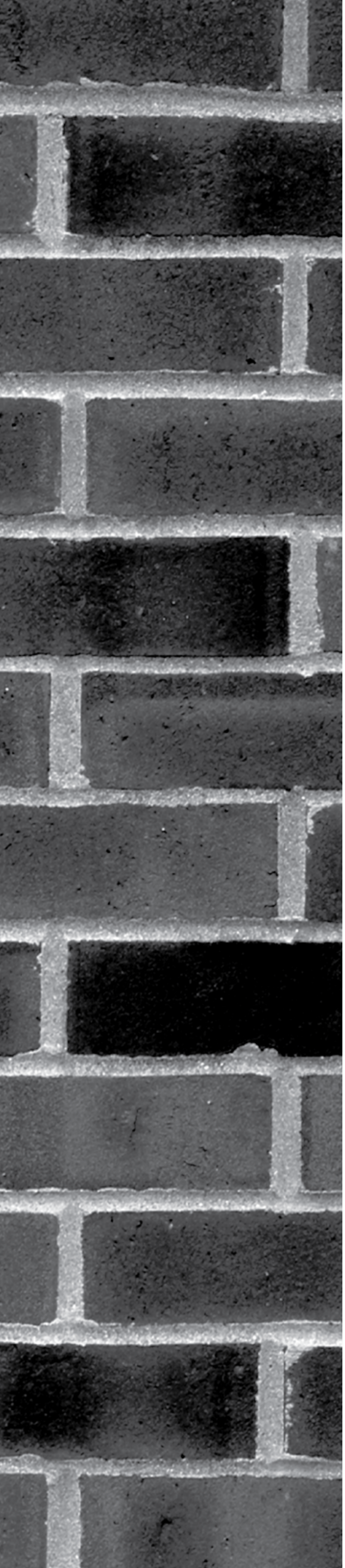
CREDIT CRUNCH PROVIDES OPPORTUNITIES FOR DISCIPLINED ABLs & FACTORS IN 2009



BY MYRA A. THOMAS

Certainly, the current credit crisis is not a welcomed situation. Yet, asset-based lenders and factors are benefiting from the downturn and the pullback in more traditional lines of credit. As businesses turn in ever-growing numbers to the secured-lending marketplace to satisfy their liquidity needs, the industry's profile is on the rise. Those in the ABL/factoring space note that staying the course in underwriting is particularly essential going forward into 2009. The rocky financial situation for many businesses demands "disciplined lending" and a "renewed focus on the fundamentals of risk management" when assessing opportunities in this difficult economic environment, notes Tom Quindlen, president and CEO of GE Corporate Lending.

Statistics from the Commercial Finance Association do indicate an uptick in asset-based lending in 2008. According to the CFA's "Quarterly Asset-Based Lending Index, Third Quarter 2008" report, respondents indicated a 17.1 percent increase in new credit commitments originated in the third quarter of this year versus the second quarter. Additionally, 75 percent of the asset-based lenders in the index experienced an increase in new credit commitments in the third quarter of 2008 from the previous quarter. The ABL industry experienced an 11 percent increase in total credit commitments in 2007, reaching the $545 billion mark. Industry insiders predict that when the final totals are in, 2008 will easily top 2007.

The numbers are looking good for many of the CFA's members. According to Sam Philbrick, president of U.S. Bank Business Credit, "Our asset-based-lending side of the business is benefiting from being a countercyclical product. We're seeing a migration to ABL and expect double-digit growth in the business in 2008." Understanding the pressures in various business sectors, looking ahead to future pressures, and staying a "generalist" has helped U.S. Bank Business Credit build its ABL portfolio.

Philbrick adds, "There's been quite a lot of activity in the market. Some of it seems to be companies testing the lending market." Fortunately, Philbrick indicates that pricing is continuing to trend upward and structures are much more conservative than they were 18 months ago. "We're moving to more traditional underwriting standards," he adds. The tightening of structures couldn't have come at a better time, he indicates, as the ABL marketplace responds appropriately to weakening economic conditions.

The Challenges Ahead: Capacity & Access to Capital

The biggest challenge in 2009 just may be the availability of capacity in larger syndicated deals, especially as demand grows, notes Philbrick. Industry consolidation is just one factor complicating the issue. He admits, "It's an evolving situation with lenders responding to opportunities as they come along." But he does add that some "partners" are less active than they were a year before, with U.S. Bank Business Credit learning which players have the capacity and whom to partner with on key deals.

The biggest challenge in 2009 just may be the availability of capacity in larger syndicated deals, especially as demand grows, notes Philbrick.

As large deposit-taking lenders take a financial hit, liquidity issues are affecting some of these institutions on their ABL side. Fortunately, collateral hasn't deteriorated as much as cash flow, notes Philbrick. Even with the capacity demands, he believes there are enough players to handle the need, with ABL playing a much more active role in the lending marketplace in 2009.

The larger players in the mezzanine-debt arena are also noting fallout of some junior capital providers. Allan Allweiss, managing director of LBC Credit Partners, notes, "In 2008, there was a retrenchment of first-lien capital providers and a drop-off in the numbers of capital providers of all kinds. There will be a fair amount of continuation in that theme, and we don't expect a meaningful number of new entrants to fill the void, at least for the first half of 2009."

Allweiss says that, in turn, asset-based lenders are playing a more significant role in the secured-lending market. "We see partnership opportunities in those instances with the ABL lender," he notes. Allweiss says that, luckily, those in the ABL space are getting higher yields on their portfolios, on average, than their indicated returns on their entry pricing. "The portfolio activity is generating additional returns with clients needing more than originally addressed — as they add a plant, handle an acquisition or address a challenge — and asset-based lenders are getting pricing enhancements along the way," he explains.

