Gaining popularity of asset-based lending

Overview and Background

As the lending market continues to evolve and the need for financing from less than traditional banking sources increased as the willingness for businesses to consider a broader range of funding solutions, asset-based lending (**ABL**) has come to the fore.

ABL has found itself in the position of becoming a significant part of the thriving FinTech and ShareEconomy industries – to such extent, that it seems to promise a disruption to the status quo in having access to credit as the lifeblood of business and economic growth. ABL, working well for borrowers with greater financial leverage and/or marginal cash flows, can be explained quite simply. In a nutshell, a financing (granted in what ever form) based on assets and structured to provide a flexible source of working capital by monetizing assets otherwise sleeping on the balance sheet. So whatever kind of assets a business has on its balance sheet (which can be quickly and easily liquidated) serves as collateral for the financing. This contrasts with cash flow lending, where the lender focuses on the borrower's historical and predicted cash flows to make decisions about whether and how much money to make available to the borrower and on what pricing terms.

Unlike factoring, traditionally serving more selective industrial markets, ABL (considered by most to be a more sophisticated and streamlined borrowing method) can be utilized by distributors, service firms and retailers as well as manufacturers. If the receivable base is deemed creditworthy and ages within certain parameters, ABL is adaptable to almost any circumstances, offering great flexibility and non-notification aspects – both major selling points and poignant advantages since the (standard) ABL facility offers the confidentiality of assigning its accounts receivable without notice. This further results in the borrower being more established, better capitalized and having greater credit policies as well as receivables management procedures in place than firms found in a factoring relationship.

Often, businesses seeking growth capital turn to ABL because they have had bad luck getting approved by traditional lenders due to simply have fallen outside of given parameters of traditional bank loan financing focusing on the creditworthiness of the business entity itself. Hence, businesses rely on ABL to provide turnaround, recapitalization and debtor-in-possession (**DIP**) financing. But ABL is also used by very established companies seeking greater flexibility in executing operating plans without tripping restrictive financial covenants. Borrowing terms and repayment schedules in ABL generally provide this flexibility and can be customized to fit individual business requirements or business cycles while allowing borrowers to monitor availability on a daily basis.

ABL *per se* refers to private financing with no securitized secondary market. As a strategy, asset-based lending is premised on idiosyncratic (essentially credit) risk transfer of the relevant assets. Its effectiveness hinges on a lender's ability to evaluate the 'quality' of the assets themselves (respectively soundness of the business model, cash generation and repayment capability step back a little bit for the benefit of loan corresponding to asset-value and asset-marketability evaluations). This can be considered structuring the financing simplier (i.e. specifying simplier terms and conditions with fewer financial covenants), keeping in mind that the core of asset-based lending is to assemble the assets (such as cars, scooters, mobile phones, other electronic devices etc.) in an insolvency remote SPV. In order to mitigate broader 'market-related risks', the loan value at maturity should be hedged or needs to be predefined and contractually agreed upon and set into reliance with the asset value.

Technically, although asset-based lenders include among others dedicated departments in domestic and foreign commercial banks, small and large independent finance companies, factoring organizations and the financing subsidiaries of major industrial corporations, a fairly large majority have not emerged unscathed through the credit crisis. Moreover, compliance with the Basel II Framework (as maintaining minimum standards for capital adequacy) has meant that banks in particular have not only had to considerably curtail their lending activities but have also had to tighten their lending requirements. This has served to broaden the window of opportunity for other participants. The consolidation in the banking industry has therefore left a niche for ABL funds.

ABL works best when loans have been and are extended to:

- businesses which generate a regular cash flow in sectors that are anticyclical because they are less likely to be prone to financial and market disruptions,
- businesses which have a high profit margin and a secure, captive target audience – the loan-based higher interest rates will and can be built and easily accommodated into the borrower's cost structure; and
- long-haul profits are expected to and should offset premiums associated with borrowing.

The primary source of repayment for revolving ABL facilities is the conversion of the assets to cash over the company's business cycle. Loan advances are limited to a percentage of eligible assets (**borrowing base**).

Close monitoring and strong control are essential features of ABL. Therefore, it not only provides ready cash to support liquidity needs, eliminating the need to wait for the collection of receivables, but also significant funding for businesses in cyclical or seasonal industries by providing liquidity during slow sales periods or just periods of inventory buildup.

