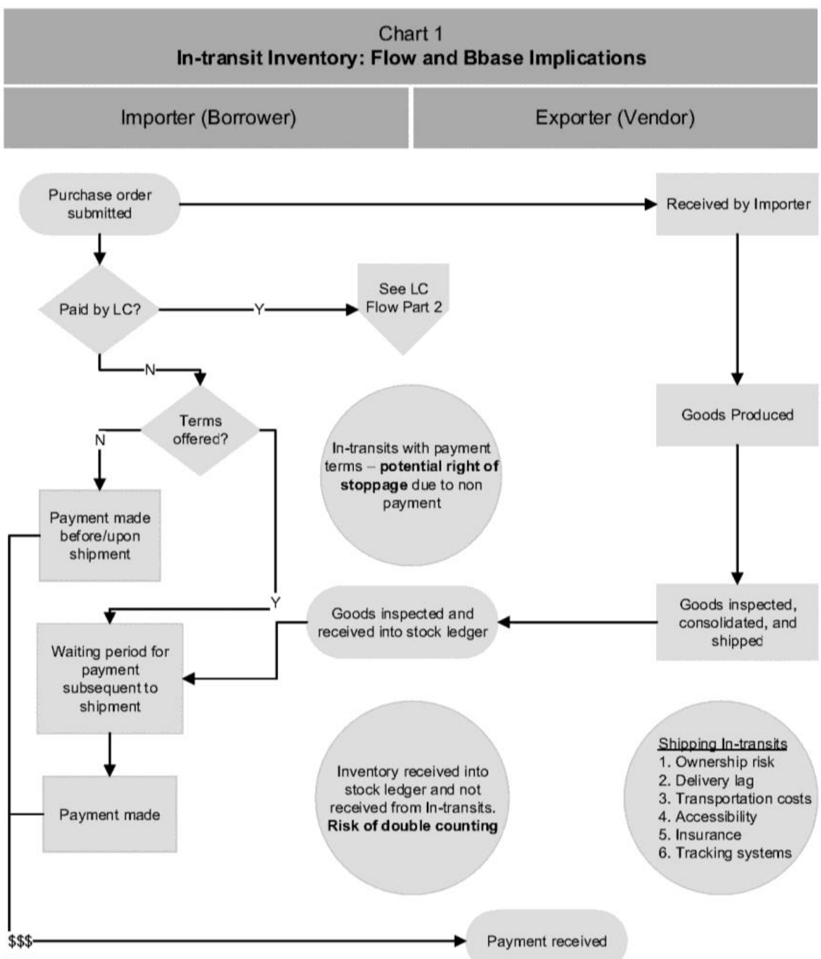
Your Collateral is in the Mail

Importing goods has a significant impact on the U.S. economy and is of particular relevance to asset-based lenders as it can lead to an important source of collateral for their borrowers; namely in-transit inventory (in-transits). Importing is also often associated with the use of documentary letters of credit (LCs). This article will review the issues associated with the inclusion of in-transits and LCs on the borrowing base (Bbase) and strategies to minimize related risks.

PART 1: IN-TRANSIT INVENTORY

In-transits are inventories that are not physically in the purchaser's possession, but rather are in the process of being delivered from a vendor. For merchandise to qualify as in-transit, transfer of ownership must occur at the vendor's factory or at the port of shipment. Because in-transits are not in the possession of the purchaser but rather held by a third party involved in the transportation process, asset-based lenders must assess the risks of including this merchandise in the Bbase. For illustrative purposes, we have provided a typical in-transit process flow chart below and have highlighted key in-transit Bbase risks.



Shipping In-Transits

An exporter will often produce goods for an importer based on purchase orders submitted. These goods can be transferred through several intermediaries before arriving at the purchaser's premises, including foreign consolidators, freight forwarders, transportation carriers, customs and/or domestic rail. Once inventory has left the vendors' premises, lenders must consider several factors prior to including the inventory as collateral on the Bbase:

Does the borrower own the collateral?

