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Baubles, Beechcrafts & Brand Names: Lending Against Untraditional Assets

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Incorporating the value of untraditional assets into a debt structure to generate incremental liquidity is anything but formulaic and lenders need to approach this with two things in mind. First, it's smart to assume a wind-down is going to happen to identify any pitfalls in the exit strategy. Second, like an archeologist, lenders need to bring a relentless commitment to digging.

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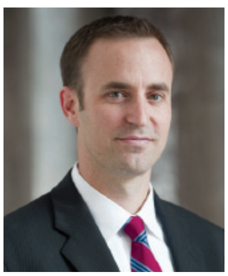

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For the majority of asset-based loans, lenders can usually estimate liquidation values with a high degree of confidence based on historical precedent. For example, the liquidation value of "brick and mortar" retail inventory can be easily substantiated using data points from numerous going out of business (GOB) sales in multiple product categories. The standard deviation of the actual liquidation values relative to the appraised values is typically a narrow range.

Conversely, these data points are not readily available for other asset classes lacking significant liquidation experience. Appraisals of such assets are more theoretical with an expected wide variance from actual liquidation results in worst-case scenarios.

In today's frothy and competitive lending environment, lenders often must look beyond accounts receivable and inventory to differentiate themselves. Lending on untraditional assets is being considered, but to do this successfully, lenders need to really understand what happens in the most draconian liquidation scenarios. Are there other parties, either strategic or financial, that would want to purchase this asset? How would they look to monetize its value or pay for the benefit of ownership?

This analysis can be further complicated when the assets are unique or intangible, or when the company and/or its industry is struggling. Despite such challenges, we believe that with appropriate diligence in understanding a company, its business model and the unique dynamics of the market in which it operates, a viable loan structure with an appropriate risk-adjusted return can be established.

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Below, we outline some of the challenges, creative structures and lessons learned from several deals closed by Crystal Financial that featured untraditional assets as the primary collateral.

TV and Digital Retailer: A Combination of Hurdles

Our client was a multimedia retailer that markets and sells merchandise direct to the consumer through various digital platforms — primarily a live 24-hour digital home shopping channel that is broadcast via satellite and cable channels, as well as through online, mobile and social media outlets. The majority of its products are watches, home goods, consumer electronics and jewelry. In addition to inventory, the company's other primary asset was a pool of installment-based consumer receivables.

At the time of our initial diligence, the company was in the early stages of a turnaround. While the senior management team was strong and committed, the company had not yet proven out its business model and its recent performance included negative EBITDA levels.

Many institutions would not consider a loan to a company that was unable to cover its fixed charges and had assets whose liquidation would require the utilization of untested distribution channels. While home shopping networks have plenty of experience selling merchandise in a promotional environment, to our knowledge such channels have never been used to sell inventory in the context of a bankruptcy process. The cable and satellite television channels also might not be viable sales channels because of the lack of contracts governing content distribution. Lastly, the network's largest content distributor had a lien on its corporate headquarters, which added uncertainty concerning access to the collateral.

To ensure we were prepared for a possible wind-down scenario and to mitigate the process risks surrounding the consumer receivable portfolio, we hired a third-party backup servicer to do regular downloads of the receivables data. By doing the data migration and mapping upfront, we were ready to transfer all data for collection if required. This element also allowed us to provide more aggressive advance rates.

Regional Airline: Survival Threat, Spare Parts and Fuel

You don't have to be an industry expert to know that the airline business can be as perilous as flying blind in a blizzard. American Airlines is only the latest entry on a long list of carriers forced to declare bankruptcy due to fierce competition, razor-thin margins, unpredictable operating costs, economic downturns and a host of other factors. In 2011, regional airlines flying in remote areas of the United States faced another kind of risk — the possibility that the federal government would no longer subsidize their operations.

This scenario was the backdrop for a $35 million commitment we provided to a regional airline in the western United States. The key issue in question involved the Essential Air Service (EAS) program, a government subsidy program to airlines flying to rural airports in the U.S. that Congress has to reapprove every year. During the summer and fall of 2011, congressional debate about the debt ceiling was at a fevered pitch, and it was unclear if the EAS program would continue. If eliminated, the regional carrier would lose nearly half of its revenues and have difficulty operating.

