Asset-Based Lending in Europe Today:

Bank of America Merrill Lynch Hosts CFA's International Lending Conference

By Hugh C. Larratt-Smith

"Bespoke ABL Financing" was a common theme at CFA's 7th Annual International Lending Conference at Bank of America Merrill Lynch in London in May 2013. This article quotes many of the conference leaders, panelists and organizers who discussed recent developments in cross-border lending and the outlook for European asset-based lending.

European lending has certainly evolved since the Battle of Waterloo. In 1811, The House of Rothschild lent money to England to pay Wellington's troops in the campaign in Portugal and Spain against Napoleon, and later to make subsidy payments to British allies after Napoleon's disastrous Russian campaign.

In these years following the War of 1812, Nathan Rothschild and his four brothers developed a network of agents, shippers and couriers to transport gold – and information – across Europe. This private intelligence service enabled the Rothschilds to receive in London the news of Wellington's victory at the Battle of Waterloo a full day ahead of the government's official messengers.

In 1818, Nathan Rothschild arranged a five-million pound loan to the Prussian government, and the issuing of bonds for government loans soon became the mainstay of the Rothschild's business. Instead of hard assets as collateral, the Rothschilds relied on information to judge risks and ensure repayment. Their loans were very much "Bespoke" – highly tailored to fit nonstandard forms.

Fast forward to today. European bank lending continues to be "Bespoke", particularly European asset-based lending, which requires careful tailoring to fit various collateral domiciles, legal jurisdictions, currencies, languages, cultures, work practices, political regimes, time zones and competing sources of capital.

"Bespoke ABL financing" was a common theme at CFA's 7th Annual International Lending Conference at Bank of America Merrill Lynch in London in May 2013. This article quotes many of the conference speakers, panelists and organizers.

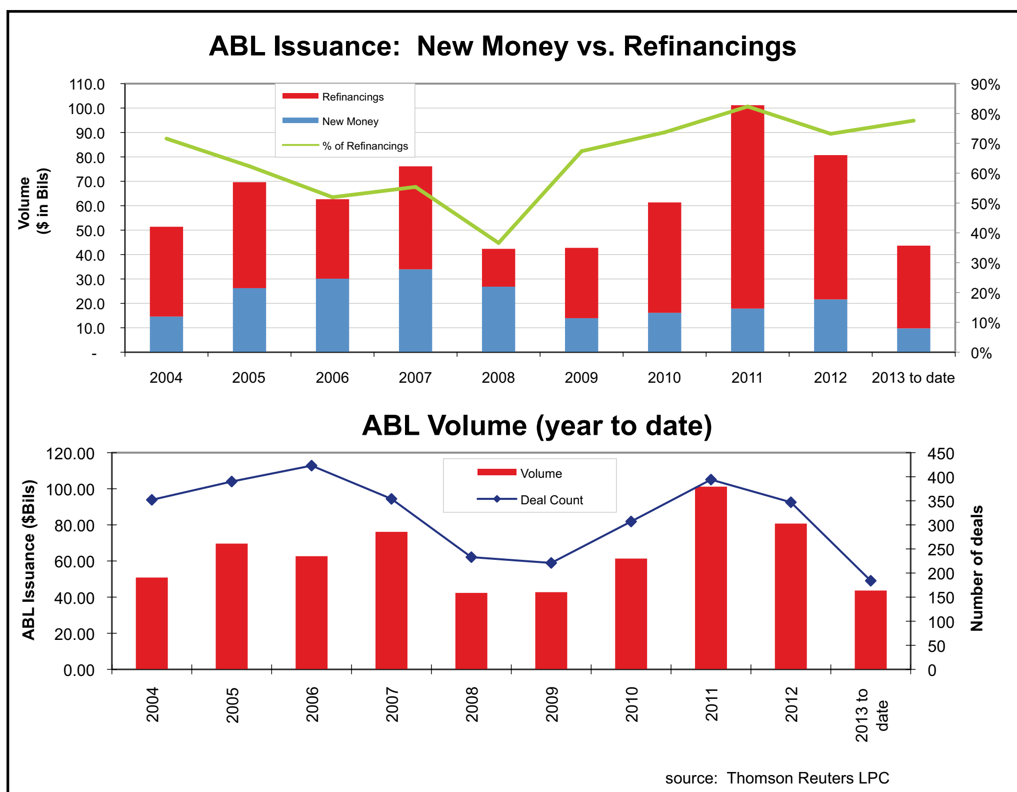
"Salus Capital Partners was pleased to be a sponsor at the 7th Annual International Lending Conference in London. We thought the Conference was well attended by both bank and private lenders, private equity firms, attorneys, asset appraisers, accountants and other parties. Attendance at this Conference was a must from our perspective, given our recent effort to determine the opportunities that the UK market would provide Salus Capital. The agenda covered a range of topics that was almost tailor-made for our benefit," noted Daniel O'Rourke, chief credit officer, Salus Capital Partners.

