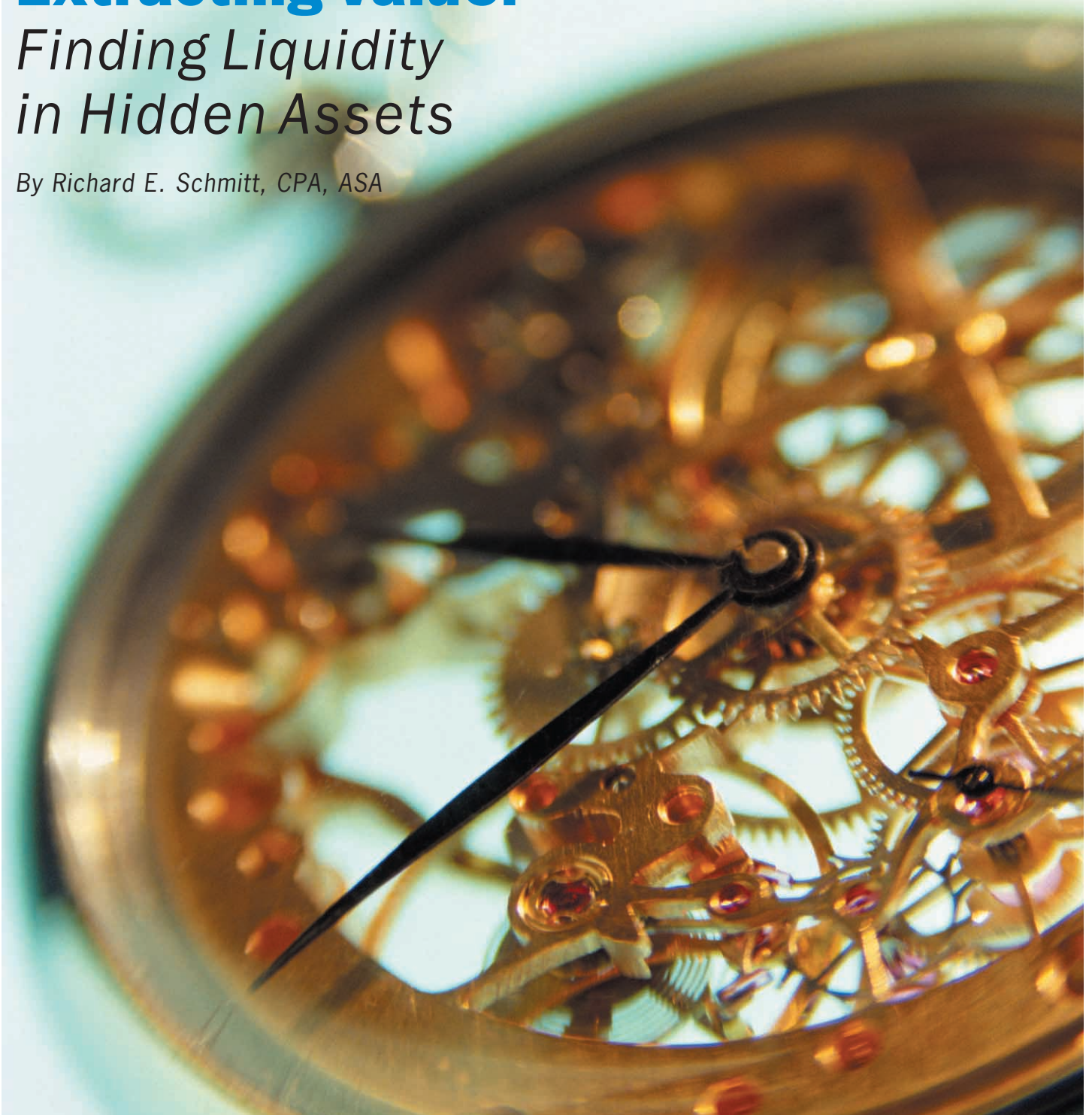


Strategies for Extracting Value:

Finding Liquidity in Hidden Assets

By Richard E. Schmitt, CPA, ASA



The following article explores several strategies which, when valued and applied properly, will assist a company in obtaining additional balance sheet leverage from hidden assets. In addition, professional valuation firms can help companies and lenders identify underutilized or hidden assets that may be used as collateral to support an asset-based loan.

