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A Publication of SPECTRUM Commercial Services

Underwriting Guidelines for Factors and Asset-Based Lenders

The Third in a Four Part Series Focusing on Underwriting Guidelines Used by Asset-Based Lenders and Factors in Relation to Accounts Receivable, Equipment, Inventory and Real Estate

Part Three: Inventory

When seeking inventory financing with an asset-based lender it is important to understand the focus of the lenders' due diligence so you can be better prepared to answer their questions and get your deal funded quickly.

As Brokers, many of you are very familiar with seeking accounts receivable or equipment financing for your clients but might have less experience in obtaining inventory financing. Like accounts receivables and equipment, a company's inventory is another collateral source that can be leveraged to provide additional working capital for your clients. Because SPECTRUM is an asset based lender and not just a receivables "factor" or "equipment lessor" we also understand the mechanics of inventory financing and hope to provide some insight to you for your clients' benefit.

Although inventory is a source of collateral that can be used to provide additional working capital, many asset-based lenders generally find that a company's inventory is the most difficult of all the asset classes to successfully liquidate. Therefore, the advance rates for inventory are generally lower than other types of collateral such as accounts receivable or equipment. With inventory lending there is also the potential of a priority claim by the supplier of the inventory (for instance, in construction related industries, if the supplier of the inventory drop ships the product to the construction site, they could potentially have a priority lien that would cause issues for a lender). Additionally, in some industries and states, the seller of the inventory may have an automatic prior lien on the inventory even without having a UCC filing (i.e. fresh and frozen produce which is subject to P.A.C.A. regulations). Further, in a liquidation scenario, lenders often find that the most desirable inventory has already been sold which leaves the less marketable inventory to be liquidated. These issues and others make it more difficult for an asset-based lender to properly liquidate inventory in the event of a wind down and, thus, result in lower advance rates.

In an asset-based lending, inventory advances are typically based on a percentage of the client's cost for the inventory. Further, most asset-based lenders will only make inventory loans in conjunction with a revolving Line of Credit based on accounts receivable as well as inventory. Therefore, if your client needs a Line of Credit based on both accounts receivable and inventory, an asset-based lender can be a good choice.

When assessing the terms of a potential inventory loan for your client, pay special attention to: (a) the advance rate; (b) the type(s) of inventory the lender is willing to accept, i.e. raw materials, work in process, finished goods; (c) the inventory location, i.e. will the lender finance both on site (company owned warehouses) or off site inventory (third party controlled warehouses); and (d) the overall cost of the loan. For asset-based lenders, these proposal items are decided prior to funding after a thorough review of the inventory and the borrower.. Therefore, your understanding of the information that an asset-based lender will review during their due diligence will help you get the best deal for your client and result in more closed deals for yourself.

Information Required by an Asset-Based Lender Assessing an Inventory Loan:

- <u>Detailed Inventory List and Overall Summary-</u> Asset based lenders will look for detailed inventory lists and a summary of the major items comprising the majority of the inventory. The detail should include the cost of each item, how many of each item and the SKU (Stock Keeping Unit) for each product and the date that the items were added to the inventory.

  Having an SKU assigned to each product generally indicates that the borrower has some sophistication in relation to their inventory reporting and tracking systems. If the asset-based lender gets comfortable with the data in the inventory reports, the likelihood of inventory financing being provided is obviously much greater.

  Ideally the inventory list clearly distinguishes the three types of inventory: raw materials, work in progress, and finished goods.

Inventory Type and Issues

Raw Materials- Often the most lendable inventory is “commodity like” raw materials, i.e. materials that have a large and ready market due to their nature. Ideally, this inventory can be used by many potential buyers. Unfortunately, even inventory which appears 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 will greatly reduce the value of that inventory in the open market as it has been “modified” for the needs of a specific customer.

