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# *How to Borrow More Effectively*

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With literally tons of inventory and typically millions of dollars in accounts receivables, most construction equipment distributors are perfect candidates for asset based loans. These loans, from asset based lenders, typically involve a revolving credit facility, called a revolver. Many distributors already have these loans that promise an interest rate of Prime+2%. With a prime rate of less than 5%, these distributors believe they are borrowing for less than 7%. Wrong! When *all* borrowing costs are considered, they may be paying 10-15% or more without even knowing it.

Typically, asset based lenders (ABLs) lend against the current assets of a business, such as the accounts receivable and inventory, but other asset classes, such as property, plant and equipment may also serve as collateral. ABLs are much more interested in underlying asset values for securing their loans than a commercial bank. Conversely, ABLs are less interested in the earnings, and ultimately financial loan covenants, of the business than a bank. Another major difference between asset based lending and commercial banking is that the latter is regulated by state and federal governments. Asset based lenders are not regulated in the same way, and therefore have more autonomy to structure deals. The asset based lending industry is sometimes called commercial finance or secured lending.

**How Asset Based Lending Works**

Normally the ABL loan is a revolving credit facility. A revolver is a loan that can be drawn down and repaid. The borrower grants a security interest in its receivables and/or inventory to the ABL as collateral to secure the loan. A security interest means the lender is granted possession of and ownership in the assets in the event of default. 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.

Asset based lenders will loan varying amounts against different asset classes. These "advance rates" differ from lender to lender. For a typical borrower, it would not be unusual for an ABL to loan 75-85% against *eligible* receivables, and 40-60% against *eligible* raw and finished goods inventory. Lending eligibility rules vary by ABL, but are stated upfront by each lender. Normally there is no advance against work in process inventory, mainly because in the event of liquidation, the WIP inventory would have little or no value to the lender. Advance rates applied against eligible assets comprise the borrowing base, or the amount that can be borrowed at a given time. Companies typically complete a Borrowing Base Certificate at least monthly, and possibly more often, depending on the lender's requirements.

**The Asset Based Lenders**

There are numerous ABLs in the United States, with many specializing in certain industry segments or loan size. There is a hierarchy for deal pricing among ABLs, primarily based on the size of the deal, but also on the perceived riskiness of the borrower. A three-tiered system exists within the ABL industry. These Tiers represent broad niches where the various ABL competitors have found some level of success.

- Tier 1 ABLs desire the least risky credit opportunities. This Tier contains most of the larger commercial banks' ABL divisions. The Tier 1 ABLs typically want initial fundings of at least $5 million, and preferably more than $10 million.

- Tier 2 ABLs tend to fund smaller, and possibly riskier borrowers, than Tier 1 ABLs. As compensation for this additional risk, Tier 2 ABL lenders require a higher interest rate than the Tier 1 lenders. Tier 2 ABLs tend to prefer initial fundings of $3-10 million, but may bid on larger or smaller deals if the borrower meets its lending criteria.

- Finally, Tier 3 ABLs are less driven by the earnings capacity of the borrower and more concerned with liquidation values. Tier 3 lenders have the highest interest rates of the three Tiers, as well as the most restrictive lending arrangements. Tier 3 ABLs may loan as little as $500,000, but normally do not loan more than $2-3 million.

By way of example, the following box shows typical loan terms from a Tier 2 ABL.

| Tier 2 ABL Example Terms | |
|---|---|
| **Example Loan:** | $5 million Facility - $3 million funded (2 year commitment) |
| **Interest Rate:** | Prime rate + 2% (Prime = 7%) |
| **Advance Rates:** | 80-85% of eligible A/R<br>40-60% of eligible inventory<br>50-60% of eligible Fixed Assets |
| **Closing Fee:** | 1% of Facility Amount |
| **Collateral Monitoring Fee:** | $24,000 per year |
| **Unused Line Fee:** | .75% per annum on unused portion |
| **Audit Fees:** | $12,000 per year |

In the example, the interest rate is Prime + 2%, with Prime assumed at 5%. Most of the sample terms are self explanatory. The following is a computation of the effective cost to the borrower of the sample terms.

**Tier 2 ABL 'Example Terms' Effective Interest Rate**

| | |
|---|---|
| 1. Total Interest Cost<br>($3 million loan times 7% interest rate) | $210,000 |
| 2. Closing Fee<br>($5 million Facility Amount times 1% divided by 2 years) | 25,000 |
| 3. Collateral Monitoring Fee | 24,000 |
| 4. Unused Line Fee<br>(($5 million Facility Amount - $3 million Funded Amount) * .75%) | 15,000 |
| 5. Audit Fees | 12,000 |
| Annual Costs of Loan | $286,000 |
| **Effective Interest Rate**<br>($286,000/$3,000,000) | **9.5%** |

Thus, in this example, the stated interest rate of 7% is increased by the 'terms cost' of 2.5%, which yields an effective interest rate (sometimes called the *all-in* rate) of 9.5%. These terms costs add about $75,000 ($3 million times 2.5%) to a company's borrowing costs *each year*.

Although not shown in this example, the Tier 1 ABL borrowing cost in today's market bears an effective interest rate of about 7-8%. Tier 3 lenders, on the other hand, often combine a 'Prime+2%' deal with high terms costs for effective rates in the 15-20% range.

What's a distributor to do? There are a number of things that will help distributors borrow more effectively:

1. Bank with commercial lenders, if possible. These are generally the cheapest source of capital. Failing, this, the lower the ABL Tier number, the better.
2. Negotiate the terms. Many lenders hope the borrower does not pay attention to the terms cost part of the deal. Every tenet is negotiable. The advance rates can often be increased 5-10 percentage points, which frees up more capital.
3. Borrow at LIBOR, if possible. LIBOR stands for the London Interbank Offering Rate. The index is quoted for one month, three months, six months as well as one-year periods. LIBOR is usually priced in the marketplace at some premium, such as "+200". This means that the quoted rate is LIBOR plus 200 basis points (or LIBOR plus 2 percent). With LIBOR itself currently running at less than 2%, it may be possible to borrow for less cost under LIBOR than prime.
4. Shop the credit. As a group, distributors are astute buyers of the inventory they sell. With the same attention to detail, they can buy credits with the same effect. A key thing for distributors to remember is that somebody on the credit side is feeling budget pressure to *put some money out*.

In a world of ever increasing profit pressures, borrowing costs matter. Hopefully the foregoing provides some insights into the asset based lending world. This is yet another area where proper planning and knowledge of the rules pays off.

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