ICAEW
CORPORATE FINANCE FACULTY

ABFA ASSET BASED FINANCE ASSOCIATION

Invoice Finance and Asset Based Lending

GROWTH

through asset based finance

BEST-PRACTICE GUIDELINE 65

ABOUT THE AUTHOR

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Foreword

Asset based finance (ABF) is increasingly being used as a source of funding by high growth companies – from small businesses, to those owned by private equity, to innovative businesses and subsidiaries of some of the world's largest companies. A thorough and up-to-date understanding of this form of funding is therefore important for anyone involved with finance and company funding.

ABF – comprising invoice finance and asset based lending (ABL) – has a long history in the UK. Its origins as trade finance and merchant capital date back to the Middle Ages, but the industry really began to expand in the 1960s. Technology has since changed the products and services on offer and expanded the range of ABF products available to businesses. Increasingly, businesses and private equity investors use it to fund M&A transactions.

The ABFA's origins go back some 40 years. ABFA members support UK and Irish clients with combined annual sales of £300bn (at 31 December 2016 almost 15% of UK and Irish GDP), providing more funding than they ever have before. When the supply of traditional bank debt became constrained during and in the aftermath of the financial crisis of 2008, ABFA members supported their clients throughout. Viewed by many as a 'challenger industry', there is now a broad range of providers – ABF teams in the large clearing banks, challenger or specialist banks, or specialist non-bank finance providers.

The industry takes a hands-on approach to providing finance, based on a thorough understanding of client businesses, their cash flows and also the challenges and opportunities they face. ABF providers will look through short-term financials to the underlying strengths and prospects of the business.

ABFA members are governed by an independent Standards Framework. This provides a clear statement of the standards its members will meet, along with independent and accessible mechanisms of investigation and, where necessary, redress.

The industry is committed to further improving awareness and accessibility. The ABFA welcomes this opportunity to partner with the ICAEW Corporate Finance Faculty in producing this guideline, which will be widely distributed both to Corporate Finance Faculty members and to businesses and those that advise them. This guideline considers both invoice finance and ABL, and provides particular detail on how the latter is delivered and can dovetail with private equity.

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Jeff Longhurst
Chief Executive Officer, Asset Based Finance Association

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ICAEW Head of Corporate Finance

1. What is asset based finance?

ABF is a collective term for various types of business funding, which are secured against specific assets of the company. ABF has recently been playing a more prominent role in M&A, being used to fund transactions, help fund management buyouts (MBOs) or to fund the growth of a business, which puts the business in a position to make acquisitions.

There are three broad types:

- factoring
- invoice discounting
- ABL

80%
of businesses using ABF facilities have turnover under £5m per annum

Factoring and invoice discounting are often referred to as 'invoice finance'. Funding is generated against unpaid invoices. It is available to businesses that sell products or services on credit to other businesses. The funding provided tracks the growth in the business – increasing turnover can unlock further funding.

Factoring and invoice discounting can close the gap between work being done, or services being provided, by a business and this being paid for. This provides a business with greater financial stability. Because it is tied directly to the level of activity of the business, the chance of overleveraging, at least through the ABF facility, is minimised.

ABL facilities can be provided against debtors, stock, plant and equipment or property. There has been emerging use of intangible assets, such as intellectual property, brands or forward income streams from contracts, as new bases for ABL facilities.

x7
Growth in the UK and Irish industry during last 2 decades

Both invoice finance and ABL are increasingly competing with other types of 'conventional' bank finance, such as loans and overdraft. And they are often cheaper than other types of 'alternative' finance. Principal ongoing running costs are a 'service' charge, which is usually based on turnover; and a 'discounting' charge, which, like interest, is charged on the funding actually drawn down from the facility.

More providers are now operating in the market, which, in turn, is leading to more competition for business. The market landscape includes both bank and non-bank providers. The UK and Irish clearing banks have significant invoice finance and ABL teams. There are arms of the big international banks which often offer invoice discounting and ABL packages, and the challenger and specialist banks which have a significant focus on providing both invoice finance and ABL facilities. In addition there are a number of non-bank specialist providers, and peer to peer (P2P) lenders are also now involved in the market. And for bigger deals, ABF packages are put together involving syndicates or clubs of finance providers. Some banks have teams which specialise in providing ABF to M&A transactions and private-equity-backed MBOs or management buy-ins (MBIs).

At the end of 2016, 43,881 UK and Irish businesses of varying sizes, stages of maturity and operating in many different sectors were using ABF facilities to fund operations.

Around 80% of those businesses have turnover under £5m per annum – those businesses account for around 20% of the amounts advanced by ABF providers. Most of the funding now advanced by ABF providers is, however, to bigger businesses. It is most commonly used in the services, manufacturing and distribution sectors.

Two decades ago members of the ABFA's predecessor organisations advanced around £2.7bn to UK and Irish businesses, mainly smaller businesses, and almost exclusively by way of factoring and invoice discounting. By the end of 2006 this figure was £13.6bn. And at the end of 2016, advances were £22.2bn. In two decades the UK and Irish industry has grown more than seven times in size.

WHAT'S IN ONE WORD?

ABF should not be confused with leasing or hire purchase, which are commonly referred to as '**asset finance**'. Crucially in an asset finance arrangement, the leasing or hire purchase company rather than the client business will generally own the asset. In an ABF arrangement the assets owned by the client business are used as collateral for securing finance.

2. Invoice finance

There are two types of invoice finance – factoring and invoice discounting. These remain the most commonly used forms of ABF. Such facilities can be used in private-equity-backed businesses to reduce the amount of equity or leverage required from the private equity house.

FACTORING

A factoring provider (a factor) provides finance to a business by purchasing debt owed by the client business's customers. The factor makes available a percentage of the value of the client business's invoices – typically between 80% and 90%. The balance of the value, less the factor's fee, is paid to the client business once the client business's customers pay the invoices.

During 2016, £21.3bn of ABFA members' client sales were supported by factoring. In 1996, £10.2bn of client businesses' sales were factored.

A factor is not just a source of finance. A factor works on behalf of the business – managing its sales ledger and its credit control by collecting money from customers. This can be particularly valuable for smaller businesses which may not have the resources for a full credit control function.

Factoring can be provided on a 'recourse' or 'non-recourse basis'. Non-recourse means that in the event of non-payment of undisputed invoices, the factor cannot demand payment from the client (up to the value of an agreed credit limit). In effect, the factor takes on the bad debt risk from the client. As a result, non-recourse factoring will typically cost a company more than the recourse option. In a recourse arrangement, the bad debt risk remains with the client and unpaid debts will be 'recoursed' back.

