CFA Education

Commercial Finance Association

Invest in Your Team

MINIMIZE LOSSES • MAXIMIZE PERFORMANCE

ABL Step 1 An Introduction

How SIPPA can change the Lending Environment and Access to Credit

Traditional Bank vs ABL

Bank

- Focused on Credit Status
- Over reliance on Real Estate
- Vulnerable to Economic Cycles
- Tends to favour Established Businesses
- Highly Regulated

ABL

- Collateral Focus
- Multi Asset Lending
- Has lower default rates in recessions
- Can be used to fund various stages of growth and entrepreneurial development
- Lower Regulatory Requirement (subject to Country and Ownership)

What is asset—based lending??

•Asset-Based-Lending ("ABL") is a form of **secured and monitored lending.**

•ABL utilizes **assets that can be valued and monitored** as collateral (principally receivables and inventory)

•ABL uses a **formula-based lending approach based lending approach** against eligible trade receivables and inventory with strict monitoring criteria to ensure the loan remains "in formula"

• **Control over cash collections** to pay down outstanding's is a key building block of ABL

•ABL matches loans to borrower's **cash conversion cycle**, allowing borrowers to borrow only what they need and pay interest only on funds borrowed

History and Development of ABL

- ABL started in the USA during the 1920's
- At that time the USA was experiencing strong economic growth, with a lot of **small and medium sized companies** needing finance to support their growth
- These companies did not have a strong capital base and needed a form of financing to fund their **working capital** growth
- Lenders developed ABL as a way to lend these companies on a **well-secured and monitored basis**

History and Development of ABL

- As with any new financing product, ABL had to fit in with **the existing legal framework**
- This meant that much of the early lending resembled **factoring and receivable discounting** instead of the ABL that we know today
- Early forms of ABL allowed lenders to provide critical **working capital financing** to grow SME's on a monitored and secured basis

The Evolution of ABL

- From it's beginnings ABL adapted to a **changing legal and regulatory environment**
- Changes in laws made it easier to take **security** in present and future receivables and inventory, thus converting ABL into a secured loan product
- New laws and regulations have:
  - Reduced the number of **unregistered priority claimants**
  - Converted retention-of-title claims to **security interest requiring public notice**
  - Made possible non-judicial enforcement of liens
- Insolvency laws have recognized the **priority of secured loans and their collateral rights**
- Thus ABL, with its secured, monitored and valuation approach to lending has become a primary form of lending to **under capitalized companies**

The Evolution of ABL

- With improved laws and regulations and acceptance of ABL, the product offering of ABL has expanded to include:
  - **Receivable and Inventory Finance**
  - **Commodity borrowing base lending**
  - **Securitization**
  - **Supply chain financing**
  - **Purchase order financing**
- ABL's growth has resulted in the expansion of **service providers including** legal, field examination, inventory valuation, and collateral realization firms.

ABL Today

- ABL is widely accepted and used form of financing in the U.S.
- ABL use has expanded from only working capital financing to **acquisition and restructuring financings**
- It is estimated that **one of every three companies** in the U.S. utilize some form of ABL

ABL Today

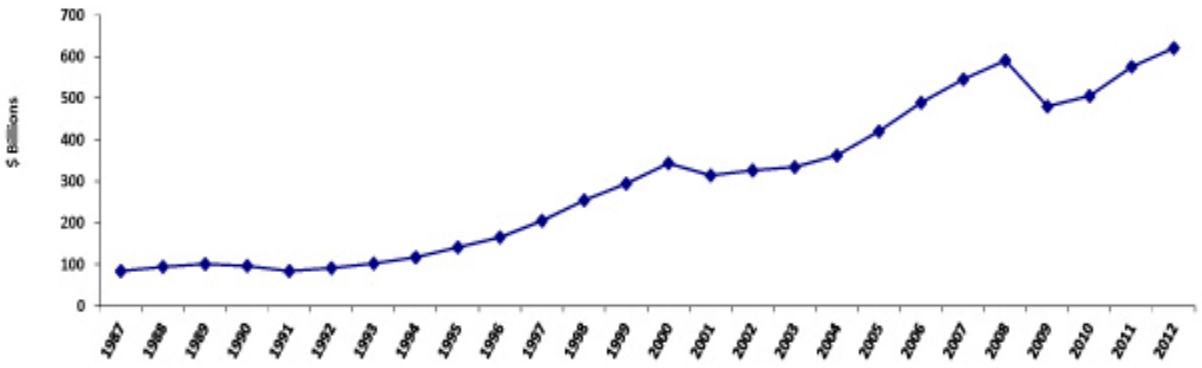
- Due to Secured and monitored aspects of ABL, this form of lending has had lower Loss Giving Default (LGD) rates during the recent U.S. recession than other unsecured and secured forms of lending
- This lower LGD allows lenders to risk rate ABL facilities higher than other forms of loans for comparable borrowers and thus **allocate lower capital** against this form of lending
- This lower LGD is a result of the pre-closing collateral analysis and valuation and post-closing collateral monitoring and collateral re-evaluations that are the hallmarks of ABL

