Asset based lending

Demystifying a trend

Asset based lending is an emerging financing product in the UK, but it can be easily confused with other forms of finance. **Andrew Rotenberg** and **Adam Scarrott** of **Jones Day** explain what it is, how it works, and look at the key practical and legal issues.

Illustration: Getty Images

Asset based lending (ABL), which originated in the US, is an emerging product in the UK and throughout Europe, as illustrated by the increasing number of large, complex multi-jurisdictional ABL deals that have been done in recent years across a number of different industry sectors. More and more UK and European based companies, as well as multi-national companies with operations in the UK and Europe, are becoming aware of the fact that ABL is a very flexible and innovative financial product which works equally well within various economic cycles.

This article:

- Explains what ABL is.
- Compares and contrasts ABL to other forms of finance.
- Discusses the mechanics of ABL.
- Considers practicalities, other legal issues and negotiating points.

WHAT IS ABL?

In broad terms, ABL is a discrete form of secured lending where the lender advances funds to a borrower based on the value of certain types of the borrower's assets. Typically, the assets will comprise trade receivables (that is, book debts or the borrower's right to payment from a customer resulting from the provision or sale of goods or

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services), inventory (also known as stock), plant and machinery, real estate and sometimes other assets such as intellectual property rights.

An ABL lender would expect to be repaid by the borrower in respect of inventory and receivables financings (which are typically structured as revolving credit facilities) from the ongoing sale of inventory and/or collection of receivables. ABL facilities that are tied to other types of assets are typically structured as term loans which amortise through a series of regular instalments (*see "ABL mechanics" below*).

ABL lenders earn profit from an ABL deal by three main sources: charging interest on the funds borrowed; applying service charges against the amount of receivables purchased; and charging arrangement and early termination fees.

The ABL market

ABL techniques and structures were developed in the US in the 1980s and 1990s. In the late 1990s, some US lenders began to provide ABL facilities to UK businesses, leading the drive from invoice discounting to full ABL financings (*see "Invoice discounting" below*). The clearing banks established or acquired specialist factoring and invoice discounting firms, and now each of HSBC, RBS, Lloyds TSB and Barclays have dedicated teams with specialist ABL underwriting and structuring capability.

While the credit crunch has slowed further innovation in syndicated transactions, the ABL market has an appetite to originate larger transactions which can be syndicated to a group of lenders, particularly because ABL financings are not highly leveraged, are structured as senior secured loans and are relatively easy for syndicate members to monitor, based on the information provided by the borrower.

The UK based trade association body once known as The Factors and Discounters Association is now known as the Asset Based Finance Association (ABFA), reflecting the maturity of the ABL product and the markets in which its members operate. ABFA's broad membership includes small independent factoring houses at the small to medium-sized enterprise (SME) end of the market, the large clearing banks and non-bank finance companies such as GE Capital.

At the end of the first quarter of 2010, advances by ABFA members (including pure invoice discounting) totalled over £14 billion, and were provided to nearly 50,000 customers in the UK. While the overall lending figures have remained relatively static over the last few years, a notable trend is that advances to large companies now form nearly a quarter of all advances and have doubled in absolute terms in the last three to four years. In addition to the ABFA community, a number of other lenders are active in the market, including some US lenders and independents such as Investec.

ABFA is not a regulatory body and membership is not compulsory; it is a community and trade body which seeks to enhance the awareness of the products and also provide education for its members.

Regulatory position

ABL is not a regulated activity or product in the UK; however, many lenders are subsidiaries of banks that are regulated by the Financial Services Authority or other regulated banks. Receivables financing and lending are regulated products in countries such as France and Germany, and UK lenders often overlook how they may lawfully market and provide ABL facilities in Europe.

Even though ABL is not regulated in the UK, ABL lenders are of course generally subject to the anti-money laundering legislation. As such, ABL lenders conduct "know your customer" checks and fulfil other compliance requirements.

Importantly, in a climate in which bank capital is scarce, ABL loans give banks a better capital treatment for banking supervision purposes, which explains in part why some banks have been trying to move many of their commercial customers away from the general overdraft over to an asset based product.