According to Conference sponsor and panelist Jeremy Harrison, Regional Group Head for Bank of America Business Capital based in London, "We expect to see increased ABL demand as the Eurozone begins to recover and, in fact, are already seeing greater deal activity," he said."While M&A activity is still lacking in Europe, there are some positive signs. For example, in the German Mittlestand, low-levered, family-owned businesses are looking to private equity buyers. We are also beginning to see green shoots in the UK, where growth is likely to be ahead of other countries. There are a variety of lending structures which can be used successfully in most Western European countries."

For the past 24 months, the U.S. capital markets have been awash with liquidity. The marketplace was hot in 2011/2012, with a significant amount of re-pricings and refinancings.

Re-financings continue to account for the majority of syndicated ABL deals in 2013, according to Thomson Reuters.

David Morse, Conference co-chair and panelist and partner, Otterbourg, Steindler, Houston & Rosen P.C. in New York commented: "Of note is that the ABL market was relatively quiet in Q1 2013 industry-wide, which goes to the theme that lenders, particularly U.S. lenders, need to press for growth, including finding new strategies for



border credit facilities."

While Europe has benefitted from this surge in liquidity in the U.S. bond and money markets, the liquidity impact has been much more muted. For large corporate borrowers in Europe, market capacity has not changed – but now there are fewer players who are taking larger participations in syndications. However, for European middle-market borrowers, the "trickle-down" impact of the liquidity surge has not been as significant as in the United States, since most European borrowers rely more heavily on banks.

In the UK, the Asset Based Finance Association reports that ABL loan growth continues to be hamstrung by the aftershocks of the financial crisis: borrowers who view ABL as a slice in their capital structure. At the other end of the spectrum are small/medium enterprises (SMEs), akin to middle-market companies in the United States. For these borrowers, ABL is the lifeblood of their business.

"Cross-border asset-based financing, like asset-based financing generally, covers a diverse array of businesses and circumstances—from small businesses with only millions in sales, to the largest companies with billions in sales, and from those companies struggling to those that are on their way to investment-grade," noted David Morse. "Given this diversity, reflecting the inherent flexibility of the product, together with the challenges of dealing with multiple legal regimes in which a business is operating, it is hardly surprising that cross-border ABL facilities are characterized as 'bespoke'".