Export factoring is available to support businesses selling goods or services internationally – it is factoring for a business's exports. The provider will assess the territory the goods are being sold to as part of its due diligence.

INVOICE DISCOUNTING

While factoring remains a very important finance option for thousands of businesses, invoice discounting is now used by the majority of ABF clients and provides most of the funding delivered through invoice finance.

Similar to factoring, in that monies are advanced against debts, invoice discounting sees the business retaining control of the administration of the sales ledger and the credit control function. An invoice discounter will therefore seek reassurance over the quality of a business's sales ledger systems and its procedures for collecting debts.

Over the last two decades there has been a significant increase in the total value of funds advanced through invoice discounting. This is because larger businesses, with robust sales ledger and credit control procedures in place, have chosen to use invoice discounting as a source of funding.

In the year to the end of December 2016, £279bn of ABFA members' client sales had monies advanced through invoice discounting. And 20 years ago, the equivalent figure was £151.6bn.

Just like factoring, a percentage of the value of the invoices is made available, with the remainder, less the invoice discounter's fees, released when the invoice is paid in full. The key difference between invoice discounting and factoring is that a discounting client manages its own debt collections. This means that the arrangement will often be provided on a confidential basis and customers will not always be aware of the arrangement between the business and the invoice discounter. Invoices are issued on the letterhead of the company and not that of the invoice discounter.

Discounting can also be provided on a recourse or non-recourse basis. Recourse is far more common, in part because larger companies that opt for discounting often have trade credit insurance.

And, like factoring, invoice discounting can be used to support exports.

£21.3bn

of ABFA members' client sales were supported by factoring

£279bn

of ABFA members' client sales had monies advanced through invoice discounting

(In the year to the end of 2016)

3. Asset based lending

£4bn
advanced by ABFA members
(end of 2016)

An ABL facility is provided against a wider pool of assets than factoring or invoice discounting. The assets used will usually include debtors (as with invoice finance), but will then also include stock, plant and equipment and possibly property. It may also include intangible assets – intellectual property, brand and/or forward income streams from contracts.

ABL is thus usually provided on a similar basis to invoice finance but with funding being extended against other assets as well. The lender will have security via fixed and floating charges.

An ABL facility can be used for MBOs or turnaround situations, and the finance raised can be used to fund or part-fund M&A. ABL has developed and expanded markedly over the past 20 years. At the end of 2016 ABFA members' advances (specifically through ABL facilities, and against all types of asset) stood at £4bn. As a product this did not exist in its current form 20 years ago. At the end of 2010 the equivalent amount advanced by ABFA members was £2bn.

In the past, ABL was used by larger small and medium-sized enterprises (SMEs) and mid-sized corporates, but it is more and more available to smaller businesses as well.

DON'T GET LOST IN TRANSLATION

In the UK and Ireland, invoice finance and ABL are the preferred terms for ABF. However, in other jurisdictions 'factoring' is sometimes used as the collective term for the whole industry. In part this reflects different legal systems, regulatory regimes, and commercial practices and culture.

Even different providers within the same country sometimes use differing terminology. However, the basic concepts and principles involved in providing both invoice finance and ABL are consistent.

- **Commercial finance:** commonly used in the US and in Europe, this describes a range of ABF services – factoring, invoice discounting, international factoring, reverse factoring and ABL facilities.
- **Non-recourse invoice financing:** a finance facility where the risk of debtor failure is passed to the finance provider.
- **Confidential factoring (or non-notification factoring):** factoring in which the assignment of the debt to the factor has not been notified to the debtor.
- **Maturity factoring:** the client business receives payment of the receivables on the due date, or on a pre-agreed date (perhaps the average payment period taken by the debtor).
- **Export factoring (or international factoring):** the client business, based in the country of the factor, assigns/sells receivables due from debtors based in another country.
- **Supplier finance (or reverse factoring):** an agreement is set up between the finance provider and one or a selection of the client business's suppliers. The finance provider offers each supplier the possibility to assign (usually without recourse) those invoices approved for payment by their debtor/the client business.

4. The process

Typically when an ABF provider is considering providing a business with a facility, it will carry out a due diligence process on the business and its assets.

INITIAL ASSESSMENT

An ABF provider is interested in the business and its assets. The provider will carry out an initial review of the business's market position, the market sector it operates in, and its key products and customers. They will assess the management team – how skilled and experienced are key members of management? They will also review the business's ownership structure.

The next stage will involve the ABF provider looking at financial information provided by the business and making an assessment of the business's financial position and ability to generate future cash flows. The provider will review the balance sheet and the business's net worth, its historical and planned future capital expenditure, its historical and forecast profit and cash flow. The provider will also look at historical performance versus budget, to assess the quality of management forecasting.

The next stage is a review of the specific assets against which the ABF provider may provide funding.

- **Debtors:** the nature of the customers and the sector in which they operate, credit and other contractual terms, actual credit terms taken by customers and the history of rebates, credit notes and bad debts. The debtor book is the key asset for invoice finance and also for ABL.

If an ABL facility is potentially an option, the finance provider will also consider additional assets.

- **Stock:** the make-up of inventory – finished goods, WIP and raw materials – its location, historical stock levels and stock turns, and the track record for write-downs and write-offs.
- **Plant and equipment:** the location, age, depreciation profile and saleability of the machinery owned by the business.
- **Property:** the size, location and condition of the premises, whether they are freehold or leasehold and any other potential uses.
- **Intangible assets:** the value of brands or intellectual property, which may involve valuation specialists.

SITE VISIT

An ABF provider will meet management and visit the business's main site of operations. The provider will assess the nature and value of the assets they intend to provide funding against. Typically finance providers work closely with management on this. In the process they assess the management team's ability and ensure management is aware of the ongoing obligations required by any facility they might provide. Certain aspects of the business will be explored in more detail, usually comprising: management accounts, debtor's listings, stock ageing, forecasts and asset valuations.

PROPOSAL

The ABF provider will make a proposal, to be agreed in principle, both internally by the finance provider and the business. Indicative term sheets will be issued and a timeline for completion of the deal can be agreed in principle.

