RIGHT: Facade of the New York Yacht Club as it appears in midtown Manhattan today.

BELOW (counterclockwise): The yacht club's main staircase, library and lounge from archive photos of its opening in 1901.

Photos: Library of Congress

Transatlantic Innovation:
ABL's Evolving Legacy

BY HUGH C. LARRATT-SMITH

From the days of The House of Morgan's global dominance in the early 1900s to current times, transatlantic transactions featuring new products such as ABLs are becoming more mainstream. European asset-based financing is gathering momentum as CFOs discover the multitude of benefits.

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The main clubhouse of The New York Yacht Club is a six-storied Beaux-Arts landmark with a nautical-themed limestone façade in midtown Manhattan. Opened in 1901, it was designed by Warren and Wetmore, architects of the exterior of Grand Central Terminal. The centerpiece of the clubhouse is the Model Room, which contains a notable collection of full and half hull models, including a scale model history of all New York Yacht Club America's Cup challenges.

From 1919 to 1921, J.P. (Jack) Morgan, Jr. was Commodore of the club and held many meetings over the years in the Model Room and on the Morgan family's yachts, negotiating transatlantic and Pan-European asset-based financings. His last yacht, the *Corsair IV*, was one of the most opulent yachts of its day and had an overall length of 343 feet. (The famous quip "If you have to ask how much the yacht cost, you can't afford it," is attributed to J.P. Morgan). As Commodore in the 1920s of The New York Yacht Club, which was the sponsor of The America's Cup yacht race, Jack was at the epicenter of transatlantic yacht racing competition.

Until World War I, Europe had been a net exporter of capital. Indeed, much of the railroad financings in the U.S. were funded by European syndicates from 1850 to 1900. However, as U.S. banks consolidated and grew in strength in the early 1900s, led by The House of Morgan, the flow of capital started to reverse. Providing a $12 million loan to Russia in 1914 and a $50 million loan to France in 1915 catapulted the House of Morgan into the first U.S. global financial powerhouse.

Over time, due to the need for asset-based lenders to grow their balance sheet, while their clients began moving east/west/south (outside of the U.S.) and because they wanted borrowing capacity against what they deem to be high-quality assets, U.S. lenders have increased foreign collateral sub-limits significantly.

Syndicated ABL Financiers

Today, U.S. banks in Europe are focused on corporate financings as opposed to sovereign financings. The dominant U.S. syndicated ABL financiers in London are Bank of America Merrill Lynch, Wells Fargo and J.P. Morgan. Other U.S. players who are very active in specific sectors of the ABL marketplace include Gordon Brothers, Fortress, AbleCo, GE Capital, PNC, CIT and Citibank.

The syndicated ABL markets have rebounded robustly from the dark days of the financial crisis. The first wave of syndicated ABL financings after the financial crisis were refinancings in order to extend maturities past the 2012-2015 "maturity wall." The most recent wave of refinancings has been price driven by CFOs wanting to lock in advantageous spreads in anticipation of rising interest rates. The wash of liquidity, which started in 2010, has continued unabated: In 2013, a record EUR 70 billion in European high-yield bonds were issued, and 2014 is showing similar strength.

Darryl Kuriger of Wells Fargo Capital Finance provides some historical backdrop to the evolution of the transatlantic ABL marketplace. "Years ago, U.S. asset-based lenders would build in small foreign sub-limits of 5% to 10% of the deal and allow it to be backed by foreign collateral," he says. "Of course, that assumed a very strong credit profile. Over time, due to the need for asset-based lenders to grow their balance sheet, while their clients began moving east/west/south (outside of the U.S.) and because they wanted borrowing capacity against what they deem to be high-quality assets, U.S. lenders have increased foreign collateral sub-limits significantly. For a good client with working capital assets in 'tier 1' or 'tier 2' countries, foreign sub-limits of 20% to 40% of the deal are commonplace, again assuming strong credit profile. Obviously, syndications prefer to lend against accounts receivable and the advance rates get lower as one moves down the balance sheet."

