Grant Thornton

Capital Thinking

Asset Based Lending – flexible funding for growth

2021

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The asset based lending ("ABL") industry has been on a steep development curve since its launch in the UK a little over 20 years ago. ABL has risen through the ranks of alternative finance to what we see today as a mature, credible product that offers flexible funding options at all levels of enterprise.

So what is ABL? Technically, it covers any funding secured against specific assets of a borrower. However, in the mid-market, the main focus of ABL is on facilities secured against accounts receivable (often referred to as "invoice finance"), inventory, plant, machinery and increasingly intellectual property. It can be a straightforward way to unlock balance sheet value and boost liquidity and can be applied in a wide range of scenarios. Furthermore, it can complement other funding solutions such as mortgages and cash flow loans.

As we approach the middle of 2021, the UK economy faces uncertain times. To be successful, businesses need to effectively react to rapid changes in their environment. This type of environment is often best supported with flexible funding facilities - step forward ABL.

Asset based lending and your business in 2021

The approach of ABL funders in the wake of the Covid-19 pandemic

The economic downturn experienced since the onset of the Covid-19 pandemic has been completely different to that seen in 2007/08. With lenders being comparatively well capitalised this time around, there remains a significant level of liquidity in the market meaning pricing for ABL facilities remains competitive with other funding options.

In addition, the maturity of the market has seen funders gain experience, and therefore comfort, in providing more complex products in increasingly demanding environments. The worlds of private equity and large corporates have seen the benefits ABL can provide, and many are seeking to take full advantage in a way hitherto unseen.

ABL has evolved to a position whereby it now has the track record, experience and the liquidity to provide a range of funding products competitively. ABL is well positioned to meet the needs of borrowers at all levels and ABL funders are very much open for business.

"There is a significant amount of liquidity in the ABL market currently, making this form of funding competitive in terms of pricing and flexibility."

Nick Wilson

What are its benefits and how does it compare to other forms of working capital finance?

ABL facilities can sit alongside other forms of debt finance such as term loans, mortgages and asset finance. However, it will not usually be appropriate to have an ABL facility in place as well as another material source of working capital funding such as a revolving credit facility ("RCF").

To fully understand where an ABL facility would be appropriate versus an RCF, it is important to compare their key features.

Feature	Typical RCF facility	Typical ABL facility
Committed facilities	A lender will tend to provide committed facilities for a set period, for example five years.	Will generally be uncommitted or committed for a shorter period than an RCF, usually one year.
Covenants and controls	Generally linked to some form of profitability metric via covenants that are ordinarily tested on a quarterly basis. In times of turbulent trading, this could lead to covenant breaches, putting the availability of funding in doubt.	ABL facilities will tend to have minimal covenants attached to the funding with the emphasis being on the maintenance of asset quality and fixed charge cover as discussed in more detail later.
Cost	Tends to be more expensive and will generally include a commitment fee or non-utilisation fee.	As an ABL loan is secured against specific assets, borrowers can benefit from a lender's lower cost of capital in the form of a cheaper "all in" pricing when compared to an RCF.
Suitable assets and security	When assessing a company's debt capacity, funders are likely to be more interested in the company's trading rather than its assets.	A company's ability to secure ABL facilities will be dependent upon it having suitable assets (generally receivables) on its balance sheet. This could mean that B2C businesses are able to secure less funding under an ABL structure, compared to other forms of working capital finance.
Flexibility, administration and financial planning	The limit of an RCF is typically fixed over the medium term making it is easier for CFOs to incorporate into a short-term cash flow forecast.	The level of funding available under an ABL facility will fluctuate in line with the company's asset base and working capital cycle. This variability can be beneficial, particularly for a growing business (or one rebuilding its trade and balance sheet following the pandemic). However, it can also present increased forecasting challenges for CFOs as accurate balance sheet modelling will be required to ascertain available funding.

Is ABL right for your business?

It is important to consider ABL funding in the context of a company's overall debt structure – ABL funding is offered by a wide range of funders meaning that a single institution can often deliver all of the debt products a corporate requires. That said, it may be desirable to have ABL facilities and other forms of debt provided by different funders in order to secure the best possible pricing. It might also be the case that the quantum of funding could be maximised by having different assets funded by different providers.

Regardless of which party provides the various elements of the debt structure, it is vital to ensure each element within the structure is being used for an appropriate purpose. ABL is designed to help fund working capital, providing temporary liquidity at different points of the cycle. That said, whilst ABL is increasingly being considered as part of a funding solution for M&A transactions, working capital funding is not an appropriate source of funding for capital projects and should not be used to repay term debt facilities.

A CFO will need to be mindful that, if the asset base reduces and available funding falls, the company may find itself experiencing liquidity issues if cash receipts have been used for a purpose other than short-term working capital funding.

"Deductions and reserves can be applied by lenders to all forms of ABL facilities. Borrowers should ensure the terms of borrowing are fully understood to allow them to manage their working capital effectively."

Richard Oddy

How much funding could I generate from ABL facilities?

