AlixPartners

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SPACE IN THE BOOT

Stretching the balance sheet to maximise borrowing power

The unavailability of cash-flow based debt facilities can hinder companies' transformation plans. The asset-backed lending market has provided an alternative solution for some time, but as discussed in this article, its evolution is making ABL increasingly attractive for certain companies.

This article provides detail on:

- The evolution of the ABL market
- The types of business that are well-suited to take advantage of the potentially huge benefits of ABL
- How ABL works, how to stretch the quantum of ABL debt available and the potential advantages and pitfalls of the key structuring options

INTRODUCTION

The European asset-backed lending (ABL) market is maturing, albeit at a slow pace. Historically, the European ABL market has been dominated by lenders that advance funds against invoices in exchange for relatively low returns (so-called accounts receivables (A/R) financing or invoice discount financing (IDF)). Increasingly though, the collateral for ABL facilities has expanded to other asset classes—notably, inventory, plant and machinery (P&M), land and buildings (L&B), intellectual property (including brand names), and even cash flows—which enables companies to raise more debt in the ABL market than they were previously able to.

At the same time, ABL lending terms have become more borrower friendly, especially with regard to loan documentation wherein, historically, lending terms would include ample provisions allowing a lender to cancel a loan or reduce the amount that can be borrowed by unilateral adjustments to the borrowing base calculations (often involving changes to so-called reserves, which will be explained later). This evolution has made ABL a more attractive and arguably more reliable product for borrowers. This is particularly the case for more savvy borrowers such as private equity owned businesses that are focused on sourcing committed facilities with as little lender discretion as possible on available debt quantum.

Furthermore, new lenders and lending practices have appeared on the scene. The European ABL market lost one major lender when GE ceased its activities a few years ago, but new lenders have emerged since and several institutions active in the ABL space are now lending against more than just A/R as noted earlier. Admittedly, this remains a work in progress for the clearing banks, many of which continue to require that A/R forms the majority of the collateral pool. In addition, several credit funds are increasingly pursuing ABL as a deployment strategy.

ABL offers several benefits to borrowers, in particular a lower cost of finance and an available debt quantum that (within limits) moves in tandem with a business's working capital needs. But because of ABL's relatively low risk and returns, lenders' advances in comparison to asset values are generally modest, especially when the borrower's business or circumstances are complex or troubled. In such cases, asset-heavy businesses can find themselves with sizable amounts of unfunded collateral "in the boot".

Recognising the untapped potential of this boot collateral, some ABL lenders and, increasingly, credit funds are angling to lend against it, in a form of financing we refer to in this article as *Stretch ABL*.

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HOW ABL AND STRETCH ABL FACILITIES WORK

ABL

Generally, ABL lenders use the following methodology to determine the amount they will make available to a borrower.

1. With regard to A/R, determine the amount of receivables that are deemed eligible to lend against (eligible receivables): This is typically achieved by taking the amount of A/R outstanding at a specific point in time and applying reserves for certain types and amounts of A/R. Typical examples are (1) prohibited territories—that is, A/R when the counterparty is based in certain countries the lender does not want to lend against; (2) contras, which involve counterparties for which there are both accounts receivable and accounts payable balances in view of the risk of "set off" by such counterparties; and (3) aged debtors: A/R that have been outstanding for a long period, which raises potential concerns about their being paid.
2. In respect of inventory and several other asset classes, determine the net ordinary liquidation value (NOLV): Simply put, the NOLV is the value that can be realised if the assets are liquidated. To reconcile between the assets' gross book value on the balance sheet and their NOLV, lenders typically make reserves for items such as work-in-progress (WIP) inventory and obsolete P&M. They will also apply a discount for selling assets in liquidation scenarios. Lenders are likely to use independent valuation specialists to assist with this exercise.
3. Apply an advance rate to eligible receivables and other asset NOLVs: Advance rates (usually well below 100%) are based on a lender's assessment of the borrower's level of risk.

The following table is an example of the methodology used for determining ABL availability. In this scenario, the theoretical ABL facility is funded against A/R and inventory. Note that all figures are arbitrary, and we have provided only examples of some very typical reserves rather than all possible reserves.

