IBS Asset Based Lending Guide

IBS INSTITUTIONAL CAPITAL

Entrepreneurs Investing in Entrepreneurs

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Financing Challenges for Small & Medium Business

"Many strong businesses seeking growth capital have simply fallen outside of the parameters of bank financing. Entrepreneurs understand that in business, there are ups and downs. IBS strives to understand the story behind the numbers to partner with companies throughout all phases of growth. That is why we are entrepreneurs investing in entrepreneurs. We have *prepared this guide to help you better understand the world of asset-based lending and the many ways businesses can benefit from this type of financing. We hope that this guide will serve you as a key resource.*"

- J. Jackson, Chairman and Chief Investment Officer

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IBS Investment ABL Criteria

IBS Institutional Capital (IBS) provides creative asset-based financing to middle-market companies throughout the United States for acquisitions, dividend recapitalizations, growth, debt restructurings, debtor-in-possession, and turnarounds. IBS provides flexible structures that include revolving lines of credit supported by accounts receivable and inventory and term loans supported by equipment and real estate.

General Lending Parameters

Loan Commitments:

- $1,000,000 to $60,000,000
- Dedicated syndication capabilities up to $500,000,000

Revolver:

- Up to 90% of eligible accounts receivable
- Up to 60% of eligible inventory with higher advance rates available based upon appraisal.

Term Loans:

- Up to 80% of the liquidation value of equipment
- Up to 75% of appraised fair market value of real estate
- Capital expenditure facilities available to finance new equipment purchases

Amortization:

- Up to 7 years – equipment loans
- Up to 15 years – real estate loans

Loans are provided for but not limited to:

- Refinancing
- Acquisition
- Growth
- Distress and Turnaround
- Working Capital

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1. What is a revolving credit facility ("revolver") and how does it work?
A revolver is a loan that can be drawn down and repaid. In a business context, a revolver frequently is secured by the borrower's receivables and/or inventory. This kind of asset-based loan is designed to optimize the availability of working capital from the borrower's current asset base. Here's how it works. The borrower grants a security interest in its receivables and/or inventory to the lender as collateral to secure the loan. This grant of security interest creates the borrowing base for the loan. As receivables are paid, the cash is turned over to the lender to pay down the loan balance. When the borrower needs additional working capital, the borrower requests another advance. The lender manages a revolving credit facility and the related collateral in order to offer the borrower the largest possible loan amount at any given time. Because the borrower's customers are generally not notified of the assignment of the accounts to the lender, the borrower continues to service its receivables. The borrowing arrangement is usually transparent to the borrower's customers.

2. Is asset-based lending such as a revolver a common type of financing?
Yes. According to the Commercial Finance Association, asset-based lending is over a $200 billion market. The users of asset-based lending span a broad range of industries, with manufacturers representing approximately 31% of the total marketplace, followed by wholesalers (28%) and retailers (17%). By revenues, the large majority of these borrowers (71%) are under $50 million in size.

3. What is the principal advantage of using a revolver secured by receivables and/or inventory?
The principal advantage is the acceleration of cash flow to the borrower to support its working capital needs. By using its current assets as collateral, a company is able to generate cash sooner than if it had to wait for inventory to be sold to become accounts receivable and accounts receivable to be paid in cash. Cash is available as needed, and any cash not needed on a daily basis is used to pay down the loan balance and minimize interest expense. A revolving credit facility is actually a very cost-efficient alternative for a business that needs to unlock its working capital without having to slow growth or add to its equity capital.

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4. Why do companies use revolving credit facilities?
Companies generally take the secured revolver alternative when they cannot obtain an unsecured bank loan which, when added to their normal cash flow, would satisfy their working capital needs. In these circumstances, a secured revolver may provide adequate incremental cash acceleration to fund ongoing business operations.

5. What kinds of companies use revolvers?
Many different kinds of companies use revolvers. They are particularly popular among retailers, wholesalers, distributors, and manufacturers because these types of companies (a) can benefit from a cost-effective source of working capital and (b) have specific types of current assets that can easily be pledged as security.

