

Frequently Asked Questions About Asset-Based Lending

Executive summary

Asset-based lending offers a powerful financing solution for midsized and larger companies that seek to maximize the value of their assets, achieve greater liquidity and pursue new growth opportunities.

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Defining asset-based loans (ABLs) and their beneficiaries

What are ABLs?

Asset-based loans, or ABLs, are a form of secured lending that is based principally on the quality, value and adequacy of the collateral that an issuer pledges.

Who can benefit from ABLs?

ABLs at Bank of America Merrill Lynch have a variety of applications and can benefit both midsized and larger companies. For example, companies seeking \$10 million–\$35 million in financing can gain from the flexibility and versatility of an asset-based structure. With experience in more than 200 industries, we serve companies of varying sizes in all sectors, including:

- Manufacturers
- Wholesalers
- Distributors
- Service companies
- Retailers

Differences between ABLs and other financing methods

How does asset-based lending differ from other types of corporate lending?

The corporate lending world can, in its simplest form, be divided into two different approaches: the asset-based credit market and the cash flow-based credit market.

In ABL transactions, the lender’s interest is secured by the borrower’s assets, which then forms the basis for determining how much credit the borrower can access. In contrast, the cash flow method of determining credit capacity is principally based on an analysis of the borrower’s enterprise value.

Asset-based lenders have generally found that, over time, the valuation of a borrower’s assets is remarkably stable over a variety of business and economic cycles. This makes calculating a borrower’s credit capacity based on asset values a highly predictable way of providing capital to clients. For these reasons, ABLs are often viewed, for certain types of borrowers, as a more reliable form of lending than cash flow-based loans.

Cash flow-based loans, while also usually a secured form of financing, often use EBITDA (or a company’s earnings before interest, taxes, depreciation and amortization) along with a multiplier to determine credit capacity, rather than the value of the underlying collateral assets. In this situation, both the level of EBITDA and the multiplier applied can change significantly during business and economic cycles. During an economic downturn, most companies will see their EBITDA decline, both on a relative and absolute basis. Often, the multiplier being used by lenders will shrink at the same time; this combination of declining EBITDA and a shrinking multiplier can result in a significant decline in available credit capacity at what could be the exact time a company most needs access to capital.

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Typical uses

What are the most frequent uses of ABLs?

As we noted before, there are a variety of applications for ABLs that can benefit both midsized and larger companies. For higher quality, large-corporate borrowers, ABLs are often used simply for financing working capital. These companies will often access the public or private capital markets for long-term forms of financing for the majority of their overall capitalization. They will then use ABLs to fund seasonal changes in working capital, for shareholder value-creating actions such as share repurchase programs, dividends or distributions, and for opportunistic acquisitions.

For midsized companies, ABLs usually comprise a larger proportion of overall capital structure. Here, in addition to providing working capital financing, ABLs often incorporate term loans, which are secured by longer-term assets such as machinery and real estate, to provide incremental credit capacity. Acquisitive companies use ABLs as part of their acquisition financing structures, which may also incorporate other forms of junior capital.

ABLs also tend to play a key role in the financing of companies facing cyclical or operating performance headwinds that have caused their credit profile to deteriorate. They need patient capital to attempt to execute on their business turnaround or restructuring plans, or just to weather the current environment, including the possibility of bankruptcy reorganization. Often, an ABL is “transitional” capital for these companies; for a time it provides incremental liquidity and structural flexibility characteristics that help owners and managers reposition the company. Once that is completed, these companies often refinance again in the cash flow credit market.

There are also times when companies use an ABL as transitional capital only to later realize that many of the characteristics of ABLs fit their business well. They may see that both the discipline and freedom associated with these loans can enhance the way they execute their plans. These companies often never go back to the cash flow loan market. In fact, there are several Fortune 500 companies that have opted to use ABLs.

Qualifying companies

Which types of companies are good candidates for ABLs?

Manufacturers, wholesale distributors, retailers, and some forms of service companies are prime candidates for ABLs. Solid ABL candidates will usually have tangible asset-rich balance sheets, often with at least half of their total assets in working capital assets, such as accounts receivable and inventory.

