Cash Flow vs. Asset-Based Business Lending: What's the Difference?

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Cash Flow vs. Asset-Based Business Lending: An Overview

Whether a company is a startup or a 200-year-old conglomerate like E. I. du Pont de Nemours and Company (DD), it relies on borrowed capital to operate the way that an automobile runs on gasoline. Business entities have many more options than individuals when it comes to borrowing which can make business borrowing somewhat more complex than the standard personal borrowing choices.

Companies may choose to borrow money from a bank or other institution to fund their operations, acquire another company, or engage in a major purchase. To do these things it can look to a multitude of options and lenders. In a broad generalization, business loans, like personal loans, can be structured as either unsecured or secured. Financial institutions can offer a wide range of lending provisions within these two broad categories to accommodate each individual borrower. Unsecured loans are not backed by collateral while secured loans are.

Within the secured loan category, businesses may identify cash flow or asset-based loans as a potential option. Here we will look at the definitions and differences of the two along with some scenarios on when one is more preferred to the other.

KEY TAKEAWAYS

- Both cash flow-based and asset-based loans are usually secured.

balance sheet assets.

- Cash flow-based loans may be better for companies without assets such as many service companies or for entities that have greater margins.
- Asset-based loans are often better for companies with strong balance sheets that might operate with tighter margins or unpredictable cash flow.
- Cash flow-based and asset-based loans can be good options for businesses seeking to efficiently manage credit costs since they are both typically secured loans which usually come with better credit terms.

Cash Flow Lending

Cash flow-based lending allows companies to borrow money based on the projected future cash flows of a company. In cash flow lending, a financial institution grants a loan that is backed by the recipient's past and future cash flows. By definition, this means a company borrows money from expected revenues they anticipate they will receive in the future. Credit ratings are also used in this form of lending as an important criterion.

For example, a company that is attempting to meet its payroll obligations might use cash flow finance to pay its employees now and pay back the loan and any interest on the profits and revenues generated by the employees on a future date. These loans do not require any type of physical collateral like property or

To underwrite cash flow loans, lenders examine expected future company incomes, its credit rating, and its enterprise value. The advantage of this method is that a company can possibly obtain financing much faster, as an appraisal of collateral is not required. Institutions usually underwrite cash flow-based loans using EBITDA (a company's earnings before interest, taxes, depreciation, and amortization) along with a credit multiplier.

This financing method enables lenders to account for any risk brought on by sector and economic cycles. During an economic downturn, many companies will see a decline in their EBITDA, while the risk multiplier used by the bank will also decline. The combination of these two declining numbers can reduce the available credit capacity for an organization or increase interest rates if provisions are included to be dependent on these criteria.

Cash flow loans are better suited to companies that maintain high margins or lack sufficient hard assets to offer as collateral. Companies that meet these qualities include service companies, marketing firms, and manufacturers of low-cost products. Interest rates for these loans are typically higher than the alternative due to the lack of physical collateral that can be obtained by the lender in the event of default. [2]

> **Important:** Both cash flow based and asset-based loans are usually secured with the pledge of cash flow or asset collateral to the lending bank.

Asset-Based Lending

Asset-based lending allows companies to borrow money based on the liquidation value of assets on their balance sheet. A recipient receives this form of financing by offering inventory, accounts receivable, and other balance sheet assets as collateral. While cash flows (particularly those tied to any physical assets) are considered when providing this loan, they are secondary as a determining factor.

company inventory, equipment, machinery, vehicles, or physical commodities. Receivables can also be included as a type of asset-based lending. Overall, if a borrower fails to repay the loan or defaults, the lending bank has a lien on the collateral and can receive approval to levy and sell the assets in order to recoup defaulted loan values.[3]

Asset-based lending is better suited for organizations that have large balance sheets and lower EBITDA margins. This can also be good for companies that require capital to operate and grow, particularly in industries that might not provide significant cash flow potential. An asset-based loan can provide a company with the needed capital to address its lack of rapid growth.

Like all secured loans, loan-to-value is a consideration in asset-based lending. A company's credit quality and credit rating will help to influence the loan-to-value ratio they can receive. Typically, high-credit quality companies can borrow anywhere from 75% to 90% of the face value of their collateral assets.[4] Firms with weaker credit quality might only be able to obtain 50% to 75% of this face value.

