ROUNDTABLE

ABL through the pandemic

A panel of senior ABL lenders, advisers and GPs discuss how ABL providers are positioning their offerings in post-Covid M&A processes and how ABLs and their clients have steered through an uncertain and volatile market.

By *Nicholas Neveling*

Company earnings uncertainty and restrictions on social interaction as a result of Covid-19 have made for tricky deal execution. What has this meant for ABL in M&A scenarios and have ABLs been able to get deals over the line against this backdrop?

Jeremy Harrison: There is no doubt that M&A activity has dropped during the last year, but we did note a rebound from September onwards. We have continued to work on deals in competitive situations and we have been able to keep to M&A process deadlines.

I have been doing ABL deals for a number of years now and I am firmly of the view that we can move fast. ABL is a serious contender in M&A and I can list multiple examples where we have delivered and kept to deadlines. We have short lines of communication and we can deliver.

Pre-Covid, the one area where things have slowed down in the past is the due diligence on the collateral, but we have seen the emergence of independent firms that can take on the work. During the last few months they have shown that they can do that work remotely.

Edward Godfrey: From my experience both the vendor and the buyer have to be familiar with the product. I work with many private equity firms who are less familiar with the product, and it is more difficult for ABL to gain traction with them.

That said, if there is a sell-side deal where the vendor has conviction in ABL as a credible option, then the groundwork can be laid for buyers. I think that is key if buyout firms less familiar with the product are going to adopt ABL. It also means that auction processes can be adapted to accommodate an ABL lender's needs.

SPEAKERS:

Richard Babington
Mobeus

Sarah Day
DLA Piper

Edward Godfrey
DC Advisory

Jeremy Harrison
ABN AMRO Commercial Finance

Oliver Jones
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Looking at it from the other side, if you have a buyer that is very familiar with ABL in a situation where ABL is appropriate, timing becomes the most important issue. This may sound counterintuitive, but I think the fact that M&A processes have been a little more complex during the last year has actually been helpful for ABLs.

Sell-side advisers are not running the same aggressive timetables and that creates more room in the process to consider a wider group of lenders and address the needs of the buyer. Selling a business has become more collaborative and that creates space for an ABL to get an audit done and for all parties to familiarise themselves with the ABL product.

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Richard Babington

Sarah Day: Historically we have seen vendors and sellers who are very keen on ABL initially, but then shy away because the due diligence the ABL needs to conduct is seen as too difficult. That is understandable to some extent, because the biggest risk for a sell-side adviser is that a deal progresses but doesn't get done near the end. So, if you are an adviser and you have two financing options, one of which is very familiar and you have used before, your instinct is to stick with what you know.

All that said, we shouldn't give in and Edward raises a very important point: there is more time in auction processes right now and the opportunity is there to do the education piece around ABL and its benefits.

During the last year we have also noted a growing recognition that ABL can be the best option for managing risk. For example, we have recently worked on a situation for a client where a large, syndicated revolving credit facility (RCF) was moved onto an ABL line for precisely that reason. Once you start to see mainstream ABL deals like this, it only takes one positive experience for a debt adviser or PE house to see a shift in mindset.

Richard and Oliver, as the GPs on the panel, what are your views on using ABL in a live M&A situation?

Oliver Jones: I first encountered ABL on a healthcare services deal I worked on back in the mid-2000s. The deal was a carve-out and the business had a high quality debtor book, but near-term earnings were quite volatile. It made perfect sense to use ABL at a sensible level for the transaction.

What I have learned from that deal and subsequent transactions financed with ABL over the years is that that the key from a GP's perspective is understanding the rules of engagement. The most important thing is to recognise that the underlying asset is everything to the ABL provider. They need quality information around the collateral and how it is policed and reported. That is why the margins on an ABL are relatively modest over the interbank rate. It is also crucial as a borrower to understand how much headroom you require to deal with the "what ifs".

We always ask ourselves what the maximum amount the ABL can provide is, and often it is more than we actually need in some situations. That part is straightforward, but we also have to look at the equity story and ask how the valuations of the core collateral are established and who is doing those valuations? What happens if an appraisal means the value of these assets has fallen 20 per cent because of a market shock? Does the lender give you a covenant holiday in that situation or do we have cure rights? How much headroom do you need to leave in a facility in case that does happen?

The industry has come a long way from the historic idea that it is just an on-demand facility. If you understand the product, there are ABL providers that have been in the industry for a long time and can be trusted to act sensibly through more challenging times in the cycle.

Richard Babington: ABL lenders are unashamedly lending on the back of assets, so it's entirely reasonable that they should be able to see an up-to-date aged debtor ledger, an up-to-date asset register and a detailed 12 or 36 month cashflow to show how the borrower paid down debt.

If you've got a business that can't show that, then I would argue that the issue is not with ABLs, because those are the basics that any private equity manager should be looking at when making an investment. Countenancing going into a deal without that kind of information is tricky. A lot of the information ABLs are asking for should be made available as a matter of course. That's just good business management.

