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Collateral, Collateral, Collateral... Valuation In The Changing World of Asset-Based Lending

By Kweku Boison, MSA, CPA, CSBA, CMEA

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CHANGES IN THE ECONOMY

Economists signal caution in their 2013 forecasts of the performance of the U.S. economy. According to the Bureau of Economic Analysis real GDP growth grew at an annualized rate of 0.1% during the final quarter of 2012. (That is, from the third quarter to the fourth quarter.) In the third quarter, real GDP increased 3.1 percent.[1]

The first quarter of 2013 is expected to be slow as businesses maintain a holding pattern (no planned expansion or growth) pending the outcome of the negotiation of new fiscal policies by the U.S. Congress. Federal government spending is expected to contract. Household expenditure is also expected to contract in the face of uncertainty of the implications of the new fiscal policies. That said economists expect a modest rebound beyond the middle of the year by which time the full implications of the new fiscal policies are expected to be clear and the return of the housing industry is expected to maintain momentum.

Though sluggish the U.S. economy continues to be the largest in the world. The U.S. economy is best described as a mixed economy where the economic structure is upheld through the interactions between the private, public and international sectors. The edge of the U.S. economy over competing economies is maintained through innovation, a key force behind U.S. economic growth and national competitiveness.

THE ASSET-BASED LENDING INDUSTRY THROUGH 2013

A feature of the crash of the U.S. economy in late 2008 was the credit squeeze. Asset-based lending (ABL) has since become very active as an option in getting new credit because the industry's approach to financing is to assess the assets or collateral first followed by the cash flow. Traditional lending tends to focus on the cash flow first and the collateral secondarily. The industry has proved to be a more predictable source of funding in the uncertain years following the 2008 crash of the U.S. economy. A recent study of loan applications to banks and asset-based lending entities[2] seems to bear this point (please see Table 1). In the survey, 53% of cash-flow based applications were declined compared to 26% collateral based applications. All other indicators seem to indicate the prevalence of this bias as long as the dismal conditions of the U.S economy subsist.

Table 1: APPLICATIONS DATA

	Offered	Declined
Cash Flow Based	47%	53%
Collateral Based	74%	26%
Real Estate	72%	28%
Average	64%	36%

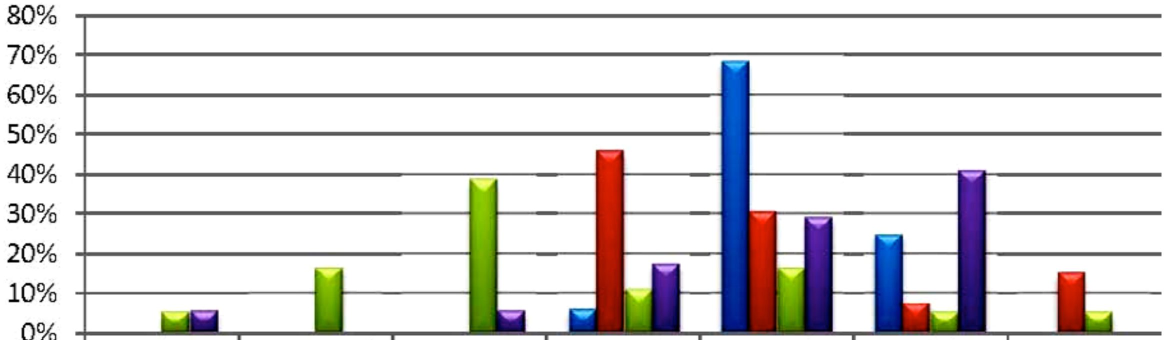
The industry typically extends a revolving line of credit facility set to formula against accounts receivable, inventory and in some cases the production machinery/equipment and intellectual property allowing for expanding or contracting financing needs. The more disciplined approach of an asset-based lender includes monitoring working capital movements almost daily and to extend funding accordingly. The importance of the valuation of the collateral and verification of the existence cannot be overstated.

