FEATURE STORY

Secured Finance Executives Predicting Modest Growth in 2024

BY MYRA THOMAS

Despite economic headwinds and higher costs of borrowing, secured lenders are expecting a profitable year ahead.

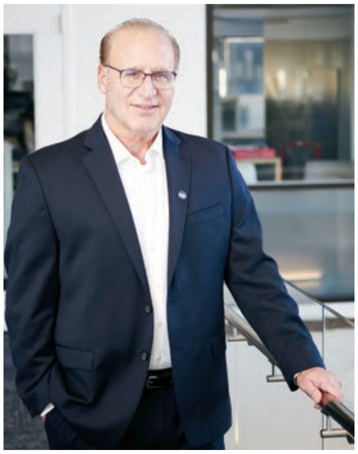
2023 wrapped up to be a year plagued by inflation, interest rate hikes, and high borrowing costs. The historically tight labor market also left many businesses struggling for workers and watching labor costs rise. Political uncertainty and war added to the tumult. The conflict between Israel and Hamas, as well as the Ukraine and Russia, continued to shape the global economic picture, particularly for the Eurozone. Given the macroeconomic factors, an increasing number of companies turned to secured lenders to boost liquidity when traditional loans were simply out of reach. Asset-based loans and factoring arrangements remain an option for borrowers, particularly during times of economic turbulence. With signs pointing to a slow recovery, secured lenders are expecting that the New Year will bring modest growth for the industry.

According to Jason Riley, Central and West Region portfolio and underwriting manager at Bank of America Business Capital, most of the bank's clients have adapted to the new normal. "They've made adjustments to react to what's happening in the external environment," he says. Secured lenders are responding to the economic upheaval by making sure to properly structure and monitor loans. Fortunately, businesses are benefitting from the expertise that secured lenders provide. "We stay in close contact with our clients to help them navigate through tough situations," notes Riley. "The way we structure our deals and monitor our credits, we're able to offer our clients a lot of flexibility to manage through difficult conditions." No matter the client, there can always be company-specific or industry-specific challenges, and secured lenders are there to provide assistance with those challenges.

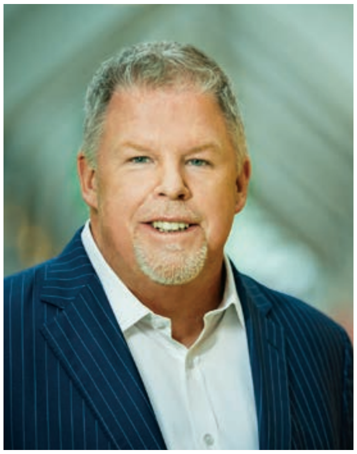
A Mixed Bag for Secured Finance

Companies are particularly attracted to the covenant-light structures that asset-based loans can provide, especially with traditional lenders tightening up lending standards. "I think we will continue to see that in 2024, especially with continued industry volatility and economic headwinds," Riley notes. While it's difficult to predict how the economy will shake out in 2024, secured lending remains relatively inflation-proof. Riley notes that secured lenders are remaining supportive of their borrowers, maintaining strong underwriting standards while doing so.

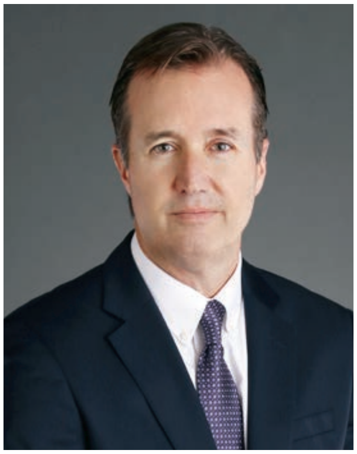
Secured lenders also made strong efforts to add new business in 2023, says Neil C. Wolfe, head of asset-based lending and factoring for IDB Bank. Those efforts are working to offset the expected drop in utilization. "Economic conditions and the higher costs of capital forced clients to be more fiscally responsible, and that resulted in them paying down loans whenever possible," he says. "Average outstandings were down despite successful efforts to put on new loans." For now, companies are not deploying cash for opportunistic or more speculative buys. Wolfe notes that companies are also making sure to reduce overhead and operating expenses, and many are simply keeping lower balances in their accounts.



