

FINANCING

Asset-based lending in a risk-averse financing environment

BY CLAIRE SPENCER



Asset-based lending (ABL), by nature, is an ideal financing instrument for companies in tight situations and uncertain business environments. This makes it the perfect debt instrument for the present climate, since a company's collateral is more certain than its financial performance and cash generating capabilities. Experts predict a resurgence in asset-based lending as a result. But while it is a mainstream financing option in both the US and the UK, many other markets have been slow to assimilate ABL into their lending culture. As the downturn continues, this may change, as it has become increasingly difficult for borrowers to qualify for sizeable cashflow loans on attractive terms. On the other hand, if conditions worsen dramatically, asset-based lenders may also feel the pinch.

Eighteen months ago, while ABL was a common component of larger leveraged finance transactions, it was generally eclipsed in such transactions by the cash flow tranches. Lenders were structuring such cash flow debt with little or no security tied to assets, then syndicating strips to cash rich investors seeking higher returns. Now that those investors have fled the market, and lenders

have revised their criteria, ABL is moving to the forefront. Borrowers are able to unlock value in their tangible and intangible assets in a market where capital is otherwise hard to access. According to Judith McMath, director of the Manchester office at Burdale, there is a growing appreciation among private equity investors and professional advisers alike that this niche lending product has an increasing role to play in the debt market. "Much effort has been made to develop the penetration of ABL into the European markets and there is an ever expanding knowledge base to draw upon when structuring pan-European transactions," she says. There has been a growing acceptance of ABL structures as a mainstream financing option in Europe in recent years, despite the lag behind the US, and in recent months there has been a marked increase in the number of large syndicated UK and European ABL transactions completed."

ABL is coming into its own as an independent mode of financing. Structures for an asset-based facility have evolved to give more flexibility to borrowers and in some cases to incorporate attributes of a cashflow loan. ABL financing is relatively inexpensive compared to cashflow or term loan financing,

and has few financial covenants. The use of a revolving credit facility to reduce interest expenses, and the benefit of tracking the value of assets, are additional advantages. "Many borrowers benefit from an ABL structure. The daily reporting and frequent monitoring is often beneficial and provides discipline to the borrower internally. In addition, an ABL lender with adequate collateral coverage may not have the same concerns that the borrower is losing money or has violated its financial covenants. Many ABL transactions will have minimal or no financial covenants – particularly beneficial in an uncertain economy," explains Lawrence F. Flick II, a partner at Blank Rome LLP. Larger ABL facilities generally have financial performance covenants that are measured only if an availability threshold is breached. Consequently, if a borrower can manage and project its cashflow it can avoid financial covenant performance testing. Another benefit is that in most cases ABL facilities can be terminated without a make-whole provision.

As is usual when a debt instrument picks up pace, new trends, developments and strategies have risen to meet demand. "There is a greater use of non-standard borrowing base collateral, such as intellectual property and real estate and there is a continuing emphasis on certain aspects of the borrowing base, including inventory, equipment and IP, if any, being determined by outside appraiser determinations of net realisable values," says Albert Fenster, a partner and co-chair of corporate & finance at Kaye Scholer LLP. But now that lenders are treading with care, opinion is split as to whether novel terms and structures will appear, or whether the asset class will return to basics, where it is safe. For the time being, geographical and structural developments are continuing. "There has been an increase in the number of multinational companies using ABL facilities with individual country limits," notes Mr Fenster. "The ability of lenders to lend directly in foreign countries, or risk participate, depending on such lenders

being able to do business in particular countries, has also improved. As ABL is a versatile product and not mutually exclusive with other financing structures, there have also been more financings that incorporate ABL with other types of financing such as traditional cashflow lending and receivable securitisation.” ABL is also a good way to provide debtor-in-possession (DIP) bankruptcy financing, as it incorporates the discipline and controls that creditors will value.

Since the onset of the credit crunch, when liquidity began to evaporate from financial markets, it has been far more difficult for banks to syndicate loans to willing investors. As a result, lenders have tightened their credit analysis processes – even for asset-based loans. “The collateralised loan obligations, collateralised debt obligations and hedge funds that had been active participants in the syndication market are no longer active participants in most deals,” observes Mr Flick. “We have also started to see agents taking on less syndication risk than they were a year ago. In some cases, commitments have been conditioned on co-lenders or participants committing as well as funding at the initial closing of the loan. We are seeing a return to true ABL deals with daily borrowing base reporting and lockbox collections of receivables and dominion over cash.”

Caution has affected the way asset-based loans are structured, priced and provided to borrowers. “The current economy and credit conditions may have brought more deals to the ABL market, but pricing has edged upwards, and structural twists such as covenant-lite and FILO components have occurred less frequently, particularly on widely syndicated deals,” says Joyce White, the president at Bank of America Business Capital. “The underwriting side of matters has been restrained, and this discipline should be encouraged to continue as we work through the cycle.”

International growth continues

The US and UK continue to be the core markets of ABL based on both the size of the markets, and most significantly the legal frameworks that exist, which are conducive to the asset-based product. However, as the US is a mature industry for ABL, growth will undoubtedly be greater, percentage-wise, outside the US, with key markets such as Mexico, Japan, Canada and Western Europe likely to lead the way over the next few years. “Mexico’s proximity to the US market and the volume of cross-border activity with the US continues to generate pressure for lenders to find ways to address the desire of customers with operations in Mexico

to have assets there provide the basis for liquidity. Furthermore, it has been almost five years since the significant changes to Mexican law in 2003 that greatly facilitate ABL. As for Japan, the changes to the secured transactions laws in 2006 have facilitated ABL. The Japanese government is finding ways to push beyond real estate as an asset that might generate financing to using personal property assets of companies to generate liquidity,” says David W. Morse, a partner at Otterbourg, Steindler, Houston & Rosen, PC. Recent changes in Canada’s tax withholding statute have made it easier for US-based asset-based lenders to lend to Canadian affiliates as part of a single credit facility.

