CapitalEyes
A Bank of America Business Capital monthly e-newsletter on middle-market leveraged finance.

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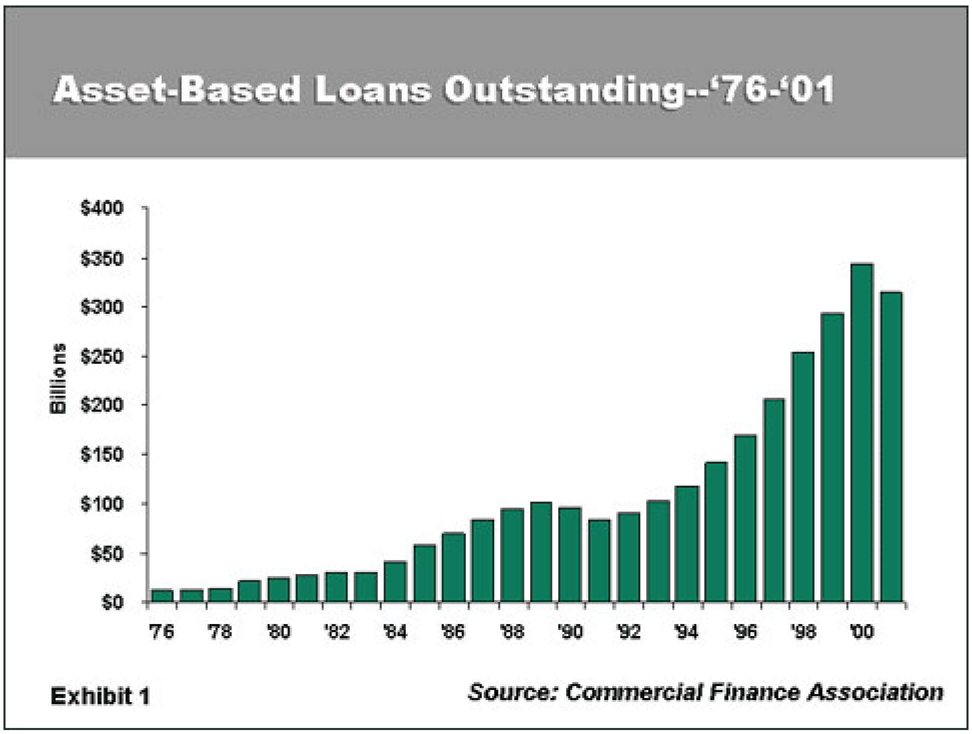
## Six Myths About Asset-Based Loans

Since its inception, the asset-based lending industry has been plagued by a pervasive image that asset-based loans are inherently bad. This view was born during a time when securing a loan with collateral simply wasn't done by "prestigious" companies and asset-based loans were offered only by a handful of lesser-known lenders. However, many of the common perceptions about asset-based loans are, in fact, misconceptions.

Asset-based loans are flexible, versatile and competitively priced. All kinds of companies—big and small, old and new—now use them for an array of liquidity needs. Today, asset-based loans are a fundamental financing solution offered by many lenders, including the major money-center banks. In fact, the total value of outstanding asset-based loans has increased nearly fourfold over the last decade, according to the Commercial Finance Association (Exhibit #1—ABL Outstandings).




In spite of wider acceptance and growing demand, myths about asset-based loans still persist. Here are six of the most prevalent ones and the reasons why they needn't give potential buyers pause.

**Myth #1: Financially healthy companies don't use asset-based loans.**
Healthy borrowers can go anywhere for financing, but good companies increasingly are turning to asset-based lenders. They're affordable, offer flexible loan structures, and can help a company maximize its borrowing capacity. Many financially healthy companies consciously use as much leverage as possible to expand and grow their businesses. What's more, some companies have no immediate need for funds but want the liquidity readily available just in case. So, it's not unusual that healthy companies planning growth or acquisitions make up a significant portion of the borrowers at many asset-based lenders.

D&K Healthcare Resources, Inc., a distributor of pharmaceutical, healthcare, and beauty products is a good example. D&K is a profitable public company that has had a lending relationship with Bank of America Business Capital for the past 15 years. During that time, D&K's credit facility has increased from $15 million to $600 million, fueling the company's constant growth.

Russell Corporation, an international athletic apparel company, and Nortek, Inc., a manufacturer of residential and commercial building products, are also strong companies that recognize the benefit of asset-based loans. Both companies have solid financial performance, sales in excess of $1 billion and very strong cash positions, yet both elected to seek out asset-based structures. Russell, a formerly unsecured company in an out-of-favor industry, needed financing options that would give it flexibility. Bank of America Business Capital underwrote and syndicated a $325 million facility that allowed Russell to restructure and execute its growth strategy.

