Asset-Based Lending: An Overview

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Callodine Commercial Finance

June 2021
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Executive Summary

Asset-Based Lending ("ABL") is a form of secured and closely monitored financing whereby banks and other lending institutions provide debt capital to companies and establish a lien on the borrower’s assets to protect the principal of their loan. ABL uses a formula-based lending approach that utilizes assets that can be valued and monitored as collateral. This form of lending is frequently used for middle-market companies in need of capital, often to effect strategic change at the business or to provide incremental liquidity during times of transition.

In contrast to traditional cash-flow lending, ABL strategies look to the underlying collateral during their underwriting process to determine if a borrower has sufficient assets to support the loan. Whereas cash flow lenders may focus on debt / EBITDA and interest coverage ratios, asset-based lenders rely upon asset coverage and the quality of the collateral backing their loans for certainty of repayment. ABL structures have traditionally fared significantly better than many other forms of debt during recessions, as they generally have both lower default rates (given their focus on assets vs. maintenance covenants) and lower Loss Given Default rates.

The investment strategy has become increasingly prevalent in recent years, both for corporate borrowers in need of more tailored financing solutions, as well as for institutional allocators in search of alternative sources of cash yield. If executed properly, asset-based lending can provide an attractive yield and capital preservation solution for investors that are looking for income-oriented strategies potentially less correlated with publicly traded fixed income markets.

This document is intended to provide a foundational understanding of asset-based lending, and specifically asset-based term loans, for those that may be newer to the asset class. As part of this white paper, we will address:

- **History and Evolution of Asset-Based Lending**
- **Collateral Types**
- **Structural Considerations**
- **Current Market Opportunity**
I. History and Evolution of Asset-Based Lending

Asset-based lending traces its roots to the 1920s, originally in the form of receivables factoring and discounting structures. The asset-based lending industry has evolved significantly over the last several decades. Beginning in the 1970s and 1980s, banks and finance companies took the factoring model a step further and began to lend directly against accounts receivable and wholesale and industrial inventory, in select cases. By the early 1990s, banks began making asset-based loans against retailers’ inventory, which historically had not been done. In the early 2000s, lenders began to stretch their clients’ accounts receivable and inventory borrowing bases by offering a term loan product, similar to the product that Callodine Commercial Finance (“CCF”) offers today. This asset-based term loan, which was primarily available to the retail sector, has since been adopted across multiple industries and asset classes by an increasingly diverse set of borrowers, allowing for term financing against a broader range of collateral types.

Once considered the “lender of last resort”, asset-based lending has proliferated as an alternative capital source as traditional funding sources have become limited in capacity and businesses consider a broader range of solutions. Additionally, what was once considered a financing tool primarily associated with the retail sector, the stretch asset-based term loan has become more widely adopted by borrowers across a more diverse array of industries that are looking for additional sources of liquidity. Finally, as banks have shied away from lending against non-working capital assets such as machinery & equipment (“M&E”), industrial real estate, and intellectual property, the market for asset-based term loans has expanded. This market evolution and the broader acceptance of asset-based lending as a viable capital markets alternative has led to an increase in both the number and quality of investment opportunities available to teams that have experience in lending against a variety of asset classes, such as CCF.

Over the past 20+ years, we have witnessed the continued emergence of asset-based lending as a viable multi-sector/multi-asset class capital source. CCF has lent to companies in industries as diverse as retail, environmental, health care, food and beverage, timber, energy, consumer products, technology, yarn manufacturing, and plastics, among others. The common thread between all these companies is that they had the assets to support our loans, including accounts receivable, inventory, M&E, real estate and intellectual property (primarily brands).