In order to be eligible Bbase collateral, the title must transfer to the buyer. Borrowers have been known to record in-transit inventories as assets for bookkeeping purposes, regardless of the transfer of ownership. This overstates Bbase collateral. Title to in-transits is determined by the terms of sale, which are usually defined in the purchase agreement and disclosed on the vendor invoice. “FOB shipping point” and “FOB ex-factory” are terms indicating that ownership transfers to the purchaser when the goods are shipped and/or accepted by a third-party carrier engaged by the purchaser. Although these are the most common terms associated with imports, other terms exist (e.g., FCA, DES, LDP, etc.) which may have different implications for the timing of the ownership transfer. Borrowers should obtain legal advice to determine when transfer of ownership occurs and what specific procedures are required during the field exam.

Delivery lag

Bbases assume that collateral could be subject to an orderly liquidation conducted in a timely manner. However, in-transits that arrive later in an orderly liquidation may have a reduced realizable value due to higher discount levels, smaller lot sizes, ongoing overhead costs, etc. Asset-based lenders should therefore ensure that inventory appraisers carefully consider the impact of in-transits on the orderly liquidation process. Field examiners should determine the average shipping lag to ensure that the appraisal assumptions are appropriate. Additionally, in order to protect lenders against inventory that is “lost at sea,” ineligible inventory should be considered for aged in-transits (90 days is a typical aging standard).

The cost of bringing the collateral home

During a realization process, an asset based lender will often incur significant costs to take possession of in-transits. Though the lender might factor these costs into the appraisal and the blended advance rate, often a more accurate approach is to establish a separate Bbase reserve based on the borrower’s average landing factor (i.e., 15%-20% of in-transits). Field examination procedures should validate this landing factor. A prudent lender should also determine if the borrower has open payment terms with the various parties providing transportation services, because goods could be held hostage in a liquidation process if there are outstanding payables at the time. Approaches to mitigating this risk include calculating Bbase reserves for accounts payable and/or obtaining unconditional release agreements from these parties (legal advice should be sought).

Does the lender have access?

Lenders must ensure that they have access to the collateral in the event of liquidation. The document that controls that access is the bill of lading (the “BOL”), which is a document issued by a carrier to a shipper acknowledging that specified goods have been received for delivery to a designated party. BOLs that state “to the order of” a designated party are negotiable and may be endorsed to a third party that can, in turn, take possession of the collateral. The best practice is to require all in-transit BOLs to state “to the order of” the lender. In a going-concern situation, the lender would retain control of in-transits and endorse the BOLs over to the borrower. Alternatively, some lenders have opted to implement written agreements with the company and all parties involved in delivering in-transits in order to ensure lender access.

Insurance

Whenever a company has a significant level of in-transits, a marine cargo insurance policy should be in effect, and the asset-based lender should be the lender loss payee. Lenders must ensure the policies provide adequate coverage and are in force.

Is there a reliable system?

The above factors provide little comfort if the reporting systems do not provide reliable Bbase information or allow for proper monitoring of in-transits. In many instances, borrower reporting consists of a manual listing that is not integrated with the accounting system and is often not appropriate for an asset-based loan. An adequate system would track intransits by purchase order (PO) in real time, provide reports detailing the amount, date shipped, expected arrival date, country of origin, etc. and update quantities based on actual units shipped. The field exam should include a system description that addresses how the borrower tracks in-transits (i.e., is the company notified of the merchandise’s whereabouts throughout the supply chain?) and lists the names and addresses of all parties involved with the in-transit process.

