

**In January, 2010, Brian Cove, Editor-In-Chief of “Secured Lender” magazine, asked representatives for several asset appraisal firms to comment on how the economic downturn has affected their ability to accurately put values on assets and collateral, particularly for asset-based lending deals, over the past year or year and a half. Hilco Appraisal Services was represented by Arnie Dratt, CEO. Joining him were Tom Scotti, President & Principal, Gordon Brothers Group, LLC and Rick Schmitt, Executive Vice President, Accuval Associates, Inc.**

**BRIAN COVE, EDITOR-IN-CHIEF, THE SECURED LENDER:**

What impact has the economic downturn had on the ability of valuation professionals and valuation firms to accurately put values on assets and collateral, particularly for asset-based lending deals, over the past year or year and a half?

**ARNIE DRATT, EXECUTIVE VICE PRESIDENT, THE HILCO ORGANIZATION:** I think, Brian, the answer to your question in some respects depends on how the appraisal firm is structured and how it goes to market. And each of us on the call today has a slightly different footprint both globally and in terms of the assets that we value and their scope.

At Hilco, we have operations in the United States, Canada, Mexico, and Europe which do the same things, but with slight variations. Wherever we value assets, we also tend to trade in them in one respect or another.

So, for example, in machinery and equipment, we have

industrial liquidation groups in four countries. In the aggregate, they conducted approximately 175 auctions in 2009. We also have a group that buys brand names, so we have a group in Hilco Appraisal dedicated to valuing trade marks and trade names. The same for real estate and accounts receivable, just as I mentioned machinery, equipment and inventory.

Clearly, it has been more challenging to value assets in the past 12 months. Take machinery and equipment for example. Macro economic forces have caused many asset categories to plunge in value. That said, in addition to extracting valuation data from historical databases and, in the case of machinery and equipment, dealers, our real-time ability to tap into the sale data of Hilco's own auctions and negotiated sales has given us a more accurate view of current market values.

If you look further at particular asset categories, you'll find, I think, that in the machinery and equipment world, there were assets that literally had no value at some period of time during that first six months of 2009, while other assets had dropped 30, 40, 50 percent in value. There's a further story to tell, which we'll get into later on, and that is how some of those assets have recovered.

**TOM SCOTTI, PRESIDENT & PRINCIPAL, GORDON**

**BROTHERS GROUP, LLC:** The issue is one of demand, and in the first half of 2009 the ability for any of the professionals to measure what demand in the marketplace actually was was a real challenge really for

two reasons. One was to the extent say in the FS inventory opportunities in terms of either the off-price marketplace, even though there may have been a lot of deals available in the market, off-price retailers constrained their open to buy dollars because of the economic downturn. And in addition, in some sectors, because of capital constraints, they cut back those lines even more because they didn't have the access to capital to take advantage opportunistically of those types of buys. So it really was a two-prong issue. One was people pulling back themselves, but also their lenders and capital, access to capital also constrained their demand as well.

**RICK SCHMITT, EXECUTIVE VICE PRESIDENT, ACCUVAL ASSOCIATES, INC.:** I would throw in there that certainly from the standpoint of understanding values, it was a moving target, and, therefore, access to good information was really key in trying to keep up with the changing marketplace. From a machinery and equipment standpoint, the auction environment increased significantly. While we differ in some degrees from the footprint of Hilco and Gordon Brothers, we kept track of the results of over 2,000 auctions throughout 2009 and providing that information to the appraisers upfront and very quickly to make sure that we were getting more of a global view of what was happening.

Likewise, there were a number of failed auctions that did happen out there with respect to some of the home industries where the products had just come to a complete halt, and to a great degree a lot of the equipment in some cases actually sat post-auction and had to wait for

demand to exist in the marketplace.

With regard to real estate, we found that in many cases the ability to predict value and demand was extremely difficult both on a domestic basis simply because there were no buyers in the market, and even those buyers that were trying to take a very opportunistic look at basically bottom figures acquiring real property, once again, you know, similarly the way that Tom indicated, didn't have access to capital to make those opportunities. Real estate continues to be a challenge going into 2010 in predicting when a property would sell along with what its value may be.

On an inventory front, we did see that there were a number of people who were strongly taking advantage of having available cash and to some degree, you know, opportunistic buys that existed in the marketplace found often times more buyers chasing those types of deals in attempts to basically make good purchases. And ultimately the lenders were still willing to advance funds against inventory viewing it more as a liquid collateral. So we felt that there was a little bit less difficulty in terms of trying to check those values, especially for certain what I would say retail oriented industries where the products still seemed to move.

