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Warehouse finance reawakened

Nomura Research Institute, Ltd.

Public warehouses' monitoring of inventories stored on their premises adds substantial value to asset-based lending. The revival of long-dormant warehouse finance should prove to be a major catalyst for the warehouse industry to branch into logistics financing.

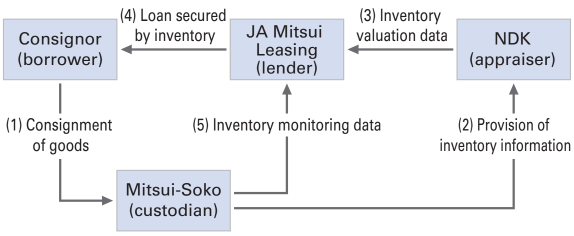
Public warehouses' monitoring function adds value to ABL

Asset-based lending (ABL) has been steadily growing in recent years even among local financial institutions, but one drawback of ABL is that property pledged as collateral cannot always be kept in the lienholder's custody. Since 2005, Japan has had a registration system that perfects chattel security interests against third parties through recordation in a registration file, but it does not provide failsafe protection to lienholders, given that chattel can generally be moved at any time.

Mitsui-Soko, a warehouse operator, has recently unveiled a scheme to better protect lienholders' interests through use of public warehouses. Newspaper articles have summarized the scheme as follows[1] (Exhibit 1).

Mitsui-Soko has developed a system to automatically monitor the quantity (weight and/or volume) of inventories pledged as collateral. The measurement data are supplemented by inventory valuations by NDK, a nonprofit personal-property appraisal service. Under the scheme, a financial institution that extends credit secured by inventory enters into a covenanted loan agreement with the borrower and a tripartite agreement with the borrower (as consignor of the pledged goods) and a public warehouse.

Exhibit 1. Mitsui-Soko's inventory custody scheme



Source: Mitsui-Soko press release

The warehouse provides inventory data to the financial institution in accord with the agreement. If, as inventory subsequently flows in and out of the warehouse, any of the predetermined loan covenants is breached (e.g., inventory quantity falls below a designated level), the warehouse notifies the financial institution, which would instruct the warehouse to cease shipments to preserve its collateral. Mitsui-Soko has also formed a nationwide network of warehouses and leases its management system to allied warehouses.

The articles' key points are that (1) third-party public warehouses adequately fulfill the role of custodian of goods pledged as collateral, (2) financial institutions are able to do credit monitoring using data transmitted from public warehouses, and (3) Mitsui-Soko's inventory custody scheme can help financial institutions cultivate new business relationships with public warehouses and their consignors. The scheme largely compensates for ABL's drawbacks and also meets general security interest requirements for financial institutions' self-assessments. Its advent is a highly significant event that has revived public warehouses' long-dormant financing function, as explained below.

Expansion of public warehouses' functions

In broad terms, public warehouses have three core functions: storage of goods, information management, and logistics management. Mitsui-Soko's inventory custody scheme enables public warehouses to fulfill additional functions based on these three core functions.

First, in terms of serving financial institutions, one such function is safeguarding security interests in pledged property and augmenting credit monitoring through transmission of inventory data as explained above. These data encompass not only static information about

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inventories at certain points in time but also dynamic data on inventory receipt and shipment trends. Providing such data for a fee could be a promising business opportunity for public warehouses. Another promising function is loan origination to help consignors obtain financing. In addition to forming alliances with financial institutions, public warehouses could develop bank agency businesses or even start their own financing businesses.

In terms of functions for the benefit of consignors, public warehouses could act as intermediaries in liquidating backlogged inventories in addition to helping to arrange financing as mentioned above. If inventory liquidation improves consignors' cash flow, it could develop into a lucrative fee business. If public warehouses have access to financing and channels for liquidating inventories, they could even temporarily assume the risk of ownership by purchasing inventories themselves.

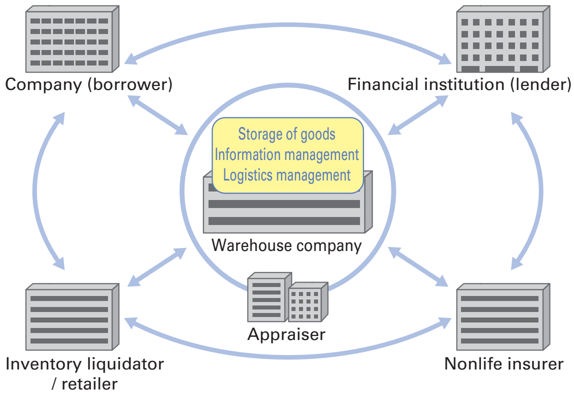
Meanwhile, an insurer has recently developed a new comprehensive chattel insurance that incorporates data management by public warehouses and inventory valuation by a personal property appraiser[2]. With conventional comprehensive chattel insurance, coverage is set based on book value, but the value of companies' inventories does not remain constant. By combining insurance with a professional inventory valuation function, an insurer can ascertain the actual value of insured property. If insurance premiums are adjusted upon expiration of the coverage term to reflect the insured property's actual value, policyholders would benefit from low premiums and possibly even premium refunds.

Public warehouses as finance hubs

In sum, public warehouses have ample potential to fulfill a variety of functions by virtue of their strong ties to consignors, financial institutions, retailers (goods buyers), and insurers. They are clearly positioned as "warehouse finance" hubs, defined as providers of a broad range of financial services revolving around public warehouses' various functions (Exhibit 2).

In public warehouses, the staff in charge of custody of

Exhibit 2. Public warehouse as a hub



Source: NRI

stored goods were called warehousemen, reportedly a low-profile position within warehouse companies. In the future, however, this position could dramatically gain prominence. The relationship between consignors and warehouse companies may also change from one in which the latter have perhaps been subservient to the former. By offering services such as those discussed above, warehouse companies could elevate their stature to equality with or even superiority to consignors.

Incidentally, Mitsui-Soko, the driving force behind the inventory custody scheme described above, was originally the warehouse division of the erstwhile Mitsui Bank before it was spun off as a separate warehouse company. Its original function was safekeeping of pledged collateral. This anecdote illustrates that Japanese financial institutions had deep ties with warehouses during the Meiji Era (1868–1912), when the modern Japanese economy was born. After a long separation, goods and money have been reunited by ABL. Public warehouses have reawakened to their long-dormant logistics financing function.

Among public warehouses targeting such functions, some companies may aggressively seek to establish themselves as logistics financing hubs. If financial institutions are remiss, they could very well lose customers to public warehouses. In such an event, how should financial institutions respond? One approach is to actively form alliances. Financial institutions' commitment to logistics financing, including ABL, is about to be tested.

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Note

1) The summary is based on articles in the October 30, 2009, edition of the *Nikkei Sangyo Shimbun* and January 13, 2011, edition of the *Nikkei Shimbun*, and a Mitsui-Soko press release dated January 13, 2011.

2) Insurer Sompo Japan has formed an alliance with appraiser NDK to offer a new type of comprehensive chattel insurance, according to an article in the February 20, 2010, *Nikkei Shimbun*.

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