STATE OF THE ABL MARKET 2018: OPPORTUNITIES AND CHALLENGES FOR LENDERS

BY SETH E. JACOBSON, GERARD C. MARTIN, DAVID M. WAGENER

Attorneys from Skadden, Arps, Slate, Meagher & Flom LLP alert lenders to what they should be prepared for in 2018.

Asset-based lending is now firmly entrenched in the mainstream of financial products, yet its role in the market continues to evolve. Market participants are exploring new ways to use the low pricing and operational flexibility provided by asset-based loans, while lenders enjoy their low historical loss rate. However, new opportunities – and challenges – will require strategic forethought and flexible implementation by asset-based lenders. ABL markets, as with the broader loan market, have experienced a continuing imbalance between supply and demand, resulting in increased competition for funded loans and, ultimately, more borrower-favorable loan terms. Meanwhile, regulatory pressures constraining bank ABL lenders from leading or participating in deals with highly leveraged capital structures or in distressed situations may be softening, as demonstrated by recent developments regarding federal guidance on bank leveraged lending. As financial transactions become increasingly global, foreign ABL markets present new opportunities, while non-bank ABL lenders simultaneously challenge traditional providers.

Financial sponsors continue to influence the ABL marketplace – as with loan markets generally – pressuring loan arrangers to market transactions with tighter pricing and more flexible terms. Thomson Reuters LPC reports that in 2017, well before year-end, lending to private equity-sponsored companies in the U.S. market hit a record high – over 50% higher than 2016 levels according to the Loan Syndications and Trading Association. Their statistics also show that, the first three quarters of 2017, sponsor ABL loan issuance has accounted for 35% of the U.S. ABL market.

In addition to driving transaction volume, sponsors typically run competitive auctions for lead left roles in transactions. It has become commonplace for sponsor/borrower counsel to prepare auction terms grids and/or commitment papers as the baseline for the auction. This creates efficiency for the sponsors as they can compare loan terms on an even basis. This competitive dynamic results in loan arrangers presenting more flexible and borrower-friendly terms than they may have proposed absent the auction. In a further effort to control costs and negotiate documentation in an efficient manner, many sponsors base ABL transactions for their portfolio companies on pre-agreed precedents. The developing trend is that the precedent sets a floor for terms, but sponsors and their portfolio companies are often able to make improvements over the course of negotiations. Meanwhile, lenders that are unwilling to compete are likely to be frozen out of lucrative arranger and agent roles, not to mention ancillary business.

Similarly, modern loan markets have created pressure on ABL lenders to adapt terms to conform to bond or term loan market norms. The balance sheet of a modern business often has multiple layers of financing, serving different purposes. The more the terms of these products differ, the more complexity and less perceived flexibility borrowers have in their overall financial structure. Throughout this decade, the "convergence" of terms in the high-yield bond and term loan B markets has been well documented.

A similar phenomenon has been occurring in ABL markets, as sponsors and CFOs have sought to unify the terms of their loans to the maximum extent possible. This dynamic is most apparent in sponsor auctions, where sponsors seek to require that terms of ABL financings will be based upon those of the borrower's bonds or term loans, with only specified changes for the ABL. In these circumstances, ABL lenders are forced to enumerate the sacred ABL terms (beyond the borrowing base) that cannot be conformed with the rest of the capital structure – springing cash dominion, field examinations and appraisals, borrowing base and other ABL-specific reporting,

among others. ABL lenders also seek to constrain certain, particularly sensitive terms – builder baskets based on retained excess cash flow or consolidated net income, unlimited baskets for restricted payments, investments and payment of junior debt based on meeting a maximum leverage ratio, and large general baskets (all of which the typical ABL lender expects to replace by payment conditions), as well as "soft" EBITDA addbacks based on run rates of cost savings initiatives and synergies, and a myriad of other terms that may be more common in the bond and term loan marketplace. Similar (but less intense) dynamics occur when a corporate CFO asks its prospective ABL lender to adapt an existing, or already-negotiated, term loan document to incorporate only necessary ABL terms.

ABL lenders are able to adapt to these demands due in part to the increasing focus on asset-based lending as a product – rather than as a line of business. The biggest deals – and rewards – go to the financial institutions that demonstrate the ability to deliver asset-based loans as part of an integrated capital structure, providing the most efficient solutions to the problems faced by CFOs and sponsors.

Another important factor to which ABL lenders have had to continually adapt is the role of government regulation, which stepped up significantly after the financial crisis. In particular, bank ABL lenders have been significantly constrained since March 2013, when the Board of Governors of the Federal Reserve System, the FDIC, and the OCC, in response to the financial crisis, issued the Interagency Guidance on Leveraged Lending. The intent of the Leveraged Lending Guidance, as perceived by the financial industry, was to address systematic risk to the U.S. financial system caused by the loan market. Bank ABL lenders, in particular, viewed the guidance as a significant constraint on their flexibility, preventing them from making ABL loans that they would anticipate to be low-risk and profitable, and restricting their ability to amend, renew, or refinance existing ABL loans to leveraged borrowers. The result has been a significant distortion in the ABL marketplace, pushing potential ABL transactions away from regulated banks and toward alternative financing providers, or preventing certain transactions from occurring at all.

In October 2017, after a review prompted by a request by Sen. Patrick Toomey, the U.S. Government Accountability Office determined that the Leveraged Lending Guidance constitutes a "rule" for purposes of the Congressional Review Act (CRA). Under the CRA, this determination throws the enforceability of the Leveraged Lending Guidance into doubt, and permits Congress during a specified time period to issue a joint resolution that would disapprove the Leveraged Lending Guidance. Such disapproval would prevent the Leveraged Lending Guidance from being effective, and would block its reissuance in substantially the same form. It is unclear how this situation will play out – but there is a significant possibility that the Leveraged Lending Guidance will be reworked in a more permissive form, or else nullified entirely until a replacement can be enacted. Either result would have a positive impact on ABL issuance by banks, and roll back the regulatory advantage enjoyed by alternative lenders (who are not subject to the same legal constraints).