With the onset of COVID-19 and the widespread borrower distress that has ensued, banks have repositioned themselves to shed certain credit exposures. Regulations have limited banks’ ability to provide the necessary debt financing solutions to businesses in transition. As a result, businesses with transitional characteristics, such as negative EBITDA and declining operating results, have been denied or have very limited access to bank financing, regardless of the fundamental strength of the business. Banks have historically been cautious lending against fixed assets and intellectual property, focusing more on working capital assets that are more core to traditional asset-based lenders. These market dynamics create an opportunity for private credit specialists such as CCF to provide additional liquidity to worthy borrowers, supplementing the leverage provided by the banks and creating a financing solution for bank clients. Assuming the appropriate level of asset coverage, providers of asset-based term loans may be willing to supply incremental leverage where appropriate, and are also able to underwrite and lend against fixed assets such as real estate and equipment, as well as intellectual property.
Recently, we have observed borrowers with attractive asset-based credit profiles, oftentimes “Fallen Angels” that were once unsecured borrowers that migrate into more flexible asset-based financing. We are also seeing some borrowers transition from cash flow loans to asset-based structures. We believe that trend will become increasingly prevalent, and as those credits migrate to ABL structures, we are confident that specialists like CCF will be well positioned to help commercial banks finance that transition.

Exhibit 1: Not all Asset-Based Lending strategies are the same, with varying structure and terms depending on the lender’s profile and motivation

II. Collateral Types

In contrast to traditional cash-flow lending strategies, asset-based lending prioritizes the quality and coverage of a borrower’s underlying collateral and liquidity. The primary path to investment realization for CCF, and presumably for our peers, is through refinancing. In certain instances, however, repayment occurs via the collection and orderly sale of underlying asset collateral through a bankruptcy process. As a result, the loan structures employed by ABL specialists are geared to provide for a recovery through the monetization of collateral, if required. ABL structures limit losses through frequent collateral reporting and ongoing valuation and verification of collateral (via appraisals and field exams).

There are various types of assets that asset-based lenders will typically accept as collateral for their loans. The collateral and borrowing base for an asset-based lender’s investments will often
include some combination of accounts receivable, inventory, M&E, intellectual property / brands and real estate. In the exhibit below from Secured Finance Network, we can see the relationship between certain asset classes and the various forms of secured financing available to each underlying collateral type.

Once a collateral package is defined, asset-based lenders will assign certain advance rates to the underlying assets to determine how much to lend a prospective borrower. The advance rates a lender chooses to apply to each category of collateral will depend on a variety of criteria, including but not limited to: asset quality, liquidity, availability of reliable third-party appraisals, observed current liquidation values or similar assets, past experience with the asset class, and costs to monetize assets.

Asset-based lenders will conduct a thorough analysis of a company’s business plan, financial results, liquidity, and collateral in advance of entering into a transaction, often in coordination with select third party appraisal firms as it relates to the value of the underlying assets. This review helps guide how much financing a lender may be comfortable extending to any particular borrower, based on the quantity and quality of their underlying collateral.

Once a loan is made, lenders will require frequent financial and collateral reporting from their

**Exhibit 2: Collateral types and secured financing tools can often overlap, with ABL at the center of collateral-backed finance.**
Exhibit 3: Asset-Based Lenders can provide financing against a variety of different collateral types, depending on the strategy and experience of the team in question.

<table>
<thead>
<tr>
<th>Collateral Type</th>
<th>Typical Advance Rate</th>
<th>Callodine Commentary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>75 – 95%</td>
<td>Traditional source of collateral with well-defined recovery values</td>
</tr>
<tr>
<td>Inventory</td>
<td>75 – 105%</td>
<td>Traditional source of collateral with well-defined Net Orderly Liquidation Values</td>
</tr>
<tr>
<td>Machinery &amp; Equipment</td>
<td>50 – 75%</td>
<td>M&amp;E advance rates may vary based on breadth of application and liquidity of the equipment, which translate to Net Orderly Liquidation Values</td>
</tr>
<tr>
<td>IP / Brands</td>
<td>50 – 75%</td>
<td>Increasing adoption by asset based lenders that have the ability and experience to underwrite to the underlying Net Orderly Liquidation Value of the asset</td>
</tr>
<tr>
<td>Real Estate</td>
<td>50 – 65%</td>
<td>May experience lower max advance rates due to illiquidity of the asset. Often underwritten to Forced Liquidation Value</td>
</tr>
</tbody>
</table>

