

AT THE TABLE

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Stephenson Harwood

James Cullen
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Jon Hughes
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Jake Hyman
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ABL COMING OF AGE IN DISLOCATED MARKET

Rising inflation, climbing interest rates and wider macroeconomic uncertainty have taken a heavy toll on debt issuance for private equity deals

Against this challenging backdrop, *Real Deals* sat down with a panel of asset-based lending (ABL) stakeholders to discuss why ABL comes into its own in periods of volatility and how the ABL community is responding to current market headwinds.

How does the overall availability of liquidity to finance deals today compare to a year ago, and what does this mean for ABL providers in particular?

Katharine Weeden: ABLs are usually well positioned to continue lending through downturns, whereas leveraged finance providers become nervous when there is uncertainty.

ABL has a specific approach and can put financing together across the credit cycle. I am not aware of any ABLs that have shut up shop and I think we are all keen to lend.

We see various ABLs looking at how they can partner with other alternative lenders to put together debt packages of larger quanta. The community is also expanding the range of assets that can be funded.

Jon Hughes: We certainly haven't stopped lending in the current climate,

and we have been pleasantly surprised by the quality of deal opportunities that are coming across our desks.

Our experience built up over many years, and particularly through the pandemic, has helped all ABLs to sharpen their skills and understand how to continue appraising and financing deals through periods of uncertainty.

A range of opportunities are opening up for ABLs as interest rates rise and liquidity tightens. Companies used up a large amount of their cash through lockdowns and need to top up the tank to start growing again. Special situations are becoming more prevalent too, and ABL can provide solutions there.

We also see more 'fallen angel' borrowers, who have strong underlying businesses but can't access the same levels of leverage from traditional sources and are exploring other areas where working capital is available.

James Cullen: There is still liquidity in the market across various buckets of capital, but there is a flight to quality by pure cashflow lenders. The senior cashflow lending community has enjoyed a remarkably strong run but has toned down during the last year. Leverage multiples are lower, and pricing and terms have tightened.

In an inflationary environment where the market is shifting, ABL becomes more and more relevant because it can cater for and align with bolstered balance sheets.

At Investec, we are focused on scaling our integrated ABL and cashflow financing solution to private equity dealmakers. Ideally, we want to work bilaterally with sponsors and take all the best attributes of ABL to provide perpetual credit revolvers against the assets on balance sheets, at a slightly cheaper cost of capital, and then blend that with structured cashflow lending, but all delivered by a single team, with a single credit process and a single set of legal documents.

Historically, ABL has hovered around the fringes in the M&A arena – predominantly in special situations and turnaround spaces – but there is a real opportunity to go on the front foot and integrate ABL techniques with cashflow lending and deliver the debt quanta to become highly relevant in mainstream M&A, and provide lower blended cost of capital, which is a real focus for all borrowers right now.

Jake Hyman: We launched Blazehill Capital with the aim of providing flexible and transformative financial solutions to fundamentally strong businesses, no

matter how non-standard the opportunity or how challenging the economic backdrop is.

Recently we have seen the traditional cashflow lenders taper down activity, but we are still out there underwriting, and we see the current credit environment as a real opportunity to accelerate our growth.

At Blazehill we tend to thrive when more traditional lenders pull away in the face of complexity – it's at this point that our team of credit professionals can really add value, taking the time to understand a company's needs and ultimately provide the support to allow sponsors and management teams to deliver on their financial goals.

Cem Yaslak: BZ is a specialist ABL provider, with additional cashflow loans considered where required. The key for us is our ability to structure deals on a bespoke basis, and we do that by looking at each credit on its merits. We offer structured, multi-jurisdictional facilities up to a £150m hold level.

As economic conditions have become more uncertain, we have seen a significant uptick in dealflow from borrowers seeking funding from alternative ABL providers. In response, we have been working closely with



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Don Brown, Stephenson Harwood



Don Brown

borrowers to provide the capital certainty they seek, often providing facilities at higher advance rates relative to more mainstream ABL lenders and sometimes with cashflow loans. We have also expanded the range of assets that we can lend against, such as intellectual property.

Finally, we take a more flexible approach to structuring, working with borrowers to implement covenants that best suit the business.

Debt package quanta is becoming a key factor for opening the door to more M&A and sponsor-backed deals. To what extent are ABLs able to club together with each other, and cashflow lenders, to get to those quanta that will make private equity sit up and take notice?

