



Josh Zegen & David Grin

Now that many traditional lenders are tightening their lending criteria, is an opportunity arising for asset-based lending funds to fill this gap? *Credit* speaks to leading ABL managers to find out. Additional answers by Martin Sands of Sands Brothers Asset Management



Asset-based lending (ABL) strategies have been gaining popularity at an impressive rate recently, and with good reason. Money has poured into the strategy in search of the low volatility and steady return stream that a well-run fund can generate. Additionally, since the return stream is tied directly to individual loan repayments, correlation to equity and debt markets is relatively low.

Though there is some variation, ABL funds originate loans which are backed by collateral, usually the assets of the company or personal assets of individuals. These assets can include real estate, inventory and equipment, accounts receivable or anything that could be liquidated in case of default. The funds provide loans to a wide array of businesses, often diversifying investments across many sectors, with the goal of reducing portfolio risk.

The financial crisis has proved to be a perfect storm of sorts for the ABL industry, as a near complete halt in commercial lending transformed hedge funds into the best source of capital for many businesses. Those traditional lenders which have continued to lend have been ever more careful in their due diligence, extending closing times to a period of months, simply too long for most businesses seeking capital.

Credit asked three ABL funds for their views on the market and how the credit crisis has changed the outlook for their business.

Q What kind of borrowers do ABL funds attract? Who typically invests in ABL funds?

A *Josh Zegen:* We lend to commercial real estate owners and developers who need short-term financing. Borrowers usually come to

us for time-sensitive situations such as a 'time is of the essence' closing or a 1031 exchange that needs to close quickly to retain the tax advantage.

David Grin: As for who invests in ABL funds, the pool of investors includes family offices, high-net-worth investors, funds of funds, banks, corporations, insurance companies, endowments and foundations.

Martin Sands: These investors are attracted to the strategy because the returns tend to incorporate the best of both the debt and equity markets. Returns are typically characterised as being low-volatility, non-correlated and consistent, while generating returns higher than publicly traded corporate debt. These higher returns are a function of the smaller loan amounts and the participation of hedge fund investors in the fees, points and equity kickers of the debt transactions.

Q In what way have ABL funds been affected by the crisis in credit?

A *DG:* The credit crunch has created extraordinary opportunity for ABL funds. As banks continue to restrict their lending, companies seeking financing have turned to alternative financing options including ABL funds. In our case, we are seeing an increased volume and quality of deal flow and have been able to structure deals with stronger terms than in previous years. We have the infrastructure in place and are confident we will be able to support the review, structuring and monitoring of potential new deals during this exciting time. However, we are also aware of the current environment and are proactively taking steps to mitigate our overall risk.



Q As real estate prices in the US have decreased, how have funds been able to protect themselves from losses? Have the terms of deals changed significantly?

A JZ: Traditionally our fund has always been a low-leverage bridge lender (up to 75% loan to value). However, in these uncertain times, because there is so much opportunity to lend given the pullback by traditional lenders, we are in the fortunate position of being able to be very selective. For the most part we are requiring borrowers to have more equity in transactions, personal guarantees, only lending on what we consider the best of locations, and sponsors with a balance sheet. We are only lending where we can see a clear and defined exit strategy for our loan. The biggest question today is value, and we believe that if we are in a senior secured, low-leverage lending position with a good sponsor and good location we have mitigated our downside protection the best we can.

Q Traditional lenders have seen liquidity almost completely dry up. As liquidity returns to the market in the future, how will it affect deal flow, and how will funds adjust?

A JZ: We believe that there is always opportunity for lending on time-sensitive transactions that need bridge financing or need a lender that can understand the 'story' better than traditional lending sources such as regulated banks. In the most competitive lending environment in 2006 and the early part of 2007, Madison closed \$350 million of loans. We believe that lenders that can make decisions without regulatory pressures will always have a place in good and bad markets.

Q How has ABL been able to compete with, or replace, PIPE deals to meet the needs of public companies?

A MS: PIPEs are not the best finance vehicle for public companies that are undervalued but have positive earnings. Asset-based lending hedge funds can provide debt in the form of bridge loans to companies that are uncomfortable with the prospect of issuing dilutive equity. Then when the company's equity share price improves and more accurate valuation returns, it can pay off the debt and do other financings without having given up a large stake of the company. Asset-based loans are also being used by public companies that acquire assets with the capital from PIPE equity raises, and that are interested in leveraging those assets for the benefit of their existing shareholders.

Q How do ABL fund managers perform their risk analysis?

A DG: Our risk management is performed on two main levels. First there is the bottom-up approach. Every prospect is evaluated based on an internal model, consisting of multiple criteria analysis, both from the creditworthiness aspects (debt), and the equity perspective (technical and upside characteristics). We then carry out specific due diligence and evaluation of the assets that

will collateralise our loan. If the fundamentals are satisfactory, the collateral is sufficient, and the equity characteristics are favourable, then the prospect is seen as a good investment candidate.

The second level of the risk management is on a total portfolio level. Despite being a secured lender, the Laurus and Valens Funds investment strategy is structured as a diversified portfolio, which minimises investment concentration risk. The Valens Funds aim for each investment position to be less than 10% of the total assets under management.

Q How can a fund align its interests with those of the borrower?

A DG: In general, a fund can align its interests with portfolio companies in several ways. First, by taking equity positions in almost every portfolio company, the fund is not acting as just a lender, it is also acting as an investor which is an important distinction. By structuring the deals with an equity component and relying on the equity component to provide much of the alpha return in each investment, the fund is heavily incentivised to work with the portfolio companies to facilitate their success and meet or exceed their business plans and targets. If the companies do well and execute, the equity should appreciate which gets the funds the desired returns in theory. This is very different than a typical lender-borrower relationship where the return comes solely from interest and fees and does not change with significant performance by the borrowers. ♦

Josh Zegen is managing partner and co-founder of Madison Realty Capital, an institutionally backed private commercial lending fund based in New York. Madison manages around \$250 million and provides short-term loans secured by a variety of commercial real estate.

David Grin is portfolio manager and co-founder of Laurus-Valens, a \$1.7 billion New York-based asset manager providing loans to publicly traded small/micro cap and private companies.

Martin Sands is senior portfolio manager at Sands Brothers Asset Management, which manages approximately \$140 million across a variety of strategies. Headquartered in Greenwich, Connecticut, the firm specialises in making asset-based loans to smaller private and public businesses.