GLOBAL TRANSACTION ADVISORY GROUP

Inventory Reserve Memo

Overview

Evaluating a Target Company's inventory reserve methodology is a critical component of the financial due diligence process, particularly within the food and beverage industry. Given the operational characteristics of this sector, Companies must maintain a well-supported reserve methodology to ensure inventory is stated at its lower of cost or net realizable value. Key risk factors that often necessitate an inventory reserve or write-down include:

- The perishable nature of products and heightened storage requirements, which increase the risk of spoilage, quality deterioration, and write-offs if inventory is not sold within a limited shelf-life window.
- Regulatory labeling and expiration-date requirements, where non-compliance or product nearing expiration may require discounting or disposal.
- Shifts in consumer demand and preferences, which may cause legacy or slow-moving SKUs to become obsolete or require price reductions.
- Packaging changes driven by customers or retailers, potentially creating obsolete finished goods or packaging components that cannot be used in future production runs.
- Promotional or limited-time-offer items tied to specific marketing campaigns, which may lose value once the campaign concludes and often require a reserve or write-down.
- Customer-specific SKUs, particularly in private label and contract manufacturing arrangements, where demand profiles are tied to a single customer and excess or aged inventory may not be saleable to alternative channels.

Having outlined the key inventory-related risks specific to the food and beverage industry, the following sections will summarize our due diligence approach for evaluating the Target Company's inventory reserve.

Step 1 Understand the Target Company's Operations

Prior to evaluating the Company's inventory reserve methodology, we first need to understand the go-to-market model utilized by the Target Company. The most common go-to-market models we encounter in financial due diligence are outlined below:

Branded Products:

Products developed, manufactured, and sold under the Target Company's own brand. The Company maintains full control over product development, packaging, marketing, and pricing. Branded products typically generate more stable and "sticky" revenues due to customer loyalty, allowing the Company to command higher margins relative to other go-to-market models. The brand itself carries intrinsic value, which reduces price sensitivity among consumers. Well-known examples include Coca-Cola beverages and Nestlé Toll House cookies.

Private Label Products:

Products manufactured by the Target Company but sold under a retailer's brand rather than the Company's own brand name. In this go-to-market model, the retailer typically determines the product formulation, packaging, and pricing, while the Company serves as the manufacturer. As a result, the Target Company differentiates itself from competitors primarily through its operational and value-added capabilities. These capabilities often includes efficient procurement and sourcing to establish a reliable, cost-effective supply chain, as well as manufacturing excellence that provides flexibility in SKU formulations and responsiveness to changes in production volumes. A well-known example of a private label product is Great Value cereal, sold by Walmart.

Contract Manufactured Products:

Products produced by the Target Company on behalf of a customer, where the customer retains ownership of the brand and defines the product specifications, packaging, and pricing. In this go-to-market model, the Target Company primarily serves as a manufacturing partner, providing production expertise, quality control, and operational efficiency. A thorough understanding of the contract terms and conditions is critical to evaluating the operational and financial performance of the Target Company, as margins are typically based on fixed-fee or cost-plus arrangements. The Target Company differentiates itself from competitors through reliable production, strict adherence to customer specifications, scalability, and timely delivery. Additionally, depending on the terms of the agreement, the Target Company may also be responsible for procuring raw materials, providing another avenue for differentiation; under other arrangements, the customer may manage procurement on behalf of the Target Company.

Step 2 Understanding the Inventory Reserve Methodology

Each Target Company typically maintains its own inventory reserve methodology, as there is no single standard prescribed under GAAP. While the specific calculation approaches may vary across companies, certain key components should be consistently evaluated during the financial due diligence process:

AGE:

The age of inventory should be carefully evaluated, particularly for perishable raw materials and finished goods. This includes a thorough understanding of the expected shelf life of materials and products, as well as the controls in place to ensure proper storage and any procedures undertaken to extend the shelf life of the materials and products. Discussions with Management should address these factors in detail, and item and SKU-level data from the Company's inventory management system should be provided and reviewed, including inventory-in dates where available.

STATUS:

Target Companies often classify inventory into relevant status categories, such as saleable, ready for use, restricted, on-hold, damaged, expired, obsolete, or slow-moving. The status of inventory can directly affect its net realizable value; and should therefore be considered when evaluating the adequacy and methodology of the inventory reserve.