Professional valuation firms can help companies and lenders identify underutilized or hidden assets that may be used as collateral to support an asset-based loan. In today's competitive environment, CFOs are looking for ways to increase balance sheet leverage. Additional leverage reduces the amount of invested equity and replaces it with debt financing, which has a much lower cost. When additional leverage is prudently used, this benefits the company by creating a lower weighted average cost of capital and increases the rate of return to the stockholders.

A company's hidden assets exist in many forms. Hidden assets are often thought of as items not recorded on the company's balance sheet. These items often include a wide range of items such as contracts, patents, trademarks and other intangible assets that are expected to generate future cash flow or benefits for the company. Hidden assets can also be items currently recorded on the balance sheet that are not utilized or are underutilized to secure financing. Examples of these assets can include excessive amounts of receivables or inventory classified as ineligible, assets located in foreign countries, assets in transit from foreign countries, or plant equipment or real estate with limited term debt. It can also include significant amounts of assets in special industries that historically were not afforded ABL deal structures.

Assets in special industries may be excluded from current loans because they are not traditional items and the current lenders are not certain of an exit strategy where the assets can be sold and they can monetize the proceeds from a sale of the collateral. In today's global economy, efficient information and transportation systems provide some of the key tools needed to execute a successful liquidation strategy for special assets. Valuation firms in a well-documented and supportable appraisal can help lenders understand the size of the market, buyers for these assets, potential proceeds from their sale, costs associated with selling the assets and both the product and market risks for disposition of special assets. This type of analysis can open the door to finding liquidity in hidden assets. The following is a discussion of some hidden assets that AccuVal, a professional valuation firm, has appraised as the basis for successful ABL loans.

The first group of hidden assets includes intangible assets. Among the list of assets, which have been the basis for successful ABL loans, include the following: trademarks/trade names; patents; customer contracts; formulations/recipes; mailing lists; pharmaceutical scripts; leasehold interests; royalty agreements; order production or backlog; use rights such as air, water, mineral or timber; computer software; and databases.

Vibrant companies that expand and grow their business often develop intangible assets having significant value. The cost of developing these intangible assets is generally expensed and therefore does not appear on the financial statements. Even if historical costs are recorded on the balance sheet, it is likely that historical cost has no relationship to value. The existence of intangible assets can be identified through an understanding of the company's products, a review of legal documents, discussions with appropriate company personnel and industry research.

Intangible assets are easiest to value and sell when there is an identifiable stream of revenues specifically associated with them. Examples include the royalties that may be obtained by licensing a patent,

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increased volume or sales price for products sold under a given trademark, cost savings achieved by the use of computer software or expected net proceeds from the competition of existing contracts. In many cases, a number of intangibles assets are related. Therefore, it is often the case that multiple intangible assets must be bundled to secure a loan. Examples can include a formula that is associated with a specific trade name, such as Coca-Cola.

Sometimes these benefits are short lived or values change due to market conditions. Examples include a short-term contract to supply coke used to make steel at prices favorable to current market prices

or pharmaceutical drugs, which are newly introduced, where competitors will shortly introduce similar drugs. Thus, it is important to closely manage loans on intangible assets and understand how market forces may affect future cash flows.

Historically, many intangible assets were often ignored or assumed to be of no value in company liquidations. In today's economic environment, we are seeing liquidation results where the price paid for the intangible assets is significantly more than the value of all of the tangible assets. Today, assets of this type currently represent a small percentage of ABL loan portfolios. Given the globalization of the economy and a continuing shift of outsourcing more manufactured goods in Third World countries, as well as a growing number of successful liquidation sales of intangible assets, the amount of intangible assets secured by loans will grow rapidly.

Other sources of hidden assets come from existing assets recorded on the balance sheet, which are underutilized from a lending perspective. The opportunity to increase borrowings against these assets can be a benefit to the company and its lenders as a source of collateral. The following is a discussion of some of the ways these assets are used by efficient companies to maximize lending potential.

Reserves or ineligible amounts are often made against accounts receivable for past-due amounts. Given the proper agreements in place, there are opportunities to sell or factor these slow-moving amounts to third parties who will collect them. This can be done with or without recourse, which will affect the amounts recovered by the company. This can turn a non-earning asset into cash.

Inventory loans often identify a variety of ineligible items. This may include slow moving or inventory identified as excess. Sometimes this inventory has value in a liquidation sale, but recovery may be more difficult and its exclusion from the borrowing base is appropriate. In certain cases, inventory may be considered ineligible because successful liquidation means it must be sold outside of normal distribution channels. There are times when this sale can be easier to consummate than sales to existing customers.

