Innovators Turn to Asset-Based Financing for Growth

In response to the more discriminating fundraising environment of the new millennium, some later-stage technology companies are utilizing a financing source previously reserved for manufacturing, retail, and other sectors of the "old economy." *Asset-based lenders* can accommodate borrowers whose risk profile may be outside of a bank's comfort zone, through their knowledge of and control over the borrower's collateral. These lenders view easily convertible assets and sound financial controls as remedies for the bruises that a challenging marketplace inflicts on a borrower's balance sheet.

Here's how it works: The lender advances a percentage of the borrower's accounts receivable (and, in some cases, inventory). The borrower directs its customers to send payment to a lockbox controlled by the lender. Funds collected in the lockbox are used to reduce the outstanding loan balance on a daily basis. The borrower can immediately re-borrow upon new sales. The net effect is that the loan moves in real-time synchrony with the collateral.

Benefits to the borrower include: 1) Access to capital even if balance sheet leverage or operating losses preclude conventional bank financing; 2) Minimized interest expense, since the loan is immediately reduced by customer payments; 3) Fewer and less restrictive financial covenants; 4) Immediate funding as new sales are generated. This last feature is very appealing to growing companies, as their borrowing capacity will increase proportionately with sales. Conversely, the lender is protected if the borrower's sales decline.

Asset-based lenders include commercial banks (through dedicated lending teams or subsidiaries), independent finance companies (such as CIT Group), and financing subsidiaries of major corporations (GE Capital or IBM Global Finance).

Technology entrepreneurs rarely explored this type of financing in years past. In the late nineties, startups used venture capital financing, lease financing, and venture debt during their growth phase, typically arriving at a liquidity event within a few years. Bank debt served to finance capital expenditures or short-term working capital in order to "extend the runway" between financing events. Following an IPO, commercial bank financing was abundant.

Simultaneously, asset-based lenders avoided the technology market due to their apprehension about the underlying assets. In many technology businesses, future deliverables (such as product support or project completion) might affect a customer's willingness to honor a payment obligation. Technology-related inventory tends to become obsolete quickly. The negative cash flow synonymous with technology ventures was another deterrent.

What has changed? Most obvious, we are in a dramatically different financing environment. Follow-on venture capital financing, while picking up, is considerably more expensive than five years ago. High-yield debt providers have moved upstream. Leasing companies, for the most part, have returned to more traditional underwriting criteria, and a number of commercial banks have discontinued their emerging technology lending practices. This turn in the capital markets creates a greater need to leverage trading assets and accelerate cash flow.

Improved discipline has matched many technology companies with an asset-based lender's profile. Prudently managed businesses have given up the "grow at all costs" mentality and have achieved a low burn rate or positive cash flow. In some cases, stronger internal controls have improved the value of

collateral. Additionally, many promising technology ventures still retain two intangible assets - the involvement of experienced venture capitalists and defendable intellectual property - which increase the probability of success and can preserve enterprise value in a downside scenario.

Lenders have adapted out of both client need and business opportunity. The economic downturn and subsequent bumpy recovery of the last few years has increased demand for flexible credit arrangements. Many lenders have steered some clients towards an asset-based approach in order to increase the comfort level and enable continued financing during periods of tight liquidity.

The increased discipline of this type of financing may eventually reduce the reliance on debt. A company may choose to utilize an asset-based credit line when turning the corner to profitability. This can allow more flexibility on bank covenants and prevent the dilution associated with a stock issuance. As cash flow turns positive, the loan balance should automatically trend toward zero.

A fully-followed credit line inherently creates a high level of trust between the lender and the borrower. The lender can respond quickly and flexibly based on the borrower's track record, which is critical in a rapidly changing marketplace.

Technology entrepreneurs continue to work vigorously to turn their ideas into sustainable businesses. The latest on their unending list of responsibilities: scrub their cash flow projections and present a "fully funded" plan to their board of directors.   Leveraging hard-earned assets through a flexible financing arrangement like an asset-based credit line could be an invaluable step in this process.