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Assessing Asset-Based Lending

This funding alternative may be viable for brokers' credit-challenged clients

AS BANK CREDIT REMAINS SCARCE AND small- and middle-market companies struggle to find ways to finance their businesses, many commercial mortgage brokers seek alternative ways to help their clients. Real estate asset-based lending may be the answer for some brokers and their business-owner clients.

What it is

Asset-based loans typically are revolving loans secured by a company's inventory and accounts receivables. The typical asset-based borrower is a company that either has had financial difficulties or that does not have an established financial history and does not qualify for bank financing.

These loans typically require periodic audits of the underlying collateral. Occasionally, an asset-based lender may take the business's machinery and equipment as collateral on a conservative loan-to-value ratio. Traditional asset-based lenders rarely provide an advance against real estate owned by operating businesses. Occasionally, a mortgage may be placed against real property, but this usually is done as part of the collateral pool.

There are some lenders that will consider real estate lending to asset-based quality borrowers, but the lending criteria are materially different from the asset-based lending approach. The classic asset-based lender audits the various asset classes and sets an advance rate for each class. For example, accounts receivables may have an advance rate of 85 percent.

Virtually all asset-based loans are done via financial covenants that require the borrower to comply with predetermined financial guidelines such as minimum net worth and debt-service-coverage and

debt-to-asset-value ratios. Any violation of covenants is considered a default and can be treated as such.

These financial covenants are rare in commercial real estate lending because mortgages typically are based on the real estate's initial value. Although requirements to maintain insurance or to keep buildings in good condition are common in mortgages, breaches of these agreements are typically accompanied by payment defaults as well.

Crossing over

A few mortgage lenders cross over to accept the more difficult credit quality that is common with asset-based financing, but they are the exception. Most traditional mortgage lenders are reluctant to lend on owner-occupied real estate when the borrower's credit quality is weak.

Some will focus on the real estate value, however, and give little consideration to the company's credit or cash flow. There are only a few lenders that provide these types of loans, so brokers will have to research to find a lender that will work with their client's particular scenario.

Mortgage brokers who have owner-user clients should keep in mind a few specifics that relate to these types of loans.

Real estate asset-based lending works best when the property is owned by a bankruptcy-remote entity — or special-purpose entity (SPE). The SPE becomes the landlord under a lease with the operating company and the lender. The member may be the operating business, the business-owner, or some partners who own the business or are related to the business-owner.

The SPE is important so that in event of a company's bankruptcy, interest does not

need to be paid monthly. But as a bankrupt tenant, the operating company must make monthly mortgage payments to its landlord, the SPE, which then makes its monthly payments to the mortgage lender.

Although there is generally not cross-collateralization between the real estate and the working-capital assets, the two lenders should have a written agreement. Absent any agreement, many states grant a landlord a statutory lien on all personal property located within the leased premises. This lien would be passed on to the mortgage lender. The inventory and fixtures are key components of the working-capital collateral base, and the working-capital lender must be able to perfect its lien in the first position.

Cooperation is needed to close both loans. Mortgage lenders often should subordinate their lien to the working-capital financing without waiving the statutory lien.

Even with subordination, the working-capital lender needs access to the real estate to sell its collateral. An agreement between the two lenders should allow the personal-property lender access to the premises and some time to either sell or relocate the collateral. Rents should be paid in this period.

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Also, the real estate lender often will seek the following in the agreement:

- **The personal-property lender's actions will not damage the real estate;**
- **Real estate will be left broom-clean;**
- **All movable fixtures and shelving will be removed;** and
- **No movable fixtures that are part of the real estate will be removed or sold.**

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For brokers with difficult mortgage scenarios, real estate asset-based lending may help solve their clients' problems. With the right lender, this type of financing can help clients with less-than-perfect credit find the funding they need. ●