Don Brown: We have seen some very successful collaborations between different types of ABL lenders. A more conservative ABL, which can't quite cover all of the assets, will partner with an ABL with a higher risk appetite to get to the quantum. It is definitely happening more and more often. The lenders that can offer a cashflow loan alongside ABL, and partner with other ABLs, are strongly positioned and I do expect to see more deals structured in this way.

Where you have an ABL partnering with a traditional cashflow lender, the intercreditor negotiation may be more challenging. You have two lenders with quite different views of life. The cashflow lender is primarily concerned with preserving enterprise value and may be concerned that the ABL will be exclusively focused on the assets. Both sides may have to move from their sweetspots and sometimes it is difficult for them to move enough to meet in the middle.

That said, it is not impossible and it does happen. There are successful deals like this in the market and we have advised on some of them. However, in a market where there is a lot of liquidity, the execution risk can prove unacceptable and somebody will come in and just do that deal on a more straightforward basis. Let's see if attitudes shift now that we are in a period of tighter liquidity.

Yaslak: We have now worked on several successful transactions in partnership with mainstream ABL lenders. These are structured so that the mainstream ABL will sit in the first-out position in the realisation waterfall, typically covered by the receivables. The financing package will cover multiple assets and there may also be a cashflow element in the capital stack.



James Cullen



Increasingly, however, borrowers are seeking a solution under one roof, which is so much easier - with no need for an intercreditor agreement. In situations where a borrower has an intense capex programme and step-up costs to deliver on big contract wins, a blended option can be very attractive

James Cullen, Investec

We are keen to work in this way because it means we can often execute larger tickets and offer a lower blended cost of capital for the borrower. This can go the other way too. Mainstream ABLs can look at transactions that are perhaps non-vanilla for their businesses in usual circumstances but when they reach out to us for extra support, we can help to get a transaction over the line.

This two-way conversation benefits the whole ABL community because it unlocks a higher volume of larger transactions. The structures and intercreditor are often not as difficult as expected. It is important to educate the advisory community about this flexibility and show that ABLs can work together to do deals that they couldn't do alone.

Weeden: Presenting yourself to an adviser as an ABL with an alternative lender that is able to provide the full sweep is definitely becoming something that you see more of. The intercreditor can be a hurdle but we are really focusing on how to move past that and work with different lenders more often.

We have worked hard to agree on high-level intercreditor principles to take away some of that execution risk when deals present themselves. It does help to smooth the path. We have seen deals

recently where the cashflow lenders will want to put a ceiling on overall leverage and cap the ABL at 1.5x Ebitda, which is actually fine for the ABL because the ABL position is then over-collateralised.

When working with alternative lenders that have experience within ABL, the negotiation on the intercreditor is easier. In the current economic climate, where alternative ABL lenders can come in and provide a greater quantum against the difficult assets, this collaboration is definitely the way to go.

There's a real focus on this for us this year. We want to get those integrated principles in place and be ahead of the game when a deal does come through.

Cullen: In the past, the ABL teams and cashflow teams within the same institutions have not cohabited easily. They have different techniques, different agendas and different P&Ls.

Increasingly, however, borrowers are seeking a solution under one roof, which is so much easier - with no need for an intercreditor agreement. In situations where a borrower has an intense capex programme and step-up costs to deliver on big contract wins, a blended option can be very attractive.

You're going to experience occasional speed bumps in cashflows, but when the

ABL credit revolver is in place, carrying meaningful headroom, a lender can think about things differently, with the ability to debt service from that headroom.

Hughes: We have found that offering a blend of cashflow and ABL has undoubtedly helped to gain more traction in the market. Our cashflow offer is relatively modest, but it does help to grease the wheels and get us into some quality deals.

It is worth pointing out that quite often, other stakeholders, particularly PE owners, will be aligned with what the ABL wants; everybody wants to protect enterprise value and make sure that when things don't go to plan, the outcome is as good as possible for all parties.

In our portfolio, about a third of our transactions are sponsor backed, and when we have those relationships, and the collateral is good, we can be more flexible and structure our documents to address any sponsor or borrower concerns.

How you behave, how you manage those relationships, and understanding where the other stakeholders are coming from, delivers a better outcome for everyone.

Is there any evidence that these developments are resonating with sponsors? Is ABL's profile rising?

