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# Putting Their Heads Together…

## CIT Corporate Finance Executives Discuss the State of ABL, Cash-Flow Lending

BY LISA A. MILLER

**To gain their perspective on the current state** of the asset-based and cash-flow lending markets, *ABF Journal* tapped the collective wisdom of Pete Connolly and Jim Hudak, co-heads of CIT's Corporate Finance group. The two discuss their outlook for middle-market borrowers and key borrower sectors, as well as the lessons learned from the Great Recession.

**PETE CONNOLLY**
*President, Co-Head*,
CIT Corporate Finance

**JIM HUDAK**
*President, Co-Head*,
CIT Corporate Finance

As co-heads of CIT Corporate Finance, Pete Connolly and Jim Hudak work as a team. Connolly, who has been at CIT since 2006, focuses on leveraged finance, asset management, distressed debt investing and capital markets. Hudak, who has been at CIT since it acquired Newcourt in 1998, concentrates on private equity and M&A trends, capital markets, and trends and convergence in the media, information services and technology, entertainment and gaming, sports, and communications sectors. Together they lead the Corporate Finance franchise, which serves the specialized financing and advisory needs of small- and middle-market companies in the U.S., Canada and Europe.

Their co-leadership started in October 2008 when the head of Corporate Finance left the company, and Connolly and Hudak stepped into what seemed like a battlefield promotion during a time when CIT was sifting through a lot of issues. "Pete was running the Syndicated Loan Group, and I was running our Communications, Media and Entertainment Group," recalls Hudak. "We divided some of the businesses and didn't backfill certain positions. This has allowed us to be more hands-on in the running of those businesses rather than sitting above them. We have a clear line of responsibility between us and work together on our credit and investment committee, the business plan and growth initiatives. It has worked very well."

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> — Pete Connolly, *President*, *Co-Head*, CIT Corporate Finance

Focusing largely on the middle market, which CIT defines as those companies with EBITDA of $50 million or less, Connolly and Hudak work with a market segment whose annual revenues add up to just over $6 trillion, comparable to companies comprising roughly 60% of the U.S. equity market's capitalization. The U.S. Census reported 106,000 companies falling into the $25 million to $1 billion revenue category, making the middle market a powerful economic engine responsible for creating the majority of U.S. jobs.

### A Borrower's Market?

Because CIT is an experienced ABL and cash-flow lender, we sought out Connolly and Hudak's perspective on the current lending environment and whether today's economy has made financing more of a borrower's game. "From the ABL perspective, things haven't really changed that much," began Connolly. "Asset-based lending is still done on a percentage of inventory and receivables, and banks stayed tried and true on that without getting aggressive. Pricing has definitely come down, but you have to remember what you are comparing that to. In 2009, there were fewer banks lending, so pricing looks lower now but it is really returning to more sustainable levels. On the cash-flow side, we see more borrower-friendly terms on larger-ticket deals and for the broadly syndicated market, but that has not yet leaked down to the middle market."

Hudak adds, "During the go-go years of 2007-2008, a number of companies, [which] had traditionally been financed through ABL, obtained financing on a cash-flow basis. "Often these were companies or industries that probably shouldn't have been leveraged as a cash-flow company. Companies were funded above their current asset basis by lenders trying to push money out the door."

Clearly, both lenders and borrowers learned something from the Great Recession, principally to push for increased equity, tighter covenants and greater due diligence in transactions. Hudak thinks increased awareness of liquidity in their asset base is warranted. "For the most part, CIT was fine in its ABL portfolio, as were most banks and institutions. But given the volatility of the market, there were much wider swings in working capital needs. Everyone needs to do a better job of looking at the next relevant deviation of a downturn and whether there is enough liquidity in the borrowing base. Take more time on due diligence with greater sensitivities around inventories and receivables."

"We've seen what can happen to some companies in a recession," declares Connolly. "The companies that got hurt on ABL were the ones that did 'airballs' higher than the finance rate, with the hope that they'd be in compliance within 18 months to two years. We saw the loss on liquidations for lenders [that] over-advanced. If they start doing that again, I think it will be a sign that the market is getting ahead of itself."

