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Asset based finance

The asset class investors are starting to look at

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Since 2008 OpenFunds' principals have been involved either as investment managers or distributors in the Asset Based Finance space.

When the financial crisis hit the market during the Fall of 2008 a number of prominent funds, in particular fund of funds, had to wind down their activities and closed. The main reason for this drastic action was the mismatch between the liquidity offered by these funds and their ability of redeeming and receiving the cash from the underlying funds and their investments. Even though these facts were a clear deterrent for many players in the industry (investors, investment managers and third party marketers) we were of the opinion that this asset class had many other positives and that if well explained we could convince investors about the benefits of having at least a marginal allocation to it within a balanced investment portfolio.
With this spirit in January 2009 we set up and seeded a fund active in the financing of the rural community in the UK. At that time only few investors would take the time to listen to our story, even fewer considered or did invest. Many actually smiled at us and wished us all the best with what they called "the tractor fund". Today, seven years later, "the tractor fund" has just passed the 500m USD mark.

Asset Based Finance has clearly become an asset class savvy investors are looking at and today we are seeing the whole spectrum of investors considering or investing in this asset class: pension funds, family offices, wealth managers and even Sovereign Wealth Funds. A key reason for this growing interest is the ability of such funds to generate consistent (positive) returns which are particularly welcome in a low (or zero) interest rate environment. Now that even central bankers are hinting at the fact that the low interest rate environment will persist for the years to come we are convinced that many more investors will be intrigued and will start investing in this asset class.

1. Introduction

Asset finance is funding used to obtain equipment – tangible assets from office phones to manufacturing plants, cars to fleets of aircraft.

In the UK it is the third most common source of finance for businesses, after bank overdrafts and loans, and provides significant cash flow and tax benefits for those using it. As at Q3 2015 approx. 45,000 businesses are using this industry's products and services to grow their businesses, namely Asset Based Lending (or ABL) and Invoice Financing under which fall Invoice Factoring and Invoice Discounting.

Asset based financial services organizations (asset based lenders) play a vital part in financing the economy. They provide their clients with cash by lending on fixed assets, accounts receivable and inventory, and engage in factoring, purchase order financing, real estate financing and leasing. They include the asset based lending arms of domestic and foreign commercial banks, small and large independent finance companies, floor plan financing organizations, factoring organizations and financing subsidiaries of major industrial corporations.

Expert in all facets of collateralized lending, asset based lenders – large and small alike – possess the experience and know how to structure the proper financing program for their borrowers. They specialize in financing businesses and business transactions involving a broad range of products and services, both domestically and internationally. They provide:

- Operating cash
- Funding for an acquisition, a merger or a leveraged buyout
- Debt consolidation
- Turnaround financing
- Bankruptcy/reorganization financing
- Equipment financing
- Inventory financing
- Floor plan financing
- Equipment leasing
- Import/export trade financing
- Growth financing
- Factoring services

2. Growth Money

Businesses need money to grow. A business cannot survive just because it has a better product, an exclusive market or the best method of distribution. The catalyst required for progress is money.

Business owners and managers must be knowledgeable about financing, what it can do, why one form may be better than another. It can be used when:

- Operating cash is tied up in receivables
- The best trade terms for supplies create cash flow shortages
- Inventory levels are high because of client demands
- Sales growth is straining resources
- Seasonality peaks cause problems
- No fixed assets are available for collateral
- Trade discounts and special pricing terms cannot be obtained
- Letters of credit are required to supply or buy overseas
- Debtor-in-possession financing is required

Asset based lenders often advance funds when traditional sources are not available. They are familiar with various types of businesses and are responsive to client needs.
Credit depends on the type of business and the content and quality of the collateral. Frequently, the credit granted is more than the net worth of the business.
The increased cash availability provided by asset based lenders often makes the difference between profitable growth and failure for the undercapitalized business. The flexibility and cash availability provided by asset based financing have enabled countless companies to grow and take advantage of market opportunities.

3. Types of finance

Asset Based Lending

Asset based lending (ABL) provides the borrower with a revolving credit facility secured against its balance sheet assets. These assets range from working capital assets, such as trade debtors and stock, to tangible fixed assets such as plant and machinery and property. In exceptional cases intangible assets can be taken into account as security and ABL providers may also offer amortising term loans based on cash flow generated in the business to increase available funding. The borrower reports asset levels to the ABL provider on a regular basis (ranging from daily to weekly or even monthly) and the ABL provider makes available a fluctuating line of credit dependent on asset levels. The calculation of available funding starts with total assets, deducts those that are not suitable as security for the ABL provider (ineligible assets), and then provides funding against the remaining (eligible) assets at an agreed percentage (advance rate).

