IS ASSET-BASED FINANCE RIGHT FOR YOUR BUSINESS?
A COMMERCIAL BANKING PERSPECTIVE

FIVE QUESTIONS BORROWERS NEED TO CONSIDER

In the past, asset-based financing was considered by many the credit option of last resort, reserved for companies in distress. While some still use asset-based lending to keep their business afloat, many more now turn to it as a flexible solution for funding strategic ongoing working capital needs, acquisitions and other growth initiatives.

Healthier companies with significant working capital or large capital bases may be able to arrange attractive deals with low interest rates and flexible covenant packages. If you’re considering asset-based financing as a part of your capital structure, here are five important questions to consider in your decision-making process.

1. Why is this capital needed?

Traditionally, asset-based finance provided working capital mainly for at-risk small-to-mid-sized companies and those in turnaround situations. This is no longer the case. Today, companies with strong fundamentals facing seasonal or cyclical cash-flow swings are choosing asset-based lending (ABL) to maximize borrowing capacity with fewer limitations. These include retailers, distributors and other low-margin, capital-intensive companies that use ABL to fund increases in revenue, replenish inventories, expand operations and finance mergers and acquisitions.

2. How restrictive is asset-based finance compared to other options?

Commercial loans — unsecured and sometimes leveraged — generally carry strict covenants that limit how much capital can be borrowed and how it can be used. But asset-based loans are usually less restrictive. For example, poor quarterly earnings — or even lower-than-expected annual results — might not trigger covenant violations as long as a healthy level of liquidity is supported by its borrowing base.

Paying dividends for private owners & investors
An asset-based revolving line of credit can be used to make capital distributions to owners and investors in privately held companies. In most cases, as long as an appropriate level of liquidity is maintained on the credit line and covenants are not violated, asset-based facilities will allow healthy permitted distributions.

The “no-covenant” option
For larger borrowers with ample liquidity, asset-based loans with “springing covenants” may offer a more flexible alternative to cash flow loans. Covenants are not tested as long as the company maintains an appropriate level of liquidity under its borrowing base. Should liquidity tighten, covenants may be imposed — but may later be removed when liquidity is restored.
Because asset-based lending limits are based primarily on the discounted value of secured assets, lenders may require borrowers to submit detailed reporting information on collateral and conduct audits and appraisals of pledged assets. Others may mandate that collections of receivables be directed to a lockbox. Borrowers pay for these services, and these fees need to be considered when comparing the total cost of asset-based loans to other credit structures.

However, even with these expenses, asset-based solutions may still be a better choice over the long run, since these give borrowers greater freedom to manage their business rather than managing earnings to meet a covenant target.

3. Which type of asset-based structure makes the most sense?

Asset-based loans are typically structured as revolving credit facilities, term loans or a combination of both — depending on the company’s borrowing needs and the kinds of assets that are available as collateral.

A profitable company that operates with lots of working capital and experiences frequent business swings may have use for a funded revolver on which it can borrow, pay off and reborrow based on need. The value of liquid assets such as receivables and inventory comprises the borrowing base. As inventory is sold and receivables are paid, the proceeds are used to pay down outstanding loan balances. Most asset-based revolvers have tenures ranging from 3 to 5 years.

Companies use asset-based term loans to fund long-term capital projects or to refinance existing debt on fixed assets. Term loans are secured by equipment, real estate, retail leases or even patents, trademarks and copyrights. These loans have a 5 to 10 year amortization schedule and usually carry a fixed-charge covenant.

In many situations, a revolver/term loan combination enables companies to access capital to address both short- and long-term capital needs.

**ABL INTEREST RATE OPTIONS**

- Prime/Prime + basis points
- LIBOR/LIBOR + basis points with 30 to 90-day lock-in periods
- Swaps: For a small premium, borrowers with interest rate concerns may be able to swap a portion of their long-term floating-rate loan for the equivalent fixed-rate loan.

**INNOVATIVE ASSET-BASED SOLUTIONS FOR ADDRESSING “BORROWING GAPS”**

In some situations, borrowers’ capital requirements may be higher than what a traditional asset-based lender is willing to provide. In these situations, the lender may bring in other institutional lenders to augment a revolver facility. Two of these solutions are explored below.

