Asset-Based Lending: *A Primer*

BY CANDICE HUBERT AND JOE ACCARDI

Simply put, asset-based lending (ABL) is a way of lending money to companies. Such loans are made by commercial banks and by specialty finance companies, and loan sizes can range from several hundred thousand to many hundreds of millions of dollars. These loan proceeds are used to assist companies in high-growth, distressed, or sometimes even in start-up situations.

The Basic Concept

The most basic concept of asset-based lending is about the need for collateral, which can be defined as an asset of a borrower that can be sold off by a lender to have a loan repaid. There is an inverse relationship between general creditworthiness and the need for collateral, i.e. the greater the financial strength and profitability of a borrower, the less importance collateral holds. This is because a financially strong borrower is very likely to have the ability to repay a loan in accordance with the agreed-upon terms, whereas a financially weaker borrower is more likely to experience challenges to its viability as a company. Given this, a weaker borrower will more likely be forced to sell off assets to repay its ABL loan.

Think about a simple residential mortgage loan. Let's say an individual is interested in buying a house for $400,000, and she is putting down $80,000 and applies for a mortgage loan of $320,000. The lender will consider two things in determining a loan approval: 1) does the borrower have an acceptable level of income to comfortably make the loan payments, and 2) if she cannot make the payments, can the mortgage lender reasonably sell off (foreclose on) the collateral (the house) to have its loan fully repaid. If the answer to both of these questions is yes, then typically the loan is made.

Conceptually, ABL is the same thing…the same two questions are asked by asset—based loan professionals in determining whether to extend a loan. 1) ABL loans are made to companies rather than to individuals, and 2) the company assets are not residential houses, but rather more complex assets like accounts receivable and inventories of goods. Examples of tangible assets include equipment, real estate, inventory, machinery and cash.

Credit Analysis

In determining the creditworthiness of a company, balance sheets, income statements, and tax returns are typically analyzed, along with other pertinent information presented by the borrower. Underwriters, people hired by the lender to evaluate risks, will review information presented by the borrower and analyze the financial data and potential risks to the lender. While analyzing data presented, underwriters look for consistent profitability and strong net worth. Additionally, underwriters will evaluate the performance of the company, and will look for supporting data to help the lender decide to extend or decline a loan request. Deep and sometimes forensic analysis of the data presented will take place. Analysts must have high analytical skills, keen research skills, and the ability to articulate factual findings about the data presented by the borrower. This allows lenders to make a sound decision and consider all risks and factors in extending a loan.

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Less creditworthy companies will be less attractive to prospective lenders, and collateral will be a more important aspect of a loan structure. Lenders interested in making loans to these less creditworthy companies will spend a lot of time analyzing the company assets and their collateral value; this is where it can get very interesting!

Determining the strength of assets as collateral

Here are couple of quick and easy definitions to set the stage:

- Accounts receivables are created when a company (A) sells goods to another company (B), and the customer (B) has been granted 30 days to pay for the goods; until the payment is made, by B to A, an accounts receivable is an asset of A. This asset can be used as collateral for a loan.
- Inventory is the goods a company has (as an asset) for sale to prospective customers. Think of a food distribution company that has thousands of cartons of canned foods for to sell and distribute to restaurants, schools, and nursing homes. This inventory is typically suitable collateral for an ABL loan.

Accounts receivable and inventory have fluctuating values. When a company sells goods, and issues an invoice to their customer, the value of accounts receivable, or the amount owed by the customer, goes up, and once money is collected and the customer pays the invoice or money owed, accounts receivable go down. Similarly, when a company sells goods to a customer, inventory goes down, thus, a company must replenish and re-stock those goods and the inventory value will then go up. Lenders must evaluate the trends and fluctuations of assets over time. If a company's receivables tend to be low and inventory levels are low, this will decrease the value of those assets. Many factors contribute to fluctuations to the value of assets. Let's reflect on the mortgage example mentioned earlier. House values are generally very stable. At times, the value of a house may go up or down a bit year over year. However, fluctuations are generally minimal.

Assets like accounts receivables and inventory are carefully monitored frequently – in some cases daily. In addition to the issue of normal fluctuation in the level of these assets, there is always a much deeper analysis of their collateral value. As an example, what would be the inventory value of Christmas tree ornaments in October? What would be the value in January? As another example, what would be the inventory value of fresh produce that is two days old? What about two months old? There are many questions like these examples that are routinely addressed in all collateral analyses.

A Healthy Ratio

As the name suggests, asset-based loans are typically geared to the assets (accounts receivable and inventory) serving as collateral for the loan, and it is critical to have an appropriate loan-to-collateral ratio. Back to the mortgage loan example – the house is worth $400,000. Since the borrower's down payment was $80,000, the loan amount is $320,000. In fact, the borrower has paid 20% into the home, thus the lender is approving a loan only up to 80% of the house's value. That is a healthy loan to value ratio! This concept is the same for ABL loans. Typically, borrowers are only allowed to borrow up to a certain percentage of the asset. Typically, lenders will extend a loan against accounts receivables, and will not lend more than 80% of the total value of receivables. So, if a borrower has $100,000 of accounts receivables, lenders will issue a loan in the amount of $80,000. The lender will consider this a healthy loan to value ratio.

Active Relationship with Borrowers

One of the important aspects of asset-based lending is that typically there is a close working relationship between lenders and executive management of borrowers. It is critical to understand trends in the borrowers' business as well as the industry in which they are doing business. This kind of relationship allows the lender to anticipate needs and help the borrower make the best use of the loans available to it.

Key Takeaways

- The goal is to make loans, earn interest, and have the loan repaid in full.
- There is an inverse relationship between a borrower's creditworthiness and the lender's need for collateral.
- Lenders must analyze the borrower's financial condition and historical operating performance.
- Lenders should aim to understand the nature and value of assets serving as collateral.
- Monitoring asset levels is important and is a mechanism to help to maintain a safe loan-to-collateral ratio.
- A strong working relationship with a borrower is critical to understanding their business and their borrowing needs.

Asset-Based Lending as a Career

Asset-based lending offers a variety of career choices to consider. Due to the many complexities of extending loans, it takes a strong team of individuals that can work collaboratively to successfully extend capital to borrowers.

If you have excellent analytical skills, and you enjoy numbers, researching, and statistics, then analyst roles could be perfect for you. These include: underwriting, credit analyst, collateral analyst, and financial analyst.

If you have a passion for people and enjoy relationship building, then a business development role might be a great path to consider. In the ABL world, it is important to build strong relationships with your colleagues and industry partners, both within your organization and externally. Your career success is predicated on the ability to learn as much as possible. Many will wonder, what if my degree is not in finance or what if I have never looked at a financial statement? That's okay! Many ABL executives did not plan a career in finance. In fact, one industry icon started off in social work.

If you have a passion to work in an ever-growing industry, enjoy working with others, and have the passion and drive to learn something new, then you just might be a great fit for the ABL industry. For further information on a career in asset-based lending, please visit www.sfnet.com or reach out to Michele Ocejo at mocejo@sfnet.com.

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