In ABL transactions, the lender's interest is secured by the borrower's assets, which then forms the basis for determining how much credit the borrower can access. Asset based lenders have generally found that, over time, the valuation of a borrower's assets is remarkably stable over a variety of business and economic cycles. This makes calculating a borrower's credit capacity based on asset values a highly predictable way of providing capital to clients.

The cost of asset based loans is influenced by the credit risk and collateral associated with the transaction. ABLs tend to track pricing in the broader secured bank, or pro rata, loan market. When cash flow lending is very active and leverage multiples are historically high, ABLs tend to be priced slightly higher than the cash flow market. The opposite may be true when the availability of cash flow loans is more restricted and when leverage multiples are historically low. But, in certain cases, pricing for ABLs can be lower than other pro rata loan market options. The reason for this is that lenders who provide ABLs look at risk differently — assets vs. cash flow or enterprise value — and, as a result, some situations may seem to be lower risk, which will be reflected in lower ABL prices.

Invoice Financing

Factoring

Traditional factoring gives businesses the opportunity to borrow against their outstanding invoices. Factoring also allows companies to outsource credit and collection functions, and provides a built-in revolving line of credit. Factoring is a complete financial solution that combines credit management, working capital financing, credit protection, accounts receivable bookkeeping, and collection services.

Some Asset Based Finance entities offer the option of including protection against bad debt losses in their factoring service. This safeguards profits, cash flow and the balance sheet.

A Factor agrees to:

- Pay an agreed percentage of approved debts as soon as debts are notified. The percentage depends upon a variety of factors, but 80% - 85% is common. The balance, less charges, is paid when customers pay. This flexible finance keeps pace with business growth, without parting with control or equity.
- Undertake all credit management and collections work, following an agreed credit policy to ensure faster customer payments without loss of goodwill. The savings in administration are substantial, and faster customer payments mean a reduced term of borrowing, resulting in lower interest costs.

With Factoring there will normally be a charge for the collections service and, if required, bad debt protection, expressed as a percentage of turnover. Charges are the subject of a formal quotation after the future provider gains an understanding of a business and the workload to be undertaken. It is commonly between 0.75% and 2.5% of turnover.
For the finance provided in advance of collections, there is usually a discount charge calculated on day-to-day usage of funds. It is likely to be comparable with normal secured bank overdraft rates.

Invoice Discounting

In the case a company already practices sound credit management, and has the staff and systems to generate rapid customer collections, the factor's skills will not be needed. But there may still be a need to turn debtors into cash faster, and generate the maximum working capital from the sales ledger balance. Invoice Discounting is often the ideal solution to meet this need. Immediate cash is available up to 80%-85% of approved invoices. However, responsibility for the sales ledger operation remains with the company, and the service is normally undisclosed to customers. Payments that the company receives are paid into a bank account administered by the Invoice Discounter, after which the company is credited with the balance, less charges. Some Invoice Discounters are also willing to include bad debt protection in the service.
The administration charge may be a flat monthly fee or a percentage of turnover. It is the subject of a formal quotation after the Invoice Discounter gains an understanding of the business and its requirements. For the finance provided in advance of collections, there is normally a discount charge calculated on day-to-day usage of funds. It is likely to be comparable with normal secured bank overdraft rates.

4. Benefits and 'drawbacks'

Asset Based Lending

Benefits – liquidity and / or flexibility

Companies use ABLs because they want to maximize liquidity or flexibility:

- When maximum liquidity is the objective, companies benefit from more loan availability from the assets pledged than was previously available under the company's prior financing.
- When maximum flexibility is the objective, companies benefit from the limited use of financial covenants and the embedded broader flexibility built into negative covenants.

Sometimes, those two objectives complement each other. When a company moves from a cash flow loan structure to an asset-based loan structure, it sheds the restrictive enterprise value-driven covenants under the former. Often, it will see its liquidity increase while being able to operate with fewer (if any) financial covenants.

