

Private Asset-Backed Credit: How Structural Protections Drive Resilient Performance

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Executive Summary

- **Private Asset-Backed Credit (“PABC”)** provides private debt investors with direct exposure to income-generating, self-amortizing assets from consumer and commercial obligors.
- **PABC differentiates itself from Private Corporate Direct Lending in several important ways:** (i) asset and borrower diversification, (ii) bankruptcy-remote structures, (iii) contractual cash flows, and (iv) tailored covenants.
- **Investors can generally participate in PABC primarily in two forms:** (i) purchasing a portfolio of receivables, or (ii) providing financing that is collateralized by a portfolio of receivables.
- **This paper highlights asset-backed warehouse financing as a differentiated source of compelling risk-adjusted returns within private credit.** PABC offers the potential for double-digit returns with strong downside protection derived from features like first-loss retention by originators (“skin-in-the-game”), and structural mechanisms such as overcollateralization, excess spread, strict asset eligibility, and multi-tiered cash flow triggers.
- **PABC can deliver meaningful yield premiums,** potentially up to 500 basis points above comparable public Asset-Backed Securities (“ABS”) in the US and Europe. Successful managers can generate yield premium through a combination of proprietary sourcing channels, underwriting and structuring expertise, robust asset management and operational excellence.

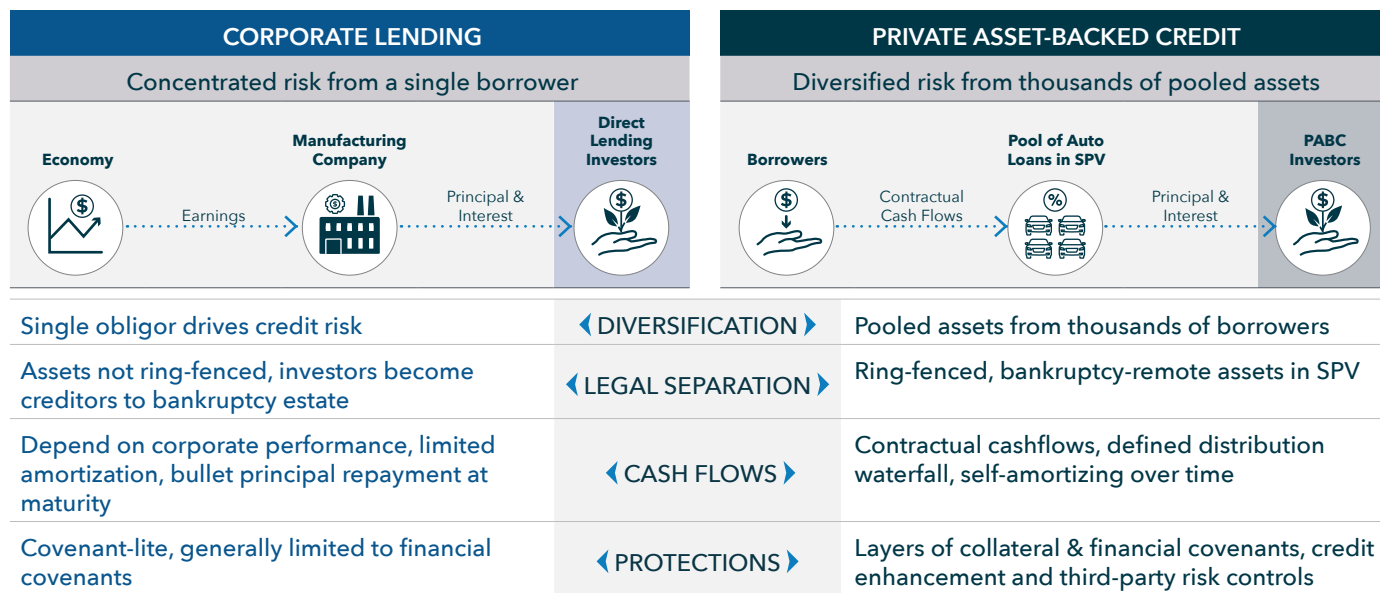
What is Private Asset-Backed Credit?

PABC refers to lending strategies in which investors provide financing secured by pools of income-generating assets. The assets are typically contractual loans or leases that generate predictable cash flows. Figure 1 illustrates some common examples of collateral utilized in PABC strategies.

