Asset-Based Finance (Private Credit)

Interview preparation summary · PC track

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INT.CA.1.a · The assets and the collateral

Explain how asset-based finance differs from cash-flow lending, and match the main asset classes to the cash flows, collateral and risks each one brings.

Asset-based finance (ABF) is lending against a pool of assets and the cash flows they produce, rather than against the enterprise value of an operating company. A cash-flow lender asks whether the business will generate enough EBITDA to service the debt and be refinanced; an ABF lender asks how much the pool will collect, how fast, and what it would fetch if the originator failed. Repayment comes from collections on the pool, so the loan is sized from the collateral (an advance rate against eligible assets) and shrinks as the pool pays down. The main asset classes are trade receivables and invoices, inventory, equipment and vehicle finance, consumer and auto loans, small business loans, mortgages originated outside banks, royalties and other contracted cash flows, and aircraft, shipping and other leasing. Each has its own drivers: receivables carry dilution and debtor concentration, loan pools carry default and prepayment, leases carry residual value, and royalties carry the durability of the contract. Granular, short, amortising pools give predictable losses; a few large assets give lumpy ones. ABF does not remove risk about the originator, whose underwriting, servicing and honesty still matter. A strong answer names the repayment source, the collateral, the main loss driver and the originator risk for the asset in question.

WORKED EXAMPLE: SIZING AGAINST A POOL INSTEAD OF A MULTIPLE

Tarrow Distribution, an invented wholesaler, has EBITDA of 12.0m, eligible receivables of 40.0m and inventory with a net orderly liquidation value (NOLV) of 15.0m. A cash-flow lender would lend 4.0x EBITDA. An ABF lender would advance 85% of eligible receivables and 80% of inventory NOLV. How do the two loans compare, and what happens if sales fall by a quarter and EBITDA halves to 6.0m? Figures in millions.

Answer: Cash-flow loan 48.0m (8.0x after the fall, with no mechanism to reduce); ABF base 46.0m falling to 34.5m, with the 11.5m reduction repaid from collections.

> **Interview tip:** Open with the repayment source: say that you size on what the pool will collect and liquidate to, and then name the originator risk that remains.

INT.CA.1.b · The assets and the collateral

Calculate a borrowing base from eligible collateral, applying ineligibles, concentration limits, dilution and reserves, and explain how reporting, collateral monitoring and field exams protect the lender.

A borrowing base is the maximum a borrower may draw: advance rates applied to eligible collateral, less reserves. Start with gross receivables and remove ineligibles: invoices past an ageing cut-off (often 90 days from invoice), the rest of a debtor's balance when too much of it is aged (cross-ageing), contra balances where the debtor is also a supplier, disputed or related-party invoices, and insolvent debtors. Then apply concentration limits, which cap how much one debtor can count, and an advance rate, commonly 80% to 90% for receivables. Dilution (credit notes, rebates and returns that reduce what is collected) lowers the advance rate or creates a reserve; a common rule cuts the rate by a point for each point of dilution above a threshold. Inventory is advanced as a percentage of its net orderly liquidation value (NOLV) from an appraisal, often with a sub-limit. Reserves cover items that rank ahead of the lender, such as rent and priority claims. The base moves with sales, collections and ageing, so the borrower reports often (monthly, weekly or daily for weak credits), and if loans exceed the base there is an overadvance to be repaid at once. Field exams and audits test that the receivables exist, the ledger matches the accounts, controls work and the borrower's figures can be trusted.

WORKED EXAMPLE: BUILDING A BORROWING BASE STEP BY STEP

Ashby Tools, an invented distributor, reports gross receivables of 18.0m. Invoices over 90 days total 2.4m, cross-aged balances 0.6m and contra balances 0.4m. Debtor A owes 4.0m of what remains. The concentration cap is 20% of eligible receivables before concentration. The advance rate is 85%, reduced by one point for each point of dilution above 5%, and dilution is 9%. A reserve of 0.5m applies and loans outstanding are 10.0m. What is the availability? Figures in millions.

Answer: Borrowing base 10.45m (eligible 13.52m at 81%, less a 0.5m reserve); availability 0.45m.