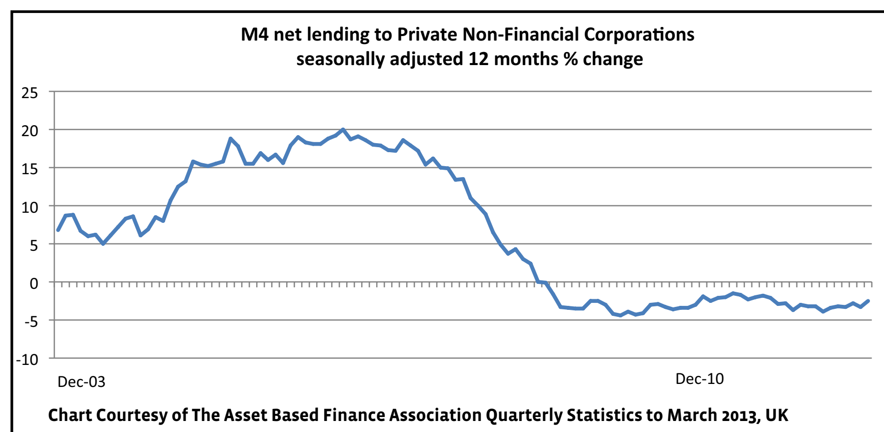


Chart Courtesy of The Asset Based Finance Association Quarterly Statistics to March 2013, UK

In Europe, large and lower middle-market companies look to their banks for financing – an estimated 80% of corporate financing comes from banks, compared to an estimated 20% in the United States. Today, Europe is similar to the 1970s banking marketplace in the United States – banks were critical business partners for U.S. companies in the 1970s before capital market disintermediation took hold. This aspect of European capital markets is amplified by the significant degree of family ownership in corporate Europe, with little access to capital markets for many family-owned companies.

To some extent, the European marketplace is a "tale of two cities". On the one hand, there are the top market

The most useful credit-analysis tool for European lenders has been a very simple one in the past five years: a map. Corporate borrowing costs are being determined almost entirely by where a company or its assets happen to be based, even if its businesses are pan-European or global.

Lending to the "beer drinking countries" is quite different from lending to the "wine drinking countries". Northern European borrowers are increasingly able to lock in extremely cheap financing—including at negative real rates—while southern European companies – Spain, Portugal, Italy and Greece – are having a much tougher time obtaining financing.

Seventy percent of Eurozone banks are facing downgrades, according to Standard & Poors Rating Services in London. While the liquidity squeeze has abated for many banks, the question of bank solvency, particularly in Southern Europe, continues to create market unease. Consequently, many companies that rely on bank financing are starved for liquidity. In many Southern European countries – Spain, Italy, France, Portugal – the tradition and dominance of short-term demand loan financings has caused liquidity squeezes for many companies, and has put a brake on economic growth.

This situation should create opportunities for the well-capitalized banks and commercial finance companies, particularly those with strong, nimble ABL/invoice finance capabilities. Daniel O'Rourke commented: "Expanding our geographical footprint would provide Salus Capital with the ability to differentiate ourselves by being able to offer credit facilities directly in countries outside the U.S. and Canada, as well as offer cross-border solutions." Salus Capital provides asset-based loans ranging from $3 million to $35 million for emerging growth, turnarounds, acquisitions and cyclical business challenges and opportunities.

ABL is becoming more mainstream in many EU jurisdictions. In years past, ABL was considered transitional financing, or a loan of last resort; today, borrowers are discovering the advantages of increased availability and become permanent ABL customers. "The ABL lenders are crucial partners for us, and the product forms an important part of our new acquisition and working capital financing," commented Philip Dougall, Conference panelist and partner, Kelso Place Asset Management in London. "We really value the flexibility of the product and the speed and deliverability with which our ABL partners in the UK can transact," he said. Kelso Place Asset

REGISTRATION IS NOW OPEN FOR CFA'S ANNUAL CONVENTION IN LOS ANGELES WWW.CFA.COM

Management specializes in long-term investments of up to £20 million in UK-based businesses that require additional resources to grow, or that are financially, operationally or strategically challenged.

Christopher Hawes, Conference panelist and corporate director, RBS Invoice Finance in London, commented: "The UK is different from Mainland Europe, where more of a receivables finance/factoring mentality persists. As we saw at the Conference, there are diverging views even amongst lawyers as to what is possible and what's not in certain jurisdictions."

