Special Comment

Moody's Global
Corporate Finance

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# Refinement to ABL Ratings

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## Summary


This special comment outlines the changes Moody's is making to differentiate the favorable recovery experience of asset-based loans (ABLs) relative to other types of senior secured first-lien loans. In most cases, the revised approach will result in a one notch upgrade to well-structured ABLs compared to the ratings suggested by Moody's Loss-Given-Default (LGD) methodology.


Over the last two years, ABLs have become a more common debt instrument among North American speculative-grade debt issuers. ABLs have been used by companies in every industry, but were present in a meaningful number of financings undertaken in the last 12 months among companies operating in the retail, equipment rental, and metals and mining industries. ABLs generally provide a revolving line of credit for seasonal and short term borrowing needs, often with lower interest rates and fewer financial covenants than more traditional secured revolving credit facilities. Once associated with commercial loans for middle market companies, several large companies have arranged syndicated ABL facilities in excess of $1 billion, such as the $4 billion facility for Sears Holdings Corp., the $2.15 billion facility for Lyondell Basell, and the $1.35 billion facility for Ryerson Inc. Similarly, ABLs are utilized by borrowers across the entire speculative-grade rating spectrum.

Moody's current approach to rating ABLs does not, in many instances, fully recognize the benefits of the typical ABL structure in ensuring a high expected recovery in the event of default. At a basic level, there are two elements of an ABL that are primarily responsible for their safety and lower losses compared to other forms of secured loans: the dynamic linkage between collateral and permitted borrowings and the rights granted to the ABL lenders to actively interface with the borrower's operations and liquidity, not the least of which is dominion over cash. We believe that a well-structured and closely monitored ABL will experience lower losses in default or bankruptcy than other types of senior secured first-lien loans.

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## Refinement to ABL Ratings

As an initial step to refining our ratings for ABLs, we are going to allow Moody's fundamental rating committees the discretion to raise ratings otherwise determined by adherence to Moody's LGD methodology by one rating notch. This one-notch rating lift will not necessarily require a commensurate downward adjustment of the ratings for the corporate family's other debt classes. This revised approach to ABL ratings conforms to and falls under a broader set of changes described in greater detail in the publication, "Flexible Application of the LGD Model," which was published on November 19, 2007. The changes discussed herein are effective immediately for new ratings. Existing ratings for ABL facilities will not be affected, although the new ABL rating approach will be considered when Moody's next has a reason to convene a rating committee for the corporate issuer.

An ABL facility will be eligible for the one-notch rating uplift as long as the fundamental rating committee determines that the ABL meets the standards set out below and there are no other unique circumstances that have a high likelihood of impairing the expected recovery of the ABL in a distress situation. Unless ABL structuring standards shift from current practices, Moody's expects the higher ratings will be appropriate in most cases.

Moody's requirements for an ABL for it to be considered eligible for the one-notch upgrade (above the rating we would otherwise assign using the LGD methodology in its current form) include the following:

- The ABL is secured by a perfected first lien security interest.
- ABL availability is governed by a dynamic borrowing base formula that specifies eligible collateral and advance rates, and the borrowing base and availability are calculated at least monthly.
- The ABL lender or agent receive from the borrower periodic reports such as an accounts receivable assignment schedule, an accounts receivable collection schedule, and a borrowing base certificate that enable it to monitor the borrower's accounts and collateral effectively; the ABL lender has at least a "springing" right to receive these reports on a weekly basis.
- The ABL lender or collateral agent have the right to perform field examinations of the borrower's business, records and collateral, as well as asset appraisals, at least annually, but more frequently if specified triggers are sprung.
- The ABL lender has, at least on a "springing" basis and in any case upon an event of default, the right to take full dominion of the borrower's cash collections and apply these proceeds to outstanding loans under the ABL facility. Lockbox accounts must be established and the mechanics of lockbox accounts must be specified in the ABL credit agreement prior to its closing.

This modified approach may still overestimate the LGD and, therefore, the expected loss, of a well-structured ABL. Therefore, we will continue to explore the loss experience of ABLs and add ABL-specific data to our default database. We are especially interested in how the presence of an ABL impacts expected losses for other debt classes and the interplay, if any, between overall family recovery and probability of default. Once we have collected more actual data regarding ABL recoveries, we will revise our ratings and methodologies accordingly to ensure that our ratings are as accurate and useful as possible.

# Eligibility Requirements for ABL One-Notch Upgrade

## Defining a "True ABL"

The goal of the five-part ABL eligibility requirements noted above is to ensure that the ABL facility is well-structured and highly unlikely to result in losses to the ABL lenders if the borrower defaults. Under Moody's current LGD methodology, ABLs are treated the same as other types of first-lien secured debt (i.e., they are both ranked the same in the waterfall) except that ABLs cannot have a collateral deficiency. As a result, ABLs are often rated the same as other first lien debt.

The remainder of this section describes in broad terms the attributes of a "true ABL". In order for an ABL to receive a one-notch rating uplift above the standard LGD-determined rating, Moody's is looking for assurance that the ABL lenders have conducted a prudent analysis and examination of the borrower's business,

collateral, and audit and accounting systems in order to properly size the ABL facility, determine eligible collateral and advance rates, and minimize the risk of fraud. Provisions must exist in advance of the closing of the ABL facility that ensure periodic and effective monitoring of collateral and accounts, field examinations and appraisals. In addition, liens must be filed, lockbox accounts established and related cash management mechanics put in place prior to the closing of the ABL facility.

- **Perfected Security Interest**

  The ABL is secured by a perfected first lien security interest, properly filed in all appropriate legal jurisdictions.