MICHAEL MAIORINO
FIrst Bank NJ



FRANK MORTON
Gordon Brothers



JASON RILEY
Bank of America
Business Capital

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Higher Pricing and Creative Arrangements

Banks and nonbanks are also dealing with the higher cost of capital. Wolfe notes, "For banks, it's the cost of deposits given the flight from low interest DDA accounts to higher yielding money market accounts. But banks are lending to nonbank finance companies, and the higher rates are being passed along to the nonbanks." The end result—

PENNY ZACHARIAS
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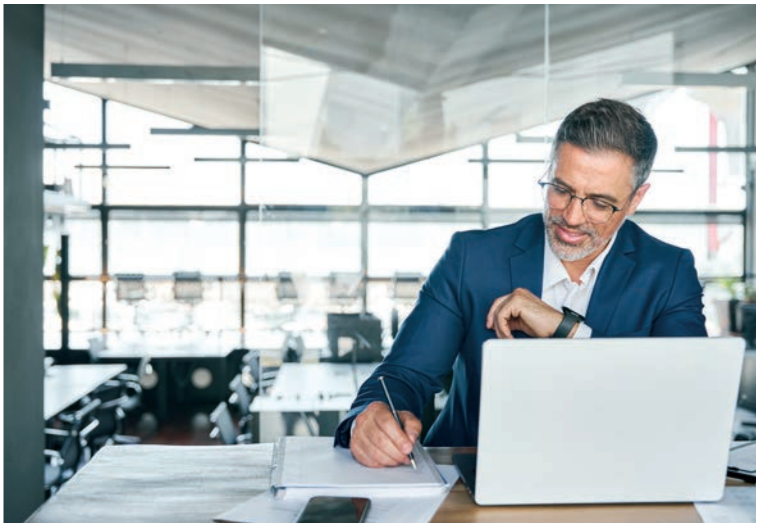
clients are seeing higher pricing for secured loans. Wolfe notes that in all likelihood, there will be continued pressure to keep pricing up, even if interest rates begin to slowly come down.

Some secured lenders are better positioned than others. Some are taking more innovative steps to get deals done. Wolfe notes that he has seen more "creative" syndicated deals than in past years. "There are agent banks willing to share the treasury management and deposit relationship in some way, shape, or form," Wolfe notes. "In one deal, they were willing to give us a certain level of deposits to entice us to come in, and that's actually helped us to do just that." This sort of arrangement is certainly not typical of syndicated lending.

Challenging conditions require asset-based lenders and factors to be more creative, but they are also looking inward and taking a deeper dive into their portfolios to make sure to consistently revisit collateral values, notes Frank Morton, chief investment officer of Gordon Brothers. "There's no question liquidity in the market has tightened up post COVID," he notes. "There was a huge amount of stimulus going into the economy, which now has dried up. You layer on the fact that the cost of money has gone up across the board, and it's had a major impact on businesses." It's essential for secured lenders to respond appropriately.



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And, after the failures of Silicon Valley Bank, Signature Bank, and Silvergate Bank in March 2023 and concerns over falling deposits, financial institutions have become more circumspect and tightened up credit standards. Nonbank players like Gordon Brothers, have been the beneficiary of new business because of it. Morton adds that on the private credit side, nonbank lenders just might be a little bit more forgiving in certain circumstances.

Private Equity Interest Grows

Banks have certainly become more selective, says Michael Maiorino, market president, asset-based lending at First Bank NJ. He does note that nonbanks are seeing more business given bank deposit concerns. And while there are worries about liquidity, he does believe that, overall, the banking industry is adapting to more stringent risk standards and oversight from regulators. Plus, concerns over declining deposits are not hitting all banks equally, says Maiorino. "Money center banks are doing fine, for instance," he says. "I know many banks that are very well-heeled in deposits, and they haven't changed a thing as far as lending," he adds.

