WHAT IS ASSET BASED LENDING?

Asset Based Lending is practice of underwriting and managing loans based upon the value of the borrower’s assets rather than the leverage profile of the borrower’s balance sheet.
WHAT DIFFERENTIATES AN ASSET BASED LOAN FROM A TRADITIONAL COMMERCIAL LOAN?

- **Financial Performance.** Asset Based loans are typically more tolerant of financial deterioration that may be brought about by market conditions and/or management issues.

- **Leverage.** Asset Based loans are focused on the value of the borrower’s assets rather than a multiple of cash flow. This makes ABL a great alternative for borrowers with significant working capital needs and/or large investments in fixed assets.

- **Use of Proceeds.** Acquisitions, business expansion, recapitalizations, stock purchases and shareholder dividends are just a few examples of acceptable use of proceeds for ABL transactions.

WHAT TYPES OF ASSET BASED LOANS ARE AVAILABLE?

- **Revolving Credit Facilities**
  - Accounts Receivable
  - Inventory

- **Term Loans**
  - Machinery & Equipment
  - Real Estate

WHAT ARE TYPICAL ADVANCE RATES FOR ASSET BASED COLLATERAL?

- Up to 85% of Eligible Accounts Receivable
- Up to 70% of Eligible Inventory
- Up to 85% of Net Orderly Liquidation Value of Equipment
- Up to 75% of Fair Market Value of Real Estate
HOW ARE ASSET BASED LOANS STRUCTURED?

• Revolving Credit Facilities: A borrowing base is developed based on the assigned value of the borrower’s collateral. Typically, the borrowing base contains:
  – Accounts Receivable
  – Inventory

• Less common forms of collateral in an Asset Based borrowing base may be:
  – Cash/Marketable Securities
  – Cash Value Life Insurance
  – Non-Current Receivables
  – Unbilled Accounts Receivable
  – Fixed Assets

HOW DO YOU DETERMINE BORROWING BASE AVAILABILITY?

• Due Diligence: The ABL lender performs a field examination of the borrower’s books and records. The field examiner will review the following collateral-oriented review procedures:
  – Dilution Review
  – Contra Accounts
  – Sales Terms
  – Inventory Test Counts
  – Inventory Conversion Testing
  – Inventory Excess/Obsolete Review
  – Inventory Remote Locations Review

WHAT ARE TYPICAL INELIGIBLE ACCOUNTS RECEIVABLE?

• Past Due > 90 Days from Due Date
• Cross Age: > 25% Past Due > 90 Days from Due Date
• Affiliate Receivables
• Contra Accounts
• Extended or Dated Terms
• Government Accounts
• Foreign Accounts Receivable
**WHAT ARE TYPICAL INELIGIBLE INVENTORY CATEGORIES?**

- Work In Process (WIP)
- On-The-Water Inventory
- Excess / Obsolete Inventory
- Packaging Materials and Supplies
- Samples
- Consigned Goods
- Goods Held in 3rd Party Locations without Bailee Letters or Landlord Lien Waivers
- Hazardous Materials
- Controlled Substances
- Inventory at Remote Locations

**ARE THERE OTHER STEPS INVOLVED IN DUE DILIGENCE?**

Depending on the situation, an ABL lender may require:

- Inventory Appraisal
- Fixed Asset Appraisal
- Third-Party Business Plan Assessment

**WHAT HAPPENS WHEN THE DUE DILIGENCE IS COMPLETED?**

The account officer will review the findings of the field examination and appraisals (if needed).

A borrowing base for the company will be tabulated and compared against:

- the amount of debt needed to repay any existing senior secured debt
- the amount of debt needed to fund other uses at closing (e.g.: acquisition, dividend, stock repurchase, etc)
- the amount of excess availability required at closing.

If the tabulation of the borrowing base and sources and uses provides adequate availability, then approval is sought.

If there is insufficient excess availability, then outside sources of liquidity such as sub debt and/or equity may be required.
HOW IS AN ASSET BASED LOAN DOCUMENTED?

The documentation process for an asset based credit facility is similar to the documentation of a commercial banking loan.

There is a loan agreement that outlines the credit terms.

UCCs are filed on the collateral securing the loan.

If necessary, Inter-creditor agreements and/or subordination agreements are negotiated.