£M	A/R	INVENTORY	RESERVE DESCRIPTION
A/R gross book value as per balance sheet	100	-	
A/R reserves:			
Prohibited territories	(5)	-	Typically, non-OECD debtors
Contras	(5)	-	Debtors who are also creditors
Aged debtors	(10)	-	Aged 120 days from invoice date
Other A/R reserves	(10)	-	For example, concentration limits, doubtful debts
A/R eligible	70	-	
Inventory gross book value as per balance sheet	-	100	
Inventory reserves:			
Work in progress	-	(10)	Full or partial reserve against WIP depending on stage of completion
Consumables	-	(5)	Consumable inventory is not typically fundable
Consignment stock	-	(10)	Inventory held at a customer's site is typically not fundable
Other inventory reserves	-	(10)	For example, stock subject to retention of title, obsolete stock
Inventory gross orderly liquidation value	-	65	
Liquidation expenses	-	(10)	Including marketability discount
Statutory and other reserves	-	(5)	For example, enterprise act, accrued holiday pay, quarter of rent and rates
Inventory NOLV	-	50	
Summary:			
Eligible/NOLV	70	50	
Advance rate	85%	80%	
Availability	59.5	40	

A further typical adjustment made is a so-called headroom block, typically defined as an absolute amount of headroom that needs to exist between the theoretical availability based on maximum advance rates and the actual amount that can be drawn. This may apply only at the inception of the facility (following which it immediately falls away), or it may apply throughout the lifetime of the facility.

Therefore, a company with an ABL facility can draw cash from a lender based on the value of its assets at a given point in time. If, as is most common, the ABL facility is extended based on outstanding A/R and/or inventory valuations, the facility is typically revolving with availability fluctuating based on eligible A/R and NOLVs. The company can normally repay and redraw without incurring penalties. Banks are usually (but not exclusively) the providers of these types of ABL facilities, which can often be cheaper than cash-flow-based debt facilities.

A detailed discussion of covenants goes beyond the scope of this article. However, we note that ABL facilities typically include operational covenants in respect of A/R, for example debtor concentration, export concentration, and dilutions (a maximum percentage of A/R that is subject to the issuance of credit notes). As to both inventory and A/R there would typically be a turn covenant, stipulating the maximum number of days that A/R and inventory are outstanding. A breach of an operational covenant typically leads to an adjustment of the available debt amount but, if occurring regularly, can lead to an event of default depending on the terms agreed/negotiated. In addition to operational covenants, ABL facilities can often have one or more financial (maintenance) covenants such as a fixed charge cover ratio and/or an interest cover ratio.

STRETCH ABL

Stretch ABL involves the provision of further asset-backed debt that stretch the quantum that can typically be obtained beyond a standard ABL facility. The following are different ways of achieving this.

1	**Cash flow strip**	This would typically involve an ABL lender adding a cash flow loan or strip to the ABL facility. This cash flow loan is theoretically underpinned by the cash flows of the business rather than being directly linked to the asset values. In practice, the total quantum of debt (aggregating the ABL facilities and the cash flow strip) will typically still be less than the underlying eligible assets/NOLV, and as such, this methodology effectively stretches the advance rates. This option is most commonly referred to *Stretch ABL* in the market, even though it is only one form of achieving a stretched debt quantum.
2	**Stretching the number of asset classes**	This would typically involve the ABL lender extending the borrowing base to other asset classes such as P&M, L&B, and, occasionally, intellectual property (including brand names). Facilities lent against these asset classes are typically not revolving but take the form of fixed-term loans with either periodic amortisation or bullet repayment.
3	**Junior debt provided by a Stretch ABL Lender**	Stretching the effective advance rates by adding an additional facility that is junior to the main ABL facility (in this article we refer to junior debt providers as Stretch ABL lenders). Credit funds are the typical providers of junior ABL facilities, and they are usually structured as a term facility that cannot be repaid early without incurring repayment penalties. Such a facility typically attracts higher pricing because of the increased advance rates and junior nature. As discussed later in this article, there are different structuring options for such an additional facility. Stretch ABL lenders use the same methodology as ABL lenders for calculating availability, as demonstrated below.

£M	ELIGIBLE/ NOLV	ABL ADVANCE RATE	STRETCH ABL ADVANCE RATE	ABL AVAILABILITY	STRETCH ABL AVAILABILITY	INCREMENTAL AVAILABILITY[1]
A/R	70	85%	95%	60	67	7
Inventory	50	80%	90%	40	45	5
P&M	50	0%	60%	-	30	30
L&B	60	0%	40%	-	24	24
Total	230			100	166	66

1. Additional incremental availability may arise from headroom block differences

The difference between the ABL and Stretch ABL calculations is the Stretch ABL availability. In the above example, the borrower could seek a £66 million additional facility.