Like all lenders, asset-based loan providers look for companies with solid management teams and a history of being able to effectively manage their businesses, even when facing difficult circumstances. They also look for companies with excellent financial accounting information systems that can provide reliable data about both operating and asset performance.

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Does company size matter in qualifying for an ABL?

No. Companies of all sizes can qualify for an ABL as long as their business is a good match for the characteristics that asset-based lenders look for. For midsized companies, annual revenues between \$35 million and \$250 million are typical of today's borrowers. But ABLs are also delivered just as easily to multibillion-dollar revenue companies.

What about credit ratings?

Since asset-based lending is always secured, its target market is non-investment grade companies (companies with an actual or equivalent S&P rating of BB+ and below, or a Moody's rating of Ba1 and below). External credit ratings are not required to issue an ABL.

Loan structures and collateral

What is the typical loan structure of an ABL facility?

Typical ABL credit facilities may include a revolving line of credit used to support working capital needs and possibly a term loan to provide availability against longer-term assets, such as machinery and real estate. It can also include capex facilities to provide financing for capital expenditures. Generally, asset-based lenders prefer structures where the amount of term loan is less than 30% of the total credit facilities.

The revolving credit facility requires interest-only payments, with the principal balance being repaid and re-advanced as the level of working capital varies over time and as excess operating cash flows are realized. The term loan will require periodic payment of both interest and principal, with typical amortizations in five to 15 years, depending on the type and mix of fixed assets that support the borrowing.

Tenors for ABLs are generally in the three-to-five-year range, but can be highly customized to the specific situation of the borrower.

Which assets qualify as collateral under ABL structures?

Accounts receivable and inventory — assets that have a high degree of market liquidity and can be easily valued and monitored — head the list of qualifying assets. Long-term assets such as equipment and real estate are often used as additional collateral when the ABL is structured as a term loan with a fixed amortization schedule.

Some proportion of even the most liquid of asset classes are typically ineligible in ABLs. Examples include substantially past due accounts receivable, some types of work-in-process inventory or assets held for sale not in the ordinary course of business. While there is some standardization of the major classes of ineligible assets, the composition of ineligible assets is often highly customized to a borrower's needs.

What criteria do asset-based lenders use to value different classes of collateral?

Asset-based lenders use a key analytical tool called a "borrowing base" to calculate the amount of credit capacity for a given issuer. The borrowing base is a reflection of the borrower's eligible and ineligible collateral, as well as the advance rate that is to be applied to the different asset classes. Generally, the more liquid the asset, the more attractive the collateral becomes in the asset-based lending equation, and the higher the advance rate that is applied in the borrowing base.

Qualifying assets for ABLs include accounts receivable and inventory — assets that have a high degree of market liquidity and can be easily valued and monitored.

For accounts receivable, factors such as length of term, collection period, dilution and degree of diversification of the client base all matter in setting the advance rate. Still, in most cases, advance rates on accounts are normally set at 85% and, in some cases, can go to 90% when backed by credit insurance.

With inventories, factors such as composition, commodity nature, how quickly it is converted into saleable products, and relative margins are all important to evaluating inventory. An asset-based lender will often turn to third-party professionals who have experience in appraising and disposing of inventory that is going to be in the borrowing base. The lender will then use a percentage of the appraised value to determine the borrowing base advance rate. There is a broader range in advance rates in this asset class, but for highly commodity-oriented inventory, the advance rate can be as high as 80% of the lower cost of market. Most typically, however, it is stated as a percentage of the net orderly liquidation value (e.g., 85%).

Using third-party professionals to appraise the value of qualifying machinery and real estate is almost always the approach of the asset-based lender. These assets are not as easily converted to cash, so they require special consideration. Advance rate approaches vary widely, but again reference back to a margin applied against the appraised value rather than the book value on the borrower's balance sheet.

What is a FILO tranche?

FILO tranches are a first-in, last-out portion of the ABL facility. These first-drawn tranches provide incremental liquidity and carry a premium pricing over the traditional revolver. First used in the retail industry sector, their use has expanded to wholesalers/distributors and other ABL borrowers. The advance under the FILO tranche is most typically an additional 5% against eligible receivables and up to 10% against eligible inventory.