In the case of Nortek, while the building products industry remained strong throughout the recent down cycle, the company wanted to refinance existing debt, buy back some senior and subordinated notes and finance ongoing working capital in a tight time frame. Speed and a flexible structure with limited covenants were among the reasons that Nortek, a portfolio company of Kelso & Company, chose a $200 million asset-based loan.

**Myth #2: There's a stigma attached to going from unsecured to an asset-based loan.**
Becoming an asset-based borrower does not reflect poorly on a company. Many companies seek out asset-based loans because of the benefits they offer in comparison to other forms of financing. Key advantages include more flexible structures and fewer covenants.

Asset-based loans generally require one or two covenants whereas cash flow loans usually require four or five covenants such as fixed charge coverage, EBITDA (earnings before interest, taxes, depreciation and amortization) minimum, interest rate coverage, and leverage ratio maximum. The restrictive nature of these covenants can hamper a company's ability to operate freely and can be burdensome, particularly in a down economy. Most of these financial performance measures are irrelevant in an asset-based facility. The asset-based lender is concerned more with the value of a company's collateral, since it secures the principal, and its excess borrowing base availability (the amount the company hasn't drawn down on the revolver). A larger excess availability gives the company more opportunity to react in the event of a downturn.

Fewer covenants are a primary reason that asset-based loans are considered more flexible than, for example, cash flow loans. They're often more flexible when it comes to how the company can use the proceeds as well. Unlike some other forms of financing, asset-based loans may permit a company to buy back a portion of its bonds, thereby enabling it to reduce its overall debt as in the Nortek example cited earlier.

**Myth #3: Asset-based loans focus solely on liquidation value.**
In order to underwrite the credit, asset-based lenders must understand the company's business as a whole as well as the overall industry. This knowledge enables them to be more patient with the ups and downs of a business. By nature, asset-based lenders work closely with borrowers to anticipate problems and future opportunities. They strive to provide credit facilities that allow companies to meet their ongoing business needs while providing enough liquidity if there's a deterioration in performance. Because the credit facilities are supported by working capital assets, asset-based lenders are comfortable leveraging at a higher level. Consequently, asset-based loans offer more liquidity than traditional bank loans.

Obviously, collateral is the foundation of any asset-based loan. For borrowers with poor or even negative cash flow, there is an intense, almost singular focus on assets. For others, such as those that want to maximize their operating flexibility, an asset-based lender can provide a solution that is influenced more heavily by strong financial performance.

Either way, the asset-based lender can be an expert ally in the business. The asset-based lender knows the company and its business. That knowledge, coupled with experience in many industries, puts the asset-based lender in the best position to appraise the collateral accurately. The asset-based lender is skilled at finding value where other lenders may not, thereby maximizing a company's borrowing power. In addition to inventory, receivables, and property, plant and equipment, intellectual property such as trademarks and trade names may be used to secure the loan.

An asset-based lender also can be helpful in identifying and sourcing other financial products and services. Additional debt capital markets products such as private placements or services including cash management, foreign exchange and interest rate protection are examples of how an asset-based lender, particularly one that is bank-owned, can meet the broad-based needs of a business.

**Myth #4: Reporting requirements for asset-based loans are daunting.**
Since the loan amount is supported by collateral, it's important for the lender to be aware of its current value. Accounts receivable and inventory change every day. Borrowers are required to report those changes daily, weekly, or monthly depending on the relative risk. However, automation and electronic communication have made this process much less onerous. Years ago, someone at the borrowing company physically had to write down the numbers, multiply them by some factor and then mail the calculations to the lender. Today, that information can be transmitted via the Internet with applications like my.bofabusinesscapital.com. This makes reporting much easier and considerably less time-consuming.

Reporting requirements used to be applied rigidly across the board, but these days lenders employ them in a much more flexible way, essentially customizing the process for each borrower. For instance, if a company has a $50 million revolver secured by inventory and receivables and draws it down to $49 million, daily reporting of collateral would be required because the excess margin is so thin the lender needs to know if the inventory goes down. But, if that same company is using only $20 million of the $50 million in borrowing capacity, it may not be necessary for the lender to see the numbers as often. As a general rule, healthy companies have more leeway when it comes to reporting while distressed companies need to check in more frequently.

Beyond the value to the lender, many companies have found that reporting adds a discipline to their businesses that can help them prosper in the future. It's not unusual for a company to continue the asset-based reporting process even after it pays off the loan.

