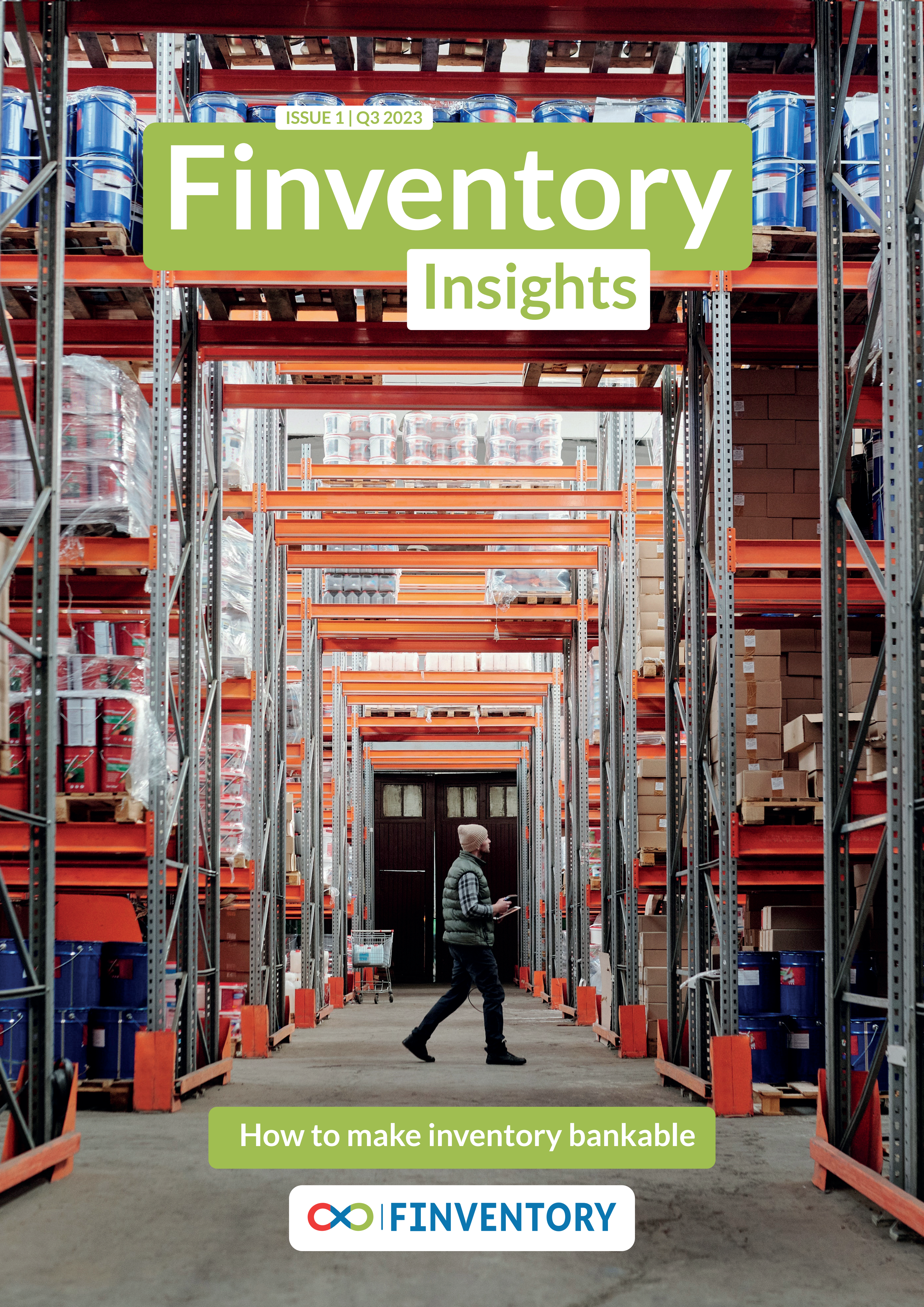

ISSUE 1 | Q3 2023

Finventory Insights

How to make inventory bankable

FINVENTORY

  

This is the first publication from the Risk and Reporting department from Finventory on the topic of inventory based lending. More will follow soon.

This edition

In this issue, one will get the basic background on the drivers of an inventory finance, the risks associated with it and the operational challenges. Especially, there is a focus on measures to make this complex and heterogeneous financing solution more suitable for lenders and borrowers by implementing a modular approach to uniform analysis.

Enabling automated and digitized inventory financing solutions

Recently, several events have caused companies to rethink their stockkeeping policy. Global events such as the COVID-19 pandemic, the war in Ukraine, and even the blocking of the Suez channel have made companies more cautious about potential stock shortages and unforeseen price movements. In addition, the rise of e-commerce has brought a fundamental shift in customer demand. Customer loyalty is dwindling, as client interests now rest primarily with the product. Consequently, businesses are compelled to expand their supply in order to meet this evolving demand. Such shocks and trends illustrate the challenge in balancing cash flow and effectively managing inventory. Especially the pressure on cash flow is troublesome. Each penny put into keeping stock puts pressure on the liquidity. Flexible solutions, such as inventory-based financing, can aid in overcoming these difficulties.