What about intangible assets?

In recent years, asset-based lenders have begun to recognize the value of intangible assets owned by a borrower. Trademarks and trade names, patents and other forms of intangibles are being evaluated today. Lenders will look to third-party professionals to assist them with valuation, and will work with outside legal counsel to ensure there is a valid, perfected security interest in the intangible asset or assets in question. In the end, ABL transactions where intangible assets have been included as eligible collateral tend to involve higher quality companies with easily recognizable brands that have value outside of the underlying products that represent the brand.

Can ABL facilities have advances beyond the value of the underlying collateral?

Yes, ABL facilities can include both seasonal and traditional overadvances. Seasonal overadvances carry a higher advance rate for several months to address working capital demands during seasonal periods. In contrast, traditional overadvances, which may be structured as either a component of a term loan or a separate facility, where the out-of-formula overadvance is amortized over two or three years, often have an excess cash flow sweep to bring the loan back into formula. Traditional overadvances are often used in connection with an LBO, acquisition or other capital transaction. The lending criteria for overadvances is higher, and there is a greater focus on both leverage and the pro forma historical and projected ability to service the debt.

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Asset-based lenders have begun to recognize the value of a borrower's intangible assets, including trademarks, trade names and patents.

We are a global company, can ABL still be an option for us?

Yes, there is a history of ABL lending in Canada and Europe as well. This can also be extended to certain other countries where the lender can obtain a good security interest in the collateral and there is precedent for the ability to recover the loan in a workout situation. Bank of America Merrill Lynch has a long history in global ABL and has developed creative financing solutions to enable borrowers access to an ABL structure on a global basis.

Financial and non-financial covenants**What kinds of financial covenants are found in asset-based lending?**

By using a borrowing base to determine credit availability, asset-based lenders are interested in ensuring that the borrower maintains sufficient liquidity — or unused loan availability under the borrowing base — to be able to meet its ongoing obligations. As a result, lenders tend to focus on financial covenants, which compare cash flow generated by the business's operations to the demands on that cash flow — for example, for capital reinvestment, payment of tax, payment of dividends or distributions to stakeholders, as well as debt servicing obligations. This is often in the form of a fixed charge coverage covenant, which is essentially an acid test for the preservation of liquidity, the predominant concern of the asset-based lender.

Unlike cash flow credit facilities, ABL facilities generally do not have a senior or total debt to EBITDA covenant. Because of the absence of such a leverage covenant, the borrower under an ABL facility has more full access to its working capital for borrowing purposes.

In certain situations, asset-based lenders will structure the fixed charge covenant so that it is only operative if the borrower's unused loan availability falls below a predetermined threshold amount. This is often offered to larger corporate issuers, who tend to be concurrent high yield bond issuers. In this case, there are no operative maintenance financial covenants — those required to be measured periodically — unless the unused loan availability is less than a threshold that is generally in the range of 10–20% of the credit facility. This approach is often referred to as a "springing covenant" and provides a good complement to the incurrence-based covenants that are in the bond indenture.

Essentially, as long as the unused loan availability threshold is not pierced, there are no maintenance financial covenants whatsoever. The borrower may not be able to meet the fixed charge test if it was to be operative, but if the unused loan availability is in excess of the threshold, that doesn't matter. This provides an unusual measure of operating freedom to stakeholders and managers to make decisions about the business without having to consider whether any or all of those kinds of actions may impact a financial covenant in a debt agreement.

There are other situations where the lender blocks the borrower's access to a certain portion of the loan availability but then requires no other financial covenants (springing or maintenance). While the borrower may not be able to tap the entire credit facility because of the block, it also doesn't ever have to worry about a financial covenant test. There is a trade-off between truly maximizing flexibility and maximizing access to capital.

Asset-based lenders need to ensure that borrowers maintain sufficient liquidity. Financial covenants compare cash flow generated by the business's operations to the demands on that cash flow.

ABLs tend to track pricing in the broader secured bank, or pro rata, loan market.