But you do see situations where buyers don't do that anymore because they are trying to be competitive in

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Sarah Day

deal processes. It is tough trying to engage a seller and demand that they go and count their widgets when a rival bidder isn't asking for the same detail.

Jones: Richard makes an excellent point. You would be amazed how many asset-heavy businesses don't always know where their assets are, or do not have a register. Understanding the assets is one of most important bits of diligence you will ever do on a business. It tells you whether a business is on top of its debtor cycle, whether it collects cash properly and whether it knows where its assets are.

Harrison: To add to those observations, I have spoken to a number of financial sponsors who say they love ABL because it gives a view on the debtor book and the cash. When private equity firms use the product they do see value in the ABL reporting because it's a good discipline for the business. This is particularly resonant when you've got a carve out that probably hasn't been used to cash constraints in the past.

It is interesting to hear that the diligence an ABL requires is very closely aligned to what an investor should be looking into anyway. Why is it then that ABL requirements are seen as "extra work", and are there any things that can be done by ABL stakeholders to build their due diligence into deal processes as a matter of course?

Day: Before answering, I think it is important to emphasise that deals financed using ABL do regularly get done: this is not a theoretical discussion we are having here. Before this meeting I checked in with some of my colleagues and they also confirmed a number of examples of ABL M&A deals that they had closed during the last year.

But to your point, I think the first thing is to look at how the need for valuations and surveys can be made a standard part of a process. If we can find ways of doing the surveys and audits faster that would be incredibly helpful. As has been mentioned, we have seen how this work can be done remotely. In the case of some industries, like recruitment, many of the assets are online anyway, so it is an easy thing to do logistically.Secondly, one of the challenges is that a borrower in an M&A situation wants certainty of funding on day one. That funding is provided against the target's assets, even though you don't actually own the target yet.

There are ways around that, and we have seen the US concept of a "virtual" or "guaranteed" borrowing base gain traction. This means that the borrower is guaranteed a fixed amount, irrespective of what the assets are. The difficulty is that the fixed amount tends to be lower than what will ultimately be available, and the question then is whether that's enough to get a deal on the table. We have also seen the provision of a cashflow loan, which is then refinanced with an ABL, as a solution.

Harrison: The industry is taking on board the "guaranteed borrowing base" concept. But even if we put that idea to one side, there is a lot of experience in the industry and ABLs can get deals done.

If we are looking at a particular transaction in a particular sector with a sponsor, we've got the knowledge to know what issues to think about. Take a supermarket supplier, for example. We know exactly how supermarkets behave and we know about rebates. We could look at a balance sheet and at simple aged debt and be able to come to a figure very quickly. Naturally, we'd like to do the due diligence, but we can come to a figure that would be pretty accurate.

We also have the ability to give a guarantee and put a bridge to an ABL in place, or we can come in once a deal is in exclusivity and do our due diligence very quickly.

One thing we have also learned while remote working is that we don't necessarily have to be on site to get our diligence done either. It means we don't have to disturb management and I know that private equity firms value that, because they don't want to disturb management during a process.

Moving on from ABL and M&A, I was interested in asking about ABL's position as a refinancing option? But first I wanted to look at refinancing more broadly. Edward, how much bandwidth have companies had to think about any kind of refinancing given all the other demands that Covid has placed on them?

Godfrey: There have been a select group of companies out there that have traded well through the pandemic and some of them have been able to refinance opportunistically and secure some competitive terms.

But those are exceptions. If we wind the clock back to the start of lockdown everything was about liquidity for the first couple of months. Borrowers had to deal with the immediate situation and worry about the consequences, like covenant breaches, later. We did see a number of situations where there was a maturity coming down the line, and then the question was whether companies could refinance at all. There were several situations where refinancing wasn't an option, and then the discussion moved to amend and extend.

The backdrop for refinancing remains challenging for most businesses, so we could see borrowers have to request multiple extensions. It is also important to remember that many lenders have put a freeze on taking on new clients, which has narrowed the universe that borrowers could turn to for a refinancing.

I think it is also fair to say that many borrowers are more comfortable dealing with existing lenders, which points to more amending and extending existing loan facilities than refinancing with a new lender.

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Jones: To follow on from that point, our mindset around banking has been to go with long-term partners that we know and trust. This approach has felt even more sensible coming into something like Covid-19. The fact that we had long-term relationships meant we could share information and trust our funding partners, which was invaluable during the huge uncertainty of the first lockdown.

Taking that all into account, there would have to be a really good reason to refinance away from people who have supported us. A long-term mindset matters when the unexpected happens. If you have a syndicated loan that's gone into different places and you don't know who your counterparty party is, it gets a lot more challenging.

Babington: We did two planned refinancings in 2020, both involved manufacturing businesses that our Mobeus institutional fund has invested in. One business makes the metal used to manufacture bakeware and the other produces cleaning products for the supermarkets. Both have traded well, and both have refinanced with their incumbent banks.

