The Slippery Slope, Part One: The Bump in the Road, and Declining Collateral Values

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Several months ago, I was discussing the challenges of lending against inventory with the senior credit officer of a major asset based lender. "Inventory is not like receivables. Receivables are clearly denominated, and you have a pretty clear idea of your recovery rate. Inventory is a whole other ballgame." And yet, for many credits, inventory represents a far greater percentage of the collateral than receivables. And he said of these credits, and their collateral values, "Once it starts going bad, it's like a slippery slope. They almost never seem to recover."

Clearly, the vast majority of companies that turn to an asset based lender for financing have a mixed revenue and profitability record. In many cases, asset based loans are the financing of last resort. Frequently, these companies are attempting to adjust to fundamental changes in their businesses, are facing structural declines in revenue, and are struggling to bring their costs and operations in line with the new reality.

This is well known, but it still doesn't explain why companies that have collateralized their inventories seem to find themselves in a spiral once they hit a bump in the road. To understand this more fully, it's necessary to fully understand the dynamic that starts with a bump and leads to an erosion in collateral value.

The trigger is a decline in sales. The direct cause is how management decides to respond to that decline. It's all about inventory management and the fact that, invariably, *when sales begin to slip, inventory levels don't decline at the same rate.*

What Happens

Why is it that inventory levels don't decline at the same rate as sales, and how does that lead to other factors that impact collateral values?

1. The spiral starts when actual weekly or monthly sales begin to come in below plan. Year over year or comparable store sales trends also begin to decline. This could be caused by new competition, changing technology, poorly received fashion offerings, dated assortments, tired stores or general inertia. For importers and distributors, this trend may be foreshadowed by weakness in future order bookings and order backlog.

2. In response to the declining sales trend, forward sales plans are adjusted downward, *but they almost always remain more aggressive than the current sales trend indicates.* Just as merchandisers and buyers are rarely going to project sales decreases before a season begins, they are not likely to respond to a declining sales trend in season by revising forward plans downward

as much as the trend indicates. They are expected by management to take steps with their assortments to re-stimulate demand (without sacrificing margin). This may include taking merchandise risks that are not prudent in a down market. However, as we've seen, buyers and merchandisers have only limited control over the factors that are frequently driving the sales declines. And in many cases, buyers are locked into extended purchase commitments, which further limit their ability to react quickly.

3. The volume of inventory in the supply chain is not adjusted to fully reflect the new sales trend. Planned monthly ending inventories may be adjusted downward to compensate for the sales shortfall, but because inventory levels are usually a function of planned forward weeks of supply, inventory levels remain pegged to the sales plan (which, as we've seen, has not been brought in line with the declining sales trend). *Inventory continues to flow through the supply pipeline in quantities that are in excess of the demand indicated by the declining sales trend.*

4. Actual monthly ending inventories begin to exceed planned monthly ending inventories, and forward weeks of supply on hand begins to increase.

5. As inventories and forward weeks of supply on hand increases, the need increases to take measures to bring inventories in line with demand. Promotional activity increases in the form of promotional markdowns (point-of-sale markdowns in support of flyers, ROP advertising, etc.) or clearance markdowns (hard markdowns).

6. Frequently, because markdowns will directly impact gross margins, and because unplanned markdowns will likely exceed budgeted levels, markdowns are deferred until a later period when the markdown impact can be absorbed without exceeding the budget. However, because retail inventories typically lose between 20% and 50% of their true retail market value on an annualized basis, deferred markdowns almost always result in a greater level of discounting to clear out inventory than markdowns taken on a timely basis.

How does this impact collateral valuation?

While the factors impacting collateral valuations are well understood in the asset based lending community, they are worth summarizing here.

1. The declining sales trend reflects a real decrease in market demand, resulting from internal factors, external factors, or a combination of both. This decrease in market demand indicates that in the event of a liquidation, additional discounts will be necessary to stimulate that demand, reducing the anticipated gross recovery as a percent of retail or selling price, and/or the length of the liquidation sale will increase, increasing the expenses associated with a liquidation and reducing the anticipated net recovery.

2. The increase in inventory, coupled with a declining sales trend, results in an increase in the actual forward weeks of supply on hand. An increase in the forward weeks of supply on hand indicates that in the event of a liquidation, additional discounts will be necessary to stimulate demand, reducing the anticipated gross recovery as a percent of retail or selling price.

3. The increase in markdown activity indicates that in the event of a liquidation, further additional discounts will be necessary to stimulate demand, further reducing the anticipated gross recovery as a percent of retail or selling price. Customers have become accustomed to the markdowns. Further, the increase in markdown activity erodes gross margin percentages, so that the reduction in anticipated gross recovery as a percent of retail or selling price results in even greater reductions in anticipated gross recovery as a percent of cost.

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In Part 2 of this article, we'll lay out the case for early intervention as soon as a company experiences an unplanned sales decrease, to provide management with an independent, factual assessment of the situation and a comprehensive plan of action, to be taken at the moment of greatest financial strength and market position, before any further erosion takes place, and finally, to provide both the Company and the Lender the best opportunity for protecting and maintaining collateral values.

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Ted Hurlbut is the Principal of Hurlbut & Associates, which helps retailers, wholesalers, importers and distributors improve the productivity of their inventory investment. Please visit www.hurlbutassociates.com for more information.