WHAT IS THE REPORTING ROUTINE?

The borrower is expected to provide a borrowing base report which shows availability based on eligible collateral. Details about A/R aging, composition and ineligible collateral are a part of this reporting package. Typically these reports are delivered monthly.

SAMPLE ABL BORROWING BASE – A/R

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Accounts Receivable</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>LESS: Past Due &gt; 90 Days</td>
<td>&lt;$ 500,000</td>
</tr>
<tr>
<td>LESS: Cross-Age @ 25%</td>
<td>&lt;$ 200,000</td>
</tr>
<tr>
<td>LESS: Affiliate Receivables</td>
<td>&lt;$ 200,000</td>
</tr>
<tr>
<td>LESS: Contra Accounts</td>
<td>&lt;$ 100,000</td>
</tr>
<tr>
<td>Total Eligible Accounts Receivable</td>
<td>$ 9,000,000</td>
</tr>
<tr>
<td>Advance Rate</td>
<td>85%</td>
</tr>
<tr>
<td>Available Accounts Receivable</td>
<td>$ 7,650,000</td>
</tr>
</tbody>
</table>
**SAMPLE ABL BORROWING BASE – INVENTORY**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Inventory</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>LESS: Work In Process</td>
<td>&lt;$2,000,000</td>
</tr>
<tr>
<td>LESS: Excess/Obsolete</td>
<td>&lt;$ 500,000</td>
</tr>
<tr>
<td>LESS: Packaging/Supplies</td>
<td>&lt;$ 100,000</td>
</tr>
<tr>
<td>LESS: Remote Locations</td>
<td>&lt;$ 100,000</td>
</tr>
<tr>
<td>Total Eligible Accounts Receivable</td>
<td>$ 7,300,000</td>
</tr>
<tr>
<td>Advance Rate</td>
<td>60%</td>
</tr>
<tr>
<td>Available Inventory</td>
<td>$ 4,380,000</td>
</tr>
</tbody>
</table>

**SAMPLE ABL BORROWING BASE – SUMMARY**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available Accounts Receivable</td>
<td>$ 7,650,000</td>
</tr>
<tr>
<td>Available Inventory</td>
<td>$ 4,380,000</td>
</tr>
<tr>
<td>Total Available for Borrowing</td>
<td>$12,030,000</td>
</tr>
<tr>
<td>LESS: Outstanding Revolver Bal.</td>
<td>&lt;$9,000,000</td>
</tr>
<tr>
<td>Net Excess Available for Borrowing</td>
<td>$ 3,030,000</td>
</tr>
</tbody>
</table>

**WHAT ELSE DO WE NEED TO DO TO MONITOR THE LOAN?**

- Periodic field exams
- Collateral test counts
- Regular reviews of financial statements
- Meetings with management
WHAT ARE THE PITFALLS OF AN ASSET BASED LOAN?

- Deviating from Underwriting Standards
- Poor Documentation Practices
- Failure to Enforce Monitoring and Reporting Procedures
- Lack of Regular Field Examinations
- Absence of Periodic Meetings with Management and Ownership

ABC CO. – AN EXAMPLE OF THE PITFALLS OF ASSET BASED LENDING

ABC Co. is a Wisconsin-based manufacturer and distributor. The company operates three subsidiaries, each of which have a unique product that is manufactured and distributed. Sales had grown modestly, from $50MM in 2010 to $64MM in 2015. The company relied on its $12MM asset based line of credit to fund its working capital needs. The company was experienced in asset based lending, having used an asset based revolver for over 10 years.

The company’s financial results were mixed. Competition had caused gross margin erosion of about 2% over a five year period. Long-time customer relationships were lost to competitors, but ABC Co. was able to offset these losses with new customer relationships. The erosion in the gross margin was partially offset by gradual staffing reductions and practices aimed at cost reductions, such as fewer staff meetings and limitations on business travel.

The company’s owners were not active in the day-to-day operations of the company. While two of the owners held the titles of CEO and President, respectively, they left the daily operations in the hands of a seemingly capable team of managers. Each subsidiary had its own business leader. The financial management of the company was handled by a CFO who was an employee of ABC Co.