Statistics from the UK Based Asset Based Finance Association shows the market share of ABL in the UK:

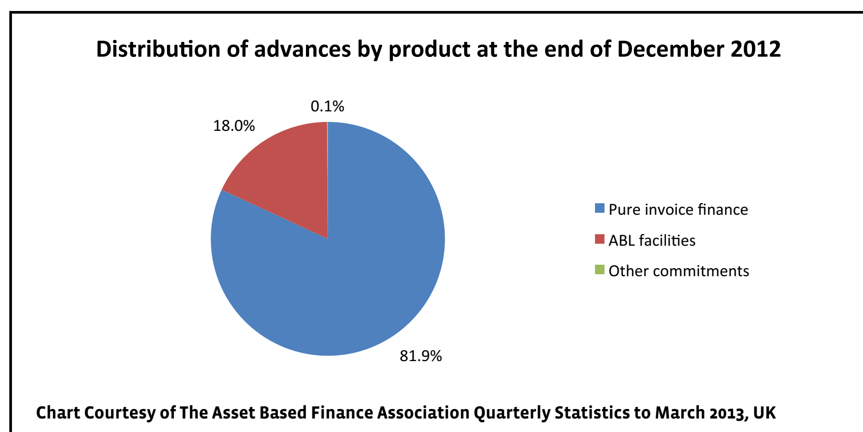


Chart Courtesy of The Asset Based Finance Association Quarterly Statistics to March 2013, UK

Even CFOs of large companies realize that the disciplines of weekly or monthly reporting can be good for a company. The improvement in the management information systems of many borrowers in the past decade makes ABL reporting easier and more efficient. "We find ourselves not selling the product idea so much, but able to sell a solution to today's CFO," commented Michael Haddad, CFA president and president & CEO, NewStar Business Credit.

However, if a deal gets too complex, expensive or unwieldy, then CFOs turn to high-yield bonds as a substitute. And CFOs are concerned about "distribution risk" in a syndicated loan – they don't want too many players in the syndicate.

All good CFOs fight hard to get the appropriate carve-out language to facilitate future borrowings. Otherwise, a large borrower can find itself painted into a corner by pledging all of its assets to get a complex Pan-European deal done, only to find that it's hamstrung. The challenge for CFOs is to balance today's cash management, tax and regulatory demands with the actual mechanics of how their businesses are going to work in Europe two to five years down the road.

Another sign of ABL's increasing role in European financing: many private equity sponsors are spending time to understand what is do-able in different European countries. A number of European private equity groups are realizing what their U.S. counterparts have known for a long time: with attractive assets to pledge to an ABL structure, the pricing can be significantly cheaper than a cash-flow equivalent structure. Those savings are especially appealing for more leveraged or lower-rated credits as interest rates return to historical norms.

The sponsor finance lenders in Europe are facing the same questions as their U.S. brethren: with the supply/demand imbalance of liquidity, why is there not more M&A? Part of the answer is that, while sponsors are awash with liquidity, many are reluctant to take a company private at a premium, and then try to grow it organically in today's bumpy economic climate.

In the past two years, the European ABL marketplace has become much more stable, but, like the U.S., pricing has tightened. Challenging deal structures can improve the yield on a loan – many better-yielding deals are a "work-around," meaning a lender needs to be highly adaptive to the borrower's geographic and legal condition. In today's European marketplace, leverage ratios are the same as 2007, but EBITDA coverage ratios are much better.

Corporate borrowers have often structured their company's geographic and legal organization on tax considerations. Now companies are organizing themselves based on liquidity considerations. "There are some exciting trends in how companies with global operations are organizing their businesses in ways that facilitate the ability of lenders to provide financing involving multiple jurisdictions," commented David Morse.

The geographic location of assets can be the driving force in deal structure. The challenge is: how does a company's CFO redistribute liquidity from an asset-rich country with a poor ABL legal environment to an asset-poor country with a good ABL legal environment? In addressing this question, many borrowers are evaluating "recentralization" of assets as a way to optimize debt capacity in Europe. The goal of recentralization is to concentrate accounts receivable in a creditor-friendly country like the Netherlands or the UK. For example, some corporate borrowers are setting up an accounts receivable entity in the UK in order to maximize their borrowing capacity in the European ABL marketplace.