Asset-based lending and factoring will continue to be a safe haven for companies as pressure increases on cash flow transactions in 2024, says Maiorino. With growing attention on secured finance, he notes that private equity companies continue to take notice, recognizing it as a consistent bet in turbulent times or not. PE funds are also taking advantage of banks looking to offload assets. He notes, "You've got some megacompanies out there, which are now so multifaceted between equipment finance, commercial finance, and factoring. You have a bunch of roll-ups, supported by Ares and other private equity firms."

In June, Ares Management completed the acquisition of a $3.5 billion specialty finance loan portfolio of asset-backed loans from PacWest Bancorp. Three months later, Ares Management closed the $6.6 Billion Pathfinder II Alternative Credit Fund to invest in private asset-based credit. Now, Ares Alternative Credit Strategy is one of the largest investors in asset-based credit. Apollo Global Management also announced the launch of its first-ever private fund for asset-based financing in July.

In Q3 2023, Varde Partners raised nearly $1.5 billion for asset-based lending through its Varde Asset Lending Fund II and related accounts and co-investments. In a statement, Brad Bauer, partner and co-chief investment officer at Varde Partners said, "The surge in demand for non-bank financing – an acceleration of a more than decade-long trend – underscores the need for private credit and magnifies already significant lending opportunities." The investment is also taking the form of startups. In the past year, Bain Capital Credit Asset Management launched Legacy Corporate Lending. While 2023 saw considerable moves from private equity in secured lending, Maiorino expects the trend to continue in 2024.

Tech Aids the Lending Process

Enhanced and emerging technology is also helping to make the industry more attractive to private equity investment, facilitating administrative and operational support and portfolio monitoring. According to Morton, there's no question that technology is streamlining the due diligence process and portfolio management, benefitting private equity and secured lenders alike. Today, it's simply easier for companies to report collateral and for lenders to record business capital. Morton adds that as the technology matures, it will certainly make secured lending an even more seamless process.

By automating loan monitoring, lenders improve performance and mitigate portfolio risk. Decades ago, secured lenders relied on green bar type reports. "At Bank of America, our CashPro credit and treasury platform is making things easier for our clients," notes Riley. "They use the platform to electronically submit their collateral and financial information that we can use to calculate their borrowing bases for them." For secured lenders, the next step will likely be the use of artificial intelligence to better manage asset-level data and credit agreements.

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Reasons for Optimism

As technology improves, secured lenders are freed up to build relationships, bring on more new business, and do the handholding necessary to see a deal through to the signed loan agreement. Penny E. Zacharias, partner at McGuireWoods LLP, notes that there are a lot of reasons to be optimistic about secured lending in 2024. "People are eager to pursue growth in their businesses, and lenders have a huge opportunity as capital providers to add value," she says. ""I believe they have a prime chance to showcase their expertise and demonstrate how their solutions can profoundly benefit a business."."

Given the economic conditions, the most successful asset-based lenders and factors in 2024 will benefit by being the most flexible, says Zacharias. Luckily, secured lending is a very disciplined form of financing in terms of monitoring, reporting, and control elements, like cash dominion. While there will be opportunities for both banks and nonbanks, she notes that secured lenders may see some downward pressure and diminishing asset values, whether it's equipment or inventory. But at the end of the day, she says, companies are looking to grow their businesses and seek out credit. Most have shored up their balance sheets since the pandemic.

There are other favorable economic indicators, as the industry heads into 2024. The GDP increased by 5.2 percent in the third quarter of 2023, signaling a boost in business investment. Sourcing and production costs are also dropping, thanks to a decrease in commodity pricing. And secured lenders will likely benefit from private equity deal growth. EY's Private Equity Pulse report indicated that in the third quarter of 2023, PE firms announced deals valued at US$101b in Q3 2023 — roughly consistent with the first two quarters of the year. And predictions are that PE will see a strong resurgence of deal activity in 2024. All good news for secured finance.

Myra Thomas is an award-winning editor and journalist with 20 years' experience covering the banking and finance sector.