Is an Asset-Based Loan Right for Your Business?

A DECISION-MAKING GUIDE FOR COMPANIES SEEKING FLEXIBLE GROWTH CAPITAL

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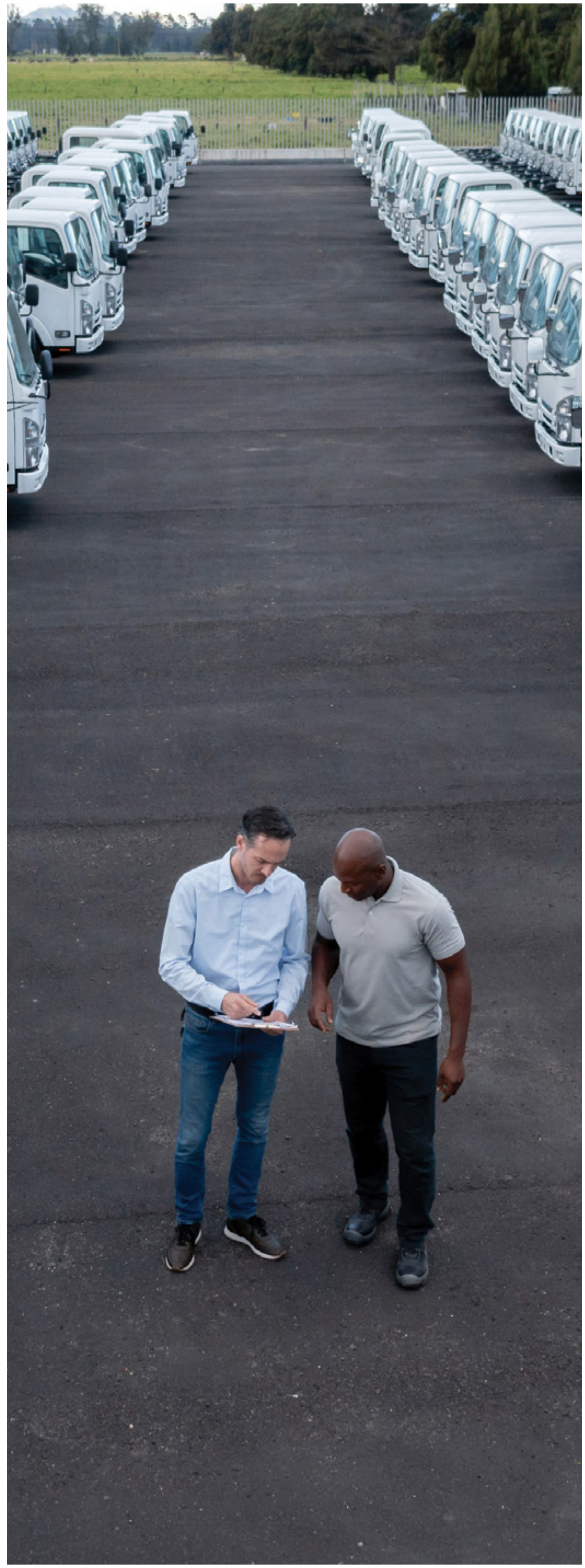

The asset-based loan (ABL) has evolved from a niche financing solution into a mainstream source of working capital and growth funding. Today's ABL facilities serve healthy, growing companies across a wide range of industries.

For business owners and executives seeking to finance expanding operations and evaluating various funding options, the key question is not simply whether their company qualifies for an ABL, but whether an ABL is the most effective financing structure for their business model, assets and growth objectives.

This paper is designed to help business leaders evaluate whether an ABL is a good fit for their organizations, understand the implementation requirements and make a more informed financing decision.

ABL Basics

Companies typically turn to asset-based loans to cover working capital needs or invest in company growth. Lenders extend ABL financing based on not only the creditworthiness of the borrower and the strength of its balance sheet, but also on the quality of the collateral supporting the facility.

