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The State of Asset-Based Lending in Q1 2024: A Comprehensive Analysis

BY SFNET'S DATA COMMITTEE

The first quarter of 2024 presented a complex landscape for asset-based lending (ABL) and the broader economic context. According to the SFNet Q1 2024 Asset-Based Lending and Confidence Index surveys, the ABL industry exhibited both stability and cautious optimism despite the economic headwinds.

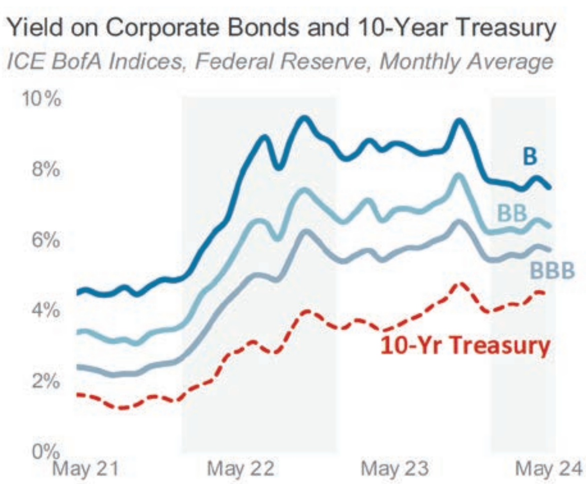
This report, based on SFNet's detailed findings, provides a comprehensive overview of the economic conditions, lender confidence, commitments, outstandings, and portfolio performance within the ABL sector.

Economic Context

The U.S. economy had a slow start to 2024, with a muted growth rate of 1.3% in the first quarter. Softer-than-expected consumer spending and declining business inventories were significant contributors to this modest growth. Rising debt burdens and slowing real income growth have started to pinch consumer spending, which has been a driving force in the economy over recent years. The unemployment rate edged up to 4%, with a corresponding decline in job postings, signaling a softening labor market. However, the labor market remains robust enough to prevent a collapse in consumer spending.

Progress on disinflation is promising, with the May Consumer Price Index (CPI) report showing unchanged prices, alleviating fears of renewed inflation. The Federal Reserve is widely expected to maintain its cautious stance, likely refraining from rate cuts until the fall, aiming to achieve a "soft landing" – reducing inflation without triggering a recession.

On balance, the ABL industry remains healthy and has a moderately improving outlook even though current economic conditions have limited demand for borrowing. Limited merger and acquisition activity has contributed to softer demand for ABL and looming regulatory changes have limited supply by spurring banks, especially smaller ones, to manage their capital with greater caution. Facing softer consumer demand, many retail clients are under stress, and lenders are closely monitoring portfolios. That said, there are indications that portfolio performance is turning a corner and starting to improve. While a stable ABL industry is poised to help clients meet their working capital needs, an uptick in loan demand may be needed to spark an improvement in business conditions.



Yield on Corporate Bonds and 10-Year Treasury

The spreads for corporate bond yields have tightened in recent months as yields trend downward, while underlying interest rates hold relatively steady. This indicates a cautious, but stable, financial environment for lenders and borrowers alike.

Tightening spreads for corporate bonds reflect investors' confidence in corporate credit quality, even as they demand higher premiums for taking on risk. The stability in underlying interest rates supports the overall borrowing environment, making it feasible for businesses to plan and execute their financing strategies without the added burden of volatile interest rates.

Lender Confidence Index

Non-bank lenders showed more optimism than banks about industry conditions in the next quarter, with non-bank confidence increasing by 5.0 points to 65.8. Banks, however, saw a slight dip in overall confidence by 2.1 points to 57.0. Both groups maintain a slightly positive outlook, with non-banks having more favorable expectations for general business conditions, portfolio performance, and employee headcounts.

Banks' expectations for new business demand and client utilization rates softened slightly, while non-bank expectations remained flat. Notably, no lenders expect demand to decrease in the next quarter. Most banks and non-banks expect utilization rates to remain the same, with a larger share of non-banks foreseeing improvements.

Commitments and Outstandings

For banks, total commitments remained essentially flat from Q4 2023 to Q1 2024, with a modest 0.2% increase. Total outstandings, however, ticked up by 1.3%. Deal activity was quiet, with new commitments with new clients falling by 36.5%. However, commitment runoff fell by 40.4%, resulting in positive net commitments.

Non-banks experienced a similar trend, with flat total commitments (-0.9% Q/Q) and a modest uptick in total outstandings (+3.2%). New commitments with new clients saw a substantial decline of 66.1%, while commitment runoff was largely unchanged. Consequently, net commitments turned negative. New outstandings also declined by 64.6%, with outstandings runoff increasing slightly, leading to negative net outstandings.