Note: Indicative Advance Rates and subjective commentary provided by Callodine Commercial Finance based on market observation. Other firms may vary, and loan terms may change based on market conditions and other factors.
III. Structural Considerations

Asset-based lending is a form of transitional capital, where repayment of principal often comes as a result of a refinancing or a restructuring. Occasionally in the instance of a restructuring, companies that use asset-based loans as part of their capital structure must file for bankruptcy. Consequently, ABL lenders must make certain that their loan structures protect their investment throughout the proceedings. Ensuring that loans are structured properly is paramount to an asset-based lender’s ability to recover their investment, with interest and fees, even when a company experiences distress.

Asset-based loans are floating rate instruments, with coupons that can vary substantially depending on the transaction. As a point of reference, CCF typically targets loans with cash coupons between 6% and 10% depending on

Exhibit 4: While results may vary, ABL strategies can provide a highly attractive risk-reward profile for investors if executed properly.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Asset Based Term Loans</th>
<th>Leveraged Loans</th>
<th>Middle Market</th>
<th>2nd Lien</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Yield to Maturity</strong></td>
<td>6.00% - 10.00%</td>
<td>5.27% Avg.</td>
<td>6.09% Avg.</td>
<td>8.65% Avg.</td>
</tr>
<tr>
<td><strong>Closing Fees / OID</strong></td>
<td>1 – 3%</td>
<td>1 – 2%</td>
<td>1 – 2%</td>
<td>1 – 2%</td>
</tr>
<tr>
<td></td>
<td>(98.6 Avg OID)</td>
<td>(98.7 Avg OID)</td>
<td>(98.8 Avg OID)</td>
<td></td>
</tr>
<tr>
<td><strong>Tenor</strong></td>
<td>3.0 – 5.5 Years</td>
<td>6.0 Year Av.</td>
<td>6.5 Year Av.</td>
<td>7.5 Year Av.</td>
</tr>
<tr>
<td><strong>Prepayment Fees / Call Protection</strong>(1)</td>
<td>Make Whole 103 / 102 / 101</td>
<td>101</td>
<td>101</td>
<td>102 / 101</td>
</tr>
<tr>
<td><strong>% of Deals with Covenants</strong></td>
<td>100%</td>
<td>14%</td>
<td>45%</td>
<td>56%</td>
</tr>
<tr>
<td><strong>Recovery Rates</strong>(2)</td>
<td>95%+</td>
<td>60%</td>
<td>75%</td>
<td>52%</td>
</tr>
</tbody>
</table>

Source: Calidodine Commercial Finance and LCD. Asset-Based Lending metrics according to Calidodine Commercial Finance based on proprietary portfolio metrics and market observations. Leveraged Loans, Middle Market and 2nd Lien metrics represent averages for LTM issuance as of March 31, 2021 according to LCD. Leveraged Loans column represents 1st Lien transactions for Large Corporates, as defined by issuers with > $50 million in EBITDA. Middle Market includes issuers with < $50 million in EBITDA. (1) Represents typical call protection as determined by highest number of occurrences during the LTM period. (2) ABL Recovery Rate representative of Calidodine Commercial Finance’s portfolio. Other Recovery Rates per LCD LossStats. Represents Average Discounted Recovery from 1987-2019.
market conditions, where interest is typically required to be paid monthly. Factoring in closing and upfront fees of anywhere from 1% to 3%, the all-in yield on these loans can often reach 9-12% depending on prevailing market conditions. We view the floating rate structure of these loans as favorable, particularly in a rising rate environment given the lack of duration risk embedded in the instrument.