ABLs can be structured as revolving lines of credit, term loans or a combination of the two. Several types of collateral can be used to support the loans, including unrestricted cash, accounts receivable, inventory, machinery and equipment, real estate, and even intangible assets such as intellectual property.

ABL financing is formula-driven against these assets. For example, a company might have an ABL credit facility that allows it to borrow up to 60% of the value of its inventory and 85% of the value of its accounts receivable. As the company grows and increases its level of AR and inventory, it can borrow against those assets and increase its borrowing capacity.

A wide range of businesses use ABL financing. Common borrowers include companies in sectors such as Retail & Supermarkets, Wholesale and General Manufacturing, Oil & Gas, Aviation & Transportation, Logistics & Distribution, and Business Services.

ABLs can be an especially valuable funding source for middle-market businesses. While large corporations tend to have greater access to established capital-market channels — including traditional and institutional bank loans, junior capital, high-yield bonds and equity markets — their middle-market counterparts often have more limited options.

Traditional Cash Flow Loan vs. an ABL

Cash Flow Loan	Asset-Based Loan
Based primarily on earnings	Based on collateral value
Multiple financial covenants	Often fewer covenants
Availability tied to EBITDA	Availability tied to assets
Less reporting	More collateral reporting

A New Era for Asset-Based Lending

Twenty years ago, an asset-based loan was often viewed as a financing option of last resort for struggling companies. Today, ABLs have shed that reputation and provide an attractive financing option for healthy, asset-strong businesses.

Here are some of the key advantages making ABLs a mainstream financing option:

- ***Flexible borrowing availability.*** With an ABL, the availability of financing grows and shrinks with the corresponding value of a company's assets. This enables the borrower to unlock more capital as eligible assets increase.
- ***Competitive pricing.*** Back when ABL borrowers were generally viewed as riskier, asset-based loans often carried higher interest rates. Now that ABL lenders are serving healthier borrowers, the pricing for ABLs is closer to the pricing for cash flow loans.
- ***Less restrictive/fewer covenants.*** While traditional financing has become more restrictive, an ABL is typically governed by only a couple covenant types, such as a fixed-charge coverage-ratio covenant and/or a leverage ratio covenant, depending on the deal.

  With traditional financing, a couple months of poor financial performance could put a borrower out of compliance with covenants and potentially in default. However, ABL covenants are typically tracked on a trailing 12-month basis, giving a borrower more leeway to recover from short-term performance challenges.
- ***Greater flexibility and customization.*** ABLs can be structured in creative ways to meet borrower needs, including combining features of term loans and revolving lines of credit.

A Custom Sub Line for M&E purchases

A building materials company was looking for a better solution for financing its frequent machinery and equipment (M&E) purchases — one that would meet its needs more effectively than a traditional revolver.

Hancock Whitney offered a sub line of credit dedicated to M&E capital expenditures. Now, when the company is considering an M&E purchase, it seeks pre-approval from the bank before purchasing the equipment through the sub line. The M&E secures the sub line, and the solution acts like a term loan that amortizes monthly.

Where an ABL Delivers the Greatest Value

Here are five common challenges where an asset-based loan can provide a solution:

1. Financing rapid growth

Fast-growing companies are often cash strapped. To keep up with demand for their products or services and fund continued growth, they need to plow cash from customer collections straight back into the business. At the same time, because of the expenses tied to growth, their financial performance may not be as strong as that of comparable companies, and they may find it difficult to qualify for a traditional loan to meet their liquidity needs. An ABL, in which the loan is supported by collateral such as accounts receivable and/or inventory, can be an attractive financing alternative.

2. Supporting seasonal business fluctuations

ABL financing can be customized to fit a company's business cycle and adjusted as needs change. This trait is particularly attractive to companies in seasonal industries — including some retailers, distributors and consumer products companies — where sales, working capital requirements and cash flow can fluctuate substantially each quarter.

For example, consider a snack food distributor that makes specialty items for the end-of-year holidays. Earlier in the year, the company needs capital to purchase inventory and prepare for the holiday season. To meet that need, the company can establish an asset-based seasonal line of credit.

