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Asset-Based Lending: A Powerful Tool With Increasing Flexibility

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Asset-based lending has historically provided to borrowers a number of benefits that are generally not available under cash flow loans, including lower pricing, a general lack of financial maintenance covenants (other than a springing fixed charge coverage ratio when availability is less than a percentage of the line) and greater operational flexibility. Asset-based loans have grown as a financing tool with greater acceptance by lenders of cross-border facilities as well as operating covenant packages that closely mirror the term loan B and high-yield markets, subject to exceptions relating to permitted investments, payment of dividends, and repurchases of stock and prepayments of junior indebtedness.

For borrowers with international operations, the optimal asset-based loan structure would provide a single, worldwide borrowing base, available to support credit needs in every jurisdiction (regardless of the location of the operations' financeable assets). In order to achieve such a structure, the borrowers and lenders must determine whether the laws of the applicable jurisdictions relating to creation, perfection and enforcement of security interests will allow the lenders to obtain expected recovery in a liquidation or restructuring (and whether those security interests are subject to priority claims). Lenders will also want to know if the applicable jurisdictions' insolvency laws generally are beneficial to them. As arrangers continue to push the envelope to provide creative structuring alternatives for their clients, the list of acceptable asset-based lending jurisdictions has expanded, with loans now including borrowing bases in the United States, Canada, United Kingdom, Ireland, Netherlands, France, Spain, Switzerland, Germany, Belgium, Australia and New Zealand, among others.

A true single, worldwide borrowing base may not be available because of jurisdiction-specific issues relating to the borrowers' cash management systems, limitations on guarantees, regulatory requirements affecting lenders and their ability to hold collateral, tax considerations, the ability of the lender group to lend in multiple currencies, and more. Arrangers can seek structuring alternatives to provide their clients maximum flexibility, including the ability to allocate excess borrowing base capacity in one jurisdiction to another jurisdiction, periodically reallocate commitments among jurisdictions, and borrow in one jurisdiction and use the proceeds to make intercompany loans to another.

Another important consideration for borrowers is the harmony of terms, including covenants, between their asset-based loan agreement and their other debt instruments, particularly high-yield bonds and term loans, as borrowers seek to have a substantially identical covenant package across their bonds, term loans and asset-based loan credit facilities. As competition for asset-based loans has grown among lenders and arrangers, especially in the sponsor-led acquisition context, borrowers have been able to negotiate covenant packages in asset-based loan agreements that by and large track their term loan or bond covenants, with a few key exceptions. First, asset-based lenders and arrangers typically do

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not agree to investment, acquisition or restricted payment baskets, or to prepayments of junior indebtedness based on "builder" or "available amount" baskets (which grow based on a percentage of consolidated net income, EBITDA or retained excess cash flows) or achieving a specified leverage ratio. Instead, these are replaced with an unlimited general basket so long as the borrower maintains a specified level of excess availability and a fixed charge coverage ratio of not less than 1 to 1. (Sometimes, if excess availability is sufficiently high, the fixed charge coverage test does not apply.) In addition, asset-based loan arrangers and lenders focus on preserving the core loan terms that are unique to an asset-based loan agreement and would not be found in cash-flow loan agreements, term loan agreements or bond indentures. These terms include borrowing base reporting, cash management, a springing financial covenant, field exams and appraisals, and the ability to establish reserves to react to unexpected future events.

The biggest deals — and rewards — go to the financial institutions that demonstrate the ability to deliver asset-based loans as part of an integrated capital structure, providing the most efficient solutions to the problems borrowers face. Asset-based lenders still enjoy low loss ratios and high recovery levels, even as liquidations have picked up in certain industries (particularly retail). The borrowing base automatically resizes availability with the expansion or contraction of the underlying business, which provides substantial control (and an early warning trigger) to the lender and minimizes potential losses. Asset-based loans also are self-liquidating, particularly in cash dominion — receipts automatically repay outstanding loans, and reborrowing requires the borrower to meet its draw conditions.

The attributes of asset-based loans suggest that corporate chief financial officers can anticipate an asset-based marketplace that will continue to adapt to provide flexible financing on favorable terms.