

# BORROWING BASE

## Adoption of the UCC principles in establishing a Borrowing Base

### GENERAL APPROACH



# Definition

Asset protection lending takes its ultimate justification in the banks confidence that it will be adequately protected against loss by the liquidation value of the firm's assets. In unsecured asset protection lending, protection is judged to be adequate when, as indicated in the pro-forma liquidation analysis, true working capital provides a cushion sufficient to absorb shrinkage in the value of the firm's assets. When true working capital does not provide an adequate cushion of protection, the bank may lend on a secured basis and achieve asset protection by establishing and maintaining a secured claim against specifically pledged asset that are of sufficient value to repay the bank in liquidation. Since the net realizable value of assets in liquidation will be less than face value for various reasons (uncollectible receivables, price declines for commodities, liquidations expenses, etc.), the bank in order to secure protection in secured lending, attaches margins to specific collateral to accommodate the risk of shrinkage and lends only that amount against the value of the collateral that is likely to be recovered in liquidation. The maximum the bank is willing to lend based on the value of the collateral in the collateral pool is called the borrowing base.

The borrowing base is determined by the lending margins set against each type of collateral; the actual dollar value of the borrowing base depends on the value of the collateral in the collateral pool at a specific point of time. When the collateral consists of inventory and/or accounts receivable that are in a continual process of liquidation and replacement, the borrowing base must be closely monitored and calculated at frequent intervals in order to control the amount borrowed and ensure that an adequate cushion of protection is maintained. The concept of the borrowing base is integral to secured and unsecured accounts receivable and inventory financing. In secured lending, borrowing base reports are explicit form of control, while in unsecured lending the concept of the borrowing base is implicit in the assessment of the working capital cushion through balance sheet and liquidation analysis. In the following discussion we will look at some of the considerations involved in setting shrinkage margins against these types of collateral which apply, of course, to the analysis of all asset protection loans both secured and unsecured.

## Determining the Borrowing Base

### Identifying Eligible Collateral

To determine the borrowing base, the bank must first determine the maximum amount the bank is willing to lend, the bank's ability to liquidate the assets in the event of default and also determine which of the firm's assets are acceptable to the bank as collateral. Inventory typically excluded from the collateral pool includes goods in the work in process stage, since such goods are likely to have little or no value in liquidation. Typical ineligible accounts receivable include foreign receivables, intra-company or related company receivables, receivables that have previously assigned to other creditors, and overdue receivables.

Having determined which assets are acceptable as collateral, the next step is to set lending margins against the eligible accounts receivable and/or inventory. The lending margin is usually stated as the percentage of book value of the assets that the bank is willing to advance (e.g., 90% on accounts receivable, 80% on inventory).

# Setting Margins on Accounts Receivables

To establish the lending margins for accounts receivable, a judgment must be made as to the likelihood that the receivables can and will be converted to cash. Factors to consider include the following:

**Customers:** Who are the borrower's customers? Is there a high concentration of receivables in a few customers, in one industry, or in one geographic region? What is the quality of the customers; do they have established a record of paying their dues on time/ How long have they been customers of the borrower?

**Credit Terms:** What credit terms does the borrower offer? Are these terms liberal or conservative?

**Charge-offs, Reserve for bad Debts, and Returns and Allowances:** What is the borrower's experience with charge-offs and returns and allowance? What is their current reserve for bad debt? What is the ageing schedule of receivables? Are there any economic conditions that may affect the customer's ability to repay debts?

The bank's experience has shown that the liquidation value of accounts receivable is rarely, if ever, equivalent to the value at which they are carried on the borrower's books. Receivables may be very difficult to collect if the company goes bankrupt, or payments may not be made until after long delays. In addition, the cost to the bank of liquidating the receivables generally amounts to at least 10% of their value. Therefore, the general bank guideline on the maximum rate of advance on receivables is 90%.

## Setting Margins on Inventory

The percentage the bank will advance against inventory that have been assigned as collateral for a loan is based on an assessment of the net realizable value of those goods in a forced liquidation, i.e. if the bank had to take over the goods and sell them in order to obtain payment.

Net realizable value can be defined as market value at the time of the goods less selling expenses incurred by the bank. The nature of the product and the characteristics of its market are the key considerations when determining the net realizable value.

When assigned inventory consists of manufactured products or other non –staple goods, the market, or economic, value may be much less than their stated or accounting value. Goods that are perishable or seasonal or subject to fashion risks, for example, will command a greatly reduced price in final liquidation, and the bank would, therefore, be willing to advance only a small percentage against the value at which they are carried on the company's books. When determining how much to advance against inventory the bank should carefully analyze the market characteristics of the assigned goods: Does a ready market exist, and what would be the expense to the bank of relocating a buyer and negotiating and completing the sales transaction? Is there a

well-defined set of buyers for the product, or is its market wide-ranging and diffuse? Does the producer sell the goods directly to the final consumer, or is buying and selling handled by brokers, distributors, or manufacturer's agents, with sales efforts concentrated in a few well-defined outlets? To what extent are sales outlets dependent on a relationship with the producer, a relationship that will no longer exist once the bank takes possession of the goods? Is the borrower a major force in the market, and is the product well-known with proven demand? Or, is the borrower a small producer operating in a narrow market segment, where goods will be more difficult to sell in liquidation? The greater the market uncertainties and the greater the potential difficulties and expense in locating a buyer, the more conservative the lending margins should be.