ABL Industry Size

- Thousands of U.S. Commercial banks are engaged in commercial and industrial lending, and the aggregate value of their Commercial and Industrial loans is well in excess of $1 trillion. Many of these loans are asset-based transactions
- At least 50 hedge funds and private equity funds with assets under management exceeding $1 billion are active in direct lending, often of an asset-based nature. Also and estimated **20% of all private equity funds are involved with some form of asset-based lending**
- Over **1500 credit unions** now provide commercial loans, including asset-based loans
- Captive finance companies often provide asset-based loans in the form of accounts receivable financing and floor planning to their distributors and dealers
- A number of equipment leasing companies also have broadened their environment in asset-based lending because of intensified competition and shrinking margins in their traditional business

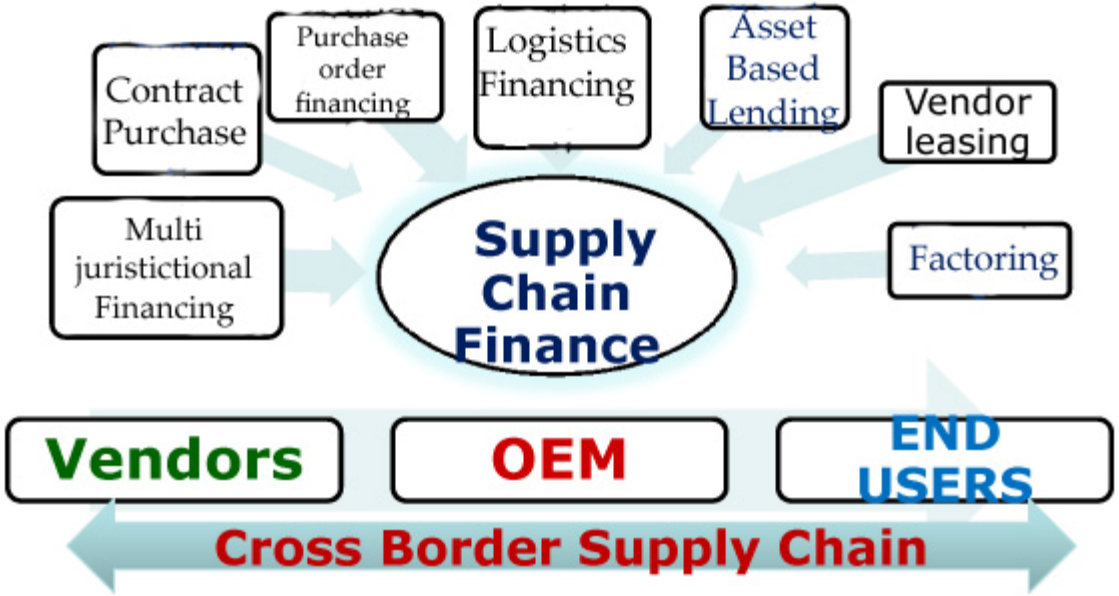
ABL industry size ABL industry size —US Market

- The size of the overall U.S. asset-based lending market in 2012 was estimated to be **$620 billion** in terms of loans outstanding. This estimate is based on extrapolations of data obtained from CFA members and other sources such as government agencies (e g FDIC) and trade publications (e.g., American Banker). The exhibit below shows market growth and how market size has been impacted by economic recessions:



SOURCE: COMMERCIAL FINANCE ASSOCIATION

ABL and other forms of business finance



ABL Philosophy

- The success of ABL lending in the U.S. and in other countries is tied to ABL's core processes and philosophy:
  - Detailed pre-closing **collateral analysis and valuation**
  - Detailed review of **borrower's ability to report collateral** on a timely basis to allow frequent **reporting and verification** of the collateral
  - **Control of cash** proceeds to repay outstanding loan balances and thus keep the loan within the collateral limits

Key elements of ABL

- The "exit strategy" is based on realization of the collateral in the event of default, even in the borrower's insolvency
- Thus, the focus is on making certain that the loan never exceeds the collateral's realizable value
- This requires the lender to:
  - Value the collateral with precision
  - Address legal and business issues inherent in the collateral
  - Monitor the collateral
  - Exercise control (dominion) over the proceeds of the collateral
  - Have immediate access to the collateral
  - Know how to realize on the collateral

The keys to ABL's success

- As with any form of successful lending, limiting losses due to fraud, collateral value deterioration and business failures are key to being a successful lender

- Although ABL structures can not prevent exposure to business failures and fraud, ABL's basic structure and methodology can reduce losses when fraud, insolvency or asset value deterioration occurs

- ABL limits losses through the principles of frequent collateral reporting, valuation and verification of collateral

ABL requires a supportive legal regime

- The balance of this presentation will focus on ten key elements of a legal regime that supports ABL
  - The legal elements are reflected in the UNCITRAL Legislative Guide on Secured Transactions
    - **Party Autonomy**
    - **Creating a security interest in receivables and inventory**
    - **Third party effectiveness of the security interest**
    - **The registry system**
    - **Clear priority rules**
    - **Access to proceeds of receivables**
    - **Access to inventory**
    - **Insurance**
    - **Enforcement**
    - **The insolvency regime**