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Asset Based Lending…
not just for the bad times

One of the more innovative financial products gaining popularity in the Canadian market is Asset Based Lending or "ABL" financing. Asset Based Lending has been available in the United States for several decades, and although originally used as a "loan of last resort" for difficult credit situations, ABL financing has gone mainstream and is now an attractive alternative to conventional loan products.

What is Asset Based Lending?

An asset based loan is usually offered as a secured revolving line of credit backed by accounts receivable and inventories as collateral; in certain cases, other assets such as equipment and/or real estate may be included. Loan advances are driven by formula-based calculations ranging from 70 to 85% of receivables plus a percentage of the estimated liquidation values of inventories or other collateral. ABL financing lends itself particularly well to "asset rich" companies poised for growth, or faced with seasonal or cyclical businesses. It can often provide more funding than a conventional facility.

Benefits of ABL Financing

Conventional facilities are basically profitability or cash flow based, that is, credit is extended on the basis of the borrower's ability to maintain a healthy balance sheet and generate sufficient cash to service the debt and sustain the business. Since conventional lenders underwrite the balance sheet and cash flow to ensure debt service, they typically impose operating and financial restrictions and will hold the borrower to respect financial covenants such as the following:

- Minimum working capital ratio,
- Minimum tangible net worth,
- Maximum debt to equity,
- Minimum interest coverage,
- Minimum Debt service coverage ratio.

Unfortunately, seasonal or cyclical businesses, or businesses that unexpectedly suffer from a temporary event (i.e. delayed shipments, inventory build-ups or economic downturn) can suddenly find such covenant ratios to be very restrictive. At worst, the borrower may needlessly find himself in default, which can trigger a series of restrictions with both the loan facility and possibly with other business agreements containing "no default" clauses.

An ABL Facility, on the other hand, provides credit based on the estimated liquidation value of the secured collateral. Although Asset Based Lenders still look to ensure that a borrower can service the debt, their primary recourse lies in the value of the collateral irrespective of seasonal, cyclical or economic fluctuations and their impact on cash flows. As a result, ABL lenders typically require fewer and less restrictive covenants; in some instances covenants may not be required at all. ABL facilities can often provide greater liquidity and are more flexible and patient financing than traditional loan products.

For example, a company building up a large inventory to drive new growth may fail to convince a conventional lender to provide as much funding as an ABL lender may be capable of delivering.

Unlike conventional loans, asset based loans can be arranged for healthy as well as distressed (or even insolvent) businesses.

Canadian banks have been slow to offer this type of financing but some are beginning to grow this sector. Otherwise, asset based loans are still largely the domain of U.S. institutions operating in Canada or through joint ventures of U.S. and Canadian institutions.

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Asset Based Lending… (cont'd)

Although ABL loans were originally more expensive than conventional facilities, the field has become more competitive and ABL lenders offer increasingly attractive rates as they move into the mainstream market. Nonetheless, since ABL lenders require close monitoring of collateral values on a monthly or even weekly basis, such facilities can be more costly to manage for some borrowers.

Key ABL concept vs. traditional Line of Credit

In addition to the usual due diligence or field exam carried out prior to obtaining credit approval, an ABL lender will require a review of the creditworthiness of the borrower's clients as well as an appraisal of inventories, and any other assets, to be included as collateral. A professional appraiser may be mandated, at the borrower's expense, to evaluate the quality of the inventories and prepare a Net Orderly Liquidation Value or "NOLV". This is essentially an estimate of the net realizable value of the assets should they have to be liquidated to repay the debt.

The lender/borrower relationship and the funding mechanics are directly related to the value of the collateral. This value, called the borrowing base, is generally calculated on a monthly basis as follows:

Pre-defined percentage (70% to 85%) of good and current trade receivables subject to maximum exposure by account and disqualifications for overdue accounts,

Plus, a pre-defined percentage of the NOLV of good and current inventories (and/or other assets),

Less priority claims (i.e. current payroll, government remittances, etc.) that may rank ahead of the lender in the event of liquidation.

A borrower may draw funds to a maximum of the value of the current borrowing base or the value of the approved facility if the borrowing base exceeds the facility. The difference between the amount actually borrowed and the borrowing base is the spare borrowing capacity or "excess availability". The size of the excess availability can be used to trigger different loan provisions. Lenders will usually agree to lessen controls and reporting requirements so long as a minimum excess availability is maintained since the greater the spread between the collateral value and the actual amount borrowed the lesser the risk to the lender.

ABL facilities can thus be structured with "springing" covenants and other conditions which are triggered if the minimum availability falls below a certain minimum. In other words as the borrowing approaches the maximum covered by collateral the lender is afforded greater control and oversight.

Terms and conditions of ABL loan agreements resemble traditional facilities but there are elements which are fundamentally different.

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