Interview tip: Walk down the page in order, ineligibles, concentration, advance rate, reserves, and say what each deduction protects against.

INT.CA.2.a · Structure and securitisation

Describe how asset-based facilities are structured: secured revolvers and term loans, warehouse and forward-flow lines, SPVs, true sale against secured loan, servicing, cash dominion and the cash waterfall.

Asset-based lenders use secured revolving and term facilities, warehouse lines and forward flow. A revolver lends against a borrowing base that moves with the collateral. A warehouse line funds an originator's loans as they are made, at an advance rate, until enough have built up to sell or term out in a securitisation. Forward flow is a commitment to buy newly originated assets meeting set criteria at an agreed price over a period. Many deals sit in a special purpose vehicle (SPV) that holds the assets, so that the lender looks to the pool rather than to the originator's other creditors. The legal route matters: in a true sale the assets are owned by the SPV and, subject to the legal opinion, fall outside the originator's insolvency; in a secured loan the originator still owns them and the lender holds security, which an insolvency process may delay or challenge. Bankruptcy remoteness limits what the SPV can do and who can petition against it. The servicer collects and reports, and a back-up servicer can step in if it fails. Collections go to an account the lender controls (cash dominion), which may spring only when availability is low, and a cash waterfall pays fees, interest and any required principal in a fixed order, with triggers that divert the rest to the lender. True-sale opinions, consolidation and tax are for counsel and advisers.

WORKED EXAMPLE: COLLECTIONS THROUGH A WAREHOUSE WATERFALL

An invented warehouse SPV receives 6.0m of collections in a month. The waterfall pays the servicer 0.15m, the back-up servicer 0.05m and senior interest 0.80m, then principal needed to cure an overadvance of 1.5m, then releases the rest to the originator. A later month has the same collections but an early amortisation trigger has been breached. What is paid in each case? Figures in millions.

Answer: Normal month: 1.5m principal and 3.5m released to the originator. After the trigger: 5.0m principal and nothing released.

Interview tip: Say that the order of payments is the protection, and that triggers change where the residual cash goes.

INT.CA.2.b · Structure and securitisation

Explain how a securitisation tranches credit risk, using subordination, overcollateralisation, excess spread and triggers, and work through a loss and prepayment example across senior, mezzanine and residual tranches.

A securitisation sells the cash flows of a pool of assets as tranches of notes with different rankings. Senior notes are paid first and absorb losses last; mezzanine notes sit beneath them; the residual or equity piece (often the originator's retained interest, or overcollateralisation where assets exceed notes) takes losses first and receives what is left. Credit enhancement for a tranche is what lies beneath it. Subordination, overcollateralisation, a reserve account and excess spread all provide it. Excess spread is the interest collected on the pool less note interest and fees, and it is the first loss absorber each period. Losses are allocated from the bottom: the residual is written down first, then mezzanine, then senior. Triggers, such as a cumulative net loss or delinquency limit, divert cash from the residual to pay down senior notes faster, which builds protection when performance weakens. Prepayments shorten the weighted average life of the notes and reduce the interest earned on the pool, so excess spread falls. A senior tranche is priced for low loss and low yield, mezzanine for more risk and a higher margin, and the residual for the highest risk and the highest possible return. Rating, accounting and regulatory treatment are for specialists.

WORKED EXAMPLE: LOSSES, EXCESS SPREAD AND PREPAYMENTS IN A SMALL DEAL

An invented securitisation holds a pool of 100.0m earning 12.0% a year. It has senior notes of 78.0m at 5.0%, mezzanine notes of 12.0m at 8.0% and a 10.0m residual (overcollateralisation). Servicing and other fees are 1.0m a year. (a) What is the credit enhancement of each rated tranche? (b) What is the first-year excess spread? (c) If cumulative losses reach 14.0m with no excess spread left, who bears them? (d) With no scheduled amortisation, what is the pool balance after two years at a 15% annual prepayment rate? Figures in millions.

Answer: Enhancement 22% (senior) and 10% (mezzanine); excess spread 6.14m; residual wiped out and mezzanine loses 4.0m of 12.0m with senior untouched; pool 72.25m after two years.