FIGURE 1: EXAMPLES OF CASH-FLOWING PABC SECTORS

SECTORS	TYPICAL ASSETS
Residential	Single-family mortgages, home equity loans, residential bridge loans, timeshare receivables
Consumer	Auto loans and leases, credit card receivables, personal loans, student loans
Small Business / SME	Small business loans and lines of credit, working capital loans, merchant cash advances, factored receivables
Hard Assets	Transportation leases (aircraft, railcars, ships), energy infrastructure, equipment leases

FIGURE 2: CORPORATE DIRECT LENDING VS. PRIVATE ASSET-BACKED CREDIT



FOUR KEY FEATURES OF PRIVATE ASSET-BACKED CREDIT

Many investors are already familiar with private credit through corporate direct lending. PABC differs from corporate direct lending in several important aspects as noted in Figure 2 above. In the following section, we identify four distinguishing features of Private Asset-Backed Credit exposure relative to senior-secured corporate lending.



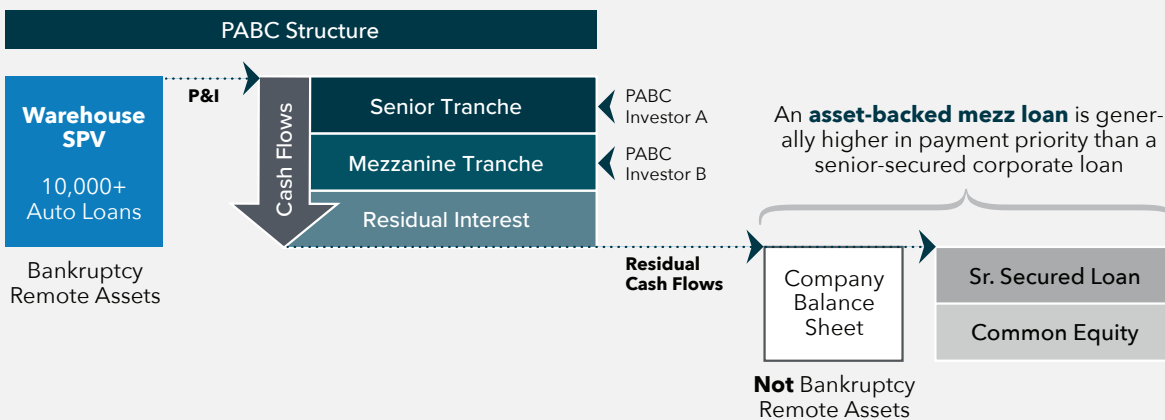
1. Asset and Borrower Diversification

One of the most compelling advantages of PABC is its inherent diversification. Instead of being tied to the performance of a single borrower or company, investors gain exposure to large pools of assets, such as loans, leases, or receivables, that involve many underlying obligors. (see Example 1)

Example 1: Consider a PABC transaction backed by a portfolio of auto loans. Rather than relying on repayments from one car dealership or manufacturer, the deal pools thousands of individual auto loans spread across numerous borrowers, geographies, and credit profiles. Even if some borrowers default, the impact on overall returns remains contained due to the sheer granularity and diversity of the asset pool.

The scale of this diversification reduces volatility, improves cash flow predictability, and provides enhanced protection during economic downturns or industry-specific stress.

Example 2: Returning to our auto-loan example, the originating lender would transfer the loans from its balance sheet into an SPV. Should the lender encounter financial distress or insolvency, these auto loans remain legally segregated and are protected from the lender’s bankruptcy proceedings. Investors maintain clear title to their collateral, ensuring that asset performance and repayment streams are insulated from sponsor-related risks. While a detailed discussion of warehouse lending structures follows in the next section, it is important to note here that the warehouse lender to the bankruptcy-remote entity receives all cash flows from the underlying assets prior to any senior secured corporate lender whose claims are limited to the bankruptcy estate.



2. Bankruptcy Remote / Legal Separation

Another key distinction is that PABC transactions typically utilize a non-recourse, “bankruptcy-remote” structure, meaning the assets backing the investment are legally isolated from the originator or sponsor’s bankruptcy estate. Assets are transferred into a dedicated special-purpose vehicle (“SPV”), whose sole function is to hold and manage those assets on behalf of investors. (see Example 2)



3. Contractual Cash Flows

The underlying cash flows in PABC are typically contractual, backed by legally binding agreements such as loans, leases, or servicing contracts. These structured and legally enforceable obligations offer a much clearer picture of future cash flow compared to the earnings-based repayments typical in corporate lending. (see Example 3)

Example 3: In our auto-loan-backed example, borrowers agree to fixed monthly principal and interest payments outlined explicitly in their loan agreements. Unlike corporate borrowers, whose earnings fluctuate based on market conditions or management actions, these auto-loan borrowers must meet contractual monthly payments, ensuring predictable, steady cash flow to investors.

