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Four Topics to Consider when Using Inventory as Collateral

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Inventory is excellent collateral for asset based lenders although it is critical to understand all of the issues, including the less discussed topics. This article was originally published in ABF Journal in March 2008.

Unlike other tangible assets, the composition of an inventory is constantly changing. As a result, appraisers, auditors, and asset based lenders should monitor a variety of different considerations when establishing and monitoring loans secured by inventory. Obvious examples include slow moving and obsolete inventory, inventory mix, turnover and gross margins. Concepts such as these are commonly discussed, well understood, and a regular part of a field audit or appraisal. However, there are other important considerations that are less discussed and often not accounted for at all. This article will address four additional considerations that we at AccuVal Associates, Incorporated assess that are often not considered in field audits or inventory appraisals. These considerations are inventory sell-offs, anticipated liquidation channels, industry strength as it affects value, and drop shipment volume. While inventory may be excellent collateral, in today's dynamic and arguably uncertain economy, risks to asset based lenders are elevated, so it is critical to understand the full array of issues that can impact an inventory.

When companies start to face financial trouble, many begin selling their best inventory at slightly discounted prices in order to generate additional revenue. Small incentives are typically offered to their customers in an effort to incentivize them to purchase additional products. Selling prime inventory in this fashion is often an attractive option to troubled companies because it is a short-term solution that is simple, effective and on its surface, not a cause for alarm.

However, inventory sell-offs ultimately begin to unfavorably alter the mix of the inventory. The concern here is that the prime inventory is sold, leaving an inventory that is likely less in demand, slower moving, and typically, less valuable. Certainly, the duration of the sell-off, the amount and the quality of inventory sold correlates to the change in the inventory mix. Companies can also reduce short term procurement at the same time, compounding the problem by trimming the entire inventory down. It is also possible that troubled companies will take the sell-off a step further by selling raw materials at discounted prices. As a result, if a liquidation of the inventory did become necessary, by the time the liquidation is even considered, the inventory that generates the best recovery value may be reduced or gone. The issue is even more severe in situations where the overall value of an entire inventory is driven by a small amount of prime inventory. An example of this is a predominantly slow moving finished goods inventory that has a small amount of fast moving and valuable items that would likely generate the majority of the liquidation proceeds.

Monitoring for this scenario can be difficult because the sell-off can occur quickly and quietly. There have been several occurrences where AccuVal has been retained in the midst of the subject company performing an inventory sell-off, literally changing the amount and mix of inventory by the day. If a company becomes financially distressed, it is important to increase the frequency of collateral monitoring. The amount of inventory should of course be monitored, but also the mix between classifications and categories, with a watchful eye on the most valuable concentrations. If an inventory sell off was occurring, one would expect to see a decline in overall inventory levels and a decrease in the ratio of finished goods relative to the remaining inventory. Declines in gross margins would also likely be observed, so monthly, weekly, or even daily sales should be monitored. Gross margins by inventory category should also be tracked in order to potentially spot price reductions. While inventory sell-offs are not new, it is important to keep the topic in consideration at all times as it can have a dramatic impact on the success of an inventory liquidation.

A critical measurement in gauging the liquidation value of an inventory is determining who will buy the inventory and what they will pay for it. The two most common liquidation channels of an inventory

are to a company's existing customers and to secondary buyers (such as competitors, brokers or scrap dealers). The customer channel normally has the highest recovery value while secondary channels are typically lower. Thus, understanding and monitoring the amount of inventory expected to sell to each avenue is critical. However, outside of having another appraisal done, a lender may not be able to determine this ratio, as there are many variables involved and the typical appraisal does not demonstrate the exact modeling used in the assessment.

While the ratio may be difficult to assess, there are indicators that can be monitored so that a lender can understand if what would be expected to sell to customers versus others has shifted. If a shift occurs, it is likely that appraised recovery rate has changed considerably. More importantly, as these levels are monitored, the question should be asked if the liquidation scenario outlined in the appraisal is consistent with the lender's internal guidelines. For example, an appraisal may outline a build-out for three weeks, then conducting a sell through of the inventory for three months, with a follow up auction for another month. Yet the last time the lender's workout department supervised an inventory liquidation, the company was shut down, placed in the hands of a receiver and auctioned in six weeks. Clearly the appraisal scenario needs to match the temperament of the lending institution regarding risk and how they would actually run a liquidation.

Monitoring the trend of the amount of inventory expected to be sold to the customer base will help describe the anticipated style of liquidation and allow for a better understanding of estimated recovery values. Key customer accounts, item specific turnover, accounts receivable balances for key customers, and inventory items with large inventory concentrations should be watched. The amount of prime inventory may also be the key to selling inventory to the customer base, but the level of second quality inventory or out of season goods could be a factor as well. If a company operates with a significant customer backlog, order levels can also be a key indicator of customer specific demand. Similarly, fill rate reports can provide an indication of whether sales are being filled from inventory versus on-going procurement. While more difficult to track, monitoring these indicators will help the asset based lender stay current with the account.