Demand for excess or overstocked retail inventories is strong. A number of big-box discounters are aggressively seeking opportunities to find excess and overstocked items. They have the cash to buy in bulk and quickly close a transaction. These items can also be sold in international markets to avoid deterioration of price points in the U.S. market. Overstock retail items, which may be classified as ineligible, may be revisited.

Similar slow-moving industrial items can have use in other markets. Product lines and component parts, which have reached the end of their economic lives in the United States, can be sold in some cases in international markets.

There are a number of opportunities to lend on inventory in countries that are part of the European Union. The laws for securing these assets vary significantly from country to country. Many U.S. lenders

choose not to advance against inventory in these countries or inventory in transit due to the complexities of monitoring and securing loans in foreign countries. This inventory is another example of a hidden asset. AccuVal has been party to a number of transactions where different lenders, familiar with specific countries, have participated in international loans.

There are also classes of assets that have not been viewed as traditional ABL assets on which an asset-based loan is done. Many readers may be familiar with a significant transaction recently completed where the inventory collateral was blood plasma and its various pharmaceutical derivatives. Prior to this transaction, no one considered loans on these assets due to a lack of understanding on how it could be sold. AccuVal assisted in providing an evaluation that identified an exit strategy, and a large syndicated transaction was completed. This also identified an opportunity in the market, and four other unrelated transactions were also completed in 2004.

Similarly, a company that performed a service of enriching uranium for nuclear power plants obtained a significant asset-based loan on its inventory. After careful study and reports prepared by industry insiders, it was identified that this inventory was very marketable. These are both

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examples of special assets that provided good collateral to the lenders to support an asset-based loan where no loan previously existed.

The conclusion is that certain types of inventory may appear to be difficult to secure, but with careful analysis, legal documentation transactions may be viable. There are a number of issues that must be analyzed and verified in these transactions that may also be an indication of increased risk. Lending on tougher assets to sell has increased risk and should be considered when underwriting the transaction.

Fixed assets can also be a source of hidden assets. In today's market, many lenders are willing to structure a term portion of a deal based on the market value in use for some asset classes. This is more common in assets that have high capital costs, limited discrete asset values and high installation costs. These terms describe assets commonly found in paper mills, steel mills and food processing and chemical plants. These assets may have existing loans based on removal concepts that are substantially less than in-place values. Once again, when the risk is properly analyzed and considered, this presents an opportunity to increase borrowings.

Loans based on the in-place value of fixed assets should be considered when there is evidence that a strategic advantage equates to an

economic advantage of an operating facility. This may include a unique location, such as low-cost access to customers or raw materials, a technology or efficiency that lowers the cost of production or significant market barriers to entry. These benefits should not be considered independent of an analysis of the expected future level of demand for the products produced.

However, when these attributes exist, it likely means a significant portion of the company's enterprise value may be attributed to the existing property, plant and equipment. In these circumstances, the successful sale of the plant from an in-place perspective is a plausible exit strategy. These statements are not meant to infer that many facilities that are not process oriented will not sell in place or as a business. Rather, they are meant to identify circumstances when lending on the value of assets from a market value in-place basis has more relevance and correspondingly the sale of the assets on an in-place basis is more likely to occur in liquidation.

Industrial real estate is often another asset that may have hidden asset potential. Lenders often limit the amount of funds they are willing to advance against this asset. This is due to the supply of vacant and available buildings, large amount of available land on which to construct new properties, financial and tax incentives offered by communities to attract new development and companies, environmental factors and specialization in design of some properties. One strategy, which has proven successful for companies to extract the most leverage out of industrial real estate, is executing a sale and lease-back transaction. When a company with reasonable credit ratings signs a long-term lease, a source of cash flow is created. There is demand by a number of market investors for long-term rentals. When the sale and lease-back transaction is based on the fair market value of the property, and done at market rates, this can present an opportunity for the company to obtain 100% financing on the real property.

Other strategies for extracting value include use of community development or government programs to finance this asset. These organizations are often driven by the benefits of the jobs brought to the community. Incorporating programs such as this into an overall loan to a company may provide more funding on the term portion of the debt and allow for greater availability on the revolver.

The above strategies, when valued and applied properly, will assist a company in obtaining additional balance sheet leverage from hidden assets. Increased leverage must be tempered with an analysis of industry factors and risks, along with an analysis of the company's ability to pay for existing or proposed debt. **abfj**

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