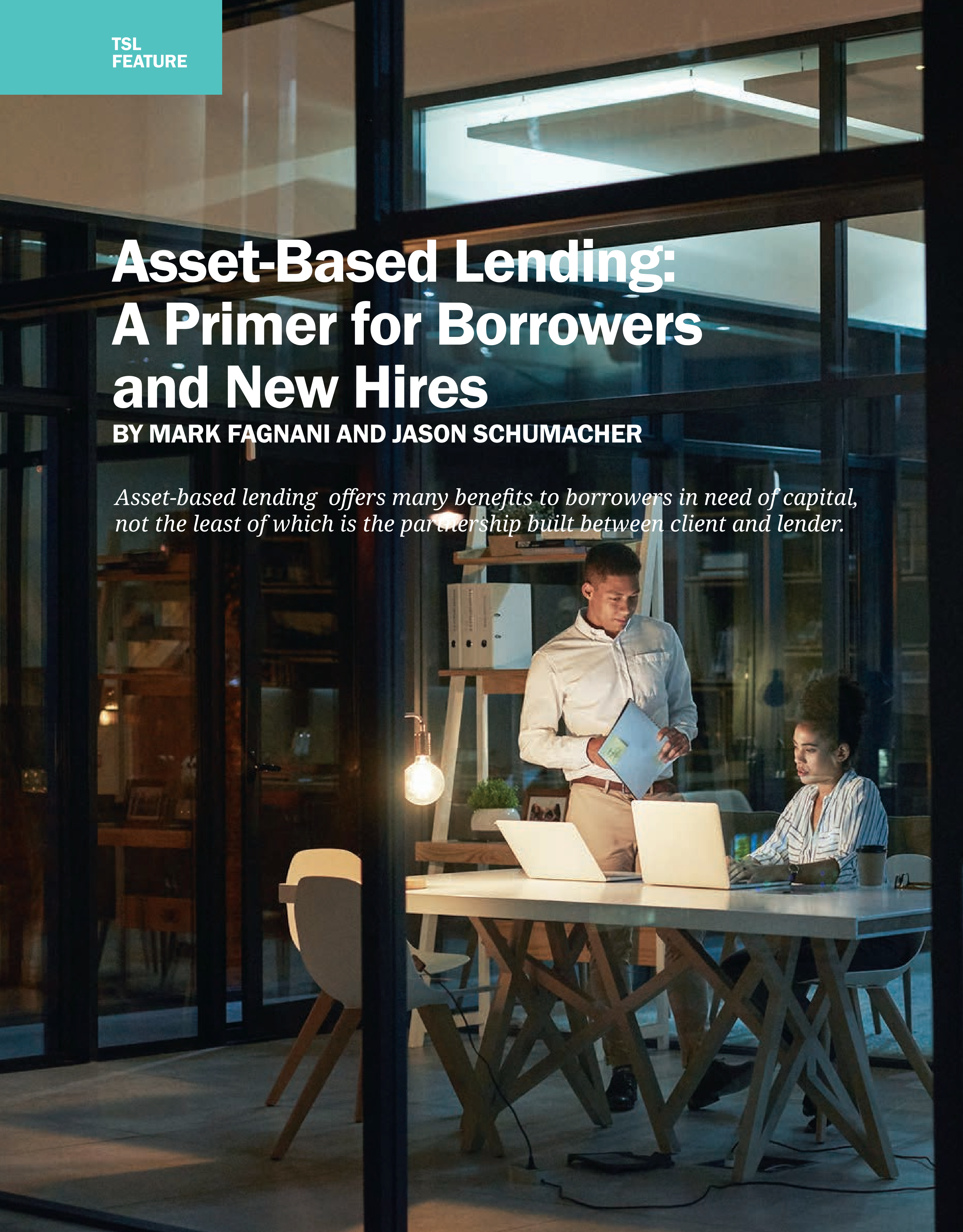


TSL FEATURE

# Asset-Based Lending: A Primer for Borrowers and New Hires

BY MARK FAGNANI AND JASON SCHUMACHER

*Asset-based lending offers many benefits to borrowers in need of capital, not the least of which is the partnership built between client and lender.*

Asset-based lending is possibly the best type of financing for any sized company. But what is it? Let's describe it here and then talk about why it works so well.