Another concern with raw material inventory is that the most useful items will likely be completely consumed or sold prior to the business closing. SPECTRUM’s experience has shown that when we begin a liquidation of a business, the inventory remaining is oftentimes just odds and ends and overruns from old jobs. The more valuable raw materials have often been sold already by the business to generate working capital. This is why inventory lenders require that the borrower have a sophisticated inventory monitoring system so that we can track the inventory closely at all times.

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. Unfortunately, in the event of a liquidation of this inventory by the lender, these arrangements are useless because the vendor will simply “credit” the returns against what the borrower owes them which results in no actual proceeds to the lender.

In asset-based lending, some types of raw material inventory such as packaging material, partial unit containers, and chemicals are generally considered ineligible. In fact, in the case of some inventory items (particularly chemicals) the asset-based lender will often have to pay disposal costs to simply have these items removed.

Work In Process (WIP) – Most asset-based lenders 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. The issue with WIP is that, by its nature, it's "in process" and the lender does not intend to run the borrower's business to complete the process and, therefore, there is no value here.

Finished Goods – Asset-based lenders 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, asset based lenders might be able to lend against the finished goods. One issue often encountered is stale inventory or excessive amounts on hand. The asset based lender will generally monitor usage reports to ensure that appropriate levels of inventory are advanced against. A borrower with greater than 12 months of supply of a particular inventory item generally cannot 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.

Issues also arise with custom or private labeled finished goods 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 manner." While this may occasionally be the case, SPECTRUM normally finds that the end customers often begin seeing problems with the supplier due to their cash constraints and will start sourcing a secondary supplier. Additionally, most lenders realize in this scenario that there is no leverage when negotiating with the "one" possible buyer of this custom inventory when a borrower shuts down.

Items to Include in Your Applications Related to Inventory

As a financing broker, you probably have your own application that for obtaining information on a prospect. Below are a few items you may want to include on your application as this information will be required by an asset-based lender considering inventory financing:

- <u>Landlord Name, Contact Information and Monthly Rent Amount-</u> If a client is renting the facility where the inventory is located, the asset-based lender will need this information to negotiate a landlord's agreement. In a liquidation scenario, this agreement will grant the asset-based lender access to the facility where the inventory is located and time to sell the inventory. In return, the agreement will assure the landlord that the asset-based lender will pay rent during this liquidation period.
- <u>Is Inventory on Site? -</u> If the inventory is not on site, the asset based lender will need to obtain an agreement with the warehouseman in order to have access to the inventory in a liquidation situation.

Conclusion- Asset-based lenders look at a variety of criteria when deciding what inventory they will loan against and at what advance rate and cost. Obviously, these criteria also affect your commission from the funding source. So have your client prepare information outlined above and you will see a quicker turnaround on your applications and a higher closing percentage.

SPECTRUM COMMERCIAL SERVICES COMPANY

- SPECTRUM's unique approach lets you work with us to determine your commission rates.
- Beyond commissions, SPECTRUM also offers you a bonus each time you fund a deal as well as year end bonuses based on the volume of invoices purchased.
- As your client grows with SPECTRUM, your commission also grows!
- **For more specifics please call or e-mail Jeff Colquette at 952-876-8229 or jeff.colquette@spectrumcommercial.com**.

SPECTRUM - Your Bridge For Those Hard to Finance Credits

SPECTRUM continues to assist banks and brokers by financing $25,000 - $4,000,000 credits that have suffered a setback, credits in transition and new companies that are currently outside the bank's parameters. SPECTRUM can provide the financing bridge for these struggling businesses until they return to stable and profitable operations.

SPECTRUM Programs:
As the source for working capital for non-bankable credits, SPECTRUM's product lines remain a strong fit to address the many issues encountered by struggling businesses.

- **Accounts Receivable Financing** --For those smaller and/or severely financially stressed companies, this program may be the best fit.
- **Asset-Based Lines of Credit** --For the larger non-bankable credits with relatively stronger performance, better internal controls and more experienced management. This program focuses on financing receivables, inventory, equipment and R.E.
- **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 and/or equipment and/or real estate.