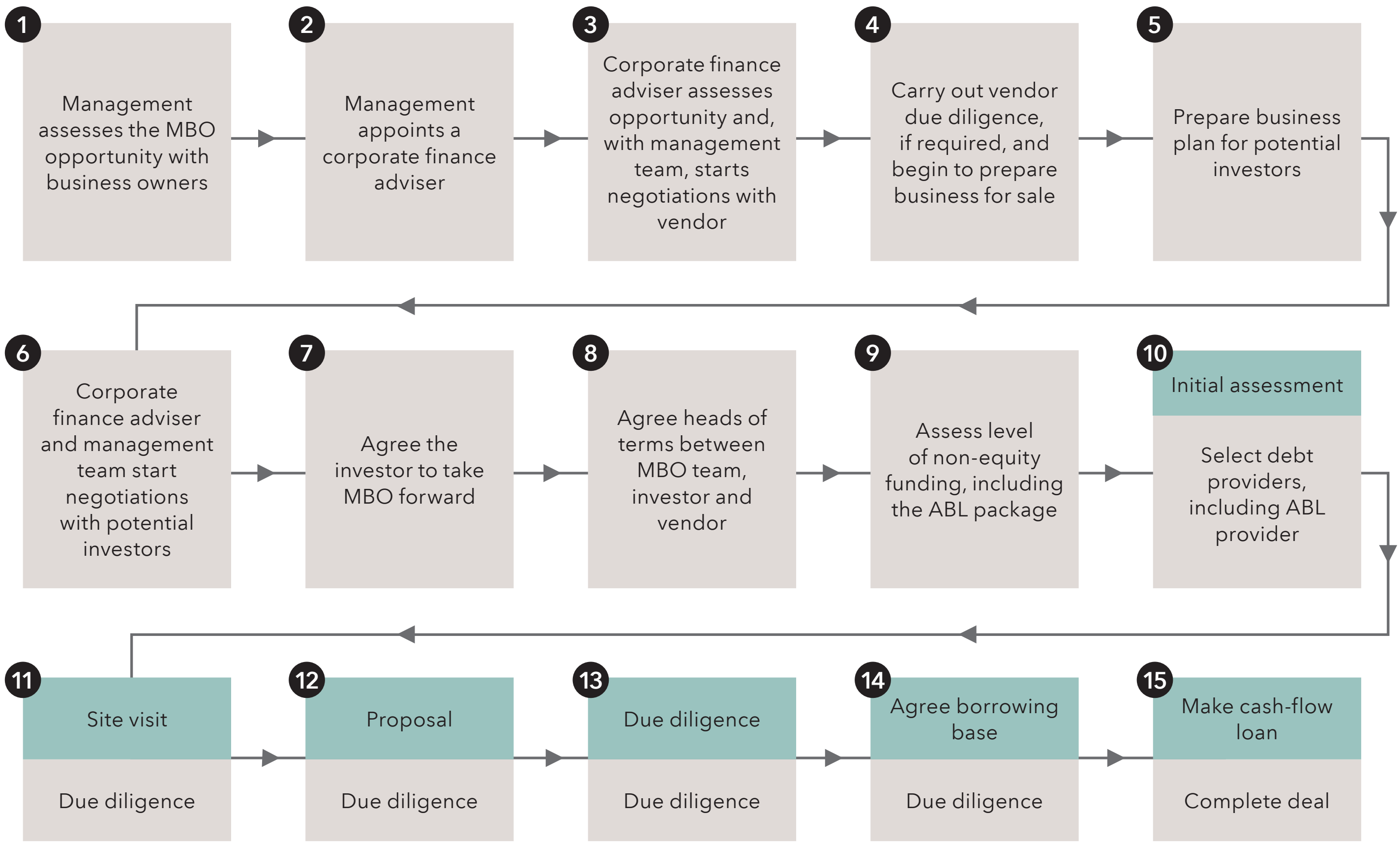
DUE DILIGENCE

The ABF provider will then carry out due diligence, which is sometimes referred to as a 'field exam' or 'field survey'. The ABF provider will look in detail at the assets they plan to lend against, be those debtors, stock, property, plant and equipment or intangibles. The provider may use specialist valuation experts for an independent valuation of intangibles, or specialist stock, or a property with multiple uses, or plant and equipment which may have a niche application. The due diligence process for a facility based around debtors may take a few days, but if a broader range of assets is being looked at or more specialist assets, which require third-party valuations, or international operations, then the process can take longer – perhaps some weeks.

The business's forecasting model will be assessed to ensure that information on sales, customers, contracts and terms underpins the forecast. The assessment will not only be made on the profit and loss account, but on the balance sheet, working capital requirements and cash flow.

ABL IN AN MBO: ILLUSTRATIVE TIMELINE

MBO process   ABL process



'BORROWING' BASE

In an ABL facility, how much a business can release is determined by its 'collateral base' or 'borrowing base' – its fundable assets. The finance provided by the ABF provider is secured through the fixed and floating charge on those assets. The ABF provider will evaluate the business's eligible assets.

Invoices will typically attract advance rates of 70–90%. The advance rate for invoices is decided based upon the location of the sales, the contract terms, payment terms, how quickly the receivables are paid and how easily the business can prove that the goods or services have been provided.

Stock carries a higher risk profile and attracts advance rates of up to 75% of a 'net orderly liquidation value' – something the ABF provider will establish.

Fixed asset loans are typically structured as amortising term loans. The lender will instruct a third party to carry out an appraisal, and the amount loaned will depend on the free cash flow.

Plant and equipment might attract advance rates of up to 75% or more of an independent 'net orderly liquidation valuation'.

A 'forecast availability schedule' will take into account seasonality. It will help both the ABF provider and the client business to assess the levels of ongoing working capital headroom generated by the facility.

CASH-FLOW LOANS

A cash-flow-based term loan is often referred to as a 'strip' or an 'air ball'. It may be offered over and above the asset based borrowings, to borrowers with strong capital structures and sufficient free cash flow to service the financing. This will be secured, but not collateralised, against specific assets and will increase liquidity and enhance headroom. It will also mean less of an equity requirement in a private equity deal, for instance.

5. Why asset based finance?

The use of ABF has increased dramatically in recent years and the number and breadth of providers has increased. So, what are the drivers for this growth?

FLEXIBILITY

As a business's sales grow, its need for working capital will increase. But as the value of its invoicing grows, so too will the availability of working capital from an ABF facility, be it factoring, invoice discounting or ABL. The amount of working capital available will flex when the business's trading is cyclical too. As a result management can concentrate on operations and driving strategy and growth.

