ROUNDTABLE

Fit for purpose

In a recent roundtable hosted by Real Deals, ABL lenders and advisers discussed what ABL can bring to the table for private equity sponsors.

PANELISTS:

Graham Barber
PNC Business Credit

Steven Chait
Wells Fargo Capital Finance

Paul Craig
SIA Group

Dave Edwards
FRP Advisory

Jeremy Harrison
ABN AMRO Commercial Finance

Jon Hughes
IGF

Mark Parsons
Shawbrook Bank

Martin Noakes
NatWest

By *Nicholas Neveling*

To begin, I wanted to build a sense of what sponsors want from lenders. What are the key capabilities? What are the turn-offs?

Dave Edwards: Working in the sponsor environment is a very, very demanding exercise. They want to know that they're dealing with credible people who, when the going gets tough, will deliver. What they want is a solution, not necessarily a product. People who can offer credible solutions are the kind of partners that sponsors want to deal with.

Paul Craig: First and foremost, the most critical factor for sponsors is the certainty of delivery. In a sponsored transaction, where time is of the essence, everything is conducted at pace and you've got to make sure that when you're committed, you're delivering the desired quantum and you're delivering on time. From our perspective, as a vital link to both the ABL and PE, teamwork, and trust are paramount, from the initial due diligence discussions to supporting the management team post-transaction as they seek to drive growth.

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> **Graham Barber**

So what does that mean for lenders? How can a lender position its offer to best interface with what sponsors are looking for?

Graham Barber: Lenders have to know which deals we are relevant for, where we are relevant as a solution, and then stay where we are relevant. Don't try and do deals that aren't you, because that's when your credibility erodes, and that's when your ability to execute and deliver becomes harder because you're not relevant, you're not reliable, and you're not repeatable. To me, that's what the key deliverable has to be. Play where you're strong and don't play where you don't need to be.

Generally speaking, does the ABL community have a clear understanding of where it can play and where it fits in the capital stack? Does it know what its advantages are relative to the other options?

Steven Chait: Definitely. I think we've developed very good relationships with the private equity community over the years, and I think they've come to trust us and our product. And yes, I think we all know where we sit in the capital stack.

The interesting thing that we've seen in the last couple of years is the move from ABL being that last form of finance to something now that's a product that gets deals done and gets good deals done. The better deals are where deliverability is key.

So if the ABLs are very clear about what their strong points are, is there awareness in the sponsor community of that capability?

Mark Parsons: There are certain sponsors who completely get it and they're very comfortable with using it. And yet, there are still plenty of others who default straight to a leveraged structured finance solution because they see that as the default move. And that's where it comes around to that point, particularly post-Covid, that they will be looking to deal with people that are able to demonstrate that experience, that knowledge, and that ability to get things done. This is where we need to be better at explaining why ABL is an equal.

Martin Noakes: Traditional leverage finance, super senior revolving credit facilities (SSRCF) and Term Loan A/B structures have been used for years and it's what the majority of private equity firms are used to using. That said, there is undoubtedly a place for ABL in a number of these structures that would traditionally been done on a straight leverage financed basis.

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> **Steven Chait**

I also think that given where the economy is, other sources of liquidity are not as fluid as they have been historically. Debt advisors and private equity are looking to ABL to help plug the gap where companies have accumulated unintended leverage where their Ebitda are much more volatile because of the pandemic.

Jon Hughes: When sponsors have a good experience with ABL, and see it working in their deals, then word spreads and momentum builds. If ABL works well the first time a sponsor uses it, then they are going to use it again, because it is a cost-effective form of capital. I would offer a different view from Graham's earlier point by saying that ABL can be extremely adaptable and where the sponsor is willing to work with the lender some innovative and effective solutions can be structured.

However, I would echo what Martin said around Ebitda volatility. Asset values may be more predictable than Ebitda is

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> **Paul Craig**

at the moment, and there are many asset-rich businesses out there that will need to refinance, or be bought or sold. The relative stability in the assets we lend against is probably going to be one of the drivers for some time.

Craig: ABL offers the flexibility of funding. As the working capital requirement of the business expands, so the asset base increases automatically and consequently so does the availability of funding generated. With a bank overdraft or a fixed loan facility, a business can easily find itself constrained by fixed limits and ceilings. Conducting an asset valuation and collateral due diligence ensures that the maximum headroom can be built into a transaction on day-one to enable growth.

What has been interesting to observe is that in some of the work we have completed recently on working-out the assets, we have seen companies getting near-new prices on assets. Asset values are holding up extremely well in the current climate, which brings even greater certainty to event-driven ABL deals.

Jeremy Harrison: Every year we are doing more deals with sponsors who are new to ABL, but there is still a way to go. Unlike the US, the bulge bracket of big private equity firms in Europe don't use ABL frequently, but I think that will change. In addition to the mid-market segment, we are doing bigger and more complicated deals now. There is much more of an opportunity and the market is growing.