As mentioned, asset based lending arrangements secured by inventory require close consideration to what would happen if the subject company became distressed. Attention is typically focused on what would happen if the inventory had to be liquidated and what the estimated sale proceeds would be. The typical liquidation scenario obviously assumes a distressed company, although a commonly overlooked consideration is the health of the company's industry. Specifically, the success of an inventory liquidation can be drastically different depending on the condition of the industry.

For example, if a company had to liquidate its inventory in a healthy industry where its customers and competitors are financially solid, there is typically a good chance that industry participants will be interested in the inventory and have the financial means necessary to make the purchases. This scenario is much different than if a company had to liquidate its inventory in a weakening or crippled industry. In the latter scenario, it is usually more probable that industry participants will be less interested or not have the financial means necessary to purchase inventory. Moreover, even if the inventory is still attractive in an unhealthy industry, it may have to be sold outside of traditional disposition avenues such as to secondary markets. While there are exceptions to this, clearly, if there is less demand, less potential purchasers or non-traditional disposition avenues used, it is more difficult to sell the inventory and the inventory will likely generate lower recovery values. A recent example of this is the downturn in the domestic housing industry. Recent liquidations are showing building materials trade hampered by weak demand and high inventory levels. Many industry participants do not have immediate need for the materials and do not have the capital or the risk tolerance to make large bulk purchases.

Clearly, it is important for asset based lenders to not only understand the condition of the company at all times, but also the condition of the industry they compete in. Industry publications, websites and market studies should be monitored on a routine basis. Frequent discussions with Management and other industry participants can also shed light on the health of the respective industry. It is also critical for asset based lenders to know whether the effective date of the most recent inventory appraisal or other market studies occurred during a healthy or unhealthy time in the industry. An inventory appraisal provides a discrete value at select point in time, but a good appraisal will provide guidance as to how an appraisal would be impacted by an industry decline. Note that the efficacy of this guidance would be affected by nature of the decline and shifts in the composition of the inventory. The Company's market share should also be monitored in the event it is increasing or decreasing. If the condition of the industry is changing, an update appraisal should be conducted. Ultimately, an increased knowledge and awareness of industry conditions allows for a better understanding of what would occur if the inventory had to be liquidated as well as the potential success of liquidation.

Another frequently overlooked trend is the start or increase in volume of drop shipments. Drop shipments are when a company orders product from a vendor and has it shipped directly from the vendor to their customer. This scenario results in a sale without the company ever taking possession or ownership of the inventory. While a popular and effective distribution model, it is important to understand what it means relative to collateralized inventory. Specifically, if a company starts to drop ship product, or if the amount of drop shipments significantly increases, it is important for asset based lenders to know whether the existing inventory is still selling normally or if it is becoming stagnant.

Drop shipments have been increasing in recent years as more companies outsource manufacturing operations to 3rd party vendors as well as overseas. In addition, increased freight and logistics costs have made drop shipments an attractive solution for many companies. Industries where drop shipment increases have been common include electronics, furniture and retail and consumer products. The concern is that if desirable products are being drop shipped, the inventory physically in possession by a company can become slow moving, aged, less attractive, and even obsolete. Moreover, the inventory can be negatively impacted while sales and gross margins remain stable, or even improve. If this situation occurs, the inventory may become substantially less attractive, negatively impacting its value as collateral. There have been recent instances when this issue is literally first discovered during the inventory appraisal process.

Certainly drop shipments can have a very positive impact without negatively affecting an inventory, although it takes analysis and monitoring to determine if that is the case. Asset based lenders should routinely ask their clients to report the amount of sales derived from drop shipments so that the trend can be monitored over time. Also, significant company events such as the movement of manufacturing overseas, key vendor changes, and new product introductions should prompt a lender to ask whether drop shipments have started or increased. If drop shipments become more prevalent, it should not cause instant concern as the change could be quite favorable. However, the situation should be discussed with the client and additional attention should be given to the inventory. At a minimum, additional attention should be given to inventory turnover, open orders, and gross margins, in order to understand the true impact on the inventory.

While these four topics are not unheard of, they frequently do not get as much consideration as they should. Asset based lenders using inventory as collateral should keep these topics fresh in their mind and give due consideration to them when needed. Often, simple monitoring and accurate appraisals can dramatically decrease the risk associated with these issues. Similarly, proper communication with valuation firms can help in keeping considerations such as these in the forefront. When considering the dynamic nature of the current economy, today's asset based lenders more than ever need to

consider all of the significant factors that could impact inventory as collateral, above and beyond the traditional metrics, as the additional knowledge and monitoring will mitigate risk substantially.

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