Lenders' criteria

ABL facilities are not suitable for every company. ABL lenders must ensure that in the event of insolvency, the value of the assets rather than the value of the business will repay the loan. Stressed and distressed companies with good assets are often ideal borrowers. Particular factors that an ABL lender will look for in a potential borrower include the following:

- Operations. The borrower should have good back office arrangements, information systems and records, and sound credit control procedures.

- Balanced assets. There should be a good spread of assets and low customer concentrations (that is, a diverse customer base).

- Assets with value. The borrower should have a good payment history of receivables (few rebates or credit notes) and appraisals of inventory and fixed assets satisfactory to a secured lender.

Uses for ABL

In practice, almost two-thirds of all borrowers are in the manufacturing or services sectors, with annual turnover ranging from less than £500,000 to over £100 million. However, the type of company is often less important than the company's financial situation, its business needs and its stage in the corporate life cycle (*see box "Business needs"*).

Working capital. ABL receivables and inventory financings are ideal to finance working capital, and as these types of facilities do not amortise like a term loan, the cost of debt is therefore minimal. As the company's working capital grows, the availability of funding grows with it, compared with a hardwired overdraft limit which can limit a company's expansion plans.

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Business needs

Business needs	Facility type	Structure
Daily working capital	• Overdraft or invoice discounting • Asset based lending (ABL)	• Overdrafts have fixed limit, while invoice discounting is more flexible • Non-amortising
Capital expansion	• Asset finance • Term loans	• Lease/hire purchase • Loan to value of asset
Integration/acquisition/buyout	• Leveraged buyout (LBO) • ABL financed buyout	• LBO leverages earnings multiples and financial covenants • ABL deal leverages the assets to provide necessary funds
Restructuring and turnaround	• Debt write down/swap for equity • ABL new money	• Closely monitored ABL facility

Acquisitions. ABL facilities can also be used to finance acquisitions. Historically, only those companies able to demonstrate several years of earnings with good potential for growth (typically in the private equity market) could access acquisition debt, now more commonly referred to as leveraged buyout financing. However, it is now common to use the assets of an acquisition target to finance its acquisition. Under the old "financial assistance" regime applicable to private companies (as set out in sections 151 to 158 of the Companies Act 1985), this technique had to be "whitewashed". The Companies Act 2006 repealed these rules, and this has reduced the complexity of ABL-funded acquisitions.

Turnaround situation. As has been the case in recent years, a company's performance often peaks so that banking financial covenants become tight or debt service payments become jeopardised. Existing lenders may be reluctant to provide further liquidity to the business and the company will then need to leverage its assets.

ABL facilities are commonly provided in such so-called "turn around" situations because the ABL lender is more comfortable taking the risk that the borrower may fail, as compared with traditional bank lending. ABL transactions are structured and tightly managed on a daily basis, so that the collateral should always exceed the finance provided, and the lender should expect full repayment even if there is an insolvency. In addition, insolvencies present fee opportunities for ABL lenders because certain early termination and servicing fees become payable.

This structuring technique and risk appetite has led to the ABL lenders being regarded somewhat unfairly as the "lenders of last resort". Indeed, ABL lenders have traditionally originated many transactions from the restructuring and insolvency market and, as the ABL market is expecting that many companies in the UK will enter into insolvency in the near future or need to be restructured in the next few years, there will be more opportunities for ABL lenders.

There are now numerous household names that use or have used ABL facilities for a variety of reasons, whether for debt restructuring or providing finance to a sector deserted during the credit crunch by traditional non-ABL bank debt, such as the retail or the auto-supplier industry; for example: Carphone Warehouse, Jaguar Landrover, Umbro, Mappin and Webb, Unipart, Woolworths, Waterford Wedgwood and Jones the Bootmaker.

ABL VS OTHER PRODUCTS

There are many financial products which contain an asset element (*see box "Asset-related finance products"*).

Asset finance

Asset finance is generally regarded as a term of art for lease and hire purchase (HP) arrangements where the finance house rather than the borrower owns the asset in question and leases it to the user.