The power of an asset-based approach to lending is its ability to look beyond the current circumstances facing a company, particularly if those circumstances have made the business unprofitable, and to find value in the investments the company makes in the ordinary course of conducting its business. Pricing for ABLs is often lower than leveraged cash flow debt markets, as risk is a function of asset and liquidity analysis, and not the going concern value.

Drawbacks – administrative requirements

The title "drawbacks" should be viewed only in the light of additional workload for the parties. In effect the increased administrative work is a positive when viewed from a risk management perspective.
The assets owned by a business change daily. New sales are recorded as new accounts receivable and existing accounts receivable (old sales) are collected in cash. Inventory is both purchased and sold. Some inventory is converted from one state to another, such as from raw materials to work-in-process, or to multiple states within a day. The composition, quality and value can change quickly, and these changes aren't always reflected in the periodic financial statements a company may publish.
Since an ABL is based on these kinds of assets, lenders need a different kind of information to be able to adequately monitor and gauge these changes in the collateral base. They require periodic reporting, such as accounts receivable aging, and inventory composition and valuation reports. ABL borrowers provide this kind of reporting along with their periodic borrowing base certificates — which recognizes the changes in these asset classes from period to period — in addition to the usual and customary financial statement reporting. The frequency with which a borrower has to provide this information is usually a function of its credit profile and the amount of unused loan availability. Stronger credit profiles with abundant liquidity generally report monthly. As credit profiles decline and/or as liquidity becomes more constrained, the frequency of reporting would be increased to weekly. In extreme situations, borrowers can be required to report changes in accounts receivable and inventories on a daily basis.

Asset based lenders also perform on-site examinations of collateral periodically. This helps to reconfirm prior assumptions about asset quality and value, or can allow lenders to spot changes and adjust their assumptions going forward. These examinations focus on collateral and the reliability of the management information systems for borrowers.

Invoice Financing

Benefits

Both kinds of Invoice Financing can provide a large and quick boost to a company's cash flow. Advantages of Invoice Factoring include:

- the invoice financier will look after the company's sales ledger, freeing up time to manage the business
- they credit check potential customers meaning the company is likely to trade with customers that pay on time
- they can help the company to negotiate better terms with its suppliers

Advantages of Invoice Discounting include:

- it can be arranged confidentially, so that the company's customers won't know that the company is borrowing against the customers invoices
- it lets the company maintain closer relationships with its customers, because the company is still managing its accounts

Drawbacks

In the case of utilising Invoice Factoring services:

- the company's customers may prefer to deal with the company directly
- it may affect what the company's customers think of the company if the invoice financier deals with them badly

Some drawbacks of Invoice Financing are that:

- the company may lose profit from orders or services that it provides
- invoice discounters will usually only buy commercial invoices
- it may affect the company's ability to get other funding, as the company won't have 'book debts' available as security

5. Leasing

Leases are classified into different types based on the variation in the elements of a lease. The most common types of leases are operating leases and finance leases. Lease is a very important financing option for an entrepreneur with no or inadequate money for financing the initial investment required in plant and machinery. In lease, the lessor finances the asset or equipment and the lessee uses it in exchange of fixed lease rentals. In other words, lease financing is an arrangement where the lessee who requires the equipment or machinery gets the finance from the lessor for the agreed rental payments. Such kind of lease is called finance lease. Certain variation in the elements of lease classifies lease into different types. Such elements are as follows:

- The degree of ownership risk and rewards transferred to the lessee
- The number of parties involved
- The location of lessor, lessee and the equipment supplier
- The lessor and the lessee

Finance Lease

In legal form a finance lease is just another lease – the legal ownership of the asset lies with the lessor and the lessee only has the right to use the asset. However, in commercial terms, finance leasing is a method of providing finance. In other words, in econ omic substance a finance lease is a loan of money with the asset as security. The 'economic' ownership of the asset – the risks and rewards of ownership – lies with the lessee. In substance the finance lessee buys the asset with a loan from the finance lessor. To put it another way, a finance lease may be viewed as an arrangement under which one person (the lessor) provides the money to buy an asset which is used by another (the lessee) in return for an interest charge. The lessor has security because they own the asset. The terms of the leasing arrangements aim to give the lessor a banker's interest turn and no more or less – however good or bad the asset proves to be for the end user.
The banker's turn may be very small (a few tens of basis points) for finance leases of very expensive assets (such as ships and aircraft), but several percentage points for leases of les expensive items (such as machine tools or photocopiers). The generally very small turn for larger leases reflects the generally very high credit rating of the lessees.

