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ASSET-BASED FINANCINGS FOR
ACQUISITIONS – COUNTING ON
YOUR ASSETS

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1. INTRODUCTION

The following discussion focuses on the practical aspects of asset-based finance in today's marketplace. Broadly speaking, asset-based financing is a type of working capital financing that is based primarily on the value of collateral that is relatively easy to value and liquidate as opposed to being based primarily on the enterprise value and projected cash flows of the borrower.

While historically these types of financings were more common in small- and middle- market financings, over the last several years they have become a broadly accepted corporate financing tool in the capital markets. In fact, asset-based loans have been combined with a high yield issues as an important part of the capital structure in acquisition financings, and have been used by traditional corporate borrowers to replace cash flow loans and avoid leverage and other financial covenants.

This paper will begin with a discussion of some of the key elements of an asset-based financing and a comparison to cash flow loans and then will focus on certain key provisions of asset-based loan documents.

2. THE BORROWING BASE IN ASSET-BASED LOANS

The distinguishing feature of an asset-based loan is that the amount that a borrower may borrow at any one time is limited by both the total commitments of the lenders under the applicable credit facility and by the borrowing base. This is in contrast to the traditional cash flow loan where, so long as the borrower is in compliance with the applicable loan documents, a borrower may borrow the entire committed amount of the facility. By limiting the outstanding balance of the loans to a borrowing base, asset-based lenders are more comfortable with the likelihood that they will be repaid

in full from the value of the collateral. This comfort level with collateral coverage often allows asset-based lenders to be more flexible in other areas of the loan documents, including mandatory prepayments, operating covenants and financial covenants.

In fact, many asset-based loans in today's market have only a single financial covenant – the minimum fixed charge coverage ratio – and even that often does not apply unless "excess availability" (i.e., the excess of (a) the lesser of the commitments and the borrowing base over (b) the outstanding loans) is less than a negotiated minimum. This "covenant-lite" structure has proven to be an effective marketing tool for lenders because it offers borrowers the ability to obtain committed facilities for their working capital needs without burdening the borrowers with ongoing financial maintenance covenants.

(a) Borrowing Base

The borrowing base in an asset-based loan may consist of accounts receivable, inventory, equipment and even real estate, depending on the borrower's needs, credit quality and industry. Each deal is different and lenders are constantly looking at the quality of the collateral and the ease with which it can be converted into cash in order to set appropriate advance rates. A typical borrowing base definition might read as follows:

"Borrowing Base" means, as of any time, the sum of (a) 85% of the borrower's eligible accounts receivable, plus (b) the lesser of (x) 65% of the value of the borrower's eligible inventory valued at the lower of cost or market, determined on a first-in, first out basis and (y) 85% of the net orderly liquidation value of the borrower's inventory determined

by the most recent appraisal delivered pursuant to the loan documents, minus (c) reserves.

The sample borrowing base definition works well in situations where the collateral value of inventory and receivables generates sufficient availability to meet the borrower's liquidity needs on a day-to-day basis. If that is not the case, many lenders are willing to include a so-called fixed asset component consisting of equipment and/or real estate subject to lower advance rates. This so-called fixed asset component often amortizes from the borrowing base on a monthly basis over a five to seven year period. The required amortization reflects the increased risk that asset-based lenders perceive in the fixed assets as well as any actual depreciation in asset value. It also reflects the asset-based lender's desire to have a high percentage of borrowing base consist of the more liquid inventory and receivables. In fact, some lenders limit the fixed asset component to no more than 25% of the borrowing base.

Before a borrower seeks to include fixed assets in the borrowing base, it should consider all available options to determine how best to unlock the value of the collateral. For example, a fixed asset term loan secured by a first lien on fixed assets and a second lien on working capital assets may provide the most efficient solution. Alternatively, in transactions where the asset-based lender requires a first lien on all assets but is not willing to include fixed assets in the borrowing base, a second lien term loan may be an effective solution. "Covenant-lite" solutions with reciprocal first liens (i.e., asset-based lenders have a first lien on working capital assets and a second lien on fixed assets while the term lenders have a first lien on the fixed assets and a second lien on working

capital assets) have added to the general acceptance of the asset-based loan product in the marketplace.