The main purpose of an ABL facility is to reduce working capital lock-up by advancing a percentage of an asset's value to the borrower. However, a borrower will typically receive less funding than is implied by the headline advance rate agreed by its funder.

In a recent article we have explored in detail the factors impacting the amount of funding that can be derived from an asset base and how a borrower can maximise the available facilities. However, below we take a look at why this might happen with a very simplified example of an invoice finance facility:

	£
Gross accounts receivable	250,000
Concentration limit	(10,000)
Aged accounts receivable	(15,000)
Overseas receivables	(5,000)
Contra accounts	(7,000)
Eligible accounts receivable	213,000
Advance rate	85%
Maximum advance	181,050
The maximum advance will be subjection to an overall facility limit	
Effective advance rate	72%
Maximum advance as a proportion of gross accounts receievable	

It is important for a borrower to understand the formula used to calculate funding availability from its facilities and the deductions that may be made to its borrowing base. A lender will typically apply reserves or make deductions from the gross ledger before applying the advance rate. These restrictions are bespoke for each situation but may include taking account of:

- Old invoices
- Concentration of the ledger towards a single customer
- Intra-group trading
- Invoices due from certain overseas jurisdictions
- Contra positions where amounts are due to and from a customer
- Credit notes

When a business is cash positive these restrictions are often overlooked, with many unaware of their existence and unconcerned that the effective rate is some way short of the contracted advance rate .

However, at times of increased cash pressure, businesses will look to their ABL facilities and try to understand why it is not operating as effectively as they understood it would. To optimise the usage of the facility and to get closer to the headline advance rate, it is crucial that the business has a good understanding of the funding formula and the actions of those working within organisations can influence the level of funds available to them.

Getting "credit ready" in 2021

2020 was certainly a year to forget for many businesses and, unsurprisingly, the need for financial support continues to be a very real and present issue. Companies and their management teams are continuing to explore funding options as the effects of the economic downturn stretch into 2021 and the end of various Government support schemes come into view over the coming months.

We have discussed how ABL may be able to support businesses as we head into 2021, but once an appropriate debt structure has been identified, what is it that lenders will be looking for to help them understand your business and enable them to provide the support that it needs?

Here we discuss some of the fundamentals that should be considered if a business needs flexibility from its debt structure, forbearance or new money and explore some of the tools that can be utilised to maximise the chances of getting the required support to navigate the credit process.

Timing is key

There is little doubt that requests for emergency financial support over the last year were both necessary and unavoidable, particularly in the early part of 2020 as businesses looked to their existing lenders as the easiest and quickest sources of funding. The immediacy of these requests is understandable, and lenders have, in the main, been sympathetic and supportive to prevent businesses failing, recognising the extent of the unprecedented economic challenges.

However, lenders do not appreciate being brought into the loop late in the day, especially if it appears that a last-minute request has been positioned intentionally in the hope that support will be granted and provide a seemingly better outcome than other alternatives.

Ensuring, as far as possible, that any request is made well ahead of any cash pinch points to enable the lender to properly consider the merits of any proposal is a much safer option. Raising the flag and presenting a challenging situation will not necessarily worry experienced lenders who will have encountered similar situations before. However, if the lender feels backed into a corner with no time to prepare, this is likely to raise concerns.

What is the plan?

Being able to articulate a clear strategic plan that is supported by robust financial and operational data is an obvious but integral component of any credit decision. Ensuring that information, particularly financial forecasts, are presented in a clear format with logical underpinning assumptions makes the decision makers' life much easier, which is exactly what you want.

As businesses seek to capitalise on opportunities after the disruption of the last year, it is more relevant than ever for management teams to consider more than one scenario and understand how risks might affect the business and its ability to support an increased level of debt.

Lenders will understand the health warnings that are built into business plans, but they will want to understand both upside opportunity and downside risk and importantly, how this impacts their own lending position.

Inclusion of wider stakeholders

The implementation of any business plan is likely to rely on the engagement and agreement of a number of stakeholders. Ensuring that there is tangible evidence of consultation with key parties including other lenders, pension schemes and customers provides additional credibility and demonstrates that you recognise the importance of key stakeholders' buy-in to any plan.

If your business is highly reliant on any particular stakeholder, especially those that could potentially derail any plans, it is critical to be able to demonstrate that you have engaged them, that they understand what you are trying to achieve and that they are ultimately supportive. Where this support is contingent on you achieving certain milestones, your lender will want to understand what these are and how they will be managed.

ABL's role in M&A

"It's worth noting that ABL can play a role in funding M&A transactions. Certain sectors (such as industrials, manufacturing, recruitment and logistics) lend themselves very well to ABL funding due to their typically strong asset base. ABL could therefore be a viable source of funding for transactions in these markets even if borrowing based on cash flow is unobtainable."

Jon Roden

Self help measures

Whilst the easiest and most logical place to seek support is often from an existing lender, they are unlikely to be the only source of support available. Exploring other potential options, especially those that are within management's control, will give lenders confidence that they are not the only stakeholder that is being asked to put its hand in its pocket. Have other stakeholders been asked for support? If not then can your lender be expected to do this in isolation?

