IS (ALL) LENDING DEAD?
AS THE CONFIDENCE CRISIS IN COMMERCIAL REAL ESTATE FINANCE CONTINUES, ASSET BASED LENDING FLOURISHES

"Well, here's another nice mess you've gotten me into." Oliver Hardy

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In the later part of 2007, and into the first several months of 2008, commercial real estate finance sharply spiraled downward with the number of real estate loans diminishing to a relative trickle. The subprime crisis, the stock market slide, the credit crunch, the housing slump, the dollar depreciation, the gasoline price run-up, the precious metal explosion, the swap turmoil, the Bear Stearns fallout, the new accounting change write downs, etc., etc., and etc. all contributed in some way to the decline. At this time, the repercussions from a lack of dollars for commercial real estate financing remain unknown and unpredictable. Cash for non real estate commercial loans, however, continues to be available, and in at least one category of finance, asset based lending, the industry is flourishing.

ASSET BASED LENDING

Asset based lenders make *working capital loans* secured by quantifiable assets, such as accounts receivable, inventory, equipment and/or real estate. The community of asset based lenders includes the asset based lending arms of domestic and foreign commercial banks, small and large independent finance companies, floor plan financing organizations, factoring organizations and financing subsidiaries of major industrial corporations. Asset based loans usually have short terms and are made to operating companies that rely on a constant stream of cash in order to operate, sustain themselves, and grow. Asset based lenders were once

considered to be the lenders of last resort for working capital, and companies that used receivables financing, factoring, and invoice discounting were often perceived to be in trouble. In addition, most businesses preferred obtaining their working capital loans from traditional banks and large commercial lenders because asset based lenders generally charge higher interest rates, costs, and fees than traditional banks and commercial lenders. But, in the modern age of finance, a highly sophisticated, more competitive secured lending industry has sprung up to provide working capital to companies that are small and large, with good credit, no credit or somewhere in between.

THE CONFIDENCE CRISIS HAS PUSHED BANKS ASIDE AND LOAN FLOW FOR ASSET BASED LENDERS HAS INCREASED

Because of the enormous current strain on the balance sheets of traditional banks and certain commercial lenders from a combination of liability, excess leverage, changes in accounting rules, and increased interbank funding costs, some of the larger asset based lenders, including banks, commercial lenders and the asset based lending divisions of major banks, have departed the market, leaving relatively small companies as the source of asset based loans. Even companies with decent credit ratings are finding it more difficult to access funds from these traditional banks and commercial lenders. Some borrowers new to the asset based lending industry are finding the loan process more borrower friendly than the traditional bank process because asset based lenders require fewer financial covenants than banks that impose multiple covenants, including total leverage, fixed charge coverage, and minimum net worth.

Loan flow for asset based lenders continues to increase and will do so for as long as the current confidence crisis exists and as the economy burrows further into a recession. The Commercial Finance Association's last survey revealed total asset based loans outstanding to be approaching $500 billion and that number should grow substantially in the coming year while

traditional banks remain on the sidelines. Not coincidentally, the larger commercial lenders and the asset based lending divisions of major banks have started to spin off free standing asset based lending groups to take advantage of the growing demand for working capital loans. Also, and not surprisingly, recently created hedge funds are specializing in asset based lending as a source of a borrowing structure that is more secure than what other troubled hedge funds found in some securitized real estate lending.

ASSET BASED LENDING WILL NOT CURE THE REAL ESTATE FINANCING VOID

When a traditional bank or commercial lender underwrites a working capital loan, it zeroes in on cash flow generated by the business and considers other factors such as the business's balance sheet and financial history. Asset based lenders, on the other hand, concentrate their underwriting decisions on quantifiable assets such as receivables, inventory, and/or equipment. Sometimes, real estate serves as part of the collateral package for an asset based loan, but it rarely constitutes the only security for the loan. Some asset based lenders make commercial real estate loans, but only for short terms and on a bridge loan basis, and usually in connection with a complete financing package for an overall working capital loan where the focus of the financing is the working capital, not the real estate. In the asset based lending context, if borrowers mortgage their land and buildings, it is usually to raise working capital or to finance expansions or improvements to their existing buildings, or to build new facilities for their businesses, not to acquire or develop real estate to rent or sell to third parties.

