Private Debt Investor

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FUND MANAGERS

Davidson Kempner argues it's time to pivot to asset-backed finance

As recovery rates plunge, a new report points to second-lien mortgages, European SME ABF and US equipment finance as areas of opportunity.

Traditional private credit – defined by many as senior-secured, mid-market direct lending to sub-investment grade borrowers – is a well that has all but dried up as the market matures and as spreads, recovery rates and documentation decline, according to a whitepaper by Davidson Kempner.

That's led to a ripe opportunity for a pivot to non-investment grade, non-rated asset-backed finance, the firm argues. More specifically, the report identifies three verticals as the most attractive: US-based second lien residential mortgage lending, European SME asset-backed lending and mid-ticket equipment finance in the US.

"For assets that are less widely supported by the institutional capital markets – whether that be bank or insurance – originators are looking for term financing partners to help grow their origination platform and lending capabilities," said Patrick Dennis, co-deputy managing partner at Davidson Kempner.

Especially with the US Federal Reserve's campaign of lowering interest rates and its uncertain path forward, direct lending may not be able to maintain the high, stable returns managers have promised in the past. Even with banks still accounting for the lion's share of the verticals DK identified, the firm argues the lack of alternative manager capital in these areas is more of a benefit than a hindrance to private credit managers.

Among other themes that make leveraged lending less attractive in their view are: the ever-growing presence of payment-in-kind interest in older private credit deals; liability management exercises in public credit deals; and declining recovery rates in leveraged lending across the board to 50 percent this year, down from 70 percent in 2010, per, data from JPMorgan and KBRA Direct Lending Deals.

Three areas of opportunity

Second lien residential mortgage lending, which encompasses both home equity loans and home equity lines of credit, has been buoyed in the US thanks to a lock-in of lower mortgage rates from previous years and the 56 percent aggregate (or 10 percent annualised) home price appreciation since 2019, per data through the second quarter of 2025 from the Federal Reserve Bank of St Louis.

Second-lien mortgages represent a $590 billion market, according to Suzanne Gibbons, partner and head of research at Davidson Kempner. She pointed to Aven Financial, which recently rolled out a product that allows eligible consumers to access home equity via a secured credit card, as an example of lenders taking advantage of an area for growth.

To be sure, most second-lien mortgages are bank and credit union dominated, with DK estimating their participation at around 90 percent of the market.

"We're in the early innings of investor capital coming into that market to partner with banks to enable the growth of that market, because otherwise the banks are disincentivised to hold these assets on their balance sheet because they come with 100-percent risk weights," said Gibbons.

By partnering with an alternative manager instead, rather than simply holding the entirety of that risk on their balance sheet, provides the typical bank with regulatory capital relief.

The same could be said for the other two areas of the market, DK's team points out, but the lack of presence of alternative lenders and investor capital forms the crux of their thesis: be there early.

"Regional banks, based on the latest data we have, have actually reduced their origination volumes," said Gibbons, referring to US mid-market equipment finance. She cited data from the equipment leasing & finance association showing that new business volume from banks declined 1.3 percent in 2024, while it rose 17.7 percent for independent financing businesses.

Equipment finance, the firm argues, is a $1 trillion market, with full-year average annual loss rates of approximately 0.5 percent since 2006. The corner of the market commonly caters to the

construction, manufacturing, healthcare and technology industries typically seeing financing on assets valued between $200,000 and $5 million.

Likewise, banks in Europe account for 74 percent of all corporate credit, but because of regulatory constraints they're often limited when it comes to extending credit to smaller, riskier businesses.

Areas of opportunity Gibbons highlighted in Europe included the UK, but she also touched on Southern Europe – Italy, Spain, Greece, Portugal – as being an under-banked market.

"The opportunity is companies with assets – more asset-heavy businesses, because we lend across both property plant and equipment, receivables, and cash flows," she said. "The real unlock is that you provide a facility that takes into account assets across jurisdictions and for some reason, with the regulations in Europe, a lot of banks don't do that – they're just focused on country-specific collateral."