



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

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. During the course of the year, we provided lenders with a series of brief tutorials that illustrate these commonly overlooked ineligible items.

In our first installment on Inventory ineligible items we looked at raw materials, work-in-process, private label, and in transit inventory. We outlined why these types of inventory should be considered as ineligible and also showed the effect on the BBC when our field examiner applies reserves to several of the ineligible categories not reported by the borrower. In the following presentation we will continue our discussion of inventory ineligible items by covering the following categories: offsite, overhead, and slow moving/obsolete inventory. Additionally, we will summarize the difference between the Examiner's calculations and what was reported on the BBC.

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 | |
| Offsite | 27,500 n | |
| Overhead | 6,350 o | |
| Slow Moving/Obsolete | <u>185,000</u> p | |
| Total Inventory Ineligibles | 348,600 | |
| Net Eligible Inventory | 911,400 | 1,250,000 |
| Advance Rate | 50% | 50% |
| Eligible Inventory @ Advance | 455,700 | 625,000 |
| Sublimit | <u>1,000,000</u> | <u>1,000,000</u> |
| Inventory Availability | <u>455,700</u> | <u>625,000</u> |
| Effective Advance Rate | 36% | 50% |

Commonly unreported Ineligible Inventory!

Common Ineligible Inventory submitted by Borrower!

Inventory Ineligibles (n) – Offsite



There are several situations when offsite inventory may be considered ineligible:

A) Vendor Locations:

This is inventory located at one or several of the company's vendor locations. As with other inventory located at outside locations, the concern is with obtaining possession and control and the related cost of doing so. In addition, this inventory in liquidation may be used as an offset by the vendor for any amounts owed to them from the customer.

B) Job Sites:

Similar concerns exist with inventory at job sites as that of in transit inventory, obtaining possession and control and related cost of doing so. This is inventory that is at the customer's jobsite that has not yet been invoiced to the customer.

C) International:

Like other location related ineligibles, inventory outside the U.S. has concerns because of obtaining possession and control and the related cost of doing so. This can be more difficult due to the legal issues with dealing with a foreign country.



Inventory Ineligibles (o) – Overhead



The Internal Revenue Service has a rule known as Section 263A which are often referred to as “Unicap” adjustments. If a company is subject to Section 263A, it is required to allocate a portion of its overhead to inventory as holding costs. The allocation of these costs increases the inventory account and is normally made at year end, but it may appear as a line item in the perpetual report used to support the inventory borrowing base.



Inventory Ineligibles (p) – Slow Moving/Obsolete



Slow moving inventory is generally deemed to be that amount of stock on hand that is in excess of one year's usage or has been purchased more than one year from the date of the exam. Some companies may be required to maintain certain inventory to be available for repairs, warranties, replacements, etc. which can be a reasonable business decision. However, that does not mean that the bank should finance this inventory.

Obsolete inventory essentially has no market. Obsolete inventory usually refers to those items in stock that are either no longer marketable or no longer used in the production cycle. Items acquire this status through technological, environmental, cost, fashion or other related factors. Being that the inventory no longer has a market, it will have a diminished value in liquidation and should be included with the ineligible.



Introduction to the Borrowing Base

Summary



Let's review the difference between the Examiner's calculations and what was reported on the BBC:

| | Examiner Calculations | | Reported on BBC | |
|--------------------------------|-----------------------|---------------------|---------------------|---------------------|
| | A/R | Inventory | A/R | Inventory |
| Gross Collateral | \$ 3,841,526 | \$ 1,250,000 | \$ 3,841,526 | \$ 1,250,000 |
| Ineligibles | <u>\$ 2,525,453</u> | <u>\$ 348,600</u> | <u>\$ 1,713,952</u> | <u>\$ -</u> |
| Net Eligible Collateral | \$ 1,316,073 | \$ 901,400 | \$ 2,127,574 | \$ 1,250,000 |
| Advance Rate | 75% | 50% | 75% | 50% |
| Eligible Collateral @ Advance | <u>\$ 987,055</u> | <u>\$ 450,700</u> | <u>\$ 1,595,681</u> | <u>\$ 625,000</u> |
| Total Eligible Collateral | | <u>\$ 1,437,755</u> | | <u>\$ 2,220,681</u> |
| Ineligibles Difference | | <u>\$ 1,160,101</u> | | |
| Eligible Collateral Difference | | <u>\$ 782,926</u> | | |

The Examiner calculated \$1,160M *MORE* in ineligibles than what was reported on the BBC resulting in \$783M *LESS* in eligible collateral!!!

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 field examination 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 ADDITIONAL TUTORIALS IN 2012!!!**

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. Mr. Epstein has been instrumental in leading LCG to double digit growth for four straight years while implementing strict quality control measures. Under his leadership, Mr. Epstein has expanded LCG's presence from Tampa, Florida to over 15 cities nationwide. In 2009, the Tampa Bay Business Journal listed LCG as #20 in their "Fast 50" Growing Companies list. In 2011, LCG was nominated by the Tampa Chamber of Commerce for the small business of the year award for the second time.

Prior to LCG, Mr. Epstein was the Executive Vice President of CitiFactors Financial Group, Inc. in Orlando, Florida where he was involved in developing CitiFactors into one of the leading niche commercial finance companies in the Southeast United States. He managed or was responsible for nearly all aspects of the business including the due diligence, client audits, account management, and operations. In addition to operational responsibilities, Mr. Epstein played a major role in the design and implementation of a sales and marketing plan. Mr. Epstein earned his Bachelor's in Finance from the University of Tampa.

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