for lawsuits, mass torts, or business disputes in exchange for a potential slice of future winnings. The legal intricacies of this strategy quite naturally demand investment professionals who are lawyers with deep expertise in finance and risk. Investment firms, and hedge funds in particular, are increasingly interested in this strategy since the outcome of a plaintiff's case would be uncorrelated with the stock market; if the S&P were to crash tomorrow, their litigation assets would be unscathed. This past March, a trading platform called JurisTrade launched with as much as $70MM in potential litigation finance trading opportunities, as the firm seeks to institutionalize access to liquidity for investors in this niche strategy.[2] As the litigation finance industry matures, it will naturally broaden, and investors will participate in a larger variety of suits and suits with smaller monetary stakes.

The Turn to Specialty Finance

As asset managers look to diversify their credit strategies and institutions continue to pour money into private credit funds, we expect to see continued growth in specialty finance as the next logical frontier of private credit. Just this past week, the fixed income behemoth PIMCO decided to extend the fundraising period for its Specialty Finance Income Fund due to outsized investor interest.[3] Neuberger Berman closed their most recent specialty finance fund in February, raising $1.6B and exceeding their initial target of $1B.[4] Firms seeking institutional capital in a crowded market are finding a fundraising edge by offering specialty finance strategies. Naturally, investment firms continue to hire and promote senior talent in the area: In January, Ares promoted partner Kevin Alexander to Co-Head of Alternative Credit, their $43B specialty lending arm.[5]

[2] JurisTrade, "The JurisTrade Litigation Asset Marketplace Recently Launched its Phase 1 Rollout with Over $70 Million in Litigation Funding Opportunities.

[3] Private Debt Investor, "Pimco extends specialty finance fundraising; seeking $5bn

[4] Neuberger Berman, "NEUBERGER BERMAN ACHIEVES SIGNIFICANT ASSET BASED FINANCE MILESTONE WITH OVER $1.6 BILLION FUNDRAISE FOR SPECIALTY FINANCE FUND III

[5] Business Wire, "Ares Management Appoints Kevin Alexander as Co-Head of Alternative Credit"

The Effects of Human Capital

The complexity and at times arcane nature of specialty finance requires talent to match. As bigger firms build their asset-backed platforms, they will look to hire professionals from a small collection of niche legal and investment firms. We expect more competition between funds as they fight to attract the few portfolio managers and investment professionals who have the necessary expertise and ability, particularly as the larger private credit market becomes more saturated. Talent with expertise and product knowledge will also be needed in the capital raising and investor relations space, as well as operational functions to support these portfolios such as accounting, finance, and legal.