A secured loan will come with covenants. They may come in many different forms, but they will most often be rigid. An ABF provider will work hard to carefully understand the capital structure of the business and the impact on the provider's security of any covenants related to bank debt.

An ABF package is a blend, which allows a business to be run through cycles without necessarily breaking strict financial covenants. The headroom and liquidity it creates can, post-acquisition, particularly help with the implementation of a business's integration plan.

RELATIONSHIPS

Even though it can be delivered more quickly than conventional lending, an ABF provider will take time to understand the business they intend to finance. The ABF provider will be interested in the customer base, the markets, key customers, the cycles the business faces, and the consequent cyclicality of cash-flow demands. The provider will be interested in the business's future plans, any capital expenditure requirements or plans for international expansion, M&A or joint ventures.

The ABF provider will often have a closer relationship with management than more traditional lenders might require. The aim is a constructive relationship, to support management as circumstances change.

An ABF provider will typically have flexibility around how procedures run in practice. In some instances, where there is bank debt in a business, internal resource will be deployed to manage the performance of the business against the bank covenants.

AVAILABILITY

The security required by ABF providers is very specific and assessable. Because different assets can be considered, more funding can often be unlocked than through a secured bank loan or overdraft. How any available funding is assessed is formulaic and, once that formula is agreed, the process from terms sheets to completion is relatively quick.

Smaller businesses will generally be able to get a higher quantum of funding – security is taken against debtors or stock or both, rather than against the personal assets of the directors or owners. For bigger businesses, more headroom can be built into their funding structure. And, for private-equity-backed businesses, that can reduce the amount of equity required.

PRICING

The pricing of ABF will depend on the circumstances and requirements of the client business. For many SMEs, the costs of an invoice discounting facility are likely to be broadly competitive with overdrafts and conventional loans; the costs of a factoring facility will reflect the added service element and so will likely be more expensive than overdrafts or loans, if they are available. In the mid and corporate market, however, invoice finance and ABL will be competitively priced with bank debt. It should be noted again, however, that the products are likely to unlock a greater quantum of finance than that available through other funding options.

FORMULA DRIVEN

ABF providers typically apply a formula based on firm policy in order to evaluate how much finance to advance. They will typically define exactly what is being funded with ABF. Firstly they will look at the customer base and how much debt is over a certain age and then establish a cut-off for what they will offer finance on.

A business may have operations that sell products, lease equipment and provide services. An ABF provider will specify what activities would be eligible for their facility.

When it comes to inventory, the starting point will be the insolvency value – which will involve looking closely at stock turnover and obsolescence.

SPEED OF DELIVERY

Typically new or additional facilities can be set up in less than a month, but in certain instances it can only take a matter of days. Additional funding can be arranged as the business grows and this is most often a swift process too. For private equity, ABF providers suggest that the execution risk is low because a term sheet can be agreed in a relatively short time.

LIQUIDITY

Because ABF follows the cyclicality of a business, it enables greater financial stability for a business. The availability of cash when it is required means that suppliers can be paid to terms, and there may be opportunities to take advantage of further savings to the business, such as volume or early payment discounts. Of course, this can have a wider economic benefit as well, releasing funding down the supply chain.

DISCIPLINE

More than just finance, a factoring facility will combine finance with a credit ledger management and collections service. While an invoice discounting facility or ABL facility based on debtors will see the company retain responsibility for the credit control function, the provider will want to ensure the procedures and disciplines meet certain standards.

Many businesses, of course, will have appropriate credit control procedures. For those that do not, tighter credit management will give management more control over the business. And for smaller businesses that are looking to grow, this discipline can be invaluable as it means growth will be more sustainable. ABF can be complemented with other services as well, including bad debt protection against customers failing to pay.

For an ABL facility secured on stock, the ABF provider will want to understand the disciplines around the procurement procedures, and how management controls stock levels.

Many of the concerns of the ABF provider around controls will mirror those of management, and seek to establish disciplines that would benefit the business and management.

DOVETAILING WITH PRIVATE EQUITY

When it backs a business, a private equity investor may wish to introduce stronger discipline around credit control, or procedures around stocking levels. Investors are all too aware of the cost of capital and the risks of bad debt and obsolete stock if credit days or stock values are too high, respectively. As a result private equity's requirements will often dovetail with those of the ABF provider, who will be able to provide the business with detailed information and guidance, if required.

FOREARMED FOREWARNED

As with any type of financing, using ABF in certain scenarios may have limitations.

- When a business is slowing down, working capital availability from an invoice finance or a debt-based ABL facility will go into reverse. Just as funding advanced on debtors goes up as sales increase, so it goes down as debtors decrease if turnover should fall. This can create cash-flow issues, and this is where a tight relationship with an ABF provider, with a deep understanding of the business, can be invaluable. Using other assets in the capital structure in a wider ABL package can provide headroom, to protect a business through a downturn. This will give the business and the ABL provider the ability to manage the cash requirements.
- For smaller companies ABF may be more expensive than certain types of bank debt (assuming that bank debt is available).
- A business may find that the ABF provider expects particular credit control or stock control procedures which it considers to be inappropriate.

6. Developments in asset based finance

TECHNOLOGY

Advances in big data analytics and data extraction technology are having an impact on providers of all types of ABF. With data analytics, systems can interrogate a business's systems in more depth and get the information an invoice finance provider would need to set up a finance package. It can speed up and better inform the process.

Similarly for ABL, data analytics can be deployed for stock analysis, stock ageing and stock write-down history, so that a stock ABL package can be set up. Blockchain also has significant potential to transform ABF.

BROADER ASSET BASE

ABL has become more common as lenders use other assets to provide greater headroom to a business and greater stability to their financing as a result. For example, as mentioned, it is now possible to get an ABL facility against intangible assets, such as IP or brands.

WIDER RANGE OF PROVIDERS

In addition to the existing diverse range of providers, increasingly ABF is available from P2P lenders as well. The amounts available to a business from P2P platforms is also increasing and, where they would previously have been a part of a facility, they are now leading the ABF facility or providing it wholly themselves.

FRAGMENTATION OF MARKETS

ABF involves markets within markets. At the smaller end ABF is dominated by invoice finance but at the larger end there is much more use of wider ABL facilities. These will often be financed by clubs or syndicates of lenders.