**The “Hybrid” ABL Structure**

If a borrower requests a revolving credit facility or revolver/term loan combination, certain issues may occur, such as:

- The ABL lender may not wish to take fixed-asset risk;
- the assets’ values aren’t high enough to support the client’s needed borrowing capacity; and/or amortization on such a term loan would be too high in an asset-based structure. In these situations, another specialized lender may be brought in to provide an institutional term loan alongside or below the ABL revolver. These loans may be structured as second-lien or split-lien loans where the senior lender takes a first lien on inventories and receivables and the institutional lender takes a first lien on the fixed assets. The two lenders then swap second liens to deliver a term loan that goes deeper into or beyond the asset coverage and is amortized on a longer schedule. This “hybrid combination” may let a company borrow more than its fixed assets would support while still allowing it to benefit from the lighter covenants of the asset-based structure.

**FILO Tranches**

The first-in last-out tranche (FILO) is a relative newcomer to the asset-based market. Used in revolver facilities, it’s designed to provide additional capital to companies that require cash advances exceeding what a typical ABL structure will afford. The lender structures a separate tranche for the FILO that may be funded by the same lender or lender group or by a fund established to take on additional risk. These tranches are usually found in arrangements where appraisal and liquidation histories are readily available and have been tested, such as with food and consumer products. The FILO lender typically provides an incremental advance on certain assets. For example, if the traditional asset-based facility lends on 85% of eligible receivables and 85% of the net orderly liquidation value of inventory, the FILO may take these rates up to 90% or 95%. Because FILO lenders are paid out after others if a liquidation occurs, they charge a higher rate to the borrower in exchange for this added risk.
4. When are borrowing terms likely to be most favorable?

Most loan customers can arrange cost-effective terms when interest rates are low and credit is widely available. Because of the still tepid M&A market and lower-than-average new money deals, asset-based lenders have continued to offer aggressive terms at historically low interest rates. It is a very good time in the credit cycle for all kinds of borrowers to explore the option of an ABL facility even if they haven’t in the past.

Asset-based prospects can take additional steps to improve the response they get from lenders when exploring their options.

Presenting lenders with well-prepared and detailed collateral information will make the process easier for lenders to evaluate and will provide consistent information to solicit comparable feedback. Getting ahead of soliciting lenders by having an investment bank prepare a lending package and getting an inventory appraisal or other third-party read on asset valuations can also be helpful.

While valuations of liquid assets are relatively straightforward, fixed asset values are subject to market forces over which companies have little control. Small outlays for maintenance and capital improvements on an ongoing basis may result in higher appraisals of equipment and property.

Borrowers can also become more attractive prospects by anticipating lenders’ risk-management concerns. Preparing up-to-date financial statements, monthly borrowing projections, aged lists of customer balances, inventory reports organized by class and locations and fixed-asset schedules for their review before they ask will go a long way toward bolstering a company’s credit-worthy credentials.

5. What do borrowers need to consider when evaluating potential lenders?

The old adage “you get what you pay for” can also be true when comparing loan offers. The lowest-priced arrangement may come from a lender that simply wants to close the deal and move on the next, with minimal support during and after the transaction. While this approach may be suitable for some clients, most will benefit by working with a lender that is willing to play an advisory role in recommending an asset-based structure that addresses each borrower’s specific needs and concerns. If your company could benefit from this consultative approach, you may want to give stronger consideration to lenders that:

- Have experience working with companies in your industry sector and understand how your financial priorities may change during different phases of the business cycle.
- Are willing to take the time to objectively explain the potential advantages and disadvantages of various credit structures based on your company’s financial situation.
- Have staff based in your region who understand the local economy and will provide ongoing account management from that region.
- Are financially stable and have access to a low cost of funds.
- Are appropriately sized to provide the credit facility you need and have the resources to meet your banking needs as your company grows.

Healthy companies are increasingly turning to asset-based lending to address both short-term financial priorities and long-term strategic objectives. An experienced, consultative lending specialist can help you evaluate available credit options and choose a solution that makes sound business sense.
ABOUT CITIZENS COMMERCIAL BANKING

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