Opportunities and Challenges:
Asset-Based Lending in 2018

BY HUGH C. LARRATT-SMITH

The digital world has transformed every aspect of our lives. Some of us still remember pasting photographs into albums and racing to answer the telephone mounted on the wall — picking up the receiver without knowing who was on the other end of the line. Technology has changed asset-based lending in ways no one could have predicted 20 years ago. *ABF Journal* contributor Hugh Larratt-Smith explores the evolving ABL landscape and evaluates the impact these changes will have in 2018.

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When people hear that General William Tecumseh Sherman was a gold rush banker in California before the Civil War, they scratch their heads. He is remembered as one of America's great military leaders, marching from Atlanta to the sea with flags flying and bands playing *Marching Through Georgia*. To this day, historians marvel at his natural ability to marshal and evaluate facts in a hectic, chaotic and confusing environment, distilling them quickly into plans of action.

In the late 1840s, California was a feverish, frenzied economy. Banking services were essential to the operations of the gold fields, yet the banks were primitive and unregulated. Very few of California's pioneer bankers actually had much previous banking experience. Sherman was no exception. What he did have was a keen mind for facts, a hard common sense and innate integrity. Before becoming a banker in San Francisco in 1853, Sherman served in the army in California for three years and possessed an encyclopedic knowledge of California gold properties.

In those heady days of 1849, few newcomers to California were interested in banking, trading or manufacturing. Only a handful, like Sherman, realized that serving the needs of the miners offered richer financial opportunity than wielding a pick and shovel. And he was correct — more money was made by gold rush suppliers like Levi Strauss than the miners made from their diggings.

Sherman was in the room with Colonel Richard Barnes Mason in Monterey when the messenger delivered the news of John Wilson Marshall's discovery of gold at Sutter's Mill. When the messenger bag was opened, Sherman took a gold nugget and tested it between his teeth. Then, to test its malleability, he hit the nugget with a hammer.

Photo: Library of Congress

1850 daguerreotype by R.H. Vance shows James Marshall standing in front of Sutter's sawmill, Coloma, CA, where he discovered gold.

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It is easy to see some similarities between today's asset-based marketplace and Sherman's gold rush banking days. Innovators can be amply rewarded. Newcomers seem to be arriving on the scene every month. Competition can be cut throat. Advances in technology are changing the economic landscape and the collateral that ABL players depend on.

A Good Year for ABL

With interest rates at historic levels, default rates at their lowest rates in years and Q2/17 economic growth at 3%, the asset-based lending marketplace is on solid footing. Capital expenditures — an important bellweather for the economy and a leading economic indicator — strengthened in Q2/17, reflecting CFO confidence.

Michael Sharkey, president of MB Business Capital, provides some color on the current marketplace. "We are having our best year in a long time. Utilization rates are up and our new business is better than it has been in five years. Our growth in utilization rates is a clear sign that sales of our borrowers are finally rising after years of flat-line performance. Customers are carrying more current assets and building fixed asset capacity. Competition amongst lenders has been fierce, but we may see some abatement in that as it seems to have found its own level with certain non-traditional and cash flow lenders settling in to the buyout market, with the rest of us focusing on the refinance and restructuring market."

Jeffery Wacker, head of U.S. ABL Originations for TD Bank in New York, adds, "The lending environment has always been competitive. The market is extremely efficient, and borrowers have a number of choices when it comes to both financing products and partners. Now, more than ever before, it is important to highlight the benefits of ABL compared to other financial solutions. At the same time, the business environment is in modest growth mode with inflation remaining tame, significant capital availability and interest rate increases remaining slower than expected."

Vincent Belcastro, managing director and group head, of Corporate Equipment Finance for Santander Bank U.S., says, "As a board member of the Equipment Leasing and Finance Association, I see all the industry trends and benchmarks. Investment in hard assets is strong and technological advances in production automation are moving companies towards retooling. The majority of deals in our market sector are for new capital expenditures. Only a small percentage of deals we are seeing are refinancings, given the low interest rates over the last five years. Corporations are spending heavily on equipment that drive down costs and speed up conversion cycles."

Rapid advances in technology are driving a nuanced, but significant impact on asset based lending. Capital expenditures by companies are skewed heavily towards lean manufacturing, smart distribution and shared services. A key aspect of lean manufacturing is fast moving inventory.

"Financing inventory is one of the key tenants of asset-based lending. Twenty years ago, the typical ABL borrower often had a significant investment in inventory and accounts receivable," says Scott Ryan, managing director and Northeast Region originations manager for Wells Fargo Capital Finance in New York. "Today, current assets turn faster as CFOs and operations managers of borrowers have the software tools to manage their current assets more efficiently."

