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Record Alternative Yield Solutions - Receivables Finance

Market Commentary – April 2024

Introduction

Due to increased regulatory pressure, banks continue to pull back from several markets. The financing gaps being left behind provide opportunities for private credit managers to offer alternative solutions for borrowers, including Receivables Finance and Digital Lending solutions. According to Preqin, total private credit assets have nearly doubled since 2020 to $1.6 trillion and are expected to grow further to $2.3 trillion by 2027. With the asset class set to expand greatly in the coming years, the question for many investors has shifted from *whether* to increase private credit exposure, and rather *how* to.

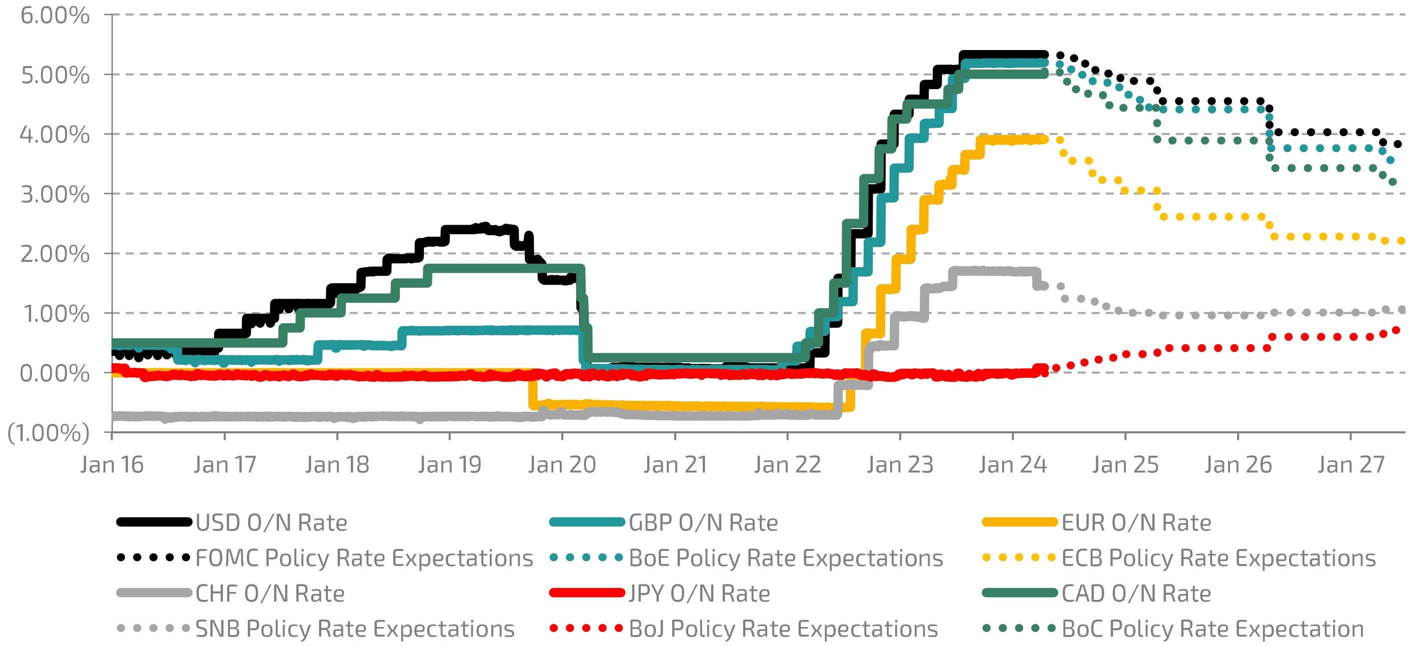
Whilst more traditional and well-trafficked private lending opportunities, such as middle market direct lending, satisfy a portion of this demand, investors in these products can be subject to limited liquidity (e.g. lock-up periods) and higher levels of portfolio concentration. Comparatively, asset-backed specialty finance solutions can offer highly diversified and granular portfolios in liquid, evergreen structures.

