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The case for consumer credit in lower middle market asset-backed finance

Executive summary

Consumer credit can be a compelling complement to traditional private credit and other asset-backed finance strategies. Consumer loan pools can combine granular exposure across many borrowers, contractual and observable cash flows, scheduled amortization and structural protections that help manage risk at the lender level. The investment case rests on pairing those attributes with disciplined underwriting, strong servicing and an appropriately structured financing.

In lower middle-market asset-backed finance, the key is to assess the performance of the collateral pool and how the financing structure allocates and absorbs that performance.



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Consumer credit offers a granular risk framework

In traditional corporate direct lending, the lender generally underwrites a single operating company. Repayment depends on the company's earnings, leverage, liquidity, refinancing prospects and, ultimately, enterprise value. A problem at that company can therefore have a direct and material effect on the loan.

Asset-backed finance approaches the risks differently. The lender evaluates a platform and a pool of financial assets, often consisting of thousands or millions of loans or receivables. Performance is assessed through origination quality, borrower characteristics, delinquencies, prepayments, recoveries, servicing and collections. This creates a more granular and statistically driven risk framework than a single-borrower credit assessment.

Consumer pools can also be more diversified than many other collateral types. A facility backed by thousands of small-balance loans is not dependent on the financial health of one borrower, one property, one equipment asset or one corporate enterprise. Individual defaults are expected but are manageable when they are reflected in underwriting assumptions, excess spread and advance rates. The portfolio can be stress-tested for recession-like loss rates as the advance rate, borrowing base exclusion and concentration limits are developed. The principal risks are more likely to arise from a combination of factors, such as poor origination, correlated deterioration, weak servicing, or inadequate controls.

Observable cash flows support active monitoring

Consumer loans offer contractual cash flows and observable payment histories, creating a foundation for ongoing performance analysis. Their scheduled amortization can return principal over time rather than relying solely on a bullet maturity or future asset sale. By comparison, the recovery value of equipment, vehicles, inventory and other physical assets may depend on valuation, condition, location, specialized buyers or secondary-market demand, and liquidation can take time and incur cost.

Loan-level reporting can provide nearly real-time visibility into delinquency, prepayment, vintage and recovery trends. This information can help a manager adjust advance rates, eligibility criteria, concentration limits or funding levels as performance changes.

The relevant protections are structural as well as analytical. Conservative advance rates, excess spread, bankruptcy-remote vehicles, controlled collection accounts, covenants and performance triggers can create multiple points of protection before lender principal is affected. These tools do not eliminate consumer credit risk, but they can make the timing, detection and management of deterioration more systematic than in collateral whose recovery depends primarily on a future liquidation event. Most importantly, a consumer loan pool can experience losses without producing a loss to the ABF lender when those losses are absorbed by excess spread, subordinated capital, amortization and the initial collateral cushion.

LMM structures can strengthen lender control

The lower middle-market setting can offer a structural advantage: a specialist lender may serve as lead agent or sole lender rather than participate in a broadly syndicated, standardized facility. That position can create flexibility to tailor eligibility criteria, advance rates, reserves, reporting requirements, cash controls and performance triggers to the specific collateral and originator. It can also give the lender more direct influence to amend terms, reduce availability or stop funding when performance deteriorates. Smaller, bespoke transactions may therefore allow controls that are harder to achieve in large-market ABF, where documentation and processes are often more standardized.

This is the core distinction: collateral performance and lender performance are not the same thing. If collateral cash flows remain sufficient and the financing begins with a meaningful cushion, ordinary defaults can be absorbed by excess spread, subordinated capital and amortization. The structure determines how much of the collateral's volatility reaches the lender.

Consumer credit adds a distinct source of diversification

Many institutional private credit portfolios are built around sponsor-backed direct lending. In that model, the direct exposure is to corporate borrowers and their cash flows, not to pools of consumer receivables. The portfolio may have indirect exposure to consumer conditions through sectors such as retail, housing, auto or healthcare, but consumer loan performance is not necessarily a primary, directly measured return driver.

That distinction can create a meaningful diversification opportunity. Adding a carefully structured consumer receivables allocation introduces exposure to different obligors, originators, cash-flow patterns and underwriting variables. It can diversify away from the single-borrower, EBITDA-driven risk that is common across many private credit portfolios. The return drivers of granular asset-backed portfolios are tied to collateral performance rather than primarily to corporate level leverage, enterprise value and corporate refinancing.

Consumer collateral can respond differently to economic stress, particularly when exposure is diversified across products, geographies, credit bands, origination channels and vintages. Shorter duration and self-amortization can also reduce reliance on long-term forecasts and refinancing markets, adding differentiated cash-flow drivers to a portfolio. Originators and servicers of short duration collateral can react timely to macroeconomic factors. Remedial actions are quickly reflected in portfolio performance metrics.

Selecting for resilience and cash-flow quality

The quality of consumer exposure depends heavily on what an investor chooses to own. A thoughtful approach may favor shorter-duration and smaller-dollar loans, which can improve diversification, accelerate the return of principal and reduce reliance on long-term economic forecasts or refinancing markets. It may also favor loans tied to essential or essential-adjacent needs, rather than purely discretionary consumption, because payment behavior can be more resilient when the underlying expense is difficult to defer. These preferences do not remove credit risk, but they can help create a more understandable and manageable cash-flow profile.

Borrower and pool characteristics should be evaluated together. Homeownership, for example, can be a useful indicator of financial stability and may provide insight into a borrower's willingness and ability to repay, but it should not be viewed in isolation. Income and employment, debt burden, payment history, credit profile, geography, loan purpose and origination channel all matter. The objective is to select exposures with observable, diversified cash flows and resilience under stress, while structuring the financing to provide sufficient protection when individual borrowers do not perform as expected.

A compelling complement to private credit portfolios

Consumer credit can serve as a source of differentiated income and diversification in a private credit portfolio when supported by disciplined underwriting and sound structure. The strongest opportunities are those where the investor understands the collateral, the originator's incentives, the servicing model, the data, the legal controls and the remedies available when performance weakens.

For a diversified private credit portfolio, the case for consumer loans extends beyond yield. The asset class can provide granular exposure, shorter cash-flow cycles, structural protection and risk drivers that differ from traditional corporate lending. In the right structure, complexity can be a source of attractive risk-adjusted returns when specialized managers can analyze, monitor and control the underlying collateral effectively.

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