> **Interview tip:** Allocate losses from the bottom of the structure, name each layer's cushion as a percentage, and mention excess spread as the first defence.

INT.CA.3.a · Performance, risk and returns

Calculate default rates, loss given default, recoveries, net loss, delinquency roll rates and weighted average life for a pool, and value collateral at net orderly liquidation value.

Pool performance is measured with a small set of ratios, and the definitions matter. The default or charge-off rate is the share of the original (or current) balance written off. Recovery is the cash collected after charge-off, and loss given default (LGD) is one minus the recovery rate. Net loss is charge-offs less recoveries, usually shown as a percentage of the original balance for a vintage so that vintages can be compared at the same age. Expected loss is probability of default times LGD. Delinquency is tracked in buckets (30, 60 and 90 days past due), and a roll rate is the share of one bucket that moves to the next worse bucket the following month; multiplying roll rates along the chain gives the share that ends in charge-off. Prepayment is often quoted as a conditional prepayment rate (CPR), an annualised percentage of the balance that pays early. Weighted average life (WAL) is the average time to principal repayment, weighted by the amounts: the sum of each repayment times its time, divided by total principal. For physical collateral, net orderly liquidation value (NOLV) is what an orderly sale would bring after the costs of selling, and an appraiser provides it; lenders advance against NOLV, not cost or book value. Always compare like with like: same vintage age, same definition of default, gross against net.

WORKED EXAMPLE: READING THE PERFORMANCE OF AN 80.0M POOL

An invented auto-loan pool had an original balance of 80.0m. Cumulative gross charge-offs are 4.4m and recoveries are 1.1m. Of 5.0m in the 30-day delinquency bucket, 1.2m has rolled into the 60-day bucket this month. A note funded by the pool repays 10.0m after one year, 30.0m after two and 60.0m after three. Work out the net loss rate, recovery rate and LGD, the 30 to 60 roll rate and the note's weighted average life. Figures in millions.

Answer: Net loss 3.3m, or 4.13% of the original balance; recovery 25.0%, LGD 75.0%; roll rate 24.0%; WAL 2.5 years.

> **Interview tip:** State the definition before the number, for example net loss as a percentage of the original balance, and always say which vintage and age you are comparing.

INT.CA.3.b · Performance, risk and returns

Assess originator and counterparty risk behind a pool, set exposure limits and estimate the return and leverage effects at fund level, and give a reasoned answer on why asset-based finance and which assets you would not lend against.

In ABF the pool is the collateral, but the originator creates, services and reports on it, so its quality is a risk in itself. Test underwriting standards (are approval rules stable, and do early-payment defaults and first-payment defaults rise as volume grows), fraud and data integrity (verification of the assets, audits and a tape you can reconcile), servicing capability and the plan if it fails (a back-up servicer and controlled collection accounts), and the originator's own funding, since a lender that loses its warehouse lines stops originating and its pools age. Set limits by originator, asset class, debtor, vintage and geography, and size positions against the fund's capital so one failure is survivable. Return comes from a margin over the base rate on drawn amounts, commitment fees on undrawn amounts and fees, less expected losses, and the spread is a payment for complexity, illiquidity and oversight, not for taking more collateral risk. Fund leverage helps only while the net asset yield after losses is above the cost of debt. In an interview, say why you like the asset class (contractual cash flows, amortisation, collateral and diversification), be able to name an asset you would not lend against, such as one with untested losses, weak controls or valuations that depend on a single buyer, and say what would change your mind.

WORKED EXAMPLE: HOW MUCH CAN THE FUND TAKE, AND WHAT DOES IT EARN

An invented fund has 500m of capital. Its limits are 6% of capital per originator and 20% in any one asset class. It already holds 85m in consumer lending, of which 12m is with Originator X. X asks for a new 20m facility at base plus 6.0%, with a base rate of 4.0% and expected annual net losses of 2.0% of the amount lent. How much can the fund lend, and what is the expected net income? Figures in millions.

Answer: The fund can lend 15m (the asset-class limit binds, not the 18m originator room), earning about 1.2m a year of net income at 8.0% after expected losses.

> **Interview tip:** Show that your limits come before your yield, and that you can say which limit binds.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.