6. Do publicly traded companies use revolving credit facilities?
Yes. Publicly held companies use revolvers for the same reasons any company uses them—to accelerate cash flow. As the capital markets continue to grow and the IPO market continues to operate efficiently, increasing numbers of smaller companies gain access to the public equity markets. Even newly public companies use revolving credit facilities to optimize the use of existing assets to provide working capital. A revolving credit facility often provides a much lower cost source of working capital than raising additional equity.

7. How does a revolving credit facility differ from a term credit facility?
The outstanding loan amount with a revolver secured by receivables may fluctuate on a daily basis. With a term loan, the outstanding amount is fixed for a period of time, such as a month or a year. A term loan generally provides for an agreed-upon payment schedule, and amounts paid on a term loan generally cannot be reborrowed. In contrast, a revolver allows the borrower to borrow, repay, and reborrow as needed over the life of the loan facility. There are advantages to both revolvers and term loans, depending on the borrower's needs. The structure of revolvers provides a great deal of flexibility for borrowing and repayment. Most companies secure a revolver with current assets, such as receivables and inventory, and use the borrowed funds to finance working capital needs. In contrast, companies tend to secure term loans with fixed assets, such as property and equipment, and use the borrowed funds to finance longer-term needs and additional capital equipment.

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8. What is a borrowing base?

A borrowing base is comprised of the assets, generally, inventory and/or accounts receivable, which are available to use as collateral to secure a revolver. The size of the borrowing base varies with changes in the amounts of the borrower's current assets. For example, as the borrower builds or acquires new inventory or as it generates fresh receivables from new sales, these assets are covered by the security interest and generally would be eligible for inclusion in the borrowing base.

9. Why does the lender monitor collateral in a revolving credit facility?

Ongoing monitoring of the collateral helps to maintain a business relationship on the basis that benefits both borrower and lender. By keeping track of the type and quality of collateral in the borrowing base, a lender can make available to the borrower the largest possible loan that can be supported by the collateral.

10. What is the cash collection cycle and how does it work?

The cash collection cycle is simply a way of segregating collections as accounts are received. As receivables are paid, the cash collected is used to pay down the outstanding loan balance. This creates a win-win situation: the lender minimizes the outstanding loan risk, and the borrower minimizes idle cash and interest expense while creating renewed borrowing availability. When the borrower requires additional cash for working capital, the lender advances funds based on the updated borrowing base. This cycle can be done as frequently as daily if needed.

11. What receivables are eligible as security for a revolving credit facility?

Most receivables from completed transactions are eligible. Some receivables which fall into specific categories, however, are not. Typical examples of ineligible receivables would include receivables 90 or more days past due and any intra-company receivables. Some lenders also have the capability to lend against certain government receivables and foreign source receivables.

12. What inventory is eligible as security for a revolving credit facility?

Treatment of inventory varies from company to company and from industry to industry. It would not be unusual for eligible inventory to include all finished goods and marketable raw materials. It would be much less common to include work in process, damaged goods, slow-moving inventory, or certain specialized products that can only be sold to a limited number of purchasers.

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13. What is dilution?

Because of factors such as warranty returns, bad debt write-offs, and incorrect invoices, not all invoices generated are ultimately collected. Dilution is the difference between the invoices generated and the cash actually collected, expressed as a percentage of the total. For example:

A company has $1,000,000 in invoices.
$950,000 is collected ($25,000 is returned goods and
$25,000 is subtracted for prompt payment discounts).
The difference is $1,000,000 - $950,000 = $50,000.
The rate of dilution is $50,000/$1,000,000 = 5%.

14. What is the advance rate?

The advance rate is the maximum percentage of the current borrowing base that the lender can make available to the borrower as a loan. Consider an example using inventory. If a given inventory consists of 25% raw material, 10% work in process, and 65% finished goods, then up to 90% of the gross inventory (everything except work in process) would be considered eligible. Assuming a 50% advance rate on eligible inventory, loan availability would amount to 45% of gross inventory (50% of 90% = 45%). Actual figures will vary by company and industry.