In the same vein, ensuring cash leakage is kept to a minimum will help to demonstrate that management is tightening its belt. No lender will look favorably on a request for new money whilst non-essential spend remains unchallenged especially where liquidity is under pressure. Many lenders would ideally like to see some equity support or may look for additional security and/or guarantees so that all parties are demonstrating an increase in commitment to the business. It is worth considering where this might come from ahead of time.

Team players

Does your management team have a clear appreciation and deep understanding of the business and the issues it is currently facing? Could it talk through how their proposal will be implemented, and point to a track record of delivering against an agreed plan? If the answer is no, you are at a distinct disadvantage.

In a time where digital communication has never been so important, relationships with people rather than organisations remain extremely relevant. Working collaboratively with your relationship manager who will often be the conduit between you and the ultimate decision makers is important.

Demonstrating that the senior team is engaged and has a credible plan is a prerequisite as without this, it is unlikely that your request will get much traction.

Advisors

Committing to additional advisor costs can seem like an unnecessary expense. However, the cost should be balanced against the consequences of failing to obtain the support that the business needs. Independent advisors can be a valuable resource providing input into strategy, planning, governance and financial reporting all of which are important contributory factors in the credit decision.

Demonstrating that your plan has been stress tested from someone outside of the business adds to the overall credibility of the proposal, especially when they are known and trusted by your lender.

Be realistic

Lenders are ultimately in the business of lending money and will want to support good businesses so long as they can get comfortable with the level of risk that any new proposal represents for them. They each have their own view on risk appetite and internal lending criteria that need to be adhered to. Being realistic in terms of what you are asking for versus what the business can support is a simple yet important sense check to ensure that any request is given serious consideration.

Requests need to be proportionate to the businesses balance sheet strength and its ability to service debt. Funders will only contemplate pushing their risk parameters in extreme circumstances and importantly, if they think they will get it back!

Being creative across the balance sheet

As we have already discussed, until relatively recently, the focus of ABL has been on assets such as receivables, plant and machinery and, notwithstanding the recent changes to Crown Preference, inventory lending remains a feasible option for many companies.

However, lenders are increasingly willing to consider funding of intangible assets such as brands and other intellectual property. Depending upon the sector, funding may also be available against WIP and annual recurring revenue streams.

As in the case of traditional ABL lending, the strength of the underlying asset is of utmost importance, but these relatively new product offerings serve to demonstrate that the ABL market is willing to think creatively in order to match funding solutions to a wide variety of different corporates and situations, beyond the traditional asset-heavy industrial sectors.

ABL as a mainstream option available to borrowers

Over the last 12 months we have advised on ABL deals across a range of sectors and business sizes, including large syndicated ABL refinancings, complex ABL bilateral debt restructurings and innovative ABL + unitranche structures used for M&A by private equity financial sponsors.

Again, this is reflective of the broadening range of scenarios where ABL solutions can be applied.

Sarah O'Toole

In summary

In the right circumstances ABL provides a dynamic, flexible funding solution that is very well placed to meet the demands of businesses in the current economic environment businesses face as we enter 2021. However, even where a business is well placed to take advantage of ABL, it is key that those early engagements with the funder are managed appropriately, and that going forward that they really understand the key components of the funding formula in order to ensure usage and cash release to working capital is optimised.

Our dedicated ABL Advisory Team has specialist knowledge and a track record of working with companies and lenders to secure new ABL facilities for businesses of all sizes across a variety of sectors. Working collaboratively with management teams we provide a range of services including refinancing, raising new finance, pre-lend reviews, lender negotiations, benchmarking and data analytics.

For support with your ABL funding, get in touch with our ABL Advisory Team.

Meet the team

ABL Advisory team

Sarah O'Toole
Head of ABL Advisory
T +44 (0)7796 175 418
E sarah.a.otoole@uk.gt.com

Paul Burke
Scotland
T +44 (0)7584 207 080
E paul.m.burke@uk.gt.com

Nick Wilson
North West
T +44 (0)7834 195 593
E nick.m.wilson@uk.gt.com

Richard Oddy
Yorkshire and North East
T +44 (0)7812 347 936
E richard.n.oddy@uk.gt.com

Jon Roden
Midlands
T +44 (0)7799 114 368
E jon.l.roden@uk.gt.com

Richard Lewis
South West
T +44 (0)7538 551 468
E richard.j.lewis@uk.gt.com

Philip Stephenson
London and South East
T +44 (0)7974 379 719
E philip.stephenson@uk.gt.com

Catherine Barnett
London and South East
T +44 (0)7980 870 523
E catherine.barnett@uk.gt.com

UK Debt Advisory team

Christopher McLean
Debt Advisory
T +44 (0)7825 865 811
E christopher.mclean@uk.gt.com

Craig Cheetham
Debt Advisory
T +44 (0)7876 817 903
E craig.cheetham@uk.gt.com

Sam Susman
Debt Advisory
T +44 (0)20 7184 4604
E samuel.susman@uk.gt.com

Gemma Sampson
Debt Advisory
T +44 (0)20 7728 2677
E gemma.sampson@uk.gt.com

Grant Thornton

grantthornton.co.uk

DS2452