Another positive development for ABL lenders has been the expansion of the international market for ABL products. Multinational businesses face significant challenges in finding flexible financing that permits multinational borrowing based upon global assets. Asset-based lending is becoming a more common solution to this dilemma. ABL lenders are becoming comfortable lending into an increasing number of jurisdictions – from the U.S. and Canada, to European jurisdictions including England, Ireland, The Netherlands, and Germany, to Australia and New Zealand, among others. In addition, lenders are sometimes able to structure transactions on a one-off basis in other jurisdictions, based upon a borrower's distribution of assets and global capital structure, and considerations of local bankruptcy, insolvency, and commercial law. Over the past decade, certain foreign jurisdictions have adapted their laws to become more ABL-friendly, further expanding the potential footprint of the ABL market. Some U.S. lenders have even arranged standalone foreign asset-based facilities, with no U.S. component.

From a borrower's perspective, the optimal asset-based loan structure would provide a single, worldwide borrowing base, available to support credit needs in every jurisdiction (regardless of the location of the business's financeable assets). The practical reality still remains much more complicated, as various legal and practical constraints require that each multinational ABL transaction be tailored to the individual borrower. For example, Section 956 of the U.S. income tax code constrains the ability of foreign subsidiaries of U.S. entities to provide guarantees of indebtedness of their U.S. parents (although any loosening of these restrictions could create substantial new flexibility for structuring ABL transactions, and would warrant a revisiting of the structures of many existing transactions). Under current law, multinational businesses that have foreign parents have the potential to enjoy substantially more transaction structuring flexibility than multinationals with a U.S. parent.

Similarly, non-U.S. laws regarding restructuring, insolvency and financial transactions generally – including laws having an impact on effectiveness of guarantees, priority of claims, and other matters – require careful consideration, both in the establishment of prudent availability reserves, and in the structuring of how borrowing base availability may (or may not) be shared among U.S. and foreign

subsidiaries. Foreign counsel can play an important role in determining how these factors affect optimal structure and implementation, although the lender and its U.S. counsel must often know what questions to ask in order to avoid unexpected consequences. Fortunately, foreign counsel are becoming increasingly sophisticated in advising on ABL transactions, particularly in those jurisdictions that are more accommodating of ABL transactions generally.

Whereas the U.S. ABL market is a mature and highly competitive market, overseas markets are becoming important to ABL lenders at an accelerating rate, and present a significant, long-term opportunity for expansion and growth. Lenders and their counsel, however, must understand the legal and business challenges inherent in ABL lending in these markets. Those who develop the mindset to ask the right questions have the opportunity to be successful. Sometimes creative solutions can solve a particularly difficult issuer request, such as structures that sell receivables from one subsidiary located in an unfavorable jurisdiction, to another subsidiary that is more favorably located.

While pursuing these opportunities, ABL lenders must keep an eye on the business cycle – both on a macro level and as it relates to specific industries. Important industries for asset-based lending have historically included (among others) retail, steel, auto supply, rental equipment, logistics, paper and office supplies. Each of these industries is affected in different ways by the business cycle and by disruptive forces in the marketplace. Retail represented almost 19% of ABL volume in 2016, according to Thomson Reuters LPC, and this market, in particular, has been hit hard by the online-shopping effect. Traditional retailers – historically an important sector for ABL – have had to rethink their business models in order to compete, and not all have been successful in this regard. Fitch Ratings has reported that retail institutional leveraged loan default rates have surged in 2017.

However, it is a testament to the inherently robust nature of ABL products that loss ratios have not followed. Fitch Ratings has stated that, while more than half of the 33 general retail bankruptcy cases since 2005 have ended in liquidation, they "tend to have outstanding first-lien recoveries". ABL lenders are protected, even in liquidation, by the structure and collateral-focus of ABL loans. The ABL borrowing base automatically resizes availability with the expansion or contraction of the underlying business; as a result, providing substantial control (and an early warning trigger) to the lender and minimizing potential losses. ABL loans are also self-liquidating, particularly in cash dominion – receipts automatically repay outstanding loans, and reborrowing requires the borrower to meet its draw conditions.

At the same time, ABL lenders enjoy significant opportunities in restructurings. Debtor-in-possession (DIP) financing levels grew 700% from 2015 to 2016 – to $7.5 billion, according to Thomson Reuters LPC. In an environment of high leverage and rising interest rates, there are likely to be borrowers that collapse under the weight of their capital structures and require super-priority financing in chapter 11 – a natural role for ABL lenders. Roll-up DIPs, where prepetition ABL facilities are refinanced by court order as postpetition DIP financings, provide substantial protection to prepetition ABL lenders. Loss ratios on ABL facilities in bankruptcy remain low, even in liquidation, and restructured businesses, with cleaner balance sheets, will still need revolving financing liquidity.

Combined, these trends point toward a bigger, more global ABL marketplace, where pressure to provide more flexible terms and finance more aggressive transactions continues, in a less-aggressively regulated marketplace. This will be true at least until rising interest rates – and default rates – slow down the acquisition and leveraged loan markets. TSL

Seth Jacobson is a partner and global co-head of the banking group at Skadden, Arps, Slate, Meagher & Flom LLP. Gerard Martin and David Wagener are counsels in the banking group.

This article represents the opinions of the authors only and not of Skadden, Arps, Slate, Meagher & Flom LLP or its affiliates, and is not intended and should not be construed as legal advice.