When inventory consists of readily saleable staples and where there is an active market, the net realizable value of the assigned commodities may be closer to their stated value, and the bank may be willing to advance a relatively high percentage against the value of the pledged goods. However, before setting margins on such commodities, the bank should study the market characteristics and determine factors that may reduce the net realizable value of the commodities. Price swings in the market, for example, may reduce the value of the assigned commodities. It should be noted also that the financial difficulty of a borrower that triggers a forced liquidation of the collateral by the bank often coincides with a decline in the market value of the commodities. Also, if the grades and standards of the assigned commodities are not the same as those quoted in the market, if the commodities have deteriorated in quality during storage, or if they are liquidated out of season, they may command a lower-than-market price. The bank must also consider the costs of liquidating the goods; selling expenses, brokerage fees, and loading and transportation charges will have to be paid out of the gross sale proceeds, as will any unpaid storage charges (such charges, which *\*Legal Claim* represent a warehouseman's lien on stored goods, are often in arrears when a borrower is encountering financial difficulties). Due to the problems and expenses in liquidating inventory, the bank generally sets margins against inventory on a rather conservative basis.

## Calculating the Borrowing Base

By setting lending margins against the accounts receivable and/or inventory that are to be assigned as collateral for a loan, we have defined the borrowing base, the maximum amount the bank is willing to lend against the collateral. The actual dollar value of the borrowing base must be calculated frequently during the course of the loan since the accounts receivable and inventory in the collateral pool are in a continual process of liquidation and replacement. In the following example, we show the calculation of the borrowing base at two different points.

## Borrowing Base Example

XYZ has a \$1500M line of credit for secured loans at 85% of invoice value of receivables that are under 60 days outstanding (the company has no foreign or inter-company receivables) and 75% of raw materials and finished goods inventory.

XYZ submits monthly reports that are used to calculate the borrowing base

<u>Monthly Reports</u>	<u>Balance</u>	
	7/31/XX	8/31/XX
<b>Accounts Receivable</b>		
0-29 Days	200M	350M
30-59	100M	200M
60-89	50M	100M
90-	50M	100M
<b>Total</b>	<b>400M</b>	<b>750M</b>
<b>Inventory</b>		
Raw Materials	500M	600M
Work in progress	300M	400M
Finished Goods	500M	500M
<b>Total</b>	<b>1,300M</b>	<b>1,500M</b>
<b>Borrowing Base Worksheet</b>		
	<u>7/31/XX</u>	<u>8/31/XX</u>
Total Accounts Receivable	400M	750M
Less ineligible (Overdue)	(100M)	(200M)
Eligible Accounts Receivable	300M	550M
Lending Margin	85%	85%
Accounts Receivable Borrowing Base	255M	468M
Total Inventory	1,300M	1,500M
Less Ineligibles (WIP)	(300M)	(400M)
Eligible inventory	1,000M	1,100M
Lending Margin	75%	75%
Inventory Borrowing Base	750M	825M
<b>Borrowing Base</b>		
Accounts Receivable	255M	468M
Inventory	750M	825M
<u><b>Total</b></u>	<u>1,005M</u>	<u>1,293M</u>

The borrowing base total is then compared to the total outstanding loans the bank has made to the company to assure that there is sufficient value in the collateral to cover the amount of the loans. By receiving such reports on a frequent basis, the bank can assure itself of sufficient **protection** of its exposure on an ongoing basis, thus helping to achieve **control**, one of the fundamental conditions of asset protection lending.

If the borrowing base is reported to be less than the amount of outstanding loans, the banker will take steps to rectify the situation immediately. The borrower will be asked to explain the deterioration in the borrowing base, and will most likely be asked to restore the required level of protection by paying a portion of the loan or by pledging additional collateral.



# Borrowing Base in Finance Company Analysis

The concept of borrowing base is defined differently for a finance company than for other types of borrowers, a result of conventional usage rather than of strict distinctions that require different definitions.

While the borrowing base for other types of borrowers is defined as the maximum amount the bank is willing to lend based on the value of the collateral in the collateral pool, for a finance company it is defined as the cushion of protection senior lenders have in current assets, i.e., it is the amount by which the value of current assets (predominantly receivables) can shrink and still be sufficient to repay in full all senior creditors. In this sense, a borrowing base, as defined for a finance company, is analogous to working capital as we have been discussing it up to now.

The actual determination of the necessary cushion of protection is a function of the quality of the assets.