**Myth #5: Asset-based loans are more costly.**
Leveraged loans typically are priced relative to the credit risk. Within the leveraged loan category, asset-based loans are one of the most cost-efficient options. Today's asset-based loans are priced competitively and may even be less expensive than other bank loans. As a result of the number of unsecured loans that have underperformed in recent years, the market has come to realize that there should be a higher premium on leveraged cash flow loans than on asset-based loans where the risk of principal loss is buffered by collateral.

**Myth #6: An asset-based loan is the last stop on the road to bankruptcy.**
Asset-based loans are used by healthy companies to fund a wide array of business objectives including growth, acquisition, expansion or working capital. Pursuing one doesn't mean a company is on the road to bankruptcy. However, in the event that bankruptcy becomes inevitable, an asset-based lender, particularly an incumbent one, is in the best position to guide the company through the courts and provide the DIP (debtor-in-possession) financing. Its intimate knowledge of the company as well as vast experience dealing with the cyclical nature of business make the asset-based lender a true advocate for the borrower.

An incumbent lender can be an adviser in the filing process and the existing senior credit facility often can remain in place while a new deal is structured. The ultimate goal of the DIP lender is for the bankrupt company to emerge from Chapter 11 as a viable entity. With that in mind, DIP lenders sometimes provide the DIP and the exit financing in one commitment. While years ago, filing bankruptcy meant the end of the business, today there are scores of businesses that have exited Chapter 11 as healthy, going concerns.

Beyond that, many companies realize the value of having an established relationship with an asset-based lender throughout the company's lifecycle. Asset-based lenders are comfortable helping companies through tough times as well as prosperous ones and can be an essential source of liquidity during a period when other funding sources may be less available (Exhibit #2—Lifecycle Lender Options).

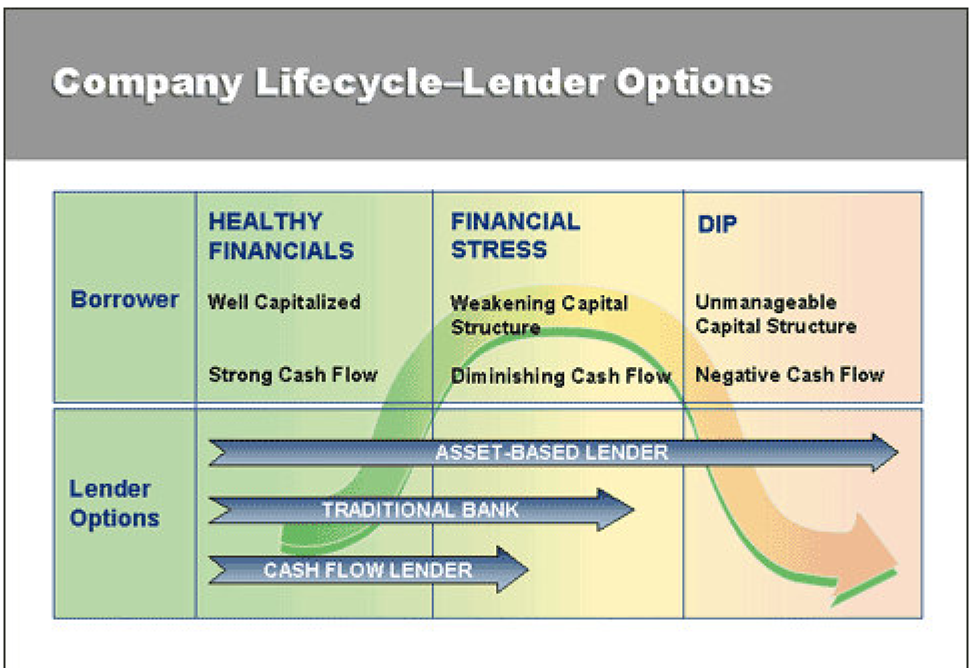



Exhibit 2

**Conclusion**
Clearly, the asset-based lending industry has evolved considerably over the past two decades. Even over the last few years, there's been a shift in the companies that use the product. K-Mart, Goodyear, The Gap, United Airlines and Rite-Aid all have

tapped the asset-based market recently for loans as large as $2 billion.  An asset-based loan of a billion dollars was unheard of as little as 24 months ago.

What hasn't changed is the fact that asset-based loans are available in good times and bad.  Unlike some other more volatile credit markets, asset-based loans are enduring.  While the image of the product still may lag behind the present day reality, asset-based loans remain a stable, steady source of financing for a variety of companies and circumstances.  In short, they're smart business.

*For more information on asset-based loans, visit:*

Frequently asked questions about asset-based loans

Tried, true and trusted-a primer on asset-based loans

Demystifying asset-based loans

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