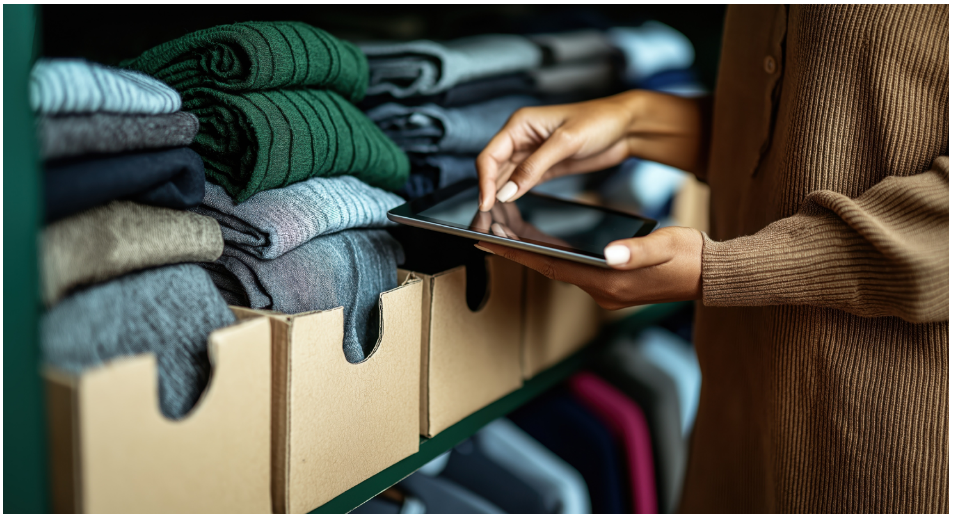
SMARTER PERSPECTIVE: APPAREL

Understanding How Apparel Inventory Characteristics Impact Appraisal Net Orderly Liquidation Values

By Stephen D'Aquila

April 2025 This primer is intended to assist asset-based lenders in better understanding many of the complex characteristics of apparel borrower inventories and how they factor into appraiser determinations of net orderly liquidation value. We also call out some important considerations for apparel companies relative to the recent and pending imposition of tariffs by the current U.S. Presidential administration.



GENERAL LENDER CONSIDERATIONS:

Seasonality: How does the time of year impact the type of product that is in stores? A Lender should be aware of how stocking spring/summer apparel (e.g., t-shirts and swimsuits) versus fall/winter apparel (e.g., sweaters and jackets) impacts costs and should account for the differential between the items typically being sold during each of those periods.

Turn Rates: Is the borrower's inventory selling through each season? If not, what percentage is being packed away to sell the following year? What percentage is being marked down, and at what level of discounting for more fashionable versus basic offerings?

Aging: A lender should be well informed as to the inventory mix of fast fashion versus classics or basics (e.g., white tee shirts and jeans) as well as replenishment items versus one-time program merchandise. Are distribution centers being used as a pass-through avenue to get merchandise directly to the store as quickly as possible versus storage and pack-away facilities? The appraiser will utilize an inventory aging report by seasonal code, which provides insight into what is on hand for the present season (current and previous year's merchandise) versus other seasons, and how marketable that merchandise will be.

Sizing: Appraisers examine inventory by size versus sales by size. Sizing may not be consistent from one manufacturer to another, and sizing accuracy affects return risk. Additionally, when consumers do not understand the sizing, they are less likely to buy online. Does the size assortment align with demand? If most customers buy the large and extra-large sizes but the inventory on hand is heavily skewed to the medium size, that is problematic.

Significant Stock-Keeping Unit (SKU) Count: Unlike other types of retail merchandise, a lender should recognize that apparel SKUs become more complex because size and color, in addition to style, result in a very long SKU specific to any one item. This compounds the number of units and can impact product turnover rates.

Return Rates: Apparel and footwear

tend to have higher return rates than other retail categories due to the complexities of fit. This is particularly true for ecommerce purchases. More-established brands with long factory relationships may be less prone to high return rates. Consideration should be given as to whether vendor changes, made for either pricing, transit time, or to limit tariff susceptibility, are likely to or are already negatively impacting return rates.

Brand Type: A lender should recognize that well-known national brands tend to be more desirable in a liquidation than lesser-known secondary brands because they can be resold and used across many different channels. Additionally, private-label brands carried by wholesalers and not sold to the intended customer may require de-branding and other rework that is costly and time-consuming, leading to reduced recovery value for stakeholders in a liquidation.

