

Asset Based Lending: Is Now the Time?

Mark Kendall, Wisemar, Inc.

Asset Based Lending (ABL) at its most basic is simply lending secured by an asset pledged by a borrower. However, in the financial services world it has become more narrowly defined as lending focused on the collateral asset's value for the loan structure. This is in contrast to the more traditional underwriting criteria that examine such things as credit ratings, working capital, debt-to-equity, and debt capacity.

ABL is a way for commercial or small business borrowers to increase debt availability to meet cyclical or seasonal needs. Traditional banks have often ignored assets such as inventories, accounts receivable, machinery and equipment, and even more anomalous things like patents, trademarks, and intellectual property.

Many have viewed ABL as the loan of last resort or a loan structure reserved for marginal clients. However, changes in the economic environment and significant technological advances are now making ABL very attractive to lenders and borrowers alike! The stigma is gone.

Smaller institutions may now safely and effectively add an ABL option to their product mix. Is now the time for ABL at your bank? This report will briefly examine these key areas:

- The Economy and ABL
- The Role of Government
- Technology's Role
- Implementing ABL

The Economy and ABL

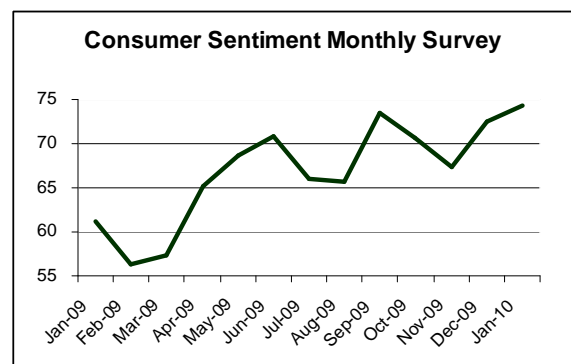
So what has the economy done to lending and more specifically to ABL? It is now commonly accepted that our current economic crisis began with a housing bubble peak. As a very simplified

explanation this housing bubble burst and securities tied to real estate plummeted leading to great distress in the financial markets and financial institutions.

As a result of this turmoil there was a huge liquidity shortfall and the economy tanked. Loan underwriting criteria tightened dramatically and portfolios were decimated. In reaction, the government began taking dramatic steps through fiscal stimulus and monetary policy expansion. Regulatory changes and bailout programs were introduced in an effort to stabilize the economy.

Given the current economic picture, portfolio scrutiny is at an all-time high. Unemployment was reported at 9.7% for January 2010¹, and economic indicators show few bright spots.²

Interestingly, the Consumer Sentiment Monthly Index is showing some improvement. This index indicates how consumers feel about the economy overall, taking into consideration both the present and the future.³



¹ "Employment Situation Summary," Bureau of Labor Statistics, United States Department of Labor, 5 February 2010.

² Economics and Statistics Administration, "Economic Indicators," U.S. Department of Commerce, February 2010.

³ "2009 - 2010 U.S. Consumer Sentiment Monthly Survey Figures," Reuters / University of Michigan, 08 March 2009.

However, businesses are not qualifying for traditional financing because their valuations are down and demand for products has decreased. Balance sheets are contracting and traditional credit facilities are being reduced by financial institutions monitoring weak portfolios. Let's face it: even good clients suffer with cash flow issues, credit problems, and profitability in times like these. No one is immune.

Is there a bright spot among all the troubling trends? The January 2010 edition of the Federal Reserve's *Summary of Commentary on Current Economic Conditions* (Beige Book) reports that 10 of their 12 districts have experienced increased activity or improvement in economic conditions. While that is good news, the loan demand continued to decline or remained weak in most districts, while credit quality continued to deteriorate.⁴

In an environment like this, what should a lending institution do? Mixed signals make strategic planning and implementation difficult. Lending institutions clearly need interest income but can't afford additional charge-offs. In many cases ABL has become a viable answer. What is driving this renewed focus on ABL?

The Role of Government

It is widely anticipated the Small Business Administration (SBA)'s CAPLines guarantee program under its 7(a) Program will experience significant growth over the next 24 months. With the Recovery Act, the guarantee available has been increased to 90% and President Obama's administration is actively pushing to permanently increase the 7(a) lending cap per transaction from \$2 million to \$5 million.⁵

Some worry that a government guarantee allows lending institutions to take on greater risk without the potential downside threat. An executive at one large traditional ABL provider indicated their firm began approving deals from a lower tier on their underwriting risk grade matrix in mid-2009.

⁴ Board of Governors, "Summary of Commentary on Current Economic Conditions," Federal Reserve, January 2010.

⁵ U.S. Small Business Administration, "Administration Announces New Small Business Commercial Real Estate and Working Capital Programs," 5 February 2010.

Another lender interviewed mentioned taking more risk but is compensating with increased pricing. Is an ABL bubble possible? None of the lenders we interviewed thought so, but the potential exists at least in theory. The key to preventing further banking trauma is sound underwriting and appropriate SBA guarantees where available.

When the economy is weak, that is the time when an ABL-type product becomes a very valuable tool for a lending institution. In fact, the top 25 ABL lenders in the country funded 23% more deals in 2009 than during the dismal 2007 and 2008 time periods.

The Wall Street Journal reports that major players such as JP Morgan Chase are proactively expanding their ABL workforce to meet this opportunity.⁶ Obviously there is a lot of life in this segment of lending.



Wisemar's independent research shows that domestic ABL lending will increase in 2010 from 8 - 30%. Regional and community-sized lenders are starting to utilize the SBA programs to enter the ABL marketplace more aggressively. The lower end of the ABL market is largely untapped as some larger lenders have minimum ABL amounts of \$5 million or greater.

