CONSIDERING AN ASSET-BASED LOAN?

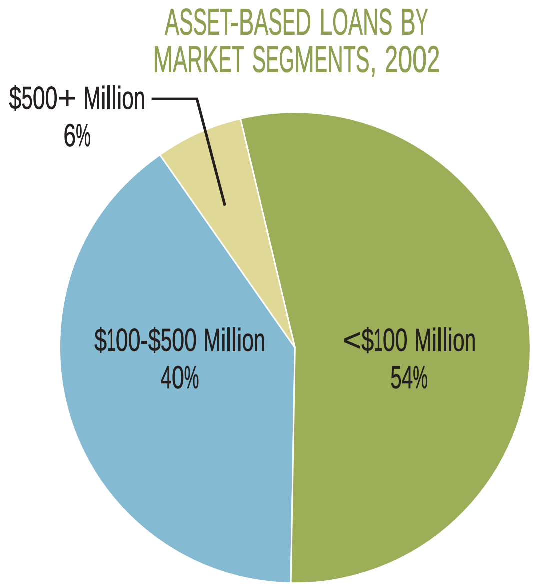
YOUR LENDER CAN BE A SOURCE OF BOTH FUNDS AND ADVICE

BY SAM PHILBRICK

Credit markets are loosening again. But traditional sources of debt remain elusive for many small and medium-sized enterprises (SME). These companies wanting to borrow $5 million to $20 million might consider asset-based financing.

Asset-based financing is typically structured as a revolving line of credit and secured by a company's accounts receivable, inventory, equipment, and/or real estate. SMEs are usually privately held businesses in which the majority shareholder is the president, chief executive officer, and chief financial officer. He or she typically makes business decisions first and worries about the financing later. Board approval for finance decisions is seldom required. These business owners are usually sales driven and growth oriented, and their entrepreneurial nature often results in earnings and enterprise value volatility that can preclude traditional financing options.

ILLUSTRATION: ARTDISC



Source: Loan Pricing Corporation

Because most business owners are loath to relinquish equity, and junior secured lenders rarely serve this segment, senior debt is the primary form of financing. Also, SMEs tend to be more cyclical than larger companies because their businesses may rely on one product line or customer base. They seek financing for a variety of reasons, such as equipment purchase, product or market expansion, acquisition, succession planning, or change of ownership. Their first foray into financing is often an asset-based structure.

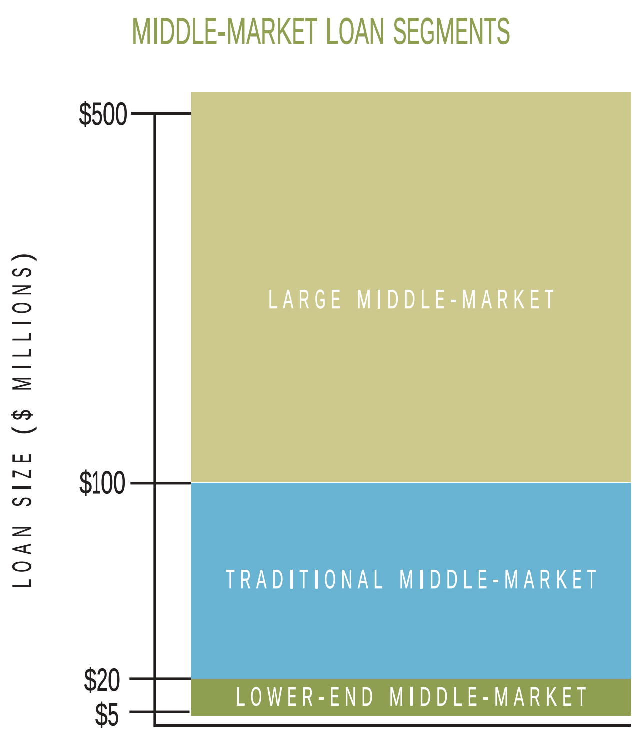
For example, CD&L, which provides ground and air transportation services, had overextended itself on acquisition debt and wanted to repay a portion of it and have more working capital. It decided against a traditional bank loan for a couple of reasons. The loan would have been structured around tighter covenants than an asset-based loan and wouldn't have allowed as much debt to be outstanding when the company needed it most. Instead, CD&L borrowed $15 million against the value of the company's accounts receivables, giving CD&L sufficient financing to support its self-insurance program, gradually pay down acquisition debt, and continue to grow its business.