3. Addressing working capital constraints

Companies with strong assets but inconsistent earnings, including businesses affected by market cycles, can sometimes struggle with liquidity challenges and the covenants accompanying traditional financing arrangements. An ABL can enable them to access their balance sheet assets and provide the financing and liquidity cushion they need to flourish.

4. Funding acquisitions and strategic expansion

It can take significant capital to fund acquisitions, enter new markets and/or expand production capacity. An ABL can provide a solution. Companies eyeing an acquisition or expansion can work with an ABL lender up front, have the lender underwrite the soon-to-be purchased assets, and include eligible assets in the business's borrowing base once the transaction is completed to boost borrowing availability.

5. Refinancing existing debt

Sometimes companies find their traditional financing arrangement just isn't working for them. Maybe it's too restrictive and they're running into covenant violations, or they aren't comfortable providing the required personal guarantee. Or maybe the facility just isn't large enough. An ABL is less restrictive, may not require a personal guarantee, and by leveraging a company's eligible assets, can increase borrowing availability and provide greater liquidity.

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Is Your Business a Good Candidate?

Before talking to lenders about ABL financing, it's important to understand how they will evaluate your suitability. Most lenders will assess a potential borrower across three broad categories:

ASSET PROFILE

A key concept in asset-based lending is the borrowing base. This is the dynamic, calculated maximum amount a lender will advance to a borrower. It acts as a revolving credit limit that fluctuates based on the value of the company's pledged collateral — such as accounts receivable, inventory or equipment — and a set of negotiated, risk-adjusted criteria.

A lender will want to determine whether you have a borrowing base that meets your stated capital needs. Some of the specific questions the lender will consider include:

Do you have meaningful accounts receivable? Not all AR are eligible to be included in the borrowing base calculation. The bank will start with a borrower's gross AR and subtract any receivables aged out past 90 days, foreign AR that aren't covered by credit insurance, as well as other high-risk AR. For instance, in calculating the borrowing base, a bank will typically limit the percentage of total eligible accounts receivable that can be concentrated with a single customer.

Do you have marketable inventory? Lenders will evaluate the value of a borrower's inventory if it had to be liquidated. They will discount obsolete, slow-moving or other inventory that would bring little value, such as work-in-process goods that would need to be finished before they could be sold.

Do you have equipment of measurable value? What would your machinery and equipment bring in a liquidation? Note that custom equipment — for instance, equipment used to produce a single part for a machine needed by only a single customer — would not contribute much to the borrowing base.

Answer 'Yes' to These Questions and an ABL Might Be a Good Fit

1. *Are any of the following driving your financing need?*

- Growth?
- Working capital?
- Acquisition?
- Seasonal demand?
- Liquidity enhancement?

2. *Do you have eligible assets?*

Evaluate your:

- Receivables quality
- Inventory quality
- Asset liquidity
- Asset turnover

3. *Can your organization support ongoing reporting?*

Consider your capabilities in these areas:

- Financial statement preparation
- Borrowing base reporting
- Inventory tracking
- Internal controls

OPERATIONAL PROFILE

Lenders want to feel confident that an ABL borrower has the systems and procedures in place to continuously and accurately monitor collateral value and financial performance. In assessing a borrower, lenders are hoping to find:

- An established ERP or accounting system
- An automated, perpetual inventory system that tracks stock levels and cost of goods sold in real time
- Reliable reporting capabilities related to both financials and collateral value
- Solid cash controls
- Strong collection policies and procedures

BUSINESS PROFILE

Lenders will also evaluate if you fit the typical business profile of an ABL borrower. Strong candidates often are:

- Middle-market companies
- Growing businesses
- Enterprises with seasonal operations
- Distribution, manufacturing, wholesale, retail, energy and business services firms
- Companies with diversified customer bases with solid collection histories

An asset-based loan may be less suitable for:

