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ABL (Asset-based Lending)

1. General outline

This document describes a method for rating individual obligations of Asset-based Lending (i.e. loans secured with movable property/accounts receivable, hereinafter referred to as “ABL”). ABL is a financing arrangement focusing on an operating company’s business continuity and value of movable property (raw materials, work in progress, products, and merchandise), accounts receivable, etc. in the company’s commercial distribution channels. It is categorized into asset finance as possibly collateralized by movable property. Major underlying assets are considered to be held in short turnover cycles and frequently changed during the financing period. Borrowing tenor can extend from a short term linked with individual underlying assets to a long term[1].

For example, raising working capital by using business inventory as collateral for loans is a typical case of financing being analyzed in this document. Loans secured with movable property include those with large-sized equipment such as ships and aircraft, which appears as capital expenditure fund. They are evaluated under other rating methodologies[2].

In comparison between liquidation of trade receivables and ABL, the liquidation of trade receivables frequently accruing in a relatively short term is considered to weigh on diversification of securitized receivables, requirement of perfection against third parties, and creditworthiness of debtors (garnishee) using trade receivables. Meanwhile, key points for ABL include the debtor[3]’s business continuity and ability[4] to carry out business operations, value of collateral[5], and strength of management or control of collateral property.

Regarding preservation of collateral, it is also characterized by the difficulty of securing funds for repayment in ways other than the market or encashment of underlying assets when the debtor becomes bankrupt and the importance of estimating collectability of receivables at the time of collateral disposal. In contrast, loans on underlying assets such as aircraft, ships, and equipment will allow the borrower to lease them to other users and expect cash flow for repayment of the funds raised.

1 Assumed finance as long-term working capital is based on a certain amount of movable property or the like for collateral. Credit limit based on collateral assessment is referred to as Borrowing Base.

2 See Information about JCR Ratings > Asset Finance > Ship Finance (June 01, 2015) and Aviation Finance (June 01, 2015) on the JCR’s web site (https://www.jcr.co.jp/en/).

3 This document divides debtors into an originator for ABL and garnishee for accounts receivable.

4 Operational execution capabilities can also be expressed as performance risks.

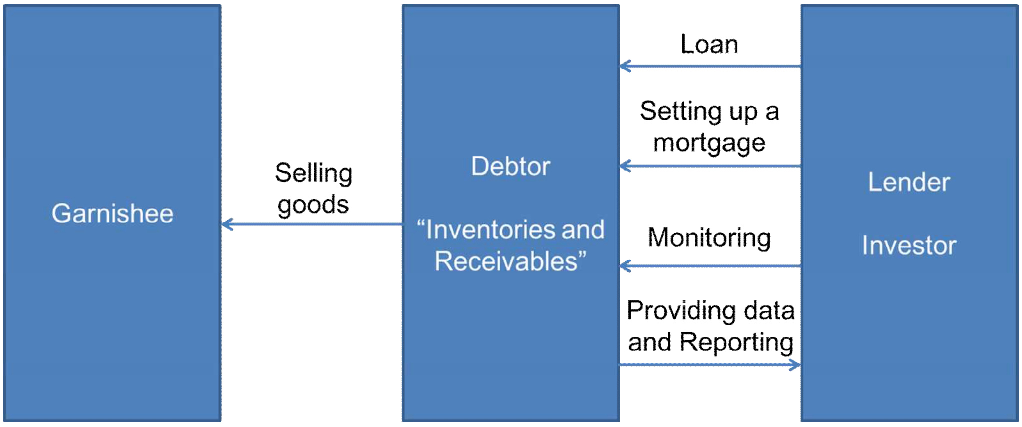
5 It is important to look at encashment value remaining after the deduction of the book value as well as a discount margin at the time of disposal and expenses.