In another asset-based borrowing example, S. Walter Packaging, a distributor of packaging, wanted to acquire competitor Franklin Packaging, Inc. It also wanted to refinance its existing line of credit and add working capital to help pay for additional acquisitions. The company was able to service an asset-based loan because, as revenues grew, it had sufficient collateral. S. Walter Packaging secured a $6 million revolving asset-based credit facility, which allowed the company to pursue its acquisition strategy. The result was a 48% growth in revenues in just one year.

WHAT BORROWERS CAN EXPECT

So what should a borrower expect? First, asset-based loans under $20 million usually come from one lender, making these loans less consistent in pricing than, for example, large syndicated loans. In a syndicated transaction, a group of lenders and investors usually divide loans of more than $100 million to spread the risk. These larger loans are priced within a narrower band to meet the needs of a larger group of lenders and investors. In contrast, there is more price fluctuation of smaller asset-based loans because a single lender often structures the loan and holds all the risk. Pricing of loans under $20 million usually exceeds syndicated transactions by 100 basis points or more.

SMEs' financial statements are often not audited, which means the lender must rely solely on its own analysis of the borrower's creditworthiness. But it's easier for a lender to understand a company with $30 million in revenue than a more complicated company that has more than $1 billion in revenue. In addition, because there's less distinction between a small, private company and the person running it, much of what the lender is underwriting is the individual's capabilities and commitment to the



Source: Loan Pricing Corporation

ASSET-BASED LENDERS UNDERSTAND THAT QUICK TURNAROUND IS OFTEN ESSENTIAL FOR AN SME'S SURVIVAL.

business. So the lender typically expects the SME owner to have something at risk, although a personal guarantee may not be required.

Most middle-market asset-based loans center on a revolving line of credit, usually for a term of three years. At the lower end of the market, borrowers expect the lender to satisfy all of their financing needs: working capital as well as property, plant, and equipment. Consequently, credit generally includes not only a three-year revolver but also a term loan in which real estate is amortized for 15 years and equipment is amortized for five to seven years. With one lender providing a multi-loan credit package, borrowers in this end of the market can spend less time thinking about their financing needs and more time focusing on managing their businesses.

In addition, because asset-based lenders typically understand that quick turnaround is often essential for an SME's survival, a borrower can reasonably expect the lender to move fast on a loan application and be responsive throughout the relationship. Also, SMEs tend to be more comfortable with local and regional lenders that live and work in their communities because lenders such as these often have first-hand knowledge of the market conditions in which the SME operates. Lenders capable of giving the borrower counsel as well as capital often serve as an extension of the enterprise.

The borrower/lender relationship is never more important than during periods of economic slowdowns as well as those of rapid growth. When business conditions slow, a lender can give a borrower advice about finance, cash flow, preservation of capital, and liquidity. Lenders can also accurately project the time and cost required to turn the business around. The same is true during periods of rapid growth. SMEs generally are focused more on growing the business than on improving profitability and creating internal procedures and systems. Growth consumes a lot of capital, and companies experiencing rapid growth use cash quickly. This can be a cause of concern for a traditional lender, which monitors the company by balance sheet leverage, but not for a collateral-focused asset-based lender.

To monitor collateral, an asset-based lender also evaluates the borrower's financial systems and controls. Credit procedures and inventory systems, for example, may need to be implemented or modified as the business changes. By establishing these processes and controls, the asset-based lender frees the business owner's time so he or she can focus on growth.

COMPLETING THE LIFECYCLE

A final distinguishing characteristic of SMEs is the need for estate planning. The entire net worth of many SME owners is tied up in the company, so succession issues and retirement planning can be critical. An asset-based lender can help the owner's children gain ownership of the business by either the company or the children acquiring the owner's shares. This way the business can be handed down while enabling the founder to preserve his or her retirement assets. If there is no family-related heir, the asset-based lender can help with the sale of the company to a strategic or financial buyer.

Lenders that support the business from its earliest stages through the final liquidity event are, in the truest sense, lifecycle lenders. Given the nature of the SME, with one credit source and its desire to grow without cash, the asset-based lender may be best.

Overall, asset-based loans are versatile and cost competitive, providing borrowers with operational flexibility. The asset-based lender is able to establish the processes and controls required to manage the changing financial aspects of the company, freeing the borrower to focus on growing the business. ■

Sam Philbrick is Northeast Division president for Fleet Capital, headquartered in Glastonbury, Conn. He's responsible for managing 400 customer relationships. You can reach him at (800) 773-5338 or samuel_philbrick@fleet.com.