Brown: I think it is. When circumstances are challenging – which they certainly are at the moment with energy costs, inflation and interest rates – there is a flexibility that an ABL provides that isn't necessarily there in the cashflow in the market, particularly around fewer financial covenants.

Often, we'll see no financial covenant at all, or maybe only one or two financial covenants. There is a lot of flexibility there and a willingness to take covenants out altogether, or to really listen to borrowers around testing and the ability to cure.

The flexibility that comes through ABL lender partnerships, and the blending of cashflow lending, is definitely lifting the profile of ABL. I'm seeing more sponsors starting to use ABL in their portfolio companies.

Once they've had that experience and observed how the ABL works, and how the ABL lender will actually support them through difficult times, the confidence in the product builds and they'll use it for another portfolio company. That is when the relationship really starts to blossom.

The age-old problem for ABL has been the wariness that some borrowers and sponsors feel about it. Once that's overcome through experience, the product gains traction.

Overall, ABL is building a stronger profile in the private equity community and it will continue to do so, because it reacts so well to volatility and provides that additional flexibility and additional quantum.

Hyman: I think it's fair to say that for some sponsors ABL has become almost a product of choice for both acquisition finance and for managing the working capital of their portfolio companies post-transaction.

For other sponsors, ABL is less commonly used and there is still a certain degree of wariness, but I don't think that's wholly down to ABL's reputation or profile in the market as

such. Every sponsor will have a different investment strategy and will look at a particular profile of deal, not all of which will necessarily be suited to ABL.

For the right sponsors and the right deals, ABL has been, and continues to be, used regularly and is a healthy way to maximise the debt capacity of sponsor-owned businesses.

On that point about the degree of wariness from some sponsors when it comes to ABL, what exactly are the reasons for that?

Weeden: The biggest sticking point is nervousness around whether an ABL facility is truly committed, and whether funding can be pulled.

I think there can be a gap between what is in the documentation – and yes, ABLs will have those controls – and what happens in real life. The gap is bridged by the experience of working with ABLs and understanding how things work in practice.

The absolute nature of an ABL can make PEs nervous, but in practice the ABL is not going to suddenly decide that an asset is no longer attractive and pull funding.

Once sponsors understand how it works and actually see the benefits of some of the processes and some of the reporting that's in there, they generally love it and will put it in where they can.

Hughes: If the borrower looks at the ABL funding line and thinks, 'will our debtor book or our inventory always be sufficient to give us the working capital we need?', there can be concern.

It is important, however, to balance that against the raft of covenants in a

cashflow loan. Borrowers don't have total control of that either and may find that they are much more comfortable working with one or two ABL covenants, knowing that ABL has no desire to pull the plug and wants to work with the business.

Cullen: Once sponsors get it, it's very easy to do repeat transactions. It is important to remember that the reputational risks for ABLs that behave badly and irrationally are massive. If any of us acted unreasonably, we wouldn't have the licence to operate in the M&A market or with sponsors. There needs to be a real sense of collective responsibility in the ABL market now.

Also, as more of us develop that ability to integrate and incorporate cashflow structures, it's much easier to alleviate any historic anxiety in the sponsor community about utilising ABL techniques. We become far more relevant for the right-shaped deals.

Hyman: There are nuances to the ABL product that can make it difficult for sponsors to get comfortable. For example, there's a significant focus during due diligence on liquidation exit analysis – and understandably this can make sponsors and management teams nervous!

ABLs will also always need to reserve the right in the legal documentation to protect the value of their underlying collateral by introducing additional reserves or reducing LTVs, which can create uncertainty around funding availability over the life of a facility.

At the end of the day, there's a certain amount of trust required from the



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Jake Hyman, Blaze Hill Capital



igf

£1.9M ABL Facility

to



Growth Capital

Sector: Beauty Products

£2.4M ABL Facility

to



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Sector: Pipework

£11.1M ABL Facility

to



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Sector: Engineering

ABL Facility

to



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borrower that the lender is going to act reasonably during the tougher times.

At BlazeHill Capital, while we need to understand what a liquidation would mean for us, we aren't restricted by conventional ABL parameters and, where appropriate, we are often pushing into the cashflows. This ultimately means that we want to preserve the enterprise value of a borrower for as long as possible and in turn align our interests with those of the sponsor.