Paying for In-Transit Inventory

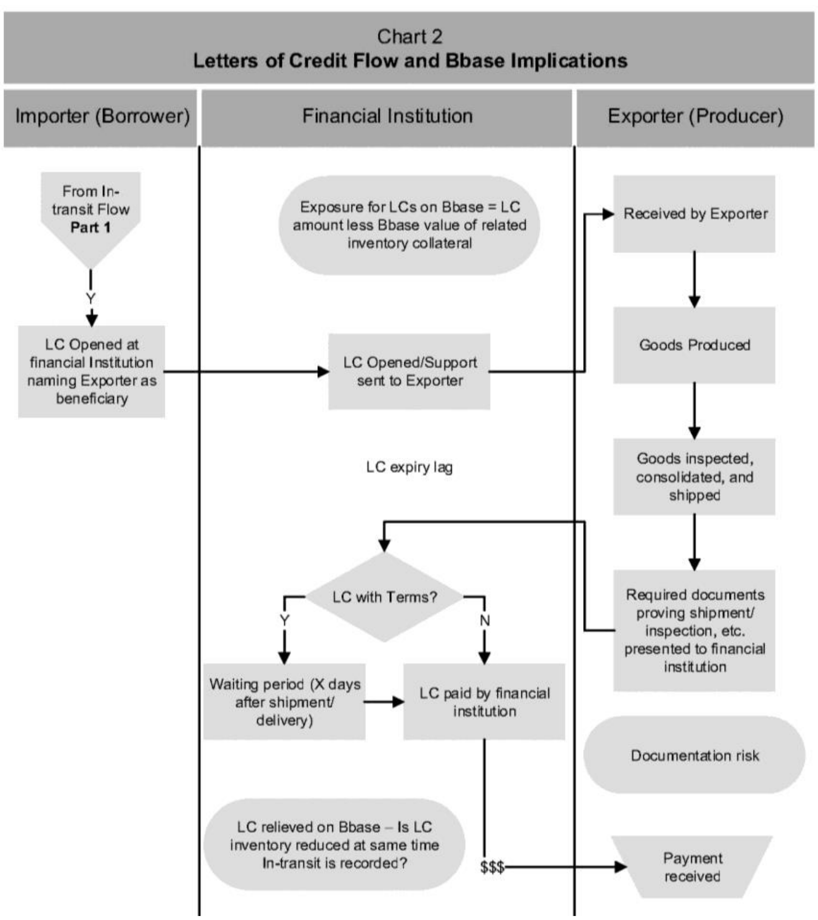
As the chart shows, the typical payment methods for in-transits include prepayment, open terms or letters of credit (LCs). Prepaying reduces the risk of vendors attempting to repossess in-transits. When the vendor offers payment terms, a situation arises where inventory is both not paid for and not in the possession of the borrower. The combination is enough to prevent some asset-based lenders from considering these in-transits as eligible Bbase collateral. After all, in the event a buyer becomes insolvent, a vendor may attempt to stop the delivery of in-transits due to nonpayment. Although a detailed legal discussion is beyond the scope of this article, lenders should be aware of two possible protections against a vendor's right to stop the delivery of goods: having possession of a negotiable bill of lading or having an agreement with the vendor that waives its right of stoppage. Though there are other arguments to defeat a vendor's right of stoppage in liquidation, caution is recommended absent at least one of these protections.

Receiving in-transit inventory and double counting

Ultimately, the borrower receives the in-transit inventory and records it in its perpetual stock ledger; however, the goods may not be decremented in a timely manner from the in-transit listing, resulting in a double counting of inventory (both in the stock ledger and the in-transit listing). Field exam procedures should include a review of the receiving dates of in-transits to ensure that double counting has not occurred.

PART 2: LCS AND LC INVENTORY

A common method of financing in-transit inventory is the documentary letter of credit. A documentary letter of credit (LC) is a commitment by a financial institution to pay an exporting company a specified amount of money upon the presentation of documents that comply with terms outlined in the LC (usually evidencing that the inventory has been shipped). The LC provides assurance to the importer and exporter that payment will occur if, and only if, the terms of the LC are met. The financial institution that grants the LC obtains repayment from the importing company when the LC is paid, usually through an increase in the importing company's creditline or revolver. For illustration purposes, we have provided a typical LC process flow chart and have highlighted key in-transit Bbase risks.



