



# INNOVATION IN ASSET-BASED LENDING





In the competitive ABL market with low loan utilization, innovation is a sure-fire route to sidestepping compression in yields and tight loan structures. Lenders who are taking new approaches to collateral are finding many profitable avenues with strong loan balance utilization. With increasing globalization, innovative lenders are finding ways to leverage international collateral.

**By Hugh C. Larratt-Smith**

The finances of the Confederacy are one of the great might-have-beens of American history. In the final analysis, it was as much a lack of good collateral as a lack of military and industrial power that hindered the Confederate war effort. The South desperately needed capital from Europe, but European investors mistrusted the Confederacy, thinking it was not creditworthy (the Confederate President, Jefferson Davis, had openly advocated the repudiation of state debts when he was a U.S. senator). To raise capital in Europe, the Confederacy had to sell bonds that were collateralized with cotton. But the blockage of New Orleans in 1862 was strangling the cotton exports of the South.

That's why, even though the fall of Vicksburg in 1863 is always judged as one of the great turning points in the Civil War, from a financial point of view it was not really the decisive one. The key event happened more than a year before in New Orleans — more than 200 miles downstream from Vicksburg. On April 29, 1862, Flag Officer David Farragut had run the guns of Fort Jackson and Fort St. Philip to seize control of New Orleans, thus strangling the South's cotton exports.

Fast-forward 100 years to the 1960s: much of asset-based lending (ABL) was still based on cotton as collateral. However, instead of raw cotton, numerous asset-based loans were collateralized by garments centered in the fashion district in New York. Many of CFA's founding members were leading factors in the New York apparel industry.

"People's appetite for risk has evolved in the past 50 years," says Bruce Sprenger, group senior vice president — region manager with Cole Taylor Business Capital in Chicago. "Asset-based lenders kick-started the industry using accounts receivable in the 1960s. Then people got comfortable using inventory as collateral — after that, lenders started to advance against machinery and equipment, and finally, real estate. It's been a process of migration of risk and collateral, with plenty of experimentation along the way."

During this time, many traditional asset-based borrowers started to disappear

from the American landscape — witness the shoe industry in New England, the furniture industry in the Carolinas, the garment-manufacturing industry in New York, the tire industry in Ohio and the glove-manufacturing industry in Upstate New York. The challenge for asset-based lenders has been to find new types of collateral to lend against.

In the late 1990s, Wells Fargo Foothill was an industry pioneer in monetizing the recurring revenue streams of software companies. They focused on "mission-critical" software that was crucial to companies and, hence, was the highest priority for borrowers to keep current. Wells looked at the maintenance contracts for software and figured that a borrower would have to be in pretty rough shape to default on a payment for mission-critical software maintenance. Some industry players cocked their eyebrows at this initiative, but word on the street is that Wells has profited handsomely from this market niche — low write-offs and great margins. A lot of education went into making sure their underwriters knew which software was mission-critical.

Today, Wells Fargo Capital Finance, the successor to Foothill, is an industry pioneer with its new film-financing venture based in Santa Monica. This new group lends against the payment streams on films that have rock-solid distribution contracts in place — say, an international distribution agreement with a minimum payment amount. Wells is leveraging off its learning curve from its technology finance group and the fact that it sits in the heart of the entertainment industry. Many other asset-based lenders have jealously noted that this is an underserved ABL market, which should augur well for profitability.

"If we like management and understand the business model, we will lend against collateral that is not bread-and-butter," says Gail Bernstein, executive vice president of PNC Business Credit in Pasadena. "We did a deal where we monetized the cash flow from parking meters in Southern California. We were impressed with management's business

acumen and innovative strategy and were comfortable with the cash-flow characteristics."

Another example of new types of collateral comes from TV production companies, which have been actively canvassing the mainstream ABL marketplace for equipment financing to support reality shows such as *The Biggest Loser*. Due to the uniqueness of the collateral and the cash-flow characteristics of preproduction and postproduction TV companies, asset-based lenders need to have a deep understanding of the industry's strengths and weaknesses.

"Equipment financing in the postproduction film marketplace is a poster child for the opportunities and challenges for the asset-based finance industry," commented Michael Haddad, president of Newstar Business Credit in Boston and CFA first vice president. "Digital technology in filmmaking is creating huge demand for new filmmaking equipment. However, many ABL players have lent against legacy filmmaking equipment, which is 'sunset' technology."

"The key to lending against 'esoteric' collateral is proving the sustainability of cash flow," commented Jeff Knopping, managing director at William Blair & Company in New York. "Lending against collateral, such as music revenue streams or intellectual property that is not readily accessible requires a high degree of comfort that the production of cash flow won't be interrupted and is, in fact, highly predictable." In a former life, Knopping closed a deal that monetized the liquor distribution rights of a municipality. "We were highly confident in the predictability of per capita and consumption growth," he said. "The math was easy and the transaction worked."

