GattiPavesiBianchiLudovici

NEWSLETTER DEBT FINANCE

Inventory Financing and other working capital tools – The Italian boost in a growing market

1. The inventory chain – A market to watch out for

Inventory management is a critical factor in a company's financial health and operational efficiency. In fact, it requires multiple variables to be considered, first among all, the readiness to meet the demand and maximise its sales volumes without suffering the financial effects of slow-moving seasons and consequent fluctuations in cash flow. Additionally, a company may want to collateralise its inventory to gain access to credit facilities at more favourable terms.

Businesses may rely on inventory financing and other non-debt working capital tools to manage all such variables.

The global inventory financing and destocking market is experiencing a sharp growth, with expectations around $ 558.7 billion by 2033, at around 10.5% CAGR[1]. This is due to several factors, mainly depending on the supply chain dynamics, such as the growth of e-commerce activities, focus on sustainability in sourcing and production and related working capital requirements, others related to the development of complementary markets, such as artificial intelligence, blockchain and IoT (Internet of Things) and other factors, mostly related to a widened and tailored range of financial products, made available not only by traditional banks but also by alternative lenders. Such

[1] *ALLIED MARKET RESEARCH, Inventory Financing Market by Product Type (Inventory Loans, Inventory Lines of Credit and Others), Organization Size (Small and Medium-sized Enterprises and Large Enterprises), Distribution Channel (Online and Offline), and Industry Vertical (Retail and E-commerce, Manufacturing, Pharmaceuticals, Food & Beverage and Others): Global Opportunity Analysis and Industry Forecast, 2024-2033"*, 2024.

deployment has been observed rather vertically, by both industry (as it involves not only "traditional" sectors such as food & beverage but also retail and e-commerce, manufacturing and pharmaceuticals) and organisation type (going from SMEs to large corporates).

2. Inventory financing and destocking – What this is all about

Both inventory financing and destocking focus on inventory, but they serve distinct purposes. Indeed, while inventory financing enables companies to secure loans using inventory (irrespective of how fast moving such inventory is) as collateral, destocking transactions, on the other hand, involve the sale and/or liquidation of inventory, often through bulk sales, to release cash tied up in the assets.

More specifically, inventory financing transactions consist in financing granted in various technical forms, such as term loans or (and most often) revolving credit lines to enable companies to effectively manage their working capital needs and purchase products and materials which will be processed and sold at a later date.

Inventory financing is an asset-based lending (ABL) product, as the features of the loan are ultimately linked to the type, value and turnover of the inventory, as underlying assets used to secure such loan. In fact, from the lender's perspective, the risk perceived and, on turn, the envisaged return, on an inventory financing transaction depends on a number of factors, such as the industry and business cycle and the fluctuation in value of the inventory (including in the context of transformation and resale), as well as the capability of the lender to keep monitored such factors. This has definitively an impact on the terms and conditions of the financing, including the amount, pricing and tenor of the loan. Needless to say, a key element of the equation is the type and strength of the security which the borrower can grant on the inventory over time.

Destocking transactions, on the other hand, will require a true sale of an *ad hoc* inventory (typically a slow-moving inventory of hard assets, semi-finished or be-spoken products) with a transfer to an unrelated purchasing entity of the control over the assets (as this term is used in accounting standards), with consequent derecognition from the company's balance-sheet. In other word, destocking transaction generates working capital (revenues from the sale of assets, without incurring any financial debt) and improves the cash flows and the balance-sheet of the same company. From a purchaser perspective, the upside might be secured by the margin arising from the trading activity of the purchased assets.

Like many asset-based and working capital experts will tell, one of the key elements of those transactions is the monitoring and tracking of the inventory, as well as the ability of a lender or an asset purchaser to enforce its rights efficiently. Under such perspective, the digitalisation of the businesses and of their respective supply chain will be the relevant factor - for the counterparty - to reduce the operational (or fraud) risk of a transaction.