Once a lender and a borrower have agreed upon the asset classes and advance rates that determine the borrowing base, it is time to examine the eligibility standards and the concept of reserves, as it is only when these are established and applied to a borrower's specific situation that the lender and the borrower will be able to determine how much may be borrowed over the life of the facility.

(b) Eligible Receivables

As previously discussed, the ability of the lenders to extend credit in the asset-based financing context is based on the relative liquidity and value of the collateral. Receivables are the most liquid of the asset classes typically found in the borrowing base, but even these are discounted by lenders. A typical advance rate on receivables is 85% of those that are eligible – the key phrase being "those that are eligible." In order for a receivable to be eligible, it generally must be an account receivable that is (i) generated in the ordinary course of business and subject to a first priority perfected security interest in favor of the administrative agent or the collateral agent, (ii) not more than a specified period of time overdue or past the original invoice date, (iii) not owing from an account debtor that has more than a specified percentage of accounts that are ineligible, (iv) not in excess of concentration limits and credit limits, (v) not a progress billing or otherwise contingent on future performance, (vi) not owing from an insolvent account debtor, (vii) owed by an account debtor that maintains its chief executive office in the United States or Canada, (viii) not owed by a government agency unless the borrower

complies with the United States Federal Assignment of Claims Act and any similar state or local law, (ix) not subject to offset or counterclaim or owed by any affiliate of the borrower and (x) not determined to be ineligible by the administrative agent in its permitted discretion. Each lending institution has its own standards of eligibility and will likely have requirements in addition to those listed above.

(c) Eligible Inventory

Following receivables, inventory is the next asset class that is relatively easy to value – although the ability to liquidate may depend on several factors, including access to the collateral, the ability to continue to use brand names in a liquidation sale and whether further investment is required to realize the value of the collateral. Inventory appraisals are typically done on an "as is- where is" basis in an attempt to arrive at the true liquidation value of the collateral. A typical definition of Eligible Inventory includes inventory only if it is (i) subject to a perfected first priority security interest in favor the administrative agent, (ii) not slow moving or obsolete, (iii) finished goods, (iv) at a location owned by the borrower or at a leased location or third-party warehouse if the administrative agent has received satisfactory lien waivers and access rights, (v) located in the United States of America, (vi) of a type that may be sold by the administrative agent without infringing on the intellectual property rights of others or requiring the administrative agent to pay additional royalties in connection with a sale, and (vii) not determined to be ineligible by the administrative agent in its permitted discretion.

(d) Reserves

Most asset-based loan agreements grant the administrative agent the right to establish reserves against the borrowing base or the commitment in its permitted discretion. These reserves may relate to costs required to liquidate the collateral (such as potential payments to landlords and third-party warehouses, payment of taxes, protection and preservation of collateral and costs of preparing collateral for sale), reserves for dilution of accounts, shrinkage reserves for inventory and other items that affect the value or liquidity of the collateral. Reserves are an important tool for asset-based lenders that may be used to ensure that credit exposure (which often includes not only the outstanding loans and letter of credit reimbursement obligations, but also cash management and hedging obligations) does not exceed the likely value of the collateral upon liquidation. While borrowers may argue against reserves and try to establish parameters, any hindrance on the ability to establish reserves may result in reduced flexibility elsewhere in the loan agreement.

