# Borrowing Causes
# Module 2

**Learning Objectives:**

After completing this Module you will be able to:

- Establish difference from cash flow and asset conversion loans
- Define the asset based lending rationale

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**Learning Objectives:**

After completing this Module you will be able to:

- Identify and define the three (3) central conditions which asset based loans are justified
- Discuss seniority, protection and control and how these conditions are achieved in cases of secured lending

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In lending there are three (3) main different lending rationales:

- **Asset Conversion**
- **Asset Based Lending**
- **Cash Flow Lending**

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**LENDING RATIONALES**

- **Asset Conversion**: This lending rationale is defined as seasonal financing provided to a company to finance a temporary build-up of current assets created by deviations in the timing of the product demand or supply during the asset conversion cycle.

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## DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Conversion**: The lending rationale assumes current asset build-up will self-liquidate from the conversion of receivables to cash and the sale of inventory

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## DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Conversion**: This is considered a short-term vehicle that finances short-term needs and payback is derived from the successful completion of asset conversion cycle

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## DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Conversion**: In these lending transactions the credit is justified on the Borrower’s demonstrated ability to recover its costs in the completion of the cycle.

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## DIFFERENCE BETWEEN LENDING RATIONALES

- **Cash Flow Lending**: In this type of lending there is the use of term loans to finance permanent assets such as plant, machinery and equipment.

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DIFFERENCE BETWEEN LENDING RATIONALES

- **Cash Flow Lending**: The rationale is based on the assumption that the acquisition or investment in those assets should generate sufficient incremental cash flow to amortize the loan.

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## DIFFERENCE BETWEEN LENDING RATIONALES

- **Cash Flow Lending**: The repayment of the loan is expected to be generated from the company’s profitability and cash flow generated from the operations.

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DIFFERENCE BETWEEN LENDING RATIONALES

- **Cash Flow Lending**: The credit is based on the assumption that the Bank will be financing future profits. The cash flow generated will repay the loan.

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DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Protection:** This lending rationale is viewed as a hybrid between the asset conversion credit facility and cash flow lending. It also known as ***Asset Based Lending***
- The difference with asset conversion is the tenor (maturity) of the financing need.

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DIFFERENCE BETWEEN LENDING RATIONALES

**Asset Based Lending (Definition):**

- Method of financing that employs short term lending to finance a permanent credit need.

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DIFFERENCE BETWEEN LENDING RATIONALES

**Asset Based Lending:**

- This lending rationale is based on the assumption that the Borrower (company) will have sufficient integrity and capability to assure the continuation as a going concern

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DIFFERENCE BETWEEN LENDING RATIONALES

## Asset Based Lending:

- Short term lending is in the form of a secured term note.
- Credit facility is usually a revolving credit arrangement.
- Assets commonly used in this type of financing are accounts receivable and inventory.

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DIFFERENCE BETWEEN LENDING RATIONALES

**Asset Based Lending**

**Credit facility is usually a revolving credit arrangement:**

- The loan is continuously rolled over
- A complete clean-up of the line does not occur

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DIFFERENCE BETWEEN LENDING RATIONALES

## Asset Based Lending

- Repayment of the line is usually the substitution of debt by other debt
- Level of current assets is usually stable or permanent.

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DIFFERENCE BETWEEN LENDING RATIONALES

**Asset Based Lending**

- The need for financing is ongoing due to rapid succession of asset conversion cycles and numerous transactions.

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DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Based Lending:** This type of lending is supported by the following assumptions:

1. Many companies due to the nature of their businesses do not generate cash flow levels sufficient to amortize substantial amounts of long term debt.

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DIFFERENCE BETWEEN LENDING RATIONALES

- **Asset Based Lending:**

2. The companies suitable for this type of financing are high volume, low value added operations with slim and volatile profit margins. They usually have low equity levels.

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**Asset Protection**: Combination of short term financing to accommodate a permanent need. The loans is considered justified when…

1. There is confidence that the Borrower will continue as a viable going concern
2. It can be demonstrated that under distress circumstances, the Bank will be adequately protected against loss by the liquidation value of the assets.

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**Asset Protection**:

3. In secured lending the Bank must properly establish and maintain a secured claim against specifically pledged assets of sufficient value to repay the Bank if liquidation is necessary.

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DIFFERENCE BETWEEN LENDING RATIONALES

**Asset Based Lending:** In this lending rationale the foundation for a solid credit under-writing is based on the following conditions:

**SENIORITY, PROTECTION AND CONTROL**

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## SENIORITY, PROTECTION AND CONTROL

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**Asset Based Lending:**

**SENIORITY, PROTECTION AND CONTROL**

**SENIORITY:**

- Secured claims have first priority in liquidation during a bankruptcy proceeding.

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**Asset Based Lending:**

**SENIORITY, PROTECTION AND CONTROL**

**SENIORITY:**

* **Explicitly:** The Bank is senior to all other creditors given a legally enforceable secured claim against specific collateral.

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**Asset Based Lending:**

**SENIORITY, PROTECTION AND CONTROL**

**SENIORITY:**

- **Implicitly:** The Bank is senior given an unsecured claim against an assets pool to which no other creditor has a prior secured claim.
- All other creditors have equally senior claim

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**Asset Based Lending:**

**SENIORITY**

The Bank needs to have a legally enforceable claim against specific collateral.

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**Asset Based Lending:**

**SENIORITY**

**METHODS TO ACHIEVE SENIORITY:**

1. **Possessory collateral:** Possession of title documents and/or cash collateral in case of marketable securities

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**Asset Based Lending:**

**SENIORITY**

**METHODS TO ACHIEVE SENIORITY:**

2. **Non-possessory collateral:** Security agreement between the Bank and the Borrower with the filing of a financing statement under Article 9 of the Uniform Commercial Code (UCC)

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**Asset Based Lending:**

**SENIORITY, PROTECTION AND CONTROL**

**PROTECTION:** It is the value of the assets to which the Bank looks for ultimate justification of the loan

- The net realizable value of the pledged assets must be sufficient to satisfy the amount of the unsecured claim.

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**Asset Based Lending:**

**PROTECTION**

**METHODS TO ACHIEVE PROTECTION:**

1. The net realizable value (NRV) of the specific collateral, upon liquidation must be sufficient to repay the Bank's loan exposure

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**Asset Based Lending:**

**PROTECTION**

**METHODS TO ACHIEVE PROTECTION:**

1. **NRV:** May be less than face value as reported in the financial statements given:

   **Price Declines**

   **Discounts**

   **Delivery**

   **Cost to liquidate the collateral**

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**Asset Based Lending:**

**SENIORITY, PROTECTION AND CONTROL**

**CONTROL:** Refers to the ongoing process by which the Bank’s seniority and protection are monitored, maintained and policed.

* **Critical**: Full understanding of the company’s operations, integrity and managerial capabilities

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**Asset Based Lending:**

**CONTROL**

Collateral, bank exposure and seniority are periodically monitored to ensure the collateral existence, the quality and the Bank's first claim on the assets.