

ABL

Asset-based lending in the current market place

BY PAULINE RENAUD



In the current financial environment, obtaining traditional bank funding on favourable terms remains a challenge for most businesses. Consequently, an increasing number of companies are looking at alternative options, such as asset-based lending (ABL), to secure financing. The renewed appetite for this form of lending is the result of several factors, including the lower-risk profile it presents for both lenders and borrowers, compared to other financing facilities. ABL however has its own issues, such as valuation and monitoring, which need to be managed early in order to limit potential risks. This is particularly important, as ABL is expected to become the mainstream and preferred source of lending for businesses going forward.

Driving forces behind ABL activity

Most lending activities have been affected by the current crisis, including asset-based lending. But unlike the majority of credit facilities, ABL provides several benefits to both lenders and borrowers, and is therefore faring better. The increase in asset-based lending activity has been particularly noticeable over the last two years, due to the lack of cash flow financing during the crisis. In the meantime, new lenders have started appearing on the ABL market as the competition has thinned out. These different factors allow the ABL market to cover a wide range of companies and sectors. "Given the spectrum within the market, putting aside the exceptional times of

last autumn and the beginning of this year, asset-based lending is generally always active to one degree or another. But the specific segments of the market that may be the most active shift depending on larger economic forces," asserts David W. Morse, a partner at Otterbourg, Steindler, Houston & Rosen, P. C. "Obviously, there has been a significant drop off in the large, sponsor-driven acquisition financings, particularly those where the asset-based component was only a small part of a complex capital structure involving other bank and capital market debt products."

But other parts of the market have witnessed vibrant activity, as confirmed by Paul Beveridge, a managing director of KBC Business Capital. "There is a generally lower level of demand for some applications of ABL. However, there is still a strong demand for refinancing and restructuring, as companies and advisers are turning to ABL as an available and committed source of finance – as opposed to on-demand overdraft financing," he says. The refinancing of corporate debt with asset-based loans has indeed experienced an up-tick, particularly in the second quarter of this year, due to the large number of companies struggling under heavy debt burdens.

Several experts have also noted that asset-based lending has been busy in the area of 'amend and extend' for existing asset-based facilities, as part of a broader restructuring of a business's capital structure. Some exit financings by companies seeking to emerge

from bankruptcy protection, and debtor-in-possession (DIP) financings for companies in Chapter 11, have also become more common, given the large number of businesses collapsing. "In addition, fewer companies are making a profit, and are therefore remaining asset-based borrowers for much longer than in the past. Indeed, many borrowers used to be profitable enough to be considered 'bankable' and transitioned to conventional banking versus remaining asset-based lending borrowers. This is no longer the case," points out Donald F. Clarke, president of Asset Based Lending Consultants, Inc.

Besides the current crisis, and the subsequent lack of financing, one of the main drivers encouraging the recourse to ABL has been its flexibility, availability and attractive pricing, compared to other types of funding. But the credit crunch has also made banks more wary of lending money, making them turn to ABL, which is considered to be a safer credit facility, says William S. Veatch, a partner at Morrison & Foerster LLP. "In the pre-recession era, there was a trend towards 'covenant light' credit agreements and loose collateral arrangements, giving the borrower complete control over its business. In the current recession, lenders are reverting back to fully-secured, asset-based loans where the lender has airtight protection vis-à-vis the collateral, and a significant voice in the event that there are early warning signs of trouble in the borrower's business. The recession has necessitated a return by lenders to stricter credit underwriting requirements," he adds.

Seizing opportunities, avoiding pitfalls

Asset-based lending is particularly recommended in some sectors or for certain types of companies, such as capital intensive businesses with assets that can be leveraged to provide working capital. Companies with assets that specifically encourage ABL funding are concentrated in the manufacturing, retail and distribution sectors, but also in the services industry. Types of assets usually include stocks or inventory, plant and machinery, property, as well as brands and intellectual property, given the fact there is a greater certainty regarding their valuation in terms of recovery. But some experts insist most categories of assets can allow a business to find

credit in the form of an asset-based loan, as every company has receivables.

But ABL is not only being used solely by struggling companies – it can also be a positive tool for taking advantage of opportunities in the market. “In addition, companies experiencing strong growth with limited capital investment look to asset-based lending to provide the working capital they need to fuel expansion,” adds Mr Clarke. Some businesses operating in specific sectors are pursuing this type of lending in particular, as part of a broader investment strategy. “The recession has created significant buying opportunities across all industries, for businesses to complete strategic acquisitions of their competitors at an attractive price,” explains Mr Veatch. “Asset-based loans can be an invaluable tool for completing such an acquisition financing. Opportunities exist in all industries, including the technology sector, where the assets consist largely of intangible intellectual property rights.”