SPECIALISMS

One development in the nature of ABF providers has been specialism within sectors, including sectors that previously would have been less favourable for invoice discounting or factoring. One example is construction, whose complexity is typified by contractual obligations, statements and retentions. Specialist teams within ABF providers take sector risk into account, so as to structure an appropriate funding package.

PRIVATE EQUITY

Private equity investors use ABF when investing in the companies they back – on completion of the MBO or after an investment has been made. There can be advantages of using a portfolio company's assets as security for lending, and for creating a capital structure that is easier and more attractive for exit.

SINGLE INVOICE FINANCE

An invoice finance provider may offer 'selective' or 'spot' invoice finance. Where traditional invoice finance will be on the basis of assignment of all or the majority of the client business's debtor ledger, a number of providers specialise in providing finance against selected invoices. While normally more expensive, it can be more flexible for businesses that have occasional rather than ongoing working capital requirements.

It is now possible to get an ABL facility against intangible assets, such as IP or brands.

7. Industry standards

Like most types of commercial finance in the UK and Ireland, ABF is not an activity that is subject to statutory regulation. In 2013, to promote best practice, the ABFA introduced an independent Standards Framework covering its membership in the UK and Ireland. The development of industry professional standards, so that clients could take on ABF facilities with confidence, helps maintain confidence in the market and the reputation of ABFA members.

The framework sets out the standards ABFA members should meet in their treatment of clients and other associated parties, and helps underpin sustainable growth.

The reputation of the industry relies on client issues being fairly and transparently addressed. To that end, the ABFA has established a clear set of principles and an independent and easily accessible process, through which concerns can be investigated and adjudicated upon.

The Standards Framework has three key components:

- the ABFA Code (the Code) and supporting guidance;
- an independent complaints process; and
- a Professional Standards Council, which is independent of the ABFA.

CODE

The Code, together with the supporting guidance, sets out the standards of best practice and professionalism ABFA members are required to meet.

Members must treat clients fairly and responsibly, and operate with integrity at all times.

The key commitments that ABFA members must meet include:

- acting with integrity and dealing fairly and responsibly with clients;
- providing clients with all appropriate information in a timely and transparent manner;
- ensuring that legal documentation issued by them is clear and unambiguous;
- providing effective and timely client service; and
- operating their own appropriate complaints procedures.

View the Code

INDEPENDENT COMPLAINTS PROCESS

The independent complaints process complements the Code and guidance, by providing an independent mechanism for client businesses that believe they have been unfairly treated by an ABFA member firm.

The complaints process investigates and enforces compliance with the Code. It is currently provided by the specialist dispute resolution organisation, Ombudsman Services. It has been designed to be independent, accessible and is particularly focused on the requirements of smaller client businesses – the type of enterprise that may lack the resources or confidence to otherwise take forward concerns about their treatment.

Modelled on the system in the statutorily regulated sector, the independent complaints process complements rather than replaces ABFA members' own complaints processes. A complaint that a member firm has been unable to resolve to the satisfaction of the complainant through their internal processes is then eligible for this independent process.

View the complaints process

PROFESSIONAL STANDARDS COUNCIL

The Professional Standards Council (PSC) oversees the Code (and supporting guidance) and the complaints process. It is the independent guardian of the Code and the Standards Framework more generally, ensuring that they are working effectively and up to date. Its overall objective is to protect and enhance the reputation of the industry, including through making appropriate recommendations.

The PSC has an independent chair and vice-chair, as well as two other members from outside the industry and three individuals from within the industry.

View the Standards Framework

8. Multiple jurisdictions

The ABFA standards do not apply outside the UK and Ireland but in most instances ABFA members will apply the standards to transactions they are undertaking in jurisdictions outside the UK. Legislation is different in each country, and country experts will be used to a lesser or greater extent depending on how different that legislation is. There is inherently more complexity in multijurisdictional ABF because there is limited harmonisation of the law surrounding it.

While the majority of the finance currently provided by the industry in the UK and Ireland relates to domestic trade, the industry also supports exporting and importing businesses.

The percentage of eligible assets across different territories is likely to be less than the percentage given against the equivalent assets domestically. To what extent it is less will depend on the ABF provider’s assessment of the risk inherent in those other territories.

Export factoring is available for debts involving international customers/debtors. The rate on which the finance provider will advance will depend on the risk in the customer base and the territories in which they operate.

Larger finance providers with an international presence are able to provide an end-to-end service for clients, covering factoring, invoice discounting and ABL. However, smaller providers can support exporters using the two-factor system. Under the two-factor system a factor uses, by sub-assignment, a factor in another country – a correspondent factor. The correspondent factor collects the receivables of an assignor exporting to a customer in that country, with or without credit protection. The relationship between correspondent factors is usually governed by an ‘interfactor’ agreement.

9. Uses for asset based finance

An ABF facility can be put into an acquired business, reducing the demand for leverage in the acquirer or the amount of equity required.

MANAGING WORKING CAPITAL REQUIREMENTS

ABF facilities effectively bridge the gap between a business carrying out the work – selling the product or providing the service – and getting paid for doing that. In the context of ever-lengthening payment terms, this is the key advantage of the products. An ABF facility enables a business to manage its operations in line with the management of its working capital.

GROWTH

The funds raised from an ABF package can be used to support growth. As the business's sales grow, so too does its debtor base and then by extension so too does the amount available through invoice finance and ABL. This capital can be invested to fund further growth.

MERGERS AND ACQUISITIONS

In M&A an acquirer company is able to use cash raised through an ABF facility to fund an acquisition. Alternatively, an ABF facility can be put into an acquired business, reducing the demand for leverage in the acquirer or the amount of equity required.

MBO/MBI

The use for ABF in an MBO or MBI transaction is very similar to M&A. The private equity investor can put in a facility and reduce the amount of equity and risk in a transaction.

RECAPITALISATION

A business may use the proceeds of an ABF package to fund share buybacks, to reduce an owner's stake in the business or to pay down other forms of debt. It may facilitate a change of ownership in the future.

REFINANCE

The proceeds of an ABF package may be used to pay down other business debt – eg, to pay off a term loan or to replace an overdraft.

RESTRUCTURE/TURNAROUND

In a turnaround situation, an ABF provider will want a priority floating charge over the debts of the business in order to provide the capital that will fund the turnaround. A lower advance rate may apply in turnarounds but it may be more available than an overdraft or loan in such scenarios.

10. Taking advice

Whenever a business takes on any new finance, it is important that management receives the relevant advice to ensure t is informed in making the decision.

