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Solutions for Financial Services

A Fresh Perspective on Asset Based Lending

While asset-based lending may often be considered "last-resort" funding, commercial borrowers of all types and sizes are using this flexible, cost-effective financing to meet their cash flow needs.

In fact, asset-based lending is a $200-billion-plus market, according to the Commercial Finance Association. Users of asset-based lending span a broad range of industries, with manufacturers representing approximately 31% of the total marketplace, followed by wholesalers (28%), and retailers (17%). Based on revenues, the bulk of these borrowers (71%) are under $50 million in size.

The attraction to asset-based lending is obvious. This versatile, cost-efficient debt instrument provides more flexibility than many other forms of traditional financing. Moreover, asset-based lending can provide borrowers with enhanced operational flexibility through all phases of the business cycle.

Understanding Asset-Based Lending

The concept of asset-based lending is relative straightforward: It's simply a business loan or line of credit secured by some type of collateral. The collateral can be any asset the borrower uses in the conduct of his or her business. If the loan or credit line isn't repaid, the asset is taken.

Also called commercial finance, asset-based lending is typically secured by accounts receivables and, less often, inventory. Lenders favor receivables because they are among the most liquid assets, and they're less susceptible to "shrinkage", physical damage and other problems faced by tangible assets.

Accounts receivables that are eligible for asset-based lending generally include receivables from completed sales. Older receivables-those more than 90 days from invoice-and foreign receivables are usually considered ineligible. Eligible inventory typically includes all finished goods and marketable raw materials. Excluded from the list of eligible inventory are works-in-progress, slow moving or obsolete inventory, and inventory on consignment with customers.

Fixed assets, such as machinery, equipment and real estate, also can be used as collateral against asset-based lending. Companies frequently use fixed assets as the borrowing base for a loan where the payments, schedule and term are pre-set. In addition, non-traditional assets like trade names and intellectual property may be eligible as collateral on a case-by-case basis.

A Different Option than Traditional Cash Flow Financing

Asset-based lending is distinctly different from traditional, cash flow-based financing. It matches a company's assets to its borrowing needs. And unlike convention cash flow financing, asset-based lending doesn't rely on balance sheet ratios and cash flow projections as loan criteria.

Instead, asset-based lending uses the borrower's business assets as its primary focus for lending. It evaluates a company's asset coverage, liquidity and, to some degree, the borrower's ability to service their debt. Thus, the quality of the collateral becomes the principle-determining factor of creditworthiness.

Asset-based lending gives financing companies the benefit of liquid assets to protect their loan, thus these loans place less reliance on the borrower's operating performance. And as one would imagine, the interest rates on asset-based loans are generally less than those on unsecured financing.

How Asset-Based Lending Works

In essence, asset-based lending provides companies with cash by lending on fixed assets or collaterals. The borrowing capacity is geared to the amount, quality and liquidity of the asset being used as collateral. For example, the current assets of accounts receivables could serve as the borrowing base for a revolving credit line that could be drawn down and repaid. This can help a company accelerate cash flow by enabling it to borrow against the future value of current assets expected to become cash in the near term. In turn, the company could use the borrowed funds to finance working capital to meet operational and other needs.

Businesses frequently use asset-based lending to fund acquisitions. And it's actually possible to use the assets of the company being acquired to finance the acquisition. Many companies also use asset-based lending to grow their business. A revolving credit line, for instance, can provide borrowers with a great deal of flexibility and borrowing capacity from its existing asset base. Moreover, an asset-based lending solution can be designed to "grow" with the company. For instance, a revolving credit option could be developed to provide a higher credit limit as the business increases its borrowing base. So, as the company's needs and collateral grow, so does its ability to borrow.

In addition to funding acquisitions and growth, asset-based lending is also used to provide operating capital for meeting payroll, building inventory, consolidating debt and financing equipment. When should a company pursue asset-based lending to meet its operational and expansion needs? Suitable situations might be when:

- Operating cash is tied up in receivables
- Sales growth is straining resources
- Seasonality peaks cause problems
- Inventory levels are high due to client demands
- The best trade terms for supplies create cash flow shortages
- Trade discounts and special pricing terms cannot be obtained
- Letters of credit are required to supply or buy overseas
- No fixed assets are available for collateral

Benefits of Asset Based Lending

- Low rate of Interest: Compared to the unsecured loans, the rate of interest of such asset-based finance is much lower. This is because the lenders money is safe with the availability of the collateral item on non-repayment of the loan.

- Liquidity: This gives greater liquidity from strong cash position. The assets are also available when the need arises for working capital loan, to bridge the financial gap in the business life cycle. As the company grows, the financial needs grow. At the same time for the growth the liquidity is very relevant. The loans are available regardless of the economic condition of the borrower.

- Profit and Loss and credit history: One major benefits of the asset based financing is that the asset value is of relevance to the financing company and not your credit history or the cash flow status.

- Quick Finance: The financing organization lends the amount required quickly with least hassles. Thus, when there is an urgent need for finance to capitalize on a great business opportunity, it can be accessed with the help of the asset pledged. It is thus useful to meet the seasonal need, rapid growth, acquisitions etc…7

- Commitment: The asset-based loans have flexible repayments plans. Short-term asset based loans get paid off quickly from the accounts receivable and the inventory.

- Many companies provide customized lending, depending upon the needs of the organizations. Some companies also have expertise in specific industries that is beneficial to understand the finance needs of the company.

- Financial discipline: The borrowing availability is dependent on the advance rates on the accounts receivables. This makes the borrowers collect the receivable amount in a more disciplined manner. Moreover, as only the completed products are eligible for financing, the company improves on efficiency in the production process.

- Few financial covenants: The asset-based loans require only a few covenants like debt service coverage and net worth as they are based on the collaterals.

- In tough financial conditions, the lender shows the willingness to give more time to the borrower as he has the collateral to protect the loaned amount.

- Industry expertise: The financing companies have expertise in dealing with the retailers, manufacturers, distributors and importers within industries dealing with automotive parts, apparel, consumer products, food and beverages, steel and transportation. Thus, these companies extend help to nearly all businesses.

Asset based lending is useful when a company has a requirement for working capital and funds for new acquisitions and major capital expenditures. It also fills in for the funds required restructuring the business and to take care of other finance needs.