A risk in recentralization is conforming to the "True Sale" concept. This means that the re-domiciliation of accounts receivables must be more than a book keeping entry – it must be a bona-fide sale between discrete corporate entities. Asset-based lenders historically have ranked accounts receivables into 1, 2 and 3 categories – but market pressures have turned

Tier 3 accounts receivable into Tier 2 accounts receivable, even in the face of "Swiss cheese" recentralizations. For example, Tier I typically includes accounts receivable in the UK, The Netherlands, Belgium, The Nordic countries, South Africa and Germany. Due to more challenging legal jurisdictions, Tier 2 typically includes France, Italy, Portugal, India, Spain and some of the peripheral EU countries. Tier 3 accounts receivable typically include countries such as Russia, Serbia, Nigeria, Pakistan and Latvia.

Bi-lateral deals in different jurisdictions are much more difficult to do than Pan European monolithic deals. The complexity of differing jurisdictions can be daunting. Due to the lack of harmony amongst many legal jurisdictions, lawyers and law play a much more prominent role in transactions than in the United States. In many parts of Europe, lenders may need to audit the legal opinions of the borrowers' legal counsel every bit as closely as the collateral needs to be audited. Some countries like Spain can have many qualifications in the borrower's legal opinion. "As a lending community, we will generally underwrite just about any credit risk, but taking legal risk is just plain unacceptable," said Haddad from NewStar Business Credit, which provides tailored asset-based and senior secured loans up to $25 million, for strategic acquisitions, management buyouts, recapitalizations and refinancing, as well as to support internal growth strategies.

"The complexity of a 14-country Pan-European ABL financing may be daunting to document when everyone is rushing to close the deal," said Nick Moser, Conference panelist and head of Restructuring & Corporate Recovery at Taylor Wessing LLP in London. "The same complexity might seem a nightmare in a restructuring, but this can be navigated through."

Whether it's a new Pan-European deal or a restructuring, it's important to have local staff who can speak the language. Field exams can get very expensive and time-consuming in the absence of local language capabilities. Translating term sheets into borrowing bases in 14 different countries can be tough for inexperienced lenders. A lack of local technical knowledge is leading to poor execution for borrowers.

In the large corporate marketplace, ABL financings are frequently part of larger changes on the right side of the balance sheet, often including high-yield bond offerings. The challenge with Bespoke ABL deals that are launched simultaneously with high-yield bond issues is that the timing demands and pressures of the bond market can be very intense – bond markets can change quickly. Calibrating the timing of a high-yield bond issue targeted to take quick advantage of market conditions with a complex Bespoke cross-border ABL deal can be challenging. For example, in a multi-jurisdictional ABL deal, local managers at the borrower may resist losing financial control and try to stonewall the deal, which adds timing delays. Many global ABL deals have restrictions on cross-border, cross-subsidiary cash transfers, which make the local management feel like they are losing control. Cash management in Pan European deals can be very time consuming for CFOs – but the lenders need a certain configuration of bank accounts in order to perfect their security interest in cash.

To syndicate a global deal, it needs to feel "American" to U.S. lenders. This means that financial statements must conform to GAAP and be in U.S. dollars. One potential hiccup in the global syndication markets is that the U.S. regulators may view certain ABL shared national credits as "HLT" – Highly Leveraged Transactions. Here's the rub – shared national credit HLTs with no amortization may be classified as substandard credits.

What's in store for the ABL in Europe?

Reform of banking regulations, some of which date back to The Battle of Waterloo, must be accelerated along with the harmonization of laws within the EU. The EU countries need harmonization of laws to encourage more stable forms of financing. As noted, financing for middle-market companies in Southern Europe largely consists of demand loans from banks.

