

BUSINESS INSIGHTS

Asset Valuations Across Global Jurisdictions

The Secured Lender's Perspective

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While the concept of an orderly or forced liquidation value is interpreted similarly across the globe, the practical considerations underpinning these definitions vary broadly across different countries. A deep understanding of the local commercial environment, as well as enforcement customs and procedures, is essential to a sound valuation and proper collateral-risk underwriting in cross-border secured loans. (Editor's Note: This is part 2 in a 3-part series. Part 1 was published in the October issue.)

"The value of a thing, is the price it will bring." — Fred Case, Emeritus Professor, UCLA Anderson School of Management

An essential element of underwriting risk for a secured loan is a reliable valuation of the pledged collateral. Ultimately, what a secured lender needs to know is quite simple: how much will someone pay for my collateral in an enforcement process? That is a plain question, but when it comes to cross-border secured loans, the answer is hardly straightforward.

The two primary valuation metrics used in asset-based lending (ABL), Net Orderly Liquidation Value (NOLV) and Forced Liquidation Value (FLV), are, by and large, interpreted consistently around the world. Almost everywhere, professional appraisers adhere to the fundamental concept adopted by leading organizations such as the American Society of Appraisers and the International Society of Appraisers. Thus, virtually everywhere that secured loans are made, NOLV means a sale conducted under orderly conditions over a defined period of time and within the economic trends existing at the time of the appraisal, and FLV denotes duress — a sale on an as-is, where-is basis as of an arbitrarily imposed date which bears no relationship with value maximization.

Beyond these basic conceptual commonalities though, notions such as an "orderly" sale or a "compelled" sale are unique to each country. Like politics, all valuations are local.

Although the list of factors affecting value in different jurisdictions is very broad, there are primarily three critical elements to consider in cross-border secured loans: the location of the collateral, the time it takes to enforce a loan, and whether local political and social dynamics affect legal outcomes.

Another material risk factor in cross-border loans worth mentioning is the existence of restrictions on the repatriation of funds by foreign lenders. While this is not per se a valuation element, and thus beyond the scope of this article, we note that the advance rate must account for any controls or assessments (e.g., withholding taxes) on the transfer of funds outside of the enforcement jurisdiction.

Location, location, location

A critical element of a sound cross-border appraisal is a keen understanding of the collateral's marketability and demand, locally and abroad. This is of particular importance if the assets are transportable. A valuation cannot consider comparative global sales in a vacuum. Instead, it must consider the context of demand for each asset regionally and globally. The level of demand and high economic activity encountered in developed markets like the United States and Europe is not present in many other regions of the world. Recovery expectations must be adjusted to account for



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Key Points

- 1** ABL collateral valuation metrics are consistent across the globe.
- 2** However, the practical application of common valuation standards differs across jurisdictions.
- 3** Cross-border secured lenders must understand the range of commercial and legal options available in each country in which their collateral is located.
- 4** The most critical elements to consider in cross-border secured lending are the location of the collateral, the time needed to enforce a loan, and any local political and social dynamics that may affect enforcement.
- 5** A cross-border valuation is as much art as it is science.

the fact that, in many places, there will be little or no demand for the pledged assets. If the assets are likely to be of interest solely to non-local purchasers, the valuation must make full allowance for the risks and costs that potential buyers will consider when bidding for that collateral (e.g., export costs, accessibility, removal costs, reliable transportation, etc.). The rule of thumb is that the more restrictive the system or remote the location of the assets, the greater the additional costs and risks that would be incurred by prospective buyers. While most valuations make broad assumptions regarding sale strategies, in the cross-border context, the appraisal should address any unique factors that may affect value in a more exhaustive fashion.

Furthermore, even when assets are expected to be sold locally, the particular market dynamics are of acute importance. A good case study to illustrate this point is wholesale inventory. This type of collateral is particularly reliant on available sale channels. In the United States or Europe, there are many well-established institutional off-price retailers. However, those do not exist in many parts of the world. Instead, most off-price goods are channeled through small regional retailers or individual stores of the “mom and pop” variety. In those locations, it is crucial to understand the capacity in each market to absorb large volumes of inventory at any one time and to adjust the sale period to the time the local market would reasonably require to process these goods. Or the valuation must take into account the sale to existing “full-price” retail channels, considering the constraints of seasonality and shelf space availability. This is but one example of the type of collateral and dynamics that are often taken for granted by appraisers and lenders alike in more developed ABL markets.

