From Appraisal to Auction:

Understanding All the Risks Inherent with the Loan

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We all seem to be moving at a hundred miles per hour these days and, in our zest to streamline as much as possible, it may be very appealing to flip to the appraisal recap of any valuation and glance at the values presented to save time. However, without a true understanding of how the values were determined, you might end up with more problems and more time spent on issues that could have been avoided.

Appraisal reports today are getting away from the narrative and going more towards charts and tables to make the reports simpler and easier to read. The downside is that there is key information provided in the narrative that is being overlooked and it is critical for the lender to read and understand the potential issues outlined in the report in order to understand the risk inherent with the loan. With this format transition comes an increased risk of missing important information contained in the narrative of a report or the complete lack of this pertinent information even being included by the appraiser writing the report. Although all of these charts and graphs included in the valuation are beneficial in giving a good visual recap, without reading the "meat" of an appraisal, you can miss important items that may not be so readily apparent in that simple chart or graph. There are many potential hurdles included in the narrative that are vital to comparing the liquidation results to the appraisal that was commissioned.

Machinery and Equipment Appraisal Pitfalls

Machinery and equipment appraisal issues that may not be readily apparent in the report from a chart or graph include such items as corralling costs of any mobile assets, deferred maintenance items that, if handled, could greatly increase potential recovery, potential difficulty in the removal of assets, rapid technological obsolescence that newer equipment may be subject to, and potential benefit of extended time frames for liquidations (which may or may not have been considered in report). These are potentially significant items and should be considered when underwriting transactions involving this type of collateral, but may be overlooked if the appraisal report is not read in its entirety.

A recent example of how circumstances changed after the appraisal and pre-liquidation that made a comparison almost meaningless included a recent valuation of a fleet of vehicles. The original appraisal included a good cross-section of equipment including newer-late model equipment as well as some poor condition and near-scrap condition items. Subsequent to the appraisal, a sale was conducted where only a small portion of the fleet and the assets included in the appraisal were sold. The items slated for sale were not the crème de la crème of the equipment appraised and only a small portion of the assets appraised. It is important to understand that the values presented in an appraisal almost always make the assumption that all of the equipment would be sold in aggregate, if and when exposed to sale. While that statement may not seem important and often not given much thought when a reader reviews an appraisal, it really is. When equipment is sold in aggregate, oftentimes the better, more desirable, pieces of equipment become "draw" items in the event of a sale, drawing buyers to the liquidation. Without the draw items, potential buyers, that may have been interested in more appealing items and would also have purchased other less desirable items, are not going to make as much of an effort. Even seemingly minor reasons for buying items, such as filling a truck, may result in the sale of less desirable equipment. impacting values in a positive manner.

Oftentimes, when a company is looking to conserve cash, the condition of its equipment will suffer. It might defer maintenance on its equipment or pilfer parts from one formerly usable piece to another, causing poor appearance and degraded condition of items, causing buyers to be driven away entirely or to expect to pay a much lower price.

Some asset classes of equipment, including high technology, bio-medical, IT, etc., are often subject to rapid technological obsolescence which will not be readily apparent in a chart or graph. Although difficulty of removal should be reflected in the appraised values, sometimes this difficult removal may affect other company "assets," specifically the real estate on which the client may also be lending. Certain conditions, including opening of walls (exterior or interior), potential roof modifications and foundation issues, may be created related to the removal that may have an impact on the potential borrower's real estate and should be considered, but not readily apparent, in a chart or graph.

Inventory Appraisal Pitfalls

As with machinery and equipment appraisals, there are several inventory appraisal pitfalls that can be included in an inventory appraisal.

Values utilizing a blended rate: One difficulty relates to "blending" the values that were assigned to individual buckets of inventory. If this is done, you can get in trouble down the road when a company sells off all of your "good"collateral; because you used a blended valuation, it may appear you had a larger percentage of value left and you end up being left with the scraps (and the low percentage dollar value scraps at that).

Changes in Values: Another challenge arises through changes in values from the date of the appraisal to the date of the sale. As one might expect, the mix and composition of the inventory is constantly changing with the daily operations of the business. Therefore, the value of the inventory will be affected by the timing of the sale. It is extremely probable that the actual makeup of the inventory at the time of a liquidation sale could be considerably different from that which is the subject of the appraisal report commissioned by the lender. Typically, inventories are liquidated in their entirety only when the company has failed. In these cases, attempts are made to sell the inventory first in its entirety and, if unsuccessful, the inventory is sold on a piecemeal basis. When selling an inventory under distress, there are typically a number of issues that impacts its value. The absence of working capital typically results in the company selling as much of the most salable inventory as possible to generate cash for operations. This negatively affects the mix of the inventory, and diminishes the overall value of this asset. It is incumbent upon the lender, through consistent monitoring as well as regularly scheduled update appraisals, to assure that the asset pool that they are lending on fairly represents the assets

that need to be liquidated.