2. General Scheme

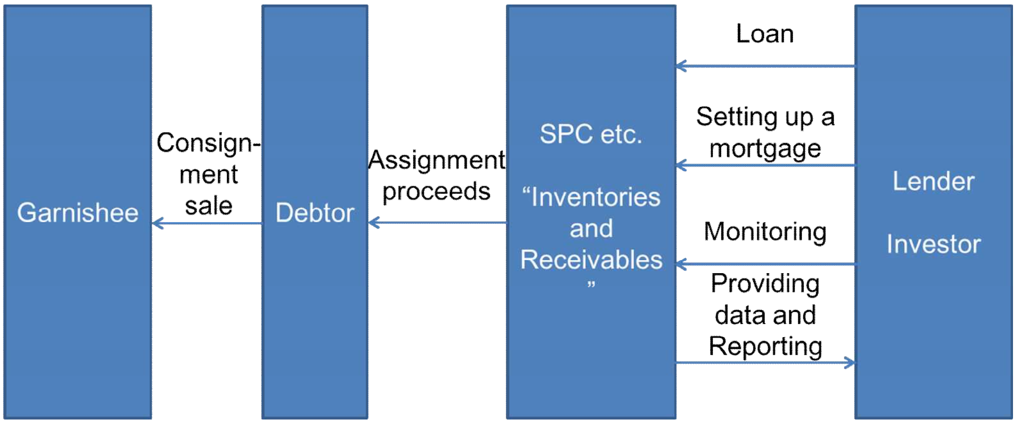
(1) Structure

Finance is provided in the scheme i where an asset pledged as collateral is included in an asset of a fund raiser (debtor) or the scheme ii where assets such as movable property/accounts receivable are separated from the debtor and assigned to SPC, etc.

Scheme example i (Movable property/accounts receivable still included in the debtor's asset)



Scheme example ii (Movable property/accounts receivable assigned to SPC, etc.)



(2) Borrowing Base

A borrowing base is a calculated amount for a gauge of lending by adjusting the movable property/accounts receivable collateral value estimate or multiplying it by an assessment rate. It is calculated based on the collateral marketability instead of the book value. Firstly, excluded are any movable property or accounts receivable inappropriate for collateral (i.e. defective goods, those associated with a high risk of offsetting, those to which non-assign ability clauses are attached, a very seasonal type of products, etc.). Secondly, the marketability is determined with consideration for the garnishee's creditworthiness, the degree of diversification or concentration, correlation between business types, etc. The marketability value is multiplied by a certain assessment rate to obtain a borrowing base. The assessment rate is related with the marketability fluctuation risk (uncertainties) that can arise from a lapse of time between the collateral assessment and real market or disposal, time required for disposal, changes in conditions, etc. Specialized firms are often used for the marketability estimate because it requires fairness and objectivity[6].

6 Generally, a borrowing base amount is obtained as a sum of movable property encashment value x assessment rate and accounts receivable x assessment rate. Prices depend on the book value, fair market value, and forced-sale value.

(3) Covenants

To supplement the ABL structure, a loan agreement or the like stipulates financial indicators (income level, interest coverage ratio, shareholders' equity ratio, etc.), financial reporting obligations, limit on pledge of collateral to other creditors, limit on move of collateral assets, obligation to report and seek approval on the selling of material assets, etc.

(4) Monitoring

Since movable property and accounts receivable are changed in the cycle of business operations performed by the debtor even after the finance is provided, the content, location, quantity, value, etc. of the collateral will change. The debtor and its collateral management agent regularly provide the lender with reports on the collateral conditions. The lender shall confirm that the borrowing base is satisfied. If not, the stipulations provided for reduction of the loan amount by partial repayment to be made until the borrowing base is satisfied are applicable. The lender shall also confirm whether the debtor has been observing the covenants.

3. Key points for assessment

(1) Operational risk of a debtor

Since the finance is provided through the debtor's commercial distribution channels, ABL entails the possibility of impacts from the debtor's ability to carry out business operations. For example, if the debtor cannot produce or maintain an expected product, its capability to generate cash flow from the distribution channels may deteriorate. Its ability to carry out business operations is also relevant to securing the management level of movable property/accounts receivable for ABL. Therefore, when assessing ABL, whether the debtor's operational execution capabilities do not deteriorate, whether any performance risk rises up to the surface, and to what extent impacts are given if the risk appears, must be checked against the previous track record, etc. The debtor's operational execution capabilities and creditworthiness assessments are not the same in meaning though there seems to be a correlation between them.

JCR believes it is appropriate to individually assess and examine in consideration of the correlation.

(2) Debtor's creditworthiness and business continuity

Normally in ABL, the selling of goods or products to users, in other words, cash flow generated from a commercial distribution channel is provided for debt repayment. In the course of business operations, however, there are risks from value fluctuation of movable property/accounts receivable, swing in demands for products, and change of the debtor's creditworthiness associated with such factors.