Collateral Sub-Limits

Wells Fargo has led several notable transactions recently with large foreign collateral sub-limits, including a > >

$1 billion ABL revolver for a global aluminum producer and a $250 million ABL deal for a global chemicals producer. Both contained foreign collateral comprising approximately 30% to 40% of the borrowing base. It's important to note that these were for companies with very strong credit profiles and leading market positions.

The U.S. lenders in Europe are focused on lending against accounts receivable in the UK and Continental Europe. A good rule of thumb for Pan-European ABL facilities is that lenders are more inclined to finance assets in the beer-drinking countries and less so in the wine-drinking countries. One of the dominating questions in the credit process of all U.S. asset-based lenders in Europe is, "How much headroom on collateral do I have in the deal?" In the view of most U.S. ABL players, inadequate collateral headroom can't be mitigated by tighter covenants.

Unlike the United States, where alternative, non-bank lenders have crowded into the ABL marketplace, Europe has few unregulated lenders outside the UK, whose relatively liberal regime permits unregulated lenders to conduct asset-based lending business without a bank license.

Collateral innovation can play a key role in winning the agent position on Pan-European syndication. Wells Fargo Capital Finance recently led a German syndicated ABL financing for a global metals producer that included a limited advance against inventory. This pioneering step won the prestigious deal for Wells Fargo. Advances against inventory in many European countries are challenging. Apart from difficult legal obstacles in many countries, lenders have limited visibility on how well inventory will liquidate. In transatlantic and Pan-European ABL, the key credit consideration for collateral is enforcement. Do ABL players have experience enforcing the claim in a particular jurisdiction against a certain type of asset class? That is the first question participants ask when an underwriter is syndicating transatlantic and Pan-European deals. No collateral SPV (special purpose vehicle) has been tested in bankruptcy court as yet, so the concept has not been stress-tested.

Cornering the Market

To some extent, asset-based lenders benefit from the lack of alternative commercial financing sources in Europe. According to Andrew Knight and Paula Laird, partners at Squire Patton Boggs in London, "Unlike the United States, where alternative, non-bank lenders have crowded into the ABL marketplace, Europe has few unregulated lenders outside the UK, whose relatively liberal regime permits unregulated lenders to conduct asset-based lending business without a bank license. Additionally, U.S. banks benefit from the capital pressures that many European banks continue to face, which acts as a brake on their lending capacity." While non-bank U.S. alternative lenders such as Oaktree, KKR and Lonestar have bought huge portfolios of non-performing loans in Ireland, Spain and Italy in the past two years, their appetites for individual asset-based loans currently seems limited.

Asset-based lending in Europe has become more mainstream, particularly as private equity groups deploy ABL as an essential part of the capital structure. Similar to the U.S., ABL transitioned from a distressed financing instrument in the early 1990s to the mainstream. European asset-based financing is gathering momentum as CFOs discover the benefits. Indeed, many borrowers that transition to asset-based lending become the most vocal advocates of this type of financing. For CFOs, the robust technology platforms of the U.S. banks can minimize the borrowing base reporting requirements of borrowers, since raw data can be electronically transferred to the banks to prepare borrowing bases. Additionally, asset-based lending can provide CFOs with better visibility on working capital and balance sheet management.

Demand for Flexibility

For new syndicated asset-based loans in Europe, the key determinant in selecting an agent and lead bank is flexibility as opposed to pure pricing. In a recent CFA European Roundtable event on transatlantic and Pan-European asset-based lending in London at the law firm of Mayer Brown, participants widely agreed that flexibility is crucial in helping CFOs transition to asset-based financing.

At the start of the process, ABL players need to articulate to the CFOs what the red flags will be for the lenders as the transaction proceeds from term sheet to closing. CFOs don't want to get blindsided halfway through the process and then have to explain the delays or obstacles to the CEO and board of directors. Additionally, CFOs need to know when and why reserves in a borrowing base will be adjusted, since most CFOs are unaccustomed to borrowing bases.

Structuring a Deal

A common issue for new transatlantic and Pan-European asset-based borrowers is understanding which subsidiaries will be included in the borrowing base. Bankers can make a mistake when they ask for all subsidiaries to be included in the borrowing base, only to get borrower pushback after determining that minimal availability can be achieved with some subsidiaries. This can be quite problematic with CFOs who are accustomed to cash-flow credit facilities that are based on EBITDA multiples as opposed to collateral availability.