**COVE:** are there certain types of assets or collateral that have proven to be more challenging to get an accurate valuation on in the kind of current economic situation we've been experiencing?

**DRATT:** I think if we're talking about machinery and equipment, we would focus on three categories: large metal stamping,

plastic injection molding and thermoforming.

**COVE:** Is that mainly due to troubles in the auto industry?

**DRATT:** I was going to say particularly as they relate to automotive. On the other hand, based on our auction experience in the last 120 days, we have seen a relative bottoming-out or pick-up in some of these assets, particularly those assets which are newer.

As Tom I'm sure will agree, because Hilco and Gordon Brothers often partner on large retail inventory disposition transactions, when you look at the whole universe of assets to be valued, the one that has the most data points would be the easiest to value. In my mind that would be retail inventory, wherein an appraisal is essentially an equity bid.

We saw that to be true almost without exception over the last 15 months. Except for one deal we bought shortly after the crisis began in early October, 2008, and which came to market in November, no matter which asset in the retail space was being sold, our models, by and large, held up.

As Rick mentioned, the machinery and equipment space also is replete with data points, lots of auctions and, therefore, we have an ability to look at and see the bidding on certain assets, As he also mentioned, there are some assets that don't sell, and, therefore, you turn to the dealer market where the information can be a bit murkier.

We have also found a third level of valuations, where certain kinds of equipment have gone offshore, so there are no U.S. buyers. Take, for example, another industry that's been impacted by technology,

which is newsprint and paper products. Values continue to fall, and I think that's pretty much a global story. So, if we're asked to appraise a paper mill, the number is going to be substantially lower, and, in fact, it may not move at all. There are lots of idle paper plants in Canada and the United States.

**SCHMITT:** I'll basically echo those thoughts and throw in a story about another industry. Certain chemical industries, which are process oriented facilities much like paper plants, as well that have assets that are relatively illiquid and in the past have been lent against more on the basis of cash flow versus the removal value of collateral. In many cases, we've seen some widely fluctuating commodity values that have caused industries to turn upside down overnight.

One interesting story that's out there is ethanol, where we saw the prices of gasoline trading up around \$4 a gallon, in that particular case, the oil companies and a number of the ethanol were blending in ethanol products in at 10 percent of value, and literally the plants were running at full complete capacity and selling every drop they could produce. And then almost overnight, the value of gasoline drops down to under \$2 a gallon, which is in excess of the cost of what many ethanol plants can produce it, and as a result of that, that industry turned upside down, and almost everyone in the industry was bankrupt.

So where you have widely fluctuating commodities which are the basis for oftentimes heavy capital investment plants, you know, the problem was is that values and the interest in the market for purchasing

those assets could change oftentimes overnight, thus, you know, creating a very challenging environment to peg a value.

**SCOTTI:** One area where we saw some decent resiliency in prices for equipment was in food processing, and you have to go back to the basics. People still have to eat, and so to the extent companies had an opportunity to upgrade their machinery in food processing in terms of newer vintage machines and lines they could take advantage of opportunistically, that they found the capital to take advantage of and to upgrade their production so that they could take advantage of those deals. It was, you know, people -- you know, the basics come into play, people have to eat, and that was one area where we saw some decent resiliency from a value standpoint.

**SCHMITT:** If you look at the largest ABL deals of 2009, you would see that most of those were food processing oriented companies, like Tyson and Pilgrim's Pride. Companies that were traditionally cash flow based moved from that over to ABL categories and were some of the successful syndications in 2009.

**COVE:** You guys aren't lenders but from your perspective, what impact has the challenges of getting accurate valuations in this environment had on lenders' willingness or ability to make loans, particularly in ABL?

**SCOTTI:** Particularly in any of the leveraged retail deals, there was usually a double whammy. One was a lot of the structures had become quite aggressive over time, lending an A or an A+ against an

asset pool, and then so they were overextended on their formulas from a structure standpoint, and then, of course, the values did go sideways for the most part, at least early on in the retail space until the consumer convinced us that they would show up at the sale events.

So it really was a double whammy from a liquidity perspective for a lot of these highly leveraged retailers. Many of them went away, the Linens 'n Things, Circuit City. There's a half dozen other ones that you could name. So a lot of these balance sheets had to be fixed. They had to cut back on their capital expenditures and get back into alignment over the last, you know, 15, 18 months.