- Early-stage companies
- Businesses lacking reporting infrastructure
- Companies with highly concentrated customer exposure
- Businesses in active bankruptcies
- Companies less than a year into a turnaround effort

Evaluating Other Financing Alternatives

	Pros	**Cons**
Traditional bank debt	Doesn't tie up assets; can be cost-effective with long payment terms	Requires strong credit and usually personal guarantees; covenant heavy, little margin for error
Additional equity	No repayment obligation; sponsors can provide additional expertise	Dilutes ownership; must deal with expectations of new partners
Junior capital	Preserves ownership; flexible repayment terms	Higher interest rates and more fees than required by senior lenders
Mezzanine financing	Unsecured gap financing; flexible repayment terms	Higher interest rates and fees; restrictive financial covenants

What to Expect During Implementation

If you apply for and are awarded an asset-based loan, the process from initial discussions with your lender to closing typically takes 6–8 weeks. It can go faster or slower depending on how quickly you provide information requested by the lender. The complexity of the deal can also affect the timeline. For instance, if you want a revolver supported only by accounts receivable, that will likely proceed faster than if you are also using machinery and equipment and/or real estate for collateral, which would require appraisals.

The entire implementation process can be broken into four steps:

Step 1: Initial Assessment

You meet with the lender to discuss financing needs and whether an ABL is appropriate. If both parties agree to move forward, the lender typically will ask for historical financial information, conduct an asset review and perform a preliminary borrowing capacity analysis. Once the lender's credit team signs off on the transaction, the lender issues a proposal letter outlining terms.

Step 2: Due Diligence

Once you agree to terms, the lender engages a field examiner to conduct an on-site or remote review of a borrower's financial records, focusing on the assets that secure the loan. Examiners test the accuracy of reported figures, assess internal controls and evaluate collateral performance over time.

A field exam helps lenders verify the borrowing base supporting loan availability; detect data inaccuracies, fraud or operational weaknesses; identify trends in customer concentration, dilution or turnover; and evaluate the borrower's overall reporting reliability.

If inventory, machinery & equipment and/or real estate will be used as collateral, the lender also engages an appraiser to evaluate those assets.

Step 3: Structuring the Facility

After the examiner and appraiser issue their reports, the lender produces an opening borrowing base and establishes the advance rates. These rates reflect the percentage of an asset's appraised value or total eligible balance that will be lent to the borrower.

The lender also finalizes the covenant structure and prepares documentation that is circulated to the borrower for final negotiations. The borrower must provide a compliance certificate testifying to the accuracy of financials and compliance with covenants.

Step 4: Transition and Closing

Prior to closing, the legal documents are finalized and the lender works with the borrower to establish two bank accounts: an operating account and a sweep account through which customer collections will flow daily to pay down the loan.

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Collateral Reporting and Control of Cash

Borrowers transitioning to ABL financing must adapt to a few changes.

The first change is meeting additional reporting requirements. ABL borrowers must provide more frequent collateral reporting, generally weekly, biweekly or monthly. Most lenders also require monthly financial statements.

Another change involves control over cash. An ABL lender will require cash dominion. As cash receipts are collected, the proceeds go directly to pay down the revolving loan balance. As the borrower requires cash to pay for goods and services, fund payroll or meet other operating needs, it borrows against its line of credit.

To initiate this process, borrowers need to train their customers to direct their payments to a different bank account.

Turn Assets into Scalable Growth

Regardless of your specific liquidity need, before you raise additional equity or seek to raise various expensive forms of junior capital, consider whether you are taking full advantage of your balance sheet. If you need more liquidity and flexibility and you can't get it from a cash flow structure, an asset-based loan may very well be the answer.

An ABL can be a strategic financing tool for healthy middle-market companies looking to grow. It's no longer a lending option of last resort and is generally less restrictive than traditional bank financing.

If you are looking for a partner to help you turn assets into scalable growth and want to learn more about asset-based loans, contact your banker or Matt Mouledous, Head of Asset-Based Lending (770-702-9769 or matt.mouledous@hancockwhitney.com).