Post-Pandemic Financing Strategies Are Changing the Game:

A global health crisis and lending facility preferences in the marketplace

Almost no aspect of the financial industry was left unaffected by COVID-19. The resulting hardships being faced by financial institutions, corporations, and middle market businesses alike have driven the financial industry to innovate and design new ways to strategize not only for the immediate future, but for the long-term financial health of their companies and clients.

The New Lending Trends

As we forge ahead through pandemic recovery, we're seeing unexpected trends emerge in the marketplace. One of the most unlikely shifts we've seen in recent months has been the transition of revolving credit facilities from secured cash-flow-based to asset-based lines of credit (ABL).

Though once thought of as typically an option for borrowers who found it difficult to qualify for a traditional bank loan or line of credit, companies experiencing operational challenges, or a way to take on more leverage in pursuit of acquisitions, ABLs have achieved a more mainstream consideration. Their popularity has only been bolstered through the uncertainty that still affects the business sector. Having accommodative structures, ABLs have even become a more likely option for investment-grade borrowers. Structure aside, we see this trend gaining speed for other reasons as well.

Why the Shift?

The first reason we see is the fear of violating covenants. If a company's EBITDA (earnings before interest, taxes, depreciation, and amortization) falls below a certain level, they run the risk of breaking the terms of their cash-flow-based revolving line of credit. Because of this, many companies are taking a proactive stance by converting to asset-based lending revolvers sooner rather than later.

The second reason this trend is growing is the overall need for liquidity. ABLs typically provide greater liquidity because borrowing limits are based on margined collateral value instead of metrics like EBITDA or leverage rations, which are only used to determine creditworthiness, not borrowing limits, when it comes to ABLs.

Typically, ABL rates (i.e., the maximum percentage of the value of collateral a lender is willing to extend) are approximately 85% of the net orderly liquidation value of inventory, a methodology that provides a lot more liquidity. This is also why companies experiencing high growth and a need to fund expansion seek out ABLs.

More Sustainable Strategies

Seeing a back-and-forth shift between cash-flow-based funding and ABLs is not uncommon, especially when we consider the impact changing financial circumstances have on companies' preferences. But this time, we're seeing that COVID-19 is pushing companies to choose ABL conversions proactively due to economic uncertainty and the loss of clear visibility into the future of their business.

Companies are using cautious foresight when it comes to covenant violations with cash-flow-based lending, and for good reason. Traditional methods of prediction just aren't reliable in the wake of the pandemic. Without a clear picture of how sales will be affected, or whether they'll be able to operate at all if their current facilities are closed, companies are opting for setting up better options for riding out an uncertain economic future by putting up assets as collateral.

The Future of ABLs

From middle-market companies to large corporate borrowers, increased ABL conversions are expected across the board, potentially having long-term effects on financial preferences. Historically, once a company is accustomed to the financial reporting conventions of ABLs, they usually find it to be a longer-lasting solution, especially with the increased liquidity ABLs provide.

We're not entirely through the crisis yet; however, ABL financing – with the impact COVID-19 has had on strategic decision-making – has quickly become an overbanked market, with the potential to continue growing exponentially.