This obstacle can be symptomatic of a larger issue where lenders apply the same ABL template to every ABL borrower and ignore the borrower's operational and tax considerations with its subsidiaries. It is crucial to determine asset values and availability with all of the borrower's subsidiaries early in the structuring process, so that no unpleasant surprises surface prior to closing.

Transatlantic and Pan-European asset-based lenders need to understand and address the borrower's operational and cash management issues early in the

process. Clients want to maximize operational flexibility in various ways: 1) between various jurisdictions, which is sometimes tricky from a legal perspective; 2) in various local currencies, which not all lenders can accommodate; and 3) across time zones. If a subsidiary in the Netherlands needs cash every day by 11 a.m. local time, a lender can't fund from New York City at 5 a.m.

Streamlining the Process

At the inaugural board of directors meeting of the CFA Europe chapter in London this past spring, much discussion centered on making the ABL process more efficient, specifically, the idea of a standard format for ABL term sheets and facilities agreements. Many transatlantic and Pan-European asset-based lenders think that a standard ABL deal structure will help prospective ABL borrowers understand the product better. Additionally, a standard format may flush out problem areas between the borrower and the lenders earlier in the process, which can save time and expenses.

Kuriger from Wells Fargo notes, "Years ago in the United States, there was no ABL template. The market evolved. As we did a greater number of large deals for public issuers, an efficient market developed. Now there are few secrets because so much public precedent exists. This has been good for the overall development of ABL as a capital markets product here in the U.S. It provides issuers with a very large window into how ABL lead arrangers structure and price transactions. Europe is evolving in the same direction."

Karl Clowry, partner at Paul Hastings in London, said he would welcome news that the European ABL community, with input from the Association of Corporate Treasurers, was developing standardized documentation in the European ABL market. "Deal execution, costs, participation by smaller debt providers and liquidity in secondary markets all improved since standardized suites of documents were devised in the European senior syndicated loan market over the last 20 years, and could really boost the next phase of ABLs' development across multiple jurisdictions," Clowry says. "Such standardization in other debt markets has certainly allowed parties to focus on the key issues in transactions rather than having to waste time on points that are regarded as market standard by many seasoned participants. Even bilateral facilities often closely track the provisions found in more involved standardized syndicated transactions, with local jurisdiction-specific provisions being dropped into templates, which is vital in many heavily regulated European countries. As developments occur, these suites of documents can be more easily updated and augmented with various ancillary documents, too. This has arguably facilitated the entry by new players into the European debt market, as they can readily analyze and invest in many more standard credit documents, thereby improving liquidity and credit participation."

Transatlantic Innovation

As a sign that "the more things change, the more things stay the same," Jack Morgan gave his London residence, 14 Princes Gate, to the U.S. government in 1920 for use as its embassy. In the 1920s, The House of Morgan spawned Morgan Guaranty Trust, Morgan Stanley and Morgan Grenville. As a memorial to his father in 1924, Jack Morgan created The Pierpont Morgan Library as a public institution with his father's Madison Avenue two-story library, which housed fabulous art treasures from Europe. What remains is the transatlantic pioneering and financial innovation begun by J.P. Morgan, Sr. and J.P. Morgan, Jr. that continue to this day by U.S. asset-based lenders in Europe. abfj

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The *Corsair IV* was constructed at the Bath Iron Works in Bath, Maine at the beginning of the Great Depression for $2.5 million (or about $60 million in today's currency). Measuring 2,142 gross tons, with a registered length of 300 feet and overall length of 343 feet, the *Corsair IV* was the largest yacht ever built in the U.S.

Designed in the traditional piratical look of Morgan yachts, *Corsair IV* was long, dark, heavy underneath – paler and suaver in the superstructure.

When it was ready for launch (pictured above) in 1930, Morgan brought three private railway cars of family and friends up to the Maine shipyards for the occasion.

—Michael Grace, *www.newyorksocialdiary.com*