COLLATERAL LIQUIDATIONS:
The Last in a Three Part Series Focusing on Liquidations of Accounts Receivable, Inventory & Equipment

Liquidating Inventory–An Overview

As an asset-based lender we evaluate prospective borrowers differently than traditional bank lenders. We start with the question “if the company shuts down tomorrow, will we be able to liquidate the collateral and satisfy our loan?” Since our borrowers are “closer to the edge” than most bank borrowers, a liquidation is, unfortunately, a real possibility. Therefore we focus our primary attention on the quality of the assets in addition to looking at the financial condition of the borrower.

Inventory is Difficult Collateral – Asset-based lenders generally find that a company’s inventory is the most difficult of all the asset classes to successfully liquidate. Inventory poses a variety of unique problems for lenders. As with other asset classes, the care you take on the front end when initially underwriting the loan, will, to a great extent, determine how well you come out in the unfortunate scenario of a liquidation.

The Key is Advance Rates and Ineligibles – Although we’ve set inventory advance rates from 25-50%, depending on the type, we’ve found that certain types of inventory have little or no value in a business liquidation and, as a result, make these categories ineligible for borrowing. Generally, we have higher ineligibles than banks because we focus on the liquidation value, not the value that inventory might have when the company is a going concern. Additionally we’ve found that inventory and cost accounting are the most difficult of accounting functions. As a result, we look closely at the reliability of the borrower’s inventory reporting and tracking systems. If we cannot trust their inventory reports, we generally cannot lend against the inventory. Therefore, focusing on the advance rates and ineligibles and the inventory systems early in the process will help protect you if a liquidation becomes necessary.

Inventory Types and Issues:

Raw Materials – this is generally the best overall type of inventory on which to lend if it is “commodity like” or “generic” materials. Ideally, this inventory can be used by many potential buyers. Unfortunately, we find that even inventory that appears on the surface to be a commodity may actually be customized in such a way that it reduces the number of potential buyers and, therefore, the value. For example, sheet metal that is purchased
or cut to a specific size or specialized depth for use by our borrower thereby reducing the value or plastic feedstock or paper of a unique color used only by one customer.

Our primary concern with raw material inventory is that the most useful items will likely be completely consumed or sold prior to the business closing. Our experience has shown that when we come into a business that has recently shut down, the inventory remaining is odds and ends and overruns from old jobs. The valuable inventory is almost always sold or used up before the company closes its doors.

Another danger area is relying on “buyback” arrangements where the borrower states they can “sell” inventory back to the original vendors for almost the entire original cost, less a modest restocking fee. But the vendor will never write a check. In a liquidation, the vendor will simply issue a “cashless” credit against outstanding A/P.

In asset-based lending, inventory such as packaging material, partial unit containers, and chemicals are ineligible. In fact, in the case of some inventory items (particularly chemicals) we often have to pay disposal costs to get rid of these items.

Work In Process (WIP) – We almost never lend against WIP. There may be cases where it’s composed of highly valuable “components” that can easily be broken out and sold for some real value but that is very rare. WIP is where we often find the biggest difference between asset lenders and bankers as we frequently see banks lending against WIP.

Finished Goods – We look at finished goods on a case by case basis. Some finished goods inventory may be commodity like or sellable to variety of potential customers or competitors. In these cases, we may be able to advance on it. One issue we often encounter is stale or excessive amounts on hand. We monitor usage reports to ensure that we are advancing against appropriate levels of inventory. A borrower with greater than 12 months of supply of a particular SKU will be unable to quickly liquidate that excess inventory. Another issue is offsite inventory in a third party warehouse where the warehousemen has a lien versus the inventory for any unpaid rent.

Another possible issue is custom or private label inventory. Companies looking for an advance on this inventory may argue that “Our customers have to take this inventory because there’s no way to replace our product in a timely way.” While this may occasionally be the case, we find that the end customers often begin seeing problems with the supplier due to their cash constraints and will start sourcing a secondary supplier. Another problem from our perspective is that we have no leverage when negotiating with the “one” possible buyer of this custom inventory when our borrower shuts down.

Steps to Take Regarding Inventory as Performance Deteriorates

If we notice significant financial performance issues:

- We may ask for more frequent inventory updates from the company. Instead of getting monthly inventory reports, we will require weekly reports.
In some cases, we tie inventory advance rates to the financial performance of the company. Deterioration in the financial performance of the company will trigger reductions in advance rates. Unfortunately, this is generally the time when the company can least afford a reduction in availability and this approach adds additional stress on the company, so it must be used with caution.

During a period of deterioration, we will also increase the frequency and intensity of our onsite audits to assure ourselves of the condition and quantity of the reported inventory. Test counting and cost testing are increased dramatically.

Third Party Warehouses are particularly concerning because of their lien rights under the UCC – if we don’t have a warehousemen lien waiver we will redouble our efforts to ensure these warehouse payments are made by our borrower.

**Liquidation of the Inventory**

*How do we sell the inventory? Where do we sell it?* – These are questions we ask prior to determining the advance rates and ineligibles. For a number of reasons, the answer is generally not the borrower’s existing customer base. Prior to making the loan, we will attempt to identify a small handful of potential buyers of the inventory. Depending on the inventory, this could be large distributors, competitors, or in some cases, dollar stores. We also always ask the business owner where he could quickly sell the inventory. (As an aside, the primary reason we require personal guaranties is to ensure the owner’s assistance in the case of liquidation.) In liquidations, we often find that the employees can be very helpful. They generally know best who would buy the remaining inventory.

*Caution is the Word* - Going into every deal that includes an inventory component, we feel most at risk with the inventory. Despite all the analysis we do on the front end, and the monitoring we do administering the loan, we often have NOT recovered our full advance in the cases where we have liquidated inventory. But the silver lining to all our work is that it has enabled us to limit our losses to a point that we have been able to cover the inventory loan shortfall with the excess recovered from other asset classes.

*In conclusion, inventory is an asset class that must be approached with caution in the initial setting of the advance rates and ineligibles and in the constant monitoring of the inventory levels and reporting systems throughout the lending relationship.*

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SPECTRUM continues to assist banks and others by financing $100,000 - $4,000,000 credits that have suffered a setback, credits in transition and new potential credits that are
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- **Structured Asset-Based Line of Credit** -- SPECTRUM also offers a unique product for those credits needing to leverage various collateral classes but who lack the required financial performance and internal controls necessary to qualify for our typical Asset-Based Line of Credit. This program is basically a hybrid program combining an **Accounts Receivable Financing** accommodation for the A/R with an **Asset-Based Line** on inventory, equipment and/or real estate.

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