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Belcastro says, "As manufacturing and distribution center robots evolve as self-learning machines, cycle times are constantly compressed and inventories are minimized. Artificial intelligence is giving companies more sophisticated tools to optimize their operations and their working capital needs."

Technology Changes the Industry

Eastman Kodak was one of the technological giants of the 20th century, a dominant seller of film and cameras. In the early days of asset-based lending, rolls of film had to be manufactured and physically shipped from Kodak's factories and warehouses in Rochester, NY. Photo finishing was also a large industry which ABL players financed. As a result of the Kodak ecosystem of suppliers and customers, asset based lending was robust in upstate New York. All of the major banks had ABL loan production offices in the region, including Chemical Bank, Irving and Manufacturers Hanover. Thirty years ago, Kodak employed close to 60,000 people in Rochester. Today, the lines of code that make an iPhone's camera work can be created once, then instantly transmitted across the globe. Film, photo paper and chemicals for developing are now obsolete, and Kodak has been reduced to about 2,500 employees in the U.S.

"FISH" inventory — "First In, Stays Here" — is rapidly becoming a distant memory for lenders. Gone are the days when collateral examiners used white gloves to see how much dust was gathering on a borrower's inventory. No more racks of furs and gowns careen across Seventh Avenue at midnight in New York's garment district. Lenders can view inventory in real time and electronically — the inventory frauds of Phar-Mor and Giant Eagle are far and few between today.

Smart distribution will affect the contours of asset-based lending in the years ahead. For example, as autonomous trucks displace two million truck drivers in the next decade, the balance sheets of trucking companies may be strengthened. However, the temporary staffing companies currently financed by asset based lenders may see a negative impact.

Shared Services Bring New Issues

Technology is enabling shared services, which represent new opportunities — but also new challenges — for asset-based lenders. Data centers are one example. Starting 10 years ago, companies realized their operating costs of computers could be driven down by > >

situating their computers in a data center run by a third party. A new industry was born. But, Lee Podair, a finance partner at Hahn & Hessen in New York, explains, new issues regarding perfection in, and competing claims to, collateral were also born. "As shared contract manufacturing hubs for companies proliferate, issues regarding competing secured creditor claims in hard assets, manufacturing contracts and proceeds thereof will surface for asset-based lenders. Interesting new collateral questions are bubbling to the surface. If my borrower has a multi-year contract to use specialized, single purpose equipment in someone else's facility, does that contract have value that my customer can use as boot collateral for borrowing? What kind of due diligence should an asset-based lender undertake regarding the owner of the shared facility? Should the asset-based lender require an access agreement and/or lien waiver from the facility owner and its secured lender?" The answer, according to Podair, depends on the specific circumstances presented.

As manufacturing and distribution equipment becomes smarter, another collateral issue is raising its head for ABL players. Fifteen years ago, a typical piece of equipment on a factory floor would consist mainly of tangible materials such as steel and wiring. In a liquidation, the equipment could be loaded onto a truck, shipped elsewhere, plugged in and turned on. Today, the capital costs of the "brains" — software — in many manufacturing and distribution robots on the factory or warehouse floor may be 50% of the total CAPEX dollars spent. Furthermore, the equipment will likely be integrated into a larger system on the factory or warehouse floor. So what is the collateral value? What's an appropriate advance rate? What is the lender's obsolescence risk in lending against M&E like this? Certainly there will be IP-related issues to consider, given the advancement in artificial intelligence and software that drive these assets.

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What Does the Future Hold?

What does 2018 hold for the industry? The line of demarcation between bank ABL players and credit funds starts with pricing. No credit fund wants to do a deal priced at LIBOR + 3%. Bank ABL players may be interested in financing a turnaround, but only if it's a broken wing company with a clear roadmap to recovery. Some credit funds, on the other hand, are showing appetite for companies dying from 1,000 cuts as long as the pricing is in their wheelhouse. A loan-to-liquidate shop recently opened its doors in Southern California with $100 million in Fund I, with pricing in the 17% to 20% range.

"Looking forward to 2018, I see both opportunities and some challenges," Sharkey says. "I am optimistic that we will see a continuation of the trend from 2017 in which owners of privately held companies have gained the confidence to shop for better ABL deals and to change lenders. With improving balance sheets and growth in revenues, they are in a position to capitalize on the ample liquidity in the ABL marketplace. In the past few years, I think that individual owners preferred to stick with the devil they knew, and didn't really have the need to move. Absent some type of catastrophic event, we should see a continuation of the 2017 trend. Of course, we are facing a rather uncertain political climate, not to mention the saber rattling that seems to be taking place in virtually every corner of the earth."

