

Lending against stock – beware the pitfalls

As asset-based lenders strive to maximise the funding available to their clients, those lenders with the capability to include stock lending in the mix are well placed to structure and win some interesting deals.

The success of the deal, however, could so easily flounder if proper attention is not given to understanding the true value and nature of the stock.

The tricky issue of valuation

Historic valuation reports, often lengthy and detailed, can divert attention from current realities and all too often they are relied upon for accurate value assessment. Valuations are usually prepared on an orderly liquidation basis and a lender needs to take into account potential dilutions on a forced sale basis. These include the costs and potential dilutions involved with an insolvency process.

When a business is in financial distress, management may attempt to inflate the value of stock to obtain maximum possible funding from its lender.

Although fast moving lines are generally recognised as having a higher realisable value when compared to slower moving lines, valuation reports often do not take into account that a distressed business is unlikely to still be holding this stock when an insolvency practitioner is on the doorstep. This is due to the fact that stock is unlikely to be replenished in the lead up to the insolvency, as distressed businesses will inevitably be on stop with a number of suppliers.

Market forces

Experience shows that in some cases in order to sell slow moving stock lines, supplementary fast moving lines are required. A customer is likely to want a number of different lines at any one time and if the business is unable to meet its customer's full requirements, they are likely to go elsewhere. If a contractual relationship exists with the customer, the above scenario can also potentially result in the customer off setting costs incurred in reordering goods elsewhere, against monies due to the business.

It is likely that once after sales service and warranties are withdrawn, the market for the business' goods can quickly dry up. In such cases, finished goods may need heavy discounts to sell, and this is not always reflected in valuations which can be very subjective.

Data, information and knowledge

So much relies on a thorough understanding of the stock itself. All too often company systems are not sophisticated enough to allow sufficiently detailed integrated reports to be produced in a timely manner. These inadequate systems inevitably also make manipulation of stock reports by management easier.

Asset-based lenders have developed sophisticated systems in order to monitor their own security, but such systems are still sadly lacking for the monitoring of funding against stock. This is particularly apparent when comparing controls

supporting stock funding to the controls and systems in place for an invoice discounting facility. It would be unwise to rely on stock for security in isolation unless the asset is fully understood on a day-to-day basis, although the costs involved in such a process may outweigh the benefits.

Even if a lender does have sophisticated systems and controls in place, it is still essential for client managers to constantly look out for the red-flags. These include, erosion of margins, increase in customer discounts, reduction in stock turn and level of customer returns increasing, to name a few.

As one component of a wider ABL funding package, stock finance can offer a highly tailored and flexible solution to the client. For the lender, there is the knowledge that a funding package can be structured to provide more comfort and additional guarantees to further improve their security.

MCR is well placed to advise on avoiding the pitfalls of lending against stock at all stages of the deal process, be it exit planning at the start of a potential lend to advising on appropriate insolvency options at the end of a business' economic life.



Jason Godefroy,
partner, MCR.
Contact him via:

jgodefroy@mcr.uk.com
T +44 (0) 20 7487 7243
M +44 (0) 7770 350788