ABC CO. – CONTINUED

In January 2014, ABC Co. began to experience intermittent over-advance needs. Initially, the over-advances occurred once or twice a month, and in amounts less than $200K. The CFO explained that it was due to poor timing brought about by finance department staffers having to take on more responsibility. The over-drafts only lasted a day, and availability was always restored with the submission of a new borrowing base.

The account officer met with the CFO to discuss the situation and was assured that the situation would be remedied immediately. Ownership was absent from the meeting, which was unusual, but it was explained that they were busy with personal matters and had been fully apprised of the situation by the CFO.

By June 2014 the over-advance needs had become more prominent, with one over-advance eclipsing $1MM. The CFO was submitting new borrowing base reports 2 or 3 times a week as a means of curing outstanding over-advances. These borrowing base certificates lacked the required supporting detail. The CFO explained that the company’s system could not generate the supporting detail on such a frequent basis, but assured the account officer that the borrowing base certificates were accurate.
Unhappy with the lack of supporting detail, the account officer requested a meeting with management and ownership to discuss the worsening liquidity position. The CFO arranged the meeting, but explained that management would not be in attendance due to the company’s limitations on travel expenses. However, management would be available by phone and ownership would be at the meeting.

The account officer arrived at ABC’s offices, however, only the CFO was there for the meeting. The CFO explained that ownership had been told the meeting was the following week and, unfortunately, they were unable to reschedule their obligations to attend the meeting. When the time came to connect ABC’s management via teleconference, the CFO discovered that the phone system in the conference room did not work properly.

The account officer now realized something was not right and told the CFO a field exam needed to be scheduled immediately. It was agreed that the field exam would begin the following week. Two days later, the CFO called the field examiner directly to reschedule the audit to the following month. The reason given was that two key staff members had vacation scheduled over the next two weeks. The CFO assured the field examiner that this change had been cleared through the account officer.

With over-advances continuing and the field exam delayed, the account officer set a meeting with ownership and management to discuss the current situation. During this meeting the account officer discovered that neither management nor ownership were aware of the over-advances. Further, the subsidiary managers expressed their frustration with the fact that the inventory reports for their businesses seemed overstated compared to their inventory on-hand.

With the assistance of ABC’s ownership the field exam began immediately. The CFO abruptly resigned the day after the commencement of the field examination. In the days and weeks that followed, we discovered that the CFO had embezzled over $1MM from the company and had hidden more than $2MM in operating losses.

Neither ownership nor management was involved in the fraudulent activity. The CFO explained that the funds were used for personal expenses and losses were covered up to avoid questions from ownership.

Never Deviate from the Reporting Schedule. ABC Co’s CFO was able to cover the growing fraud by submitting borrowing base certificates more frequently than the weekly schedule set forth in the loan agreement. By submitting borrowing base certificates on an non-standard schedule the CFO was able to avoid sending critical support documents that would have alerted the account officer that things were amiss.

Delaying / Rescheduling Field Exams are Reasons for Concern. The field exam is an asset based lenders best means of monitoring the integrity of reporting and the quality of collateral. Delays in the field exam, even for the best of reasons, is cause for concern. In the case of ABC Co., the CFO knew that the field exam would reveal the fraud. While the CFO’s reasons for postponing the field exam seemed reasonable at the time, it was later determined that the delays created significant exposure for the bank.

Meet Regularly with Management and Ownership. The account officer allowed the CFO to become the sole point of contact. Sensitivity to travel costs and personal schedules overshadowed the need for regular contact with management and ownership. Had the account officer met with management and ownership earlier, it would have been learned that the subsidiary managers were frustrated by inventory discrepancies which would have been a clear signal that there were issues with the company’s books and records. Further, it would have been revealed that ownership was unaware of the growing liquidity issues.
When underwritten and managed correctly, asset based loans offer safety and returns that are attractive to banks of all sizes. However, even well-seasoned asset based lenders are susceptible to fraudulent activity.

The keys to success in asset based lending are:

- Thorough **Due Diligence Review** of the Borrower
- **Proper Documentation**, including UCC filings and Appropriate Subordination and Inter-Creditor Agreements
- **Detailed Collateral Reporting** on a Regular Basis
- **Disciplined Routine Monitoring**
- **Regular Field Examinations** to Ensure Accuracy of Reporting and Quality of Collateral

**QUESTIONS**