Expense considerations

A reasonable estimate of enforcement expenses is an essential element of an ABL appraisal. In addition to well-developed concepts like “carve outs” in US Chapter 11 cases to the “prescribed part” in UK insolvencies, a valuation must account

for the variety of other costs that the lender will be forced to incur to conduct an orderly sale of its collateral. Again, it is vital for a lender to have a full understanding of everything it will encounter along the way, including statutory costs, expenses germane to each jurisdiction, and the specific type of assets comprising the collateral. Of particular importance are statutory expenses such as labor, tax, and similar claims, which in many jurisdictions have priority over prior-recorded liens. This also relates to specific critical vendor obligations which may raise to a different level of importance depending on the borrower’s location and available alternatives.

The time from default to a sale

Another key element of any collateral value assessment is the expected time to convert the pledged assets into cash proceeds once the secured lender can enforce its rights. While a possessory security interest will generally (but not everywhere) allow for a quicker sale, every legal system has a different number of hoops to jump through before a lender can dispose of its collateral. Moreover, what is orderly in one country may look like a forced sale in another. And forced does not necessarily mean rushed. For instance, in many countries (mainly civil law jurisdictions as commonly found in Latin America and continental Europe), it may take years for the sale of the collateral to be authorized, yet once that milestone is reached, the sale must happen within a very limited (and often arbitrary) period of time.

Such disparities require a profound understanding of the lender’s right to force, or at least cause, the sale of its collateral on a jurisdiction-by-jurisdiction basis. In some countries like the United Kingdom or Australia, a lender generally has the right to unilaterally, and without court supervision, select and appoint an administrator or other fiduciary to sell its collateral after a default goes uncured. In these jurisdictions, the lender-appointed administrator can even operate the underlying business for the sole purpose of disposing of the collateral. Conversely, there are many countries (mainly civil law jurisdictions as noted above) where a secured lender is powerless to enforce its rights without undergoing a lengthy judicial process. Similarly, many of these countries’ laws impose restrictions on auction sale prices which are tied to valuations conducted by court-appointed appraisers (not selected by the lender) with little or no practical understanding of the market for the underlying assets. Most other countries’ practices fall somewhere along this continuum. A deep understanding and assessment of the local enforcement process, customs, and their impact on the conversion of assets into proceeds is essential to a trustworthy cross-border valuation.

Legal, political and social considerations

Every country with active commerce possesses some form of secured financing and insolvency courts to adjudicate rights

between debtors and creditors. However, for secured lenders accustomed to traditional ABL underwriting benchmarks, this is where the similarities end. There are countless dynamics that affect enforcement in each legal system, many of which are extraneous to the written law or the four corners of the loan agreement. Many of these factors are driven by political and social conditions. One typical example is the presumed priority of labor claims over secured creditor rights, even if not written into the law. Another is the unwillingness of many courts to allow the enforcement of rights against key operating assets of a borrower, even if not included in the borrower's insolvency proceedings. In addition, the U.S. Chapter 11 concept of adequate protection, which is entrenched in traditional ABL underwriting, is not afforded to secured lenders everywhere. And there are many jurisdictions where courts will not look kindly at contractual penalties and default interest, even if the borrower was highly sophisticated and had other funding options at the time it agreed to those terms.

It is not the onus of a valuation to address all legal, social, and political factors that may affect risk. Nonetheless, in the increasingly global footprint of many asset-based loans, it is incumbent upon the appraiser to be acquainted at a minimum with the specific traits of the legal and political system that will govern disposal of the collateral being valued. That knowledge should be a part of any well-thought-out appraisal involving assets in cross-border facilities.

Conclusion

In summary, while valuation theory is mostly consistent across the globe, asset recovery expectations vary wildly by location. There are a multitude of factors to consider, some of which may matter in one jurisdiction and not at all in another one. A prudent cross-border lender should not rely on the

conclusions of a valuation without being fully satisfied that every foreseeable hurdle indigenous to the collateral location that may affect recoveries has been accounted for. ■

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