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PRIVATE CREDIT · ORIGINATION PLATFORM

Warehouse Facility Rate Mismatch at a Private Credit Originator

SCENARIO TYPE	Private credit, origination platform
ASSET CLASS	Asset-based lending (receivables and inventory finance, Asia)
RISK FOCUS	Warehouse cost that resets every quarter against loan pricing that doesn't, margin squeeze, covenant headroom

Illustrative case study.

THE SITUATION

In a quarter of record loan volumes, the board of an Asian asset-based lender asked its CFO what higher rates would do to the business. With SOFR at 4% and forecasters split on where it went next, the CFO ran it 2% higher (200 basis points). Profit before tax would fall from about USD27m a year to about USD7m, even before any rise in credit losses.

The business lent against receivables and inventory, with a book of about USD1.2bn, and it had built that book rapidly. Clients were approved and funded in two to three days, and they paid about 11% for that certainty rather than shopping for the lowest rate. About USD1bn was drawn on average on a bank warehouse facility, at 3-month Term SOFR plus a spread of 2.5%, reset every quarter, with USD200m of equity behind the book. With SOFR at 4%, that produced a pre-tax return on equity of approximately 13.5%, and for several years it looked like a well-run, low-risk business.

Part of the reason it looked low risk was the way the risk reporting looked at the book. It measured interest rate exposure by the loan drawdown maturity, which averaged under four months, and on that view there was very little to hedge. The reporting was accurate about the drawdowns, but the rate for each drawdown was set in the client's facility agreement and ranged from 12 to 24 months.

HOW THE RISK SHOWS UP

The warehouse cost moves with SOFR every quarter, while the loan book reprices when client facilities roll, 12 to 24 months later. In between, every rise in SOFR comes straight out of the margin. In effect the business was running a leveraged carry trade, with USD5 of floating-rate funding for every USD1 of equity and assets whose price was fixed for up to two years.

If SOFR rises from 4% to 6%, the warehouse costs roughly USD20m a year more. Income stays at USD132m, funding rises from USD65m to USD85m, and with costs and credit losses at around USD40m, profit before tax falls to an annual run-rate of USD7m, a 3.5% return on equity. It stays at that level until facilities roll and can be repriced.

WHERE IT GOES WRONG

Growth adds to the mismatch

Every new facility fixes today's pricing for 12 to 24 months against funding that still resets every three months, so a record quarter adds to the exposure as well as to expected margin.

Clients pay for certainty, not for a rising price

They accept a premium for speed and certainty, but deposit-funded banks can hold their pricing for longer, so repricing early means losing clients to lenders whose own funding hasn't moved as fast.

Covenant headroom disappears

Interest cover on the warehouse falls from about 1.4x at 4% SOFR to about 1.1x at 6%, below the facility's 1.25x test, at the point where the platform needs the lender's goodwill most.

The renewal comes at a bad time

The warehouse comes up for renewal within the year, while the numbers are weakest, and the lender can cut the advance rate (how much it lends against the loans) or raise the margin.

THE OPTIONS

Each option has a cost:

- Reprice faster, with shorter client commitments and rate-linked pricing on new facilities. Slow to take effect, and some clients will leave.
- A pay-fixed swap on the drawn balance. Fixes the cost but gives up any benefit if rates fall. The drawn balance moves, so a fixed notional ends up too big in quiet months and too small in busy ones.
- Buy an interest rate cap at 5%. Keeps the benefit of falling rates. On USD900m for two years, with the curve near 4%, the premium is roughly USD1–2m upfront.
- A collar: buy the same cap, paid for by selling a floor at a level the business can live with, staying floating in between. Strikes can be set so that little or no premium changes hands. The cost is any saving below the floor.

Under a CSA (the collateral agreement with the bank), the swap and the collar can call for collateral if rates fall, so the cash plan must allow for it.

WHAT THE BOARD CHOSE

The head of sales argued against shortening client commitments, since certainty of pricing for the life of a facility was the reason clients paid 11%. The board agreed that changing the product was the slower and costlier fix. The CFO's first choice was the cap on its own, so that nothing would be given away if rates fell. The board's view was that at around 3% SOFR the business would be earning about USD37m, an 18.5% return on equity, so the benefit it would give up there mattered less than the premium it would save now.

It chose a collar with a 5% cap and a floor a little above 3% on the same 3-month Term SOFR and reset dates as the warehouse. The notional started at USD900m, the lowest drawn balance of the year, so the hedge was never bigger than the borrowing, and stepped down over two years as client facilities came up for repricing, so the hedge ran off as the gap it covered closed. Growth got a smaller cap starting in six months, sized to facilities already signed and bought for a small upfront premium, so no floor was sold against lending that hadn't been written. The collar sat under the warehouse bank's credit line rather than a CSA, so a fall in rates would not call for cash, and the bank's charge for that line went into the floor.

While the notional is near USD900m and SOFR is at 6%, the cap would pay about USD9m a year, and profit before tax runs at around USD16m instead of USD7m, an 8% return on equity instead of 3.5%. The trade-off was that if SOFR falls below the floor, the saving stops there for the life of the collar. Interest cover improves to about 1.2x, which narrows the gap to the 1.25x test without clearing it, so the board also took the hedge policy to the warehouse lender ahead of the renewal, before the lender set terms.

THE LESSON

The drawdowns were short. The pricing on them wasn't.

TEST IT ON YOUR OWN NUMBERS

- Set out when your loan pricing resets against when the warehouse does. How long is the gap, and does your risk report measure that gap or the drawdown maturity?
- Run SOFR 2% (200 basis points) higher for 12 months through the P&L, with and without repricing as facilities roll. What happens to return on equity and to the warehouse interest cover test?
- Compare your average drawn balance with the peaks and troughs before you size any hedge.

When the warehouse resets every quarter and loan pricing is fixed for up to two years, a 2% rise in SOFR (200 basis points) can take most of a year's profit. If you couldn't say what it would take from yours, that's worth an exploratory discussion with Mike Duncan.

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