# The State of Asset-Based Lending

09/29/15

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Asset-based lending continues to be an important financing tool in today's market, and one that provides benefits to both lenders and issuers. Lenders benefit from their collateral position and low historical loss rate in asset-based facilities, while issuers benefit from lower pricing and increased operating flexibility as compared to other loan products. Asset-based facilities were once looked down upon as a loan of last resort, mainly for companies unable to borrow on the strength of their cash flow or enterprise value. However, asset-based facilities now are mainstream financial products and often are used by private equity sponsors as a key component of acquisition financings. Volume has grown from $50.89 billion in 2004 to $92.61 billion in 2014, according to Thomson Reuters LPC, with a record volume of $101.17 billion in 2011.

The product is prominent across a wide range of industries, with transactions in the retail, steel, auto-supply, rental equipment, logistics, paper and office supply industries, among many others. Asset-based facilities typically feature low pricing, reflecting the low risk of loss to lenders due to their collateral position; a single financial covenant that is only triggered when a substantial portion of the line of credit is utilized; and flexible covenant packages based on unused borrowing capacity. In addition, the ability to borrow directly against foreign assets in many European jurisdictions has helped fuel the increase in asset-based loans in recent years.

Pricing is perhaps the most important aspect of asset-based loans, with performance pricing grids for many issuers ranging from London Interbank Offered Rate (LIBOR) plus 150 basis points at the low end to LIBOR plus 200 basis points at the high end. Unused line fees range from 37.5 to 50 basis points in the current market. The rates offer a lower-cost alternative to a traditional "cash flow" revolving credit facility, and in some cases the differences can be substantial.

The second key element of an asset-based loan is that lenders generally do not include financial covenants unless the borrower utilizes a substantial portion (often up to 90 percent) of the facility. The only financial covenant, once triggered, is generally a minimum fixed-charge coverage test. The fixed-charge covenant generally provides the issuer's ratio of EBITDA to the sum of interest, taxes, capital expenditures, debt amortization and dividends is required to be at least 1.0 to 1.0. In some cases, shareholders have the right to contribute equity to cure a breach of the financial covenant, similar to equity cure rights in cash flow loans. The absence of an ongoing financial maintenance covenant makes an asset-based facility a natural pairing with a covenant-lite term loan (*i.e.*, a term loan without a financial maintenance covenant) or a secured or unsecured bond (which typically do not have financial covenants).

Asset-based lenders also provide flexibility in structuring collateral packages. At one time, they insisted on having a first lien on all assets, only allowing term lenders and bondholders a junior lien. In today's market, often the liens are shared such that term lenders and bondholders have a first lien on fixed assets, while the asset-based lenders retain a first lien on current assets (with each taking a second lien in the other's primary collateral). Intercreditor agreements for these split-lien structures are now fairly standardized on key issues, including standstill periods, access and intellectual property rights, and certain bankruptcy-related waivers. This standardization has significantly reduced execution risk for the issuers because both classes of lenders know what to expect from the outset.

The advent of so-called "payment conditions" in covenant packages also have made asset-based loans more issuer friendly. Credit agreements often contain payment conditions, which provide that if the issuer has a specified minimum level of unused

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borrowing capacity under the line of credit together with a fixed-charge coverage ratio of at least 1.0 to 1.0, the traditional limitations on investments, restricted payments and prepayments of other indebtedness do not apply. In addition, where asset-based loans are part of a larger capital structure, including a term loan or secured bonds, asset-based lenders have been willing to loosen traditional restrictions on indebtedness, liens, asset sales, mergers and other fundamental changes, restrictive agreements and affiliate transactions to more closely match the comparable restrictions in the applicable term loan or secured bonds. One key exception to this general trend is that asset-based lenders continue to resist baskets that grow over time based on retained excess cash flow or consolidated net income and large general baskets for investments, restricted payments and payments of other indebtedness because of their focus on maintaining liquidity. For this reason asset-based lenders assert that borrowers should be required to meet payment conditions to make investments, pay dividends or voluntarily prepay other indebtedness.

Another benefit of asset-based loans is that they may provide availability based on foreign assets. Historically, asset-based lenders were hesitant to lend against assets located in other countries, in large part due to uncertainty as to how the proceeds would be divided up on liquidation and whether priority would be given to certain types of claims (including claims for accrued and unpaid wages, vacation time and pension costs). However, over time, asset-based lenders have become comfortable lending into Canada, the United Kingdom, Ireland, the Netherlands, Germany, Australia and many other jurisdictions. Recently, we have seen U.S. lenders participate in standalone foreign asset-based facilities.

Significant challenges with asset-based loans are twofold: First, issuers must deliver to the lenders a tremendous amount of information relating to the borrowing base on an ongoing basis. Second, the amount available for the issuer to borrow is entirely dependent on the value of its borrowing base. For example, a steel company or an aluminum company that borrows against its inventory is susceptible to declines in commodity prices, which could shrink its borrowing base and thus its ability to borrow.

Asset-based loans can be a powerful financing tool. Given advantages in pricing, covenant flexibility and the ability to borrow against international assets, the asset-based loan is likely to continue to figure prominently in the capital structure of issuers across a broad range of industries.