Licensed brands: Inventories that include licensed brands may involve certain royalties during wholesaler liquidations. Confusion often arises because, even though the product is on-hand, that does not universally mean that all required licensing fees have been paid; agreements may stipulate payment only when those items are sold through versus when they are bought from the manufacturer. For this reason, any associated cost or expense obligation must be factored into the valuation, with any prior monies owed considered in a lender's reserve calculation.

Formality and Retail Price Point: Certain formal apparel, as well as exclusive designers, may command a higher price point, resulting in a smaller addressable market. Even at 50% off, a $1,500 dress might be out of the comfort zone for most people, while a $150 dress might not. For this reason, it is important for a lender to consider the space in which the company operates (e.g., formal versus informal wear) and how the merchandise on hand is priced. Additionally, would the customer typically expect to receive alterations when purchasing a formal item, and what are the labor and cost implications and feasibility of that expectation in a liquidation environment?

Situation Specificity: Consideration should be given as to whether inventory items are of limited use or usable only by a limited audience. Maternity wear, for example, is marketable only to a subset of the population and only useful for a limited period. A retailer may offer such items online only to increase the addressable market beyond the reach of its individual brick-and-mortar stores. Accordingly, a liquidator also may need to do so during a going-out-of-business sale.

Similarly, certain apparel categories (e.g., women's intimates) create challenges in terms of limited purchase frequency and fit and categories such as athleisure and career-wear can be impacted by work-from-home versus return-to-office trends.

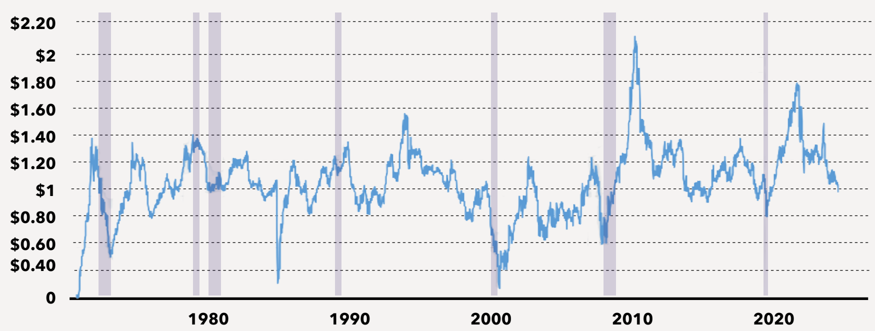
Full-line (or front-line or full-price) versus made-for-outlet product: If a retailer operates with multiple banners, including full-line and outlet locations, attention should be paid to differences among the offerings. The overall store base must be assessed to determine what inventory is in the operator's full-price versus outlet stores and to understand the historical marketing metrics between the two. For example: what product is made for sale in the outlets only, what product is from prior seasons, and what slow-moving product has been moved during the current season to the outlets? Recovery value will be a function of various factors, with an emphasis on where that merchandise is currently located.

Raw costs: These include the cost of raw materials incorporated into apparel designs and include cotton, linen, and polyester synthetics, as well as trims such as zippers, buttons, threads, labels, and other components used in the manufacturing and assembly processes. Raw material procurement costs have decreased over the last 12 months and availability is better, which has been beneficial in bringing costs down for wholesalers and retailers. Customer pricing has remained stable, with minimal year-over-year inflation. It is important for a lender to understand if a borrower is maximizing its potential to save costs on raw materials and, if not, how that can best be accomplished.

The following chart from Macrotrends LLC displays historical daily cotton prices back to 1969. The price shown is in U.S. dollars per pound. The price of cotton as of March 12, 2025, was $0.67 per pound.

Historical Daily Cotton Prices

U.S. Dollars per Pound



Source: Macrotrends LLC

Vendor Monitoring: Lenders should remain well informed regarding any changes in "first costs," the initial price paid for a product from the manufacturer exclusive of any shipping, handling, customs, or other landing costs. It is also important to remain up to speed on vendor shipment countries of origin and any impact that may have on raw materials sourcing, transit times, tariffs, and the potential need to shift production geographies.

Factory direct versus sourcing agent relationships: Does the company have a direct relationship with the factories or is that managed via a sourcing agent who has relationships with many factories? There are advantages and disadvantages to each type of relationship; understanding which is in effect is important.

Reserve Strategy: In determining the borrowing base relative to inventory, is the lender reserving for the full projected cash outlay, including landing costs, or merely for the value being incorporated into the liquidation analysis exclusive of the expense that is effectuated into the net orderly liquidation value? Reserving for the projected cash outlay enables the lender to adjust the reserve calculation to reflect each shipment's in-transit assortment and fully capture all potential liability.