These legally bound payment streams facilitate more precise underwriting, structured servicing, and effective enforcement, all of which strengthen the consistency and reliability of investor returns.



4. Tailored Structures and Covenants to Mitigate Risk

Because underlying cash flows in PABC deals are contractual and generally predictable, structures can be carefully customized to match both the unique characteristics of the underlying assets and the specific objectives of investors. Different asset types allow for different structural approaches, enabling investors to calibrate their exposure and mitigate targeted risks through customized covenants aligned to asset performance. (see Example 4)

Example 4: Revisiting our prior example, auto loans typically have straightforward monthly repayment schedules covering principal and interest. This allows the structure to closely align maturity dates, payment frequencies, and cash-flow waterfalls with investor preferences, whether they seek short-term liquidity or stable, long-term returns. To mitigate risks specific to auto lending, such as increased borrower defaults or declining used-car values, PABC transactions also include financial and asset coverage covenants (for example, minimum excess spread, maximum delinquency rate, maximum charge-off rate) designed to trigger protective mechanisms.

Tailored structures and targeted covenants enable investors to better manage specific asset risks, thus enhancing protection and helping to optimize the risk-return profile of their investments.

Sourcing Private Asset-Backed Credit Transactions

At the heart of Private Asset-Backed Credit are specialty finance lenders who originate the underlying receivables by extending loans or leases directly to individual consumers or small businesses, underwriting each borrower according to their established credit criteria.

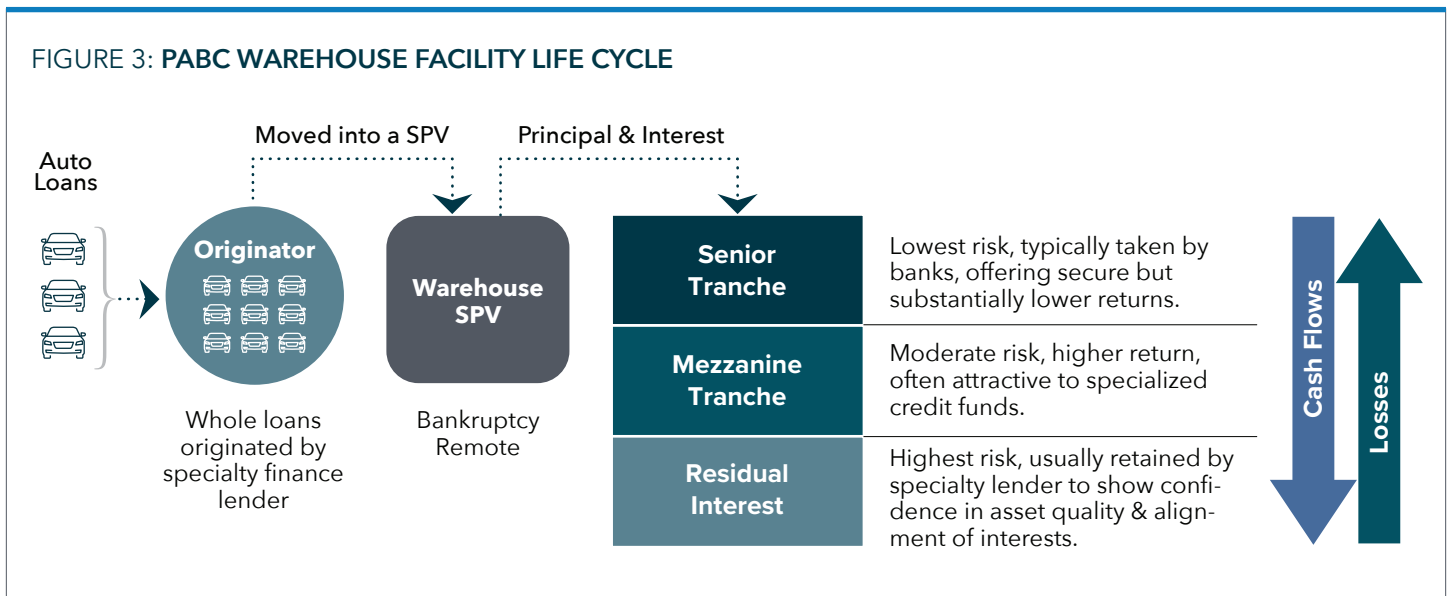
Once these assets have been originated, the lender typically has two primary choices to unlock capital:

