Hybrid Asset Based Lending: Controls Are Necessary

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As an independent loan review provider to approximately 150 foreign and domestic lending institutions, CEIS Review has the benefit of being able to gain insights towards the emerging and prevalent developments within the banking arena regarding commercial lending activities. One such is the entrance or expanded interest of some banks to engage in hybrid asset-based lending operations with varying levels of success and effectiveness. While portfolio and income fee diversification is important, the increased activity should be fully vetted before the additional risk is added to the portfolio.

Hybrid asset-based loans involve a unique credit structure designed to solve certain specific credit needs of customers by combining cash flow and asset-based lending in one credit facility. While the portion of the loan approved on a cash flow coverage basis is often managed with financial covenants, the asset-based loan portion is supported by collateral coverage that is monitored with a monthly borrowing base. Therefore the lender must regularly ensure proper levels of both collateral and cash flow are acceptable prior to disbursement of loan advances. More importantly, as this type of transaction is ever evolving, the lender should identify and be prepared to initiate at least two exit strategies.

Banks generally offer hybrid asset-based lending to borrowers as their overall financial position and/or operating performance does not otherwise qualify for terms "typically" associated with a bank loan. The prospective borrower may be characterized by any one or a combination of issues such as strong growth, high leverage, undercapitalization, "temporary" operating losses, seasonal requirements, etc. Loans are made directly to operating companies and include manufacturers, wholesalers, distributors, retailers, and service companies. Financing can be used for, among other things, working capital, acquisitions, recapitalizations, and dividends. Most often the banker's accommodation is an interim measure with the belief that the borrowing entity will at some point (1-3 years) qualify for terms associated with "typical" loan extensions.

As hybrid asset-based loans are made to non-investment grade companies, a lender must employ a disciplined approach for monitoring compliance and managing exit strategies. Banks that are successful in this arena identify a clearly defined target market to participate in, and then set specific risk assessment criteria for that market before engaging in lending.

Each deal requires detailed analysis of borrower's financial position, historical and projected operating performance. And as collateral performance and availability are essential to the transaction, analysis of receivable quality (e.g. turnover, dilution, terms of sale, payment history, class of debtors, etc.) is important. The sufficiency of the cash budget to support operations and to meet obligations as projected for each of the following 12-months should be also assessed.

Proper due diligence is necessary to justify the terms of the loan.

Monitoring

- Financial Statements and Borrowing Based Certificates

  The loan agreement should require timely submission of financial statements and monthly borrowing base certificates. Both should be carefully analyzed by the relationship manager for issues, changes, trends, etc. The borrowing base structure should not be considered an abundance of caution, but a critical component of relationship management as the risk of insufficient collateral coverage must be eliminated. Unlike real estate collateral loans, accounts receivable and inventory financing need frequent updated monitoring.

- Field Exams

  A wide variety of issues can cause a borrower's cash flow to deteriorate, not the least of which is re-stated financial statements. Therefore, a field exam conducted by a proven ABL examiner should be a condition prior to funding and at least annually thereafter. The field exam usually takes a week or more to perform but provides the lender with important and detailed current information.

  The bank must understand the full scope of its exposure to credit risk. Therefore there are numerous cash flow and collateral issues reviewed by the field examiner that can include: quality of earnings, financial trends, gross margins, terms of sale, class of debtors, cross-age, concentrations, contras, turnover, dilution, bill & hold, progress billings, etc. If cash flows weaken for any reason, the loan should be converted to a fully monitored asset-based loan while there may still be collateral coverage.

  The Field Exam is a detailed and comprehensive report which should be thoroughly evaluated by a corporate finance professional with in-depth knowledge of leveraged finance and asset-based lending. The relationship manager should watch for changes, weaknesses, trends, unexplained fluctuations, etc.

  While the borrower generally pays for the Field Exams, the lender must ensure that the time and money are well spent. Field exams provide essential information about ineligible collateral, necessary reserves, and overall advance rates for the varied collateral mix in the borrowing base.

  As long as the bank receives timely financial statements, timely monthly borrowing base and the loan is in full compliance - a field exam should only be needed once a year.

- Covenants and Triggers

  Hybrid asset-based loans need covenants and triggers that can be tracked to detect negative operating performance, too much rapid growth or negative borrowing base trends. A well-controlled loan provides early warning signs that can be tracked. At a minimum, review quality financial statements should be required a requirement; although more frequent field audits may offset accepting lesser quality financial statements. Monthly or quarterly financial statements must be spread in a timely manner and evaluated for adequate loan coverage and trends. Triggers for more frequent field exams should be established based on specific performance metrics.

Fixed Charge Covenant

In addition to reporting and field examinations, the loan agreement should require a rolling four quarter fixed charge covenant of 1.25x. If it falls below the covenant, the loan should be considered for reclassification to a full asset-based loan which requires more frequent collateral reporting and at least two field exams per year. It may also be advisable to have the inventory appraised. Additionally, managing for cash is critical (e.g. leasing instead of buying equipment, discounting or securitizing receivables, etc.).

Liquidity Covenant

A minimum liquidity covenant of at least 10% of excess availability from the borrowing base should also be mandated. Violation of this covenant would also initiate a full asset-based loan process.

- Stress Testing

  The lender and the borrower should periodically stress test monthly projections to determine adequate cash flow and liquidity coverage. The relationship manager must have confidence in the borrower's ability to meet a changing environment.

On-Going Management

The relationship manager and supervisor should be pro-active and accept accountability for responding to the borrower's performance. Being so, a monthly sign off should be required regarding compliance and approved exceptions. Additionally, any trends should be noted.

Diligent monitoring of cash flow and collateral coverage is necessary to detect early deterioration and is required for proper on-going management. Cash flow loans are fine when they cash flow, but when debt / EBITDA multiple exceeds 4x one needs confidence that the collateral has been monitored and will be sufficient to provide an adequate fallback position. Although other potential exit strategies exist: guarantees, refinance, asset sales and capital infusion – one frequently returns to collateral protection as the primary exit strategy. The lender must remain vigilant lest he/she finds themselves struggling to meet the liquidity needs of a desperate client.

Transition

Once a loan is determined to require full monitoring, the transition should be smooth for the customer. Providing future adequate financing is a must. The ABL process usually requires electronic reporting on receivables, payables, inventory, etc. These reports are already prepared by the customer and can be transferred easily. The ABL department can efficiently manage this information for accurate controls and borrowing. ABL teams analyze, appraise, monitor, and verify the collateral. Defaults will occur, but ABL losses should be minimal. If the borrower is in compliance, he has the comfort of knowing that there is a binding contract that generally remains available for three years.

The Stucky Electronic Operating System is used by virtually all ABL shops and greatly streamlines reporting for both the customer and the bank. The system provides complete clarity regarding sub-limits, dilution, ineligible, borrowing availability, etc.

Conclusion

There is no need to lose a valued customer as long as the bank can provide adequate financing. Historic losses using ABL are low and many banks will improve the risk rating if the loan is properly monitored with full collateral protection.

A bank should only book asset-based hybrid loans if they have lenders experienced in this area and organizationally, the structural know-how. Otherwise, the bank should consider developing a strategic alliance to out-source this service or consider exiting the loan through a refinance. An advisory comment is to not fall into the trap of thinking the only asset(s) you need to follow is the collateral in the Borrowing Base. A broader perspective on the borrower's assets, liabilities, and cash flow are warranted.

It is important to keep your customer happy, but naturally, hybrid asset-based lending is potentially an area for notable losses if the bank's internal skills and internal structure does not follow good practices.

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