ANATOMY
OF A DEAL

Anatomy of a Deal:

Non-Bank ABL Solutions - Maximizing Availability and Flexibility

BY TOM OTTE AND KEVIN COX

White Oak executives detail a complex deal that unlocked substantial liquidity for an asset-heavy borrower in a non-traditional ABL industry.

In today's uncertain economic climate, companies are faced with a significant rise in interest rates, compressed gross margins, inflationary pressures on operating expenses, and declining cash flow to support working capital needs. Traditional bank financing, whether cash flow or asset-based, can be stressed and severely restrictive in this type of environment, posing a challenge to companies. Banks meanwhile are under internal and external pressures to evaluate portfolio companies, and may not be able to provide the liquidity and support that a borrower needs.

This is where private credit and non-bank direct lenders can step in. Private credit and non-bank direct financing can provide small and medium-sized enterprises ("SMEs"), whether sponsor owned or independent, access to liquidity that is critical to support growth and acquisitions and can help a company through a transition that may otherwise be significantly limited by a traditional bank financing. In this economic and lending environment companies are frequently turning to investment bankers and advisors to navigate the expanding world of private credit. Borrowers considering a move to a non-bank lender are looking for a partner who can be flexible and collaborative, and unconstrained by a rigid, regulatory-based, "credit box" that can leave borrowers and prospects needing more.

A non-bank lender may look at the same pool of assets differently than a bank lender and still be able to preserve protections typical for lenders. Asset-based lenders love the velocity and turnover of collateral into cash collections, which can be used to pay down the debt if needed. Companies in asset-heavy but cash flow constrained industries can slip between the cracks, as traditional ABL structures favor receivables and inventory over fixed assets and real estate. These "upside down" borrowing bases can be tricky to navigate, especially in industries that have historically not found much success in ABL, such as construction. Fixed asset-heavy borrowers tend to gravitate towards financing via a term loan, which is typically less flexible and can be problematic if leverage is elevated. However, by strategically including fixed assets in the borrowing base of an ABL, the borrower can be less constrained by leverage requirements, fixed amortization, and excess cash flow sweeps and unlock liquidity from the value of the assets.

Having a keen and capable advisor alongside the management team can be a valuable asset today. The most impactful advisors can target lenders that are known to lean-in on an opportunity and find solutions where others may only find roadblocks. Advisors can help companies unlock value and liquidity by finding a lender that can meet the credit need; or identify a group of lenders to meet the credit need together (e.g., sale/lease back transactions, junior debt, etc.). Finding lenders who can work collaboratively and with management can make for a more successful deal execution for all parties involved, and meet the liquidity and flexibility needs of the borrower.

White Oak did exactly that in a recent transaction with a leading specialty construction company that provides marine and industrial construction, dredging, and specialty services. With a track record spanning decades of completing complex projects, the borrower has established a solid reputation among clients and investors for delivering high-quality projects across various sectors, including transportation, energy, and infrastructure.

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The company had financed its growth and working capital through bank-provided cash-flow and capital lease financing. However, due to macroeconomic and industry conditions, its cash flow facility was constrained and not sufficient to finance growth initiatives. There was significant value locked up in the company's fixed assets and real estate, but given the mix of collateral and the industry that the borrower operates in, the borrower didn't quite fit into the "credit box" of a traditional asset-based lender. With extensive experience in lending against non-traditional assets, White Oak was able to provide more than 2x the borrowing capacity with a more flexible structure and the liquidity the company needed while maintaining adequate borrowing-base controls to help protect investor capital.

Lending against fixed assets, especially those that are specialized, high-value, or thinly traded requires a lender's willingness to conduct extensive third-party diligence with multiple constituents. Industry experts, field examiners, appraisers, and specialty legal advisors are all necessary to underwrite the risk associated with these types of assets. The "typical 85% and 90%" advance rates against a receivable or book value of commodity inventory no longer applies when a lender assesses billed and unbilled receivables that have retainage or contractor offset concerns, fleet assets that have limited varying useful lifecycles and value to an outside party, or real estate with specific uses and potential environmental considerations. This exhaustive diligence can add a significant amount of time to a refinancing process. While managing the borrower, advisor, and existing lender's expectations can be tricky to navigate, the additional diligence becomes the pivot point that helps win the approval of the lender's investment committee and lead to a successful close and funding, and a hopefully fruitful long-term relationship between the borrower and new lender.