Asset-based lending (ABL) as the name implies, is a form of secured lending. The primary sources of collateral to secure the loan are Accounts Receivable (A/R), Inventory, Machinery and Equipment (M&E), Real Estate and Intellectual Property (IP), typically in that order of preference.

The lender will file UCC financing statements (a type of public notice) over the assets being pledged. That, coupled with a security agreement, will provide a priority lien that adds an additional form of repayment and level of protection for the loan.

Some asset-based lenders are bank-owned entities. Others are non-bank companies. Each has advantages and disadvantages. Bank-owned ABL lenders are regulated and therefore may be subject to certain restrictions. On the other hand, they can offer a variety of bank services, including cash management and letters of credit. Non-bank ABL lenders are not regulated and may have a greater risk appetite and fewer layers of command in the decision-making chain. Prospective borrowers should meet with both types to determine what best suits the needs of your company.

Lenders conduct preliminary due diligence on a prospective borrower's collateral to determine performance metrics – who are the customers, what is the customer concentration, what are their paying habits, what is the normal level of returns or allowances, how is the inventory maintained and accounted for, etc.?

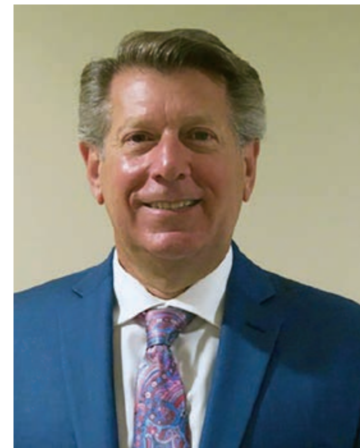
Lenders may retain an appraisal firm to provide a reasonable estimate of the recovery values of the inventory under a variety of assumptions. The same would be true of M&E, Real Estate and/or IP.

Typically, ABL lenders will try to determine recovery values in the event of an orderly liquidation of the business. This is not because they want or intend to liquidate a borrower, but because this provides a realistic picture of exactly how much a lender can lend and still recover the full loan with the assistance of the borrower. This approach focuses entirely on the collateral and not on earnings or cash flow. For this reason, even companies with losses or a history of up and down performance can obtain an ABL loan.

This is not to suggest that financial performance is not important to the lender. No company can lose money indefinitely and hope to survive. A lender will want to satisfy itself as to the viability of their borrowers. However, this emphasis on collateral allows an ABL lender to be patient, to give a borrower time to resolve their performance issues, to listen to and understand their challenges.

Lenders will also determine ineligible categories. These are assets that would not be included in the amounts to be borrowed primarily because they are old (non-paying A/R or slow-moving, stale, dated inventory) or have potential offsets.

Once due diligence is complete, the lender will formulate advance rates for the various assets. These are the percentage amounts the lender will lend up to. Eighty-five to 90 percent of the value of eligible A/R is typical although it could be higher or lower depending upon performance metrics. Key performance indicators (KPIs) for A/R include customer credit quality, repayment history, repayment terms and aging spread.



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Fifty to 75 percent is typical for eligible inventory although, again, it can vary depending upon many factors. If the inventory has been appraised, a lender might lend up to 85-90% of the appraised value. Alternatively, if the inventory has not been appraised, the lender will determine the advance rate based on their expertise and experience within the specific industry sector. KPIs for inventory include velocity of turnover and gross profit margins.

If the M&E was appraised, a lender might lend up to 85-90% of the appraised value. KPI's for machinery and equipment include market demand and historical auction values. Varying advance rates will apply to each asset.

IP advance rates are determined by a valuation conducted by an appraiser. IP is valued by a market sales comparison, discounted cash flow directly attributed to the IP or both.