15. How does a lender determine the appropriate advance rate on eligible receivables?

A common rule of thumb in the finance industry for determining the advance
rate on receivables is 1 minus 2 times the rate of dilution, plus 5%:
Advance Rate = 1 - [(2D) + .05], where D is dilution
If dilution is 5%, the advance rate is 85%:
Advance Rate = 1 - [(2 x .05) + .05] = 85%
In determining the advance rate, a lender may also look at factors including
receivables turnover and the borrower's overall receivables management.

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16. How does a lender determine the appropriate advance rate on eligible inventory?

An advance on eligible inventory may be affected by its type (raw materials, work in process, finished goods), its age, how quickly it turns, and how effectively the company tracks and controls it. Many lenders seek advice regarding the appropriate advance rate from outside appraisal firms that specialize in assessing the collateral value of inventory goods. The borrower may work with the appraisal firms and the lender to help them better understand the market for the collateral inventory, helping to maximize the collateral value and, therefore, the size of the loan.

17. Can I have a revolving credit facility if I don't have receivables?

Yes. It is possible to have a revolving credit facility secured solely by inventory, although advance rates are generally not as high as for facilities secured by receivables. Inventory-only facilities are commonly used in the retail industry, where most cash sales are generated from inventory.

18. Can I have a revolving credit facility secured by inventory in different countries?

It may be possible to use the inventory as collateral to support a U.S.-based revolving credit facility, depending on which country the assets are located in, and provided the assets are owned by a U.S. parent company or a company domiciled in the U.S. In an increasingly global marketplace, a growing number of businesses cross borders to service customers or source inventory. Not all revolving credit lenders can offer cross-border facilities, and few can offer a borrower a foreign revolving credit facility. If your needs involve cross-border facilities, ask about a lender's cross-border capabilities before accepting any proposal.

19. Do all industries use asset-based lending secured by receivables or inventory?

No. Some businesses may not have the accounts receivable or a tangible inventory traditionally associated with asset-based lending. For example, a hotel may have receivables from its clientele, but most asset-based lenders would not consider these receivables as eligible collateral. A company in the heavy construction business may be entitled to receive progress payments as a project is built, but these progress payments are not receivables in the pure sense; should the project not be completed or the work stopped, the lender might not be able to collect the accounts. Different industries have different kinds of collateral depending on the business they are in.

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20. Does asset-based borrowing add new cash to a business?
A revolver accelerates cash flow by enabling a business to borrow against the future value of receivables and/or inventory that are expected to become cash in the near term. This acceleration of cash provides liquidity and allows the borrower to extend and optimize its equity base.

21. Does my company need to be profitable to use asset-based lending?
No, not necessarily. A lack of profitability does not eliminate asset-based lending as an option. A company that has experienced a profit downturn may still be eligible provided its management has identified the problem and developed a viable corrective action plan. In addition, many companies which are not profitable have fine operating results and simply need to adjust their capital structure. Asset-based lenders can help through a variety of recapitalization approaches, including loan restructures, asset spin-offs, and cooperative dispositions. If bankruptcy is a possibility, borrowers can consider a Debtor-In-Possession (DIP) facility. In such cases, prospective borrowers should inquire as to the lender's experience and expertise regarding financing and the bankruptcy process; not all asset-based lenders are knowledgeable about this highly complex arena.

22. Can an asset-based loan be used to finance an acquisition?
Yes, this is a commonly used means to finance acquisitions. In fact, it is possible to use the assets of the company being acquired to finance the acquisition. This can be especially advantageous when the prospective acquisition has a high level of eligible receivables and/or inventory in relation to the purchase price of the company. Such companies are often excellent prospects for acquisition, and asset-based lending can provide a significant source of the acquisition capita

21. Can asset-based lending be used as growth financing?
Yes. A revolving credit facility will tend to give a business the greatest amount of flexibility and borrowing capacity from its existing asset base. An innovative asset-based lender can design a facility that can grow as the company grows. For example, a revolving credit facility could be designed to provide a higher credit limit as the business increases its borrowing base, provided certain key operating ratios are maintained. As the company's needs and collateral grow, so can its ability to borrow.