**DRATT:** It's probably evident, but I would say the impact of lower values on assets that form part of the borrowing base is that the advance a lender could make against those assets goes down. We see this both in our own work and in the comments that come back from lenders to us.

When you look at the large syndicated ABL market today and compare it to a year and a half ago, there are far fewer deals being done of the size that we once saw. The buoyancy of that marketplace meant a lender could do a billion dollar ABL pretty quickly.

**SCHMITT:** What we saw is that lenders were certainly had their feet burned, if you will, by the dropping values in a lot of the machinery and equipment and real estate markets. And as they moved and became unwilling to advance against term debts of any companies, they turned towards financing receivables and revolvers for the new

transactions. Some lenders just made bold statements saying we're not doing term debt.

As a result of that, there were a lot of companies that could not find the capital to advance their capital expenditures or even take opportunities to acquire some other distressed companies in these down times. Basically the whole market shrunk substantially.

**DRATT:** One thing I'd add to what Rick just said, from the exit perspective, if you're either an appraiser doing a liquidation analysis with a strategy or you are actually the liquidator, there's no longer a world of orderly liquidations. Today, it's all about forced liquidations.

Hilco, like others today, is not willing to hold a deal for six months. We'll go in and buy on the machinery and equipment side, but the auction is going to take place within 90 days of the day we bought. And, at one point in 2009, between the Chrysler and the GM bankruptcies, we stopped buying and we held to fee and commission deals for about three months beyond that before we started to buy again.

So NOLV is a nice concept that works in the ordinary world. In the so-called new normal, I'm sure that NOLV is really more akin to FLV.

**COVE:** How has the large number of business bankruptcies in the past year affected the liquidations business?

**SCOTTI:** It's really a tale which has two parts because, initially right after the onset of a financial meltdown, I think the entire liquidation community was extremely busy with transactions as banks and

other entities dealt with the implosion of the marketplace. And there was, the first six months after the meltdown, there was an extraordinary amount of activity. I have one client, one lender, who probably had a bankruptcy a week from January 1<sup>st</sup> through March. That's how active that portfolio was in terms of dealing with restructuring.

Over the last six months, however, at least as it relates to consumer products and retail, there's been a dearth of activity. All those highly leveraged situations were dealt with early on by the lenders, and for the most part even with a middling to slightly above average holiday season, with the exception of a couple weak companies, which you always seem to have in almost any economic environment, it's been very, very quiet. There has not been a rush of bankruptcies post-holiday this year like you saw last year.

So most companies' balance sheets are in okay shape as a general rule, at least in terms of getting through this past holiday season. So it's been rather quiet in general in terms of at least what I would call the large liquidations.

**DRATT:** I'd like to add two things to what Tom just said. One concerns the retail sector and the other touches on intellectual property that flows from that.

In the first six months of 2009, as Tom correctly points out, there were an enormous number of very large retail liquidation transactions, and Hilco and Gordon Brothers wound up partnering on any number of bids. Some were won, others were not. I think one of the

interesting consequences of that flood of transactions was, if you will, a question as to whether the service providers were equipped to handle the volume of liquidation work?

If two or three huge deals came down and then a fourth one followed, it's questionable where the resources would have come from, both capital as well as manpower to handle the work. We spoke to a number of lenders about that. I think, today, the market is quite different.

Another thing that fell out from these liquidations was the interest in and value of trademarks and trade names. We've partnered on a number of them, including, most recently, Polaroid. Even though Polaroid is a consumer brand, not a retailer, we have found that there is substantial value in the name and we paid it.

Several years ago lenders, ABL lenders competing against cash flow deals were stretching the envelope a bit to lend against intellectual property. I think, by and large, intellectual property has come out pretty well in terms of holding value. Tom, you have a perspective there?

**SCOTTI:** I do. What I find interesting is, as you mentioned, there's some good examples, Polaroid being one, Bombay, Sharper Image, where brand names have come to market and there's been bidding, though the number of bidders has been reduced over the past year or so as the hedge funds and other players, financial players, have sort of dropped out of the marketplace.

Having said, that, even though there are these very good

examples of some significant value being generated from an auction in bankruptcy, I think that lenders have become much more cautious, certainly senior lenders have, against lending into that asset class. So your tranche B lenders, perhaps your mezzanine lenders, to the extent there is a mezzanine market at all, might find that there are some good data points but the liquidity is not really there.

