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INVENTORY SECURITISATION

Inventory financing represents an alternative funding source for stock heavy businesses, and provides a valuable liquidity tool for those looking to manage their cash flow position. Amongst other benefits, inventory financing allows capital that would otherwise be tied up in unsold stock/ inventory to be freed up for deployment and growth. Financing solutions can be utilised for a wide variety of inventory types, ranging from ordinary trade/consumer goods and equipment, to luxury items such as champagne, whiskey and diamonds.

Inventory financing arrangements are of varying complexity. Simpler transactions may consist of, short-term loans or revolving credit facilities that are secured over the relevant warehoused inventory prior to its sale to customers, or a sale and buyback of stock on extended payment terms accompanied by a payment guarantee from a well-capitalised member of the group. More complex transactions may consist of the securitisation of the relevant inventory, incorporating a true sale of the inventory to a special purpose vehicle established for such purpose. While an inventory securitisation brings with it a lead time for establishment and associated costs thereof, the isolation of assets from the risk of corporate insolvency brings with it beneficial pricing terms, particularly when contrasted with unsecured inventory financing.

Aside from pricing and speed of execution, another significant factor that will influence in what form inventory financing solutions can be deployed is the presence of permissions and restrictions on the incurrence of additional debt in a company's other financing documents.

Inventory financings differ from trade receivables financings, as it is the unsold inventory itself (and the value thereof) that is the basis for calculating how much may be borrowed, and which forms the basis of the financier's security package. By contrast, trade receivables financings are backed by customer receivables arising from the sale of inventory (where the purchase price therefor is payable by the customer at a future date). However, when securitising inventory, transactions may be structured to also include trade receivables resulting from the sale of such inventory within the collateral pool for the securitisation.

CASE STUDY: DIAMOND INVENTORY SECURITISATION

Inventory financing has been used for a variety of assets, including electronic equipment, medical products, consumer/household goods and foodstuff. One esoteric asset class that collateralises inventory securitisation transactions, and illustrates issues common to such transactions, is rough and polished diamond inventory (and associated receivables). Weil has acted for arrangers of/investors in a number of diamond inventory and receivables securitisation transactions with different underlying diamantaires, including the Diarough group's first 144A private placement deal in 2017.

The securitisation of such easily moveable, high value assets brings to the fore a number of the surmountable challenges that arise in the structuring of various types of complex inventory transactions. The use of experienced legal counsel is therefore essential for the successful completion of such transactions.

Challenge 1: Multi-jurisdictional Assets

In any cross-border asset based transaction, the legal analysis will need to consider a number of key questions in each relevant jurisdiction and the interplay between the requirements of those jurisdictions. Diamond inventory securitisations are true multi-jurisdictional transactions, with the relevant inventory likely being held in numerous locations (such as Belgium, the USA, Hong Kong and Dubai). This brings with it the usual challenge of ensuring that: (i) title to the inventory can be the subject of a true sale to the Issuer SPV under the laws of the relevant jurisdictions; and (ii) appropriate (and perfected) security is created in favour of the securitisation trustee over the inventory located in the relevant jurisdictions. Questions of security perfection become particularly complex when dealing with tangible, moveable and unregistered assets, particularly where assets may move between jurisdictions and be placed on consignment.

Challenge 2: Consignment Arrangements

The use of consignment arrangements with customers (such as global jewellery maisons) is a common feature of the diamond industry, allowing the relevant customer to review the diamonds from a quality control perspective prior to payment. Multi-jurisdictional consignment arrangements require complex analysis to ensure adequate retention of title by the Issuer SPV (prior to payment). For example, when utilised properly, consignment memoranda can help to ensure the Issuer SPV may repossess the diamonds where the consignee fails to pay for or return the inventory.

Additional structural mitigants can include: (i) limits on the proportion of inventory that can be placed on consignment with third parties (including customers); (ii) limits on the maximum value of inventory that can be on consignment with any one individual eligible consignee; and (iii) restrictions on locations in which inventory may be consigned, with any inventory in excess of such limits being excluded from the borrowing base (as described further below).

Challenge 3: Risk of Theft, Physical Loss or Damage

Given the nature of easily moveable, high value inventory such as diamonds and its storage in numerous locations, there is an ongoing risk of theft/improper removal/physical loss or damage, including when inventory is transported. This can be partially mitigated by requiring that relevant insurance policies are maintained for the benefit of the Issuer SPV, with the securitisation trustee being named as a loss payee thereunder.

Challenge 4: Volatility of Asset Prices

Asset prices, particularly with respect to larger stones in the case of diamonds, are subject to price volatility, with price being influenced by supply-demand conditions, inflation and market trends. As well as utilising concentration limits to mitigate the risks of price volatility with respect to the collateral, lenders may require the use of a borrowing base construct. A borrowing base test determines the maximum aggregate debt balance which may be outstanding at a particular point in time, by reference to the eligible collateral balance. A combination of frequent borrowing base testing (as often as weekly), and a requirement to calculate the borrowing base by reference to recent collateral valuations, looks to ensure that a transaction maintains sufficient collateral coverage for lenders on an ongoing basis.

Challenge 5: Illiquidity of Inventory

When considering a book of inventory being financed, certain inventory assets may be more liquid than others. In the case of diamonds, rough are generally more liquid than polished, and smaller are generally more liquid than larger. To ensure inventory collateral can be liquidated in a timely manner and the value of security maximised, lenders can be aided by a combination of structural features, including concentration limits and turnover tests.

FOR MORE INFORMATION

This briefing provides an overview of some common features of inventory securitisations and is not intended to be exhaustive. It does not constitute legal advice and is provided purely for informational purposes. We recommend that you seek specific legal, regulatory, tax and accounting advice for any transactions that you wish to undertake.

Our Structured Finance team is available to discuss any of these issues with you and answer any specific questions you may have. If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below:

JACKY KELLY
+44 20 7903 1045
jacky.kelly@weil.com

BRIAN MAHER
+44 20 7903 1292
brian.maher@weil.com

STEVEN ONG
+44 20 7903 1041
steven.ong@weil.com

EMILY FIRMSTON
+44 20 7903 1340
emily.firmston@weil.com