1. **Sell the assets directly:** The lender can sell pools of assets outright to investors, immediately freeing up capital to originate new receivables. Notably, this method transfers asset risk entirely to the investor.
2. **Obtain financing against the assets:** If the lender prefers to retain some exposure and upside, it may secure financing against the asset portfolio as its origination volume grows. Typically, the lender uses a revolving financing facility as a bridge until a more permanent financing structure is established such as publicly rated ABS issuance.

A Spotlight on Private Asset-Backed Warehouse Lending Structures

Under the warehouse-lending structure, the originated assets are transferred into a non-recourse SPV, legally separating the assets from the lender’s balance sheet. Within the SPV, the pool of loans is often divided into multiple tranches within a static capital structure which is financed by investors that provide senior or subordinate financing, with each tranche creating distinct layers of risk and reward. (see Figure 3)

Over time, the specialty finance lender may choose to “term out” this warehouse facility by refinancing through a public securitization. In these transactions, the lender issues publicly rated securities backed by the loan portfolio, which allows access to broader capital markets, longer-term financing, and typically lower funding costs.



Risk Mitigation and Credit Enhancement

PABC warehouse lending structures include several protective features that are incorporated to enhance the risk/return profile. We highlight four elements which we believe are critical differentiators that can significantly strengthen investor protections and credit performance.

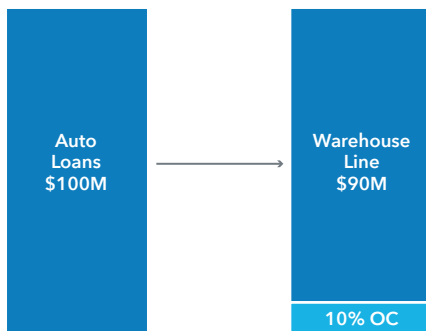
Credit Enhancement	Borrowing Base	Performance Triggers	Financial Covenants on Lender
<ul style="list-style-type: none"> • Overcollateralization • Excess Spread • Cash Reserve Account 	<ul style="list-style-type: none"> • Eligibility Criteria (What is eligible) • Excess Concentration Limits (How much is eligible) 	<ul style="list-style-type: none"> • Advance Rate Stepdown Trigger • Early Amortization Event Trigger • Event of Default Trigger 	<ul style="list-style-type: none"> • Liquidity Covenants • Net Worth Covenants • Leverage Covenants • Profitability Covenants

In-depth underwriting enables customized structures and covenants that align multiple layers of risk mitigation features to strengthen investment performance especially under stressed scenarios.

1. Structural Credit Enhancement

Structural enhancements improve the credit profile of warehouse financing by increasing loss-absorption capacity through mechanisms such as overcollateralization and excess spread. (see Figure 4) Importantly, the originator retains a first-loss position and meaningful “skin-in-the-game”, aligning incentives and enhancing the stability of senior and mezzanine investor returns.

FIGURE 4: **OVERCOLLATERALIZATION & EXCESS SPREAD**



Overcollateralization refers to a structure where the total value of collateral (the pool of underlying auto loans, in our example) exceeds the total amount borrowed under the warehouse line.

For instance, if a specialty auto lender secures a \$90 million warehouse line, they might pledge a \$100 million portfolio of auto loans as collateral, creating an overcollateralization cushion of \$10 million (10%). This excess collateral acts as a built-in protective layer, absorbing potential losses from borrower defaults or reduced recoveries from repossessed vehicles, providing significant downside protection for mezzanine and senior investors.

$$10\% \text{ Net Interest on Auto Loans} - 6\% \text{ Financing Cost} = 4\% \text{ Excess Spread}$$

Excess Spread is the additional cash flow generated by the underlying asset pool above and beyond the cost of servicing and financing.

Continuing our auto loan example, if the average net interest rate paid by car borrowers is 10% per year, but the cost of financing under the warehouse facility is only 6%, the resulting 4% differential represents excess spread. This excess spread accumulates over time, forming a protective cash buffer that can offset losses from borrower defaults or loan delinquencies, further enhancing investor protection and improving overall credit quality.

