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REPRINTED FROM THE MAR 2018 ISSUE, VOL. 16, NO. 2

A Crucial Link in Complex Specialty Finance: The Role of Debt Advisors in Asset Based Lending

BY HUGH C. LARRATT-SMITH

Navigating the waters of specialty lending can be a challenge for lenders not familiar with industries like education, staffing or cannabis. Debt advisors provide expertise in those areas and can broker deals, acting as matchmakers between borrowers and lenders. Hugh Larratt Smith takes a look at this rising industry and explains the value debt advisors can bring to specialty lending.

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By 1976, New York City was on the brink of financial disaster. Behind The New York Public Library on Fifth Avenue, Bryant Park was a den of drug dealers and addicts. Prostitutes, pimps and peep shows lined the streets of Times Square. Central Park was feared as a site of muggings and rapes. U.S. economic stagnation in the 1970s hit New York City particularly hard, amplified by a large movement of middle-class residents to the suburbs. During the fiscal crisis, drastic funding cuts spun the dirty, graffiti-scarred subway into a downward spiral of deteriorating tracks and stations, malfunctioning subway cars, declining ridership and increasing crime that mirrored New York City's collapse. A year earlier, President Gerald Ford denied federal assistance to the city, prompting the *New York Post* headline, "Ford to City: Drop Dead."

The city faced the prospect of filing for bankruptcy. The city government was reluctant to confront municipal labor unions. An announced *hiring freeze* was followed by an increase in city payrolls of 13,000 people in one quarter, and an announced layoff of 8,000 workers resulted in only 436 employees leaving the city government. When the city could not meet its payroll in mid-April 1975, New York Governor Hugh Carey advanced state funds to allow New York to pay its bills, on the condition that the city turn over management of its finances to the State of New York and outside debt advisors. Governor Carey appointed Felix Rohatyn, a partner at Lazard on Wall Street, to head a blue-ribbon debt crisis advisory committee. > >

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> — Neil Legan, *Executive Director*, CIT Asset Management

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Fast forward to today. Debt advisors are a crucial link between lenders and borrowers in complex specialized finance. This is particularly true in industry sectors which are specialized, such as education, temporary staffing, films, software and cannabis. With cannabis legalization around the corner this June in Canada, Ernst & Young and Deloitte have established transaction advisory teams in Toronto.

Industry Expertise is Key

The marketplace for debt advisors is extremely competitive. Industry expertise is the key factor. Debt advisors with industry-specific research staff will often win mandates because they can provide borrowers and potential lenders with objective assessments of key developments in the industry. Industry expertise can also mitigate the risk that a debt advisor will overpromise to win the advisory mandate.

Thomas Hayes, senior vice president and Western regional manager of PNC Business Credit in Los Angeles, explains, "Debt advisors can make the process much more efficient. They can make the path to transaction closing predictable and reliable, which is very important to private equity sponsors."

John Brignola, managing partner at LBC Credit Partners, an alternative debt provider to the middle market in Philadelphia, adds, "There has been a proliferation of debt advisory groups over the last several years, and given the number of new groups, it's important that all parties involved in a deal understand the advisory group's level of expertise and expected involvement in the transaction. Doing so will help to mitigate deal execution risk."

In the world of specialty finance, it is important to know which lenders have an appetite for certain types of transactions. Building on its legacy of specialty asset-based lending, which ranges from railcar finance to toys, CIT Bank in New York recently established a joint venture with AllState Insurance, CIT Northbridge.

> **"Some chief financial officers have never arranged an asset-based loan — the proverbial babe in the woods. So debt advisors are very important."**
>
> — Michael Haddad, *Division President*, Asset Based Lending, Sterling National Bank

Debt Advisors Add Value

Neal Legan, executive officer, CIT Asset Management and advisor to CIT Northbridge Credit in Dallas, says, "We have extensive expertise in sourcing, structuring and managing non-bankable ABL loans directly with prospects. Even so, debt advisors can add tremendous value for both the lender and particularly for borrowers by helping find lenders with the right risk appetite and regulatory environment to best serve the customer's needs. Our new business pipeline at CIT Northbridge primarily consists of asset-based lending transactions with $15 [million] to $150 million in individual commitments. We source these through diverse channels, with debt advisors being a robust source of non-bank lending opportunities. They provide an increasingly important intermediary service for borrowers seeking alternative lending sources, especially as regulated banks continue to exit some commercial loans due to regulatory scrutiny."

