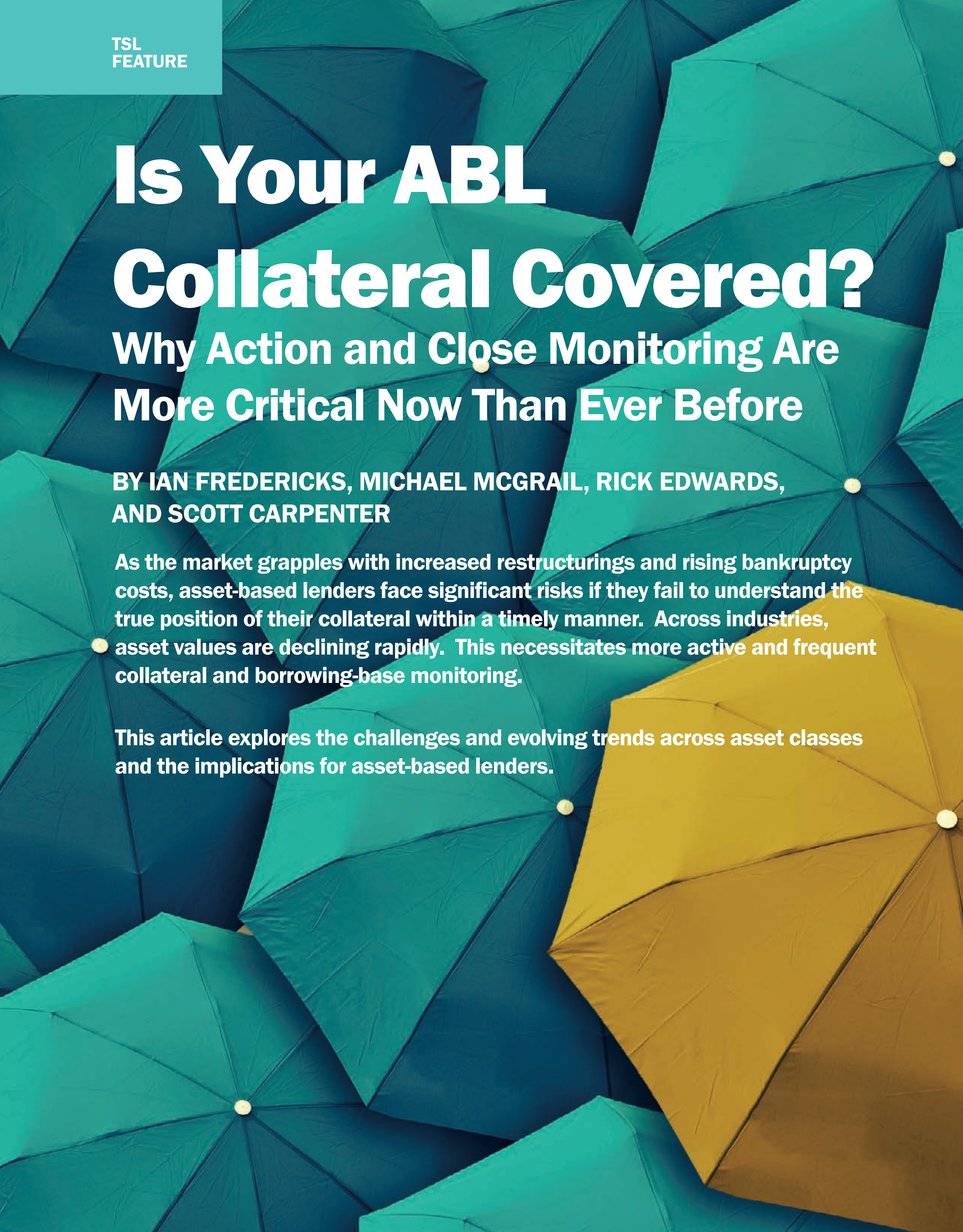


Is Your ABL Collateral Covered?

Why Action and Close Monitoring Are More Critical Now Than Ever Before

BY IAN FREDERICKS, MICHAEL MCGRAIL, RICK EDWARDS, AND SCOTT CARPENTER

As the market grapples with increased restructurings and rising bankruptcy costs, asset-based lenders face significant risks if they fail to understand the true position of their collateral within a timely manner. Across industries, asset values are declining rapidly. This necessitates more active and frequent collateral and borrowing-base monitoring.

This article explores the challenges and evolving trends across asset classes and the implications for asset-based lenders.

Asset Challenges

The volatile nature of asset values in the current market presents a substantial risk to lenders. Appraised values are trending down, reflecting not just increased capital costs and broader economic challenges, but also rapid value erosion resulting from the very decisions lenders make as their borrowers begin to struggle. This instability demands a more proactive approach from lenders, from forbearances to milestones and everything in between.

Valuation Considerations

Trends in Consumer Goods and Retail: With stubborn inflation and increased interest rates, the consumer is getting squeezed, especially consumers with lower to middle incomes. These consumers are looking for value, causing retailers to discount aggressively to drive sales and sacrificing margin. This promotional activity has a negative impact on gross orderly liquidation values (GOLVs), which has a direct correlation to lower net orderly liquidation values (NOLVs).

