

Playing to Win: How Appraisers Are Helping Lenders Secure Deals & Avoid Losses

Many lenders are anticipating that when the current credit cycle turns, aggressive deal structures will prove problematic. While there are a myriad of challenges that a lender must deal with in a troubled situation, the accurate valuation of assets should not be one of them.

By Kenneth S. Frieze

As asset-based lending becomes hyper-competitive and flush with liquidity, assets once considered ineligible or “boot” are making their way into borrowing bases and collateral pools. Build-out analyses are becoming more fashionable. Consumer cash flow streams are being assessed with greater regularity and values are being ascribed to once-ineligible, aged inventory. Traditional senior ABLs are stretching to lend on the value of intellectual property — including brands and prescription files. In some sectors, ABLs are even lending on enterprise values, emulating cash-flow more than asset-based lending. While ABLs have demonstrated a willingness to entertain these additional “risks,” pricing is narrower than ever.

Here at GB Asset Advisors, many of these ABLs are our clients. We’ve seen a lot of “rolled-eyes” and heard many exasperated statements describing a deal they lost to an “unbelievably” aggressive competitor. In this environment, what can lenders do to compete? Deals are being won or lost at the margin. At the same time, given aggressive deal structures, sub-par credits are more likely to lead to loan losses. Ultimately, the key factor determining success or failure is in a comprehensive and accurate assessment of asset values.

One way to navigate this aggressive period is to engage a competent appraiser at the proposal stage, through the initial appraisal and then continually thereafter through periodic updates. Appraisers can provide “back-of-the-envelope” perspectives as to the likely range of net orderly liquidation values for various types of collateral, key valuation drivers and insight into ineligibles. Many of our clients call upon us early in the process to get some collateral perspective, affording them the ability to be as aggressive as possible with a prospect while gaining comfort with likely liquidation values.

After a formal appraisal is issued, a skilled appraiser will both proactively and reactively help the lender monitor underlying collateral values over time. Again, many of our clients call upon us to perform quick, quiet or specific checks on their borrower’s collateral between appraisals. In addition, there are times when we see changes in either marketplace or consumer trends, and will inform lenders of anticipated valuation adjustments. As lenders look at entire industry sectors, appraisers should be able to provide macro and industry-specific perspectives, making the lender smarter — both in terms of talking to their prospects and later during underwriting. At GBAA, for example, we have recently trained a number of our clients on the unique issues of lending into the supermarket sector.

The accuracy of the appraisal itself is obviously critical to being aggressive in maximizing client liquidity while minimizing risk. Yes, using an appraisal that is more accurate can win deals at the margin and help avoid loan losses down the road. However, appraisals, by definition, are not an exact science. Lenders have recognized this for more than a decade and have invariably

relied on liquidators for the “most accurate” appraisals — hoping to incorporate up-to-the-minute liquidation market data into the appraisal itself. Most liquidators have appraisal arms, seemingly satisfying this lender requirement. Unfortunately, this requirement has become so widely accepted that many lenders have stopped asking the original question itself — is the liquidation experience relevant to this asset category really being included in the appraisal? Many appraisal shops operating discretely from their liquidation sister divisions fail to incorporate the current experience of their liquidators.

Lenders should insist that their appraisers work directly with their sister liquidation arms in determining values and have the liquidators participate in the sign-off of every appraisal. Additionally, lenders should pre-qualify appraisers by demanding examples of relevant liquidation and appraisal experience. Regardless of the asset category, from retail to wholesale; real estate to industrial equipment; accounts receivable to intellectual property, the insight of an experienced liquidator will often be the difference between a somewhat and a truly accurate appraisal. In some cases, it can be the difference between the lender winning or losing a deal — or more importantly, avoiding a loan loss.

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While being more accurate on conventional hard assets is crucial for lenders to maximize “in-the-box” formulas, many deals are being won by looking to assets once excluded, considered boot or off the balance sheet altogether.

Aged, work-in-process or in-transit inventories are prime examples of historically ineligible inventories for borrowing-base certificates. As appraisers, we see some value in almost all inventory. Therefore, including some of this inventory, at the appropriate recovery values, can broaden the collateral base and increase liquidity. With aged inventory, the lender needs to be prepared to closely monitor overall inventory mix between formal appraisals to ensure the mix between lower-recovery aged inventories and higher-recovery fresh inventory is accounted for. Similarly, many WIP inventories tend to have some value if an appropriate build-out plan is contemplated. With in-transit goods, understanding the timing and status of the flow and how these goods would enter into a disposition strategy are critical for valuation purposes. Transit times, duty and freight all impact the ability to extract value from these goods.