Management will need to understand not just the cash cost of the ABF to the business, but the impact the ABF will have on available cash, the balance sheet and the capital structure of the business. It will need to understand how to report the financing in the company accounts (in the UK, generally in compliance with FRS 5) and how the tax authorities will treat ABF costs in a business's tax calculation.

TAX

The tax considerations for ABF are minimal, as it is effectively treated as a 'simple' financing. From an accounting perspective the business's accounts must ensure that the substance and true commercial effect of transactions are shown, not their legal form. An asset may only be omitted from the balance sheet if no significant risk or interest is retained by the business. This is the case with non-recourse transactions only, but otherwise the assets must be shown in the balance sheet at their full value and the purchase price or other finance received must be shown as a liability or a deduction from the value of the asset.

The VAT treatment of factoring, in particular, has been debated. As the factor effectively takes over the collection of the debt, to what extent is the provision of a service involved? If it was deemed to be, VAT would be payable. However, factoring was determined not to be a service. So just like invoice discounting and other forms of ABF, no VAT is payable.

The tax treatment of leasing and hire purchase used to be more advantageous from a tax perspective, but as many of these advantages apply to a more limited extent, companies have increasingly used ABL as a means of financing rather than leasing or hire purchase.

As with any lending facility a business takes on, management should take advice to ensure it fully understands any implications for the business, including in relation to taxation.

REPORTING

In general ABF is treated simply as lending, and so (unlike the accounting treatments for leasing and hire purchase) the amounts borrowed through an ABF facility are treated as a debt. The assets (the debtors, stock, plant and machinery, property or intangibles) generally remain on the balance sheet, and the related borrowing is a creditor on the balance sheet too.

However, if an ABF facility is provided on a non-recourse basis, different accounting treatments are possible in compliance with the requirements of FRS 5 (in the UK). To determine the accounting treatment, there are two initial questions a business must ask:

- Does the business have access to the benefits – the future cash flows from payments by debtors – and exposure to the slow payment and credit risks?
- Does the business have a liability to repay amounts received from the finance provider?

Where all benefits and risks sit with the finance provider, and the client business has no obligation to repay (in a pure non-recourse facility), 'derecognition' is appropriate. 'Derecognition' means the debts are removed from the balance sheet and, because there is no liability in respect of any proceeds received from the finance provider, the cash received is simply included in current assets as cash.

Where the business has retained significant benefits and related risks, but the downside exposure to loss is limited, a 'linked' presentation should be used – a situation where there is some recourse. 'Linked' presentation means the proceeds from the finance provider are deducted from the 'assigned' debts, on the face of the balance sheet.

In all other cases a 'separate' presentation of the assets and the liability of the funding provided should be used. 'Separate' presentation means the debts remain presented as an asset, with a corresponding liability on the balance sheet for the proceeds received from the provider.

The type of ABF that is likely to be derecognised, 'pure non-recourse', is the preserve of larger businesses. As well as getting the assets and liabilities off the balance sheet, it will adjust the borrowing level and improve the metrics by which publicly listed businesses are measured. It is available to larger businesses and, typically, against their bigger customers.

Because the finance provider has taken on all of the risks in this context, pure non-recourse ABF is typically more expensive than an equivalent recourse product. As well as taking on the risk, there is more administration involved for the finance provider. The agreements are likely to have been drawn up in the context of FRS 5 requirements, but businesses should always seek their auditor's advice on the correct accounting treatment for a specific agreement.

11. Worked example

How an ABF provider arrives at the amount they will provide to a business is formulaic. This worked example demonstrates how the provider will assess the assets of a business to arrive at a full ABF (invoice finance and ABL) package.

DEBTOR BORROWING BASE

31 December 2016		UK	North America	Europe	Total
		£	£	£	£
Debtors (including credit balances)		25,453,500	1,905,250	1,112,320	28,471,070
Less: non-notified or excluded accounts	1	31,470	124,270	4,550	160,290
Notified ledger balance		25,422,030	1,780,980	1,107,770	28,310,780
Less ineligibles:					
Overdue	2	1,978,490	323,110	217,900	2,519,500
Credit balances		8,990	11,150	0	20,140
Contras	3	372,000	0	0	372,000
Credit note – disputes	4	0	0	3,450	3,450
Sale or return invoices		0	2,780	0	2,780
Customer credit limit exceeded		0	0	0	0
Debtor spread restriction – 20% of exports notified ledger	5	0	0	0	0
Export restriction cap	6	0	0	19,860	19,860
Carrier 'ransom' payment	7	137,730	0	0	137,730
Total ineligibles		2,497,210	337,040	241,210	3,075,460
Net eligible	8	22,924,820	1,443,940	866,560	25,235,320
Advance rate	9	85%	85%	85%	85%
Availability		19,486,097	1,227,349	736,576	21,450,022
Effective advance rate on notified ledger		77%	69%	66%	75%
Facility limit					25,000,000
Availability					21,450,022
Drawdown as per capital structure	10				18,540,500
Headroom	**11**				**2,909,522**

NOTES (FOR REFERENCE SEE CHAPTER FOUR):

1. Inter-company sales, cash or pro-forma sales and sales deemed non-fundable
2. Debtors that remain unpaid past the eligible funding period – if 50% or more is outstanding, the whole balance is reserved
3. Reserve for any offset, where buyer and seller have reciprocal trading relationship
4. Reserve returns or disputes
5. Limit based on assessment of borrower and debtor credit quality, plus sale terms, payment history and location of debtor
6. Reserve for all 'high risk/sanctioned' debtor territories, and under- or non-insured debtors
7. Value of any payables outstanding beyond payment terms to carriers who ship/deliver to debtors
8. Total value of all eligible debtors collateral on which the advance rate is applied
9. Percentage ABL advances funding against the debtors, based on overall collateral evaluation
10. The forecast usage of debtor borrowing base
11. Difference between availability and drawdown

STOCK BORROWING BASE

31 December 2016		
		£
Gross stock at cost	1	47,569,840
Less: ineligibles	2	12,994,885
Appraised stock at cost price		34,574,955
Gross orderly liquidation price	3	38,765,540
Less: liquidation expenses	4	4,229,830
Net orderly liquidation value		34,535,710
Advance rate	5	85%
Gross availability		29,355,354
Less:		
Specific reserves		220,000
Enterprise Act	6	4,480,000
Preferential creditors		280,000
Net availability		24,375,354
Effective rate on gross orderly liquidation price		63%

