Private Debt Investor

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FUND MANAGEMENT

Asset-based lending: Formulaic but not simple

A focus on collateral allows asset-based lending to provide something of a safe haven in volatile times. Larry Klaff and Lisa Galeota of First Eagle Alternative Credit consider its merits.

Asset-based lending facilities – corporate loans supported by the borrower's assets rather than its cashflows – have long represented a differentiated, if somewhat unheralded, potential source of return for institutional investors. Given their potential for higher yields and strong downside mitigation relative to cashflow based lending, this subset of private credit may serve as a potential compliment to an institution's other public and private credit exposures, particularly in an environment marked by macroeconomic uncertainty, market volatility and diminishing liquidity.

Traditional mid-market loan structures, including both broadly syndicated loans and direct lending, typically are underwritten based on an assessment of the borrower's cashflows and governed by a range of maintenance covenants tied to those cashflows. Asset-based loans, in contrast, are secured by specific assets of the borrower such as inventory, accounts receivable, real estate, machinery and equipment, and intellectual property, and feature provisions designed to preserve the value of those collateral assets and maintain strict loan-to-value guidelines. Though liquidation is a last recourse for most lenders, explicit collateral backing combined with loan terms that are highly structured to preserve the lender's interests help to minimise losses in a downside scenario.

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The funds available in an ABL facility are determined by a simple formula based on the type and value of the borrower's pledged collateral. Thus, collateral is the primary focus of lenders' initial loan underwriting and ongoing oversight. At First Eagle Alternative Credit, for example, we assess both the quality and resilience of collateral by appraising the asset's liquidation value in a difficult market environment. Term sheets outline frequent and detailed monitoring requirements for collateral, along with a variety of triggers intended to mitigate downside impact and keep the loan within the formula.

ABL facilities pay a floating interest rate spread over the Secured Overnight Financing Rate. They typically have a term of five years or less, though the average life of these loans is normally shorter. As an ABL term loan facility tends to charge a higher interest rate than a traditional cashflow loan, borrowers often seek a cheaper alternative as soon as their balance sheets allow. Deals often are structured to ensure lenders are compensated in the event a loan is retired early, and this condensed loan life can have a positive impact on the internal rate of return lenders are able to generate for their investors.

ABL deals may seem formulaic on the surface, but don't mistake that for simplicity. Success in the ABL space depends in large part on access to the deals, the appraisers and depth of experience that can only be developed after many years in the business.

With mid-market companies facing numerous financial and operational challenges alongside a sea change in the cost and availability of capital, such access may be particularly important to lenders today. Arduous conditions have tended to create opportunities for non-bank lenders with the resources, scale and expertise required to provide borrowers with flexible financing solutions and assemble these rigorously underwritten asset-based loans into portfolios which can offer investors an attractive blend of risk and reward.

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- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements; and
- Below investment-grade loans which may default and adversely affect returns.

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