EXPERT Q&A

Asset-based lending has certain compelling features when measured against cashflow lending, say Gordon Brothers' global head of credit Mark Bohntinsky; managing director, capital, Samantha Findley; and chief transaction officer Kyle Shonak

How flexibility is driving demand

Q Over the past few years, we've seen a huge increase in interest in the asset-based lending industry, particularly on the private credit side. What has been driving this demand?

Mark Bohntinsky: First, when you look at asset-based lending (ABL) versus cashflow lending, many private equity firms and other borrowers have realised that ABL provides more flexibility. ABL is generally less covenant driven, but everything is tied to asset values and liquidity. ABL can give companies flexibility to operate their businesses with fewer restrictions than a typical cashflow loan might require. For industries that are working capital intensive, that can be very attractive.

Secondly, when you look at bank ABL versus private credit, the regulatory environment has left banks less willing to take on certain levels of risk. They are under pressure to get out of these loans because of regulatory capital requirements, so as private credit has grown, the pricing differential between private credit ABL and bank ABL has compressed.

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Kyle Shonak: ABL was previously viewed as an alternative financing option for distressed companies that did not have the cashflow needed for traditional loans, but it has become more accepted as borrowers have grown to appreciate the ability it gives them to leverage assets to navigate the ups and downs of business cycles. ABL allows more liquidity in a lot of instances and can deliver cleaner capital structures, in part because lenders are focused on where companies are currently in their operations, instead of looking at past performance. Additionally, the flexibility ABL provides benefits companies at all stages of their lifecycle.

Samantha Findley: In Australia and New Zealand, pure borrowing base financing structures for retail and commercial inventory or industrial plant and equipment are still relatively new when compared with the North America and EMEA markets. Year on year, ABL continues to evolve and is gaining substantial interest from such asset-rich borrowers, in particular those with private equity sponsors seeking to increase both leverage and flexibility to support growth and turnaround strategies. This

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>
> **SAMANTHA FINDLEY**

growth in the ABL space is being seen now both in private credit funds who are not subject to stringent prudential regulations focused on credit profiles and performance of borrowers, and also trading banks in situations where the credit profile can support a mix of borrowing base and financial covenants.

Q What are the political and economic factors driving increased demand in ABL?

MB: ABL tends to experience higher demand during periods when the economic cycle is either high growth or under stress. That is when we see more opportunities and look at more transactions because we can often get comfortable with things that cashflow lenders may find difficult.

KS: Economic uncertainty lends itself to ABL. Borrowers can get an appraisal taking into account what is going on today with their business, whereas cashflow lenders look back two years. Also, given its increasing acceptance, ABL can be competitive with cashflow lending from a pricing perspective.

SF: Political and economic instability tends to drive earnings volatility, which can quickly unravel borrowers subject to earnings-based covenants. Asset values, particularly hard assets and pools of accounts receivable, are not typically as volatile, making ABL structures more attractive in times of uncertainty.

Q What does the current growth of ABL look like, and do you expect it to continue?

KS: The ABL market is seeing a substantial number of new entrants in the US. There has been less M&A activity and so capital has been sitting on the sidelines – direct lending through ABL is another way for investors to deploy capital and price it in line with their risk tolerance. At the same time, ABL is growing in other jurisdictions and funds are expanding their platforms in response to borrowers growing internationally.

MB: As ABL becomes more common in private equity, in new industries and in new geographies, growth shows no signs of slowing. The flexibility it provides, the fact that the pricing differential between private credit ABL and bank ABL has compressed, and the regulatory pressure that banks are under means the market opportunity just keeps growing.

SF: As previously mentioned, ABL is in a rapid growth trajectory in Australia being driven by private credit players and increased interest by the domestic banks, which are also seeking to partner with private credit on ABL solutions, as is common in other global markets, to recapture market share. This should lead to increased leverage, lower interest costs and a balanced risk-sharing approach.

Q With the increase in entrants to the ABL market, what are some of the biggest challenges or opportunities that both lenders and borrowers are facing?