Asset-based term loans typically have a legal final maturity of between three and five years. The average duration of a typical loan, however, is frequently shorter than the stated maturity. Often, the average life of a transaction is between 18 to 24 months before a lender is taken out of its position. A common path to repayment as noted previously is refinancing. Companies that perform as expected or on par with their business plan usually repay ABL financing in 18 to 24 months with cheaper capital from traditional sources. If a borrower refinances a loan before its final maturity, the lender may earn prepayment fees as part of the call protection structured into a loan. In addition, if a borrower is required to amend the structure of their loan during the original loan term, the lender may earn amendment fees to compensate them for additional flexibility afforded to the borrower. All of these potential fees serve to enhance the overall return profile of asset-based loans.

Asset-based loans are often highly tailored to the specific borrower and situation, and thus may vary widely in terms of coupon, fees, structural features and security. While the bespoke nature of the asset class makes it incredibly hard to benchmark versus larger and more established asset classes within private credit, that is also what makes asset-based term loans such a unique segment of the capital markets. The esoteric nature of the investment strategy makes it hard to replicate, creating a barrier to entry for market participants that are new to the space.

IV. Current Market Opportunity

Defining the total size of the asset-based lending market can be somewhat difficult based on the private nature of ABL transactions and the lack of industry-wide reporting data. According to the 2019 Market Sizing & Impact Study conducted by the Secured Finance Network, however, the asset-based lending market was approximately $465 billion based on total commitments, and approximately $164 billion based on loans outstanding as of 2018. As noted in the exhibit below, this makes the ABL market larger than the asset backed securitization market, but still only a fraction of the cash flow lending and leveraged loan markets.

The addressable market for asset-based lending strategies continues to grow as the strategy becomes more widely accepted as a useful capital markets tool. Borrowers from a wider array of industries can now access the ABL market for as an alternative funding source. Sectors with active borrowers in the market today include, but may not be limited to:

- Retail & Consumer
- Industrials
- Technology
- Energy
- Textiles, Plastics & Timber
- Pharma & Healthcare
- Transportation / Logistics
- Food & Beverage
Exhibit 5: ABL is a large and growing asset class, with the majority of the market historically served by traditional commercial banks via revolving credit facilities.

<table>
<thead>
<tr>
<th>Transaction:</th>
<th>Calendar year 2018</th>
<th>YE 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volume</td>
<td>Growth</td>
</tr>
<tr>
<td>Asset-based lending</td>
<td>$164</td>
<td>6% - 7%</td>
</tr>
<tr>
<td>Factoring</td>
<td>$101</td>
<td>3% - 5%</td>
</tr>
<tr>
<td>Supply chain finance</td>
<td>$416</td>
<td>5% - 6%</td>
</tr>
<tr>
<td>Equipment finance and leasing</td>
<td>$1,040</td>
<td>3% - 5%</td>
</tr>
<tr>
<td>Leveraged lending</td>
<td>$1,240</td>
<td>-10% - -12%</td>
</tr>
<tr>
<td>Cash flow lending</td>
<td>$1,035</td>
<td>22% - 26%</td>
</tr>
<tr>
<td>Securitization</td>
<td>$127</td>
<td>3% - 5%</td>
</tr>
</tbody>
</table>

Total | $4,123 |

Source: Secured Finance 2019 Market Sizing & Impact Study. Dollars in Billions. Indicated levels are Study estimates and subject to future revision. ABL: values based on total facility commitments and include syndicated and non-syndicated loans; Factoring: net funds outstanding assumes annual volume of factored purchases average 45-day terms with 22-day average outstanding funds; Supply chain finance: annual volume derived using an assumption of 90-day average terms on YE estimated outstanding amount; Equipment finance: annual volume uses assumptions from 2018 Equipment Leasing and Finance Foundation Industry Horizon report, outstanding level assumes five-year amortizing terms; Leveraged lending and cash flow lending: Study estimates based on LPC Refinitiv data; Securitization: includes only commercial asset-related ABS, Study estimates based on SIFMA data.

The application of ABL structures across a wider swath of industries and collateral types benefits borrowers as well as those lenders that have the sourcing capabilities and expertise to capitalize on the broader adoption of the strategy.