From an investor's perspective, the strategy in general is fairly recession resistant, but not depression proof, with stable returns. The innovative financing solution in terms of its structuring can be definitely seen as a strength: using a quasi-bank like business structure instead of a hedge fund wrapper or notes.

Scope of ABL

At first sight, arrangements around ABL facilities can appear complex and mechanical. In ABL the borrowing base – as a formula used to determine the maximum amount of money that the borrower can borrow at any point in time based on the value of the agreed asset pool – supports the loan and is not synonymous with collateral which secures the loans. However, the collateral securing the asset-based loan will often extend beyond these assets that are in the borrowing base providing an additional collateral safety net for the bank in an enforcement scenario (if the assets should be sold to recover the loans).

For lenders it is important that in a default scenario they have the tools (typically by appointing a Back-Up-Servicer for the borrowing base assets, who is experienced in selling the relevant assets to the market) to take control of the borrowing base assets and convert these readily into cash to obtain repayment of the financing. The solutions here will vary depending upon the asset classes in question and the approach to security.

In ABL the lender generally exercises more control over the borrowing base assets than lenders typically exercise over collateral on other secured loans. This leads to negotiating regarding the frequency of borrowing base reporting to lenders, the extent of other financial information that the lender should receive beyond simply that relating to the borrowing base, and occasionally clean-down requirements to reduce the outstanding loans to zero for a brief period before reborrowing in accordance with the borrowing base.

Risks

However, ABL can present disadvantages for both parties. For the borrower, an ABL facility is often more expensive than other types of commercial lending: interest rates and loan fees are generally higher and costs associated with frequent reporting requirements greater. Also, the financing agreements typically allow the lender to take control of the borrower's cash or more readily seize collateral if the borrowing base declines to such level that it is not able to support the financing.

It should be noted that borrowing from a pure asset-based lending firm will likewise require more monitoring and reporting than a traditional bank loan/line would. Therefore, for the lender, the administration and monitoring of ABL is time as well as cost-intensive and unfortunately, in particular susceptible to borrower fraud.

In addition, credit risk is probably the most important risk associated with ABL. The borrower may not be as financially strong in comparison to other commercial borrowers, may operate in a highly volatile industry, or may be experiencing rapid growth. Hence, higher default risk, such as high leverage, erratic cash flows, limited working capital, and constantly changing collateral pools are quite common. If properly controlled, ABL can result in lower losses in event of default when compared to other types of lending. Its reliance on controls and monitoring, however, can pose a higher risk when the facility is not properly underwritten, structured and/or administered. Credit risk can be posed by a borrower's inadequate accounting and inventory control systems or poor credit and collection practices, fraud, the failure of a major customer, inaccurate collateral valuation or lack of marketability of the borrowing base assets, prior liens etc.

ABL is also subject to the same regulatory and compliance issues as other types of commercial lending. Given the emphasis on the borrowing base assets and the typically higher borrower risk profile, ABL can be more vulnerable to certain aspects of compliance risk – however, compliance with more asset related duties like maintenance, asset liquidation, asset related laws and regulations and sound book keeping of the assets.

Final thoughts

Once considered a last-resort method of raising capital, the specialized financing product ABL, providing fully asset backed credit facilities, is now growing rapidly in popularity as more and more entities become favourably disposed to using ABL after discovering the freedom, flexibility and cost savings this financing tool offers.

Rapid advances, especially in the technology sector, are driving a nuanced yet significant impact on ABL. Capital expenditures by businesses are skewed heavily towards lean manufacturing, smart distribution and shared services. An important aspect of lean manufacturing is fast moving inventory. Gone are the days with collateral examiners using white gloves to see how much dust was gathering on inventory – lenders view inventory in real time and electronically. The influx of technology is absolutely a plus, resulting in making ABL more accessible as increased speed of service allows businesses to receive the funds they need quickly due to sophisticated data capture, analysis techniques and its more innovative, flexible and tech-driven approach.

Hence, asset-based finance in general has seen record levels of lending in recent years and is maturing fast – this trend can be seen as a sign of how asset-based finance is increasingly taken seriously, becoming more widely accepted among businesses and law firms.

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