Thought leaders at the Conference offered some insights into the issues facing the European asset-based marketplace:

"Future harmonization of secured lending laws will eventually accelerate the growth of ABL in Europe," said CFA Conference co-chair Richard Kohn, founder and senior principal, Goldberg Kohn Ltd., in Chicago. Kohn is spearheading the CFA's involvement with the United Nation's effort to help countries modernize their secured lending laws. These efforts are conducted by the United Nations Commission on International Trade Law (known as UNCITRAL), which is the branch of the U.N. that seeks to promote commerce as a way of promoting peace. Although UNCITRAL's efforts in the field of secured lending are focused primarily on developing countries, Kohn is optimistic that they will have a positive influence on developed countries as well, including some Member States of the European Union. As a case in point, he refers to Belgium, which, this past May, adopted a modern secured transactions law that is currently scheduled to become effective by December 2014.

Collateral eligibility for European ABL borrowers needs to be wider and more liberal to include accounts receivable from a wider range of countries. "What seems to be apparent, though, is that a combination of regulatory, macro-economic and market acceptance facets are driving ABL up the agenda when companies consider how to finance themselves for the future," noted Hawes at RBS Invoice Finance.

The real challenge in European ABL is inventory. Inventory financing laws are changing in many countries. For example, "Germany allows granting of

security in inventory by assigning the inventory to the borrower. Usually this is done by assigning the contents of a warehouse or another specified location," noted Christof Schiller, Conference panelist and Rechtsanwalt-CPA, Wellensiek Rechstanwalte Partnerschaftgesellschaft in Heidleberg, Germany. "Reservation of title is a key issue in Germany. To calculate the borrowing base, German lenders deduct the vendor liabilities from the value of the collateral. Since most German vendors have trade credit insurance, they rely heavily on reservation of title."

"ABL enables businesses to leverage their assets, including accounts receivable, inventory, plant and equipment and even intellectual property, to access working and growth capital. It is crucial that CFA and other industry organizations raise awareness and understanding in Europe and around the world about this critical capability," stated Bob Trojan, chief executive officer, Commercial Finance Association in New York.

"ABL in the EU is still gaining popularity despite the legal issues and the fact that the product has not been around as long as in the U.S.," noted Bruce Sprenger, group senior vice president and region executive, Cole Taylor Business Capital and CFA chairman of the board. At the Conference, "the energy amongst the attendees was terrific and the interchange of ideas and concepts was at a new high. Despite the European theatre challenges due to sovereign debt issues amongst others, the outlook remains positive for ABL and factoring in these venues. With the strategic alliances that CFA has fostered, for example with the IFG, globalization continues."

Commented O'Rourke, from Salus Capital Partners: "The CFA Conference offered both the relevant topics and the right mix of attendees to provide us with access to the information and people we needed to continue our effort in the UK and Europe."

Morse added a final note: "The conference was a great opportunity to provide lenders with some ideas to bring to potential borrowers looking for financing across a range of jurisdictions. It clearly reflects the degree of interest of asset-based lenders in looking for new opportunities to expand their portfolios by tackling the challenges of multi-jurisdictional facilities and to better serve their customers with global financing solutions."

At his death in 1836, Nathan Rothschild's personal net worth amounted to nearly 1% of British national income. He gained a position of such power in the City of London that, by 1825, he was able to supply enough currency to the Bank of England to enable it to avert a liquidity crisis.

Some historians agree that the Rothschilds' couriers did get to London first and alerted the family to Napoleon's defeat, but argue that, since the family had been banking on a protracted military campaign, the losses arising from the disruption to their business more than offset any short-term gains in bonds after Waterloo. The family made huge profits over a number of years from this governmental financing by adopting a high-risk strategy involving loans to warring governments, exchange-rate transactions, bond-price speculations and commissions.

Their economic power and financial status gave the Rothschilds unique political leverage. Churchill and Disraeli were their friends; Hitler and Bismarck their foes. Yet their failure to establish themselves successfully in the United States proved fateful. As financial power shifted from London to New York after World War I, the Rothschilds' power waned. **TSL**

Hugh C. Larratt-Smith is a regular contributing author for *The Secured Lender*. He is a managing director of Trimingham Inc., a Financial Advisory firm with offices in New York, London, Santa Monica and West Palm Beach. He is an Advisory Board Member of CFA's Education Foundation.