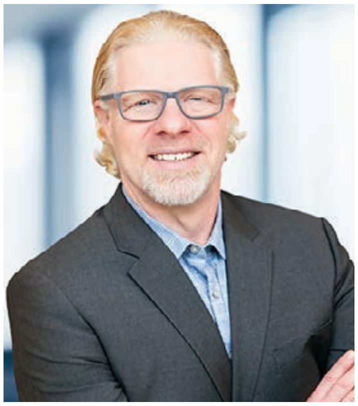
During the pandemic, supply chain issues caused a spike in the value of consumer goods, particularly durable assets such as home goods, furniture, exercise equipment, and outdoor goods. While this had a positive short-term effect on firms' revenue and profits, and brand value, it ultimately decreased future sales as the long-lasting nature of these products suppressed future demand.

More recently, we've experienced a downturn in the real estate market due to increased interest rates. Consequently, we've observed materially increased inventory levels across the home goods, furniture, and mattress sectors. These "big ticket" goods are recovering well below historical levels as consumers simply lack the disposable income to purchase these goods, even in going out of business or store closing sales. Consumers are also carrying record credit card debt with high interest rates, further softening demand across these and other inventory categories.

Direct-to-consumer (DTC) companies, which for years leveraged low-cost capital to market to consumers—some without ever becoming profitable, are now facing materially higher costs and limited capital availability. This financial strain is weighing heavily on DTC businesses, forcing more widespread restructuring and bankruptcy.

The food and grocery sectors, however, continue to perform generally well despite some downward pressure on higher-end brands as consumers trade down to private labels to navigate inflationary pressures.

Consumer Intellectual Property (IP): Prior to and early in the pandemic, we saw new, smaller entrants in the brand acquisition space. Poor financial performance post-acquisition and rising capital costs caused some entrants to liquidate while others saw liquidity dry up. Additionally, the largest brand aggregators in the space have been focused on larger and larger acquisitions to drive growth. Consequently,



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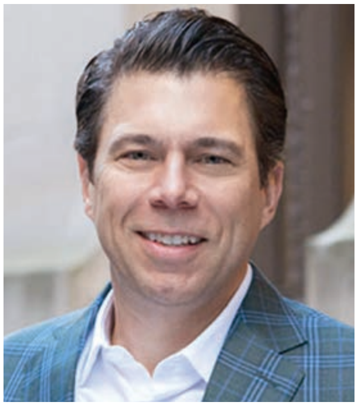

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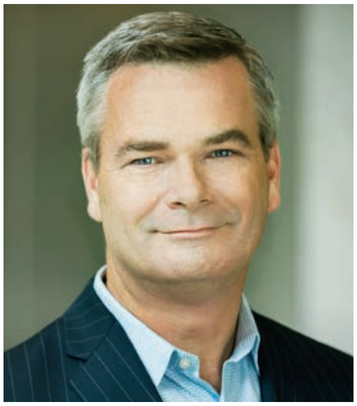

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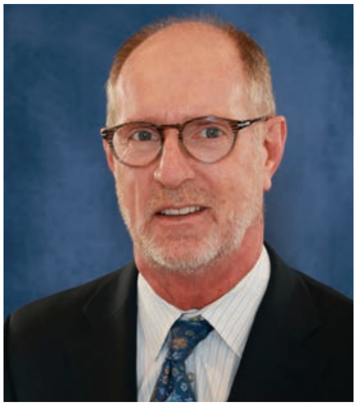

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there are fewer and fewer potential buyers, driving down IP recoveries.

With the continued rise of social media, many new, digitally native "brands" surfaced. Many of these brands were linked to one or more celebrities or social media influencers and on growth without profitability. These brands have recovered poorly, especially in distressed circumstances.

As noted above, the mismatched home goods, furniture, exercise equipment, and outdoor goods supply issues led to increased on-hand inventories and substantial discounts to push products through retail doors. Unexpectedly, this resulted in rapidly decreasing brand value as potential acquirors question when the demand will return.

Despite some headwinds, luxury brands in the consumer goods space with a long history and strong public awareness continued to perform well despite reductions in revenue and profits. Lenders should consider more frequent valuations of luxury IP.

Real Estate Sectors: The office sector is experiencing a significant shift due to work-from-home trends leading to oversupply and low demand, which is expected to continue throughout 2025. Filling vacant spaces and retaining tenants remain challenging with negative rental growth and high overall cap rates persisting. However, the transition to recovery is expected in 2026 or 2027, with limited supply additions and conversions to alternative uses.

The industrial sector is seeing rising vacancy rates and flattening rental rates due to supply additions and a slowdown in leasing activity. This has led to stable to moderately declining market fundamentals, which is expected to continue in 2025.

The multi-family sector varies significantly across regions with expansion anticipated to dominate by the end of 2025, including strong demand, low vacancy rates, rental growth, and decreasing overall cap rates.