If the debtor's creditworthiness becomes lower or business operation cannot be carried out, cash flow for debt repayment can be secured by market or encashment of the collateral. If the structure where repayment fund can be secured by market or encashment is strong, and if the debtor's creditworthiness will not likely to be lower, the assuredness (collectability) of finance provision can be expected separately from the debtor's creditworthiness for unsecured loans. However, precedents for ABL show that the collection ratio significantly depends on a choice of either business revitalization or business liquidation in a case where the debtor lowers its creditworthiness and goes bankrupt. The collectability can be materially affected by whether the business can be continued or not.

If the debtor starts corporate rehabilitation proceedings, assignment by way of security is subordinated to secured claim under a reorganization plan. Lenders or others who have security interests cannot exercise their rights arbitrarily and needs to consult with a trustee or custodian. In this case, the Scheme example i raises concerns about the collection by foreclosure and the securing of prioritized collection after that. Therefore, JCR considers that the rating for the loan basically cannot exceed the debtor's creditworthiness.

In the Scheme example ii, in a case where SPC is isolated from the parties and not involved in the debtor's corporate rehabilitation proceedings, etc. if an originator becomes bankrupt ((hereinafter, referred to as "case of bankruptcy remoteness scheme secured by SPC etc."), the rating can be higher than the debtor's creditworthiness in JCR's view. Depending on the extent of dependency on the debtor's distribution channels for the collection, there can be cases on the bases of i) notching from the debtor's creditworthiness, and ii) reliance on the value and collectability of movable property/accounts receivable. The i) cases include raw material that the debtor uses on its own and is strongly expected to be bought by debtors and products sold on under the debtor's own brand or through its own sales and service networks. The ii) cases typically include those such as commodity for which transactions and pricing are standardized.

(3) Assessment of movable property/accounts receivable

Assessment of movable property/accounts receivable is essential to ABL along with the debtor evaluation. From the debtor's perspective, key points are (i) the appropriateness of the asset management and (ii) the probability of the collateral being marketed at an expected price. The following shall be checked and considered for each.

(i) Appropriateness of the movable property/accounts receivable management

- Accurate grasp of data on the quantity and condition of movable property/accounts receivable on a real-time basis
- Physical identification of the movable property in data and its marketability segregated from other movable properties[7]
- Possibility of value fluctuation due to management condition, etc.
- Possibility of mixture of any inferior or defective product; possibility of a higher defection rate than expected

(ii) Probability of the collateral being marketed at an expected price

- Likelihood of objective assessment, the obtainability of appraisal value or amount assessed when necessary
- Marketability or likelihood of encashment for a relative value (taking into account the number of buyers and frequency of biased transactions)
- Availability of historical data on market values
- Value fluctuation by lapse of time
- Product attribute: commodity or customized product for a specific user or equipment
- Degree of liquidity at a trading market
- Possibility of seasonality impact; the extent of the impact if any
- Whether or not the product can be priced with reliance on the debtor's fame

Given the above, to assign a high rating for ABL, an advanced management method and data for physical inventories and assessment method for market prices must be in place[8] under an adequate scheme. Therefore, required functions are not simply limited to the possession of an asset isolated from the bankrupt debtor by SPC, etc. even under the scheme using SPC, etc. Also needed is a

7 It is important that title to the collateral inventory has been fully acquired and control over the inventory is established.

8 Since these requirements are also related to specific operations, system infrastructures, etc. in the business, the limited number of business entities meets them in advance. Meeting the requirements later sets a bar too high and may be a cause for difficulty to implement ABL.

function to provide value-added service for requirements such as an operation and system infrastructure of advanced movable property management.[9]

(4) Degree of diversification of purchasers and their creditworthiness, etc.

To assess the accounts receivable's collectability, purchasers' bias toward specific customers or diversified, purchasers' creditworthiness at an individual level and as a pool must be considered. It will be more important to estimate a risk of purchasers shifting to competitive or substitute goods if they are biased. Sales channel, price negotiation, time to be taken until market may be affected when the movable property/accounts receivable is marketed.

(5) Covenants and contract robustness

It is important to maintain soundness of the structure through validity and monitoring of collateral agreement, covenants, and stipulation of the borrowing base in lending-related agreements. It is common practice to stipulate for additional reserve accumulation, partial repayment, change of interest rate or lending terms and conditions, suspension of new execution, etc. in case a covenant is breached. If a breach of covenant is not remedied or not expected to be remedied, prepayment, pledge of additional collateral, foreclosure or other measures can be taken. ABL is characterized by dynamic management-oriented approach with a grasp of the both sides of changes in the debtor's business conditions and collateral, etc. through monitoring.

