ABLs in Uncertain Times: Sorting Risk From Opportunity In Today’s Fragile Recovery

BY STEPHEN J. MCCABE

ABL Journal spoke with leading executives, primarily from bank-affiliated ABLs, to get their perspective on where we might be headed through the remainder of this year and into 2013 and beyond. While most ABLs seem to agree there’s room for cautious optimism, the uncertainty surrounding a wide variety of factors gives many a sense that progress will be limited until resolution is gained.

The first quarter of 2012 saw some hopeful signs of a strengthening U.S. economy. And with it, many ABLs were encouraged by the record-breaking pace of transactions they saw in 2011 — a year they hope could be laying the foundation for expansion and continued growth into 2012. Economic data continues to show significant, albeit modest, improvement in a number of sectors.

During the first quarter on 2012, progress was made on the euro-zone debt crisis, and domestic unemployment numbers, while still stubbornly high, are declining. Yet, most ABLs agree the most significant factor limiting confidence in the recovery could be the number and variety of uncertainties surrounding markets in 2012 — and beyond. As one leading ABL put it, “You can’t manage for uncertainty; you can only sit tight and wait it out.”

And in a year when uncertainty abounds, so, too, does caution and hesitancy on the part of both lenders and borrowers. The ABL Journal spoke with leading executives, primarily from bank-affiliated ABLs, to get their perspective on where we might be headed through the remainder of this year and into 2013 and beyond. While most ABLs seem to agree there’s room for cautious optimism, the uncertainty surrounding a wide variety of factors — ranging from energy and commodity prices, to housing starts, to the viability of progress on the euro-zone debt crisis, to the uncertainty surrounding the vagaries of an election year — gives many a sense that progress will be limited until resolution is gained.

A Tough Act to Follow

So, how does this year compare to the last for ABLs? According to Thomson Reuters LPC’s Maria Dikeos, writing in the March 2012 ABL Journal, “Most lenders concede that volume will not be what it was last year.” Has that prediction proven true for ABL activity in the first quarter of 2012?

Not from Bill Kosis’ perspective. A 35-year veteran of bank lending, Kosis is currently in his sixteenth year as executive vice president of the asset-based funding group of PNC Business Credit. “In the first quarter and into the start of the second, we’re slightly ahead of last year,” Kosis says. “We had a record year for closings last year, and we seem to be close to or maybe even a little ahead of that pace this year,” he says.

Other ABLs are seeing a similar continuation of the strength they saw in 2011. Bob McCarrick is one of them. As chief commercial officer-lending for GE Capital, Corporate Finance, McCarrick brings a unique perspective from almost 20 years with GE Capital. During that time, his unit has emerged as a leader an ABL financing, and GE Capital is at the top in cash-flow financing within the middle market.

“As we look at our YTD performance given the level of market activity, we feel very comfortable with that,” McCarrick says. He reports closing about six ABL transactions in the first quarter, with an aggregate value of $1.4 billion. But he knows it would be highly unlikely he will see anything close to the banner year he and other ABLs saw in 2011.

“I think when you look back at 2011, what you see is a year that had incredible ABL volume — I think it was close to $100 billion or so. To repeat that in 2012, given the overall market activity that we’ve seen YTD, is probably not going to happen — unless for some reason there is a very large uptick in activity through the second half of the year,” McCarrick says.

Sam Philbrick agrees: “2011, by any measure, in terms of absolute volume in the league tables, was a banner year.” Philbrick serves as president of U.S. Bank Asset Based Finance and held similar roles with Bank of America and Fleet before joining U.S. Bank five years ago.

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Joe Nemia, who leads the ABL corporate special banking division of TD Bank, concurs with both McCarrick and Philbrick. “Given the huge volume we saw in 2011, I think it’s going to be difficult — frankly, unlikely — that 2012 volume will exceed the record year of 2011,” Nemia says. “It would be phenomenal.” And Nemia, along with many other ABLs, thinks he knows both the source of the strength for 2011 and that it will not last indefinitely.