The other benefits of ABL for borrowers include the fact that it provides a revolving line of credit attached to asset values. In other words, the borrower can use the facility only when needed and pay it back when money is available. “Also, ABL represents a source of funding that will grow in line with sales. This can be an advantage as the recession ends, due to the fact that ABLs are well placed to support increased working capital needs, unlike other funders,” asserts Mr Beveridge. The financial resources of the borrower will also be affected less by a slowdown in business. For lenders, the ABL borrower is usually a long-term client that provides steady revenues. It also represents funding linked to collateral values, which can be monitored. The lender gets information, on a regular basis, regarding the borrower’s situation, and can therefore react quickly if issues arise, explains Mr Morse. “The reporting and monitoring of the borrower and its assets provide the lender with a basis for better understanding its risk and being proactive in dealing with such risks. Also, having the collateral as

a basis for its exposure gives a better exit than for most debt products,” he says.

Even though ABL is attractive for both borrowers and lenders, there are a number of risks attached. Fraud and information manipulation is one, although it can be mitigated by collateral monitoring and auditing, among other tools. Another risk is that changes in asset valuations are constant, making it essential for the lender to maintain the proper ratio between the outstanding loans and the value of the collateral. Hence companies with reliable valuations are usually the best candidates for asset-based lending. “Also, one of the risks in asset-based lending is the risk inherent in specific asset types,” says Mr Veatch. “In other words, it is not sufficient to simply take a perfected, first-priority lien or security interest in all assets, but rather it is essential to understand other factors that may make it difficult to realise value upon a foreclosure on the collateral. For example, as a general rule, a lien on licences for intellectual property cannot be enforced without the consent of the licensor. Therefore, it is essential to understand when third-party licensor consent is required,” he explains. Mr Veatch also gives the example of assets that are on lease, such as shipping containers. In such cases, he recommends understanding the nature of the leasing business, including fluctuations in utilisation rates and rental rates.

Specific issues can also arise in cross-border deals, given the different legislations involved. Such transactions are particularly attractive in the current turmoil, as they allow investors to enter new markets, but there are several legal risks attached. “The lender must be connected with perfection issues, as all legal domains have specific nuances which affect perfection,” insists Mr Clarke. “It is suggested that the lender procures legal counsel who are fluent in local laws to do the documentation in the specific country where the borrower is domiciled.” Obtaining advice from local professionals is indeed essential to avoiding potential pitfalls. Regarding liens, for example,

various options exist. In some jurisdictions, title retention may be preferable to a security interest, while in others, a letter of credit is advised. Concerning taxes, liabilities can be minimised by careful planning, so that parties can take advantage of tax treaties. “Also, it is important for the lender to understand the insolvency process in the applicable jurisdiction, as well as the basis on which an insolvency administrator, receiver or other court-appointed official might seek to avoid the liens of the lender, and how the insolvency administrator might approach the realisation on the assets,” explains Mr Morse.

Mitigating those issues and being able to seize opportunities related to ABL is particularly important, as activity is expected to continue growing over the next few months, at least. “This should be the time when ABL can become the mainstream and preferred source of lending for businesses, driven by Basel II, and the scarcity of available capital for banks following the recapitalisations and recession. ABL will increasingly be promoted by the professional advisory community as the best way of sourcing funding, as we come out of the recession,” predicts Mr Beveridge. Some experts also believe that restructurings, workouts and insolvencies will continue to dominate ABL activity, given that most companies are currently trying to navigate the downturn. “Although there is a preponderance of questionable loans in this present toxic economy, lenders are hesitant to do write offs but will elect instead to do restructuring, allowing the borrower enough recovery time after weathering this difficult economy,” says Mr Clarke. But ABL will also continue to steadily grow in other areas, particularly in ‘club deals’ and the middle market. Indeed, despite the fact that all lending activities have been impacted by the recession, debt is still being utilised as a tool. And the various benefits attached to ABL are expected to continue making it one of the most popular types of credit facility in the current financial climate. ■



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William S. Veatch’s practice is focused on representing foreign and domestic banks, equipment leasing companies and other institutional lenders in the structuring, documentation and administration of various forms of complex debt and equity financings, including asset based and leveraged lease

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Prior to joining Morrison & Foerster, Mr. Veatch practiced with Cooley Godward in its San Francisco office. Early in his legal career, he practiced corporate law with Hosie, Wes, McLaughlin & Sacks in San Francisco. He was assistant counsel at Bank of the West in Walnut Creek from 1990 to 1991.

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