The current real estate lending crisis requires lenders who will provide cash for acquisitions, construction, development and refinancings to be repaid over a longer term, preferably no less than three years or at least as long as necessary to move well past this current cycle and crisis. During this crisis, regional and local banks will be a source of commercial real

estate lending, but these banks will make only a very small fraction of the loans previously generated in connection with securitized lending. Moreover, loans by regional and local banks will be underwritten conservatively, embracing and returning to the rudiments of real estate lending: personal recourse, additional principal amortization, low loan to value, more equity, higher debt service coverage, and proven track record.

Asset based lending, by its nature, provides for a continual rapid flow of money in a financing structure that is designed to be self replenishing. Although asset based lenders make long term commitments to finance the working capital needs of their borrowers, the loans usually require repayment in 30 to 90 days, obviously much shorter periods than expected for real estate financing. Not even construction loans contemplate loan repayment turnaround like that prescribed in an asset based loan. Asset based lending generally is not structured, equipped or designed for longer term real estate finance. During this confidence crisis, some conventional commercial real estate loans will be made by asset based lenders, particularly by asset based lenders who are the asset based lending arms or divisions of commercial banks. Asset based lenders, however, will not be the white knights who save commercial real estate and provide the financing so desperately needed now for the commercial real estate industry.

MISCELLANEOUS: SOME OTHER TRENDS IN ASSET BASED LENDING DURING THE CONFIDENCE CRISIS

WHERE ASSET BASED LOAN FLOW WILL INCREASE

A. Where have all the banks gone?

The Federal Deposit Insurance Corporation, the federal agency that backs bank deposits, recently reported the biggest jump in "problem institutions" it has seen since the savings and loan crisis of the late 1980s. While the extent of the problem is still low by historic standards, it identified 76 banks as in trouble - a 52% increase from a year ago. Some sources say the 76

banks now under scrutiny are likely only a small part of the problems looming over the banking sector. Reports indicate that regulators are expecting about 200 bank failures in the coming year or two. If that occurs, it could rival the flood of bank failures seen during the Savings and Loan crisis. In 1989, the nation saw a post-Depression era record of 206 bank failures.

With less banks in the market, whether they have closed or choose not to participate, fewer sources for working capital loans will exist, and borrowers who are more accustomed to dealing with banks will turn to asset based lenders for their working capital needs. Also, some asset based lenders will fill other voids created by having fewer banks in the market, including, for example, increasing their financing of mergers and acquisitions and leveraged buyouts.

B. Debtor in Possession Financing---Confidence Crisis Produces More Bankruptcies

A debtor in possession (DIP) refers to a company that has filed for protection under Chapter XI of the Federal Bankruptcy Code and has been permitted by the bankruptcy court to continue its operations to effect a formal reorganization. A DIP can still obtain loans but only with prior bankruptcy court approval.

Asset based lenders historically have been the prime suppliers of loans to debtors in possession. Such loans, called DIP Financing, represent new funds to the DIP allowing the DIP to continue to operate during the reorganization process. Asset based lenders also provide exit financing or confirmation financing to debtors in possession emerging from bankruptcy.

The American Bankruptcy Institute and other sources, citing data from the National Bankruptcy Research Center, reported recently that, in addition to the 15% increase in February, 2008, of personal bankruptcy filings from January, 2008, business bankruptcies also surged, climbing to a four-month high of 4,326. Some believe The Sharper Image and Lillian Vernon

may just be the first of many high profile businesses that file for bankruptcy protection. Asset based lenders will be the source of financing many of these businesses on the way into, during and out of bankruptcy.