Operating Lease

Generally accepted accounting practice (both SSAP 21 and IAS 17) defines an operating lease as a lease other than a finance lease. Thus all the accountancy definitional material is in connection with finance leases.
In contrast to a finance lease, an operating lease does not transfer substantially all of the risks and rewards of ownership to the lessee. That is, an operating lease is a lease where the lease terms do not guarantee that the lessor will get back all, or substantially all, of the cost of the asset plus a commercial rate of interest. In many cases the asset may be leased several times throughout the course of its life, though this is not always the case.
This means that operating leasing leaves the lessor with an equity risk. That is, at the end of the term of the lease the lessor will be relying on the value of the leased asset to ensure they make an overall profit. In some cases operating lease rentals can be thought of as reflecting the market rate for hiring the asset concerned. However, this is not always the case and has nothing to do with the definition of an operating lease.

Hire Purchase contract

A hire purchase (HP) contract is a type of finance lease where the user has the option to purchase the asset at the end of the hire period, typically for a nominal sum. In terms of economic effects the differences between a hire purchase contract and an ordinary finance lease are limited.
In both cases the user of the asset enjoys the risks and rewards of ownership. But the distinction between the two has significant tax consequences for the purposes of plant or machinery capital allowances:

- the finance lessor gets the allowances, not the finance lessee;
- the hire purchase lessee gets the allowances, not the hire purchase lessor.

The parties will usually choose whether or not to enter into a hire purchase contract to maximise the use of the available capital allowances.

Contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions, sometimes known as HP or lease purchase contracts, fall within the definition of a lease for accounting purposes. For accounting purposes no special classification exists for HP contracts, instead they are classified, and accounted for, as finance leases or operating leases, depending on the nature of the contract. Most HP contracts, which typically have a nominal purchase price, are classified as finance leases. However, in the case where the option to purchase the asset at the end of the hire period is set at a relatively high price (typically around market value), such that the hirer may not exercise the option to buy, the HP contact will be treated as an operating lease.

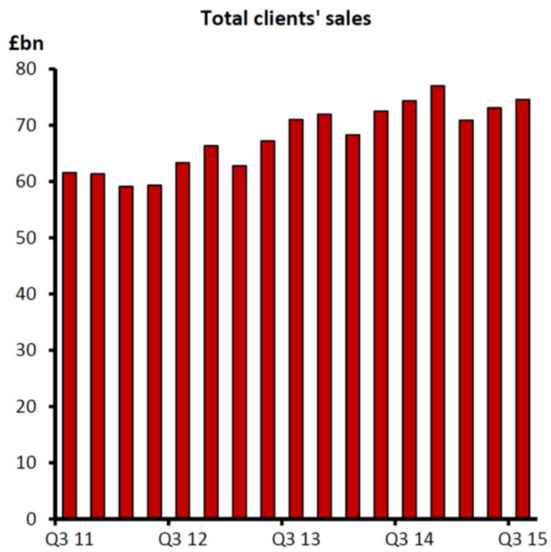
The hire purchase price of goods is normally higher than the cash down price of the article because it includes the interest as well as the cash price. Under the hire purchase system, the vendor is responsible to repair the goods which are in the possession of the buyer provided that the buyer takes the utmost proper care of the goods acquired. The risk is also borne by the vendor until the payment of the last instalment. The buyer has the right to return the goods to the vendor, if they are not according to the terms and condition of the hire purchase agreement.

