Bank of America Merrill Lynch

Asset-Based Lending Rides a Perfect Storm

Are you riding a cyclical business and hoping you don't run out of capital? Is the volatility of your cash-flow scaring off lenders?

Sure, it's been rough going for companies with lower credit ratings seeking conventional loans. But those very same conditions are stimulating a rapid rise in lending secured by something that many companies have in abundance: their assets.

The New Normal

With the recession and credit downturn that began in 2008, lenders renewed their focus on underwriting collateral since it was uncertain how badly business' incomes would be affected. Collateral has always been a key for asset-based lenders (ABL), which look to balance sheet assets rather than cash flow or credit ratings in determining loan size and terms. As long as your tangible assets can be reliably valued, your assets are like money in the bank. Even intangible assets such as trade names, patents and intellectual property can sometimes be considered.

Asset-based lenders utilize a tool called the borrowing base to determine how much you can borrow. The borrowing base consists of eligible collateral assets. Advance rates applied against this collateral are based on the lender's evaluation of how much cash those assets could be converted to within a short period of time. A company then seeks advances against the total borrowing base to fund its needs.

Because asset-based loans are based on your assets (which are collateral for your borrowings), lenders can work with you as you manage your business to the changing market and economic conditions. We like to say that "the asset-based lending market is the last market to close and the first to open" when it comes to periods of financial uncertainty. This form of lending has become the "new normal" in the current credit environment. Many of your competitors and industry colleagues have found this out over the last two years.

How Asset-based Loans Work

Asset-based loans consist of revolving lines of credit which is where the borrowing base is determined. You can borrow up to 85% against the value of your eligible accounts receivable and up to 65% against the value of eligible inventory. If your inventory is a highly-marketable commodity, you may be able to borrow even more. Under a revolving line of credit your level of borrowings adjusts as your working capital fluctuates. And you pay interest only until maturity.

Term loans can also be incorporated into asset-based loans, secured by fixed assets and with repayments scheduled over the course of their useful life. For companies looking to use intangible assets as collateral, "over-advance" or "stretch loans" can combine elements of asset-based and cash-flow loans to offer more versatility.

Financial covenants are usually very limited in asset-based loans due to the rigor that goes into constructing the borrowing base. In fact, if you have a significant amount of accessible liquidity, the lender may not even require your business be subject to any financial covenants unless you later borrow a more substantial portion of your credit facility. Even when financial covenants are imposed, they are limited typically to just one calculation: the fixed charge coverage ratio, which is the asset-based lender's way of evaluating whether your business is generating enough cash flow to cover debt servicing and capital reinvestment obligations.

Asset-based lenders can give you additional flexibility

around negative covenants to pursue acquisition, expansion or investment plans and can even allow you to buy back stock from existing shareholders or make dividend or distribution payments with very few limitations.

Your business assists the asset-based lender's ability to make this flexible form of financing available by providing periodic information about the collateral assets. You do this by recalculating the borrowing base, permitting lenders to perform examinations of your books and records and allowing your inventory and fixed assets to be valued by third-party appraisers. Cadence of asset-based loan reporting, examinations and appraisals is often determined by factors such as your business credit profile and how much liquidity it has available to it to support its operations. The better the profile and the more available liquidity the less the asset-based lender will need to perform these periodic tasks.

Your asset-based lender will work much like a checkbook. As you collect cash from your customers, you will use that cash to reduce your borrowings and your accounts receivable. When you need to pay for inventory, you will request an advance. Cash will flow daily into and out of your asset-based loan to meet your needs. Back-office systems of asset-based lenders usually make this process extremely efficient for you to manage your loan and pass electronic forms of information.

Is an Asset-Based Loan Right for Your Company?

If your business is in manufacturing, distribution, or retail, you are a possible candidate for an asset-based loan credit facility. Asset-based loans can also be a source of financing for service-based businesses that need the ability to finance working capital that arises from the final rendering of the service. And asset-based loans finance not only working capital but can support acquisitions, investments, capital expenditures or other growth-oriented initiatives.

What advantages do asset-based loans have over cash flow-based loans?

Asset-based loans are insensitive to a key factor in cash flow-based loans: financial leverage or how much you can borrow compared to your cash flow. If you borrow in a cash flow-based loan and see your cash flow drop because of a downturn in your business, your access to the credit facility is likely to diminish at the same time your need for liquidity could be increasing. In an asset-based loan, you use your assets to finance the needs your cash flows may not be able to cover. Because of this, many borrowers find that their asset-based credit facilities are larger than they would be under a cash flow-based loan.

Asset-based loans also offer key advantages in terms of minimal financial covenant requirements and greater flexibility around negative covenant issue. Whereas in cash flow-based loans there may be multiple on-going financial covenant requirements, in asset-based loans there may not be any financial covenants unless you have used 80-90% of your credit facility. And, as long as you maintain good liquidity, asset-based loans provide you with flexibility to pursue your plans for expansion or for stakeholder initiatives such as dividends and distributions. If you're in the process of changing or restructuring your business, asset-based loans can give you breathing room and needed liquidity to execute on your plans.

Flexibility around financial and negative covenants is one reason why larger companies who are issuers of bonds typically use asset-based loans for working capital financing as the bond's incurrence-based covenants align well with the springing-covenant structures of asset-based loans. This flexibility gives the senior management teams and boards of directors many options to run their businesses in different market and economic conditions without having to seek lender consent for their actions.

Another significant difference between asset-based loans and cash flow based loans can be their cost. Over the last two years, asset-based loans have in many cases had a lower interest spread than comparable cash flow loans. This is because asset-based lenders take comfort in their diligence around asset values, how they construct the borrowing base, and the reporting that confirms their analysis. History suggests lender losses in asset-based loans are substantially below comparable cash flow-based loans, leading to lower costs for the borrower in many instances.

The Asset-based Loan Market Comes of Age

Over the last two decades, the market for asset-based loans has literally exploded. From a niche market that had been used mostly by smaller businesses as a financing option of last report, asset-based lending has grown into a mainstream capital markets option for companies small and large, private and public. As of 2008, asset-based loans were nearly a $600 billion market according to the Commercial Finance Association. That made the asset-based loan market nearly 14% of the overall non-investment grade loan market – today, it is approaching 20%. That's a big increase and underscores asset-based lending's increasing value to businesses. Now may be exactly the time to make use of asset-based lendings for your business.

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