2. Borrowing Base: Ensuring Asset Quality and Credit Protection

The second critical structural protection in warehouse lending is the concept of a borrowing base. This mechanism ensures lenders only finance assets that meet clearly defined credit-quality criteria, creating an additional layer of credit protection and control.

Under a borrowing base structure, warehouse lenders establish explicit criteria defining which assets are eligible for financing. Assets that fail to meet these pre-agreed criteria are automatically excluded, protecting the overall quality of the collateral pool. (see Example 5) These eligibility standards are customized according to lender preferences and risk tolerances, typically addressing factors such as those described in Figure 5.

Example 5: Suppose an auto-loan borrower becomes delinquent, missing a scheduled payment. Under certain borrowing-base rules, this loan immediately becomes ineligible for financing. To maintain borrowing-base compliance, the specialty finance lender must promptly replace that delinquent loan with an eligible performing loan or, if no replacement asset is available, repay cash into the warehouse line to maintain borrowing base compliance.

By consistently enforcing these borrowing-base rules, warehouse lenders ensure high collateral standards and structural integrity, significantly mitigating the risk of asset quality deterioration.

FIGURE 5: BORROWING BASE EXAMPLES



Credit Quality as defined by minimum borrower FICO scores and proprietary lender risk models



Asset Concentration Limits which restrict exposure to high risk borrowers or specific geographic regions



Minimum Coupon Rates to ensure sufficient excess spread

Maximum Loan or Lease Term to address duration risk



Delinquency Thresholds will exclude non-performing or late-paying assets

3. Covenant Protections: Performance Triggers

The third structural safeguard in private asset-backed warehouse lending facilities involves **performance-based covenants**. These covenants offer lenders strategic protections against unexpected declines in asset performance, typically structured into three cascading triggers, each progressively more protective and severe. (see Figure 6)

4. Additional Protection: Financial Covenants on Specialty Finance Companies

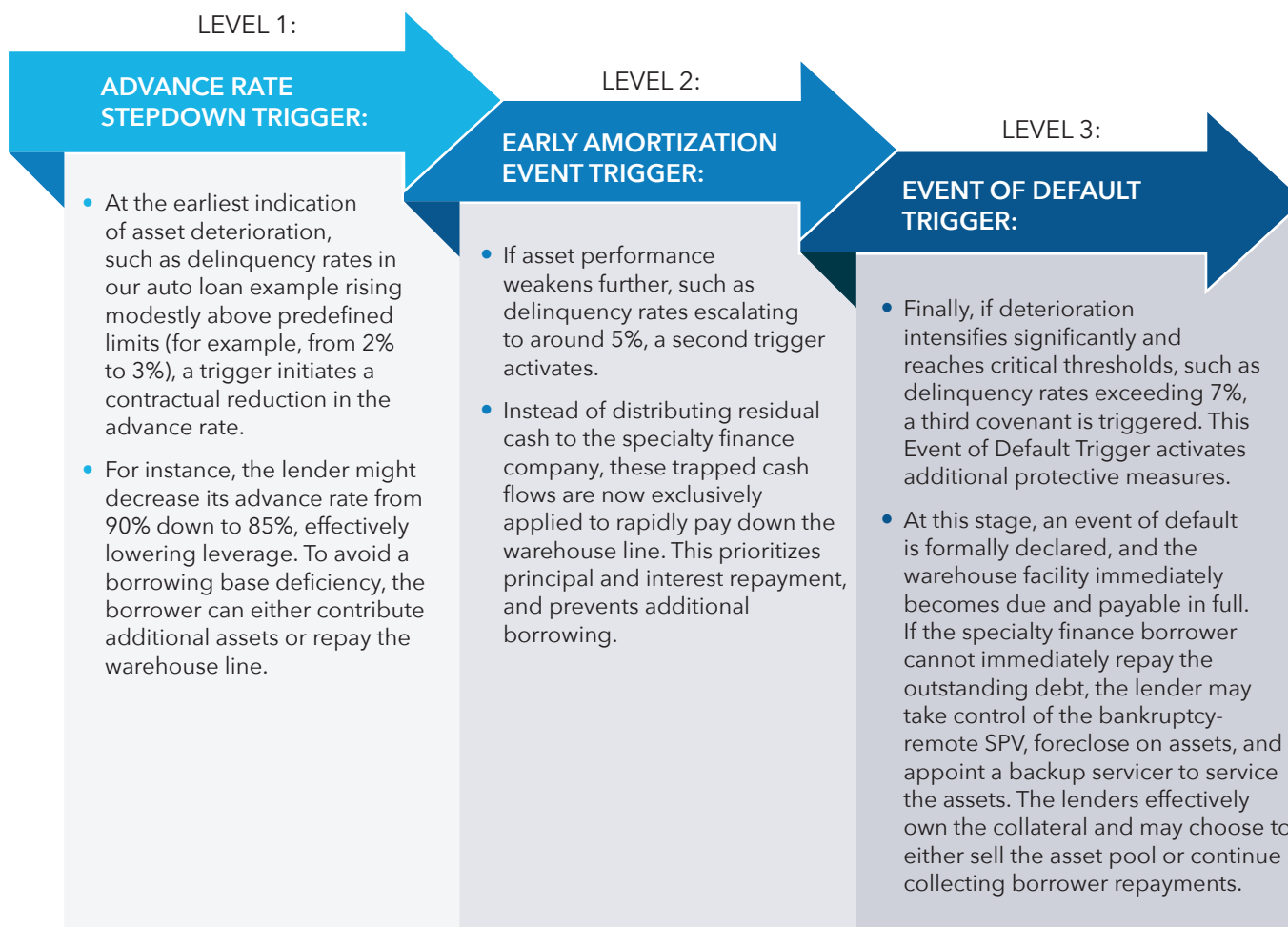
Beyond the asset-level covenants outlined above, warehouse lending facilities often incorporate **financial covenants** directly on the specialty finance companies originating the underlying receivables. These covenants aim to ensure the borrowing entity maintains sufficient financial strength to originate and service the assets and maintain borrowing base compliance.