With global interest rates set to fall throughout 2024, this update examines the implications of current interest rate expectations on Receivables Financing ("*RF*"), a portfolio building-block within the asset-backed specialty finance universe.

Rate Cuts Commence with Swiss National Bank as First Mover

Overall, G10 central banks have largely reduced their tightening bias with cuts widely anticipated this year (see Figure 2). Indeed, the Central Bank of Switzerland (SNB) is leading the cycle following a 25bps rate cut in March, surprising market expectations where only 8bps of cuts were priced going into the meeting.

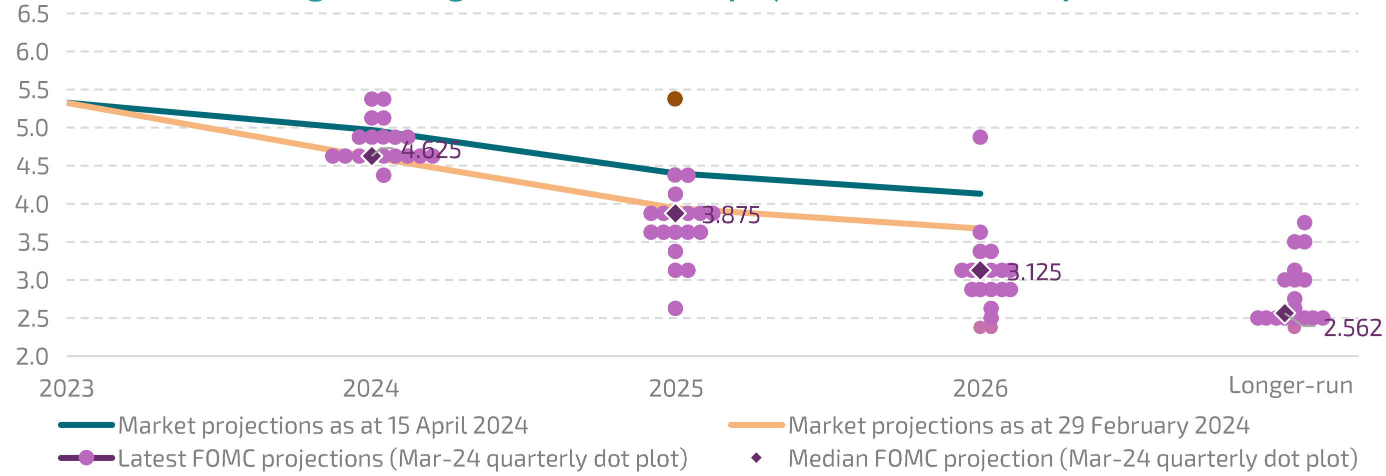
Figure 2: Short Term Interest Rates and OIS Based Expectations



Source: Record. Bloomberg. Data as at April 15, 2024.

Whilst the Federal Reserve kept rates unchanged in March, they maintained their dot plot forecasts for three 25bps cuts this year. The market had been anticipating a potential scaling back to two rate cuts expected, however, the Fed kept their bias in place. However, the speed and depth of the rate cutting cycle remains data dependent, with market expectations beginning to diverge from the FOMC dot plot following elevated US inflation figures. Despite this, rate cuts remain likely towards the end of the year as the majority of central banks look to avoid second-round inflation shocks.

Figure 3: Target federal fund rate projections vs. FOMC dot plot



Source: Record. Bloomberg. Data as at April 15, 2024.