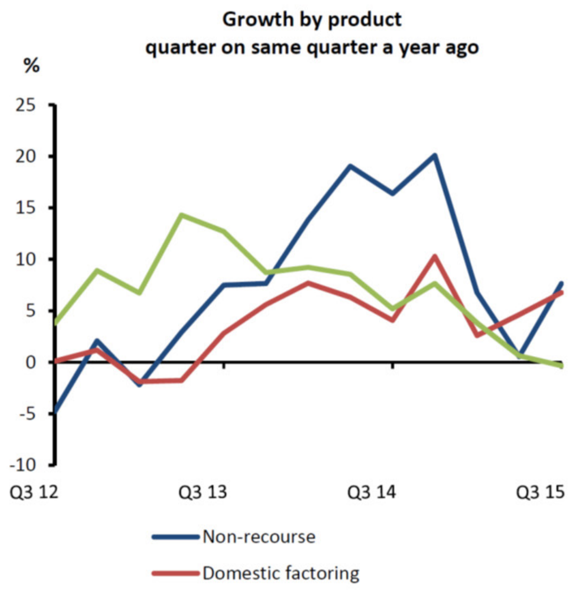
6. Conclusions

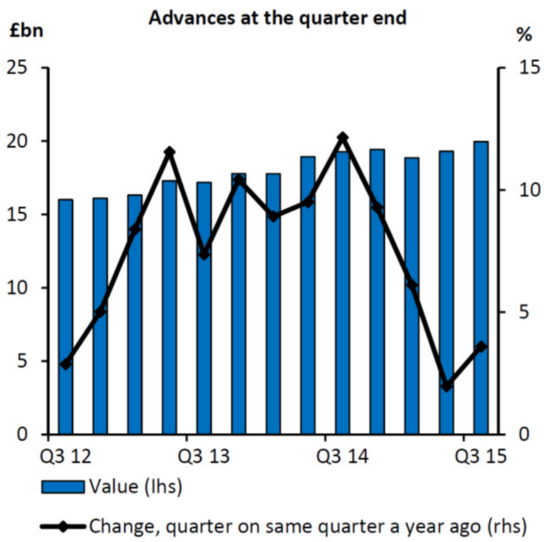
Asset based finance has gained substantial ground during the last few years and it has become an important financing tool in today's market, and one that provides benefits to both lenders and issuers. In the case of ABL lenders benefit from their collateral position and low historical loss rate in asset 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. Today they are more and more recognised for their comparative efficiency against alternative lending products.

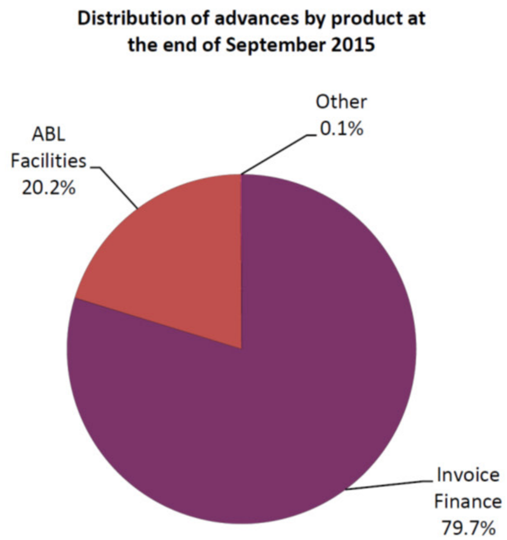
The views expressed in this paper are those of the authors and should not be used without appropriate advice.

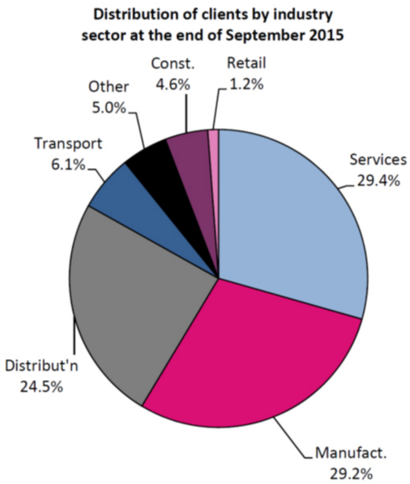
Supporting data (all UK related)

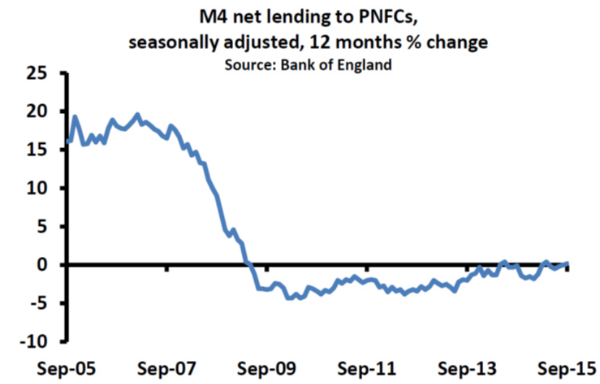












PNFC = Private Non-Financial Corporations

Source: Bank of England

Sources

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HM Revenue & Customs	www.hmrc.gov.uk
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