Typically, these financial covenants include:

- **Liquidity Covenant:** Requires the specialty finance company to maintain a minimum level of cash or liquid assets at all times, ensuring financial and operational stability.
- **Net Worth Covenant:** Mandates the maintenance of a minimum net worth level, ensuring the company is sufficiently capitalized to meet debt service obligations.

By layering these financial covenants onto the specialty finance borrower, lenders create a dual layer of protection, ensuring that both the underlying collateral and the originating company's financial health remain strong enough to effectively address performance-driven deleveraging events.

FIGURE 6: MULTIPLE LEVELS OF PERFORMANCE TRIGGERS FOR ADDED PROTECTION

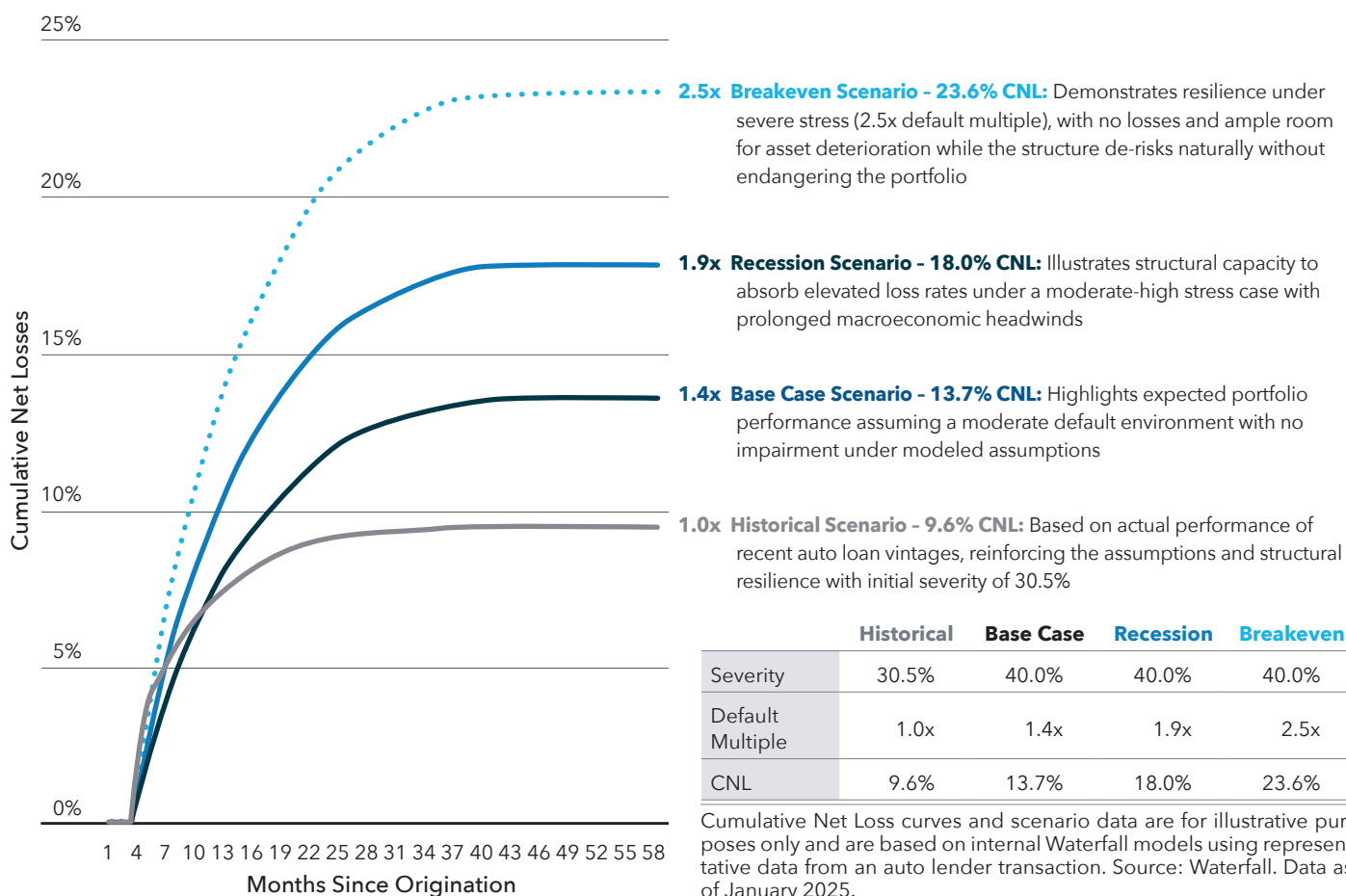


Demonstrated Resilience: Stress Testing Structural Protections

The aforementioned risk mitigation features, including structural enhancements, borrowing base controls, and layered performance triggers, collectively position PABC structures to manage credit volatility with discipline and resilience. Figure 7 below, which is drawn from a real-world auto loan transaction, illustrates how these protections enable the portfolio to absorb substantial increases in asset defaults, up to 2.5 times the base case, without triggering losses to investors.

FIGURE 7: ILLUSTRATIVE LOSS CURVES – AUTO LOANS

Historical performance, underwriting criteria, and macro factors are analyzed to set the base-case loss level and anchor stress scenario modeling



Loss Curve - Key Definitions

"CNL"	Cumulative Net Loss - total expected lifetime losses as a % of original principal balance
