Browne Jacobson

The reasons for asset-based lending's growing acceptance as a preferred funding source

13 July 2023 Shaun McCabe

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As the debt market evolves to address UK and global economic conditions, there is increased willingness and appetite for assets based lending (ABL) as businesses and lenders seek a broader range of funding solutions. In recent months, ABL is becoming an increasing prominent part of senior debt funding structures. Shaun McCabe, joint head of the banking & finance team at Browne Jacobson, explores the key drivers impacting the increased use of ABL and some of the innovations in ABL and market trends.

ABL has been a funding option for many years with both mainstream and challenger banks and numerous independent funders providing ABL facilities. In summary, ABL is a financing based on, and secured by, the assets of the business and structured to provide working capital by monetizing assets on the balance sheet (which can include receivables, plant and equipment, real property, inventory and intellectual property). ABL differs from a traditional cash flow loan which is based on a borrower's historic and forecasted cash flows which determine the level of debt provided to a business.

Changing economic conditions

During the COVID pandemic the market for ABL was relatively quiet, with funders and businesses preferring the use of revolving credit, term loan and overdraft facilities (often backed by a guarantee from the UK Government as part of the CBILs/CLBILs/Bounce Back schemes). Since then, raising interest rates and inflation has led to more caution in the debt market with credit underwriters preferring to structure, in whole or in part, funding solutions based on asset values given the improved collateral this offers to funders compared to cash flow lending. A significant number of CBILs and CLBILs facilities provided during the pandemic are coming up to maturity and need to refinancing. Unless repaid on maturity, going forward those facilities will not have the benefit of the CBILs/CLBILs government backed guarantee. Lenders ae increasing focus on credit risk and , in certain cases, the most viable (or possibly the only) funding option to refinance these facilities will be some form of ABL facility given the increased security it offers funders compared with other types of lending. In certain sectors (for example manufacturing) ABL may become one of the main sources of finance available in the market.

ABL has always been an important source of funding to businesses in stressed or distressed and turnaround situations. Even though the UK has avoided going into recession, there have been numerous businesses which have been adversely impacted by inflationary pressures, raising interest rates and the cost of living crisis. Banks have increasingly flipped overdraft or revolving credit facilities into receivable financing facilities. In restructuring situations, ABLs have also refinanced bank funding from distressed borrowers.

Pricing

For borrowers, ABL often represents a competitively priced option compared with cash flow lending given the asset backed nature of the facilities. ABL pricing is a mix of interest (or discounting charges in invoice finance facilities) and upfront and on-going fees. The blended cost of capital is generally lower than a leveraged cash flow loan. In a higher interest rate environment, borrowers have increasing turned to ABL to source competitively priced funding.

Sponsor market , facility terms and committed facilities

In recent times, private equity sponsors have become far more comfortable with utilising ABL in their transactions including management buy outs and acquisitions. Those ABL providers focused on the sponsor community have worked hard with sponsors to allay their concerns. For instance, standard ABL document gave ABL providers significant flexibility to alter limits and other terms in their documents. The “uncommitted” or “on demand” nature of the documentation did not suit sponsor backed transactions. Certain ABL providers have recognised this issue and agreed more committed facilities. We have seen a number of private equity transactions where a sponsor has formed an on going relationship with an ABL , providing funding to a number of companies in its portfolio. In addition, the Loan Market Association has recognised the importance of ABL to the debt market and published a borrowing base facility agreement to facilitate market practice and standard terms for ABL facilities.

Innovations in ABL facilities

With the macro-economic conditions being as they are, we have seen funders having broader conversations with funding solutions. Increasingly important is the need for flexible funding solutions to help businesses meet the challenges they face.

We have seen certain ABL providers give more thought to creative and bespoke funding packages. For instance, we have seen one lender changing the nature of the facilities to further enhance the flexibility of its ABL funding to simplify and speed up businesses unlocking vale ties up in assets. Rather than advancing funds against individual classes of assets (such as inventory or receivables) the ABL lends against a number of difference fundable assets classes. This enables businesses to benefit from enhanced funding availability through its working capital cycle and can be adapted to the needs of each borrower. For example, funding availability under an invoice discounting facility may be impaired by “reserves” (i.e. an amount which the ABL may reduce availability e.g. because of an issue with certain customer invoices). By taking into account the value of other assets (rather than limiting funding for each individual asset class such as receivables) the effect of this on funding availability may be offset or mitigated. These types of facility is provided by way of either a term debt or revolving credit facility (or both) with a borrowing base certificate being produced on a monthly basis. It is likely that these innovations will increase ABL funding for strategic opportunities including supporting an acquisition buy and build strategy.

It is also worth noting that, for particularly strong borrowers or those backed by private equity houses, some ABLs are willing to offer cash flow lending as a bolt-on to ABL facilities.

Technological advances

There has been significant technological advances in the systems employed by businesses and by ABLs. In an environment where lean manufacturing is increasing important to the business competitiveness, businesses have invested heavily in technology to facilitate fast moving inventory. These advances have allowed ABLS to monitor inventory in real time and electronically which, in turn, has got ABLs more comfortable in funding against inventory values. ABLs have also invested in the platforms used by their customers to operate and manage ABL facilities allowing businesses to receive the funds they need quickly.

Final thoughts

There is no doubt we will see ABL as being more prevalent as a funding solution over the next few years with the factors outlined above providing driving this trend. Liquidity in the market (and in the past few years debt has been plentiful) and lending appetite remains strong but is now tempered with more caution amongst credit underwriters faced with economic uncertainities. ABL correctly structured can often provide the solution to the need for provide funding to a business whilst providing lenders with the comfort they need if that business does not perform to plan. It also offers the flexibility needed as the business grows whether organically or by acquisition. Willingness by ABLs to adapt their funding solutions and give a greater level of commitment will serve to enhance ABL as an important source of funding in the UK economy.

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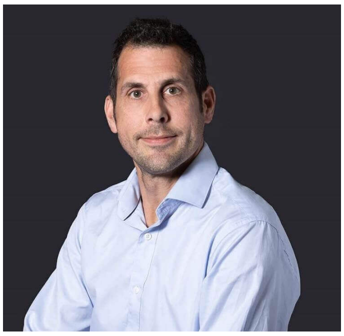

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