NOTES:

1. Raw materials, WIP and finished goods
2. Stock identified as slow moving or obsolete, subject to reservation of title, stored at a third-party location, or damaged
3. Appraiser's stock valuation, based on historical sales and margin mix and cost analysis (which will not include ineligibles)
4. Costs of liquidating all stock in a given time period, usually 120 days (which will include agent costs, insolvency practitioner costs and property costs)
5. Advance rate appropriate for types of stock being funded, determined by ABL
6. Mandatory amount ABL would have to pay to creditors in order to realise its lending in an insolvent liquidation

ABL STRUCTURE EXAMPLE

31 December 2016	Debtors	Stock	Plant and equipment	Freehold property	Cash flow ('airball' or 'top slice')	Total
	1	1	2	3	4	
Gross	28,471,070	38,765,540	6,750,448	3,750,000	500,000	78,237,058
Ineligible/liquidation expenses	3,235,750	4,229,830	0	0	0	7,465,580
Net eligible	25,235,320	34,535,710	6,750,448	3,750,000	500,000	70,771,478
Advance rate	85%	85%	75%	75%	100%	
	21,450,022	29,355,354	5,062,836	2,812,500	500,000	59,180,712
Statutory reserves	0	4,980,000	0	0	0	4,980,000
Availability	21,450,022	24,375,354	5,062,836	2,812,500	500,000	54,200,712
Drawdown	18,540,500	20,000,000	5,062,836	2,812,500	500,000	46,915,836
Facility limit	25,000,000	28,000,000	5,062,836	2,812,500	500,000	61,375,336
Headroom	**2,909,522**	**4,375,354**	**0**	**0**	**0**	**7,284,876**

NOTES:

1. 5-year revolving facility with no amortisation or bullet repayment
2. 5-year fully amortising term loan
3. 5-year amortising loan (for half the loan), with bullet repayment of half the loan after 5 years
4. 3-year fully amortising term loan

CASH-FLOW IMPACT

	Annual amortisation	Bullet repayment
1	0	0
2	1,012,567	0
3	281,250	1,406,250
4	166,667	0
	1,460,484	**1,406,250**

HOW MUCH FUNDING CAN BE RELEASED?

For invoice finance, the main determinants of the quantum of funding available will be set out within the client agreement. This will include the **prepayment percentage**, or **advance rate**, which is the proportion of debts against which the finance provider will provide advance payment. This would be expressed as a percentage, and would typically range from 70% to 90%, depending on the nature of the client and its debtors. So, a new invoice of £1,000 would increase the client's availability by £900, on an advance rate of 90%, with the remaining 10%, less fees, available on payment by the debtor.

Additional parameters within the facility are designed to monitor and manage indebtedness and risk. These will be negotiated and agreed with the client in advance, and clearly set out in the agreement. For example, specific invoices may not be eligible because of disputes or for reasons of credit rating.

Case study 1: International buyout

Headquartered in Newport, South Wales, Halo Foods Limited employs around 300 people. It produces cereal bars and nut-related products from a factory on site and another in Swindon. In July 2016 Dutch private equity house Nimbus acquired Halo from Finnish food and nutrition business Raisio PLC.

Soon after completing the acquisition (the terms of which were not disclosed) Nimbus approached Shawbrook Bank with three strategic priorities:

- repay a proportion of the acquisition consideration;
- generate ongoing working capital for Halo for growth; and
- deliver additional funding for further investment in automation.

To meet those objectives, Shawbrook structured a £4.96m ABL facility. The funding package comprised a £4m invoice discounting line, a £600,000 stock facility and a £364,000 plant and machinery loan.

Both the Newport and Swindon sites have the capacity to expand, to meet any demands of market growth. Halo's products include energy bars, technically advanced diet bars, low-carb bars, low-glycaemic index products and chocolate-covered snack bars. Its customers include many of the world's largest household name brands in slimming, snacks and confectionery.

As well as creating financial headroom for the business, the Shawbrook team had to meet the demands of a tight timetable, one typical of private equity. Shawbrook undertook its own financial analysis, including 'EBITDA profit bridges', to understand historical and current financial performance, as well as the forecasts. This included a detailed review of the order book and customer base. SIA Group undertook specialist asset valuations.

With the debtors, stock and plant and machinery ABL facility in place, Halo has the working capital availability to streamline production to achieve greater efficiencies and undertake other operational and new business projects.

CASE STUDY PROVIDED BY SHAWBROOK BANK

Case study 2: Financing growth through acquisition

EPI provides exploration and production consultancy services to the oil and gas industry. The business has 30 years' experience in supporting clients, with seismic surveys, environmental projects and wellsite operations. It is headquartered in Surrey and has international offices in the US, Australia, Russia, France, Ghana and South America.

In 2014 private equity firm Palatine backed an MBO of the business. Between 2009 and 2014 turnover had grown rapidly from £9m to £24m. CEO Edward Bowen and CFO Richard Bailey led the MBO team.

Then in late 2016, EPI acquired a leading UK-based oil and gas consultancy, PDF. The acquisition complemented EPI's core operations and introduced a new advisory arm, offering clients a full suite of geoscience services. The strategic rationale was that the acquisition would build a stronger foundation for continued global expansion and diversification. EPI required a financing facility that provided the necessary headroom for further growth.

EPI needed a funder who could support the company's international dimensions. IGF: Independent Growth Finance worked collaboratively with the management of EPI, as it was the first time EPI had used invoice discounting. IGF provided a £3m invoice discounting facility. Crucially the facility provided funding against overseas sister company debtors. It also provided flexibility to support future funding needs.

CASE STUDY PROVIDED BY IGF: INDEPENDENT GROWTH FINANCE

Case study 3: Funding growth

Uist Asco, headquartered in Inverness, is an innovative sustainable business with operations in North Uist, in the Outer Hebrides. It harvests seaweed from around the island and dries it organically for use in animal feed and organic fertiliser. The business that was set up in 2012 by the Maclain family has customers all over the world.

Close Brothers Asset Finance initially provided Uist Asco with a hire purchase facility, over a seven-year term, to finance the business through the initial start-up phase and allow it to purchase the essential plant and machinery it needed.