As the market improves, there have been a lot of new players in the ABL market. "Traditional ABL lenders are used to a difficult situation," Hudak explains. "We know how to work with a troubled industry or credit, and structure the deal accordingly. Lenders [that] get into ABL without the experience can have a knee-jerk reaction when things begin to change. CIT has been doing ABL lending for years, and we know to look beyond the headlines to see what's happening in the industry. For example, we were in a transaction with a large book retailer that went out of business. A lot of lenders less familiar with ABL asked why we were in an industry that was going through a secular change from books to digital media. But our focus was on the underlying collateral base, which was very good, and it proved out. We also provided DIP financing and have now been fully paid out of that. So, if you are a borrower with a bank group, we encourage you to have lenders in there [that] have been doing ABL for a long time."

"Typically ABL borrowers have a higher probability of default, but a much lower loss, given default," states Connolly. "An experienced ABL lender is constantly looking at inventory and receivables and revising the borrowing base relative to that. We tightly monitor against the borrowing base, and any dip in collateral causes us to resize the loan. With cash flow lending, you have already put your money out the door, and it can be difficult to correct a problem."

## Outlook on Key Sectors

Housing and homebuilding industries continue to show signs of distress, and manufacturing seems to be holding steady. Connolly and Hudak have seen improvement in the automobile industry and say that general industry is improving marginally. "During the recession, many of these companies adjusted their cost structures to pay down debt or stay in compliance with covenants. Better cost control is beginning to show up on the bottom line," says Connolly. "Retail performance is also improving, especially for stores targeting high-end sales. Value retailers are not improving as quickly. We've also seen a drop in the advertising-based printing and publishing industries as advertisers move to more innovative Internet options. CIT is also looking at green technologies for power generation, including wind power."

There is improvement in the manufacturing industry. "Companies producing durable goods, such as automobiles and parts, did what they should have done 20 years ago and resized their industry to fit the market," remarks Hudak. "We haven't seen much pick-up in non-durable goods." Through ABL funding, CIT often provides a large financing commitment from which a company pulls down what it needs, but until now they haven't seen a lot of usage on the unfunded line. Hudak says that usage is starting to come up, which usually indicates increased company reinvestment.

The healthcare sector continues to be an attractive industry that has performed well for CIT. Budget turmoil and financial pressures at the state and federal levels continue to be concerns, along with possible changes in Medicaid and Medicare reimbursements. "We have our expert in Washington who keeps an eye on these things for us," says Hudak. "No matter what side of the aisle you are on regarding healthcare reform, I think more people will be covered by some type of insurance in this country. That bodes well for healthcare lending."

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## The Future of ABL

Are borrowers familiar with cash-flow structures now more willing to turn to ABL structures to meet their financing needs? "When the high-yield market was hot, some of our borrowers, [that] we had previously financed in a senior secured cash-flow loan, flipped to a combination of a high-yield bond and an ABL to replace the cash-flow loan," reports Connolly. "Instead of doing a senior secured cash-flow loan, they did a small ABL loan with the next part of the capital structure as high-yield debt. If high-yield picks up again, you may see more of that. On the private equity side, there has been more openness toward looking at ABL financing."

"The private equity sponsor is trying to put as much leverage as is rationally possible on companies in order to drive a better return," continues Hudak. "There are some companies that are asset-rich, and we can provide them with a good advance rate. The private equity sponsors are much more cognizant, that in these times, they cannot get as much debt on a cash-flow basis. We find they are much more open to looking at a good ABL solution."

"We structure our business around industries where there is a great capital need," adds Hudak, "and these industries make up a big piece of the GDP. Last quarter we put over a billion dollars to work, mostly with middle-market companies, and people welcome that in the marketplace."

"We have a good team of originators and underwriters," adds Connolly. "For us, it's been a fun year, and we are excited to be out there lending." abfj

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