“There were limited new monies in 2011,” Nemia notes. “It was mostly amend-and-extends.” And Nemia knows the supply of these transactions is not inexhaustible. “In 2011, you had a lot of maturities and refinancings, but I think we may have hit the cliff for these transactions, which were just replacing deals that were done in the preceding two or three years at a much higher interest rate.”

So while many ABLs are gaining optimism from the great strength of 2011, they are also keenly aware that its record-breaking volume alone may not be all that significant for this year — or beyond.

A Need for Quality, Not Just Quantity
That’s why Philbrick looks for the quality of the transactions, not necessarily their quantity, as being a better indicator of where ABL might be headed in 2012. “The negative of 2011 is that the vast majority of this volume was simply refinancing of deals that had been done in the more distressed credit environment after the recession,” he says. “So a lot was just driven by improved market conditions from an issuer’s standpoint and banks willing to accommodate them by giving them extended maturities as well as lower credit spreads.”

Philbrick is one of many ABLs that see the refinancings that fueled transaction volume in 2011 drying up this year. So what will take its place? “The question now in 2012 is whether ABL activity is going to be driven by true economic activity,” Philbrick says. “In 2011, the economy was okay; in 2012, I think the economy is going to be okay once again, with slow and steady growth. But you’re not going to have this sort of pent-up refinancing demand that we enjoyed in 2011,” he says.

So, if the potential for lower transaction volume is not necessarily a negative for ABLs, what type of deals will constitute a positive step for the industry?

For Philbrick and other ABLs, the outlook for the rest of 2012 is going to depend on the strength of the underlying economy. “As ABL lenders, we’re primarily financing working capital — companies’ investments in receivables and inventory — and that’s driven by the amount of business they have or they’re anticipating,” he says.

From Nemia’s perspective, maybe that sort of correlation is not quite as strong, and perhaps some refinancings are still to come. “Yes, I think the majority of refinancings did occur last year, but I think given the interest rate climate we’re in, we’re still going to see them,” Nemia says. “As companies show improvement and they recognize the depth of the market for refinancings, I think we’re going to continue to see them.”

Guy Fuchs, a 23-year ABL veteran and currently head of the Corporate Finance Group of Wells Fargo Capital Finance, notes that several large refinancings during the first quarter actually pushed his group’s volume higher than anticipated, especially given the predictions that 2012 would be a tough year to even come close to matching the record transaction volume seen in 2011.

“Uncertainty is the Real Enemy
One area of widespread consensus among ABLs is the air of uncertainty surrounding today’s fragile economy and the usual distractions associated with election-year politics. A variety of additional factors — ranging from continuing thin loan demand resulting in increased competition to the fallout from the European debt crisis to increased regulatory oversight — are also contributing to one of the most difficult challenges ABLs face: the innate tendency of borrowers and business leaders to sit tight and await answers or clarity before making a decision or committing resources.

“If you’re a CEO or CFO, you’re sitting there saying, ‘Gosh, there’s a lot of uncertainty out there. Is this the right time to go out and start spending money on CAPEX, and on growth initiatives and on acquisitions?’ says McCarrick. “The answer is, probably not, right?”

“That’s very true,” says Nemia. “We almost get to a point where people are paralyzed, not wanting to take on any risk until they see a steadier state, an environment that’s a little bit more predictable.”

Of course, with 2012 being an election year, nothing could be less predictable than the immediate political future. “I think no matter where you sit politically, the reality is that the one thing we all hate is uncertainty,” says Philbrick. “It’s hard to manage against uncertainty. So, whatever the outcome is, I think it will be better than where we are today — in terms, at least, of eliminating the uncertainty.”