Asset-backed loans often maintain a very strict set of rules regarding the collateral status of the physical assets being used to obtain a loan. Above all else, the company usually cannot offer these assets as a form of collateral to other lenders. In some cases, second loans on collateral can be illegal.

Prior to authorizing an asset-based loan, lenders can require a relatively lengthy due diligence process. This process can include the inspection of accounting, tax, and legal issues along with the analysis of financial statements and asset appraisals. Overall, the underwriting of the loan will influence its approval as well as the interest rates charged and allowable principal offered.

Receivables lending is one example of an asset-based loan that many companies may utilize. In receivables lending, a company borrows funds against their accounts receivables to fill a gap between revenue booking and receipt of funds. Receivables-based lending is generally a type of asset-based loan since the receivables are usually pledged as collateral.[5]

companies may prefer to maintain ownership over their assets as opposed to selling them for capital; for this reason, companies are willing to pay an interest expense to borrow money against these assets.

Key Differences

There are ultimately several primary differences between these forms of lending. Financial institutions more interested in cash flow lending are focused on the future prospects of a company, whereas institutions issuing asset-based loans take a historical view by prioritizing the current balance sheet over future income statements.

Cash flow-based loans don't use collateral; asset-based lending is rooting is having assets to post to minimize risk. For this reason, companies may find it harder to secure cash flow-based loans as they must ensure working capital is appropriated specifically for the loan. Some companies simply won't have margin capabilities to do this.

Last, each type of loan uses different metrics to assess qualification. Cash flow-based loans are more interested in EBITDA that strip away accounting impacts on income and focus more on net cash available. Alternatively, asset-based loans are less concerned with income; institutions will still monitor liquidity and solvency but have less requirements regarding operations.

Asset-Based Lending vs. Cash Flow Based-Lending

Asset-Based Lending

- Based on the historical activity of how a company has previously made money
- Use assets as collateral
- May be easier to obtain as there are often less operating covenants
- Tracked using liquidity and solvency but not as focused on future operations

Cash Flow-Based Lending

- Based on the future prospective of a company earning money

- Tracked using profitability metrics that strip away non-cash accounting impacts

Business Loan Options and Underwriting

Businesses have a much wider range of options for borrowing than individuals. In the growing business of online financing, new types of loans and loan options are also being created to help provide new capital access products for all kinds of businesses.

In general, underwriting for any type of loan will be heavily dependent on the borrower's credit score and credit quality. While a borrower's credit score is typically a primary factor in lending approval, each lender in the market has its own set of underwriting criteria for determining the credit quality of borrowers. [6]

Comprehensively, unsecured loans of any type can be harder to obtain and will usually come with higher relative interest rates due to the risks of default. Secured loans backed by any type of collateral can reduce the risks of default for the underwriter and therefore potentially lead to better loan terms for the borrower. Cash flow-based and asset-based loans are two potential types of secured loans a business can consider when seeking to identify the best available loan terms for reducing credit costs.

Is Asset-Based Lending Better Than Cash Flow-Based Lending?

One type of financing isn't necessarily better than the other. One is better suited for larger companies that can post collateral or operate with very tight margins. The other may be better suited for companies that don't have assets (i.e. many service companies) but are confident in future cash flow.

Why Do Lenders Look at Cash Flow?

Lenders look at future cash flow because that is one of the greatest indicators of liquidity and being able to repay a loan. Future cash flow projections are also an indicator of risk; companies that have greater cash flow are simply less risky because they anticipating have more resources available to meet liabilities as they come due.

includes pending accounts receivables, unsold inventory, manufacturing equipment, or other long-term assets. Each of these categories will be defined various levels of risk (i.e. receivables may be uncollectable, land assets may depreciate in value).

The Bottom Line

When trying to obtain capital, companies often have many options. Two such options are asset-based financing or cash flow-based financing. Companies with stronger balance sheets and higher existing assets may prefer securing asset-based financing. Alternatively, companies with greater prospects and less collateral may be better suited for cash flow-based financing.

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