Inventory financing is part of the asset-based finance branch with a medium term where the inventory serves as a pledge for the lender and therefore is driving the credit facility. Due to its nature, inventory-backed loans are more flexible and suitable for growth and seasonality. In general, there is growth in the demand of working-capital solutions and inventory financing is an enabler of this. Although the importance of inventory financing is increasing as a financing mechanism, it's handling is subject to several challenges.

Challenges of inventory financing

Currently, processing and monitoring of inventory-backed loans are predominantly carried out using manually-created Excel files sent by the borrower to the lender. However, manual processing and monitoring of these loans proves to be inefficient and cumbersome. By processing manually, you require both parties to do redundant work which can be automated. Furthermore, the loss in time reduces the resources to effectively adopt a risk-based approach.

The following characteristics show the complexity:

- **Heterogeneity of risks:**
  For example, for stock to qualify as collateral for financing, information about ageing, turnover, perishability, location and characteristics are essential.
- **Heterogeneity of systems:**
  Each company has its own ERP-system and often several sources (e.g. reporting systems, ERP-systems, manual excel files and more) are used to gather data for its report.
- **Composition of inventory:**
  A company may have stock which is perishable and not perishable, stock laying in warehouses abroad or still in transit, have saleable inventory (finished products) or inventory that still needs to be processed (raw materials) and many more.

> "Customer loyalty is dwindling, as client interests now rest primarily with the product."

For a borrower, these characteristics affect the amount of work required for the financing, increase the complexity in obtaining and structuring the entire dataset, and ends up with a result that does not provide insight into how the data is processed and the credit facility is calculated. Substantial effort is put in, but from an analytical perspective, not much on information is gained.

On the lender's side, it decreases the comparability on portfolio level, still requires a lot of analytical thinking to simply calculate the credit facility and reduces possibilities to adopt a risk-based approach.

Most importantly, the lender has to blindly trust that the borrower's Excel files adhere to the agreed-upon terms. It is entirely possible, whether intentionally or unintentionally, for the borrower to interpret clauses differently. This blind trust refers to the fact that the lender does not know what preparations went into the Excel file and thus, cannot know if all clauses are adhered to.

It is apparent that the combination of complexity and manual processing causes a clear problem in manageability for both lender and borrower.

The situation that is outlined, reduces the attractiveness of receiving and providing inventory-backed loans, summarized by the following four challenges.

Extensive administrative costs:
The cost of manually preparing and processing vast amounts of data

Lack of uniformity:
There is no uniform way to handle the heterogeneity of the data and the companies

Lack of analysis capabilities:
Analyzing the vast amount of data is difficult, time-consuming, and occasionally impossible

Lack of transparency:
The lender is reliant on what the borrower provides, but does not know how it was processed. The borrower is reliant on the lender to process the data correctly, but does not know exactly how its credit facility was calculated.

However, there are ways to deal with this using a modular approach.

- Extract data directly from various sources, such as ERP systems or warehouse management systems, in an automated way on daily base. Thus eliminating actions between the extraction of data and the calculation of the facility.
- Structure the raw data using templates for different systems into a standardized data model, enabling automated data processing and comparability between borrowers.
- Use the structured data as input for customizable risk reports and credit facility calculation that can be visible for both borrower and lender in a SaaS-solution.

By extracting data directly from any source, one enhances transparency for lenders. This approach ensures that clauses in credit agreements are aligned with accurate information. Also, the lender knows that the same methodologies are applied to their entire portfolio of inventory based loans.

By configuring the data into a standardized data model, you establish a consistent and uniform presentation of information This allows for a uniform representation of borrowers, regardless of their individual characteristics. This enhances the efficiency and effectiveness of the risk management for inventory financing.

After configuring the extracted data into a data model, the entire workflow can be automated. This significantly reduces administrative costs and enables a higher frequency of data processing. The increased frequency of data processing facilitates more detailed analysis of trends, inventory composition, and longitudinal analysis over time. On top of that, it enables the cash-flow on the borrower side to directly adapt to volatile working capital funding needs. Finally, it provides more opportunities for data plausibility checks and fraud detection.

"This automation of data processing and asset monitoring streamlines operations and enhances risk management capabilities for both borrowers and lenders"

By having a highly configurable SaaS-solution on these structured datasets, one can use a central system for first-line monitoring of collateral. This includes tasks such as detecting accounting errors, tracking unexpected changes in inventory composition, and managing risks associated with the assets. This ensures greater accuracy and reliability in asset management for the lender.

The mentioned modular approach can be offered by Finventory. This automation of data processing and asset monitoring streamlines operations and enhances risk management capabilities for both borrowers and lenders. While inventory financing is on the rise, its characteristics causes cautiousness by both lenders and borrowers.

Finventory strives to boost comfort by reducing the workload, increasing transparency, and enabling more analysis possibilities. This leads to more insight, less risk and more efficiency.

Future publications

This was the first publication from an upcoming sequence of publications related to inventory financing. In future publications, we will further elaborate on the details of the aforementioned concepts like the plausibility of data, trends that can be detected from inventory data and managing inventory related risks as a lender in a digitized way; making this finance solution more bankable.

Want to know more?

finventory21.com
info@finventory21.com
+31 (0) 85 303 73 00