

INITIATIVE

The Pulse of New Jersey Business

THE STIGMA IS GONE:

More Companies Turn to Asset-Based Lending for Working Capital

Once considered the “financing strategy of last resort”, Asset-Based Lending (ABL) has been growing in popularity and helping to drive an economic turnaround for businesses across the region.

During the country’s sustained period of economic uncertainty, companies seeking working capital through traditional bank financing saw many lenders pull back on their lending.

As a result, an increasing number of companies explored financing alternatives – ABL being one of them – to secure access to credit and fuel their growth. This renewed appetite is reflected in [The Quarterly Asset-Based Lending Index, Q3 2010](#) (see chart below) published by the Commercial Finance Association that revealed a number of vital signs:

- Commitments for new credit increased 2.7 percent in Q3.
- 35 percent of reporting asset-based lenders saw increases in new credit commitments.
- Credit line usage rose to 36.8 percent – the fourth consecutive quarter of growth.

These indicators are sending clear signals that more businesses – attracted by the lower risk profile needed to secure an asset-based loan – are pursuing ABL as an alternative to traditional bank financing to meet their credit needs.

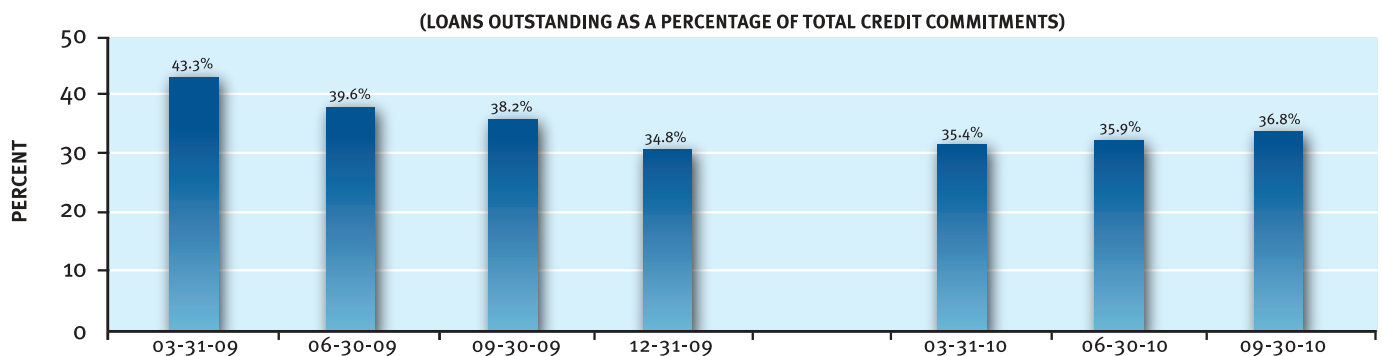
Asset-Based Lending At A Glance

An asset-based loan is secured by an asset (e.g., accounts receivables or inventory) pledged by a borrower whereby the lender focuses on the value of the assets or collateral when structuring the loan’s terms and conditions. This process stands in contrast to the more traditional underwriting guidelines that involve the close scrutiny of credit worthiness, minimum net worth, debt-to-equity ratios, working capital, and other criteria.

Strategically, ABL provides an opportunity for businesses of all sizes to borrow against their assets and secure operating capital to meet any number of seasonal or cyclical cash flow needs. Assets such as accounts receivables, inventory, equipment and machinery have often been overlooked by bank lenders as many of them viewed asset-based loans as a life raft appropriate only for marginal companies.

However, evolving changes in the economic landscape and advances in technology are making ABL more viable to lenders and borrowers alike.

Qualification criteria: The preference of asset-based lenders is to work with companies whose collateral can be converted quickly into cash if circumstances dictate.



Source: [The Quarterly Asset-Based Lending Index, Q3 2010](#). The Commercial Finance Association, October 2010.



Terms: Rates for this type of loan are usually higher than those of traditional bank loans, and generally lower than terms and conditions available with most credit card programs. The rule of thumb regarding interest rates is “The more liquid the asset offered as collateral, the lower the rate”.

According to [The Wall Street Journal](#), the majority of asset-based lenders operate with loan-to-value ratios of around 60 percent on hard assets and up to 80 percent on accounts receivables.

Uses: Companies apply their asset-based loans to fulfill a broad range of needs, including acquisition, merger or leveraged buyout, debt consolidation, growth and expansion, inventory, reorganization, obligations and payroll, and import and export trading.

What's Driving ABL Growth?

In the aftermath of the credit crunch, banks have emerged far more risk averse when it comes to lending. Attracted by its inherent flexibility, availability and safety, many have turned to ABL as a viable solution for their customers compared to other, more traditional loan practices.

Prior to the recession, borrowers tended to retain more control over their business based on credit and collateral agreements that appeared loose by today's more disciplined standards. In the current world of double due diligence however, lenders are applying more stringent underwriting criteria. This process makes them more likely to offer fully secured, asset-based loans since they provide added protection, more recourse through collateralization, and more control should problems occur in the borrower's business.

From a strategic perspective, ABL tends to work best for capital-intensive businesses with significant assets that can be collateralized and quickly converted to working capital. Since most companies have accounts receivables, they can put up those assets to secure funding. Good prospects for asset-based loans generally cluster in the following business sectors:

- Manufacturing
- Retail
- Distribution
- Business and Professional Services

Companies leveraging ABL financing can take advantage of emerging opportunities such as the strategic acquisition of a competitor or a product line extension. For those business leaders whose organizations are experiencing steady growth but have limited capital investment, asset-based lending can provide working capital to drive your expansion.

Borrowers can generally obtain these loans more expediently, with less creditworthiness and fewer financial requirements than traditional financing. There are some lenders with industry-specific expertise who are more likely to propose terms that

capitalize on business cycles and other factors germane to that line of business. Some lenders also bundle additional services such as payment processing and collections along with the loan to consolidate related functions.

Asset-based loans can also be set up as a revolving lines of credit linked to asset value. This enables borrowers to access their line only when needed, and pay it back with a greater degree of certainty.

Caveat Emptor

While attractive to both lenders and borrowers, asset-based lending is not without risk. For example:

- Asset values tend to fluctuate on a regular basis placing pressure on the lender to maintain the correct loan-to-value ratio. This tends to make the best ABL prospects those companies with the most reliable valuations.
- According to [CFO Magazine](#), sales concentration (having over 20 percent of sales with one customer) dilution (large percentage of returns and chargebacks) and aging can all affect the total funding a lender is willing to advance.
- Information fraud and the manipulation of data present potential pitfalls, but can be offset by applying collateral monitoring and auditing procedures.

Borrowers should also be clear that in addition to higher rates, asset-based loans are secured transactions and, therefore, less forgiving. In the event of severe financial trauma, the lender has the authority to seize those assets if principal is not repaid.

Looking Beyond the Horizon

Despite traditional bank lending having been affected across the board by the recession, company debt is still being used as a borrowing tool making ABL a viable alternative to traditional lending. If a company is in a leveraged position or is coming off a turn around, the asset-based lender is willing to look past the leverage. The company can maximize its loan by borrowing against accounts receivable, inventory and machinery and equipment. As a result, the company is able to not only survive but thrive.

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