In Europe, debt advisors play a key role in middle-market asset-based lending. This is particularly true in specialty lending situations, which have specific industry dynamics, collateral twists and cross border nuances. "Due to the way debt advisors are positioned in the UK's regional markets, Wells Fargo places the same importance on debt advisors as we place on our relationships with our clients, private equity houses and the wider professional services community," says Tom Weedall, director of Loan Originations at Wells Fargo Capital Finance in London.

"Over the last few years, UK debt advisors have played a significant role in introducing clients to us, such as Arlington Industries (Clearwater International), Nisa Retail (KPMG) and First Milk (Marlborough Partners), among others. Following support from the debt advisory community, Wells Fargo was able to secure these businesses as new clients through our bespoke solutions, which accommodated the needs of the customer, alongside the requirements of the private equity owner and/or debt advisor."

"Middle market capital structures are growing in complexity, and debt advisors are more frequently looking to source various types of debt for their borrowers in a single engagement. This represents an opportunity to add incremental value for their clients by reducing debt service levels. Advisors are recognizing the lower blended cost of capital in a split lien transaction and now, rather than solely seeking a traditional cash flow solution for their clients, debt placement agents are also seeking a split lien solution combining an ABL revolver with a term loan from an alternative debt provider like LBC. It is an efficient combination for the borrower," Brignola says.

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Help CFOs Enter the ABL Market

Debt advisors play an important role with companies that do not tap the specialty ABL markets often. "Some chief financial officers have never arranged an asset-based loan — the proverbial babe in the woods. So debt advisors are very important," notes Michael Haddad, division president, Asset Based Lending, Sterling National Bank in New York and Dallas. "Other borrowers are so lean that the CFO may not have the time — or the internal resources — to prepare an information memorandum or request. Farming out the preparation of the book can help the CFO and, in some cases, is essential. Debt advisors can take the pressure off a borrower."

Let's take the case of a UK High Street retailer that recently tapped the UK debt market. The CFO thought the most he could borrow was £35 million ($49 million) through a traditional revolver from his legacy bank, given the sectoral turmoil that High Street retail in the UK has experienced because of online shopping. His debt advisor in London canvassed the ABL community, and sourced an asset-based loan of £60 million ($84 million)! The debt advisor was able to slice and dice the collateral to maximize the debt capacity of the retailer.

For the CFO who is unaccustomed to the specialized process of asset-based loans, meeting with a plethora of different lenders may seem like listening to Billy Joel's song, *We Didn't Start the Fire* — a total information overload. Instead of the 119 references to events in the three-minute song, the CFO could be hearing a torrent of words like *FILO, springing lien, LIBOR floor, accordion* and *left lead agency*. Head spinning indeed!

"At times, it seems like the borrower is speaking one language … and the lender is speaking a different language," says George Psomas, managing director at Brooks Houghton, Investment Bankers in New York. "For example, in the fast-changing world of healthcare financing with its complexity of reimbursement rates and occasional byzantine state and local regulations, this can be a head scratcher for the lender. Debt advisors can help the CFO organize a mass of information into the package that the lender needs. In this current environment for even a seasoned CFO or a sophisticated PE investor, getting a financing done can be quite confounding given the variability of credit appetite and numerous new players in the market."

Legan adds, "Additionally, debt advisors can help develop the information that lenders routinely require to efficiently assess the facility risk, leading to a financing solution with maximum flexibility and competitive pricing. They can strip out any extraneous information and distill the transaction into actionable information."

"Some debt advisors commit to industry or even asset specialization as a way of distinguishing themselves in a crowded field," Brignola says. "The role of the debt advisor has become more important for companies with greater asset complexity. Those companies typically don't have the internal resources and experience to effectively manage their debt raise."

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Understanding Collateral is King

"All asset-based lenders are heavily focused on collateral," notes Hayes. "The information on the proposed transaction from some private equity sponsors doesn't drill down on the collateral to the extent that asset-based lenders need to get the deal through their credit committees. Debt advisors know that collateral is the knife and fork of our process, so they can make sure that we have the requisite detail up front."

