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Asset-Based Loans Offer Liquidity in Tough Times

A persistently sluggish economy has combined with a tight traditional commercial lending market to direct the interest of manufacturers and distributors to new options for the liquid capital they need to finance growth. One of the alternatives drawing interest is asset-based lending.

Asset-based loans are secured with company assets such as accounts receivable, inventory, equipment and real estate. With traditional financing, commercial banks look to cash flow for repayment, then collateral. With asset-based lending, the lender looks at collateral first.

Asset-based borrowing often appeals to manufacturers or distributors with leveraged balance sheets. A growth-oriented business plan, a down economy, a cyclical industry or changes within an industry can result in heavy investment in assets, marginal profitability or less-than-ideal capitalization. Any combination of these circumstances can make it difficult to obtain traditional commercial financing.

Financing Growth

In the current economy, many well-established, soundly operated companies encounter the financial challenges that make it difficult to secure traditional loans. Asset-based lending provides an alternative, enabling these companies to press forward with growth plans. Loans can be used for working capital, acquisitions, turnarounds, capital expenditures and stock repurchases.

Asset-based loan agreements usually include fewer financial covenants than conventional loans. Since the loan is based on assets, lenders require a careful accounting of the assets on an ongoing basis. The level of controls and monitoring is usually closely tied to the borrower's credit history.

Typical controls include a borrowing base certificate, which documents the relationship between the value of the collateral securing the loan and the actual loan balance. Depending on the secured assets and how the value changes, reporting may be required daily, weekly or monthly. Regular reporting may include monthly accounts receivable aging, inventory listings, daily sales invoices and shipping documents.

The loan agreement may also include a deposit account into which accounts receivable collections are deposited to give the lender control over the cash, and there may be periodic collateral audits to verify the accuracy and validity of records and asset values.

Application Requirements

To assure a borrower's ability to comply with the loan agreement, asset-based lenders will want to learn a great deal about the borrower's business and the assets pledged to secure a loan.

The prefunding audit may include a complete due diligence review, looking at a borrower's financial statements, accounts receivable, cash flow, inventory, accounts payable, taxes and insurance.

The lender will want to learn about a borrower's accounting systems, backup and personnel to assure the accounting function adequately reflects the company's financial capabilities. Before submitting records to the lender, a borrower should seek the advice of an accountant or attorney.

Advantages

Asset-based loans may seem complicated, but they offer some advantages. Not only do they create a sense of discipline about collecting accounts receivable, but they also encourage efficiency in the production process because work-in-process is usually ineligible as collateral. In addition, lenders may show greater patience in collecting because they hold collateral to protect the loan.

Although asset-based lending once was confined to the riskiest borrowers, it has emerged as a strategic financing method for a wider group of clients. If your company is considering an asset-based loan, we can help you assess your options and prepare for the necessary reporting.