Severity	Average % loss on defaulted loans
Default Multiple	Multiple applied to historical-case to reflect stress severity
Breakeven	Highest CNL the structure can absorb before senior tranches incur losses

Pricing: Capturing Meaningful Premiums in Private Asset-Backed Credit

Despite their conservative risk profile, PABC investments offer yield premiums that defy the typical low-risk, low-return tradeoff. Private and public asset-backed investments differ significantly in structure, investor base, and market access, leading to differentiated risk-return profiles. We estimate that PABC transactions often price approximately 300-500 basis points wide of comparable public ABS deals. Figure 8 below shows a side-by-side comparison of a public vs private transaction backed by a pool of auto loans, issued by the same originator. The mezzanine note on the private asset-backed warehouse roughly corresponds to a BBB/BB tranche on the publicly issued rated deal; yet prices about 400 bps wide of where the public bonds trade.

This yield premium over comparable public ABS reflects the lower liquidity, greater structural complexity, and more limited market access typical of PABC investments. A useful way to frame this incremental return is to consider three primary sources of private market risk premium:

1. Illiquidity Premium

- PABC warehouses are privately issued, with minimal secondary market activity, making trades infrequent and bilateral.
- Entire tranches are often acquired by a single buy-and-hold investor, usually held through maturity without syndication.