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24. What are covenants? What covenants are customary for an asset-based loan?
Covenants are simply promises to conform to specific guidelines as part of a loan agreement. They are customary for asset-based loans. An example of a covenant would be the borrower's promise to conform to specified financial ratios for the life of the loan. Covenants help the lender monitor and control the loan while providing the borrower with the greatest possible loan.

25. Is a "zero covenant" loan a good deal?
Maybe. Covenants are "tools of the trade" that help the lender monitor the loan's performance. For example, if a lender provides an asset-based loan with no covenants, the lender may have to structure the deal as a demand loan to protect its interests. Then, if the borrower's financial condition deteriorates markedly, the lender may decide to cut off cash availability to the borrower and terminate the loan without notice. In contrast, a loan including performance covenants can give the lender some latitude to work with the borrower in such a situation to the benefit of both parties.

26. What confirmation procedures are customary in an asset-based loan?
A lender customarily confirms financial and collateral information provided by the borrower in order to support ongoing loan requests. There are two basic types of confirmation:
(a) Field Examinations. Many major lending organizations have a field examination group that visits the borrower's operation to better understand its business. Field examinations benefit the borrower because they enable the lender to provide the maximum amount of liquidity possible, which can be supported by the collateral. A field examination is not like the audit a CPA firm would conduct at a business. Instead, it confirms collateral and financial information and helps the lender evaluate trends in the borrower's business. Although transaction costs can be structured in a vast variety of ways, in most cases, the prospective borrower is responsible for costs related to a field examination.
(b) Accounts Receivable Verifications. Verifying accounts receivable simply
involves confirming some or all of the borrower's receivables directly with the borrower's customers.

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27. What is factoring?

In a traditional factoring arrangement, a company actually sells its receivables to another company (a "Factor") at a discount. After the sale, the receivables balances are carried on the Factor's balance sheet since title has been transferred. Because the Factor then owns the receivables, it generally provides all the required credit, collection, and accounting services necessary to collect the receivables, including the assumption of the ultimate loss exposure from the client debtor. The important difference between factoring and asset-based lending is ownership. In a factoring relationship, the receivables are purchased and owned by the factor. In asset-based lending arrangements, accounts receivable are pledged to the lender as security for the loan, but the borrower retains ownership and complete control of the receivables, and the value of the receivables remains on the borrower's financial statement.

28. When would a company use factoring?

In some industries, including distribution and manufacturing, the use of factoring is very common. Factoring is appropriate if the seller of the receivables (a) seeks to shed its risk and the cost of collecting receivables from its customers, and (b) is willing to allow a third party to have control of a portion of its relationship with its customers. While factoring eliminates the time, expense, and risk related to collecting receivables, it is the factor, not the company that sells its receivables that conducts the payment or collection process with the end-customer.

29. How is "floor plan financing" different from a revolver secured by inventory?

Floor plan financing is a method of financing inventory that usually involves a manufacturer selling its product to a dealer or distributor. While a revolver secured by inventory is designed to help the borrower meet the overall financial needs of a business, floor plan financing typically is geared to the acquisition of specific items of inventory. For example, a tire manufacturer may use a floor planning program on the tires it supplies to a seller of auto parts and accessories. Floor plan financing often takes the form of a purchase money security interest, through which a seller of goods on credit retains a preferred lien on the goods sold to secure payment of the purchase price, or through which a lender who advances funds to enable the borrower to acquire certain goods is granted a preferred lien on the goods so acquired to secure repayment of the funds advanced.

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30. Is tax leasing a type of asset-based lending?

