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Asset Based Lending
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Introduction

Given the multitude of financing choices available from different types of lenders it is not surprising that asset based lending means different things to different people. So, I thought that it might be beneficial to use my 15 minutes of fame in sharing with you my interpretation of asset based lending and the differences among other commercial finance options.

Asset Based Lending

In one sense, Asset Based Lending, referred to as ABL, simply means: making loans that are secured by assets. Which assets, you ask? The four major ABL asset classes are 1) accounts receivable, 2) inventory, 3) equipment and 4) real estate. More recently, intangible assets such as trademarks and customer lists have been used to back up asset based loans. And given today's financial crisis, you have probably heard about Asset Based Securities called "ABS", which includes CDO's, formally known as collateralized debt obligations.

The first distinction that may appear self evident is that while all loans are paid back from the cash generated from an enterprise, asset based lending relates to loans or lines of credit directly related to and secured by specific assets, referred to as collateral, whereas so called "Cash Flow" lending describes loans expected to be repaid through the business' cash flow, not related to any specific collateral. While the reality of today's sophisticated and complex financial markets reflects our "masters of the universe" having sliced and diced the positioning of their loans, blurring the lines between secured and unsecured, for this overview, I am limiting my remarks to the position of Senior Lender; that is, the lender at the top of the capital structure, with a priority secured recorded or "perfected" interest in the collateral. A discussion of Junior, Subordinated, Second Lien and Mezzanine loans must wait for another time.

Longer lived assets such as equipment and real estate offer the opportunity to be financed over a period of time more in keeping with the useful life of that asset and, therefore, generally are the basis for what is referred to as a "Term Loan". While in some cases, lines of credit include all 4 or more asset classes, my focus and Webster Business Credit's emphasis is on providing financing for accounts receivable and inventory, which generally replenish themselves several times a year and collectively fall in the category described as "Working Capital" financing.

A second important characteristic distinguishing ABL is the concept of controlling cash, known in the industry as "Dominion". Asset Based Lenders tend to require the borrower to have the payments on its invoices remitted directly to a bank account controlled by the lender. This "blocked" account is swept daily so the excess funds can be moved to an operating account used by the borrower. A modified version of this procedure is called "Springing Dominium". In this arrangement, monies are deposited into the client's regular operating account, and then the funds necessary to pay down the line are transferred to the lender or to a "blocked account".

Asset based lenders establish a formula by which "advances" under the line of credit can be taken. For example, a borrower might finance 85% of its eligible accounts receivable and 80% of the net orderly liquidating value ("NOLV") of its inventory. The ABL lender focuses on the borrower's assets on a daily basis, both to secure and monitor the performance of the loan, since the loan is directly tied to those assets, the quote "underlying collateral". By comparison, Cash Flow lenders generally are satisfied with monthly reporting. For example, Webster Bank, as a commercial bank, lends to middle market companies. Webster Business Credit, the asset based lending division, monitors cash and collateral on a daily basis, whereas Webster's commercial banking group only requires monthly reporting, often just requiring a "borrowing base certificate".

Asset Based or Cash Flow Lending

Please allow me to emphasize that given the efficiency of computers and the flexibility of the internet, unlike years ago, the reporting requirements today for asset based borrowers in minimal. Nevertheless, you ask, why would anyone opt for an asset based line over a cash flow line?

Glad you asked. There are several valid answers. The principal reason, but not the only one, reflects the borrower's creditworthiness. Because middle market and upper market Cash Flow lenders are not relying on specific assets to support their loan, and are not closely monitoring any underlying collateral, they properly require the borrower to maintain a more conservative financial position. For example, the typical commercial bank requires that the ratio of total liabilities to tangible net worth be less than 4 to 1. And, the amount of free cash flow needed to pay interest and principal, known as debt service, to exceed a ratio of 1.25 to 1.5 to 1. Thus, there are a lot of creditworthy companies, with positive cash flow, but whose leverage exceeds 4 to 1, that won't qualify for Cash Flow based loan but, can obtain necessary working capital financing by utilizing ABL.

Another important difference between ABL and traditional commercial bank lines of credit, and why very creditworthy borrowers often choose an ABL arrangement, relates to the application of the credit limit set by the lender. In a traditional cash flow based "Line of Credit", an annual fixed amount is established, based on an analysis of the balance sheet, combined with the cash flow generated by the enterprise. Once the credit limit is set, and provided no default has occurred, the borrower has the right to draw down up to the full amount of the line. However, this can limit a borrower facing a seasonal buildup of inventory or receivables, or one in a high growth mode. With ABL, a line is set, but the borrower has more flexibility to draw down on the line, or more quickly obtain an increase in the line, since the borrowings are formula based and directly related to the underlying assets established for the "Borrowing Base".