Because ABLs focus on asset valuation rather than on enterprise valuation, other financial covenants that control the level of debt to enterprise value or cash flow, or are net worth-focused, are not viewed as helpful by asset-based lenders. To the asset-based lender, as long as there is unused loan availability (liquidity) in the borrowing base, other financial covenants are not viewed as being very helpful in adequately monitoring credit.

How are non-financial covenants handled in an ABL?

In addition to the flexibility that ABLs provide on financial covenants, a company can also gain substantial flexibility on non-financial, or what are called negative, covenants. These are covenants where the borrower typically agrees not to undertake certain actions without the approval of its lenders. Significant flexibility can be provided for the borrowers to undertake mergers and acquisitions, pay dividends or other distributions, and redeem junior capital.

Cost comparison

Is asset-based lending more or less expensive than other forms of corporate lending?

ABLs tend to track pricing in the broader secured bank, or pro rata, loan market. When cash flow lending is very active and leverage multiples are historically high, ABLs tend to be priced slightly higher than the cash flow market. The opposite may be true when the availability of cash flow loans is more restricted and when leverage multiples are historically low.

But, in certain cases, pricing for ABLs can be lower than other pro rata loan market options. The reason for this is that lenders who provide ABLs look at risk differently—assets vs. cash flow or enterprise value—and, as a result, some situations may seem to be lower risk, which will be reflected in lower ABL prices.

Benefits and drawbacks

What are the benefits of ABLs?

Companies use ABLs because they want to maximize liquidity or flexibility. When maximum liquidity is the objective, companies benefit from more loan availability from the assets pledged than was previously available under the company’s prior financing. When maximum flexibility is the objective, companies benefit from the limited use of financial covenants and the embedded broader flexibility built into negative covenants.

Sometimes, those two objectives complement each other. When a company moves from a cash flow loan structure to an asset-based loan structure, it sheds the restrictive enterprise value-driven covenants under the former. Often, it will see its liquidity increase while being able to operate with fewer (if any) financial covenants. This provides significant flexibility to make acquisitions, offer dividends and repurchase shares.

The power of an asset-based approach to lending is its ability to look beyond the current circumstances facing a company, particularly if those circumstances have made the business unprofitable, and to find value in the investments the company makes in the ordinary course of conducting its business.

The power of asset-based lending is its ability to look beyond the current circumstances facing a company, and find value in the investments the company makes in the course of conducting its business.

The assets owned by a business change daily, so lenders must closely monitor these changes in the collateral base. As a result, borrowers could need to provide extra or more frequent information.

Pricing for ABLs is often lower than leveraged cash flow debt markets, as risk is a function of asset and liquidity analysis, and not the going concern value.

What are the drawbacks?

The assets owned by a business change daily. New sales are recorded as new accounts receivable and existing accounts receivable (old sales) are collected in cash. Inventory is both purchased and sold. Some inventory is converted from one state to another, such as from raw materials to work-in-process, or to multiple states within a day. The composition, quality and value can change quickly, and these changes aren't always reflected in the periodic financial statements a company may publish.

Since an ABL is based on these kinds of assets, lenders need a different kind of information to be able to adequately monitor and gauge these changes in the collateral base. They require periodic reporting, such as accounts receivable agings, and inventory composition and valuation reports. ABL borrowers provide this kind of reporting along with their periodic borrowing base certificates—which recognizes the changes in these asset classes from period to period—in addition to the usual and customary financial statement reporting. The frequency with which a borrower has to provide this information is usually a function of its credit profile and the amount of unused loan availability. Stronger credit profiles with abundant liquidity generally report monthly. As credit profiles decline and/or as liquidity becomes more constrained, the frequency of reporting would be increased to weekly. In extreme situations, borrowers can be required to report changes in accounts receivable and inventories on a daily basis.

To reduce the reporting burden on borrowers, Bank of America Merrill Lynch has made considerable investment in software and processes for reporting, determining ineligible collateral and uploading information. These technological advances substantially mitigate one of the drawbacks of ABL.

Asset-based lenders also perform on-site examinations of collateral periodically. This helps to reconfirm prior assumptions about asset quality and value, or can allow lenders to spot changes and adjust their assumptions going forward. These examinations focus on collateral and the reliability of the management information systems for borrowers.

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