2. Complexity Premium

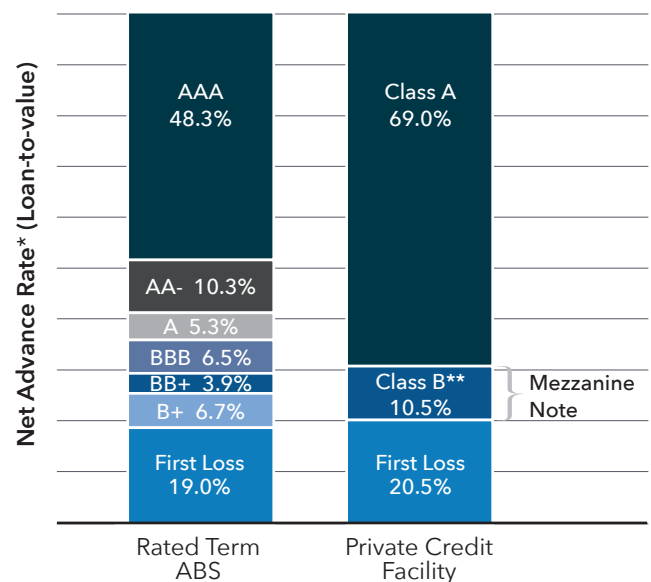
- PABC deals are highly customized, with non-standard terms, cash-flow waterfalls, and tailored collateral structures, compared to public rated deals.
- Operational complexity in PABC warehouses is significant due to their revolving nature, requiring regular (often weekly or bi-weekly) monitoring of cash flows, borrowing bases, collateral performance, and covenant compliance.

3. Sourcing Premium

- Origination of PABC warehouses typically requires specialized access and proprietary deal flow, leveraging deep relationships with specialty finance companies and senior lenders.
- Negotiation and structuring of bespoke agreements and deal documentation generally occur without intermediaries, demanding expertise and dedicated resources.

Indeed, capturing these return premiums is far from passive. Successful execution demands a unique combination of specialized capabilities that few traditional investment managers possess in full. These include strategic sourcing relationships, structured lending expertise throughout multiple market cycles, proactive asset management, and a customized technology and

FIGURE 8: PUBLIC VS. PRIVATE AUTO LOAN TRANSACTION STRUCTURE



*Advance Rate equals the initial ratio of (i) aggregate note balance(s) to (ii) trust assets; trust assets may include the loan balance and reserve account balance. Source: Waterfall. Data as of June 2025.

**The Advance Rate illustrated is a blended figure based on the assumed collateral mix at underwriting.

operations infrastructure. To consistently deliver attractive risk-adjusted returns, such capabilities must not only be present but also deeply integrated within the institutional infrastructure of an asset manager whereby they can demonstrate an executional model with multi-disciplinary experience and a track record of operational precision, both of which are brought together within a single, cohesive investment platform.

Conclusion

Private Asset-Backed Credit is a compelling evolution in the private credit landscape, offering a unique blend of contractual cash flow stability, structural credit protections, and customizable risk-return profiles. By aligning credit underwriting and covenant structuring to the idiosyncratic characteristics of each asset type, PABC strategies can be specifically designed to perform under stressed scenarios, mitigate downside risk, and enhance return consistency. In a volatile macroeconomic environment, asset-backed credit strategies can provide a resilient and scalable path forward for credit investors seeking diversification and defensible yield.

About Waterfall Asset Management

Waterfall Asset Management was founded in 2005 by Jack Ross and Tom Capasse, who established Merrill Lynch's ABS Group in the 1980s and led many early private asset-backed credit transactions. As a global alternative investment manager and leading liquidity provider to specialty finance issuers primarily across North America & Europe, the firm has grown to approximately \$13 billion in global AUM with more than 150 employees. The firm is headquartered in New York City and has additional offices in London and Dublin. Waterfall has deployed \$9.6 billion in PABC investments with zero realized losses since inception¹.

An Integrated Private Asset-Backed Credit Platform



Waterfall Asset Management

1251 Avenue of the Americas, 50th Floor
New York, NY 10020
(212) 257-4600
www.waterfallam.com

General Inquiries

clientservices@waterfallam.com

AUM data is approximate and estimated as of 4/30/2025 and includes unfunded committed amounts. 1. Includes all private asset backed credit investments structured as credit facilities, excluding investments in litigation finance, made by Waterfall on behalf of certain of its funds ("Select Waterfall Funds") from March 11, 2015 (the date of initial funding of the first investment in the strategy) to 3/31/2025.

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Waterfall Asset Management

1251 Avenue of the Americas, 50th Floor
New York, NY 10020
(212) 257-4600
www.waterfallam.com