McCarrick couldn’t agree more: “That uncertainty, at least through this fall’s elections, will create some gridlock and prevent CEOs and CFOs from spending money and creating new opportunities for capital to be deployed,” he explains. “After the elections, I would hope we’ll start to see some movement forward now that that uncertainty, at least, has been eliminated from the equation,” he says. He feels that...
having the elections decided, regardless of which way they go, may result in some increase in transaction volume late in the fourth quarter and going into 2013.

Philbrick agrees: “No matter what the outcome, we can all adjust how we operate accordingly. Just having the election done will give people a little more confidence to make the decisions they’re delaying right now.”

But the fall elections are just one factor that might be contributing to the air of unpredictability surrounding 2012. For Philbrick, decision makers could be waiting quite some time for anything approaching predictability to return on a wide variety of factors. He agrees that now is not the time when borrowers are inclined to take on any significant risk.

But walking softly is not a business strategy for the long term. How can ABLs leverage these prevalent uncertainties toward their advantage today? Maybe they can’t. Perhaps patience is the best and only option at this point, says Kosis. Or there could be a silver lining for ABLs in the clouds of uncertainty pervading the markets. “All of that uncertainty probably leads more and more borrowers to AIBF,” says Kosis. “All of these uncertainties are challenges, but they’re also opportunities for us.”

And those opportunities could remain, adds Nemia, who has watched how lending has reacted to the uncertainty surrounding the European debt crisis, in particular. He notes how markets overall, but especially the cash-flow financing markets, have reflected the volatility associated with the euro-zone’s problems. “Interestingly, ABL has been fairly steady to improving throughout the crisis, despite the volatility in other financing markets,” Nemia says. “And the ABL product will likely continue to be viewed as a financing solution vis-à-vis cash-flow lending.”

Fuchs of Wells Fargo has seen a similar ripple effect of the euro-zone’s instability spilling over into the U.S. “The U.S. ABL market is not immune to events in Europe,” he says. “The dampening impact of the European recession is clearly impacting the U.S. economy, and M&A activity seems muted due to the uncertainty facing U.S. businesses.” And Fuchs notes that while loan demand remains very strong among U.S. banks, European-based banks that do not have a dollar funding source are curtailing their activities in this market. “The uncertainty and how it will impact the U.S. expansion is a chief concern of Wells Fargo,” he says.

Kosis agrees that while there are many uncertainties today, they’re certainly not unprecedented compared to what he has seen during his career at PNC. “We’ve ridden ups and downs in the economy, and there are opportunities in both,” he says. “During the up times, when our customers are doing better, we see add-ons and a pickup in M&A transactions. And during the downturns, there are refinancing activities.”

Age-Old Challenges — and New Opportunities

While the uncertainties ABLs are facing early in 2012 present unique challenges, some see them as simply a reincarnation of issues the industry has faced. And to the extent they’ve been seen before, solutions to meet them today have probably been deployed in the past.

Most ABLs agree on a core of challenges facing them in 2012. “Right now CEOs and CFOs are a little bit reluctant to put money to use, which is somewhat impacting loan volume,” says McCarrick. “There’s also a lot of money available out there in the ABL world chasing fewer deals, which is good for borrowers but not so good for lenders. So you have a supply and demand imbalance, which just puts a lot of pressure into the market surrounding pricing and terms.”

McCarrick feels gaining some clarity around financial regulations, healthcare costs and the euro-zone debt crisis, as well as an outcome for the U.S. elections, should help spur movement. “We may see an increase in loan volume going forward as CEOs and CFOs gain the confidence to invest after a period of delaying capital expenditures while waiting to see how things unfold.”

For Philbrick, many of the challenges ABLs are seeing are largely out of their control. Thin loan demand is at the top of his list. “But the truth of the matter is that it is what it is; it’s the market, and we can’t change the market. I think what’s important is that we be aware of the market and position ourselves as appropriately as possible in terms of who we want to do business with and what solutions we’re willing to provide them.” Transforming this challenge — and others — into opportunities in 2012 is just the most recent task ABLs are being forced to take on, he says. “I don’t stay up at night worrying about it, but I certainly do spend a lot of time making sure that, to the best of our abilities, we understand the implications of this environment for our customers and our business.”

