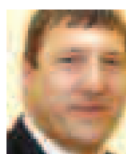
Powerful leveraging



Jon Norton of Burdale Financial Limited explains how comprehensive asset-based lending is making inroads into the UK.

Executive summary

- Corporate treasurers are finding an increasing need for asset-backed lending which provides flexible support to the increasingly complex working capital and cash needs of today's corporates.

On a global basis corporate treasurers have enjoyed the services of specialist asset-based lenders for many years. The UK alone boasts experienced companies and teams specialising in finance for aircraft, ships, properties, etc, on the large, fixed asset side and book debts and stocks on the working asset side. Many of the providers of such finance specialise in a particular asset class rather than providing flexible working capital finance to support the myriad cash and working capital needs of a company.

Comprehensive asset-based lending (CABL) – the product offered by my company – is playing an increasingly prominent role in corporate finance. CABL is senior debt, just like conventional bank debt, but it differs in that it can be secured against all the assets of a business. The key is to incorporate all the fundable assets (valued at market rather than book values) into a single structured funding package, the borrowing base, which gives the company sufficient liquidity (headroom) to operate its business.

Unlike conventional bank debt, CABL does not depend exclusively on analysing the future cashflow of the business (except to calculate that there is sufficient headroom available to the company over the life of the facility), so CABL facilities generally enjoy lighter covenant structures than cashflow facilities, providing the same degree of leverage.

CABL lenders protect their position by thorough monitoring of the asset base. This control, while initially seeming to be an additional administrative burden for the treasurer, frequently yields benefits to the company in terms of better controls and reduced working capital.

WELL ESTABLISHED CABL has been established in the US for many years (the US market is estimated at some $185bn, according to Asset Based Finance) and has developed into far more than a niche financing product. As well as the 'traditional' CABL product for mid-market companies, we have witnessed increasing utilisation of ABL in the 'top slice' of large buyouts as an alternative or addition to the revolving credit fund (RCF) tranche. A good example would be the recent – and, at the time, record – $33bn buyout of HCA by Bain Capital, KKR and Merrill Lynch Global PE. A $2bn ABL loan tranche augmented the $21bn of other senior debt, $5bn of second lien and $5bn of common equity. The ABL tranche accommodates the seasonal fluctuations in working capital and carries slightly lower pricing (see *Chart 1*).

European security laws mean that pan-European activity is primarily driven by invoice financing in quasi-securitisation structures. However, we do expect sizeable, multi-jurisdictional European CABL transactions to complete in 2007. In the UK, where CABL is still relatively underutilised, there is a growing realisation that it is an ideal source of funding for borrowers in transition who might otherwise face higher-cost junior, senior and mezzanine debt (see *Figure 1*).

Companies undergoing restructuring, or even companies that are not performing as they should, face many challenges, not least when it comes to gaining access to finance for working capital or for capital investment. Traditionally, banks' credit analyses of companies in this situation generates a high probability of default (PD) rating and an uncertain loss given default (LGD) rating, mainly because they fear the companies' distressed situation makes them less secure when it comes to repaying bank debt.

Also, banks are less aware of the underlying asset values of previously investment-grade or quasi-investment-grade clients. Many stressed companies, as a result, find themselves in a vicious circle:

Chart 1. How asset-based lending works

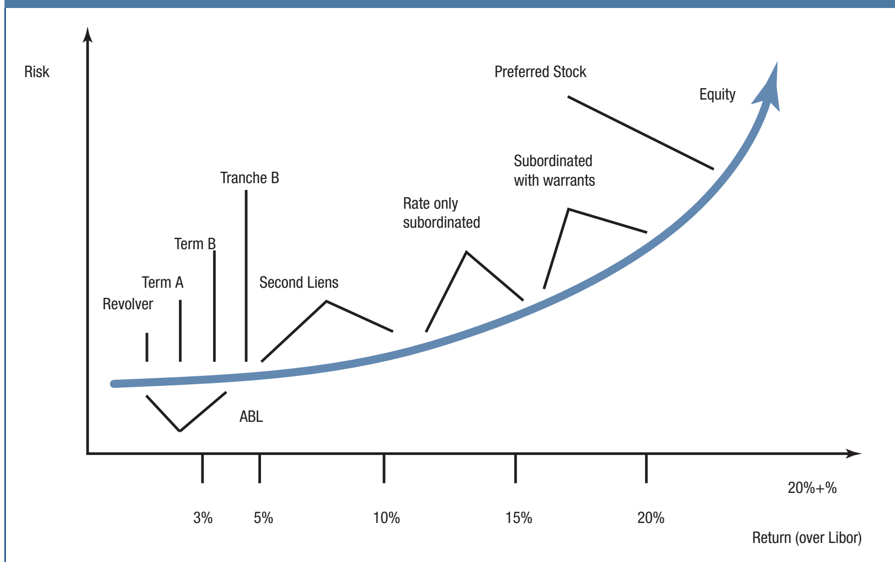


Figure 1. CABL's better funding mix

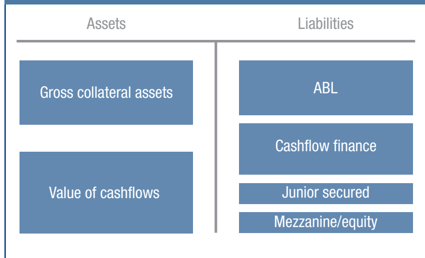
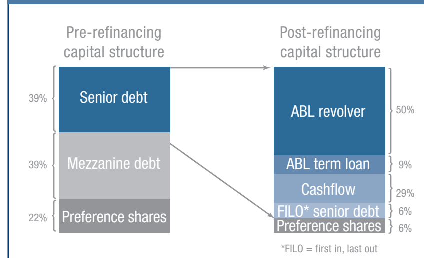


Figure 2. Effects of CABL refinancing



they need access to finance to recover or improve their situation, but that finance often cannot be obtained on satisfactory terms – the banks' pricing models are frequently driven by PD rather than LGD ratings – until the companies have turned themselves around.

POWERFUL WAYS OF LEVERAGING CABL is one of the more advanced forms of asset-based commercial finance and one of the most powerful ways of leveraging a company's underlying assets. Other asset-based forms of finance, such as factoring and invoice discounting, have been around for many years, but CABL is a relatively new and specialist form of financing. Because it is not limited to one particular asset class, shortfalls in, say, invoices might not lead to a liquidity squeeze in a business financed by CABL. The CABL lender may be willing to cover the shortfall by reloading the property lend, for example.

Typically, businesses that would benefit from CABL are capital-intensive, have significant tangible and/or intangible assets, are highly leveraged and may be underperforming or undergoing a major transition. CABL is also an ideal funding solution in turnaround situations and an increasingly common component where private equity is investing in turnarounds.

Using a recent example as a case study, Burdale arranged debt for a leading energy distributor which replaced a significant portion of accreting mezzanine debt with structured senior debt (see *Figure 2*). Following a buyout, the company managed to reduce its debt by half – but it was the cheaper senior debt and not the expensive mezzanine finance that was reduced. Because CABL requires less amortisation than traditional leveraged debt, a lender can refinance the debt to the extent that on this occasion the company was able not just to degear and reduce debt, but to look at small strategic acquisitions at a far earlier stage than if the initial capital structure had been maintained.

CABL deals in the UK have been as large as £160m, but deals can range from as little as £10m to as high as £250m. Burdale estimates the UK market size at about £1bn in 2006. There is a growing acceptance of CABL, as demonstrated by the plethora of household name companies which have benefited from it. Companies can obtain CABL finance without diluting equity or having to use expensive second lien or mezzanine finance.

Periodically, conventional debt markets may undergo a tightening of underwriting standards driven by credit losses, but asset-based finance is a source of funding that is much less volatile and which does not tend to suffer from periodic bouts of excess liquidity and illiquidity.

A GROWING REALISATION Virtually any quality asset of a company may be included in a CABL package, whether tangible (land, buildings, plant, machinery, stock and debtors) or intangible (brands, titles or goodwill). As a result, funding levels are determined subject to the underlying asset base being maintained at agreed levels, rather than against conventional covenants such as cashflow or the performance of the business. In many cases, CABL lenders have leveraged the client's asset base to a far higher degree than conventional lenders.

Private equity houses have tended to avoid asset-based lending, mainly in the belief that their investment should be secured by cashflow. But the default of some high-profile private-equity backed enterprises on their banking covenants has led to a reappraisal by the private equity industry of CABL as a way of financing investee companies. It can suit companies where shareholders and investors may be looking for partial or full exits. It can allow a successful company to refinance amortising debt, allow dividends to be paid and loan capital to be returned to shareholders.

There is a growing realisation among companies and their professional advisers that asset-based financing is an ideal solution for many companies, particularly those which, for reasons outside their control, find themselves running to stand still.

Burdale
Financial Limited

A decade ago, Burdale Financial Limited (Burdale), now a wholly owned subsidiary of Bank of Ireland, identified a niche for providing finance based on substantially all of a client's assets – property, plant and machinery, stock, book debts and, in some cases, intangible assets. For more details, contact Jon Norton, BSc (Hons), ARCS, MBA, Director, Structured Finance, at Burdale Financial Limited

jnorton@burdale.co.uk
www.burdale.co.uk