

Specialty Finance

OVERVIEW

As mentioned in our 2026 Capital Markets Forecast, we expect private debt to remain a compelling source of risk-adjusted returns, supported by structural protections and disciplined underwriting. Specialty finance is an attractive segment of private debt that can offer attractive diversification and structural protection in an increasingly competitive private debt market.

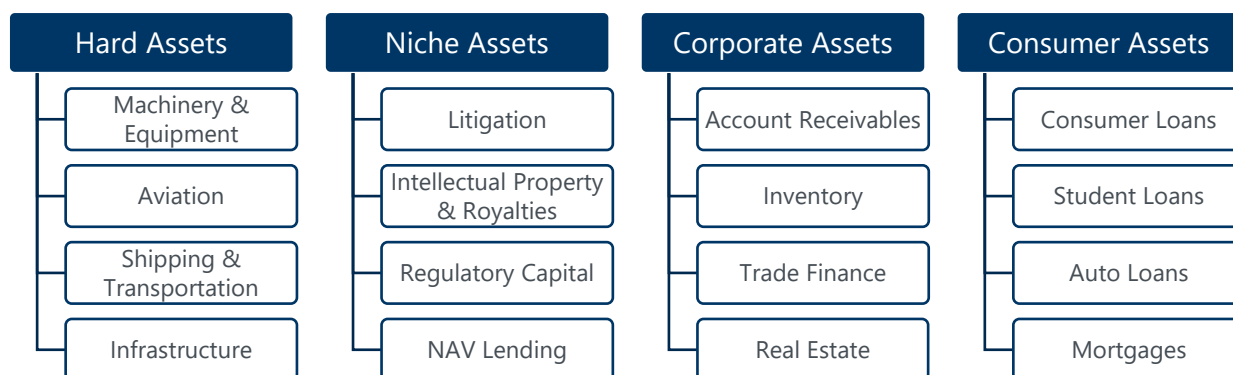
Specialty finance represents a form of lending in which loans are underwritten and secured (collateralized) primarily on the value of a borrower's assets, ranging from traditional working-capital assets such as receivables and inventory to hard and niche assets like aviation and royalties. The primary underwriting focus for specialty finance is on asset values, collateral liquidity, and liquidation values.

Specialty finance strategies typically incorporate structural discipline through conservative loan-to-value or advance rate structures, strict asset eligibility criteria, and frequent collateral appraisals and monitoring, along with tight lender safeguards designed to prioritize capital preservation. While outcomes depend on asset quality and manager execution, well-structured specialty finance strategies generally exhibit reduced sensitivity to the corporate earnings cycle and provide downside protection through underwriting, risk management, and enforceable structural protections, offering diversification benefits to a private debt allocation within portfolios.

OPPORTUNITY SET

The specialty finance market is fragmented and shaped by supply-and-demand imbalances. Bank retrenchment, driven by regulatory and capital constraints following the Global Financial Crisis (GFC), has driven borrowers toward capital from non-bank and private lenders seeking flexibility, certainty, and faster execution.

As the market has grown, asset types have expanded from corporate working-capital assets to include aviation, transportation, equipment, royalties, intellectual property, and other specialized pools (see visual below). Limited competition persists due to the high levels of expertise, sector specialization, and operational resources required to underwrite and monitor these types of loans. The structural imbalance between borrowers and available capital providers combined with a fragmented market has created a durable opportunity set across market cycles within private debt.



KEY FEATURES

Specialty finance combines capital preservation with yield through disciplined asset-based underwriting and structural protections. Underwriting emphasizes collateral quality and incorporates multiple layers of risk mitigation, including covenants and shorter durations that enable for faster de-leveraging. Since specialty finance loans are often bespoke, structural protections and covenants are highly customized and unique. Some key features of specialty finance loans are outlined below.

Loan to Value Limits

Credit exposure is tied to asset values, capped by defined percentages of eligible or appraised collateral. For frequently turning assets (e.g. receivables, intangible assets), this is managed through a borrowing base and an advance rate; for tangible assets it is managed through loan-to-value (LTV) limits. Both approaches aim to constrain exposure relative to the collateral value, mitigate loss protection, and allow adjustments as asset values fluctuate. To reinforce this protection, collateralized assets are often subject to periodic valuation (weekly to quarterly depending on asset type), reporting, and third-party validation, with lenders retaining rights to intervene early if asset quality deteriorates.

Cash Control

Cash control mechanisms provide lenders direct visibility into, and influence over, cash flows generated by the underlying collateral. In practice, this can include arrangements where cash flows are directed into accounts monitored or controlled by lenders or where excess cash is automatically applied to reduce outstanding loan balances. These arrangements limit the potential for cash leakage, support faster unwinding of the loan when underlying collateral performance weakens, and allow lenders to respond quickly to signs of stress.

Structural Protections

Structural protections guard against collateral dilution or value leakage, where value intended to support the loan erodes over time. These protections often include covenants such as springing, negative, and positive covenants tailored to preserve collateral value and limit adverse borrower actions.

Springing covenants activate automatically upon breaches of predefined thresholds, such as declines in asset values, increases in leverage, or breaches of reporting requirements. These thresholds

when crossed, may lead to tighter lender protections such as increased oversight, restricted distributions, or accelerated repayments.

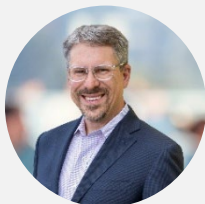
Negative covenants prohibit actions that impair the underlying collateral, such as selling pledged assets, incurring additional debt, or transferring asset value outside of the collateralized asset pool.

Positive covenants mandate actions that maintain asset quality and transparency. These covenants are particularly important for monitoring and reporting of collateralized assets and may include provisions to protect asset conditions and resale value. In certain cases, collateral is held in bankruptcy-remote entities, meaning the underlying collateralized assets are legally separated from the operating company (borrower) to insulate lenders from company-level insolvency risk and enforce recoveries.

CONCLUSION

Specialty finance can offer a differentiated source of return and risk within private debt allocations. Conservative underwriting, structural protections, and defined paths to recovery reduce reliance on refinancing conditions and corporate earnings. Operational complexity and supply constraints limit competition, making specialty finance a complement to other private debt strategies. When thoughtfully integrated, specialty finance strategies can enhance portfolio resilience across market cycles while maintaining durable, attractive risk-adjusted returns across market environments. We prioritize specialty finance investment managers with demonstrated expertise in underwriting, structuring, and workout execution.

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