This broadening of the addressable market has also taken place as banks and other traditional sources of financing have pulled back from more transitional credits. But whereas non-bank lending institutions such as private credit firms have proliferated in the wake of the Great Financial Crisis to absorb cash flow loans, the same dynamic has not yet taken place in the ABL arena, given the limited number of skilled investors in the space.
Exhibit 6: Structural shifts in the market have led to increasing demand for asset-based lending strategies to fill the capital void left by banks.

![Diagram showing Robust Demand and Reduced Supply]

**Robust Demand**

A. Capital void has developed that is increasingly being filled by private credit

B. Lower and middle-market private equity activity has grown dramatically over the last 10 years

C. Increasing viability of asset-based lending as a capital source in the eyes of borrowers

**Reduced Supply**

- Banks, hedge funds, proprietary desks constrained by regulation (e.g., Basel III) and liquidity
- Small BDCs can face funding hurdles, pushing them further down the capital structure
- Large BDCs and peers focusing on upper middle-market loans of $100mm+
- Bank consolidation and regulation has accelerated over the last 15 years


From an investor's perspective, ABL strategies can provide an attractive source of incremental yield over traditional private credit alternatives. Asset-based lending strategies, if executed properly, can also witness recovery rates that exceed similar direct lending strategies. It is this combination of the potential for strong cash yields with high capital preservation that we believe makes asset-based lending an attractive allocation for institutional investors, and an increasingly relevant strategy within global credit markets.
**Glossary**

**Advance Rates:** The percentage applied to any given asset class in a borrowing base. Advance Rates typically vary by asset class.

**Appraisals:** Perhaps the most crucial of any third-party report, asset appraisals support and give comfort to the Net Orderly Liquidation Value (“NOLV”) of the assets serving as collateral for the loans.

**Borrowing Base:** The formula that governs the amount an ABL lender is willing to advance against a company’s assets, typically derived by adding the product of the different asset classes times the applicable Advance Rate for such assets and subtracting Reserves.

**Field Exam:** The purpose of these exams is to ensure that prospective borrowers have the means to accurately report what they are required to report to the lenders. Field exams include, but are not limited to:
- Review of books & records
- Reconciliation of stock ledger to general ledger
- In-depth analysis of payables and receivables (aging, payment terms, concentrations)
- Review of internal cash management systems
- Review of enterprise software and computer systems
- Review of inventory systems

**FILO:** “First-In, Last-Out.” When 2 ABL lenders share the same lien (typically between a traditional ABL revolver lender and an ABL term loan lender), a FILO structure indicates that the ABL term loan must be fully funded before any revolving loan can be funded. However, as to any recovery from the sale of collateral, the ABL revolving loans rank first in right of repayment ahead of the FILO term loan.

**FLV:** “Forced Liquidation Value.” The value determined by an appraisal firm that would be generated in the event of an immediate, forced auction of a borrower’s assets.

**LTV:** “Loan to Value.” The ratio amount borrowed as a percentage of the appraised value of the underlying assets.

**NOLV:** “Net Orderly Liquidation Value.” The value determined by an appraisal firm satisfactory to the ABL lender, such value representing the final realization generated from the liquidation of collateral after all operating costs and fees associated with a liquidation sale have been deducted.

**Reserves:** Reserves have the effect of reducing the Borrowing Base, and refer to amounts determined by the ABL lender in its Permitted Discretion as being appropriate (a) to reflect the impediments to the ABL lender’s ability to realize upon the collateral, (b) to reflect claims and liabilities that the ABL lender determines will need to be satisfied in connection with the realization of the collateral, or (c) to reflect criteria, events, conditions, contingencies or risks which adversely affect any component of the Borrowing Base, or the assets, business, financial performance or financial condition of any borrower. By “reserving” these amounts in the Borrowing Base, these items should be covered by the borrowers assets, further helping the ABL lender preserve the value of the collateral covering its loan.