FINANCIAL TIMES

July 8, 2012

Investor search for yield renews interest in ABLs

By Eric Uhlfelder

Before the global financial crisis, hedge funds following asset-based lending strategies were carving out a compelling niche for investors looking for steady, secure, and ostensibly lower-risk returns.

The concept was simple. According to Jonathan Kanterman, a manager at Stillwater Partners, a former asset-based lending shop in New York: “ABLs would lend to small- to mid-sized firms that cannot readily access traditional bank lending, which have hard, unencumbered assets that generate established cash flow, and are willing to pay two to three times prime lending rates for immediate short-term financing.”

The reason why certain borrowers turn to ABLs for financing is that banks, which concentrate more on a company’s creditworthiness, largely ignore the value of tangible assets that can be ringfenced from its balance sheet.

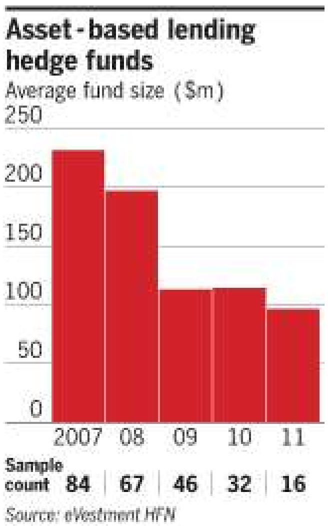
Borrowers range from manufacturers with their own plant and equipment, trading operations with proven receivables, to pending settlement credits. Each investment involves substantial due diligence and loan underwriting. Capital is constantly recycled upon loan repayment, generating net annualised returns that range up to the low teens.

“But starting in 2008, managers realised that even annual investor liquidity was not always feasible with the loans they had been making,” says Mr Kanterman. When investors, such as funds of funds, sought redemptions because their own leverage got pulled by banks, ABL managers found they were forced to sell into illiquid markets that significantly undervalued their loans and collateral, locking in losses.

Or if managers did not want to sell into the bear market, the other choice was to suspend redemptions until they could get a better price. But this move effectively killed a fund by preventing it from attracting new investors.

Alex Schmid, chief executive of the European Special Opportunities fund, says: “While many of the original ABL managers, such as Fortress and Cerberus, understood the value of underlying assets and associated credit risk, many of those who followed into the space were less experienced [and got hurt], especially when things didn’t go as planned.”

The result: the number and average asset size of ABL hedge funds has plummeted. At the end of 2007 84 funds of an average size of $232m were reporting to industry data-tracker eVestment/HFN. By the end of 2011, the average size of the remaining 16 funds in the database had been cut by more than half.



Industry data do not yet indicate the bottoming of flow out of the strategy. But there is anecdotal evidence to suggest money is returning, now often in the form of private equity funds, as the search for yield in a zero-interest rate environment is propelling renewed interest in the space.

Before setting up his own shop (Czech Asset Management), Steve Czech, former FrontPoint Partners manager, had raised commitments of more than $1bn by the beginning of 2011 for the FrontPoint-SJC Direct Lending Fund. (FrontPoint, which was a wholly-owned subsidiary of Morgan Stanley, has since shut down operations as a result of redemptions triggered by an insider trading scandal involving an unrelated fund.)

Despite FrontPoint's ability to raise assets throughout the crisis, capitalisation of this fund may have marked the informal end to the industry's multi-year drought in which smaller managers had found it virtually impossible to raise new money because of investor fear.

But as the economy stabilised and asset values rebounded, liquidity and credit returned to the market, and investors began reconsidering the potential of the strategy.

This space is compelling, says Mr Czech, because middle-market businesses have been left with fewer financing options as many former lenders have disappeared and larger lenders are targeting larger borrowers.

He says Dodd-Frank and Basel III have pushed commercial banking dollars into the higher-end of ABL because these loans require less risk-based capital. According to Mr Czech: “Banks targeting firms that are generating more than $50m in annual Ebitda [earnings before interest, taxes, depreciation and amortisation] and seeking loans of more than $100m are offering three- to five-year ABL rates below 2.5 per cent.”

Because his fund size requires scale, Mr Czech incorporates other direct lending beyond asset-based, including riskier cash-flow and enterprise value loans to companies with annual Ebitda as low as $10m and which are paying gross interest rates of 12-15 per cent.

Mr Czech captures additional yield by taking on riskier second-lien positioned loans, but only after borrowers pass rigorous due diligence to determine cash flow sustainability.

Industry sources report that Mr Czech is now raising capital for a second version of the fund with a targeted capacity of $1.5bn.

Josh Green, a former in-house asset-based lender at Merrill Lynch, is starting up Raven Capital in New York. With $40m in hand and expectations of another $30m this month, Mr Green is intending to focus on several industries he knows well, including transportation, commercial real estate, and infrastructure. He requires a minimum lock-up of three years and then plans to return investor capital within two years thereafter.

In 2009, New York-based Garrison Investment Group, whose diversified credit shop manages $3bn, decided to morph its original hybrid funds into a private equity structure.

According to Mitch Drucker, head of the corporate finance group, “this longer lock-up of capital better enables our managers to realise performance goals by not ceding to issues of liquidity and time constraints”.

By being industry agnostic and focused on lower-end middle-market businesses, Garrison’s average contract maturities run longer than most other firms, ranging between five to six years, and grossing 10-18 per cent annually. Mr Drucker believes Garrison mitigates overall risk by requiring first lien status against hard assets and by stress-testing both operations and collateral value.

Garrison is raising an additional $350m-$500m in a private equity structure for asset-based lending.

Mr Schmid of ESO, who is also starting up a new fund, extends his risk management to investors, analysing their balance sheets to ensure ability to sustain their investments after a commitment is made. He says: “The days of annual liquidity in ABL are gone. The space has turned into a short-dated private equity model with a five-year lock up and no reinvestment.”