Overall, I think lenders did retrench in March and April last year, which was perfectly understandable given the circumstances, but in Q3 2020 and Q4 2020 the market did open up again and we certainly saw ABL providers come straight back. If they know that the liquidity in the underlying assets hasn't really changed, then why wouldn't they?

Generally, our experience at Mobeus has been that deserve credit for being incredibly supportive through this period. I'd mirror what Oliver said. We trust our lenders, so on day one we were comfortable passing on our up-to-date cashflows and expectations for trading. Lenders could see exactly what was happening and that gave them comfort.

Harrison: From our perspective as a lender, we have always done a high volume of refinancing. It is in our blood. In the mid-market last year, however, a lot of that refinancing activity did slow down because of tax deferment schemes and the fact that incumbent clearing banks were actively providing CBILs.

That did take a bit of our market away initially, but that did come back in the second half of the year and there was never a point when we stopped lending. We had a deal, for example, that we closed in April. It was an all asset deal of around £50m. Work had started on that pre-Covid, so when lockdown came in, we sense checked ourselves to make sure that the business was not directly impacted by Covid and closed the transaction. In that case, the borrower simply felt unloved by its incumbent lender, and we have seen a lot more of that subsequently.

We also worked hard to help our existing clients. We put our own taskforce together and in the end we provided additional support to all our clients that asked for it, which was around a quarter of our borrowers. That included measures such as allowing 100 per cent on debtors, providing additional term loans and rolling out the CBILS scheme.

Ultimately, clients have borrowed less through this period, so we have been able to put a real focus on new business. It will take time to close the gap to previous activity levels, but I do think that as tax deferral and government support measures unwind, we will start to see more borrowings in our existing book.

Sarah you mentioned an example earlier of a client refinancing from an RCF to an ABL. Could you go into a bit more detail about the reasons for that deal and why the borrower went down that route?

Day: For that deal, the funders were a big driver for the change. The ABL de-risked their position because they were better secured against the trading assets, which resulted in a more favourable capital treatment for the funders. The company also liked the ABL solution because of the flexibility, which allowed the business to grow and reduce its facility across different cycles.

There were some questions around how committed the facility was, but all that was required was an upfront conversation. The industry has matured hugely in this area. The option is still there to put an uncommitted facility in place that will be cheaper but highly discretionary, but there is also scope to agree a bespoke document that gives the borrower additional commitment.

To close, I wanted to go back to the point raised briefly earlier about how ABL providers have adapted to restrictions on travel and the onsite audits in more detail. Have restrictions held up ABL transactions at all?

Godfrey: When we first entered lockdown, there were other problems that everyone was faced with, and at the time there was probably still the view that people needed to be on site and that there needed to be a physical meeting to get a deal done. The longer the restrictions remained in place, the more people realised that this was a long-term situation and that things had to progress remotely or not at all.

Lenders have adapted and accepted that video calls are a legitimate forum to have meetings that would normally be done face-to-face. Lenders have generally been pragmatic and sensible to get deals done.

Day: For ABLs, there has been a lot more flexibility in terms of doing virtual audits and checking things

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Oliver Jones

remotely. That can bring a heightened risk in some instances, but it is something that funders have been alert to and are managing accordingly. The risk is there, but you can mitigate that by testing to the best of your ability and monitoring the reserves and retention more closely. You can look at the categories of assets that you're funding against too in terms of risk. It also depends on how long you have worked with a customer. If you've got three years trading, then you can talk to management about what's happening on the ground and find a solution.

Jones: We've learned a lot about how online conferencing technology works. A crash course from a fairly low beginning, I'd say! It is challenging when you are meeting new people and management teams. The subtleties that you notice when meeting in person are stripped away. There is still huge value in meeting in person.

But on the positive side, there is now this new tool in the armoury. You can save the time lost on train journeys, taxi rides and flights. It affords opportunities to be much more efficient when working with people who you already know.

Babington: The option to do meetings virtually has been very valuable, but it is worth remembering that there are still a large number of people around the country who don't get the option of working remotely. We have 60 people working at the plant of a portfolio company in Wolverhampton and they have not missed a day of work during the last year. We shouldn't ignore that. From our side, we are looking forward to being able to move more freely when we are able to. Meeting people in person will still be a differentiator and I do feel a bit edgy when I see reports of deals that were done entirely virtually, without a site visit. A new house can look fantastic on the internet, but it's only when you go through the front door that you find out whether it smells of cigarettes or not.

We still want to be going physically on site for the sniff test and to look under the tables, but to the extent we can blend the two, working virtually can be quite efficient.

Harrison: Everyone will agree that the priority is the safety of our people, and we have had to adjust how we operate. The observation that audits might take a bit more time remotely is fair, but that is also because clients also have their finance teams working remotely. When the information is in a filing cabinet in the office it takes a little longer to access! Overall, from an asset-based lending perspective, we do want to get a feel for a client and see the assets, but we have managed to do remote audits and closings and our teams have been able to work effectively from home.