"Debt advisors also know that a quality of earnings analysis (QOE) is important to us. Not only does this require significant time up front to prepare, but there is always a lot of back-and-forth between the private equity sponsor and the lender about what EBITDA addbacks are acceptable to the lenders. This process can be very time-intensive and can lead to delays in the deal's timeline if not properly and efficiently executed," Haddad says.

Many private equity sponsors look at EBITDA as the fulcrum number in a transaction. In a deal that is weighted towards specialized collateral, this can be like two ships passing in the night. EBITDA, while important, is not the Rosetta Stone in a deal where the balance sheet is good but the legacy EBITDA is choppy. In a deal that relies on pro-forma EBITDA in an industry sector with unique characteristics and single-use boot collateral, debt advisors need to pay special attention to getting it right. > >

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Chris Hawes, head of Transaction Risk Management — Europe, Global Trade and Receivables Finance, HSBC in London, says, "In Europe, where asset-based lending is not as commonplace with private equity sponsors as the U.S., debt advisors can assist sponsors and CFOs in determining the right blend of asset-based lending and cashflow financing to get the most out of the borrower's collateral. Pan-European ABL transactions can be a jigsaw puzzle of collateral in various jurisdictions. An effective debt advisor can streamline the process. The deal closing can be smoother with less last-minute hiccups. The last thing anyone wants is a problem with opening availability or a spongy borrowing base."

"Debt advisors know that collateral is the knife and fork of our process, so they can make sure that we have the requisite detail up front."

— Thomas Hayes, *Senior Vice President*, PNC Business Credit

Jeremy Harrison, regional group head, senior vice president and senior business development officer of business capital, Bank of America Merrill Lynch in London, says, "Debt advisors are an important presence at CFA Europe events. They serve as a good clearinghouse of information about potential transactions coming to market. I would also echo Chris Hawes' comments, quite frequently at CFA European Chapter events, that it would be beneficial to educate potential ABL users and increase knowledge of ABL. Debt advisors are crucial in sharing knowledge of our business."

Debt advisors can play an important role in situations where the borrower has come to the well one too many times. We have all seen companies change lenders every three years. At some point, these companies reach the end of the runway with no takeoff. One industrial wire cable manufacturer in Rome, NY changed lenders so many times over a 20-year period it was rare to meet a lender that had never done a filed exam or underwritten a loan with the company at one time or another. A high-end bicycle manufacturer in Eastern Connecticut switched asset-based lenders so often the owner's first name was immediately recognized at every CFA and TMA event. In cases like this, debt advisors can present the name to the market in a different or new way to get the plane off the runway.

They can also play an important role in a story credit. In addition to translating a challenging story to lenders, debt advisors know the right audience for the story. Additionally, the implicit endorsement of a debt advisor can add credibility to a challenging credit.

Cherry Pick Best Terms

Still, the risk remains of the debt advisor foaming the runway. Sometimes the debt advisor's book bears little resemblance to the actual situation, and it's simply a case of putting makeup on a corpse. Other times, debt advisors may stretch the truth or spin the story in a certain direction. A debt advisor's book may attempt to divert attention away from the real issue facing the company, such as a broken business model. Critics of debt advisors will say in a *hog call* — an aggressively shopped deal — debt advisors play lenders against each other and cherry-pick the best terms. In the long term, this can hurt the borrower, particularly if the company hits some turbulence.

Weedall effectively sums up the relationships between lenders and debt advisors, saying, "By extending our solutions, which support customer growth, Wells Fargo is focused on developing long-term relationships with our clients and their respective stakeholders. We have a solid working relationship with the debt advisory community, and by utilizing these contacts — which support a myriad of customers as well as hosting an impressive database on market intelligence — we can leverage Wells Fargo's capabilities to support companies which power UK plc. "

Felix Rohatyn brought credibility and deep experience to New York City's financial crisis. Within weeks, Rohatyn and The Emergency Financial Control Board took full control of the city's budget. They made drastic cuts in municipal services and spending and raised bus and subway fares. Bloated welfare spending was slashed, and some hospitals, branch libraries and fire stations were closed. The labor unions helped by allocating much of their pension funds to the purchase of new city bonds.

By 2016, New York City and its wider footprint generated $1.7 trillion in gross metropolitan product, roughly 9% of the nation's overall GNP. abfj

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