ASSET-BASED LENDING FOR NON-ASSET-BASED LENDERS[1]

ASSET-BASED LENDING ESSENTIALS

- Asset-based lending (often referred to as "ABL") is a form of commercial lending designed to finance safely the working capital needs of a borrower whose cash flow may not support debt repayment.

- Cash flow is the primary repayment source for an asset-based loan, with strong reliance on the company's assets as collateral.

- Working Capital Cycle is the cycle of cash through the working capital assets, inventory, accounts payable and accounts receivable.

- Collateral typically available to secure the asset-based loan includes accounts receivable, inventory, machinery and equipment, general and specific intangibles, real estate, and other assets. Because working capital support is the primary objective of most asset-based loan facilities, accounts receivable and inventory generally are the bank's core collateral. Personal guaranties, often secured, can be taken.

- Monitoring and controlling collateral are of paramount importance to the asset-based lender to mitigate operational risk. Collateral evaluation begins with a comprehensive field examination to determine value, followed by a continuing program of periodic examinations. The collateral and loan values are monitored continuously (daily/weekly/monthly) to ensure that the realizable value of the collateral is always sufficient to repay outstandings.

- The bank generally exercises control over the borrower's cash and the proceeds of the collateral. Receivables are collected by the bank through lockbox arrangements, with collections applied by the bank directly to the outstanding loan balance. Subsequent loan advances are made only on written evidence of the existence of additional collateral.

- Note that in many Community Banks, this type of control is not employed. Instead, there is a monthly Borrowing Base Certificate submitted which is relied on for advances for the next 30 days. The increased risk is typically mitigated through allowing less leverage and most likely includes outside support of owner guarantees.

- Traditional and standard credit underwriting techniques also apply to asset-based loans, including financial analyses, financial reporting requirements, and periodic credit reviews

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[1] This material consists of excerpts from an RMA presentation of the same name.

CHARACTERISTICS OF ABL BORROWERS

- High growth.
  - Larger financing gap

- Seasonality.
  - Larger gap in peak season

- Long-term capital commitments.
  - Financing gap never goes away

- Acquisition financing.
  - Larger inventory/accounts receivable

- Weakened creditworthiness.

CUSTOMERS' ADVANTAGES FOR AN ABL FACILITY

- Access to greater amount of credit.

- Higher advance rates.

- Higher leverage accepted by the bank.

COLLATERAL CONSIDERATIONS

There is no difference between asset-based lending and traditional collateral per se, but an asset-based lender is typically more exacting in scrutiny of the prospective collateral than a traditional lender. The value of the collateral is key in determining the amount of the financing, so the asset-based lender focuses on considerations that affect collateral value.

Collateral concerns can be divided into two comprehensive areas:

- **Quality.** How "good" is the collateral: What is its value, and how readily can we expect to realize that value in the event of liquidation?
  - Consider: Book Value vs. Intrinsic Value

- **Verifiability.** How accurate is our assessment? Does the collateral conform to representations made by the borrower regarding type, quantity, and quality? Do we have the means to test the accuracy of the borrower's representations for the type of collateral under consideration?
  - Basically, you want to verify it: (a) exists and (b) is accurate.

RISKS

What kinds of risk are inherent in asset-based lending?

- Credit Risk.
- Collateral Risk.
- Operational Risk.

THE FACILITY

- Funds Tied to Working Asset Levels.
- Lender Retains Cash Control.
- Advances Fully Secured.
- Reporting and Monitoring Daily.

HOW ADVANCE RATES ARE DETERMINED

- Accounts Receivable Advance Rate.
- Inventory Advance Rate.
- Inventory Caps.