COLLATERAL INVENTORY: SHIFT IN EXIT STRATEGIES AND VALUATIONS

As noted above collateral for asset-based loans could involve inventory. Valuations are used by asset-based lenders to set appropriate lending safety margins or advance rates depending on the type of inventory. Valuations or re-valuations may also be required during the duration of the credit facility at frequencies that depend on the type of collateral and the financial and operating conditions of the borrower. Valuations for ABL purposes may be done quarterly, semi annually or annually though monthly or weekly valuations or valuation revisions are not unheard of.

To the benefit of both the lenders and the borrowers, the advance rates have increasingly been based on net orderly liquidation value, NOLV of inventory. NOLV represents the gross orderly liquidation value recovery less any expenses associated with the disposition. Historically ABL deals had been premised on forced liquidation values, FLV, of the borrowers' inventory as the exit strategy. FLV is often synonymous with "fire sale". The reason for the shift in exit strategy is the realization that rather than dispose in a forced liquidation scenario at a range of 5 cents to 20 cents on the dollar, companies in the business of disposing collaterals and business assets in general make efforts to sell some or all of the inventory to typical consumers over an extended period of time usually within 60 to 90 days. This mode of exit strategy on behalf of lenders allows for a much higher gross recovery than a "fire sale". A portion of the collateral may be disposed at a higher percentage of cost and occasionally at a profit. On the flip side, since this is a protracted exit strategy, the expenses associated with dispositions are much higher as compared to the "fire sale". However, since the inventory is of value to typical consumers this exit strategy results in a higher NOLV when disposal expenses are deducted from gross proceeds. This realization has led the ABL industry to be comfortable lending against NOLV rather than FLV. A recent independent study[3] also came up with similar findings; respondents reported on valuation standards used to estimate Loan to Value, LTV ratios as follows in figure 1.

Figure 1: Valuation Standards Used to Estimate LTV Ratio



	Purchase price	Depreciated Value (Book)	Face value	Fair Market Value	Forced liquidation	Orderly liquidation	Other
Equipment	0%	0%	0%	6%	69%	25%	0%
Real estate	0%	0%	0%	46%	31%	8%	15%
Accounts Receivable	6%	17%	39%	11%	17%	6%	6%
Inventory	6%	0%	6%	18%	29%	41%	0%

The graph shows that when considering inventory as collateral 41% of respondents used OLV (gross/net) to estimate LTV.

In valuation reporting, the valuer lays out the exit strategy that is most efficient for the inventory in question. Typically the disposal of the inventory is based on the premise that the operating facilities, whether distribution centers or retail facilities, are in limited operation, utilizing select current employees for the purpose of liquidating the collateral. The collateral is sold on a piecemeal basis "as-is", "where-is" for cash or cash equivalent. The terms of sale are Free On Board, F.O.B., the premises of disposal, with purchasers responsible for removal of purchases at their own risk and expense.

In designing the exit strategy the following are taken into consideration including but not limited to physical location, accessibility, difficulty of removal, physical condition, adaptability, specialization, composition, inventory mix, marketability, overall appearance, and psychological appeal.

It must, however, be noted that the exit strategy is based on the collateral at the time of valuation and that realization of the valuation opinion could be affected is there is a change in the mix of the collateral or the surrounding circumstances.

