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WHAT KEEPS ABL LENDERS UP AT NIGHT?

PERILS CAN LURK WITHIN THE MOST COMMON ABL REPORTING TOOLS

BY **ROBERT O. RIISKA** AND **WILLIAM L. WHITE**

ABL lending may seem cut and dried to outsiders, but those on the inside know that even the most carefully designed loans can go awry. Turnaround specialists Robert Riiska and William White explain what could go wrong with the ABL lender toolkit and how to repair it.

ROBERT O. RIISKA
Managing Director
SierraConstellation Partners

WILLIAM L. WHITE
Managing Director
SierraConstellation Partners

Asset based lending may seem straightforward and formulistic. With little reliance on enterprise value, loaning only up to the collateral's liquidation value and closely monitoring cash flow, what could possibly cause loan officers to lose sleep? We will discuss a few reasons, including:

- Undiscovered, significant flaws in the borrowing base certificate
- Overly simplistic or unrealistic 13-week cash flow projections
- Outdated or unachievable business plans

Most of the lenders we've worked with are very good at what they do. They know how to value assets; they know how to evaluate the near-term prospects of a business and have lent successfully in good and bad economies. The ABL reporting toolkit has generally worked for them and they believe in it.

One of the key principles of asset-based lending is the loan officer has close to real-time access to information on the borrower's activity rather than having to wait for traditional financial statements to be provided weeks or months later. So, what could go wrong with three of the most common tools in an ABL lender's toolkit?

BORROWING BASE CERTIFICATE

ABL borrowers are required to calculate, document and certify the value of available collateral for the lender on a monthly, weekly or sometimes even daily basis. This forms the foundation of the borrowing base and is meant to protect the lender against sudden changes in the value of their collateral.

Many factors and sets of hands are involved in determining a company's borrowing availability at any given time, including the calculations spelled out in the underlying loan documentation, the lender's internal policies, interpretations by lender's

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and borrower's counsel, reports from the lender's field examiners, appraisers of inventory, machinery & equipment, real property and intellectual property. After the form and substance of the borrowing base certificate has been agreed to, a lender is asked to advance funds day-in and day-out based on a borrower's self-reporting of its asset position.

Putting aside the risks of outright fraud, it is not uncommon to see errors, mischaracterizations and other issues creep into a borrowing base template over time. Some examples we have encountered are:

• Assumptions driving advance rates that may have been reasonable at the time of underwriting can grow stale with time.

• Accounting systems are generally not set up to report accounts receivable in the various ineligible categories typically seen in an ABL borrowing base. Parsing out the accounts typically requires an element of manual manipulation, which can result in errors that become codified over time. This is often due to borrowers' personnel not having a full grasp of the rationale for the calculations.

• Amounts reserved against accounts receivable for potential offsets, such as customer rebates and allowances, can easily become stale if the seasonality of the underlying programs are not understood and considered.

• Inventory quantities may be accurately reflected but the categorization of such inventory may not have been aligned with the underlying inventory appraisal definitions. Since finished goods, work-in-process and raw materials may have wildly different advance rates, the borrowing base certificate can be severely compromised if they are miscategorized. Lenders should periodically reconfirm such inventory categorization and, at the same time, verify that consigned inventory has been properly segregated from owned collateral.

• Slow-moving or excess inventory might not be worth as much as initially expected. Consumer trends and industrial needs change. Slow-moving inventory might be a sign that the customer base is either moving on or is already gone. A related issue is appraisals of real assets and equipment may be stale.

Any of these issues could add up to an inflated borrowing base, and more risk than the lender thinks they've taken on.

13-WEEK CASH FLOW

Often borrowers will prepare a 13-week cash flow projection solely to satisfy the requirements of their lenders. If the management team does not use a weekly cash flow forecast as a tool to manage the business (or does not have prior experience doing so), they likely do not have a reliable, disciplined approach to forecasting and reporting on this basis.

Some common issues include:

• Starting from an unrealistic, "stretch" sales projection

• Failing to account for dilution and uncollectable accounts when forecasting cash receipts

• Failing to account for all cash expenditures of the business (not reconciling weekly disbursements forecast to GL-based financial projections)

• Mistiming or completely missing large lumpy payments such as property taxes and insurance renewals

• Failing to fully consider the impact of seasonality

• Projecting based on bank cash, without considering check float

We recommend requiring reporting of both weekly and cumulative variances versus plan to make the weekly cash flow a useful measurement tool. Keep an eye on trade accounts payable balances which are often glossed over in a simplistic 13-week cash flow projection. We also recommend reviewing trade AP balance levels and aging reports on a regular basis to determine whether cash flow outperformance on lower than projected disbursements has been achieved by simply stretching vendors, rather than through sustainable cost reductions.

BUSINESS PLAN

The business plan is often neglected at companies struggling with day-to-day operations. When executive management is striving to meet customer expectations, stave off vendors' demands and seek out capital to properly run the business, long-term planning gets pushed off to another day. A business plan might not even be drawn up until a prospective lender asks for one.

Almost as bad as having no business plan is having a static business plan based on assumptions that are no longer relevant. A plan which takes "business as usual" as its base case will leave a borrower vulnerable to errors or surprise negative events. Whenever a borrower experiences changes that will materially impact the performance of the business, the plan should be refreshed. Examples from recent experience include: the loss of a major customer or contract, getting hit with new or increased tariffs, significant increases in commodity prices, and the unexpected tightening of payment terms by a key vendor.

Further, a three-statement monthly business plan with monthly reporting of actuals can provide insight into how a borrower is tracking to its working capital and cash flow assumptions. Why has inventory increased far beyond projected levels? Why have AP balances (and DPO) expanded beyond plan and prior year levels? Management's answers to such questions can reveal a lot about their understanding of the current situation and ability to forecast going forward.

GETTING A HANDLE ON THESE RISKS

By all accounts, we are late into an economic expansion. Whether we're facing a slowdown or a downturn, any worsening of the economy will bring hidden credit risks to the surface. As economic stresses increase, management teams will find their attentions divided, making them more prone to mistakes or oversights. It is more important now than ever for ABL lenders to re-examine their portfolios for such hidden credit risks.

The first step is to perform a comprehensive review of a borrower's currently pledged collateral, including borrowing base certificate calculations. Look for errors that may have crept into the accounting, changes in asset valuations and changes in either business conditions or business operations. There's an element of going beyond just a traditional field exam here, so even a seasoned lender might need help.

Receiving the borrower's 13-week cash flow projection is just a starting point. Ongoing, meaningful variance reporting and analysis can help you discern whether the business is performing as promised and can provide an early warning of trouble ahead.

Finally, revisit the borrower's business plan. If you've never asked for one, start now. The business plan is the backdrop against which a lender can put a borrower's day to day activities in perspective, while also helping provide a view into major initiatives. When actual performance deviates from the plan, challenge the validity of key assumptions going forward.

The borrowing base certificate, 13-week cash flow and business plan are three core, time-tested monitoring tools for ABL lenders. However, their effectiveness in mitigating risk should not be taken as a given. These tools are only as useful as the quality of the data and thought that goes into them. Given where we are in the credit cycle, lenders who proactively take a step back and scrutinize these tools will reduce risk in their portfolios and mitigate potential losses. •

ROBERT O. RIISKA AND **WILLIAM L. WHITE** ARE MANAGING DIRECTORS AT SIERRACONSTELLATION PARTNERS, A LOS ANGELES-BASED INTERIM MANAGEMENT AND ADVISORY FIRM.

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