Some assets, particularly modern printing presses or injection moulding machines can be financed by either asset finance or ABL arrangements. Assets of very high value such as rolling stock, oil rigs, aircraft, trucks, buses and the like are rarely financed by an ABL lender as they would normally be financed by leasing companies with specialist technical and marketing expertise. Similarly, assets of relatively low value such as photocopiers or motor vehicles are not generally financed by an ABL lender but would regularly be financed on a bulk or fleet basis by an asset finance house.

ABL lenders avoid financing low value fixed assets as the costs of repossession are too high and the ABL lenders do not possess fleet management expertise. In addition, the leasing/HP industry is well established and finance directors are very comfortable with the lease/HP product when they are seeking to fund a class of assets. ABL lenders generally look to take security over all assets rather than a specified sub-section of the assets.

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Asset-related finance products

	Factoring	Invoice discounting	Asset based lending	Asset finance	Asset backed finance	Trade finance
Features	◆ Funding against invoices ◆ Full credit control service, with or without bad debt protection ◆ Management information	◆ Funding against invoices ◆ With or without bad debt protection ◆ Management information ◆ Can be disclosed or undisclosed	◆ Funding against a range of corporate assets including invoices, stock, plant and machinery, property and cashflow loans ◆ Management information ◆ Can be disclosed or undisclosed	◆ Funding large assets such as rolling stock, rail, aircraft, ships, trucks and high volumes of smaller assets such as photocopiers or cars	◆ Raising finance against a pool of assets, such as trade receivables, aircraft leases, mortgages, loans or other financial assets	◆ Financing imports and exports, secured over the goods and shipping documents
Users	◆ Start-ups, SMEs, small companies including sole traders, and partnerships	◆ SMEs and larger organisations with a more mature collections process in place	◆ Financially mature companies ranging from turnover of £20 million up to multinational, sometimes global, corporations	◆ Operators of high value equipment such as airlines, oil companies and ferry companies ◆ All types of companies use asset finance for small value items	◆ Investment banks package the product and sell rated notes to investors ◆ Some receivables deals may use hybrid ABL/ABS structures (and are similar to ABL structures)	◆ Creditworthy traders and re-sellers ◆ Commodity buyers and sellers ◆ Manufacturers
Applications	◆ To improve cashflow ◆ To provide outsourced credit control ◆ To have a flexible financial solution that grows and diminishes in line with the business	◆ To improve cashflow ◆ To have a flexible financial solution that grows and diminishes in line with the business	◆ To provide a cash flow solution for strategic purposes, such as an MBO/MBI, refinancing or rapid expansion ◆ To have a flexible financial solution that grows and diminishes in line with the business	◆ Tax-based financings ◆ Capital intensive industries ◆ Where operational flexibility is important (such as leasing an aircraft for five years rather than financing the whole value of the aircraft)	◆ To fund financial institution investments such as a leasing company's assets or a loan portfolio ◆ Corporates wishing to reduce their cost of funds by having their assets rated and securitised	◆ Wide variety of applications ◆ Facilitates secure international trade ◆ Ease importer's cash flow (pay when goods arrive at dock)

Asset backed finance

In asset backed finance, debt securities (such as bonds or notes) are issued in the course of a securitisation and backed by (that is, funded by and secured over) a portfolio of cash flow-generating assets such as credit card receivables, trade receivables, auto loans and leases. Residential mortgages are often funded in similar way by so-called "RMBS" structures (residential mortgage-backed securities) and are now back in the news with RBS's recent announcement of its £4.7 billion issue of RMBS.