CHALLENGES IN THE USED EQUIPMENT MARKET

Since the 2008/2009 recession, the Federal Reserve has kept interest rates near all-time lows and, as a result, a higher proportion of companies are drawing on credit for their equipment acquisitions. This trend was apparent in Equipment Leasing & Finance Foundation's study sample, where 72% of firms used at least one form of financing (excluding credit card use) to fund equipment acquisition. Companies with revenues less than $1 million were the least likely to use financing, but even this segment saw an increase from 45% of respondents in 2007 to 49% in 2012. The hands-down winners in terms of drawing upon financing for equipment acquisition were companies with revenues between $25 million and $100 million. This segment used financing in 86% of their acquisitions, a noticeable jump from the 76% figure observed in 2007.[4]

In the wake of the financial meltdown, traditional banks have capitalized on their cost of funds advantage over the ABL industry. Between the Foundation's 2007 study and 2012 study, banks' share of equipment financing rose from 47% of total equipment finance volume to 57%. The 2012 study confirms that banks were the primary lenders across all equipment types, with the smallest penetration in trucks and trailers. Consistent with the behavior of traditional banks since the 2008/2009 credit crunch, when comparing the two studies, it also appears that banks actively moved their new financing volume to companies with lower risk profiles[5] creating room for innovative lending from the ABL industry. The share of bank financing of highly profitable companies rose from 26% to 47% between 2006 and 2011, while the share of bank lending to unprofitable companies declined from 65% to 53%. To be successful with innovative lending the ABL industry relies on good equipment valuations to support its loan structures.

However, a trend noted in the ABL industry is that lenders are leaning towards requiring FLVs to estimate LTVs when it comes to loans backed by equipment. In figure 1, 69% of respondents used FLVs to estimate LTVs as compared to 25% of respondents who relied on OLVs. A U.S. Equipment Finance Market Study suggests that the financing of equipment will be more challenging in the next 12 to 18 months. The silver lining in this cloud is that technological innovation and equipment replacement needs should spur rapid growth in financing in late 2014 and beyond.[6]

TREND: INTELLECTUAL PROPERTY AS COLLATERAL

The ABL industry has conventionally relied on accounts receivables, inventory and machinery. In recent years, ABL has been as competitive as the cash flow lending market; competing on price, structure and other aspects of the lending packages. A lot of current deals are in the nature of replacing existing lenders. Lenders looking beyond the conventional working capital assets are being more creative, increasingly seeking to bring fixed assets and intellectual property (intangible assets) into the collateral mix up to almost 30% of a transaction.

A report released by the U.S. Commerce Department entitled "Intellectual Property and the U.S. Economy: Industries in Focus," found that intellectual property (IP)-intensive industries support at least 40 million jobs and contribute more than $5 trillion dollars to, or 34.8 percent of, U.S. gross domestic product (GDP). The report authored by the Economics and Statistics Administration (ESA) and the United States Patent and Trademark Office (USPTO) identified 75 industries (from among 313, total) as IP-intensive. These IP-intensive industries support tens of millions of jobs and contribute several trillion dollars to America's GDP. The report not only estimates the contributions of these industries to the U.S. economy, but also gauges the ripple, or domino, effects they have on employment throughout the economy.[7]

According to the Under Secretary of Commerce for Intellectual Property and USPTO Director David Kappos , "Every job in some way, produces, supplies, consumes, or relies on innovation, creativity, and commercial distinctiveness"……. "America needs to continue investing in a high quality and appropriately balanced intellectual property system that will promote innovative, open, and competitive markets while helping to ensure that the U.S. private sector remains America's innovation engine."[8]

Intellectual properties are classified into two groups; licensed intellectual property rights which have attached to them payment streams emanating from these rights. These property rights include but are not limited to patents, copyrights and trademarks. Lenders favor these to the extent that these payment streams are adequate collateral.

The second group is made up of nonlicensed intellectual property. Often these are internally developed and utilized internally. These types of property include, but are not limited to, trade secrets, recipes, customer lists, trade routes, unique access to markets, contracts, etc.