**SCHMITT:** I would say that we've also seen situations where, in the assets that we've liquidated, that there has been more interest in the aggregation of volume. Where people were not necessarily interested in the value of the equipment and the real estate because they had underutilized facilities, they were interested in acquiring some of the intangible assets and sums of smaller categories that were just talked about by Tom and Arnie, things such as URLs, things such as computer software, things such as tooling, that was sitting at vendors in China.

And, again, trade names and trademarks as well as blueprints where companies had the opportunity to acquire for what they perceived as relatively lower prices to acquire basically the intellectual property of a company that went out of business because they were overleveraged. We absolutely have seen companies, you know, where they have been liquidated, where those assets have garnered a lot more interest than in past.

**COVE:** What do you see for the industry in 2010? Will it be the same as 2009 or do you expect things to be different?

**DRATT:** It's very hard, obviously, to speak for the lenders.

So I don't know what the ABLs will be doing, what their capital constraints will be, or what deal they work out with the Obama administration and the Congress. But, assuming there is capital in the banking world to lend, and they want to make reasonable advances against assets, Hilco expects equipment values to recover slowly over the course of the year. We have seen that in spades in the last 120 days in machinery and equipment. And, as mentioned before, I think lenders who did not get updates or collaterals on their machinery equipment valuations within the last year, depending on the category, will be surprised to find out that their worst fears have not been realized and that there actually may be a pick-up from the depressed valuations of a year ago.

Inventory remains an interesting story because, as Tom mentioned, many retailers and other consumer products and industrial companies have done a very good job of managing inventories down. I recently had a cup of coffee with the head risk manager for one of the country's largest banks, who told me that he has never in his lifetime seen a deleveraging of inventory by his clients to the extent he has in the last 18 months.

That said, a lot of ineligibles should be cleaned-up and the buying base for inventory going forward may be a lot cleaner than it was 12 to 18 months ago. Also, there are probably fewer customers for the inventory and the liquidation. So, it's kind of a yin and a yang. There's a positive story and then there's a potential negative story as well.

With regard to intellectual property, we are still bullish buyers,

we are interested buyers at reasonable prices, and we find that our success in achieving licensed revenue is quite good despite the lowered activity that we see in the States. And we're doing this globally, not just in the United States.

Some countries are reacting better than the U.S. and some worse. Mexico, where we have quite a large office, has been impacted even worse than the U.S., but Canada, in many respects, has been impacted far less than the United States.

**SCOTTI:** Now, one of the big unknowns about the level of activity in 2010 has to do with private equity and where they are in the equation because historically they drove a lot of the transactions, the M&A activity and so on that we helped support historically. Right now, private equity has a lot of money sitting on the sidelines and there's starting to be a tremendous demand by folks to start to put that money to work on deals because over the last 12, 18 months, they really have been sitting on the sidelines determining that it's better off doing no deals than doing risky deals. And if in 2010 things start to stabilize, that money is going to start to be put to work.

**SCHMITT:** I think that we have certainly seen many of the clients clean up their balance sheets and reduce their inventory levels, in many cases taking advantage of getting rid of some excess and slow moving inventory. So as a result in many cases, their balance sheets are a bit healthier and, again, there is an opportunity in some cases to add additional coverage as lenders remain very interested in that category for

ABL transactions.

From an equipment perspective, we also talked to a number of the large lenders that are out there and they all indicate a desire to go back into term lending as a means of growing their business because certainly their portfolios have shrunk. They all are sitting a bit idle on the sideline waiting for the final bank regulations to be published relative to capital but certainly some of the smaller finance companies have been active throughout 2009 and will be more active in 2010 in making some term loans and, like Arnie, we have seen some recoveries in equipment values and many lenders with some, even with a level of conservatism against the value of the machinery equipment can be more successful at winning deals, new deals from competing lenders by just putting their toes back into the term debts specifically on the equipment side, and there is certainly a market for equipment in the event of a liquidation.

So we look at the marketplace in 2010 and see that it is probable that while a lot of the valuation work in 2009 was portfolio related, lenders trying to decide, where am I, what are the values of the assets that I have already lent against, we see that that will transition hopefully into more new funds going out in 2010 and we still expect that the valuation market will be strong. And, likewise, as there becomes continuing evidence for the value of intellectual property, that selling in auction environments we expect that lenders will continue to look at that or will begin to look at that again as being a part of the boot collateral for some of these transactions.

**COVE:** Very interesting. Thanks to all of you for sharing your insight and perspectives with our readers.