The retail sector was showing signs of recovery with improving fundamentals, increased occupancy, and rents expected to strengthen. However, recent distress in the retail sector – with thousands of stores closing and retailers looking to restructure their leases – has softened the near-term outlook for retail real estate, especially in B and C centers. Transaction activity is relatively low, but is expected to increase if interest rates decline in the coming quarters.

Machinery & Equipment: Beginning in mid-2020, the machinery and equipment market experienced a price bubble that lasted through the summer of 2022 due to increased raw material and wage costs, labor shortages, and supply chain issues. This led to high prices for used equipment as original equipment manufacturers (OEM) struggled with backlogs and extended lead times. As the pandemic waned asset classes stabilized, and 2023 saw a downward correction in used market values. The availability of used equipment increased as end-users replaced older assets with new ones, driving prices lower.

- Although labor challenges persist today, wages and availability have stabilized, and raw material prices and logistics have normalized. While the metalworking and manufacturing sector faced demand declines due to disruptions in the construction and automotive markets, it has rebounded driven by increased demand for metal products and technological advancements. Stronger business conditions and better access to credit are encouraging investment in new metalworking tools, despite challenges in key downstream sectors.
- The construction equipment industry continues to correct from peak pandemic values impacted by OEMs catching up with demand and high interest rates. Most used equipment entering the market is aged and overutilized. However, a positive outlook for 2025 is expected with government construction investment and a talent shortage increasing receptiveness to new technologies.
- The trucking industry is expected to see a more favorable rate environment in 2025, gradually ending the freight recession. The upcoming 2027 EPA emissions regulations are expected to benefit sale pricing and volume for new vehicles exempt from the new standards. The van trailer market in 2025 is anticipated to be subdued due to cooling demand and oversupply with a market rebound likely not improving until 2026.

Factors Impacting Appraisal Accuracy

More and more, liquidation outcomes vary materially from appraised values, many of which are outside the control of liquidation firms because of the time between appraisal and liquidation, reduced demand, inventory mix erosion, increased promotional activity, and, critically, store and distribution center (DC) employee challenges. While some of these are within lenders' control, others are less so.

For example, lenders do not – and should not – determine a retailer's sales and promotional strategy. But increasingly, lenders have given their borrowers more time and flexibility leading to a potential insolvency. During these periods, retailers desperate to drive sales to avoid a potential filing begin promoting their best-selling inventory at the same time vendors begin to slow ship or stop shipping inventory. So, the highest recovering inventory is partially or completely gone by the time a liquidation begins, significantly suppressing GOLVs and NOLVs.

In all retail and consumer winddowns and business liquidations with minimal or no DTC, employees are the key to success in both sale performance and avoiding shrink or inventory loss. Prior to the pandemic, liquidation firms implemented standard incentive and retention bonus programs for these employees, which typically required a pool of about 10% of base payroll. Since the pandemic, this pool was increased to 15% of base payroll, which is proving inadequate to retain employees as mass walkouts and callouts frequently disrupt liquidations. Moreover, the entire pool, or nearly the entire pool, is allocated to retention. So, if employees stay, they receive their bonus regardless of performance.

Many appraisals are written on a "guaranteed" or "equity" basis pursuant to which liquidation firms will advance capital to pay off or down lenders in exchange for the right to liquidate the collateral and control many aspects of the liquidation such as term, expenses, marketing, promotions or discounts. In fee-for-service transactions, liquidation firms only make recommendations on these and other aspects, relying on management to make the final decisions. But more and more, management teams disagree with the recommendations. In many instances, they may have objectives unrelated to maximizing the asset recovery, which are driving decisions contrary to recommendations. Thus, the explicit assumptions underlying the appraisal do not exist. Yet, lenders and professionals expect the NOLVs in the appraisal to hold, which is not happening.

Lastly, not following a liquidation expert's guidance on timelines can result in the slower movement of goods and/or poor allocations from DCs to stores and from shuttered facilities or holding points to other locations. This leads to (i) lower in-stock levels in stores and imbalances among the stores that cause poor sales and force inventory discounts more than intended and (ii) inefficient order fulfillment and increased labor and occupancy costs. Similarly, post-sale removal and shipment of inventory and delayed equipment sales can impact seller liquidity as well as buyer production output, leading to the delayed delivery of goods, violation of a buyer's contractual obligations, and missed seasonal or other critical selling periods.

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Conclusion

The rapidly evolving market conditions – coupled with evolving dynamics between borrowers, lenders, professionals, and liquidation firms – underscore the importance of remaining diligent and active in monitoring borrower performance, borrowing bases, and collateral value. As requests come from borrowers and their professionals, lenders would be well-served to remember that they did not take equity risk; they only have downside and not upside potential. While lenders do not have control of outcomes, they do have more tools at their disposal to mitigate risk and influence outcomes than they currently employ.

To hear more, the authors will be speaking on a panel at the upcoming Secured Finance Network Asset-Based Capital Conference in Las Vegas, Nevada on February 12, 2025. For more information, please visit www.sfnet.com.

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