The environmentally sustainable, fully integrated operation is unique in northern Europe. Uist Asco makes use of local sustainably managed pine forest as biomass to power a boiler, which uses water from a nearby loch to create the heat to dry the seaweed. The seaweed is harvested from within a 10 mile radius by local cutters, is 100% pure, and is almost the only source of non-contaminated seaweed powder found anywhere in the world. The company has grown steadily, becoming the second largest employer on North Uist.

In June 2014 the business approached Working Capital Partners, with the aim of obtaining an ABF facility to fund the expansion of the business in the UK and internationally. The local enterprise agency and the business's bank were unable to provide the finance for its ongoing working capital requirements. Working Capital Partners visited the operation in North Uist.

In less than a week it had approved a substantial invoice factoring facility. The directors had reinvented the company, and Working Capital Partners sought to translate the business plan into a reality. The facility and usage has since been monitored closely and the credit available will be increased in line with growth. The funding has enabled Uist Asco to pay bills quicker and invest in its steady growth trajectory. It now has plans for additional machinery to help the business expand internationally.

CASE STUDY PROVIDED BY WORKING CAPITAL PARTNERS

Case study 4: International big ticket

Global Garden Products (GGP) is one of Europe's largest manufacturers and sellers of powered garden equipment for residential and commercial use. Headquartered in Italy, the business supplies lawnmowers and other garden machinery to dealers, garden centres and retail chains. It owns the brands Stiga, Mountfield and Alpina, and supplies other leading original equipment manufacturer (OEM) customers. With subsidiaries in the UK, Germany, France, Italy and Sweden, its products are sold in more than 70 countries worldwide.

The business needed a cost-effective funding solution that worked with their seasonal trade cycle and provided access to working capital when required, to allow them to meet their growth plans. Management also wanted to develop a new generation of garden machinery.

The HSBC Global Trade and Receivables Finance team worked with GGP management to put together a pan-European funding package to support the business's growth across new and existing markets.

The transaction was structured with a mixture of recourse and non-recourse facilities, to make best use of legal frameworks. There was a single umbrella agreement, rather than five separate local arrangements for each country.

An €80m (£69.04m) receivables finance facility was put in place in November 2016. It was a club deal led by HSBC, who provided €50m (£43.15m), with ABN AMRO Commercial Finance contributing €30m (£25.89m).

As a business with a seasonal trade cycle, the facilities allowed GGP to smooth its cash flow by efficiently generating working capital from invoices to fund its growth. The ongoing finance cost is limited to periods when finance is actually required. The facility improved GGP's balance sheet structure and provided a solution to the complex task of securing finance across five countries, allowing them to focus on developing their business and future growth plans.

CASE STUDY PROVIDED BY HSBC

1 EUR = 0.863 GBP,
28 March 2017.

Case study 5: International expansion

Based in Leicestershire, FSi was founded in 2000 and has developed a worldwide reputation for built-in fire protection and compartmentation systems, which are manufactured in the UK.

Founded by Chairman Carl Atkinson, the business has gone from strength to strength by expanding its product line in international markets after the slump in the UK construction industry in 2008.

Since 2008 the focus has been on product. FSi recruited additional R&D resource, invested in its own in-house furnace for testing and developed a strategy to expand both the product range and improve the capabilities of the products already being sold.

Over an eight-year period, the company invested over £750,000 in R&D to ensure its products met global standards. The business was able to expand into Europe and Australia, as well as Middle East and Asian markets. FSi also benefited from the UK market regaining some lost ground.

To fund the international growth, FSi approached Bibby Financial Services (BFS) in 2011. A £450,000 invoice finance facility was initially agreed, which has now been extended to £2m. In addition to invoice finance, the firm also uses BFS's asset finance, export finance and foreign exchange expertise to provide working capital and protect against currency fluctuations.

The funding enabled FSi to expand into new markets internationally. Combining invoice finance, asset finance, export finance and foreign exchange provided not only cash flow, but protection against exchange rate fluctuations. Overall, turnover grew from £4.7m in 2013 to a forecast of £15m in 2017.

CASE STUDY PROVIDED BY BIBBY FINANCIAL SERVICES

Case study 6: Turnaround MBO financing

In June 2015 Rutland Partners backed the MBO of Gardman Group. Based in Peterborough and founded in 1992, Gardman is a garden products supplier. Sourced mainly from overseas, it supplies both independent garden centres and national chains. Catalyst Corporate Finance was the adviser on the deal.

Gardman had gone through an £85m Equistone Capital Partners-backed MBO in 2007. Then it was restructured under bank ownership in 2012, with a consortium led by Goldman Sachs and TPG taking control of the business.

Following the restructuring it started to reposition its brands in the market and improve its product offering. Rutland Partners' investment replaced third-party bank debt and also provided significant investment into the business. The investment was to fund the strategy for further improvement in the product range and investment in operations and customer service.

While the value of the MBO was not disclosed, to give a sense of the scale of the group, for the year to the end of December 2015 turnover was £57m and there was an average of 198 full-time equivalent employees.

In December 2015 PNC Business Credit provided a £25m ABL facility, which comprised a complementary mix of a revolving credit facility structured against eligible accounts receivables and inventories and a term loan. PNC worked closely with Rutland and management from the completion of the acquisition to make sure the proposed deal structure would be robust and deliver enhanced financial headroom across the working capital cycle.

The financing package was put in place to provide the business with the necessary capital to allow Rutland and management to focus on the implementation of their growth strategy.

CASE STUDY PROVIDED BY PNC BUSINESS CREDIT

Invoice Finance and Asset Based Lending

THE ASSET BASED FINANCE ASSOCIATION (ABFA)

The ABFA is the trade association that represents the invoice finance and ABL industry in the UK and the Republic of Ireland. The ABFA membership comprises around 40 bank and non-bank finance providers and represents approximately 95% of the UK and Irish market.

In 2013 the ABFA established an independent Standards Framework for its members and their clients. The Standards Framework sets out the standards which clients and potential clients can expect from ABFA members. It also incorporates an independent complaints process currently provided by Ombudsman Services, and an independent Professional Standards Council, which has overall responsibility for the framework. Further information can be found at abfa.org.uk/standards.

The industry that the ABFA represents provides around £22bn of funding to around 44,000 UK and Irish businesses (balance of advances as at the end of 2016).
Read more industry statistics

ABFA members support businesses in the real economy of all sizes and operating in all industries. Client businesses currently supported by ABFA members have a combined turnover of over £300bn per annum. The invoice finance and ABL industry is an essential part of the business funding landscape.
View the list of ABFA members

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