The sale of inventory under extraneous conditions: It is important for a lender to understand that an inventory appraisal does not consider the sale of inventory under extraneous conditions. For example, when appraising beef inventories, extraneous conditions may include a batch of meat infected with Foot and Mouth Disease and/or inappropriate labeling practices. Any extraneous conditions could have a material impact on the perception of the quality of the product and, therefore, affect the liquidation value realized. While the appraisal has assumed the existence of financial reasons for the shutdown of the business, the appraiser has not assumed any significant change in the quality or perception of quality of the product being sold. In cases of a recall, the merchandise would be destroyed. In performing an appraisal analysis, it is assumed that there would be no recall factors affecting the salability of the inventory. This may be a remote issue, but must be considered by the lender.

Items in public storage: Inventory at public storage facilities is another potential challenge. Under an orderly liquidation scenario, it is likely that the operators of public storage facilities will be owed money for the storage and handling of the inventory prior to, and during, the orderly liquidation period. In a liquidation scenario, these storage facility operators are unsecured creditors, whose only leverage to obtain payment for their services are the inventory in their possession. In order to have the inventory recoverable for an orderly liquidation, the subject company and/or the secured lender will have to continue payments for the storage and handling fees. If payment is not continued, the public storage facility operator and/or the courts may delay access to the inventory. Parties with an interest in the inventory need to monitor that the payments to storage operators remain current in order to secure access to the inventory in the event of a liquidation, or, must be sure that they obtain a landlord or warehouse waiver at the time they make the loan, which gives them access to the inventory for a sufficient period of time to monetize it.

Months on-hand composition: As part of an appraisal, most appraisal firms will perform a stock-keeping unit (SKU) analysis, which compares current inventory levels with sales from a recent period. This analysis allows months-on-hand to be quantified at the lowest reporting level, the SKU level. SKU analysis often provides better insight into the true marketability of the inventory. Sales activity is utilized as an indicator of an individual item's attractiveness. Merchandise that has accumulated in the inventory and demonstrates supply far in excess of demand often requires extensive discounting in order to interest purchasers. The months-on-hand composition constantly changes as the business changes and, as a company gets closer to a liquidation event, the months-on-hand composition is likely to degrade significantly. The secured lender has to be aware of this mix change when it comes time to liquidate.

Total Asset Pool Vs. The Assets Appraised

When comparing an appraisal to the expected results of a liquidation, it must be considered whether or not the asset pool closely resembles the assets that were appraised. It is important to realize that appraisals are based on the assumption that all assets on site will be sold. If the best assets are cherry-picked, it is highly likely that the recovery rates for the remaining assets will be lower than those in the appraisal. Many buyers at auction attend an event, whether it be online or in person, to have the opportunity to buy certain assets and, if those assets are pre-sold, they will likely lose interest in the remaining assets. Fewer bidders mean less competition and, hence, lower recovery numbers.

How You Liquidate Can Make A World Of Difference

Before proceeding with a straight liquidation, a lender should ask, "Is there still a business here? Would the collateral be worth more if the business itself were sold, rather than just the underlying assets?" Frequently, strategic buyers trying to get to a customer base, a distribution network, or key talent are willing to pay a much higher price for inventory, receivables and equipment, as a way to get to the "soft assets" and "the business". The inventory in place, tied to some customer base, is generally worth more than inventory that has to be quickly moved and sold outside the normal course of business. By retaining an investment banking firm that will work on a success fee basis, the lender and the borrower give themselves, and other creditors, a chance to preserve the going-concern value, even in a distressed situation, with little downside risk. The analysis then becomes a comparison of the likely upside by pursuing this course, with the costs of allowing the business to continue to operate for a month or two while suitors are sought. A very broad marketing campaign, conducted by an experienced intermediary, can produce both kinds of buyers (pure inventory buyers and strategic business buyers) and get them to compete for the assets, thereby maximizing recovery.

Conduct An Apples-To-Apples Comparison When You Get To Liquidation

Comparisons between appraisals and liquidation results are more than just opening up the appraisal and comparing it to the check received from the liquidation firm. It is understanding the asset pool that was actually available for liquidation, which requires monitoring after the appraisal is completed. The graphs and charts certainly have a place in appraisal reports, but good old-fashioned narrative is more likely to tell the whole story. **TSL**

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