(e) Amendment of the Borrowing Base

As discussed, the concept of the borrowing base is the cornerstone of an asset-based loan. Given that the credit decisions of many lenders in the syndicate will be based on their analysis of the collateral included in the borrowing base and the advance rates associated with that collateral, it is not surprising that syndicate members attempt to limit the discretion of the administrative agent to include new items in the borrowing base and are hesitant to allow amendments to the definition of borrowing base and related terms. A typical asset-based loan agreement will require

either super-majority or unanimous lender consent to change the definition of the borrowing base, increase advance rates or add new classes of eligible assets to the borrowing base.

3. PREPAYMENTS AND COMMITMENT REDUCTIONS

(a) Mandatory Prepayments

Like cash flow loans, typical asset-based loans require mandatory prepayment of the loans upon issuance of debt, issuance of equity securities and the sale or other disposition of assets (other than the sale of inventory in the ordinary course of business and other limited exceptions). In addition, a mandatory prepayment is required at any time the amounts outstanding under the loan agreement exceed the borrowing base. However, if the asset-based loan in question is solely a revolving loan (*i.e.*, there is no term component that requires a permanent deleveraging), the loan is often structured so the borrower may reborrow the amount prepaid so long as the borrowing base will support the borrowing. This makes the loan unlike many other types of loans where these prepayments would also be accompanied by a permanent reduction of commitments.

In addition to the typical prepayments described in the preceding paragraph, most asset-based facilities either have the concept of "full dominion" from the outset or "springing dominion." "Dominion" is a term of art in the asset-based lending market and refers to how proceeds of collateral (*i.e.*, payments on receivables that are received on a daily basis) are to be applied. In a springing dominion transaction, the lenders agree that so long as the borrower maintains some minimum level of excess availability under the

loan agreement (i.e., the excess of (i) the lower of the total commitments or the borrowing base over (ii) amounts outstanding under the loan agreement), payments in respect of collateral may be collected into a lockbox, transmitted to a concentration account and then retained by the borrower. Once full dominion takes effect, the collections that reach the concentration account are used to repay the outstanding loans on a daily basis. In this scenario, the borrower borrows on a daily basis to meet its cash needs.

(b) Voluntary Prepayments

In today's market, borrowers are generally allowed to prepay revolving loans without premium or penalty, other than customary breakage costs if loans are repaid other than on an interest payment date. The effect of a prepayment is simply to lower the cost of the loan to a borrower, effectively trading the full interest rate for the unused line fee.

(c) Voluntary Commitment Reductions and Termination of Commitments

Voluntary commitment reductions are also common in the asset-based lending market, although these are often accompanied by limitations on the size of any reduction, and a prepayment fee in the early years of the facility. In addition, because asset-based lenders focus on liquidity, many asset-based loans require a minimum facility size after giving effect to any commitment reduction.

4. REPORTING REQUIREMENTS

(a) General

Another area where the asset-based loan differs significantly from the traditional cash flow loan is in the area of financial reporting. While the typical cash flow loan requires delivery of annual, quarterly and sometimes monthly financial statements as well as notices of certain material events, the asset-based loan will require detailed reporting with respect to the collateral in addition to traditional financing reporting. This detailed reporting is essential to the asset-based lender given that its credit decision is based in large part on setting (and possibly adjusting) advance rates and borrowing base definitions in a timely manner so that the loans and other secured obligations outstanding never exceed the collateral value.

(b) Borrowing Base Certificates

Depending on the credit quality of a particular borrower and the level of excess availability from time to time, a borrower under an asset-based loan agreement is generally required to deliver a borrowing base certificate on a weekly or monthly basis. Often, the lenders are entitled to ask for more frequent reporting if the administrative agent requires greater frequency in order to ensure an accurate determination of availability.

(c) Backup Information

In addition to the monthly or weekly borrowing base certificates, a borrower under an asset-based loan agreement is often required to deliver, on a weekly or monthly basis, detailed agings of accounts receivable and accounts payable, schedules of the borrower's

inventory and worksheets setting forth the calculation of eligible inventory and receivables.