"If you take the time to understand the business model, there are many other types of opportunities that can be financed," said Mike Maiorino, executive vice president of Peoples United Business Capital in Bridgeport, CT. "In my experience, regional lenders can show a higher degree of flexibility and a willingness to consider unique collateral than perhaps most of the large national players who

usually cannot invest the time.”

Asset-based lenders have done deals with litigation claims, tax liens and drug prescriptions. “Lending against litigation ‘claims’ has a lot of nuances, and my group did a tremendous amount of research before we considered doing a deal in that segment,” Maiorino commented.

“I like to focus attention on a borrower’s intangible assets such as intellectual property, customer base, distribution footprint, contractual revenue streams, etc., to see if they can support a loan underwriting,” said Colin Cross, senior managing director at Crystal Financial in Chicago. “Consumer brands are a category we have been lending on for years, usually with a term loan supported by the brand and related intellectual property. Though intangible, these assets are often the most attractive to a strategic buyer.”

John Brignola, a partner at LBC Credit Partners in Philadelphia, echoes this lending thesis: “We spend a lot of time understanding a company’s business model. In addition to formulating an opinion of the business’s enterprise value, our analysis, oftentimes, will uncover intangible assets that may have intrinsic value. These assets could be customer lists, intellectual property, licensing rights and many others. In a downside situation, these types of assets can create additional exit strategies for us.”

Some lenders have the ability to look at collateral through multiple lenses at the same time. Bernstein noted: “We are able to differentiate ourselves with term overadvances and a second-lien product, which has been helpful for companies involved in a buyout or dividend recap.”

Speaking of tough collateral, what does Hulk Hogan have to do with ABL? Earlier this year, the Los Angeles loan production offices of two banks booked a \$60 million ABL revolver secured by subprime car titles. The company is 800LoanMart, which recently signed up Hulk Hogan as their spokesperson. The average loan is \$2,500 against a car title, and some have weekly amortization with a spread over Treasuries that makes Greek debt look cheap (like the Eagles song “Hotel California,” you can never leave!).

Many lenders are becoming more cautious about business plans that borrowers are presenting for new underwritings. “We are sensitizing any plan that we get now — we’re assuming flat 2011 growth over 2010,” said Haddad. “The political gridlock in Washington, the problems in Europe, the high unemployment levels, continuing housing and commercial construction weakness and poor consumer sentiment are causing hesitation in the asset-based lending world.”

Despite the flashing yellow lights on the global economy, some ABL sectors will continue to show sustained strength. “We think there’s an addressable capital equipment finance marketplace of \$45 billion in 2012. Notwithstanding stagnant economic growth forecasts, investments in equipment are projected to rebound due to companies’ prolonged cutbacks in capital expenditures. Particularly in the energy and technology sectors, we’re optimistic about loan demand,” says Vincent Belcastro, group head of CIT Capital Equipment Finance, in New York. “For example, Stage 3 EPA requirements for trucks will create significant demand for equipment financing. Food CAPEX will continue to be steady — we’re in the underwriting stage of a food-processing equipment line where our security interest will coexist with the UCC security interest of the senior lender.”

“Asset-based lending is becoming more global, and ABL players need to be able to address their U.S. borrowers’ international financing requirements. Getting comfortable with foreign accounts receivable has always posed a challenge to domestic ABL players,” Haddad said. “CFA has recognized this increasing globalization and is establishing strategic alliances, such as with a UK factoring association. The CFA board and staff are looking at Spain, Italy and then Germany as areas to focus our international efforts. CFA recently held conferences in London and Mexico, and we are working on cosponsoring a conference in China later this year,” Haddad noted.

Gail Bernstein adds, “We had a borrower with international operations, so we partnered with a well-known logistics

company who could track inventory worldwide and were able to increase a borrower’s line by \$10 million to cover their operations in China. This value-added approach allowed us to lure this customer away from one of our biggest competitors.”

Jim Cannella, president of Asset Based Lending at The Huntington National Bank in Cleveland, echoed this. “In today’s global economy, we very rarely encounter a company that does not have some semblance of a global presence (i.e., import, export, overseas operations, etc.). If the industry is to remain competitive, we need to continue to find better ways to mitigate the risks of lending into Mexico, South America and China.”

Desperate to get financing after the New Orleans blockade in 1862, the Confederacy manipulated the price of cotton, driving it up from \$6.50 per pound in 1860 to \$27.25 to make their collateralized bonds attractive to lenders. If the South had managed to hang on to New Orleans until the 1862 cotton harvest had been exported through New Orleans to the cotton mills of England, then they might have managed to sell £3 million of cotton-collateralized bonds in London. However, as we all know, collateral is only good if a creditor can lay its hands on it. In 1862, any bondholder who wanted to get his collateral had to run the Union blockade in and out of New Orleans, which was not an enticing prospect. The lesson learned here is that breaking a lender’s trust is devastating to a borrower’s larger efforts. **TSL**

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