Tax leasing differs from asset-based lending in that the lessor owns the equipment (instead of taking it as security for a loan) and leases it to the end-user. As the owner of the equipment, the lessor typically gains all the tax benefits for its own account along with the risk of obsolescence regarding the leased equipment. Both leasing and asset-based lending use traditional collateral monitoring techniques to provide the lessee or borrower with the largest possible amount of funding while at the same time minimizing the financier's risk. A lessor that understands the inherent value of the equipment will be able to grant the borrower the most generous amount of funding from a specific asset. Additionally, due to the tax benefits of ownership belonging to the lessor, the effective stream rate on a lease may be lower than the interest rate on a traditional equipment loan. A lease may be structured as off-balance sheet financing. A financing company that can provide both leasing and asset-based lending would be best able to evaluate your needs objectively and provide the optimal funding mix.

31. Should I expect an asset-based lender to understand the cycles of my industry?

Yes. You are absolutely entitled to expect your lender to understand your business. If you work with a lender that is not fully aware of how your industry's cycles impact your business, you may find your ability to borrow is cut back or even eliminated at exactly the time when your demand for credit is highest. The more your lender knows about your business, the more your lender can do for your business. Expect and demand that your lender know a great deal about your industry from the start, and expect your lender to actively learn more about your industry and your business as the relationship evolves.

32. If a company is in bankruptcy, does that necessarily mean it is not creditworthy?

No. A company in a Chapter 11 bankruptcy proceeding is frequently considered a more creditworthy borrower due to the supervision and protection implicit in a Bankruptcy Court proceeding. Bankruptcy proceedings may occur for many reasons, including (1) poor capital structure, (2) poor operating results, (3) inability to fully access liquidity, (4) pending litigation, and (5) unfavorable contracts or leases. There are as many reasons as there are companies that go into bankruptcy, pre-petition creditors are prevented from taking action against the debtor. While secured creditors are entitled to adequate protection, unsecured or under-secured creditors are blocked from receiving any payments during the case. An asset-based lender providing Debtor-In-Possession (DIP) financing following the filing of either a voluntary or involuntary bankruptcy proceeding utilizes the same fundamental asset valuation approach to provide the loan as it would utilize for a company, not in bankruptcy. The availability of DIP financing may depend on the perceived

viability of the company during the proceeding and on its ability to successfully complete a Plan of Reorganization (POR) or Section 363 asset sale (these terms are defined in the Glossary). The availability of capital—and access to it—is the foundation of a company's ability to operate in bankruptcy. It is absolutely critical that any company considering a Chapter 11 proceeding contact a prospective lender to determine the availability of DIP financing prior to initiating a proceeding. In most cases, DIP loans are arranged for prior to or in conjunction with the actual petition date.
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33. What is the difference between asset-based lending, revolving credit facilities, and commercial finance?
Asset-based lending refers to loans secured by a wide variety of assets. Businesses can borrow money using the liquid, current assets of the company (such as accounts receivable and/or inventory) or the fixed assets of a business (such as plant, property, and equipment) as collateral. Asset-based lenders rely on the value of the underlying collateral to minimize the loan's credit risk. Asset-based loans also can include equipment loans and real estate mortgages. Commercial finance is the term most commonly affiliated with the industry group of lenders that provides all types of asset-based loans to business and commercial borrowers. Asset-based lenders are sometimes referred to as secured lenders.

34. How does a finance company differ from a bank?
While both lend money to businesses, a bank's lending activity and reserve requirements are regulated by state and federal governments. Finance companies are not regulated in the same way and, as a result, can take on a wider variety of loans and move faster in response to market changes and customer needs. Some finance companies are part of large manufacturing and/or distribution concerns and were originally created to provide financing for customers. Such lenders can provide unique practical insight into business borrowing needs.

35. What is risk rating of loans? Do all lenders engage in risk rating of loans?
Not all lenders risk rate their loans. A lender that is not subject to state and federal bank regulations is not required to risk rate its loans. However, lenders who accept public deposits, such as commercial banks that also provide asset-based loans, must risk rate their loans for the respective state and/or federal bank regulatory agencies. Unfortunately, no one particular standard has been accepted by all lenders and/or regulatory agencies. As a result, the explanations of exactly how an institution rates its loans will vary widely. Many different scales are used, so the actual score used to rate a borrower's loan may provide little useful information.