APPAREL PRODUCTION COUNTRIES

China, Cambodia, Bangladesh, Vietnam, Madagascar, Indonesia, Sri Lanka, Myanmar, and Egypt are all active producers and exporters of apparel to the U.S.

China: The country of choice for certain production such as cashmere, sweaters, and heavily embellished items is China. If it becomes necessary to move production and switch a factory to another country, it may be difficult to find the capabilities needed for specialty embellishment and other apparel detail work. Additionally, many raw inventory parts (see Raw Costs above), such as cottons, linens, polyesters, and other synthetics, originate in China, and their lower costs assist in maintaining gross margin. It is important to note that it is difficult for companies to move away from China because capabilities and resources there are so expansive. It might be possible, for example, to contract the product for less elsewhere, but is it possible to meet the time frames and quantities needed through production in another country?

Europe: Some higher-end designers may source from various European countries because they are willing to pay a premium for certain types of wools, leathers, and other raw materials, as well as for more highly skilled craftspeople to assemble the garment, at least in part, by hand.

Mexico & Guatemala: Production capabilities in these near-shore markets have continued to grow. While U.S. procurement costs from nearby markets such as Mexico and Guatemala are higher than from some other regions, they offer the benefit of reduced lead times without the dependence, cost, and uncertainty of ocean freight from distant factories.

TARIFFS:

Given recent developments, we also want to point out some important considerations related to the imposition of tariffs, how companies may choose to deal with them, and the ramifications that might be involved.

Companies have a variety of levers they can pull as tariffs are implemented:

1. They can simply increase pricing to customers and hope those customers absorb it and demand is not impacted.
2. They can absorb part of the increased cost of the tariff and pass the remaining portion on to customers; of course, this option will somewhat lower the gross margin of the business and does not fully ensure against a drop in customer demand.
3. They can fully absorb the cost increase, likely ensuring continued demand but dramatically impacting gross margin to the point that some businesses may not be able to withstand such a step for long without liquidity issues.

Making matters even more complex in the current U.S./China tariff environment, the Chinese government has shown a willingness in the past to reimburse factories in its country for any discounts they pass along to the buyer. This is not the case for U.S. manufacturers exporting goods to other countries, tipping the tariff scales in favor of Chinese manufacturers.

Additionally, while U.S. companies may seek to transition manufacturing to lower-duty regions, these areas must be capable of meeting their production, quality, quantity, and transport standards for that to happen. It is also important to consider that raw materials still may need to be sourced from China, which can add cost back into the equation. Furthermore, if factories located elsewhere have partial Chinese ownership (which is not uncommon), tariff complications may still arise. Companies that are just now considering moving out of China have many factors to consider, not the least of which is they are very late to the situation.

ADDITIONAL CONSIDERATIONS:

From a borrowing base standpoint, it is also noteworthy that shifting manufacturing to other countries can have unforeseen circumstances. A good example is Bangladesh, which some have and will look to as an alternative country of origin for production. For goods imported from Bangladesh, the consignee is typically a bank in Bangladesh, not the borrower; technically, the borrower does not hold control over the goods in transit. This protects the vendor in Bangladesh if there is a liquidation event while these goods are in transit and ensures the vendor gets paid before releasing goods at the arrival port. Therefore, Bangladesh in-transits are generally deemed ineligible on a borrowing certificate. As a general practice, on the bill of lading, the lender should ensure the borrower is listed as the consignee, with control over the inventory in transit.

Additionally, certain transactions that fall under a specified dollar threshold may, in some cases, be excluded from tariffs under what is known as the "de minimis rule." To leverage this loophole, some companies buy product from China and bring it directly into dedicated "free-trade zone" receiving/holding areas within their U.S. distribution centers. Then, for example, when an online order for $100 is received for product that was part of that original shipment, they will ship that product via bonded carrier from the U.S. into Canada, where it will be cross-docked and then shipped back into the U.S. to the customer address. Although the product originated in China, the company pays a Canadian duty instead by triangulating the shipment through Canada.

Hilco Valuation Services is the world's leading provider of asset appraisals, with a proven, decades-long track record of providing the most accurate valuations to the retail apparel and other industries, and across all asset categories. We encourage you to reach out to our team to discuss any concerns or needs you may have pertaining to apparel businesses in your portfolio. We are here to help.

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