

The Fundamental Benefits of Today's Asset-Based Finance

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Companies in an array of industries and at varying stages of their lifecycles use asset-based loans for a multitude of reasons including mergers and acquisitions, debt refinancing, capital expenditures, working capital, leverage buyouts and even employee stock ownership programs. In fact, according to the Commercial Finance Association, the total value of outstanding asset-based loans surpassed the \$500 billion mark for the first time in 2007, reaching \$545 billion.

Structures

An asset-based loan is a secured loan that is backed by assets such as accounts receivable and inventory, and is typically structured as a revolving line of credit. The borrowing base is usually calculated at between 70 and 85 percent of accounts receivable and up to 65 percent of inventory. The borrower is required to make interest payments only and the revolving loan balance increases and decreases in concert with the borrower's assets.

In addition to the revolving line of credit, an asset-based facility may include a term loan secured by fixed assets such as machinery, equipment and real estate. The term loan portion generally carries a repayment schedule that is equivalent to the useful life of the fixed assets.

While asset-based loans traditionally are secured with tangible assets, borrowers may be able to generate additional liquidity using trade names, patents and intellectual property as collateral. Looking beyond traditional inventory and receivables toward intangibles is what lenders refer to as an "overadvance" or "stretch loan." An overadvance, which features elements of both an asset-based loan and cash flow loan—a loan based on a company's earnings—is a highly versatile structure.

Borrower Benefits

Asset-based finance is used by financially healthy borrowers as well as companies that have experienced diminished or inconsistent cash flow due to seasonal needs, a weak economy or a cyclical industry. Borrowers often choose asset-based finance because it offers a number of advantages over cash flow loans. Cash flow loans, which typically come with restrictive financial covenants, rely heavily on the borrower's operating performance. Asset-based loans look primarily at the company's assets, and can offer borrowers the following benefits:

Enhanced Liquidity: If a company borrows against a multiple of EBITDA (earnings before interest, taxes, depreciation and amortization) and its earnings decline, its borrowing capacity is diminished. Borrowing against assets may result in greater liquidity and more predictable availability.

Greater Flexibility: Asset-based loans generally require one or two covenants whereas cash flow loans typically have four or five such as fixed charge coverage, EBITDA minimum, interest rate coverage, and leverage ratio maximum. Asset-based lenders aren't as concerned about these financial performance metrics since their loans are tied to collateral value. This flexibility frees management to focus on executing the operating plan rather than worrying about violating quarterly covenants.

More Versatile: Asset-based loans also may be more flexible when it comes to how the company can use the proceeds. Unlike cash flow loans, asset-based loans may permit a company to buy back a portion of its bonds, repurchase shares of stock or provide more freedom to pursue potential acquisitions.

Lender Patience: With collateral securing the credit facility, an asset-based lender is usually willing to give the borrower more time to turn around the company in the event of financial difficulty. Often forward-thinking chief financial officers put asset-based loans in place for the protection they can provide should an economic downturn materialize.

Financial Discipline

Asset-based loans carry some monitoring and reporting disciplines that are related to the borrower's credit profile. As a general rule, healthy companies have more leeway when it comes to reporting while distressed companies need to check in more frequently.

For example, the borrower provides the lender with a Borrowing Base Certificate, showing the relationship between the value of the collateral available to secure a loan and the actual balance of the loan. Depending on the credit risk of the borrower, it may be required by the lender monthly, weekly or daily. The borrower also provides common reports that include aging of accounts receivable on a monthly basis, inventory listings, daily sales invoices and shipping documents. Information is transmitted electronically, which makes the process fast and convenient.

In addition, the lender has dominion over the borrower's cash by establishing a deposit account or lockbox into which the borrower's accounts receivable are collected and then used to directly repay the loan. The lender also performs periodic field exams and inventory appraisals, to validate the accuracy of the reports, substantiate accounts receivable and inventory values, and confirm ineligible collateral. Trade names may be re-evaluated on an annual basis, a process that can benefit both the borrower and lender since the value of the trade names of growing companies is likely to increase.

Total Financing Solution

Many asset-based loans today are used in combination with other financial products or services including treasury management, foreign exchange and interest rate hedging, and investment banking products and services. Many borrowers look for lenders that have broad capabilities and can offer a total financing solution. The result is a total capital structure that allows the company to meet current customer needs, pursue strategic growth plans and improve operational efficiency.

This white paper is meant to be a general introduction and overview of the benefits of asset-based financing, but is not a substitute for experienced professional advice and guidance relative to the best financing option for your business. You should consult with your legal and financial professionals in order to determine the most appropriate financing option for your circumstances.

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