The Implications for Receivables Financing

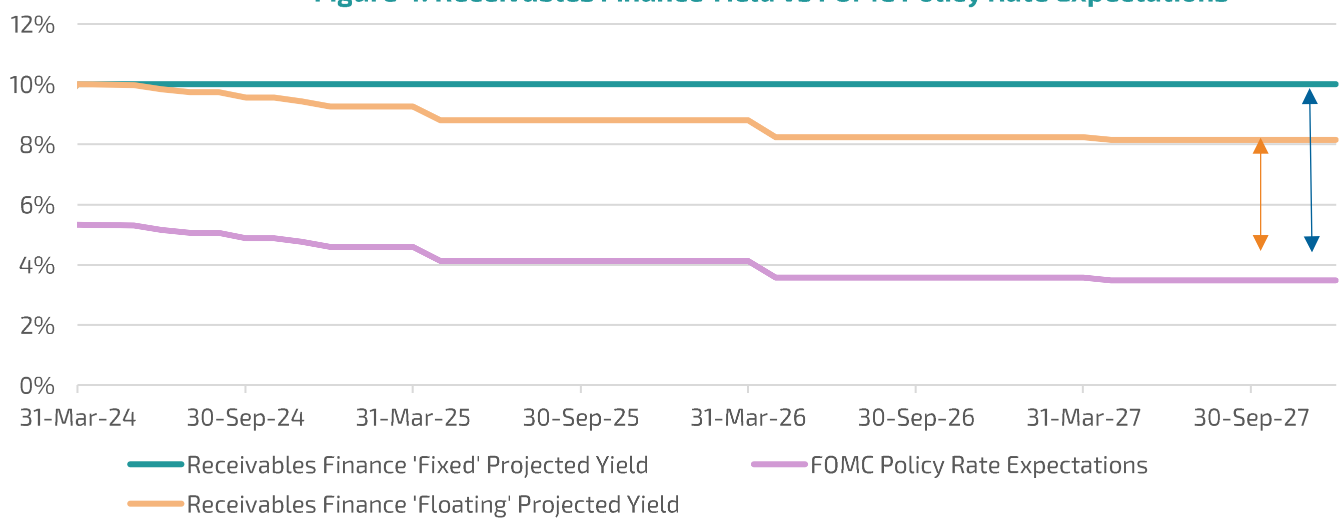
Receivables Finance strategies invest in accounts receivables that are claims against companies that purchase a good or service from a supplier. In effect, the investor is taking ownership of an invoice. Subsequently, the investors' return is made up of the invoice principal amount plus any interest earned from paying the supplier early.

There is a diverse universe of *RF* strategies in the market today, varying significantly by credit quality, insurance policies, portfolio diversification, transaction size and leverage employed. Subsequently, returns also vary somewhat, but tend to be in the region of 8-13% p.a.. This target yield tends to either be a fixed, pre-negotiated rate with an origination platform or be based on a spread over floating rate. We look at the implications for both in the following analysis, in both Figure 4 and 5.

In scenario 1, we present a *RF* strategy that earns a fixed, pre-negotiated rate of 10% p.a.. Assuming the expected rate cuts in 2024 and beyond materialise, the spread of *RF* returns over the risk-free rate (SOFR) would gradually widen from 467 basis points (bps) currently to 652bps in 2027. In relative terms, the *RF* strategy return as a multiple of SOFR would increase from 1.88x to 2.87x.

In scenario 2, we present a *RF* strategy that earns a fixed spread above the risk-free rate. For comparative purposes, we have set the fixed spread as 467bps, so the total current return is also 10% p.a.. If US interest rates fall in line with current expectations, and hence the *RF* yield falls, the *RF* return as a multiple of SOFR would increase by a lesser extent, but increase nonetheless to 2.34x.

Figure 4: Receivables Finance Yield vs FOMC Policy Rate Expectations



Source: Record.

Figure 5: Receivables Finance Yield as a multiple of US O/N Rate			
		Projections	
Scenario	**Current**	**Scenario 1**	**Scenario 2**
When?	April 2024	April 2027	April 2027
Spread	467bps	652bps	467bps
Multiple	**1.88x**	**2.87x**	**2.34x**

The above analysis of the Receivables Financing asset class demonstrates that it is positioned to perform well in a falling rate environment whether the yield is fixed or floating.

Summary

Overall, G10 central banks continue to remain in a highly data dependent approach and will exercise caution before implementing rate cuts. However, with further rate hikes becoming seemingly less likely, Receivable Finance strategies are well positioned to continue performing strongly on both a relative and absolute basis.

With this backdrop in mind, combined with other benefits including liquidity and low correlations to traditional asset classes, 2024 may turn out to be the year asset-backed lending strategies, such as Receivables Finance, become a more meaningful proportion of investors strategic asset allocation.

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