One area where I see a huge opportunity for ABL is to provide an alternative to the revolving credit facility (RCF). The traditional financiers just don't want to do RCFs anymore. They haven't for a long time. It's not capital effective for them to do it. They only do it because that's what the sponsor wants. But as regulation increases for those types of products, I do believe that ABL will step in its place.

The panel has articulated the value the ABL product can offer sponsors very well. Given all these advantages, should ABL have a larger market share than it does presently?

Barber: Some context is important here, and I think you do need to take into account how the M&A market has performed over the last 12 months. Around three-quarters of the deals that have been done have been in TMT, healthcare, and business services. So, they're not exactly asset-rich fertile territory for ABLs.

The sponsors also have a plethora of capital that needs to be deployed. Now, the multiples have been considerably higher in the three sectors I mentioned, but considerably lower in the sectors that are traditionally ABL territory, such as manufacturing and distribution.

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>
> **Dave Edwards**

ABL is relevant in larger asset-based businesses where you can have a larger proportion of your debt structure on a revolving, non-amortizing basis at a much lower cost of capital. In a leveraged finance structure, by contrast, there is a lot more high-cost capital that's sitting out there with a seven-year bullet.

So, you've got to know where you're going to play. You can put an ABL revolver in front of a leveraged finance structure to replace the superseding or RCF, as Jeremy mentioned. Our cost of capital is also considerably cheaper.

But, sponsors have to get over the hump and be clear that ABL is super senior, that it has its triggers and that it can move the asset base. Once sponsors understand that, they can see that ABL is usable and that it works. I know we've said this for a number of years, but borrowers that use ABL love using ABL, and they don't like to go away from it.

What about this question around speed of deliverability. I think it is fair to say that there is a view in the sponsor community that the ABL product is great, but that in a fast-moving deal process the ABLs require too much time for due diligence?

Craig: One significant change in the market has been that financial sponsors and corporate financiers have a better understanding of ABL and are coming to us earlier in the deal process to discuss the various asset classes and collateral due diligence requirements. Previously, you'd have a situation where ABLs would bring in their own due diligence teams later on in the deal process to look at the assets, whereas now we're being instructed at a much earlier stage to provide all of the information required in one all-encompassing collateral due diligence report.

We work closely and diligently with the company's management team and the financial sponsor to understand nuances, ask the difficult questions, and look at anything that needs to be challenged to enable the key parties to make more informed decisions. We have deep working relationships with the ABLs, and they know that we will deliver precisely what they are looking for in terms of their due diligence requirements, with the advantage of an independent perspective being brought to the deal structuring process.

Today, the ABL due diligence process is more effective and efficient as it is now considered a prerequisite at the front of the deal process, rather than consigned to being an afterthought towards the end of the transaction.

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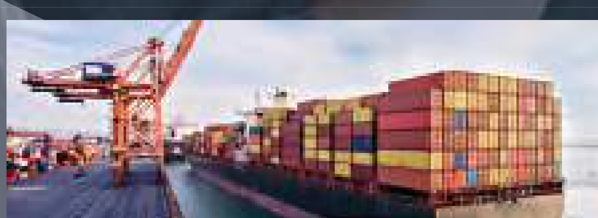

Raising & refinancing debt, ABL

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Debt financing, ABL

Anglian Home Improvements

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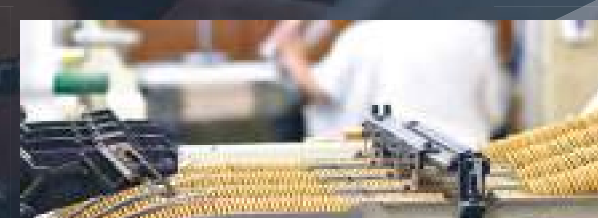

Debt financing, growth finance, ABL

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Manufacturing

Our team were able to source a new three-year, £40 million asset-based lending facility.

Getting in touch

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Some excellent points there. One thing I wanted to follow up on is whether this means that ABLs should be defining the deals they will take on very narrowly? Is ABL always only going to be relevant to certain deals in certain sectors?

Chait: The assets and working capital assets are always going to be crucial for us. There is no getting away from that. What we can do is finance businesses, regardless of Ebitda, because of the collateral cover.

Hughes: I would add that ABL is not just relevant for turnaround sponsors. We've all worked with sponsors operating up and down the risk curve and proven that ABL can provide a cost effective line of working capital or be part of an acquisition funding structure.

Harrison: If I look back 10 years ago, we would not have done any equipment rental business deals. At the time our business was invoice discounting and receivables only. Roll on a decade, and we're very happy to do equipment rental businesses, where the majority of the borrowing base is equipment, it's not receivable. There is value in looking forward and thinking about where we could go with ABL.

Edwards: The sector filter is something that is considered by sponsors, but I think the key thing for the ABLs is to maintain their credibility, whatever the deal or sector. Lending is not sell-and-forget, so if you can't do something because of the contractual elements, or the deal is unusual, don't be afraid to say no. I think people will respect you more for that than stringing them along for six weeks and then pulling out. The quick no is as invaluable as the yes.