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36. Can risk rating of loans have a significant impact on a borrower?

Yes, it can. Factors outside of a bank's control have the potential to change the way its asset-based lending accounts are handled. For example, should there be a downturn in a specific industry or geographic area where the bank has loan activity, bank regulators may look at the institution's underwriting criteria and their portfolio of like businesses and require the bank to post new and higher loss reserves, or stop accruing interest on similar asset-based lending accounts. That can result in an account being transferred to a bank work-out group that is more closely supervised by the bank regulators. The net effect on the borrower could be as significant as being asked to find a new lender, a process that can substantially disrupt the borrower's day-to-day operations. Depending on the performance of the borrower's business at that time, having to find a new lender may be extremely difficult and costly.

37. What is more important in selecting a lender: the people or the institution?

An argument could be made that the people are the institution when it comes to lending money. A good working relationship with your lender is important because you will be interacting regularly, in all likelihood, every day. Make sure you are comfortable with the people and the organization. Are the people you propose to work with innovative and knowledgeable? Are they part of an organization that is committed to asset-based lending?

If your lender does not have a specific product to suit your needs, will it be able to create one for you? As your business grows and changes, will your lender have the resources to address your evolving capital needs? Is your lender financially stable? (Its stability is directly related to its ability to raise money and, therefore, to your ability to borrow money.)

38. I'm thinking of an IPO in the next 18 months. How can the selection of an asset-based lender impact my company's ability to issue stock?

Lenders, just like businesses in your industry, have reputations for the types of customers they tend to serve. Some lenders specialize in financing distressed companies, and others specialize in financing certain industries such as health care companies. Some institutions have more cachet value to outside investors than other companies. If you are planning an IPO, the selection of your lender is important because the potential purchasers of your stock will be relying on this lender to supply the company with working capital as it grows. Institutional investors, in particular, tend to like a recognizable and stable institution for a company's senior lender.

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41. What kinds of fees are typically involved in an asset-based loan?

Fees are generally charged to the borrower to help the lender recover its initial costs in putting a transaction together and to contribute toward earning a fair profit. There is generally a commitment fee and closing fee for an asset-based facility. The commitment fee is paid in cash upon obtaining the commitment. The commitment fee is often credited toward payment of the closing fee, and the balance of the closing fee generally is paid from the proceeds of the initial loan. Each of these fees may range from one-half of 1% of the loan to many times that amount. Fees may vary depending on the creditworthiness of the borrower, the type of event being financed, and other factors. For example, fees charged to a company that needs a bankruptcy facility will differ from a very successful company that is seeking to conclude a refinancing of its senior loan facility and from a sponsor group seeking to acquire a business through a leveraged buyout. Depending on the type of loan, some other typical fees may include: (a) an unused line fee which is designed to compensate the lender for its cost to retain the liquidity to lend the borrower the maximum amount of their committed facility as needed, (b) an administrative fee to compensate the lender for ongoing collateral auditing and monitoring, (c) a prepayment fee to compensate the lender if the borrower decides to end the facility prematurely, and (d) an audit fee. Not every borrower pays every fee. Other costs which are the borrower's responsibility include the field examination and the borrower's and the lender's legal representation. The amount of these fees will vary according to each borrower's circumstances.

42. How long does it take to close a revolving credit facility?

Normally you should expect a 4 - 6 week period from the date a proposal is accepted until a new facility is funded. Of course, depending on the complexity, type of facility, and amount of negotiation engaged in by the parties, it may take more or less time. Certain types of transactions, such as Debtor-In-Possession transactions, are commonly concluded or committed to within a few days. Closing can take longer if unusual circumstances such as significant inter-creditor negotiations or third-party consents are required to complete the transaction.