EXPERT Q&A

Diverse opportunities and economic insulation characterise the speciality finance opportunity, say Magnetar's David Snyderman and Erik Falk

How speciality finance drives the economy

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Q Speciality finance means different things to different managers. Can you define the investable universe?

David Snyderman: Speciality finance drives the economy, from the cars we drive, to the homes we buy and rent, and the songs we stream. It involves the ownership of, or lending secured by investors earning returns tied to the performance of a range of assets, from financial assets such as consumer loans, to hard assets like aviation or solar, and more esoteric contractual cashflows such as music or drug royalties.

This offers more diversity and insulation from economic cycles than corporate direct lending. Our focus is identifying investments with the potential to generate a high quality of earnings, so we look for attractive pay-off profiles on self-liquidating, high cashflowing assets that have low correlation to the broader markets and to one another. We also look for structures that are forgiving in downside cases and may provide upside participation because we know that many assets correlate in market crises.

Examples of the investable universe might include a portfolio of music royalties, where artists like Taylor Swift's and Fleetwood Mac's music downloads drive returns. It could include agricultural finance, where farmland prices drive performance, or the latest Nvidia graphics processing units (GPUs) in a cloud computing portfolio, where the growth of machine learning and AI drives outcomes. The economic insulation in these examples is intuitive and can be validated quantitatively.

Q What makes speciality finance investable?

DS: With such a wide set of possible opportunities in speciality finance, we start at first principles to determine what is investible. At the outset, are the asset classes ones we understand and have experience with? Do we have, and can we scale, quality data to underwrite across a range of economic and market environments? Can we structure investments with the proper downside protection? And can we add value to the assets and any origination partners?

Next, we break down the investment process into sourcing, analysing, structuring and risk management to generate returns. Our goal is to find excess return by adding value at each step. So, sourcing involves finding the right partners and creating alignment. Analysis involves working fundamentally and quantitatively with the data and evaluating cashflows to minimise tail risk. Structuring is critical in creating a stable return profile across a range of outcomes, as well as the potential for upside. And risk management is multi-layered, from bottom-up work to top-down portfolio analysis across historical and unforeseen scenarios.

We want the right governance framework in place, so we have a formal new business and ethics committee that considers opportunities across a range of non-financial metrics, like regulatory and reputational risk.

Q How has the new interest rate and macro environment impacted speciality finance investments, and what does that mean for risk and return today?

Erik Falk: Many people in the market today weren't investing during previous interest rate shocks, but our experience has taught us to think about rate risk across multiple dimensions.

As debt investors, the first order risk is the fixed interest rate exposure in the portfolio, which can be easily hedged and immunised. More difficult is the second order business impact on the portfolio – how profit margins will change, how this will affect the underlying portfolio company's originations, and how much more expensive future debt refinancing will be for them. Today's yields and spreads do not tell this full story.

We are cautious around consumer and related businesses, given the affordability factor. There are knock-on effects to the residential real estate market, too. Building in more margin of safety is critical, from shorter-duration investments to higher collateralisation ratios or some form of subsidy or support in areas such as affordable workforce housing.

Q What should speciality finance investors look for when it comes to portfolio construction, given the broad array of asset classes?

DS: When you have many different asset classes, most of which generate high cashflow, it is essential to thoughtfully contemplate portfolio construction. It's not as easy as an equity portfolio where a mean-variance framework applies. Credit is about return, tail risk and downside duration.

Any analysis starts with the data, looking at both historical and theoretical scenarios. You can see the correlation between different asset classes and take that to develop weights towards the assets you want more or less of, evolving those over time.

On the quantitative side, it's important to ask how many independent asset classes you are really running. The attractive part about speciality finance is that if investments and portfolios are structured correctly, it is possible to meaningfully protect capital on the downside and participate on the upside.

Q How are LPs thinking about speciality finance opportunities in this climate?

EF: We have seen a few stages of adoption by LPs. Shortly after the global financial crisis, as private credit was beginning to grow, LPs sought to include it among their allocations. Most began by focusing on corporate direct lending, as it was the easiest to underwrite.