WHERE ASSET BASED LENDING LOAN FLOW WILL DECREASE

A. Purchase order financing has slowed--The China Syndrome

Purchase order financing is an asset based lending method that enables a company to purchase raw materials or finished goods that will be turned into products and sold in a very short period of time. Purchase order financing is short term in duration and is usually retired within 30 to 60 days of issuance. This is an example of the way that purchase order financing works:

Company A is in the toy and baby products business. It assembles a basket filled with baby items: bottles, bibs, rattles, pacifiers, etc. Company A signs a purchase order with Company B, a large discount retail chain, to sell to Company B 100,000 basket units. The various items to fill the baskets are manufactured by three different manufacturers in Hong Kong, China and Thailand. Shipment to Company B has to be made before a specified date or Company B has the right to cancel the purchase order. Company A arranges with Lender X to have Lender X's bank issue three separate letters of credit to each of the different foreign manufacturers to provide payment to the manufacturers upon shipment, arrival and inspection of the products manufactured for Company A. No letter of credit, however, can be subject to a condition that if any one manufacturer fails to deliver on time, the letter of credit is not payable. Company A also has received the agreement of Lender Y, its accounts receivable lender, to repay Lender X the funds it advanced for the three letters of credit along with Lender X's fees

after the baskets are shipped to Company B and an account receivable is created. Lender Y will be repaid when Company B pays for the baskets 30 to 60 days after it receives the baskets.

Until last year, the major risk of a purchase order financing illustrated in this example was the ability to have all three manufacturers ship the products on time. If one of the manufactures ships late, Lender A is left with a useless basket of toys comprised of less than all the items Company B ordered.

Now, the new major, additional risk for the purchase order lender arises from concerns over defective or unsafe products produced in China and the chance that products manufactured in China could be rejected prior to delivery. The Chinese government continues to scramble to crack down on manufacturers, increase inspections, and make legal reforms, but in the meantime, purchase order financing for goods manufactured in China has slowed.

B. Some Asset Based Lending Affected by the Housing Crisis

Despite the growth of overall asset based lending as described in this paper, some areas of asset based lending are softening because the underlying businesses of regular asset based borrowers is in temporary decline. For example, vendors to the housing industry have diminished borrowing needs because they have fewer customers to whom they can sell their products. Today, suppliers of flooring to new home builders show drastically reduced sales. The receivables lenders for these suppliers have fewer and smaller loans outstanding to the suppliers. These loans may or may not be in jeopardy of default (which raises an important issue for the lender), but the amounts of these loans are most probably substantially lower, meaning less loan business for the asset based lender.

C. Transportation—Keep on Truckin'

The North American trucking industry has been hit hard by the rising cost of fuel and the economic slowdown, and particularly by the battered U.S. housing sector. The "freight recession" has led to fewer shipments of everything from auto parts and lumber to copper pipe and roofing supplies. With lower truck utilization and diminishing business, the industry will attempt to extend the lives of its current fleets and reduce new truck purchases, resulting in less need for fleet finance, a type of finance historically provided by asset based lenders. Less loan flow from the troubled transportation business at this time, however, may not upset the asset based lending community. As the economy contracts, as fuel prices soar, as some shippers delay payments, and as fewer products (whether machine tools, retail goods, or imported items from China) are shipped, the wisdom of new lending to the transportation industry is problematic.

CONCLUSION

Many banks and commercial lenders currently lack the liquidity and capital to finance the working capital needs of businesses. Demand for working capital, however, remains high. During this confidence crisis, all lenders will be cautious, but the asset based lending community will continue to provide businesses with working capital as it has for many years and also will help fill the void created by other lenders who choose to stay out of the market, who are forced to remain on the side lines, or who have gone out of existence. While the asset based lending community does its part to satisfy the requirements of businesses for working capital, commercial real estate continues the search for white knights who will rescue it from this current confidence crisis.