Many aircraft leases and residential mortgages have been securitised by transferring lease rental streams or mortgage payments to a special purpose vehicle (SPV). This transfer of assets from the owner to the SPV is the key distinguishing feature of asset backed finance. (*For more information, see feature article "Securitisation: the options available", www.practicallaw.com/8-203-4749.*)

Interestingly, in the last few years, some larger ABL transactions have adopted the SPV structure in transactions known as "securitisation-lite", particularly in the context of a pan-European financing. Capital maintenance requirements and corporate benefit laws in many European jurisdictions are much stricter than in the UK in that they prohibit, or severely limit, the ability of subsidiaries to cross guarantee each other's credit lines. In an asset backed structure, all the receivables from various jurisdictions are transferred into one SPV incorporated in a favourable tax and legal jurisdiction (such as Ireland or The Netherlands), creating a cross-collateralised pool of assets contained in one legal entity without having to rely on cross-guarantees. The ABL lender, having used asset backed techniques to secure the assets, then lends against the assets, just like in a typical ABL deal.

Based on our experience in a number of these transactions, we predict further convergence between the techniques used in asset backed finance and ABL.

Trade finance

Trade finance is a long-established financial product which provides financial security to a foreign seller (that is, the supplier) that a domestic buyer (that is, the importer) has the ability to pay that foreign seller on the invoice due date. The domestic buyer pays for the goods (via a commercial letter of credit facility issued by its local bank) when the shipping documents are provided to

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that bank. The trade finance product assists the importer in obtaining open account terms with its suppliers, avoiding the need for upfront cash payments.

ABL financiers, on the other hand, generally finance the sales of the product imported or subsequently manufactured and then sold. They may provide credit against the inventory purchased from abroad but this will almost exclusively be on the basis that the inventory is located in the UK and that any trade financier's interest in the inventory or receivables is waived.

Invoice discounting

Invoice discounting is where a company which supplies goods or services on credit terms (such as being due 60 days after invoice date) assigns its unpaid invoices (that is, book debts or other receivables) to a finance company at a discount for immediate cash to provide working capital. The finance company charges a fee and interest on the amount advanced. Generally, the company retains responsibility for collecting the debts and administering its sales ledger. Invoice discounting can be:

- "Disclosed", where the customer is aware of the invoice discounting agreement (as it is notified, this would normally be a legal assignment complying with section 136 of the Law of Property Act 1925).

- "Undisclosed", where the customer is not aware of the invoice discounting agreement (as it is not notified to the customer, this would be an equitable assignment).

- "Non-recourse", where the finance company takes the credit risk of the invoices not being paid.

- "Recourse", where the company retains the credit risk of the invoices not being paid. If invoices are not paid the finance company can sell them back to the company or receive payment under an indemnity from the company. The fees charged to the company reflect this risk.

Invoice discounting is similar to factoring, although in factoring, the supplier company usually discloses the facility to its customers and the facility is operated on an invoice by invoice granular basis (rather than operating on the total balance of invoices, as in the case of invoice discounting). (*For more information, see feature article "Unlocking capital: factoring and invoice discounting", www.practicallaw.com/4-100-0399.*)

While some purists refer to trade receivables-only transactions as invoice discounting, as they involve buying, rather than lending, against receivables, it is now commonplace in the UK to refer to such deals within the ABL umbrella term.

Note that while Scottish invoice discounting is certainly possible and there is a Scottish market for the product, this is a specialist area where the flexible English law assignment mechanism does not work, as Scots law applies very different assignment and security rules. The Irish market (both sides of the border) follows the English model; ABFA members come from all over the UK and Ireland.

ABL MECHANICS

The mechanics of an ABL facility will depend on the type of asset being lent against.

Working capital assets

Working capital assets comprise receivables and inventory. In the UK, it is quite common that the trade receivables element of an ABL facility will be financed on an invoice discounting basis (*see "Invoice discounting" above*). This means that the trade receivables are assigned outright to the ABL lender, which then advances to the seller/borrower between 75% and 90% of the face value of them. The underlying customers will be directed to pay the invoices into a segregated account which will be applied against the then outstanding amount of the ABL facility.

However, another lending structure can also be found in the UK, based on the US experience. In the US, an ABL lender will rarely provide a debt purchase facility like invoice discounting because, unless the transaction can be classified to be a "true sale", the US Uniform Commercial Code will recharacterise the debt purchase as a loan secured against the receivables. As such, US lenders providing facilities in the UK have been historically more comfortable than UK lenders with a genuine loan structure as opposed to a debt purchase structure.