SF: For borrowers, the biggest opportunity is more optionality, which in turn

Q Are there regional nuances to asset-based lending? What trends are we seeing globally for ABL?

MB: From an ABL perspective, the one thing you need to be comfortable with as a lender is the insolvency laws of a jurisdiction and how the wind-down of a company works. You need to understand what potential reserves you need, whether that is entitlements or other types of expenses that need to be paid through a bankruptcy process.

There are laws you need to understand as an ABL lender to be sure you can operate and behave in a way you are used to, to execute your strategy in line with how you underwrite a deal. There are jurisdictions today in which asset-based lenders are less comfortable because laws do not allow lenders to liquidate collateral or exit deals as they like.

The US and Canada are very efficient markets from an ABL perspective, with lots of case law and precedent, and the same is true in the UK and Australia. As you start to get into other markets, there are more nuances that factor into an ABL lender's decision making.

SF: There continues to be a phenomenal influx of private credit players into the Asia-Pacific region, and Australia in particular, driving the focus on ABL. Australia and New Zealand are sought-after jurisdictions for ABL, given the strong insolvency and security regimes.

drives better terms and better pricing. The challenge for lenders is to continue to be dynamic and consider new ways to structure facilities to provide more flexibility at competitive pricing while not compromising on the integrity of the facility and risk appetite.

KS: There are more people lending money, but that does not necessarily mean people have the knowledge, experience or acumen to be in ABL. When things get hyper-competitive, you see people sacrificing structure or pricing, but ABL really comes down to the predictability of asset values. If you are not taking into account EBITDA or the predictability of the business, you need the confidence in your ability to realise on your asset values through those twists and turns. That can be a pitfall for some new entrants.

As a lender, you can fall into the trap of sacrificing things that will help you monitor where you sit on the risk curve. If you give up too much, things can slide pretty quickly if values or asset levels change, and you may find yourself in a much riskier deal.

MB: Another real challenge for our industry is attracting interest from finance majors. There are a lot of people who have been in this industry for decades, but many graduates aren't as familiar with ABL as they are with private equity or investment banking. As a firm, we are fortunate to have a good mix of those experienced in ABL and those with general finance backgrounds who are newer to this sector; but recruitment is an issue that comes up all the time in industry panels.

Q How important is portfolio management within ABL, and what do borrowers need to look for in their lending partners when sourcing capital?

SF: Integrally understanding the business and continuously monitoring your client is vital to an ongoing and successful client relationship. Identifying potential issues well in advance provides increased optionality for solutions.

MB: The key from an ABL perspective is that lenders get paid to take on risk and have to identify the risk and mitigate it, then maintain discipline and rigour once a deal closes. Lenders have to make sure they are getting updated due diligence to understand the keys to the transaction that will impact the loan and provide optionality if issues arise.

One of the things we pride ourselves on is working with clients if they have problems – if you understand the value of the assets, you can help clients navigate tough times, then clients want to stay with you. That also comes down to robust structuring as you scale, consistently leveraging your resources to understand what assets are worth as we go through a cycle, and continuously watching what that means for your risk profile.

Q How do managers need to evolve to meet the demands within the ABL space?

KS: We are fortunate to have a 120-year-old platform as one of the best known asset appraisers and traders in the world. We have built a capital platform around that asset expertise and we have evolved over the past few years to offer more capital products to our clients based on our deep knowledge of assets and how to treat them.

Borrowers need their lenders to build out a pretty large menu of options for them, whether that is being able to exit a bank out of a transaction, speaking for the entire spectrum of an ABL programme, or providing ancillary offerings like sale-and-leaseback or vendor financing to maximise liquidity. ABL is about maximising the liquidity you have in your assets, and we have positioned ourselves to be a one-stop-shop helping our clients maximise every dollar in every pocket of assets they own.

That requires managers to have deep expertise across assets. To meet client demands you need to know what their needs are, what drives those asset values and how you can best structure your financing to give clients the flexibility needed for maximum value. ■