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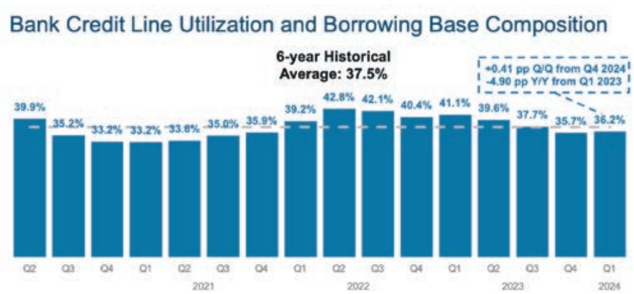
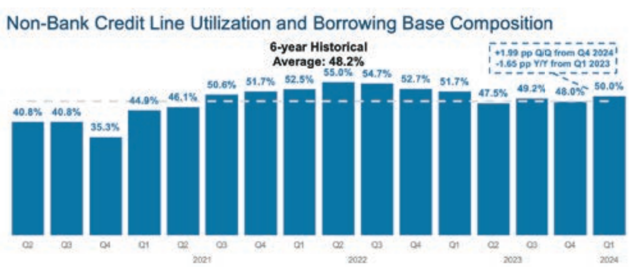
Credit Line Utilization

With modest increases in outstandings and flat commitments, the utilization rate increased for both banks and non-banks. Bank utilization rose by 0.41 percentage points to 36.2%, remaining below the long-term historical average, while non-bank utilization increased by 1.99 percentage points to 50.0%, just above average.

The increases in utilization rates for both banks and non-banks indicate a cautious, but steady, demand for credit. This trend suggests that while new business may be slower, existing clients are drawing on their available lines more frequently, possibly to manage cash flow amid economic uncertainty. Banks' lower utilization rates compared to non-banks reflectsthe availability of other types of debt capital for larger borrowers. It also reflects bank's generally more conservative approach and stricter credit controls, which align with their regulatory requirements and risk management strategies.

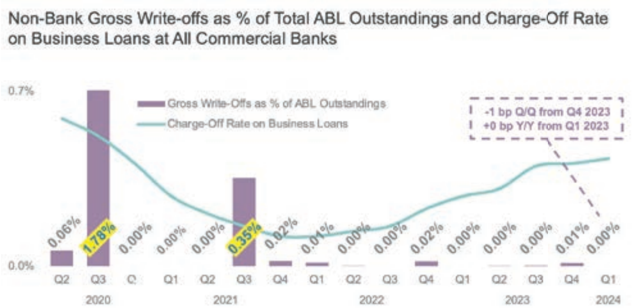




Portfolio Performance

Portfolio performance remained stable for both banks and non-banks in Q1 2024. Among banks, criticized/classified loans and write-offs increased, but non-accruals declined. Non-banks reported decreased non-accruals and write-offs. As the large liquidity injection from pandemic-era stimulus dissipates, lenders are closely monitoring portfolios for signs of stress, but overall portfolios remain healthy by historical standards.

The stability in portfolio performance highlights the resilience of ABL portfolios amidst economic fluctuations. Banks' slight increase in criticized/classified loans and write-offs indicates some pressure points, but the decline in non-accruals suggests that problematic loans are being managed effectively. Non-banks' decrease in non-accruals and write-offs points to strong portfolio management practices and possibly more flexible loan structures that can accommodate borrowers' needs during economic slowdowns.

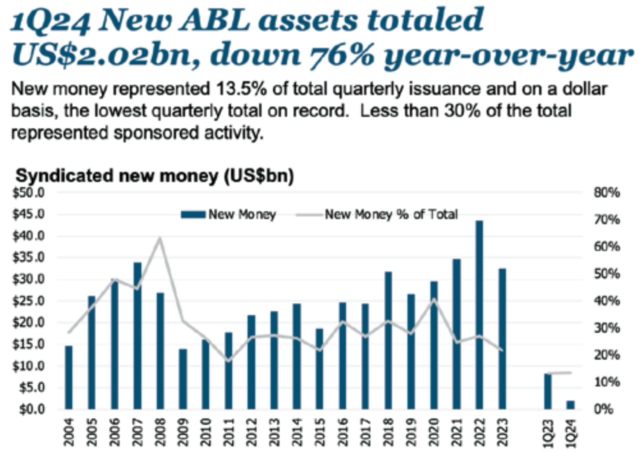


Syndicated ABL Overview

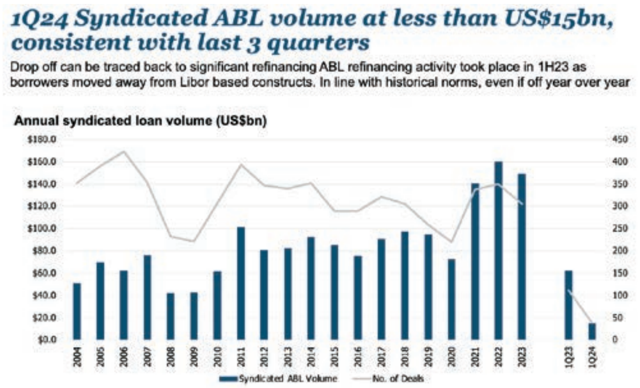
The syndicated ABL market saw less than $15 billion in volume in Q1 2024, consistent with the last three quarters. This decline can be traced back to significant ABL refinancing activity in the first half of 2023, as borrowers moved away from LIBOR-based constructs. New ABL assets totaled $2.02 billion, down 76% year-over-year, marking the lowest quarterly total on record for new money.

