Asset Based Finance for Growth, Acquisitions and Turnarounds

When companies most need an injection of capital, it is often the worst time to go cap in hand to a bank for a conventional loan. When times are tough, in a turnaround situation for example, many lenders will be wary of handing over money based on cash flow. However often all the company needs is a controlled input of cash to get them back on track.

Asset Based Finance (ABF) is a well-established way of financing businesses in the USA and is becoming increasingly popular in the UK. There is a trade body in the UK (The Asset Based Finance Association – ABFA) and currently around 42,000 businesses are using ABF. Since 2006 the level of assets financed has grown by a third, and in 2012 the sales of ABFA members' clients were £250bn.

Firstly, some basics: ABF incorporates **Invoice Finance** and **Asset Based Lending** (ABL).

Invoice Finance

Invoice Finance involves raising cash from sales invoices and comprises both **Factoring** and **Invoice Discounting**. An agreed percentage of approved invoices is paid to the organisation as soon as they have been notified to the lender. The percentage depends upon a variety of factors, but between 75% and 85% is common. The balance, minus charges, is paid when the customer pays.

Factoring is different to Invoice Discounting as the lender undertakes all credit management and collections, potentially leading to savings in administration. There will normally be a charge for the collections service and, if required, bad debt protection, expressed as a percentage of turnover. Charges are commonly between 0.75% and 2.5% of turnover.

If the organisation has credit control in place then Invoice Discounting is the solution. Responsibility for the sales ledger remains with the business and the service is normally not disclosed to customers. Receipts are paid into a bank account administered by the Invoice Discounter, after which the balance, minus charges, is paid over to the client. Charges may be a flat monthly fee or a percentage of turnover and will commonly be around, or lower than, 1% of turnover.

Asset Based Lending

In the simplest terms ABL is any kind of lending secured by an asset. Commercially, these assets typically include debtors, stock, plant and machinery, and property. An ABL provider will offer financing against these assets within one legal document. Their client is then free to borrow against these assets as they wish. Usually finance secured against stock and debtors is provided as a revolving line of credit, while term loans against fixed assets are fixed and amortise over a number of years. Intangible assets are usually taken into account as security and may be used to support additional lines of credit over and above the assets mentioned above.

Brumark

This is an historic case that has changed the way that institutions view lending secured against receivables. While the case was initially conducted in Australia it went all the way to the Privy Council in the UK. The terms of the security given to its bankers over book debts were that it was a fixed charge. The Privy Council ruled that uncollected debts are covered by a floating charge. This has changed the way lenders view their security in the UK. If the book debts are not at the free disposal of the company they become fixed charges. In essence, the asset based lender buys the book debt and thus, with the equivalent of a fixed charge, has a better level of security. They may therefore be able to lend more than traditional lenders with their floating charge.

ABF compared to traditional cash flow lending

Each lender will focus primarily on the difference between asset based finance and traditional lending. A traditional lender will look first at the cash flow and then at collateral. An asset based lender looks to collateral first, debt load, and quality of earnings. Companies with a strong asset base can provide a greater level of security to the lender and, as a result, finance can be raised in excess of the amount that would normally be advanced by conventional lenders. The traditional cash flow lender assesses debt capacity and focuses on levels of cash flow generated by business. The ABF lender, while interested in cash flow, is able to take a high level of comfort from the value of the secured assets.

When to utilise Asset Based Finance

Growth
ABF grows with a business and is suited to any company that is expanding. As long as the business is profitable it will not run out of cash when growing; the greater the sales the greater the cash that will be generated from an ABL facility. The cash is often received from the funder before the supplier has to be paid.

As funding changes with movements in working capital, ABF is ideal for a business that needs to fund seasonal peaks in working capital. That funding can be disproportionate to the levels of EBITDA that are often used when assessing debt capacity.

Acquisitions
Following on from its success in the US Asset Based Finance has become an increasingly popular source of financing for acquisitions in the UK. The main appeal of using asset based lending to fund an acquisition is that the funds generated from the assets being acquired can be used to part-fund the acquisition, and to provide on-going working capital to the new company. In many cases, this allows a reduced level of external equity finance.

Turnaround
In the early days of a turnaround there may be asset cover but limited, or even negative, cash generation. ABF funding has the flexibility to allow a business to focus on its cost improvement plans and thus return to viability. As the funding package flexes with movements in working capital, the company does not suffer from a customer paying a few days late. As there is no requirement for repayments to be made for a large part of the facility, funding from cash flow is reduced. When the turnaround gathers momentum and the business starts to grow again, ABF provides a good platform for growth.

Impact on systems and reporting

The company will have to make changes in how it operates: reporting systems may need amending and cash flows have to be prepared on a different basis to reflect the different timings of receipts and any reserves the lender may require.

If the company has an ABL facility, it must pay particular attention to reporting and cut off dates. It is very easy to submit sales invoices daily and have stock reporting monthly. The danger comes from high stock levels at the start of the month which are then sold. The company has received money for stock, which it effectively receives again when the sales invoice is raised. If not properly tracked the company may not have the cash available to 'repay' for the reduction in inventory. ABL's usually require weekly stock reporting for this reason. The company should consider when it pays bills in respect of items (such as logistic costs) that may be reserved by the funder.

Benefits

Asset Based Finance keeps pace with business growth without necessarily parting with control or equity. It provides finance for businesses with suitable assets and good management and systems. It can also deliver greater levels of financing than those available through traditional methods by fully valuing a company's assets and by not suffering from lending ratio restrictions. It is a lending regime that provides working capital for seasonal, developing, growing and even struggling businesses. The product is ideally suited for manufacturers, retailers and importers.

Conclusion

In short, Asset Based Finance can provide a vital injection of funds just when an organisation needs it, whether it is just starting up, growing quickly or even facing a turnaround situation. It provides a greater degree of security for the lender and, they may advance more in circumstances where normal lenders would not.

Do not underestimate the internal revisions to reporting systems and the like that will be required. There is value in getting advice on any implementation of ABF *before* facilities are signed to make sure your systems are robust.

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