Brown: It is important to remember how far ABL has come. Many private equity portfolios now use ABL in some form. The market has come a long way from where it was 10 years ago and we are in a completely different place.

Finally, how are ABLs thinking about underwriting in the current environment and what is everyone's focus for the next 12 to 18 months?

Weeden: ESG is something that is firmly on our radar, and we are investing significant resources in originating opportunities where there is a sustainability element to the business. As part of that, we have already provided capital structures with ESG-linked margin ratchets. We set key performance indicators (KPIs) linked to ESG for the business, and the margin then ratchets up or down depending on progress against the ESG KPIs. What is interesting is how much the broader risk profile of credit is tied to ESG. Businesses that take ESG seriously are generally better at identifying and mitigating risks to their operations.

Hughes: Macroeconomic conditions may have shifted significantly during the last

12 months, but our underwriting hasn't changed. We are on the lookout for opportunities to support businesses and work with owners and management teams.

Our business is backed by private equity, and one of the advantages of being an independent lender is that we can look at a broad range of sectors where there isn't nearly as much traditional banking support as there used to be.

We see significant opportunities in sectors that are challenging for mainstream lenders, including bank ABLs. When you take the time to look at these credits more closely, there is so much value. We remain as openminded as ever and will look at each transaction on its own merits.

Cullen: We want to work with great management teams because, to Jon's point, great management teams, even in tough sectors, will deliver rewards. It's our job to figure out the right debt structures to support them.

We also want to continue deepening our relationships with sponsors. We want to foster partnership-type relationships that are not exclusively transactional. When you experience some choppy waters, those relationships come to the fore.

Yaslak: Our team is set up to support businesses that are stressed or in some form of turnaround or transitional phase. We're generally comfortable when the overall economic climate is as it is now, and our underwriting and general credit policy is set up to deal with that.

At times like this we see a lot more deals coming across our desks, because



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the mainstream banks are sitting back a little bit, while some of the smaller cashflow lenders have either disappeared or consolidated. That has limited the options for borrowers in the SME cashflow market, and more of those borrowers are thinking of firms like ours that can provide both ABL and cashflow.

But for us, at the moment, the focus really is, as James said, on backing good management teams and backing good sponsors, particularly where there's a turnaround business plan that we can buy into.

Serviceability is another priority. Several of the transactions we see are complex, so there may be other debt instruments in the structure. We really need to think about the serviceability of our facility, as well as the other facilities in the structure.

Hyman: ABL is traditionally a supportive product across all points of the cycle, and at BlazeHill Capital we are very much open for business and our approach to underwriting transactions in the current environment is no different.

The common thread across all the borrowers in our portfolio is that they have solid fundamentals and a reason to exist. A comprehensive review of the underlying credit quality sits at the core of our underwriting process and we then supplement that analysis with classic ABL techniques, including looking at the asset base and understanding where the value of the collateral breaks in different exit scenarios.

When credit fundamentals stack up, we can expand beyond the traditional ABL

parameters and push into the cashflows, which has certainly grabbed the attention of sponsors. Of course we focus on the assets, but we take a pragmatic view on every deal and think creatively around how we can deliver the optimal debt quantum for the sponsor or borrower.

We have really supportive LPs with significant firepower and see the next 24 months as a big window of opportunity to accelerate our growth and cement our position as a key player in the mid-market private credit space.

Brown: One of the real strengths of ABL, and one of the things that makes the ABL market so interesting, is that there really is a lender for everybody in this market.

We act for a whole range of asset-based lenders, from those on the more conservative end, right through to the special situations/turnaround lenders. At both ends of the spectrum there is a willingness to be creative and find solutions when the more traditional cashflow lenders are inclined to pull back.

Strong credits with strong management teams in less risky sectors will have multiple lenders competing to provide finance. At the more challenging end, and in the more difficult sectors, it might only be one or two who are prepared to put in that extra work... but there will always be someone there to step in.

The ABL market is so incredibly diverse and so broad, and it's that flexibility, creativity and willingness to find solutions that makes it such a good product, especially in the difficult period in the credit cycle in which we find ourselves. ●

Legal opinion, clearly expressed

Our technically excellent and highly experienced ABL team advises borrowers, lenders and sponsors on a wide range of domestic and cross-border transactions.

For clear, practical and commercial advice on your ABL deal, please get in touch.



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