The ABL industry has come to the point of realization that reliance on intellectual property does not necessarily increase the lender's risk exposure if the intellectual property is carefully valued. To the extent that the assets based lenders can visualize a clear path for the marketing and realization of intellectual property when needed, they are keen to lend on intellectual property. Valuations of intangibles such as intellectual property are based on discounting the cash flow that can be determined as emanating from the rights inherent in the intangible or intellectual property. In general, valuation of intellectual properties which are licensed and already generating payment streams can be valued with a higher degree of reliability. For example, licensed intellectual properties such as trademarks and brand names can be realized at significant values because payment streams are attached to and generated through licensing agreements. For nonlicensed intellectual properties, comparable licensed properties can be used to simulate the payment streams in the prevailing market. Although intangible property valuations need to be reviewed carefully when being considered as collateral support, there have been cases where inventory and machinery have been more difficult to liquidate compared to intellectual properties.

INTEREST BY INSURANCE COMPANIES

Intellectual property insurance is a growing industry, not quite developed, but at its present stage provides comfort to lenders who lend against intellectual property. The average business carries Commercial General Liability insurance policies, which does not cover intellectual property claims. Innovative insurers currently market three types of intellectual property policies; (i) First-Party IP Coverage, which protects the value of an insured's direct loss sustained when its revenue streams are diminished from a direct and resultant impact upon its IP rights; (ii) IP Defense Cost (defense coverage), which protects the insured against allegations that it improperly used the IP of another; and (iii) IP Abatement Coverage (enforcement coverage), which funds an attack on a party that improperly uses the insured's IP. Given that the U.S. market is particularly difficult for IP insurers due to the high frequency of suits and the high cost of litigation, policy limits typically range from US$1-50 million and premiums range from 10-15% of the policy limit. Players in this arena include AIG, Hiscox, IPISC, Kiln and The Hartford.[9]

ACTIVE IP MARKETS

The market for intellectual property is young and evolving, but holds much promise. Market participants have realized intellectual property as the latent capital source and when combined with technology and innovation, the limits of the potential is not within sight. The existence of active markets adds to the comfort of lenders in that not only is there a ready forum to dispose of intellectual property, but it also provides a point of reference of the value of the intellectual property collateral. There are various market models in operation and a few are discussed here.

IP Brokers: These are entities which seek to assist owners of IP (primarily patents) in finding buyers. However, they operate both on the sell-side and the buy-side. In the latter case they often assist technology companies in acquiring patents having "strategic" (i.e., defensive) value vis-à-vis their competitors. In a typical engagement term between an IP Brokerage firm and an IP owner once the IP is sold, the IP Broker takes a percentage of the sale as a success fee and the engagement is done. Thus, there is no opportunity for recurring revenue (unless the client later decides to sell additional IP). In contrast, buy-side brokerage engagements can continue indefinitely as the broker's client strengthens and extends its IP position over time. Entities that function under this business model also often call themselves "IP advisory," "IP management," "IP merchant banking" or "technology transfer" firms. While the amount, quality and depth of services vary, in some shape or form, when representing a seller, they all prepare a "pitch package," identify potential buyers and earn retainer and/or success fees by actually assisting IP owners in negotiating the terms and conditions of the sale agreement with buyers. These entities may function more like traditional consultants where the IP owner stays very involved in the process, or they may function more like information technology, IT, companies when the IP owner essentially "outsources" the monetization of the IP and is not involved in the day-to-day sale efforts, but still collects a majority of the sale revenue (minus the Broker's commission and, in some cases, the Broker's expenses). In contrast, buy-side, brokerage engagement almost always involves a close working relationship between buyer and broker. Notable companies include Bramson & Pressman, Iceberg, Inflexion Point, Epicenter IP Group, Pluritas, Semiconductor Insights and ThinkFire.[10]

IP Auction Houses: Similar to Christie's and Sotheby's in the antique and art marketplace, these entities are auction houses that hold multi-lot, live auctions for patents with the intent of providing a marketplace for facilitating the exchange of intellectual property. While there are various auction formats and structures (English, Dutch, etc.), such auctions enable sellers to offer one or more patents according to a pre-determined set of terms and conditions and allows the auction house to charge listing fees, attendance fees, buyers' premiums and/or sellers' commissions. Also, other entities aim to be the "eBay of patents" by offering online patent auctioning services. Prominent companies in this line of marketing include PatentAuction.com, IPAuctions.com, IP Auctions GmbH, and ICAP.[11]