3. The revised Italian legal framework and blockchain – Does it make inventory more attractive for the stakeholders?

Inventory financing, in its general structure, is not new in the Italian supply chain market, even if more utilised in some industries utilising agriculture products, raw materials and semi-finished metal, plastic and paper products. In this context, subject to a few and specific exceptions, lenders have become familiar with the "possessory" pledge provided by the Italian civil code (which however entails some level of control on the warehouses) and the special privilege for term financing

pursuant to Article 46 of the Italian Banking Act, both such instruments known to be cumbersome and time consuming as a matter of perfection formalities and ongoing maintenance of the security. This has ultimately ended up in limiting the use of inventory financing in certain sectors where stocks can be warehoused for a sufficiently long period of time before being transformed or sold to customers.

Recently, the Italian legislator has finally introduced the long-awaited "non-possessory pledge" (NPP) and made the legal framework more palatable for foreign investors, which are long accustomed to the UK floating charge. We can expect that this legal instrument, in combination with the use of innovative technologies – such as IoT, blockchain and the so called "smart contracts" – for the ongoing management of the collateral, fits the purpose to bring the Italian inventory market in line with the global trend of growth.

Compared to traditional security package, the NPP presents several advantages, both on the lender and the borrower's side. In fact, beside the absence of dispossession and the revolving nature of the security – as the debtor, while retaining possession of the pledged inventory, will also be able to transform and dispose of it in the context of the company's business – the NPP can be constituted on a wider range of movable assets (excluding registered movable assets, *i.e.* cars, ships, aircrafts… but not their spare parts….), as well as intangible assets, receivables and cash, unlike the traditional Article 46 special privilege, which can only be established on unregistered movable assets intended for the company's business.

The ongoing monitoring tools and safeguards available to the lenders, which are ultimately aimed at balancing the non-possessory nature of the instrument, are particularly noteworthy. In fact, each NPP shall be registered in a common register (regardless of the place of business/registered office of the pledgor or where the collateral is located), which can be consulted by creditors. Additionally, the secured creditor may seek protective measures or injunctive relief in the event of abuse in the use of secured assets by the debtor and benefit from simplified out-of court enforcement involving, at certain conditions, the sale, lease or appropriation of the collateral up to the secured amount.

In this context, fintech may give further uplift. Innovative technologies applied to financial contracts allow creditors and investors to monitor the production chain, the origin and quality of goods, the consistency and value of inventory and the transfer of the assets.

As to the destocking transactions, the relevance of the non-possessory pledge is indirect. In fact, since the transaction is based on a true sale of assets (as opposed to a credit transaction), the purchasing entity will become the legal owner of the assets. In turn, it may well be that such purchasing entity might wish to finance its trading activity by granting on the same assets a non-possessory pledge in favour of its debt providers.

It is also worth highlighting that the new Italian accounting principle OIC34 on revenues is applicable as of 1 January 2024. This means that the accounting and legal structure of such transactions for companies applying the Italian accounting principles will need to achieve, among others, a substantial transfer of the risks and rewards relating to the sale to the purchasing entity.

4. Conclusions

Inventory financing and destocking transactions are valuable tools for effective inventory and cash flow management for the companies and might become a new asset class for alternative fund managers. Inventory financing allows companies to unlock cash without selling assets, while destocking directly converts inventory into revenues. Each strategy comes with benefits and risks

and lenders and investors must carefully assess the market position of the relevant companies, their financial needs and operational goals to determine the most effective approach. Together, these strategies offer the companies the flexibility to remain financially agile and responsive to market changes and to the lenders the opportunity to place innovative products without foregoing their credit protection.

We remain available for any further information.

GATTI PAVESI BIANCHI LUDOVICI

Debt Finance

Andrea Novarese andrea.novarese@gpblex.it

Marc-Alexandre Courtejoie marcalexandre.courtejoie@gpblex.it

Tiziana Germinario tiziana.germinario@gpblex.it

Carolina Caslini carolina.Caslini@gpblex.it

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