With today's rising interest rates and potentially recessionary business environment, access to capital and financial flexibility are paramount. Management teams and their trusted advisors need to recognize the need to optimize their capital structures to support growth initiatives, have access to diverse and flexible funding sources, and enhance their ability to weather potential economic uncertainties. The COVID-19 pandemic serves as a stark reminder of how unexpected events can disrupt business operations and strain cash flows. Companies, and lenders, that have diversified their financing strategies are better positioned to navigate through such challenges and continue their growth trajectories. Lenders, both banks and non-banks, are cautious of the economic uncertainty on the horizon and are structuring more conservative investments because of it. While non-bank lenders tend to provide more availability and covenant flexibility, the controls afforded to the lenders have increased. The days of springing financial covenants and cash dominion are being traded for maximizing liquidity as borrowers have been more accepting of additional monitoring, reporting, and interest rate spread for more liquidity and patient capital.

We believe investor activity and appetite for private credit are strong. Investors looking for diversification across assets classes and among their managers may be drawn to the attractive risk-adjusted returns in non-bank ABL, which typically offer higher returns compared to traditional fixed-income investments, while still retaining acceptable collateral coverage and controls. Private credit is often viewed as an interest rate risk hedge, given most direct lending deals feature floating rates that are locked-in with higher floors than in recent years. Private credit investments also may be less susceptible to market volatility, as these investments typically are not subject to the same market fluctuation and volatility as the public markets. Asset-based lending can be a notable diversifier to many investors' existing exposure to corporate direct lending. We expect investor appetite for private credit to remain strong and interest in ABL to continue to grow, which will provide more dry powder for non-bank lenders to deploy and meet the borrower needs for this type of financing. This may have the impact of encouraging some - often less experienced - non-bank lenders to get even more creative, while others will stick to their underwriting disciplines and core investment mandates to control potential workouts from emerging within their portfolios during the next phase of this economic cycle.

Conclusion

Traditional financing methods, while still relevant, are being complemented by innovative and customized solutions that can be structured in ways that cater to the specific needs and challenges that companies are facing today and provide flexible for the future, while preserving the needs and protections of the lender. As private credit continues to evolve and adapt, this article should serve as a reminder that structural decisions by a lender should be driven by a deep understanding of a company's unique circumstances, growth aspirations, the broader economic environment, and a desire to be a patient and collaborative partner during these uncertain economic times.

Key Points

1 Non-bank asset-based lenders can unlock value by lending against less liquid, but still valuable, assets.

2 Well-connected advisors are critical in today's market environment.

3 Smart lenders are leaning-in to provide creative financing solutions across challenging industries.

4 Borrowing capacity and access to patient capital are at the forefront for prospective borrowers.

5 We expect investor and lender appetite for capital deployment in private credit to continue to rise.

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Kevin Cox serves White Oak as managing director of underwriting, with primary responsibility for structuring and underwriting new investment opportunities for White Oak's private debt fund. He joined White Oak in May 2021. Cox has 20 years of asset-based lending and commercial finance experience, having served in various originations, relationship management, and underwriting roles throughout his career. Prior to joining White Oak, Cox was managing director and Western Region ABL underwriting manager at Wells Fargo Capital Finance, managing a team of underwriters focused on delivering financing solutions to middle-market and mid-corporate sponsor-backed, public, or privately owned companies across North America. During his tenure at Wells Fargo, Cox was also a senior relationship manager in the Syndicated Finance division and a business development officer with Wells Fargo Business Credit. He also previously served as a vice president, relationship manager, in Bridge Bank's Capital Finance lending group and as vice president, underwriter, in Bay View Bank's factoring division. He received a B.A. in political science from Harding University. Over the years he has been active in SFNet, ACG, and TMA.