Average ABL undrawn pricing edged down, with drawn spreads at 200 basis points. Demand for new loan assets continues to fuel competition, keeping cash flow deal spreads stable. Outstanding ABL commitments, after reaching a record high of $353.7 billion at the end of 2023, edged down to $349.5 billion by the end of Q1 2024. Note that the pricing reflects average across the entire market sample and is not necessarily indicative of any individual transaction pricing.

The syndicated ABL market's performance underscores the cautious stance that lenders and borrowers are taking amid economic uncertainties. The significant drop in new ABL



assets indicates a wait-and-see approach, with businesses possibly postponing new hiring until there is more clarity on the economic outlook. The stable, but competitive, pricing environment reflects lenders' need to balance risk and return while maintaining market share.



Borrowing Base Composition

The borrowing base composition for ABL remains diversified, with receivables making up the largest share at 51.3%, followed by inventory at 40.3%. Other components include machinery and equipment (3.9%), property (1.1%), and intellectual property (0.7%).

This diversified borrowing base composition allows lenders to spread their risk across different asset types, which can provide a buffer against sector-specific downturns. The high proportion of receivables and inventory in the borrowing base reflects the typical collateral profile of ABL, which is heavily reliant on assets that can be quickly converted to cash in case of borrower default.

Non-Bank Lenders' Performance

Non-bank lenders had a quieter quarter in terms of new commitments, which fell by 66.1%, but they managed to maintain a slight increase in outstandings. The net commitments turned negative due to higher commitment runoff. The decline in new commitments reflects the broader trend of cautious lending amid economic uncertainties.

Despite the decline in new commitments, non-bank lenders' ability to maintain and even increase outstandings shows their resilience and adaptability. Their more flexible lending structures and willingness to work with clients to manage existing commitments can help them maintain portfolio stability even in challenging economic conditions.

Criticized and Classified Loans

For both banks and non-banks, the levels of criticized and classified loans have shown some increases, but the overall portfolio health remains stable. Banks reported a 9.2% increase in criticized/classified loans quarter-over-quarter and a 14.5% increase year-over-year. Non-banks reported an increase in criticized/classified loans, with higher proportions of non-accruing loans compared to the previous quarter.

The increases in criticized and classified loans indicate areas of concern within the portfolios, but the stability in overall health suggests that these issues are being managed effectively. Continuous monitoring and proactive management of these loans are crucial to prevent further deterioration and to maintain portfolio quality.

Gross Write-Offs

Banks and non-banks reported changes in gross write-offs, with banks showing a significant 66.9% increase quarter-over-quarter and a 46.1% increase year-over-year. While these increases are significant statistically the actual chargeoffs remain at a low level from a historical perspective. Non-banks' gross write-offs remained relatively flat, reflecting their effective management of distressed assets.

The increase in gross write-offs for banks highlights the challenges they face in managing distressed assets. However, the ability to absorb these write-offs without significant impact on overall portfolio performance indicates strong capital buffers and effective risk management practices.

Long-Term Outstandings vs. Monthly Commercial & Industrial (C&I) Loans

Comparing long-term outstandings with monthly C&I loans provides insight into the broader lending trends. While ABL outstandings showed modest growth, C&I loans experienced more volatility, reflecting the different dynamics in these lending segments.

The comparison between ABL and C&I loans underscores the stability of ABL as a financing option. ABL's reliance on secured assets provides a more predictable performance for lenders, even when broader commercial lending experiences fluctuations. This stability makes ABL an attractive option for lending businesses seeking reliable financing sources.

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Headcount Expectations

Lender expectations for headcount growth remained largely stable, with banks showing a slight dip and non-banks exhibiting a modest increase. Banks' headcount expectations dipped by 4.7 points to 54.3, while non-banks' expectations increased by 4.2 points to 62.5.

Stable headcount expectations reflect the cautious optimism within the ABL sector. Lenders are maintaining their workforce levels to ensure they can manage existing portfolios effectively while being prepared for potential increases in demand. Non-banks' higher expectations for headcount growth indicate their anticipation of more robust activity in the near future.

Conclusion

The asset-based lending industry in Q1 2024 faced a mixed set of issues, but lenders remain cautiously optimistic. While economic conditions and demand for borrowing were softer, lenders maintained stable portfolios and showed positive outlooks for the future. Non-bank lenders were notably more optimistic than banks, reflecting differing perspectives within the industry. As the year progresses, the ABL sector will continue to navigate economic challenges and opportunities, supported by a resilient and adaptive approach.

The insights from the SFNet Q1 2024 report highlight the importance of continuous monitoring, proactive management, and strategic flexibility in maintaining the health and performance of ABL portfolios. As economic conditions evolve, the ability of lenders to adapt and respond to changing circumstances will be crucial in ensuring the ongoing stability and growth of the asset-based lending industry.

For details on participating in SFNet's ABL and Factoring Surveys, please contact Aydan Savaser at asavaser@sfnet.com.