Borrowing base. US facilities have developed the concept of a "borrowing base", which is calculated by taking the value of the assets and deducting from it certain "ineligible receivables" and "reserves". Typically, ineligible receivables are those receivables which are subject to set-offs by the underlying customer or where the customer has a poor payment record. ABL lenders establish "reserves" by placing a block on the value of the assets. For example, if the ABL lender is aware that its borrower gives discounts or rebates to its customers which mean that less than the full face value of the invoices will be paid to the segregated account, then the lender will establish a reserve to mitigate against this risk.

As regards inventory financing, most ABL lenders will only consider lending against finished goods. Some lenders will finance raw materials, but relatively few will finance work in progress. The simple reason is that both raw materials and finished goods can be turned into cash quite quickly.

Once the contents of the borrowing base are agreed on, the lender next decides what proportion of the value of the eligible borrowing base assets it is prepared to make available to the borrower in loans. This is known as the advance rate and is expressed as a percentage of the value of the eligible assets (*see box "Inventory borrowing base"*). Advance rates are negotiated between the borrower and lender and depend on the types of assets involved.

The resulting values under a borrowing base calculation are compared against

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Inventory borrowing base (in GBP as at month end)

Raw materials		7,000,000			
Less ineligible	1,000,000				
Eligible raw materials		6,000,000	@	50%	3,000,000
Work in progress (WIP)		5,000,000			
Less ineligible	1,500,000				
Eligible WIP		3,500,000	@	20%	700,000
Finished goods		12,000,000			
Less ineligible	1,000,000				
Eligible finished goods		11,000,000	@	50%	5,500,000
Total borrowing base prior to reserves		9,200,000			
Enterprise Act 2002 reserves (£600,000), other reserves (£400,000)		1,000,000			
A) Total net borrowing base		8,200,000			
B) Drawings		7,600,000			
C) Facility limit		8,000,000			
Availability (lesser of (A-B) and (C-B))		400,000			

the level of borrowings; any excess is referred to as "availability" and may be drawn down, subject to any facility limit. However, while the lender is not willing to lend more funds to the borrower than the borrowing base will support, the collateral securing the asset based loan is not usually limited to those assets that are in the borrowing base.

Given that the assets are changing every day, it is essential that the ABL lender receives regular updates of the borrowing base. Some borrowers regard these reporting requirements as onerous.

Formalities and priority. In US-style ABL deals, borrowers generally obtain revolving loans for receivables and inventory. The revolving loans are repaid as the cash from sales comes into the business and are re-borrowed as new receivables and inventory are created.

In the vast majority of cases, the ABL lender's security is an all-assets debenture: the ABL lender will always require a first ranking debenture giving it first recourse to the assets financed, but also, importantly, the power to appoint an administrator. The ABL lender may permit other assets to be secured to other lenders, but it will insist on appropriate intercreditor documentation giving it first priority over the assets funded by it and first priority over assets not funded by any other lenders. The security over the assets not specifically financed is referred to as "boot collateral".

The inventory is generally supposed to be fast moving and ready for sale and it is usually not practicable for a seller to have to contact its bank every time it wishes to sell some stock; it is therefore usually subject to a floating charge (*see box "Floating charges"*). There are some exceptions to this, however, often known as "distribution finance" or "floor planning". Some auto dealers must obtain releases from the bank before delivering motorcycles or motorcars to customers; these assets could be subject to a fixed charge.

The receivables will usually fall within the fixed charges created by the debenture. The borrower will be required to ensure that its customers pay its invoices into blocked accounts often referred to as "collection accounts" (in just the same manner as an invoice discounting arrangement). The ABL lender would have the classic element of control and would ordinarily have fixed security.

In the case of floating charges, given the nature of the financing and that the lender's exit route is the proceeds of sale of the assets, the lender must set aside reserves to mitigate against the risk that the sale of the assets it has financed leads to large payments being made to the prescribed part or to employees (*section 176A, Insolvency Act 1986 (1986 Act), as amended by section 252, 2002 Act*) (*see box "Floating charges"*). Fixed charge holders have greater rights than floating charge holders as regards the administrator's conduct of a sale of assets.