We then saw more LPs use corporate private credit to fill newly formed and fast-growing allocation buckets. Direct lending became core, while some LPs sought diversification but often with single-strategy speciality finance funds, say for royalties or consumer loans.

Today's LP approach was born out of the pandemic, reinforced by the current macro environment. Pre-2020, few LPs had a speciality finance or asset-based allocation, so there was no place to put speciality finance exposure in their asset allocation and governance structures; now, it has a defined space and support from the institutional LP base and consultants.

DS: Investors today are focused on the security of assets, the benefits of cashflow and the potential for lower correlation to broader risk markets and general credit markets. LP interest in multi-asset approaches has also grown, given that what is attractive may change in a year or two. LPs are reluctant to choose five managers for five distinct asset classes and would rather capture the value of fee netting and work with managers who can construct portfolios that capitalise on changing market dynamics.

Q What opportunities and challenges do you see in niche asset classes such as intellectual property, music royalties, film and television?

EF: We began looking at film and television investments in 2005, when many investors were losing money, which we put down to insufficient diversification and structure. The slates of movies were not large or diverse enough, which made the distribution of outcomes wide, and structurally these deals often saw investors participate below the line such that expense overruns and bad surprises led to suboptimal bottom-line returns.

We invested in our first film transaction in 2013, which included dozens of films that smoothed the distribution of return outcomes. Additionally, the return was based on top-line cashflows from the films, which led to a better outcome and a scalable, repeatable approach.

In music royalties, we take the same approach. While the headlines focus on multiples when a musician sells their catalogue, we analyse the data. Through both proprietary and public sources, we have collected over a decade's worth of data for nearly all music released to commercial channels, spanning 200 countries, and created an expected cashflow profile for each song using characteristics like artist, vintage and genre.

Once we isolate the right catalogue, we can use many levers to increase value, from increasing streaming prices, to promotional uplift and better technology around reducing piracy.

Q Magnetar has emerged as a meaningful investment partner to CoreWeave, the AI hyperscaler. How did this come about?

DS: We identified CoreWeave as an early investment opportunity because we saw a compelling thesis and the requisite data to understand the assets. From there, we went to the next layer of CoreWeave's business and found attractive attributes that were a strong fit with our investment approach: a focused business strategy, a disciplined and forward-thinking management team and an asset-based business with significant value in both the underlying assets (the GPUs) and predictable, quality cashflows from customer contracts.

EF: Magnetar began its relationship with CoreWeave in 2021 as its first institutional investor with an initial $50 million investment, and completed several subsequent transactions – including a $1.15 billion convertible preferred issue – as it grew. Institutional backing and capital support have helped enable CoreWeave to build the infrastructure to power the AI revolution and meet current and future demands for high-performance computing at scale.

"We have seen a few stages of adoption by LPs"

ERIK FALK

"There is a benefit to taking the patient approach"

DAVID SNYDERMAN

A critical part of this story is the recognition that innovation exists in speciality finance around high-quality assets.

Q What are the primary risks associated with investing in speciality finance?

DS: The two we think about a lot are default risk and opportunity cost. On default risk, system shocks that could lead to a pick-up in defaults will impact all credit investments, whether corporate or asset-backed. While we prefer the margin of safety in asset-backed, we are always focused on default risk and loss minimisation.

Given the importance of sourcing in speciality finance, and the need to invest across a diverse set of assets, we do drill dry holes. As market microstructures evolve, deal structures can change and become harder to get comfortable with. There is a benefit to taking the patient approach, but the burden is that, through a rigorous diligence process, the opportunity can move out of scope.

Q What is the outlook for this part of private credit?

EF: What began with the GFC has continued and recently accelerated with the US regional bank crisis and BASEL III endgame. Bank business models look drastically different than they did going into 2008. The recent surge in regulatory capital and significant risk transfer transactions show banks need to continue to grow their core lending businesses, while also reducing regulatory capital.

These transactions have actually been a core part of bank capital management, particularly in Europe, since 2008. We believe these trends will continue, and the availability of speciality finance opportunities will increase over time. Naturally, so will competition, which is why proprietary data and sourcing are critical. ■

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