Other jurisdictions are not as friendly to ABL structures. Continental Europe, for one, has been slow to accept ABL as a standard lending practice. “In many regions of mainland Europe, the legal framework is undeveloped, undefined and, if anything, protective of the unsecured creditors of a business rather than the secured lender,” explains Ms McMath. “This is due to the historically unleveraged operating models employed within many European businesses where they tended to self-finance from internally generated cashflows and grow accordingly, rather than gear up to accelerate growth or acquisition.” Although these attitudes are embedded in Europe’s lending practices, lenders are sophisticated enough to make progress by working within existing confines and creating new solutions. “Without doubt, there is less of a culture of lenders working through problems with their borrowers and the local laws make both the taking of security and its reliable enforcement fraught with difficulty,” says Paul Hancock, a managing director, asset-based lending at JP Morgan. “However, structures to try to overcome these issues are emerging.”

It is necessary for lenders to tread carefully within these jurisdictions and be mindful of any negative practices. According to Mr Morse, the tendency to ‘ring-fence’ assets is quite common, for example. “There are some jurisdictions that have migrated towards attempting to set aside or ring-fence a portion of an insolvent company’s assets for the benefit of unsecured creditors. Obviously such an approach diminishes the amount of credit that a secured lender may be able to provide based on the company’s assets, which can then adversely affect the ability to generate sufficient liquidity from the asset-based facility to make it viable,” he says.

Legal issues

Lenders see the US’ Uniform Commercial Code and other laws pertaining to secured transac-

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tions as something of a benchmark in terms of creditor rights. “The Uniform Commercial Code and the certainty of the laws relating to secured transactions and the relative priority among creditors in the US gives ABL lenders great comfort,” says Mr Flick. “Properly underwritten, an ABL lender expects to be able to liquidate the assets of its borrower and recover its loan in full. Advance rates are set to reflect the cost and timing of liquidation and expected dilution of collateral.” High quality legislation and a transparent route of enforcement are required to satisfy lenders that their investment is safe.

For ABL to succeed, the legal environment needs to be both reliable and predictable. “The lender needs to know that if circumstances go badly for the borrower, or the borrower breaches its agreements with the lender, at some point, through an identifiable process, the lender will have access to, and the ability to realise upon, the collateral. Many jurisdictions do not yet have sufficient certainty of outcome but may very well move in that direction,” observes Mr Fenster. The lender also needs to know which claims – whether from creditors, the government, employees or other stakeholders – can prime its liens so it can set up effective reserves in determining the borrowing base.

As a result, pushing ABL into new waters is not always straightforward. Common challenges can be loosely divided into two ele- ▶▶

ments: the presence of relevant laws and a judicial infrastructure that provides for its enforcement. "As to the first, there are two principal areas that are problematic," observes Mr Morse. "There are many jurisdictions, principally those whose law is based on the civil code tradition, that do not have a legal framework for a lender to obtain a non-possessory lien or pledge of assets that 'float' over a changing pool of assets like inventory or accounts. The second is the retention of title, particularly within the European Union. Even in jurisdictions like the UK where the retention of title is relatively relaxed compared to some continental European jurisdictions, this can limit the amount of credit that the asset-based lender provides by requiring the exclusion of certain categories of inventory or limit the ability to finance inventory in certain industries." Furthermore, the retention of title in jurisdictions like Germany creates even greater

issues given the recognition of 'extended' retention of title under German law. There, receivables generated from the sale of the assets may be subject to suppliers' claims.

The year ahead

It seems clear that ABL, in its capacity as a re-inforcement to other debt instruments, and as a form of lending in its own right, will continue to flourish in 2008. "ABL will be waiting in the wings to provide support to debt burdened corporates who need continued and potentially increasing financial support to enable them to weather the economic storm and to continue to invest in their longer term strategic objectives. An improving knowledge base concerning alternative funding options amongst professional advisers and an ever increasing level of sophistication and reach within the ABL sector itself should combine to ensure that the European markets have strong and enduring

lines of credit to support them through the potentially ongoing turbulence within the global markets for the foreseeable future," predicts Ms McMath.

In the current environment, it is expected that corporates and private equity portfolio companies will turn to ABL in the absence of other sources of debt. ABL growth will be further enhanced by DIP loans structured with ABL and the forecasted growth in restructurings. However, if the market worsens dramatically, even asset-based lenders may shy away from participating in deals of all sizes. Furthermore, even optimal conditions can nature only patchy growth, since several regions, including swathes of continental Europe, lack adequate legislation to allow ABL to become anything other than niche. Whether these nations will be motivated enough to make the necessary changes to creditors' rights could be influenced by market forces during 2008 and beyond. ■



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Burdale
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Career to date

- Qualified as an ACA with Ernst & Young in London
- Moved to Grant Thornton Corporate Finance in Manchester to develop business in the North of England
- Main Plc Board director of Euro Sales Finance in 2000, then founder-director of Enterprise Finance Europe in 2002 (Bank of Ireland's start-up receivables lending

business).

- 2005 Joined Burdale Financial Ltd when it became a wholly-owned subsidiary of Bank of Ireland Group

Current Role

Role in Burdale is to develop the Burdale business in terms of both regional presence in the North of England and bringing Corporate Finance experience to deal structuring and developing

product offering.

Hobbies

These include tennis, keeping fit, travel, fast cars and kids!

Qualifications

BSc in Mathematics
FCA