Finance Company compared to Bank Asset Based Lenders

What I have described so far is a commercial bank Asset Based Lender, such as Webster Business Credit. However, working capital financing is not limited to commercial banks, nor the criteria so far described. There are many companies requiring working capital financing whose creditworthiness is not up to commercial banking standards. Non commercial bank asset based lenders and finance companies distinguish themselves by accepting a greater degree of credit risk. Specifically, banks' ABL divisions generally require positive cash flow, sometimes referred to as EBITDA, which stands for Earnings Before Interest, Taxes, Depreciation and Amortization, or Free Cash Flow, which is EBITDA less capital expenditures, informally called "Capex" and "Debt Service", which represents payments of principal and interest on the borrowers total outstanding debt. Finance companies often do not look for positive EBITDA, but rather to the collateral and the ratio of the loan to the value of the collateral (LTV) and/or extra or "side" collateral provided to the lender.

Understandably, the cost to the borrower from a finance company is expected to be higher to reflect the increased credit risk underwritten. Borrowers need to understand the ways the cost may be higher. For example, how the cash receipts are credited against the loan can represent a "hidden" charge. For example, is 100% of the receipts credited against the loan or only the advance percentage? How many days above the Federal Reserve Bank clearance days before the cash receipts are credited against the loan? Asset Based Lenders refer to these as "Collection Days". Zero, 3, or 5 days? These extra days add to the borrower's expense.

Factoring

Factoring, which is an alternative financing method, often is confused with ABL. For companies whose creditworthiness is not strong enough for a traditional formula based ABL, but who sell to customers who are creditworthy, factoring makes sense. The difference is that while an Asset Based Lender is making a loan to a creditworthy company against its receivables, the Factor is purchasing outright from the less creditworthy company, referred to as the client, its receivables. This type of factoring is referred to as Advance Factoring. A valuable function provided by the Factor in this connection is the credit review process. Because Factors deal with so many companies, and for many of whom, financial information is not available, Factors are able to offer credit guidance and help establish credit limits for its client. The cost of factoring generally is higher than ABL financing. Borrowers also need to understand that the pricing model is different. While the stated interest charge may appear comparable to an ABL or Finance Company, because the receivables are being purchased at a discount, the effective yield to the Factor is higher. An alternative factoring arrangement is a variation called "Collection Factoring". In this option, the Factor provides the credit review and guarantee function for a fee, but does not provide the financing. The financing is provided by a lender such as a bank ABL who relies on the guarantee of the factor to provide a better pricing option to the borrower.

Credit Insurance

Credit Insurance also is an alternative to Advance Factoring. A Credit Insurance company provides the Borrower with a credit review process in a manner similar to that of a Factor. However, rather than purchase the receivables as does the Factor, the Credit Insurance Company provides the borrower with an insurance policy covering the receivables, similar to the guarantee under Collection Factoring. And, just as a Factor may limit its exposure to certain customers, or tell the borrower that the receivables from certain customers are not acceptable, the credit insurer may do the same. Not to confuse the issue, but it is not uncommon for Asset Based Lenders who are financing companies in for example the retail industry to require credit insurance. The cost is modest and depending on the specific circumstances, where ABL financing is viable, purchasing credit insurance may prove to be a less expensive alternative than factoring.

Another circumstance where the use of factoring and credit insurance may come into play is with respect to foreign receivables. Due to the specialized laws of the different foreign countries regarding perfection and collection, utilizing firms specializing in factoring of or providing credit insurance on foreign receivables represent sound financial risk management complementing one's domestic receivable financing.

Purchase Order Financing

Lastly, with respect to working capital financing, I want to mention lenders who provide what is known as Purchase Order financing. Purchase Order financing is ideal for those companies with limited working capital availability who receive an unusually large order from a customer and, as a result require additional funds to buy materials to manufacture or supply its product, prior to the purchase qualifying for an inventory or receivable advance. A Purchase Order finance company accepts the purchase order from the customer as collateral for a loan. These are companies that are willing to accept the added risk that the order will be completed, delivered and accepted by the client's customer. While the cost is also higher than traditional ABL, based on the profit margin for the client, and maintaining or establishing its relationship with the customer, the cost of the Purchase Order financing may be minimal.
In conclusion, despite the financial crisis in which we find ourselves, working capital financing is essential to drive business and, forgive my shameless commercial, stable banks like Webster continue to offer working capital financing on attractive terms with superior customer service.

Thank you and I will be pleased to answer any questions, which you may have.