Lenders will also establish sub limits to quantify their exposure to each asset class. For example, a lender may indicate that inventory advances must not exceed 50% of the line limit.

Once that is done, the lender and potential borrower can formulate a "Borrowing Base" applying the various advance rates against each class of assets. This represents the maximum amount that can be borrowed up to the line limit.

Since A/R and inventory levels fluctuate continuously, this maximum amount also fluctuates. These changes are captured through borrowing base reporting which could be daily, weekly, monthly, or even quarterly. Many lenders now use software that automates much of the reporting process. Updating the numbers is not onerous and does not necessitate adding personnel to accomplish this task,

Lenders will also either have dominion over A/R cash receipts (that

is, receipts go directly to the lender) or they will have a "springing" mechanism that would allow them to have A/R cash receipts redirected to them under certain circumstances (i.e., an Event of Default).

If dominion is in effect from Day 1 of the loan, then the borrower would typically borrow every day and the loan would go up and down depending upon borrowings and receipts. This is why the loans are commonly called revolving loans.

In cases where a borrower maintains cash dominion, they can use their own cash and only borrow if the amount of collections is insufficient to cover cash disbursements. Similarly, if there is excess cash, the borrower may elect to pay down the loan thereby reducing interest expense. In this manner, the loan is still revolving.

As long as the amount of collateral after giving effect to the advance rates (i.e. – the Borrowing Base) exceeds the loan balance, the company can borrow any excess amounts. If the collateral is less than the loan, the lender has the right to ask the borrower to pay down the loan unless this "overadvance" or "out of formula" situation has been agreed to by both parties.

So, now that we understand what ABL is, why is it such a great financing tool? Here are just a few reasons:

*It is flexible*. For businesses that are growing and have increasing inventory or A/R levels, the borrowing base goes up as asset levels go up.

*Improved liquidity.* Your cash conversion cycle is funded by the ABL, and you get your cash sooner and repeatedly throughout the business cycle.

Similarly, if a business is seasonal in nature and has a peak season and a low season, the borrowing base and loan will capture that and fluctuate with the seasons.

*It is cost effective.* Interest is only charged on the amount of the credit line used and as described above that can revolve with the level of assets and seasonality.

*It is patient.* As noted above, the emphasis on collateral and recovery values allows ABL lenders to work with a borrower and not pull the plug at the first sign of trouble.

*Fewer or no covenants.* An ABL facility has a frequent reporting cycle (monthly, weekly, or daily) and a reliance on the pledged collateral which makes the covenant package less important to the lender.

ABL is compatible with other forms of debt. If a borrower is looking to add additional debt to their capital structure the ABL is well situated for uni-tranche, split- lien or mezzanine debt structures.

It is well suited for importers. ABL has a long tradition of lending against in- transit assets. Goods in-transit are typically acceptable forms of collateral with proper documentation. Lenders will establish sub-limits and reserves depending on their credit criteria.

Many borrowers appreciate the discipline that an ABL facility can provide. It can help companies focus on their A/R and Inventory performance as optimal performance maximizes borrowing power.

The foregoing is a summary of how asset-based lending works and why it can work for every borrower. Of course, each lender, each borrower and each loan is unique and as such each loan is structured slightly differently to capture both borrower and industry nuances. The Secured Finance Network ("SFNet") has many resources on its website (www.sfnet.com) which you may find helpful if you are interested in learning more or talking to a lender.

*Mark Fagnani is senior managing director, PKF Clear Thinking. He has more than 30 years of hands-on experience working with large bank groups, private equity sponsors, turnarounds, workouts and insolvencies. Over the course of his lending career, Fagnani has worked with companies in a multitude of industries including steel and aluminum, coal mining, transportation, plastic injection and blow molding, beverage distribution, retail, lighting, and generic pharmaceuticals.*

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*Fagnani is a frequent lecturer and panelist. Most notably, he spoke on behalf of the World Bank and the Secured Finance Network in China, instructing over 250 bankers on asset-based lending.*

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