"The asset-based lending industry remains on a growth trajectory as a staple of commercial and corporate lending. Private equity, corporate mergers and acquisitions and refinancing are some of the biggest drivers, and with record PE fundraising in the last couple years, we expect more activity in these areas," Wacker says. "Additionally, due to attractive equity market valuations, public corporate acquirers should find consolidation an attractive strategy. All of these factors will be required to propel ABL to new heights in 2018, especially since scheduled maturities are modest over the next 18 months. We have also seen credit spreads compress, with borrowers benefiting from a low cost of capital in a low default environment. The most activity seems to be in retail, where the volume of DIP financings and liquidations have increased in the last 12 months. If this trend continues, I expect the ABL market will accept it in stride, given the historical knowledge we have in this industry sector."

Will 2018 Be the Peak of the Cycle?

A looming question is whether 2018 will be the peak of the current credit cycle. Let's look at Europe: In 2007 — arguably the peak of the last credit boom — private equity fundraising averaged just under €5.5 billion ($6.48 billion) per month, according to Pitchbook. As we close out 2017, this year's fundraising pace is currently at more than €5.6 billion ($6.58 billion) per month. In the first six months of 2017, prices paid by private equity firms in Europe have reached a high water mark since the financial crisis at 11.6X EBITDA, according to Fitch Ratings. Leverage levels were similarly high at

5.9X EBITDA, according to Deloitte in London. Some readers will reflect back on "The Burning Bed" deal which heralded the peak of the credit cycle in 1989 — the infamous Ohio Mattress buyout at 13X EBITDA by Credit Suisse First Boston.

"I think that the intense competition of 2017 in our domestic and international markets will continue into 2018," Ryan says. "Wells Fargo supports our international customers through our enhanced presence of innovative and bespoke solutions, alongside cultivating our expertise and industry networks."

Building on that point, Belcastro says, "Santander is able to provide U.S. borrowers with asset-based loans in Mexico, which is a major advantage. Many of our U.S. competitors shy away from Mexico because of the perceived challenges of perfecting security interests. We have a bank in Mexico, which facilitates multi-jurisdictional loans."

Stephen Bellah, director of Super G Funding in Dallas, says, "Technology is driving big changes for lenders in every aspect of our business from how we find our customers (digital lead generation), how our customers find us (SEO and social media marketing), how we access the information and analyze opportunities, how we monitor our portfolio clients (client portals and data exchange), to how we communicate internally and externally with our clients. Decision processes are being compressed using algorithms, marketing is digitally driven and communication is more transparent and collaborative. For those who have not achieved the scale or the focus to embrace the evolving technology impact on our business and develop talent, the future will be difficult."

Need for New Talent

Looking ahead to 2018, Sharkey adds a final note of caution, "Certain lenders will be challenged from a funding perspective as cheap deposits become more difficult to access, and interest rates continue to rise. I think that [the] biggest challenge in the short term will be finding cheap liquidity to fund our loans and good talent to staff our operations. Gaining entry for a new player is a challenge as talent is scarce and becoming more scarce as we staff up to accommodate the growth we are seeing. Adding good, strong talent is our biggest challenge as we continue to grow. We just surpassed the billion dollar mark in loans outstanding, and at our average loan size, that is a lot of transactions that need to be managed. I think that it is incumbent on us in the ABL community to focus on training young people in true asset-based lending disciplines, so that our industry has a safe and sound future. Many of us — and I don't just mean the most senior people — are getting closer to retirement than we would like. The average age of one of our 70 or so people is over 50 years old! I am sure that we are not the only ones in that position!"

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Sherman Sinks in San Francisco

When Sherman finally arrived in San Francisco on April 9, 1853, it was not an auspicious start to his banking career. On the last day of his voyage to California from New York, his steamboat, *The Lewis*, hit a reef north of Golden Gate at 4:00 a.m. and began rapidly sinking. All 385 passengers were rescued. Walking along the shore around noon, Sherman talked his way aboard a schooner that was loading lumber for San Francisco. In the late afternoon, the schooner hoisted sail on Sherman's second voyage of the day. At the Golden Gate, the schooner capsized, and Sherman swam to shore to The Presidio, which now anchors the Golden Gate Bridge. He said in his memoirs, "Two shipwrecks in one day is not a good beginning for a peaceful new career." Fortunately for America, the foresight that he showed in his California's gold rush banking career foreshadowed his skill as a Union general in The Civil War. abfj

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***Above:** San Francisco harbor circa 1853 when Sherman arrived in California.* (Library of Congress)
***Top Right:** Pre-civil war portrait of William T. Sherman.* (Public Domain)