Underwriting, Underwriting, Underwriting

Of course, additional opportunities are not always the best ones, and disciplined underwriting and more conservative deal structures have become the inevitable response to the weakening economic conditions. Allweiss adds, "Our research effort remains strong and the same as it has been in the past, and we are expecting pressure in most industries. We are underwriting to that expectation. We're looking for those businesses that have a real reason to exist within their industry — looking for industries that will perform to an acceptable standard in this environment."

As the overall economic picture clouds, Allweiss says that there are still jewels to be found. "There are companies with strong positions in their market and management teams able to withstand this kind of market. We want to work with those survivors," he says. He points to prudent metrics to uncover those gems — companies with the right amount of leverage and the right overall capital structure.

For now, average ABL pricing, first-lien cash flow pricing, pricing in the second-lien market and pricing in subordinated debt has increased, and Allweiss admits that this is due to the increasing underlying risk. He also predicts that pricing in the first half of 2009 will stay strong, "at least until more capital providers return to the industry and there is a real perceived stabilization in the fundamentals of the market. Capital providers should be paid for the higher risk."

Responding to the Cycles

For astute lenders, understanding the changing environment and responding to the product needs of clients translates into success in up-and-down times and across a number of product lines. For instance, GE Corporate Lending's Quindlen notes that GE's restructuring finance team is responding to the pickup in business from troubled retailers. And, with waning consumer confidence and dour predictions for the overall economy in 2009, demand for restructuring and turnaround finance for retailers, among many other troubled sectors, will continue to grow.

For players providing smaller lines of credit, such as receivables financing and working-capital credit, there is also additional demand, especially as more traditional lines of credit dry up. Steven Gold, president of Allied Financial Corporation, notes, "Our company is seeing a large amount of phone calls and referrals — maybe five times last year — but that still doesn't mean we are booking business at that same level."

Gold believes that asset-based lenders can take advantage of every economic cycle, especially if they maintain high standards of risk management. "We offer small lines of credit, but we still check routinely on every one of our existing clients to see how they are doing," Gold explains. He describes 2008 as a growth year for his firm, and he credits personal relationships for improving his book of business. "It's important to listen more carefully than ever to your clients," he adds, "and to follow through on receiving financial statements and audit on a quarterly basis."

Despite the downturn, Gold agrees that not every company is teetering on the brink. But for the real estate industry, including home building, contracting and supply firms, there are certainly rocky times ahead. Says Gold, "It would be an oxymoron to say that we are being much more conservative in the ABL marketplace today. You definitely have to be more disciplined. We're still not sure if the worst is over yet."

Handling the Phones

Even this heyday for the ABL space is providing needed retrospection in the industry. Some might call the current flurry of new business a mixed blessing. Gold adds, "I view it as a cautiously optimistic time. You need to maintain the same philosophy you've always had and not get too excited about doubling the portfolio too quickly. There will be enough quality opportunities, but you need to be consistent and not force deals."

As ABL lenders and factors field an increasing number of calls from prospective clients, other calls are coming from concerned clients worried about the troubles in the financial-institution marketplace. Gold notes, "Everyone is getting those calls, and we are thrilled to reassure borrowers that we are in great financial shape." Ron Winicour, president of Gibraltar Financial, agrees that all lenders are dealing with client anxiety about financial-industry news. He recommends that lenders confront the generalized fears head-on and reassure clients of the stability of their firms.

Winicour is also fielding a large number of business requests from prospective clients. "The amount of inquiries is up dramatically," he notes. "There is an incredible amount of time spent on the phone, doing initial evaluations." As traditional lines of credit shrink, Winicour says that the quality of deals is actually improving. He predicts that 2009 will be a banner year for the ABL/factoring space, provided that the industry can remain disciplined and escape significant losses.

Since the credit crisis began, it appears the secured-lending marketplace has done just that — effectively weathering the storm and prospering. CFA statistics indicate that, of the lenders surveyed, nonaccruing loans as a percentage of total asset-based loans were four basis points lower in the third-quarter of 2008 than in the prior quarter. Only 25 percent of the lenders reported an increase in nonaccruals in the third-quarter of 2008, compared to 40 percent in the second quarter.

With respect to gross write-offs, 35 percent of lenders in the CFA survey reported an increase in the third-quarter compared to 25 percent in the second-quarter. According to the CFA's statistics, over the last four quarters total gross write-offs, as a percentage of total loans outstanding at September 30, 2008, remained well below 50 basis points. The figure represents the asset-based lending industry's median for the past 15 years — a good indication of the health of the space.

The Year Ahead

Looking ahead, Winicour notes that key industries are certainly going to feel the impact of the downturn. He believes a diversified client base is essential to maintaining a healthy portfolio. "With the automotive industry and retail, it's hard to say what will happen," Winicour explains. "There's no question that the worst of the economic troubles are in front of us, and now there is also deflation to worry about. This is a good time to be a generalist."

Tracey Eden, national marketing director for the Commercial Finance Group, notes that his firm is also busy handling the phones as it deals with prospect calls. But he admits that, in 2009, the concerns over consumer confidence do have factors and asset-based lenders worried. He agrees that larger syndicated deals are becoming a concern because the liquidity just may not be there.

Eden predicts that, by the end of the 2009, overall average deal size may shrink and many of the cutting-edge and creative deals done by the larger banks could be a thing of the past. Some in the ABL and factoring space, including Eden, note that this tightening up is a good thing. Even with the inundation of client calls and prospective client requests, Eden says that the wise lender needs to stick with strong underwriting. "It's business as usual for us," he concludes. TSL

Myra A. Thomas is a leading business editor, author and journalist with 13 years covering the finance sector.