

EMPLOYMENT

COVID-19: Could borrowing base funding mechanisms be the answer for smaller businesses suffering from cash flow shortages?

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There is hope for small businesses suffering from the impact of the COVID-19 national lockdown who have been unable to look to financial institutions for funding assistance. Small businesses are aware that [unsecured loans](#) are a hard thing to come by and many businesses lack sufficient collateral to satisfy a financial institution's requirements for purposes of advancing a secured loan.

We could learn a thing or two from first world countries like the United States of America and the United Kingdom, whose economies have benefitted from the use of 'borrowing base financing' mechanisms, otherwise known as "asset-based financing" for several years. Borrowing base financing is a specialist financial product designed to target developing loan markets and assist small businesses, particularly those experiencing drastic cash flow shortfalls.

A borrowing base facility is akin to a revolving financing mechanism which caters for the working capital requirements of companies, predominantly those companies which deal in the sale and/or supply of commodities (being retailers, distributors, wholesalers and service providers). This type of facility allows a financial institution to provide a company with funding to continue producing (e.g., inventory), without the company having the looming concern of liquidity shortfalls and lack of collateral, whilst the financial institution remains fully secured.

But, how exactly does this work? A borrowing base facility operates on the principle that the amount of funding which may be advanced by a financial institution to a company will be based on the value of an identified pool of assets held by that company at any given time. Given the types of companies who would benefit from a borrowing base facility, the pool of assets can vary from time to time. As such, the funds advanced by a financial institution to such company will vary synchronously with that pool of assets. In other words, the more inventory a company is able to produce or the more sales that a company is able to make, the greater the amount of funding the company would be eligible to access under the facility. On the converse, the less inventory produced and/or sales made by such company, the lower the funding which the company would be eligible to access under the facility.

In these types of scenarios, a financial institution would generally limit the borrowing base facility to a maximum cap of funding which it would be willing to provide, this cap being known as the 'borrowing base'. The borrowing base will, in turn, form the collateral granted by the company in favour of the financial institution for the provision of the borrowing base facility. The collateral would usually take the form of a general notarial bond over the company's inventory, a security cession over equipment and debtors book and in some cases even security over immovable property.

In the United States of America, financial institutions calculate the maximum borrowing base facility using information provided in the company's financial statements, which is known as the 'margin method'. Such method adds the value of the inventory on the basis of its actual value at the time of the valuation, the value of the company's equipment (accounting for depreciation and maintenance costs) and the value of the company's debtors book at the time of the valuation, which then totals up to the value of the company's assets to be used as collateral. Financial institutions must then assess their risks in providing the facility, by applying a 'discount factor' which represents the percentage of the company's assets that will actually be advanced as collateral, based on the financial institution's risk in funding the

relevant company. This discount rate is multiplied by the total value of the collateral which equates to the total borrowing base and accordingly the value of the borrowing base facility.

A financial institution can benefit from this type of funding through its ability to monitor the borrowing base on a daily basis, providing flexibility to companies, ongoing security, decreased risk exposure, interest rates and developing new relationships with clients that were originally not on their radar.

After the Minister of Trade, Industry and Competition published Regulations imposing various regulatory relief measures within the banking sector, many financial institutions have been at the forefront of assisting companies (small and large) to stay afloat during the COVID-19 pandemic. Although some South African financial institutions already provide this type of funding, South Africa still has a long way to go, but this model of funding may prove to be beneficial to companies and financial institutions alike in the current circumstances.



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