



Borrowing Base – Overlooked Ineligibles Can
Affect Collateral!!!
Inventory – Part I

Introduction to the Borrowing Base

Part Two



As many of you already know, Lender's Consulting Group, Inc. provides collateral field examinations for lenders of all shapes and sizes throughout the country. Historically, the majority of the field examinations we have provided have been for traditional asset based lending. This figure is dramatically changing now with more and more commercial banks requiring collateral field examinations on a majority of their C&I deals.

Several commercial banks that fail to utilize field examinations, or properly monitor their client's borrowing base certificate (BBC), are unable to capture many of the ineligible items that could severely impact the true borrowing capacity of a company. Over the next several months, we will be providing lenders with a series of brief tutorials that illustrate these commonly overlooked ineligible items.

In our first section, we illustrated the differences between what a borrower typically reports as ineligible A/R on its borrowing base report compared to what can be uncovered during a thorough due diligence exam. As a continuation of our series, we will shift from A/R Ineligibles to begin focusing on Inventory Ineligibles. The first installment will demonstrate what a borrower typically considers ineligible compared to the results of a due diligence field examination. In the following presentation, please notice the difference between how the borrower calculated borrowing base availability and how our Field Examiner calculated availability by applying reserves to several of the more common inventory ineligible categories not reported by the borrower.

Introduction to the Borrowing Base

Part Two



<u>Comparative Availability</u>	<u>Examiner</u>	<u>Borrowing Base</u>
Total Inventory	1,250,000	1,250,000
Inventory Ineligibles:		
Raw Materials	15,000 i	
Work-In-Process	7,500 j	
Private Label	85,000 k	
In Transit	3,750 l	
Consigned Inventory	18,500 m	
Bill and Hold	7,500 n	
Offsite	27,500 o	
Overhead	6,350 p	
Slow Moving/Obsolete	<u>185,000</u> q	
Total Inventory Ineligibles	356,100	
Net Eligible Inventory	893,900	1,250,000
Advance Rate	50%	50%
Eligible Inventory @ Advance	446,950	625,000
Sublimit	<u>1,000,000</u>	<u>1,000,000</u>
Inventory Availability	<u>446,950</u>	<u>625,000</u>
Effective Advance Rate	36%	50%

Commonly unreported Ineligible Inventory!

Common Ineligible Inventory submitted by Borrower!

Inventory Ineligibles (i) – Raw Materials



Inventory is an asset whose liquidity is a function of marketability, possession, control, and various negotiating factors. A basic risk concerning inventory collateral is the mix, especially if the bank is only lending on specific types of inventory. Knowledge of the inventory mix is especially important because it is the basis for establishing the initial advance rate on inventory. Therefore, if the mix changes, the Examiner informs the manager at the bank to determine the necessity of adjusting the advance rate.



The three major classifications are raw materials (RM), work-in-process (WIP), and finished goods (FG). However, a company will classify inventory into these categories in relation to its particular production processes. One company's finished goods may be another company's raw material. The two primary factors that influence a raw materials liquidation value are its market demand and the ease with which it can be converted into usable product.

Inventory Ineligibles (j) – Work-in-Process



This is inventory that requires completion of the production process to make it saleable. Related expenses that the bank incurs to complete production usually would offset any realizable value from the ensuing sale. This is identified by the Examiner reviewing inventory reports and/or the general ledger provided by the Company, and physically observing and understanding the borrower's production process.



Inventory Ineligibles (k) – Private Label



This inventory can be custom goods, private label goods, proprietary goods, or tooling; it has limited value as it can generally be used by only one customer and has a limited market. This ineligible is determined by physically reviewing the products/warehouse, questioning or interviewing the Company and by conducting additional inventory tests.



Inventory Ineligibles (1) – In Transit



This is inventory that is being transferred from one location to another (which can be from the vendor to the company or between company locations). The concern with this type of inventory is obtaining possession and control as well as the related cost of doing so. This inventory is identified by the Examiner testing shipping reports, questioning company personnel as well as by reviewing other miscellaneous inventory reports (e.g. location report).



Inventory Ineligibles (m) – Consigned Inventory



Inventory not owned by the company; typically, consigned inventory should not be reflected on the company's books. This inventory should be segregated and easily identified in the warehouse. When encountered, due diligence examiners with Lender's Consulting Group determine the dollar value reflected in inventory and the company's method of tracking. Subsequently, the Examiner deems the value of all consigned inventory included on the company's books as ineligible.



Remember Your URL



Understand- the company's industry and learn about any unusual inventory or accounts receivable practice. Perform trend analysis by tracking new reports against prior periods.

Review- the detail of the report and supporting documentation (knowing you are watching is a good deterrent to fraud).

Learn- how your client sells, invoices and collects; know the paper trail! And insist on timely borrowing base reports and all supporting material.

Things to consider when developing an Audit Program



- Use professional collateral auditing firms in appropriate situations (i.e., larger facilities or early in a distressed situation).

- A CPA audit or review does not take the place of a collateral field exam!

- STAY TUNED FOR PART 4 –
COMMONLY OVERLOOKED INVENTORY INELIGIBLES
 - Offsite
 - Bill and Hold
 - Slow Moving/Obsolete
 - Overhead

Management Team...



Brian Smith is Managing Partner and co-founder of LCG. Mr. Smith brings to LCG extensive experience in commercial and corporate finance, most notably in the areas of investment banking, commercial credit, underwriting and due diligence. Mr. Smith was most recently a Vice President of Textron Financial Corporation where he managed the structuring and underwriting for several TFC operating divisions. He also was appointed to lead portfolio and operations reviews of other divisions.

Mr. Smith was formerly the President of Association of Medical Finance Professionals and held various management positions with MediFin and Professional Factors in Tampa, Florida provided factoring and asset-based lending to businesses nationwide. Mr. Smith holds Bachelor's Degrees in Finance and Economics from the University of Tampa and has completed numerous industry-specific training programs.



Paul Epstein, Managing Partner and co-founder of LCG. Prior to LCG, Mr. Epstein was most recently Executive Vice President of CitiFactors Financial Group where managed or was responsible for nearly all aspects of the business including the underwriting, due diligence, and operations. During Mr. Epstein's tenure sales increased over five hundred percent and CitiFactors was placed in the top 100 Fastest Growing Companies in Florida per a University of Florida study. He trained account executives and operations personnel in both credit policies and fraud detection.

Previously, Mr. Epstein was the Credit Manager at Professional Factor's, Inc. and Healthcare Financial Services, Inc. in Tampa, Florida where he was responsible for credit policies, and asset recovery. Mr. Epstein earned his Bachelor's in Finance from the University of Tampa. He is a member of the Association for Corporate Growth, currently serving on the board of directors for ACG's Orlando chapter

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