If you say I can do this part of a deal, but I will need to work alongside somebody else in the stack and agree on an intercreditor, that's the way you make friends.

Parsons: For us, it isn't about narrowing the deals or limiting the sectors but more about combining the right facilities to create a solution that works.

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Jeremy Harrison

Noakes: The point on relevance and being upfront about what you can and can't deliver is spot on. That said, I don't think that means ABLs have to straitjacket themselves to just vanilla refinances. I am confident there is scope to push the boundaries for the right opportunity. Having confidence in our expertise and being clear on our core sectors where we can leverage our institutional knowledge has enabled us to push the boundaries on some of our product offering.

For example, if a borrower needs committed terms on the table within a couple weeks, and we have experience of the sector and asset class, we can gain approval on a deemed borrowing base basis. Two years ago, that would have been difficult, but now we know that the relationships are there with the advisors and sponsors to support such a process. To remain relevant in such a competitive marketplace we can't be afraid to push the boundaries.

Harrison: We need to be bold on occasions, particularly when talking to certain sponsors. One area where there is a real opportunity to push the boundaries is around ESG and sustainability. ESG is high on the sponsor and LP agenda, and investors want to see what private equity firms are doing about it across their portfolios.

Where it is possible, and where it works, ABL can finance the sustainability and ESG-related part of a transaction. We have all the tools and capability to look at deals where companies are seeking to transition to a more energy-efficient business model, such as electric charging points.

What would that look like then? Would it be that if a deal fits certain ESG credentials, you offer a discount on your margin, or something similar?

Harrison: Yes, exactly. I think that's where we're going to be. I think that is the way that we're going to have to think about things.

Chait: There will undoubtedly be capital expenditure requirements to replace machinery with more environmentally-friendly options. We can fund that capex and we can also provide term loans over and above the assets where applicable. So, rather than just taking out a cash flow loan, a borrower could opt for an ESG loan, that includes asset financing and amortises over a longer period. This is a new area, but I agree with Jeremy, there is a really exciting opportunity for ABLs when it comes to ESG finance.

Mark, I wanted to come back to a point you raised earlier about how ABL can learn from the way unitranche providers have been able to adapt their structures and offer to appeal to sponsors, but without compromising their fundamentals. Are there any specific things ABL can take from how unitranche has evolved?

Parsons: There is. We have seen opportunities to build a hybrid solution, where we bring the strengths of both ABL and unitranche to the table. It means we are able to use the strength that's out there within the asset, while also using the principles of what the cash generation is actually doing, to be able to loosen some of the edges around what will help to make a debt fund or a sponsor more comfortable.

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> **Martin Noakes**

It means we can provide a whole solution when up against a clearer and a debt fund, and take pole position because of the certainty and deliverability. But we can also go to a debt fund and work alongside them if they can't do the whole structure on their own.

Hughes: I do think there is an opportunity for ABL to continue to test some of its self-imposed rules in the right circumstances.

Historically, ABLs have been quite conservative about particular fixed asset classes, but I think we can be more ambitious about what the product can do. As long as you do this in a collegiate way and don't let the advisory and sponsor communities down at the point of execution, you can step beyond the well-defined areas for ABL. You are more likely to do this for a well-managed business which, typically, sponsor owned businesses tend to be.

One theme that has run through the conversation has been the evolving interplay between the debt funds providing unitranche and ABLs. Is there more opportunity to work with debt funds, with ABLs providing the RCF and the debt funds laying on the term loan?

Noakes: There is definitely an element of the market that is going in that direction. Partnering with debt funds and other finance providers to provide a full solution is going to be key.

In a typical super senior debt fund structure, ABL may only be providing between 10 to 20 per cent of the capital stack, with a debt fund covering the remainder. The debt fund will therefore want to control its investment in the short term, as opposed to the ABL provider taking control on day one.

We are absolutely aware of the control dynamic in these structures and we work with our partners via the intercreditor, adjusting controls and standstills for each scenario.

We also see other transactions where the company may want to maximise the funding benefit out of their receivables base. Again, this is fine, however we will look to adjust the control dynamics accordingly.

There's no right or wrong answer and there is no one solution that will fit all, however, as ABL tranches figure more in these types of financing solutions going forward they will become more commonplace.

Edwards: Working on an intercreditor basis with another lender is a skill that the ABL industry has only acquired in the last five years. I think that will be one of the big trends. Those who want to keep all the rights and remedies themselves, they're just going to keep themselves out of that market.

On a related point, there have been so many punchy capital structures put together in recent years on high leverage multiples, and with the Covid situation, you can't tell me that those leverage multiples haven't increased. The debt funds behind these structures are going to have to show some form of return to their investors, and I can see that happening by turning to ABL to refinance.

Chait: Somebody's going to have to fund the next round of new working capital and provide the money to get businesses going again. ABL is perfectly placed to do that.

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