Before the ABL lender can provide a loan against assets secured by a floating charge, it must perform an assessment of potential liabilities that will rank ahead of its security, and monitor this going forward: it will be important to ensure that the receivables are in fact paid to the collection accounts, and the lender may wish to estimate the amount of the prescribed part and preferential claims so that up-to-date reserves may be made.

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Fixed assets

The fixed asset portion of ABL (property and plant and machinery (P&M), which cannot so easily be converted into cash) is usually provided by way of an amortising term loan, where interest and principal are repaid on a regular basis, just like a mortgage. These loans are typically used to finance the borrower's longer term needs and are repaid over a longer period of time. It is very common that the ABL lender will automatically deduct payments due on the term loans as a drawdown under the receivables and inventory lines. This has the effect of increasing the "overdraft", but also ensures the ABL lender does not have to chase payments.

It is fair to say that ABL lenders are now less willing to provide commercial real estate mortgages than a few years ago. Where mortgages are provided, the amortisation profile of the loan will be quite steep at around ten years (as opposed to the normal domestic mortgage rule of 25 years). In addition to the issues raised in this article in the context of ABL facilities, all the commercial and legal principles of property finance would apply to this type of loan; these are not considered further here.

P&M is generally a less valuable asset than real estate in absolute terms and also because its market value will depreciate significantly. P&M loans tend to be medium-term (around five years) and present their own particular issues for consideration.

P&M and real estate loans are often documented separately from the receivables by add-on schedules.

Formalities and priority. P&M is quite similar to real estate in that it is usually secured by a fixed charge contained within standard debentures, although it does not, of course, have any registry like the Land Registry. Again, the lender will insist on first ranking security over the P&M.

Most lenders assume that fixed assets should be subject to the fixed charge. However, it should not be assumed that the word "fixed" in accounting terminology will have the same meaning in law. We have seen examples in practice where the borrower regularly bought and sold P&M without reference to the ABL lender, despite the terms of the relevant debenture.

The risk to the ABL lender is that it will be deemed not to have exercised sufficient control over the P&M as set down by the principles in *Spectrum Plus* (*see box "Floating charges"*) (*[2005] UKHL 41*). As a consequence, the relevant assets could be deemed to be subject only to a floating (rather than a fixed) charge, and the lender risks not receiving all its loans back. It is of course critical that the ABL lender in practice monitors and exercises control over the collateral in a manner consistent with the terms of the relevant debenture.

Floating charges

It is important to be able to distinguish between a fixed or a floating charge in the context of taking security over assets in asset based lending. The leading judgment in what constitutes a floating charge is the House of Lords' decision in *National Westminster Bank plc v Spectrum Plus Limited and Others* (*[2005] UKHL 41*) (*for background, see feature article "Floating charges: where are we after Spectrum Plus?", www.practicallaw.com/8-214-1952*). Their Lordships held that in order for a security to amount to a fixed charge, the security holder must exercise sufficient control over the asset so that the company granting the security may not deal with the asset without the security holder's consent.

In an insolvency, the floating chargeholder's recoveries will be subject to the claims of preferential creditors, such as certain employee claims and the so-called "prescribed part" (in relation to floating charges created after 15 September 2003). The Enterprise Act 2002 (2002 Act) introduced into the administration process this "prescribed part", as a set aside fund for the benefit of unsecured creditors, capped at £600,000 (*section 176A, Insolvency Act 1986 (1986 Act), as amended by section 252, 2002 Act*) (*for background, see feature article "Enterprise Act: corporate insolvency aspects", www.practicallaw.com/3-102-3042*).

OTHER LEGAL ISSUES AND PRACTICALITIES

ABL is a skilled business. ABL lenders must have good credit skills but must also understand the true market value of the assets financed, particularly in the context of a potential liquidation sale. ABL lawyers must understand insolvency and general banking law, be expert in the ranking of security, understand the difference between financing receivables by way of loan or by way of debt purchase and must have a good grasp of general commercial law (as the assets being financed often arise through general commercial contracts). They must also have significant litigation expertise, from the enforcement of personal guarantees and mortgages through to pursuing complex civil and criminal fraud cases.