Fuchs reports that one of Wells Fargo’s top concerns is the combination of lower-yielding assets and increased costs. “Many of our competitors are under continued pressure to grow assets and profits. Because of that, we are seeing a downward trend in ABL pricing and more aggressive structuring,” he says. “We are also experiencing increasing regulatory and compliance oversight, which translates into increased costs.”

Through 2012 and Toward 2013

So, where do ABLs go from here? Not surprisingly, most ABLs agree options are limited until some fundamental resolution occurs. But in the meantime, those taking the long view can take some comfort in what they’ve seen work successfully in similar situations in the past.

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From Philbrick’s vantage point at U.S. Bank, the long view might just be the only view. “To me, the best solutions we can bring to this marketplace are those that can stand the test of time,” he says. “They’re reasonably priced from a client’s perspective, they’re reasonably aggressive from a structuring perspective, and they’re also structures that, with this level of uncertainty, will continue to meet a company’s financing needs even if there is some variation in the environment they’re operating in.”

McCarrick urges patience. “Until there’s less market volatility, CFOs will likely continue to wait and see how things pan out over the next couple of quarters — from the election to GDP growth to unemployment,” he says. “While we expect greater growth in cash-flow lending, many asset-rich companies will continue to find ABL is the right solution.”

Kosis is confident that PNC Business Credit’s activity is looking strong. “Business is pretty steady, we’re at a low level of credit issues, and we’re right where we should be, looking to meet or surpass last year’s results,” he says. “In fact, the last four or five years have been very strong for us, so I’m expecting it to continue.”

Fuchs expects the ABL market will continue the trends of the first quarter into the remainder of this year. “Loan activity is relatively flat compared to last year, but it’s still strong on a historical basis,” Fuchs says. “And while most of our ABL activity is being driven by refinancing, we are seeing a recent uptick in sponsor-related M&A.” Fuchs also notes that pricing has stabilized after three consecutive years of declines.

Nemia sees some hopeful signs as well: “Given the low interest rate environment, expectations are that market demand will remain fairly steady. If the M&A market begins to show signs of life, it could positively impact ABL volumes, even more so than the upcoming elections,” he says. Looking into 2013, Nemia says the budget deficit may impact the low interest rate environment companies have enjoyed and ultimately increase pressure on loan demand.

Beyond just the challenges facing ABLs through this year and into next, Philbrick takes heart from the evolution and maturation of ABL product he has seen over the past 20 years. “It used to be an ABL was the loan that borrowers would take because they couldn’t get any other kind of loan. Now, in a lot of situations you get an ABL when everyone else says no. This tells me we have long-term potential,” he notes. “It used to be hugely cyclical: when credit would deteriorate, everyone would shift to ABL. There’s still some of that, but it’s no longer the way it used to be.”

But most ABLs know that even with a maturing product garnering increased recognition among borrowers, they must not become complacent. “For us at GE Capital, Corporate Finance, ABL is a bedrock of what we do,” says McCarrick. “It’s fundamental, it’s at our roots, it’s a product that we have tremendous expertise around, and, all things considered and compared to other products, it’s a very safe play for lenders.” But most importantly, he says, “It’s a good product for borrowers. So it’s one we will continue to be dedicated to and focused on.”

Kosis knows the limitations of predictions, even with the maturation of the ABL industry, and he’s reluctant to rely on past performance as a reliable indicator of ABL’s future success. Any optimism he may feel is always grounded in a commitment to meeting the challenges facing the ABL market today. “We have to keep blocking and tackling and doing what we do in terms of serving our customers and potential customers. I think then things will work out well in the end for us,” he says. “Let’s face it: there’s always going to be change. That’s the one guarantee.”

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