Asset Based Lending

In finance, asset based lending encompasses loans that are backed by some kind of asset. If the loan is not repaid the lender acquires the asset. In the broad definition of the term, asset based lending might involve lending secured by houses, cars, equipment, inventories, accounts receivable, purchase orders and many others. In the corporate world, asset based finance involves assets normally found within a business such as accounts receivable, purchase orders, equipment and inventories.

Asset-Based Vs. Cash Flow Facilities Asset-based lenders have the benefit of liquid assets to protect their loan, thus these loans place less reliance on the borrower's operating performance, reflected by the number of covenant requirements attached to the loan. By contrast, cash flow loans typically come with stringent—sometimes highly restrictive—financial covenants, such as a leverage ratio maximum, fixed charge coverage, interest coverage and minimum EBITDA that can put significant stress on a company's ability to operate freely, especially during an economic downturn. Asset-based lenders are concerned with a company's asset coverage, liquidity and, to varying degrees, the borrower's ability to service their debt. The leverage ratio itself is not material.

Factors Driving Asset-Based Loan Market Many factors have spurred the recent appeal of asset-based loans, but three things stand out. The first factor is the widespread presence of aggressively structured cash flow loans completed in the late 1990's and early 2000's. During this period, when many companies were executing leveraged buyouts, acquisitions and roll-ups, banks were delivering highly leveraged cash flow loans, which were based on a multiple of the borrower's trailing earnings. The shortcoming of this lending strategy was that many of these loans depended on continued improvement in the cash flows of these companies, as well as a strong capital markets environment, to provide an exit for the borrowers and the lenders. Neither of these conditions held true, with the result being many of these companies are now struggling to meet covenants or to fulfill maturing debt obligations.

The second factor driving the demand for asset-based loans is the economic slowdown since 2001 and the effect it has had on companies—particularly those that operate in cyclical businesses. As these companies' earnings have suffered, they have turned to the inherent value of their assets—accounts receivable, inventory and fixed assets—to provide the operational flexibility and borrowing power their cash flows can no longer provide. Beyond mere necessity, however, these companies generally find asset-based loans offer additional benefits beyond increased liquidity. Today's asset-based loans are priced competitively with cash flow loans, and, as noted earlier, often come with fewer financial covenants.

The third factor driving companies to pursue asset-based loan structures is that the asset-based market remains steady and competitive in spite of large-scale bank consolidation that currently affects many other types of loan markets, especially the cash flow market. This consolidation, along with recent regulatory and shareholder pressures placed on lenders' portfolios, has caused many lenders to push under-performing loans out the door, an unfortunate trend made more commonplace in difficult economic times. The asset-based lending market is less volatile by nature since the borrowing power of a company's assets are characteristically more stable than its earnings. This makes for more competitive pricing and the large number of lenders in the market means there is a greater pool competing for the syndication of larger asset-based loans, such as the $2 billion credit facility recently provided to Kmart.

Defining Assets Unlike a cash flow loan, the borrowing capacity for an asset-based loan is based on the amount, quality and liquidity of a company's accounts receivable, inventory and fixed assets. Generally, the current assets of accounts receivable and inventory serve as the borrowing base for a revolving credit facility that can be drawn down and repaid. This structure can accelerate a company's cash flow by allowing it to borrow against the future value of its current assets that are expected to become cash in the near term, in turn using the borrowed funds to finance working capital.

In addition, fixed assets (machinery, equipment, real estate) can be used to collateralize an asset-based loan. In contrast to its current assets, a company's fixed assets frequently serve as the borrowing base for a term loan credit facility, where the amount is fixed for a period of time, there is an agreed upon payment schedule, and amounts paid cannot be re-borrowed. There are also occasions where certain non-traditional assets (e.g., trade names and intellectual property) are eligible as collateral, but these assets are considered on a case-by-case basis. For the traditional form of assets, however, guidelines provide estimates for the value of assets as collateral in an asset-based loan. For example, eligible accounts receivable typically include receivables from completed sales, whereas items like older receivables (over 90 days from invoice) and foreign receivables are usually considered ineligible. Eligible inventory typically includes all finished goods and marketable raw materials, and usually excludes work-in-progress (WIP), slow moving or obsolete inventory, or inventory on consignment with customers.

Beyond Asset-Based Loans An "overadvance" or "senior stretch" loan features elements of both an asset-based and cash flow loan by offering availability beyond the lendable value of current and fixed assets as long as the company can demonstrate sufficient cash flows. In combination with funds lent on assets, the senior stretch product rewards companies with strong cash flows by providing a highly versatile structure that is generally priced lower than a pure cash flow loan.

As the lending industry re-evaluates its relationships with customers who are affected by the current dip in the economy, those financial institutions that offer asset-based loans are finding wide acceptance for their product. At Core Capital, we believe in delivering strategic financing at competitive terms, allowing companies in all types of industries to achieve operational flexibility through the value of their assets.