4	**Hybrid structures**	With elements of options 2 and 3, hybrid structures also exist.

WHICH BORROWERS CAN BENEFIT MOST FROM STRETCH ABL FINANCING

The businesses best suited to Stretch ABL financing include:

- **Asset-heavy businesses.** ABL or Stretch ABL financing is, obviously, only feasible when the borrower carries fundable assets on its balance sheet. Asset-heavy businesses such as industrial companies, aircraft component manufacturers and retailers are typically candidates for this financing option.
- **Businesses going through a period of transformation.** Stretch ABL is well suited to businesses in periods of transition, including those executing turnarounds. As ABL and Stretch ABL lenders rely on asset valuations, borrowers in turnaround mode may be able to obtain an ABL or Stretch ABL facility even when cash flow financing is unavailable. Increasingly, however, ABL and Stretch ABL lenders are factoring cash flow projections into their underwriting decisions, so borrowers will need to demonstrate a clear transformation plan. A company considering capex expansion or bolt-on acquisitions is likewise a prime candidate for Stretch ABL financing, particularly if the business has recently or is currently executing a turnaround. Facilities can be sized or flexed to take account of expected growth in the asset base, with many credit funds offering war chests that enable management to pounce on expansion opportunities.

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STRUCTURING OPTIONS AVAILABLE

There are several options for structuring a junior ABL facility. In practical terms, every structure provides the borrower with a revolving ABL facility and a Stretch ABL facility, but the structure used has an impact on the risk apportionment between lenders and, therefore, the deliverability of the financing.

The three structuring options for a Stretch ABL facility are shown in the following table. In this article, all options apply to a theoretical borrower that already has an ABL facility in place (funded against A/R and inventory) that is looking to secure further debt through a Stretch ABL facility (funded against A/R and inventory and, in addition, P&M).

	SECOND LIEN FACILITY (2L)	BIFURCATED ABL FACILITY	FIRST IN LAST OUT FACILITY (FILO)
Security description	• ABL lenders have first ranking security over all assets • Junior ABL lenders have the same asset security as main ABL lenders but second ranking	• ABL lenders have first ranking security over A/R and inventory and, potentially, second ranking security over other assets • Stretch ABL lenders have first ranking security against P&M (and other assets, if applicable) and, potentially, second ranking security against A/R and inventory	• ABL and Stretch ABL Lenders share first ranking security against all assets, but Stretch ABL Lenders are paid out behind the ABL in the waterfall of payments on enforcement
Key features	• Classic second lien structure, in which a 2L is documented separately, with intercreditor terms stipulating that upon enforcement, the 2L gets repaid after the ABL. Standstill periods apply to 2L lender(s) when an event of default occurs	• Frequently used permutation of the classic 2L structure, with each lender group being in control of collateral monitoring for its primary asset class. Intercreditor agreement and standstill provisions are key	• Common structure in the US. ABL and FILO are documented in same facilities agreement with same terms, including covenants and one borrowing base/ collateral agent. Used recently by British Steel in the UK

The optimal Stretch ABL structure depends on several factors, including the proportional split of the total facility, lenders' appetite for deploying capital, lenders' views on controlling or delegating collateral monitoring, the interaction among asset classes in the borrower’s business model and the borrower's public profile. Selecting the correct structure will maximise lender appetite for the opportunity and improve the chances of a successful financing.

More detail on the three main structures and some of the pros and cons of each are included in Appendix A.

CONCLUSION

Unlocking the value of balance sheet collateral can deliver huge benefits to businesses in specific situations. If a business is both asset heavy and a poor candidate for cash flow lending, Stretch ABL may well enable it to raise capital and continue with its business plans. But as this article explains, the structures of Stretch ABL facilities can vary significantly. In our experience, the intercreditor discussions involved with a Stretch ABL in place can be complex and time consuming. It is vital to select the right structure as well as parties that can come to an agreement to enhance both the chances of a successful financing and the quality of the borrower’s debt structure. We recommend working with experienced legal and financial advisors who have deep experience in navigating complex ABL structures.