Valuation

In the case of inventory, P&M and real estate assets, the ABL lender must be certain of the value of the asset being financed and will regularly "appraise" (that is, audit, stock check and professionally value) the assets using specialist firms (such as Hilco or Gordon Brothers for inventory or Cushman and Wakefield or DTZ for real estate).

Ownership and title

Particular issues arise for P&M and inventory:

P&M. P&M is very likely to constitute "fixtures", and appropriate waivers from the respective landlords will have to be obtained to ensure the company retains its title. P&M is often tradeable and it is not uncommon for ABL lenders to require nameplates to be physically attached to the P&M

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stating that it is subject to their security. Specialist appraisals of the value of P&M often provide a shock to the borrower: the appraisal will provide a value on an open market and a liquidation basis which may often be much lower than the acquisition cost. Very specialist P&M may have very little value at all, simply because if the borrower becomes insolvent, there may not be any other company that would want to buy unique machinery. More creditworthy companies might prefer to look to a leasing product where 80-90% of the acquisition cost could be financed in a tax-efficient manner.

Inventory. The ABL lender must also be certain that the borrower has good title to the inventory. Supplier retention of title claims are common. "Consignment stock" is inventory provided by a supplier to the borrower's premises but title remains at all times with the supplier until the point of sale; this is common in the retail sector. In the metal industry, large customers may wish to pre-purchase steel or copper from the borrower at favourable market rates intending to have that copper or steel manufactured into a desired product at a later date.

The ABL lender must be certain that it knows which stock belongs to the borrower and which stock belongs to customers or suppliers. Well-advised ABL lenders will also seek landlord waivers so that the landlord agrees that it will not distrain against the goods (that is, sell the goods and set the proceeds off against overdue rent payments), or on payment of the rent it will not terminate the lease. ABL lenders may consider establishing a six-month rent reserve so that funds should be available to continue rent payments. The last thing an ABL lender needs in a distressed situation is not to have access to, or anywhere to store, the inventory.

The ABL lender will also consider how readily the inventory can be turned into cash: slow moving or obsolete inventory could become ineligible for funding. In retail fashion inventory financing, the ABL lender may be advised to seek consent from the brand name owner, so that the ABL lender may sell the stock with the branding attached, rather than having to remove the branding from the clothing (and likely making the inventory worthless).

It can be seen that ABL requires very careful due diligence as it is a very risky business. The best lenders conduct "collect out" scenarios and "exit route" planning, so that they can predict the appropriate advance rates and reserve levels required to ensure that, even on an insolvency, the lender will receive all its money back.

Negotiating an ABL facility

Given the risk scenarios and the relatively high likelihood of borrower failure, ABL lenders have traditionally relied on very lender-friendly documentation. While ABL lenders have risk controls and regularly audit and check the facilities, they are also exposed to the risk that the borrower could provide misleading asset information. Unfortunately, ABL lenders have suffered significant frauds over the years.

In order for the ABL lenders to protect themselves against a breach of that trust, the ABL documentation provides for a wide discretion for the ABL lender to reduce facility limits, introduce new reserves or increase existing reserves and/or classify certain assets as ineligible. Indeed, many facilities are provided as "uncommitted", and are effectively on demand financings. Many lawyers who read ABL documentation for the first time are aghast at the terms and conditions.

In recent years, ABL lenders have been more open to negotiating terms. Well-advised borrowers look to reduce the minimum notice periods and termination fees, to set out the parameters under which an ABL lender can exercise its discretions and to require explanations of why an ABL lender has established reserves or changed the advance rates. However, only the strongest and best advised borrowers will be able to prohibit any right of an ABL lender to change the facility terms on a going forward basis.

Arguably, ABL lenders will need to be willing to be more flexible if the ABL product on offer is going to be acceptable to larger companies. When the credit market improves, it is likely that lenders will be more open to negotiating their terms and conditions: those lenders must hope that the clients they want to lend to have not found financing elsewhere.

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