On-Line IP/Technology Exchanges, Clearinghouses, Bulletin Boards, and Innovation Portals: These are entities that function like the business-to-business (B2B) web sites. These entities offer web platforms and interfaces specialized for patent and other IP assets. Essentially, this model can be thought of as online classifieds like Craigslist, but for IP. Within the model, there are variances such as whether listing fees are charged to patent owners/sellers in addition to, or versus, back-end fees for successful patent sale or licensing transactions. Additional variances include whether these sites are public and browse-able for free, or whether they are private, "member's only" sites that require registration (and presumably a registration and/or annual membership fees). Some of these sites also offer forums, bounties, challenges and idea exchange platforms that aim to spur innovation and thus create new IP. Some of these online forums include InnoCentive, NineSigma, Novience, Open-IP.org, Tynax, and Yet2.com.[12]

WHAT THE VALUATION PROFESSION HAS TO OFFER THE ABL INDUSTRY

The valuation expert brings to the valuation assignment a wealth of experience and knowledge of the subject of valuation, the industry and the market. The typical ABL valuation is done on a form of liquidation basis. Whereas for inventory increasingly lenders lean on net orderly liquidation values, when it comes to equipment the premise of value as discussed is the increasingly being done on the basis of forced liquidation value. For the intangible assets such as intellectual properties the premise of value could be the market value, the financial value or the value of anticipated future benefits; the choice is dependent of the nature of the deal, the availability of data and degree of assurance, the nature of the intellectual property and the rights thereof. In some instances, valuers have in conjunction with lenders fashioned out custom liquidation values to aid the comfort of the lenders.

By virtue of the valuation process, valuers provide exit strategies on the basis of the understanding of the following: the mix of the asset categories (inventory – raw materials, finished goods, work in progress; machinery and equipment; intangibles, including intellectual properties); the mix within categories (inventory – brands versus private label; intellectual property – patents, copyrights versus managerial know-how); the location of assets – at site, third party locations or in transit; age and condition – (inventory - slow moving, obsolete, out of season; obsolete equipment; intellectual property – legal life). The exit strategies provided include the outline for the reporting of the progress of exits in electronic formats to lenders. In the ABL industry the daily/weekly reporting is preferred.

Some valuers are set up to provide liquidation services at physical locations and/or on line. Other valuers leverage membership of marketing networks on behalf of lender or borrower.

Each year over half a million patent applications are filed, over a quarter of a million patents are issued. In 2012 the U.S. Department of Commerce asserted that intellectual property – intensive industries -- contribute more than $5 trillion dollars to, or 34.8% of U.S. gross domestic product (GDP). The use of intellectual property to secure loans has gained the attention of borrowers and lenders alike in part because of the United States economy's shift away from manufacturing. This trend is expected to be sustained through 2013 and for the next five years or so depending on rate of recovery of the strength of the U.S. economy. As the economy evolves to be one reliant on intellectual capital and technology, traditional cash flow lending, though continues to have a role, may overall be limiting when juxtaposed to asset-based lending. Interest shown by the insurance industry has added to the growth in lending against IPs.

As the economy continues to evolve after the 2008 crash, the old strategies and solutions for lending on cash flow only has increasingly been found to be limiting. Coupled with globalization, the effect on the marketability of collaterals is ever changing and it remains critical that these changes are factored into the process of determining the ultimate value of the collaterals. The collateral valuation whether for tangible or intangible assets will continue to be highly specialized and complex. Valuation experts will continue to be challenged on their expertise with certain assets and experience in certain industries. ABL industry may increasingly find the need to engage the expertise of more than one valuation specialty in a transaction – inventory, machinery, intellectual property. **TSL**

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