APPENDIX A

SITUATION PRE-TRANSACTION	SITUATION POST-TRANSACTION
• Business with A/R, inventory and P&M • ABL facility, funded against A/R and inventory only	• Business with A/R, inventory, and P&M • ABL facility, funded against A/R and inventory only • Stretch ABL facility, funded against A/R, inventory and P&M

	SECOND LIEN (2L)	BIFURCATED	FILO
Security	• ABL lenders have first ranking security over all assets • Stretch ABL lenders have the same asset security as main ABL lenders but second ranking	• ABL lenders have first ranking security over A/R and inventory and, potentially, second ranking security over other assets • Stretch ABL lenders have first ranking security against P&M (and other assets, if applicable) and, potentially, second ranking security against A/R and inventory • Often called split lien or split collateral	• ABL and Stretch ABL lenders share first ranking security against all assets
Repayment in case of enforcement	• Stretch ABL lenders paid out after ABL lenders	• Lenders paid out when their respective assets are sold	• Stretch ABL lenders paid out after ABL lenders in the waterfall of payments

APPENDIX A
continued

SITUATION PRE-TRANSACTION	SITUATION POST-TRANSACTION
• Business with A/R, inventory and P&M • ABL facility, funded against A/R and inventory only	• Business with A/R, inventory, and P&M • ABL facility, funded against A/R and inventory only • Stretch ABL facility, funded against A/R, inventory and P&M

	SECOND LIEN (2L)	BIFURCATED	FILO
Documentation	• Typically documented in a separate agreement from the main ABL facility. Covenants, events of default, standstill periods to be negotiated • Security may be taken separately from the main ABL security but on almost identical terms	• As for second lien	• Typically documented in the same loan agreement as a separate term facility with the same covenants, events of default, and, on occasion, standstill provisions (although these are not typical in a FILO structure, except in very specific circumstances) • Repayment is pursuant to an agreement among lenders or an intercreditor agreement
Collateral monitoring/ security agency	• Both lenders typically rely on the same collateral-monitoring processes, which are managed by the ABL lender	• ABL lender monitors A/R and inventory • Stretch ABL lender monitors P&M (and other assets, if applicable)	• Both lenders typically rely on the same collateral monitoring processes
Pros	• The existing lender's security package is not adversely impacted	• Considered to be fair that ABL lenders do not receive first ranking security over assets that they are not funding against • Good solution for cases in which ABL lenders don't already have security over all assets • Each lender class is responsible for monitoring its own primary asset class	• ABL lenders' security package is not impacted (subject to the specifics of the intercreditor agreement) • Relatively straightforward structure, easier to document and monitor • Lenders' pari passu security status is likely to align their interests in an exit scenario

APPENDIX A
continued

SITUATION PRE-TRANSACTION	SITUATION POST-TRANSACTION
• Business with A/R, inventory and P&M • ABL facility, funded against A/R and inventory only	• Business with A/R, inventory, and P&M • ABL facility, funded against A/R and inventory only • Stretch ABL facility, funded against A/R, inventory and P&M

	SECOND LIEN (2L)	BIFURCATED	FILO
Cons	• ABL lenders may not be incentivised to maximise proceeds beyond their exposure, which is likely to suppress Stretch ABL lenders’ appetite or lead to intercreditor conflicts • Stretch ABL lender will want right to independent review of borrowing base controlled by ABL lenders/collateral/agent	• Even if ABL lenders do not fund against P&M, ABL credit teams may take comfort from having first claim on the boot collateral • Use of P&M and other assets such as premises, IT and IP may be required by the ABL to maximise the value of A/R and inventory in a work-out scenario. Stretch ABL lenders could leverage their first-ranking claim if there is a disagreement on exit strategy • Increasingly common (copying US practice) to negotiate in advance the rights for the ABL to use these assets for a defined period of time after enforcement, and to require these rights to be enforceable against any buyer from the Stretch ABL lenders if the relevant assets are sold during this period	• Relative size of facilities and voting rights can be source of debate (given that all vote as one class) • Stretch ABL lenders will want right to independent review of borrowing base controlled by ABL lenders' collateral agent • Some senior ABL agents may be reluctant to hold security for Stretch ABL lenders as well as themselves and/or to assume increased responsibility to monitor all collateral. This may result in higher agency fees (but may compare favorably with the analogous costs of second liens or bifurcated security)

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

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