4. Rating Methodology

(1) Assessment Framework

First, we confirm the existence of the bankruptcy remoteness scheme secured by SPC etc. and soundness of the scheme which moderates the debtor's credit deterioration and the impact from bankruptcy risk (Table 1, left column).

Next, we assess the dependency on debtor or debtor's distribution channel in case of the collateral liquidation (Table 1, center column).

During the assessment, we consider notching and notching range based on the evaluation of the movable property/accounts receivable value and management described in Table 2.

(Table 1) Rating assessment framework

Scheme example *i* No bankruptcy remoteness secured for SPC, etc.	→	A rating will basically not surpass the originator's creditworthiness and be the same as the rating for the originator.
Scheme example *ii* Bankruptcy remoteness secured for SPC, etc.	The market or use of movable property/accounts receivable depends mostly on the originator or its distribution channel.	i Notching will be considered in accordance with the movable property/accounts receivable value and management evaluation of Low to High and the collateral value coverage[10] for finance.
	The market or use of movable property/accounts receivable does not depend on the originator or its distribution channel.11	ii Notching will be considered in accordance with the movable property/accounts receivable value and management evaluation of Low to High and the collateral value coverage for finance.

9 SPC itself may have such a function, while the function can be provided through a service provider for SPC.

10 It is expressed by a ratio of collateral value to the credit amount.

11 The market or use of movable property/accounts receivable does not depend on the originator or its distribution channel is applicable to easily sellable goods such as a commodity and a standardized or normalized product for which many buyers exist.

(2) Movable property/accounts receivable value and management evaluation

For comparative merits and demerits of the movable property/accounts receivable value/management evaluation, qualitative assessment shall be performed from i and ii viewpoints given in the above-described "Key points to the movable property/accounts receivable value assessment" and expressed by three stages of Strong (No specific problem is found in light of individual perspectives), Appropriate (A minor problem was found in light of individual perspectives but does not lead to a serious situation as a whole), and Weak (Multiple problems were found in light of individual perspectives and can lead to a significant situation as a whole.). Combinations (in random order) of i and ii are expressed as High, Medium and N/A (not applicable to notch up). Specifically, High is a combination of Strong each, Medium includes a combination of Strong and Appropriate or Appropriate each, and Low includes all combinations comprising Weak.

(Table 2) Matrix of movable property/accounts receivable value and management evaluation

		Appropriateness of movable property/accounts receivable management		
		Weak	Appropriate	Strong
Stabilities of a price expected at the time of disposal by sale	Weak	N/A[12]	Low	Low
	Appropriate	Low	Medium	Medium
	Strong	Low	Medium	High

(3) Case based on notching in light of the originator's creditworthiness

When the bankruptcy remoteness scheme is secured by SPC etc.," rating is based on the originator's creditworthiness if the market or use of movable property/accounts receivable depends on the originator's distribution channel.[13] Notching range is determined in accordance with advantages and disadvantages of movable property/accounts receivable value/management evaluation and a margin of the asset coverage for debt. Notching can range from 0 to approximately 3 in many cases.

(4) Case relying on the marketability of movable property/accounts receivable

When the bankruptcy remoteness scheme is secured by SPC etc.," rating is based on the marketability of movable property/accounts receivable as collateral if the market or use of movable property/accounts receivable does not depend on the originator or its distribution channel. With consideration for market prices of the asset, the movable property/accounts receivable cycle, etc., rating shall be determined in accordance with advantages and disadvantages of the movable property/accounts receivable value/management evaluation and a margin of the asset coverage for debt.

5. Conclusion

Rating ABL in a real case, we shall pay attention to details which are not mentioned in this document individually. Some examples may include, but are not limited to legal arrangement for perfection, preparations for risks such as fraud or steal, security package for mismatching between income from encashment and debt repayment.

ABL is a financing scheme which varies from case to case. Based on the rating methodologies described in this document, JCR believes it is important to fully consider case-specific factors[14].

12 Not Applicable for notching.
13 Business feasibility or continuity of the distribution channels may be considered.
14 ABL also applies to business revitalization.

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026