COMMERCIAL FINANCE ASSOCIATION'S
BUSINESS CAPITAL NETWORK
CONNECTING YOU TO THE CAPITAL YOU NEED

Entrepreneurial Asset-Based Lending (ABL)

By: Neville Grusd, CPA, President, Merchant Financial Corporation
Mon, 20 Aug 2012 at 18:10

What is ABL?

ABL is an alternative form of financing utilizing the company's assets as collateral. Usually the term applies to working capital financing, i.e. availability to borrow is based on receivables and inventory.
Long-term assets, such as equipment and real estate, are usually financed through separate term loans.
ABL is a valuable tool when bank lines are not available to the borrower, or are insufficient for its needs. ABL works particularly well for growing companies, giving them the ability to maximize all available opportunities.

How does ABL work?

ABL financing is set up a revolving credit line, with a cap.
The amount available to borrow is based on percentages of eligible account receivables and eligible inventory.
The borrower can draw down funds as needed, subject to the availability formula.

Accounts Receivables (A/R)

The typical advance rate on A/R is 80%. The rate can vary depending upon historic and expected dilution of receivables. "Dilution" is calculated based on returns, allowances and deductions from sales, i.e. the reduction of gross sales to net sales. The advance rate of 80% is usually used when the dilution rate is around 5%. With very low dilution rates, an advance rate of 85% is not uncommon. If customer discounts are netted out off the invoiced amount; then they would not be included in the dilution calculation.

It is important that receivables relate to goods delivered and services already rendered in terms of unambiguous purchase orders. If billings are based on long-term contracts or progress billing, it is advisable to obtain customer sign-offs and submit these with the invoices.

"Eligible" receivables are defined as those not older than an agreed period (usually 90 days from invoice date when there are 30 day terms) and those deemed credit-worthy by the lender. If extended terms are offered to credit-worthy customers, then the eligibility period may also be extended.

It is also typical that "cross-aging" may be applied in computing availability. Where more than an agreed percentage, say, 25% of an account has aged out beyond the eligibility period, then the entire account may be excluded.
In some cases, concentration reserves on A/R may be set up in the lender's discretion, i.e. where an account is more than, say, 10% of total A/R. Whether or not a lender enforces this is negotiable, depending upon who the customer is and the lender's ability to confirm outstanding balances.

Inventory

The typical advance rate on inventory is 50% of cost. "Eligible" inventory usually comprises finished goods on hand, but could include raw materials. WIP, in-transit inventory, and inventory held for more than a specified period is usually excluded.

The majority of considerations as to whether lenders will advance on inventory are the types of inventory; the extent to which it is pre-sold; historic inventory turn; the age of the inventory; and whether a reliable perpetual inventory system exists. In some cases lenders may require appraisals to establish the advance rate.

Where inventory is included in the advance formula there is usually a sub-limit cap and/or such lending is restricted to a percentage of total borrowings or the A/R availability.

Projections

The best way for borrowers and lenders to ensure that the credit line and advance formulas being put in place are acceptable to both parties is for the borrower to prepare a detailed projection. This should be for one year; comprising monthly income statements, cash flows, balance sheets, and an availability calculation. The latter will show the monthly borrowing needs compared with the availability based on the suggested advance formulas on A/R and inventory.
If in any month the borrowing needs exceed the availability, then this "over-advance" must be addressed. Either additional collateral must be provided, or the business plan must change to fit the formula, or the lender may agree to fund this. It is critical that such situations be considered and settled before they occur to avoid a crisis.
It is also important to note that most projections reflect month-end figures only, whereas the borrowing availability is usually computed daily. It is possible that "intra-month peaks" may occur and these should be computed, especially during peak periods, and any possible over-advances arising therefrom should be discussed as part of the lending arrangement.

Requirements for ABL

- The lender will require a first lien on at least the assets on which advances are being made. If there are existing liens, they must either be satisfied or subordinated to the lender.
- A/R collections flow into the lender's lockbox account. Borrower will request advances for funds as needed, which could be daily. Accordingly, this is a revolving credit facility and interest is only paid on funds in use.Usually customers are notified that payments must be made to the lender's lockbox. In some cases, where the borrower is a strong company and there is sensitivity about customers being aware that the receivables are being collateralized, the lender may waive the notification requirement. In this case, customers would be directed to make payments into the lockbox account without disclosing the lender's name.
- From time to time, the lender will confirm outstanding balances with customers. If there is sensitivity regarding the financing arrangement, then confirmations could be done as "an internal audit" procedure.
- For inventory lending, the lender will require a period Inventory Designation detailing the eligible collateral. The frequency of such reporting depends on the amount of reliance on inventory as collateral.
- Depending on the size of the credit line, usually annual reviewed financial statements and half-year compilations from an acceptable accountant are required. Quarterly or monthly internal statements may also be required. For smaller credit lines, tax returns may be acceptable. However, the stronger the financial reporting, the better the credit line and the more favorable the terms will be to the borrower.
- ABL lenders require far fewer covenants than banks. Usually only Tangible Net Worth (which also includes subordinated debt) (TNW) and/or working capital covenants are specified. As long as these are met, shareholders are not restricted as to what they can withdraw from the business. ABL lenders are far less restrictive than banks in the amount of TNW covenants with regard to leverage, and 5 to 1 or more is not uncommon.
- Personal guarantees of the owners of the company are usually required, backed by Personal Financial Statements. ABL lenders want the owners to stand behind the company. This allows them to be more aggressive, knowing that the owners will be assisting to solve problems and liquidate assets, if it becomes necessary.

Rates

Rates and charges vary among lenders depending upon the size, quality and financial condition of the borrower. For larger credit lines (in excess of $1 million) there is usually an annual credit line fee and interest at a rate above the prime rate. Some lenders may also charge a collateral administration fee, clearance days and legal expenses. It is advisable for the borrower to request a written proposal detailing <u>all</u> costs so that an "all-in cost of borrowing" can be computed. ABL rates will exceed bank rates, but as the facility will provide more financing and/or more timely financing than a bank would offer, the facility should more than pay for the difference.

Advantages of ABL

- Entrepreneurial asset-based lenders are more flexible and non-bureaucratic than banks. They react quickly and make business-like decisions to ensure that borrowers can obtain the funds they need, when they need them. Because of constant communication the relationship develops quickly and the lender becomes a true "business partner" of the borrower.

- ABL lenders do not blow hot and cold, and support borrowers who perform throughout the business cycles. It is a fact that ABL lending increased during the current financial crisis.
- As the business grows, the credit line will grow automatically, and no clean-ups are required.
- While it may appear that there is additional work in administering an ABL line, everything the lender requires should be readily available in a well-run business.
- By funds flowing into a lockbox, the loan account is automatically paid down daily thereby minimizing interest costs. This arrangement permits the borrower to operate close to a zero-balance checking account.
- It has been argued that notification of customers by lenders is detrimental to the business. However, it has been found that customers pay faster when they know payment is being made to a financial institution, for fear that late payments will impair their credit-ratings.
- ABL works well with all types of businesses, including service companies such as security guards, staffing agencies, IT consultants, trucking, etc.
- ABL lenders are forward-looking. They are more interested in future prospects, growth opportunities and management, than purely historical information. They do not "drive the car looking in the rear-view mirror".