OPENING THE LC

Impact on the Bbase

An LC, which may be opened well before inventory is produced or shipped, represents a lender's commitment to fund the LC and a vendor's commitment to produce and ship specified inventory. Given their commitment nature, LCs are not recorded as an asset or a liability on the borrower's books and records. From an asset-based lender's perspective, LCs represent a source of collateral (future inventory) as well as a liability that should be reflected on the Bbase. The table below reflects a common approach to presenting LCs and the related collateral on a Bbase.

Bbase Availability Created by LC's	
LC Inventory	$ 1,000,000
Inventory advance rate	60%
Net LC inventory	600,000
LC Reserve	(1,000,000)
Net availability impact of LC's	**$ (400,000)**

The example assumes a borrower has an inventory Bbase advance rate of 60% and open merchandise LCs of $1MM. The Bbase impact is as follows: The net impact on the Bbase availability is negative. Though the LC commitment represents a liability for the financial institution and it therefore must include it as a Bbase reserve, the value of the future collateral offsets it. This approach is only warranted to the extent that the asset-based lender anticipates that a realization of this inventory can occur, if warranted, at the prevailing advance rate. This may not always be the case, however. The following factors show how lenders might experience lower recoveries.

Delivery lag

LC inventory that arrives at company premises later in the liquidation period could have a lower realizable value than merchandise on hand. This risk is more pronounced for LC inventory than in-transits because the borrower has committed to purchase the inventory even if it has yet to be produced when the liquidation commences. The most important control over delivery lag is thus the LC expiry date, as the borrower does not necessarily have to honor LCs for shipments made after that date. Similar to in-transits, appraisers must consider the impact that LC inventory could have on a liquidation plan. Lenders should consider holding Bbase ineligibles for LCs with longer expiry dates because the goods may fall outside of the assumed liquidation period and have nominal value. Although the cutoff for exclusion of LC merchandise depends on the nature of the inventory and the length of the liquidation period, many asset-based lenders consider 60 days a common standard.

What is the cost of bringing the collateral home?

Because LC inventory represents future in-transit inventory, borrowers will incur landing costs to deliver it to the borrower's premises. As such, the appraisal should consider landing costs for LC inventory in the advance rate. Alternatively, lenders can establish a separate Bbase reserve for landing costs using the historical financial data of the borrower. Once the related LC inventory is produced and shipped, the vendor has a specified time period (usually 30 days) to present documents to the financial institution for immediate payment. The required documents typically include inspection certificates, bills of lading, commercial invoices, etc. Payment may be deferred if the LC has payment terms (i.e., paid 90 days after shipment, 60 days after receipt, etc.).

Documentation risk

Paying the LC revolves around producing the documents outlined in the LC terms, and lenders cannot normally stop payment due to disputes or other issues. Therefore, there is always a risk that the financial institution could be forced to pay for inventory that is undesirable (i.e., out of spec, the wrong color or season, etc.). A company must thus properly inspect the goods prior to taking possession and should require an inspection certificate with the documents required for LC payment.

Double counting

Due to the time it takes to process the LC for payment, as well as the potential additional wait time if there are extended terms, an LC may be paid well after the related inventory has been shipped or even received at the borrower's premises. As a result, LC inventory may be double counted (included in in-transits or the stock ledger). In these circumstances, the lender would have an outstanding LC liability with no offsetting LC inventory asset. To minimize this risk, the borrower needs to implement a process that allows for proper monitoring of LC inventory. A good system will detect LC inventory that is shipped but not paid and will hold that inventory as a Bbase ineligible. Field exam procedures should include comparing (by PO number) in-transits and LC inventory to detect double counting. Examiners should also review the shipping dates and stock ledger receiving dates for LC inventory POs.

Conclusion

In-transit and LC inventory represent a potential source of leverage for asset based lenders to offer their customers. However, lenders need to address the many inherent risks to leveraging this collateral. Many borrower systems are not geared to account for in-transits and LCs properly, and therefore they must conduct proper ongoing diligence and planning if they include this collateral on the Bbase.

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