(d) Field Exams and Appraisals

In addition to the rights to inspect the books and records of the borrower and to discuss the borrower's business, operations and financial condition with the borrower's officers and independent accountants, all customarily found in a cash flow loan agreement, lenders (or the administrative agent on behalf of the lenders) under asset-based loan agreements have the ability to conduct field exams and inventory appraisals. While lenders require the unlimited right to conduct these exams, in some transactions the borrower's obligation to pay (or reimburse the administrative agent and the lenders for) these exams and appraisals is limited to two field exams per year so long as no event of default has occurred and the borrower has sufficient excess availability.

5. FINANCIAL COVENANTS

(a) Springing Fixed Charge Coverage Ratio

One of the biggest benefits to a borrower in today's asset-based loan market is that often there are no financial covenants unless the borrower's excess availability falls below some threshold set at the outset of the transaction. Even when excess availability falls below that level, frequently the only financial maintenance covenant is a requirement to maintain a fixed charge coverage ratio of at least 1.00:1.00. However, it is important for borrowers to continue to monitor the fixed charge coverage ratio even while excess availability is above the threshold because the fixed charge coverage ratio is usually drafted to be based on the most recently delivered

financial statements under the loan agreement. Therefore, if excess availability drops below the relevant threshold mid-quarter, the borrower will automatically be in default if the fixed charge coverage ratio is less than 1.00:1.00 as of the last day of the preceding fiscal quarter. This "lookback" is extremely important to asset-based lenders because they have no other financial covenants that serve as early warning signs and trigger defaults under the loan agreement. Therefore, without the "lookback," excess availability could drop to dangerously low levels (at least in the eyes of an asset-based lender) and the lenders could be forced to fund into a deteriorating situation and risk not having sufficient cushion in their collateral coverage to repay the loan and other secured obligations (i.e., cash management, hedging and letter of credit obligations) in full.

(b) Minimum Availability

Some, but not all, asset-based loan agreements include the concept of minimum availability. Minimum availability requirements may take the form of a reserve against the borrowing base or a covenant to maintain minimum availability. In either event, it is a signal that the lenders are concerned that if the borrower does not meet its financial forecast, the lenders will need to spend significant sums to realize on their collateral. Because the initial credit decision is made on the assumption that the collateral will cover the outstanding loans and other secured obligations under the loan agreement and the costs of enforcement, the lenders believe that in some circumstances the minimum availability requirement is justified.

Of course, a borrower may object to the minimum availability covenant because it means that the borrower must pay for the full line of credit without being able to use it. One solution to this problem is to base the minimum availability covenant on the "collateral availability" – or the amount by which the borrowing base exceeds the amounts outstanding under the loan agreement. Therefore, if the borrowing base exceeds the aggregate commitments by an amount in excess of the minimum availability, the borrower may use the entire line of credit. Whether this will work for any particular borrower and the lenders needs to be determined on a case-by-case basis.

6. SUMMARY

The asset-based loan has become an important capital markets tool in today's world of acquisition financings, recapitalizations and restructuring of corporate credits, sometimes replacing existing cash flow loans. The attractiveness of the asset-based loan product to corporate credits and financial sponsors is based on several distinguishing features. First, the asset-based loan allows borrowers that do not have sufficient historical or projected earnings for a cash flow or enterprise value loans to obtain significant amounts of secured financing largely based on working capital assets. Second, given the "covenant lite" or "springing covenant" structures prevalent in today's asset-based marketplace, borrowers with significant earnings projections now have the option of borrowing based on collateral value with limited or no financial maintenance covenants. This feature is very attractive to highly leveraged companies with significant amounts of public debt as it significantly reduces the risk that failure to comply with a financial covenant in the senior credit facility will trigger cross-defaults throughout the capital structure. Finally, the asset-based product is now viewed as a mainstream product

in the capital markets, allowing traditional financing sources to use this product in combination with term loans and capital markets transactions to offer optimal capital structures to their customers.