While all of the noise around the EAS program gave us pause, our research suggested that the likelihood of it being cancelled was low given the importance of providing air service to the rural U.S. As with many of our transactions, we evaluated the risk relative to the ability of the collateral to cover the loan in full in a worst-case scenario.

Although the value of airplanes in the secondary market can be evaluated relatively easily, a number of lenders have gotten burned lending on spare parts. The value is not a function of discounting, since buying is driven primarily by need, not price. To determine the addressable market for the company's thousands and thousands of parts, we had them appraised by the world's largest specialist in the recovery of aviation equipment. In the company's favor was the fact that the majority of the spare parts inventory was used on two extremely popular aircraft, the 1900D and the King Air. This active secondary market was a significant factor in this transaction.

Fuel has been a primary driver of bankruptcy in this industry. This regional airline, however, operates a fleet of efficient turboprop airplanes, which tend to hold their value more than regional jets in times of rising fuel prices. Understanding this critical industry dynamic was an important factor in discerning the value of the aircraft that make up a large portion of the collateral pool.

Through our diligence, we gained an understanding about the EAS program and other industry issues such as the impact of changes in fuel prices on the company's profitability. Ultimately, we collaborated with management to structure a revolver and a term loan that met their objectives and positioned them with sufficient liquidity to continue to expand and enhance their business.

Art & Science: Intellectual Property, Contracts & Lease Streams

Intangible assets are usually considered boot collateral in asset-based structures and are not generally incorporated into the borrowing base. We've recently been involved in many deals in which intangible assets were key components in the financing structure. We have found that incorporating these assets and their value into the underwriting is both an art and a science.

Intellectual property, such as brands, can have significant value to third parties under certain circumstances. To ascertain that value, however, goes well beyond a discounted cash flow or relief from royalty analysis. It requires a qualitative analysis of who would want to buy this intellectual property, and why, and under what circumstances they would want to buy it. Crystal has underwritten multiple transactions for which a company's brand has been a direct component of the borrowing base.

Long-term contracts of recurring revenue businesses also can prove to be a valuable intangible asset. Crystal recently closed a transaction to a company whose primary revenue driver was the maintenance and service contracts for its mission critical machines, which its customers needed to operate 24/7. Crystal concluded that these contracts would have value to a third-party servicer and worked with industry experts to properly value them as collateral support for the term loan.

A third example of an unusual type of asset class is a lease stream, which is far different than a receivable. While a receivable is earned, a lease stream requires the combination of time and certain actions to generate value equivalent to a traditional receivable. Like other intangible assets, historical data plays a significant role in figuring out the collectability of a lease stream. However, a qualitative analysis of all factors that could negatively impact value is equally important.

As players in the asset-based market seek growth opportunities, lending against untraditional assets will likely become more commonplace... The difference between being creative to find value in assets and straying too far ... can be a fine line.

Asset Archeologists

Incorporating the value of untraditional assets into a debt structure to generate incremental liquidity is anything but formulaic. Our experience has taught us that there are two prerequisites.

First, a lender must approach the analysis from the perspective that a wind-down is going to happen. We have found that mentally considering this outcome and the appropriate actions you would take can help you identify any potential pitfalls in an exit strategy.

Second, like an archeologist, a lender has to have a relentless commitment to keep digging. Lenders must take the time to dive deep into a company's "story" — its business plan, competition, market conditions, risk factors and prospects for success — as well as its assets and all of the factors that can affect the value of those assets. Because of the complexity inherent with untraditional assets, it is best to have expert third parties (e.g., appraisers, consultants) along side you to help with the "excavation."

As new entrants and existing players in the asset-based market continue to seek growth opportunities, lending against untraditional assets will likely become more commonplace. A word of caution: The difference between being creative to find value in assets and straying too far from a disciplined credit policy can be a fine line. By doing extensive diligence on companies and industries, and leveraging external resources to understand the worst-case scenarios, we have been able to make these types of transactions both a value add for the client as well as a core competency for our firm. abfj

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