Entry into this marketplace has been much easier with the titans of ABL slugging it out for market share at the top end of the market leaving the smaller ABL deals untouched. ABL vendors to the banking industry are reporting an increase in

⁶ Stock, Kyle. "Asset-Based Lending Grows in Popularity," Wall Street Journal, 2 February 2010.

activity of 20-30% through the last two quarters.⁷ It's also interesting to note that the average pricing on all ABL has increased over the past year even in the face of rising competition.

Technology's Role

Whether you are a cutting edge institution looking for a new competitive edge or one who waits to learn from others experience, the correct technology solution will come from a vendor committed to service, upgrades, and support. The vendor must be as robust as the ABL field is dynamic.



Using a premium technology solution for your ABL platform will:

- Reduce risk
- Lower operating expenses
- Facilitate borrowing base audits
- Clearly define and monitor Ineligibles, Reserves, and Dilution
- Provide timely and easy reporting processes, preferably in real-time
- Ensure covenant compliance and default notifications
- Communicate the bank's position clearly to the borrower and regulators

- Integrate seamlessly with existing bank software platforms and lockbox operations
- Handle multiple currencies
- Be intuitive for your staff

A quality technology solution is the optimal way to make ABL a cornerstone product in commercial lending.

Implementing ABL

ABL is clearly one area of lending with significant growth potential. So how can banks successfully implement an ABL platform to realize more interest and fee income?

SBA Certification

Many lenders may wish to evaluate the merits of actively pursuing SBA certification and becoming a "preferred" SBA lender. An SBA guarantee on deals will mitigate some of the risk and allow banks to target smaller relationships. Each organization will need to prepare internal processes and policies so that it may adequately meet the paperwork, tracking, and other requirements as an SBA lender.

Be a Niche Player

Lenders may find value in researching and identifying areas of specialization of ABL lending for industries within its footprint. Most find it easier to be a niche provider and focus on what they can do well. As you seek to determine your strengths, survey your lending team to uncover hidden areas of industry expertise and create a corporate index of this knowledge base. Your employees are your greatest resource (See Wisemar's white paper, *A Renewed Focus on the Employee*, www.wisemar.com).

Regarding a corporate knowledge base, the Bureau of Labor and Statistics issued a news release in June of 2008 reporting that on average people born between 1957 and 1964 "held an average of 10.8 jobs from ages 18 to 42."⁸ Simply stated,

⁷ Wisemar Proprietary Research, Industry Executive Interviews, February and March 2010.

⁸ "Number of Jobs Held, Labor Market Activity, and Earnings Growth Among the Youngest Baby Boomers: Results from a

some team members may know the industries in your footprint because they've worked in them prior to becoming bankers.



Industry knowledge and the opportunity for superior underwriting will allow you to aggressively capture ABL deals and build a quality portfolio. The prior experience and non-bank skill sets of your lenders may be used as a distinct competitive advantage.

Leverage Industry Data & External Talent

It is important that a firm fully documents its underwriting guidelines, policies, and procedures. That information can be used to conduct a thorough benchmark against other lenders for its specific industries. While each organization will have independent risk tolerances, this benchmark process can uncover areas where the firm may be too conservative or too liberal in its policies and procedures.

Additionally, it is advisable to utilize external talent with expertise in this type of implementation to bring your product to market quickly and efficiently. Generally using external third-party resources can dramatically increase the speed-to-market, which will lift current year financial performance accordingly.

Technology Implementation & Integration

To create a sustainable and prudent operation, implement technology solutions to support ABL back office operational efficiency. An emphasis

should be placed on data capture, data quality, multi-currency handling, and real time processing.

An industry best practice is to have ABL integrated into the commercial lending platform to deepen client relationships, not just be a stand-alone product.

Conclusion

So the question remains, is now the time for ABL? Given the economic conditions, now appears to be the optimal time for ABL lending. Industry research and executive interviews by Wisemar affirm that indeed, now is the time for ABL.

Growth in the ABL market is quite evident and the lower end of the market with smaller ABL deals is a particularly attractive target with the right technology solutions in place. Many lenders are evaluating their technology with a focus on future ABL capabilities, and these efforts will provide for future efficiencies.

There is greater fee income and interest income to be realized with ABL lending. It is far less risky than unsecured credit card debt, particularly when you consider the SBA guarantee programs. President Obama's stimulus program and Recovery Act is stirring early growth in the lower end of the market.

Implementing ABL lending leverages many of the capabilities and experiences already in place within your organization. By tapping your internal talent pool, you may be able to uncover new target markets and niche segments where you have in-house expertise.

ABL lending has so much potential, and even in situations where an ABL loan unravels, there is typically a much faster recovery of funds providing less loss. For banks seeking revenue and lending growth in a challenging environment, now is the time for ABL.

Longitudinal Survey," Bureau of Labor Statistics, United States Department of Labor, 27 June 2008.

Mark Kendall is Vice President at Wisemar, Inc. Prior to joining Wisemar, Kendall was with BB&T in the Commercial Lending Group. He has also served with Wells Fargo in the Evergreen Investments, Corporate Marketing, E-Commerce, and Specialty Finance groups. Kendall's previous roles also include president of a marketing and design firm as well as manager of a regional wholesale operation.

Wisemar is a management consulting firm providing dynamic solutions for the alignment of people, processes, products, and technology. The firm specializes in helping financial services clients through business process improvement, change management, and corporate strategy engagements. Wisemar was founded based on one simple principle – “client satisfaction.”

Wisemar leverages experienced senior consultants with a structured engagement process to deliver consistent positive results for clients. Wisemar executives and consultants have worked with the majority of the top 50 US banks; regional, community, and direct banks; and many of the top vendors and partners in the financial services space. This diverse experience helps provide the framework necessary to deliver innovative best practices to clients to help them improve performance. Wisemar is headquartered in Charlotte, NC.

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