Traditionally, collateral such as fixtures have not been worth appraising since other dominant assets (e.g., accounts receivable and inventory) have been sufficient to close the loan. Today, when many loans are being won or lost at the margin, appraising fixtures and other boot collateral can provide ABLs with the ability to add a crucial term loan or stretch the lending formula close the deal.

While lending against brand values has historically been the purview of cash flow lenders or tranche B shops, more and more senior ABLs are now looking to brands to secure their loans.

The greatest area of activity, however, is in off-balance sheet assets. Increasingly, ABLs are lending against the appraised value of brands, prescription files and other intangible assets. While lending against brand values has historically been the purview of cash flow lenders or tranche B shops, more and more senior ABLs are now looking to brands to secure their loans.

Conventional brand and enterprise evaluations have been used for decades to establish a benchmark sale price or for accounting purposes. Typically, these assessments do an excellent job of estimating brand value in healthy businesses. Brands are assumed to be part of an on-going enterprise where any sale would likely be to a strategic buyer. While helpful, these assumptions, methodologies and processes are not what an ABL needs to back a secured loan.

A brand appraisal for use by an ABL should reflect the net orderly liquidation value of the brand, and only the brand, in a distressed sale environment to a liquid market of financial buyers. While a strategic buyer may rise to the occasion and purchase the brand during a court-authorized liquidation of a company, the inherent liquid market value is set by competing financial buyers.

Here at GBAA, we use our proprietary database of third-party intellectual property sales and licensing transactions to pinpoint recoveries in distressed sales of intellectual property assets. To formulate bids and determine values, we perform detailed reviews of financial information related to the intangible asset's performance, conduct comprehensive field visits, run comparisons to our proprietary database and build an extensive discounted cash flow (DCF) model. The unique perspective of our merchant group provides current, real world insight into various intellectual property values. Bid and appraisal determinations are made by combining market benchmarks with proprietary insights to arrive at an accurate reflection of the orderly liquidation value.

Our brand appraisals estimate the cash purchase price a financial buyer would pay under a court-authorized liquidation of the brand. The brand is assumed to be stripped away from the other assets (inventory, people, backlog, etc.), to be somewhat "tainted" due to the Chapter 11 proceeding, and to incorporate some sales disruption as ownership changes hands. While industry-standard income and market valuation methods are used to estimate intellectual property values, we always develop real-world scenarios reflecting specific-buyer bid behavior to determine appraised value.

This process differs from the "enterprise valuation" typified by traditional appraisers. The purpose of the methodology used in our brand appraisals, similar to that of our other asset appraisals, is to help asset-based lenders make highly informed credit decisions based on the most accurate information.

Our analysis of pharmacy prescription files (scripts) tends to reflect more of a pure market-based valuation process. There have been numerous successful script auctions in Chapter 11 proceedings as healthy drug stores and supermarkets bid to win the foot traffic represented by these potential customers. Typically, scripts have been auctioned off on a location-by-location basis, packaged with that store's pharmacy inventory, and transferred to the winner prior to the start of any store liquidation. Our analysis is primarily driven by the proximity of competitors to that location and the competitors' willingness to bid in an auction environment. This distressed sale environment represents the real-world scenario by which this intangible asset is sold.

There are other exit scenarios for these types of stores and there have been instances where drug stores or supermarkets have been sold on a going-concern basis (in whole or in part) to strategic buyers. As a separate analysis, we have valued these assets on an enterprise basis using EBITDA multiples for the stores.

The ABL marketplace is maturing. Deals have become much more aggressive in terms of both pricing and structure and the lender now has a much smaller margin for error. Many lenders are anticipating that when the current credit cycle turns, these aggressive deal structures will prove problematic and result in significant pain for both the institutions that underwrote them and the participants who bought into them. As appraisers who base valuations on real-world liquidation practices, our goal is to act as the primary conduit of market knowledge to our lending clients to help them both win deals that should be won and avoid deals that will lead to losses. While there are a myriad of challenges that a lender must deal with in a troubled situation, the accurate valuation of assets should not be one of them. [abfj](#)

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