- **Borrowing Base and Advance Rates**

  Moody's expects that the ABL lenders will have thoughtfully considered the realizable value, in a stressed set of circumstances, of the assets that secure the ABL and determine ABL availability. The lenders' objective is to use a combination of eligible collateral, advance rates, reserves and availability blocks to ensure that the outstanding loan will never exceed the net proceeds from liquidating the collateral, inclusive of all collection costs. The borrowing base will specify the accounts that are ineligible and the advance rates used to calculate ABL availability. In addition, ABL lenders generally have discretion to designate additional ineligibles, modify reserves against the borrowing base, or adjust advance rates as circumstances change. Since advance rates tend to be fairly uniform, it is the determination of ineligibles that becomes critical. Ineligible A/R typically includes receivables more than 90 days old, cross-age accounts, contra accounts, intercompany receivables, credit memos and foreign receivables. Ineligible inventory may be old, perishable, subject to obsolescence or require a high degree of maintenance to preserve its value. Generally, work-in-process is not included as eligible inventory, although WIP may be acceptable if it is predominantly a commodity-like raw material that is merely being further processed. The borrowing base and ABL availability should be calculated at least monthly.

- **Lenders' Right to Conduct Frequent Monitoring**

  ABL lenders have access to the borrower's invoices, inventory, and accounts payable records and reports. From these, the lenders will be able to observe sales over time and by customer, monitor receivables aging, past-due amounts, customer concentration, and discounts being offered, see if inventory is building or goods are being returned (credits), and see if suppliers are demanding shorter terms. These reports also position the ABL lender to detect fraud. For higher rated borrowers, or when ABL borrowings are moderate, the lenders may only monitor these and other reports on a monthly or quarterly basis, but the lenders must have a springing right (which is often based on excess availability falling below a specified amount) to receive these reports on a weekly basis.

- **Field Examinations and Asset Appraisals**

  The ABL credit agreement should grant the lenders, or the collateral agent, the right to perform field examinations of the borrower's business, records and collateral, as well as asset appraisals, at least once per year, but more frequently if certain conditions are triggered. As part of the field exam, customers may be called to verify invoices, shipping information will be compared to invoices, and inventory will be counted. The updated information can be used to refine definitions of eligible collateral and indicate whether more frequent monitoring is necessary.

- **Dominion Over Cash**

  The ABL lender has, at least on a "springing" basis and in any case upon an event of default, the right to take full dominion of the borrower's cash collections and apply these proceeds to outstanding loans under the ABL facility. In addition, lockbox accounts must be established and related cash management mechanics must be in place prior to the closing of the ABL facility.

## Exceptions to the One-Notch Uplift

If the above standards are met, then a one-notch rating uplift should be granted to an ABL facility. However, there is one specific exception and a broad general exception. The specific exception concerns the first-in, last-out (FILO) tranches of an ABL facility. While it is unclear how FILO lenders would be treated relative to the "normal" FIFO tranche of an ABL facility in a bankruptcy, FILO tranches involve higher advance rates and have higher spreads than the FIFO tranche of an ABL. Therefore, Moody's will generally not assign a one-notch higher rating for the FILO tranche of an ABL.

The broad exception covers all the unknowns that may arise as financings get done in a creative capital markets arena. Moody's rating committees will have the discretion to not assign a one-notch higher rating to an ABL where there is a high likelihood that the ABL will experience higher than normal losses in a distress situation. This is expected to be an unusual event.

# Moody's Information Needs for ABL Ratings

The eligibility requirements discussed above are not intended to be difficult to achieve. They are merely a check that the ABL has been well-structured to protect lenders and that the ABL merits a one-notch higher rating. Nevertheless, the requirements do necessitate that the terms of the ABL credit agreement be fairly well-advanced prior to assignment of the ABL rating so that the language regarding the rights of the lenders for monitoring, field examinations and appraisals and, in particular, cash dominion are clearly specified. A draft version of the ABL credit agreement would normally suffice, but a detailed term sheet may also be acceptable to the rating committee. For ABLs that have received the one-notch upgrade, Moody's reserves the right to receive copies of any information generally provided to the ABL lenders that we deem necessary in order for us to continue to maintain the rating. This could include periodic or special monitoring reports, field exams, appraisals and audits.

# Conclusion

Moody's current approach to rating ABLs does not, in many instances, fully recognize the benefits of the typical ABL structure in ensuring a high expected recovery in the event of default. We believe that a well-structured and closely monitored ABL will experience lower losses in a default or bankruptcy than other forms of secured first-lien loans.

As an initial step to refining our ratings for ABLs, Moody's fundamental rating committees have the latitude of raising ratings otherwise determined by adherence to Moody's LGD methodology by one rating notch. This one-notch uplift will not necessarily require a commensurate downward adjustment of the ratings for other debt classes. The ABL rating change is effective immediately for new ratings. Existing ratings for ABL facilities will not be affected, although the new ABL rating approach will apply when Moody's next has a reason to convene a rating committee for the corporate issuer.

Moody's will continue to explore the loss experience of ABLs and add ABL-specific data to our default database. We are especially interested in how the presence of an ABL impacts expected losses for other debt classes and the interplay, if any, between overall family recovery and probability of default. Once we have collected more actual data regarding ABL recoveries, we will revise our ratings and methodologies accordingly to ensure that our ratings are as accurate and useful as possible.

# Moody's Related Research

## Special Comment:

- Flexible Application of the LGD Model, November 2007 (105751)
- Loss Given Default Analytics: Users' Guide Prioritizing Claims and Applying the LGD Model, September 2006 (99071)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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