Inventory is a Snowflake

Why Lenders Must Monitor Inventory Collateral Regularly

Inventory is often best understood through analogy. One useful comparison is a snowflake: no two are exactly alike. In lending, inventory often plays a crucial role as collateral for businesses seeking financing. It is a key asset used to support repayment in a downside scenario. However, unlike other types of collateral, inventory is inherently complex and variable, making it unique. Just as every snowflake has its own distinct shape, each inventory, whether in a retail store, warehouse, or manufacturing facility, has its own set of characteristics that shift over time. This distinction highlights why lenders need to monitor inventory regularly, as these nuances can significantly impact collateral value and lending risk.

The Snowflake Analogy

At first glance, comparing inventory to a snowflake may seem unusual. After all, snowflakes are delicate, transient structures, while inventory represents physical goods. However, the analogy serves to emphasize the uniqueness and ever-changing nature of inventory. Snowflakes are shaped by various environmental conditions, and their formation is influenced by temperature, humidity, and atmospheric pressure. Similarly, inventories are shaped by numerous internal and external factors, such as market demand, product lifecycle, and seasonality. Each inventory has distinct characteristics, whether it's the product mix, age, or storage conditions, making it different from others, even if they are in the same industry or sector.

Just as no two snowflakes are identical, inventories differ in composition, condition, and marketability. One company may have a diverse range of high-end, slow-moving products, while another may focus on fast-moving consumer goods with a high turnover rate. The value of each will depend on its composition, reliance on products subject to tariffs, condition, pricing/discounting, and marketability. These variables constantly evolve, meaning the value of inventory collateral can fluctuate over time. Lenders cannot afford to treat all inventory the same, nor can they assume that a company's inventory will retain its value without regular reassessment.

No two inventories behave the same, even within the same industry.

Same Industry, Different Liquidity

In practice, we often see situations where two industrial distributors carry nearly identical reported inventory balances within the same sector yet perform very differently in liquidation.

- **Company A** carries standardized fasteners and hardware with broad secondary markets.
- **Company B** carries customized, project-specific components tied to a limited group of contractors.

On paper, both inventories appear similar in size and gross margin profile. In liquidation, they behave very differently. Company A's inventory has wide buyer appeal and relatively stable pricing support. Company B's inventory requires discounting and longer marketing periods because much of it is project-specific and less transferable.

Company A	Company B
Standardized products	Project-specific components
Broad secondary markets	Limited buyers
Stable pricing support	Requires discounting

Same industry. Same reported balance. Very different recovery profile.

Variability in Inventory

One of the primary reasons why lenders need to monitor inventory is its inherent variability. In the case of physical goods, the items themselves can change in value based on a wide range of factors. Product obsolescence is one example: technological advancements or shifts in consumer preferences can quickly render a product obsolete, leading to a decrease in its value. For instance, in the electronics industry, a phone model that was once highly sought after may become outdated within months of a new release, resulting in a decline in value for the inventory containing the older model.

One important aspect of monitoring is the age of the inventory. As time passes, older inventory may need to be discounted, or businesses may need to offer promotions to move products that are no longer in high demand. Lenders who are attuned to these changes can adjust their lending terms accordingly, reducing risk by ensuring that the collateral remains liquid and valuable. Moreover, if lenders notice that a business's inventory is becoming overstocked or stagnant, they may need to intervene or restructure the terms of the loan to mitigate the risk of devaluation.

Aging vs. Obsolescence

Consider two manufacturing borrowers, each holding approximately six months of finished goods inventory.

Borrower One

Produces consumable replacement parts tied to a large installed equipment base.

Borrower Two

Produces components for a platform that has recently been redesigned.

Both inventories show similar aging schedules. However, the first borrower's parts remain in steady demand due to maintenance cycles and installed-base support. The second borrower's inventory becomes slow-moving as customers transition to the updated platform.

> **"The aging looks similar. The liquidation risk is not."**

Similarly, the condition of the inventory can vary. Perishable goods or products with a limited shelf life, such as food and pharmaceuticals, as well as fashion items with seasonal cycles, lose value over time if not sold quickly. Inventory that is damaged, outdated, or in poor condition will be worth much less than fresh, well-maintained stock. For lenders, this presents a risk: the collateral value is not static and can change unpredictably.

Market Dynamics

Market dynamics also affect inventory values. Prices of raw materials fluctuate due to changes in tariffs, supply and demand, which directly impacts the value of finished goods. Tariffs continue to influence supply chains in uneven ways. Manufacturers adjust sourcing, suppliers reprice inputs, and customers reassess purchasing decisions. Some borrowers stockpile inputs. Others shift sourcing domestically, while some delay capital expenditures. The impact of macroeconomic factors, such as inflation, tariffs, supply chain disruptions, and geopolitical events, can also influence the cost of inventory. Because of these dynamics, lenders must regularly track market conditions affecting inventory valuation to ensure the collateral remains sufficient.

Regular Monitoring of Inventory Collateral

Given the variability and complexity of inventory, lenders must be proactive in monitoring this collateral regularly. It is not enough to assess the value of the inventory at the time of the loan origination and assume that value will remain unchanged. Frequent, ongoing assessments are necessary to account for fluctuations in inventory composition, market conditions, and the physical condition of the goods.

Inventory monitoring can take many forms, including physical inspections, periodic inventory counts, and the use of technology such as RFID (Radio Frequency Identification) systems and barcode scanning to track the movement of goods. By implementing these tools, lenders can gain real-time insight into the quantity and quality of the collateral. In addition, lenders can require businesses to provide updated financial statements as well as inventory valuations, to maintain transparency and ensure the ongoing viability of the collateral.

Conclusion

Inventory, like a snowflake, is a unique and constantly changing asset that poses challenges for lenders. No two inventories are exactly alike, and factors such as product composition, tariffs, condition, market dynamics, and aging all affect their value. To maintain adequate collateral coverage, lenders must regularly monitor inventory. Without frequent assessments, lenders risk overestimating the value of inventory and exposing themselves to greater risk. By staying engaged with inventory and market shifts, lenders can better manage variability in collateral value and ensure the financial security of their loan portfolios. As with snowflakes, careful attention to the distinctiveness and fluidity of inventory will help lenders navigate the complexities of using inventory as collateral in the lending process.

About the Author: Mike Goldstein is an Executive Managing Director with Heritage Global Valuations, based in Boca Raton, Florida. He has over 30 years of experience in the appraisal and liquidation industry specializing in manufacturing, wholesale, and retail inventory appraisals. HGV delivers independent valuations of industrial, wholesale, and retail inventories and machinery and equipment with a focus on how assets convert to cash under real market conditions. We do not originate loans, and our analyses are designed to help stakeholders understand liquidity, time-to-sell, and net recovery drivers.