USAGE:

While most relevant to finished goods, when data is available, a Company should compare trailing sales quantities over a defined period, such as the last 12 months, with inventory on-hand to identify potentially slow-moving products. Once significant slow-moving items are identified, Management should be consulted to understand the underlying circumstances, which are most commonly new products with no sales history or legacy products with no viable path to realization.

SPECIFIC IDENTIFICATION:

Certain operational circumstances may require the use of a specific-identification inventory reserve. Common examples observed during financial due diligence include discontinued products, SKU rationalization, and outdated packaging. When inventory is reserved on a specific-identification basis, it is important to assess any potential avenues for cost recovery, these may include selling raw materials through secondary markets or the repurposing of outdated packaging, to determine whether a portion of the underlying cost can be recovered.

Regardless of how the inventory reserve is calculated, an appropriate inventory reserve methodology should consider inventory age, status, usage, and specific operational facts and circumstances.

Step 3 Understanding the Consistency of Application

The inventory reserve should first be evaluated based using the most current methodology. It is also critical to understand the effective date of implementation for this methodology and the frequency with which the reserve is updated (e.g., monthly, quarterly, or annually.) under the calculation framework. To the extent that the reserve methodology changed during the Historical Period under review, such changes could have a material impact on the assessment of normalized EBITDA and the carrying value of inventory.

To properly assess whether the inventory reserve methodology has been applied consistently, the following information should be requested as part of the financial due diligence procedures:

- Inventory reserve calculation as of the most recent month-end and as of the two most recent year-ends.
- Monthly inventory reserve roll forward for the Historical Period under review, showing the beginning balance of the reserve, income or expense charged to the P&L, inventory write-offs, and the ending balance, to allow for a comprehensive review of changes over time.

Consistent application of the inventory reserve methodology is critical. If a Target Company has changed its reserve calculation methodology during the period under review, or has not applied the methodology with sufficient frequency (monthly or quarterly), the Target Company may generate significant out-of-period income or expense. These inconsistencies can distort both historical earnings and the carrying value of inventory, and should be normalized as part of the Quality of Earnings analysis and when establishing a normalized inventory level within the Target Net Working Capital.

Step 4 Evaluating Inventory Reserve Risks Specific to the Target Company

The most common risk areas by the go-to-market strategies discussed previously are outlined below:

Branded Products

The Company assumes responsibility for the product throughout its life cycle, from procurement to sale. Accordingly, the primary inventory risks relate to:

- Aged, excess, or obsolete raw materials
- Promotional or seasonal SKUs that were not sold during the relevant promotional or seasonal period
- Legacy SKUs with outdated formulations that were subsequently updated to meet current consumer preferences
- Outdated packaging, whether due to regulatory requirements or legacy SKUs
- Strategic SKU rationalization implemented by Management where a clear sell-through or disposition plan for discontinued SKUs has not been established

Private Label and Contract Manufactured Products

The specific terms and conditions of these agreements dictate the associated risk areas; therefore, it is essential to review and evaluate any material private label and contract manufacturing agreements of the Target Company. In addition to the key risks identified for branded products, which remain relevant, the following considerations are particularly important for private label and contract manufactured products:

- Customer-specific SKUs and packaging on-hand for which purchase volumes are determined solely by the associated customer.

The contracts associated with private label and contract manufacturing agreements often have mitigating clauses that protect the manufacturing entity. As part of due diligence procedures, these clauses should be carefully reviewed as legal protections can reduce the risks associated with inventory obsolescence. These clauses include:

- Sell-out agreements, whereby the retailer or customer agrees to purchase remaining inventory related to a legacy SKU or product formulation before transitioning the manufacturer to a new or replacement SKU.
- Reimbursement clauses for raw materials, finished goods, or packaging in the event the retailer or customer discontinues production of certain SKUs or items.
- Take-or-pay agreements, under which the customer or retailer is obligated to pay for a predetermined quantity of SKUs or items produced by the manufacturer, regardless of whether the product is ultimately shipped.
- Enforceable advanced demand forecasts, in which the retailer or customer provides the manufacturer with projected order volumes for future periods.

Step 5 Assess Quality of Earnings and Net Working Capital Implications

Having completed steps 1 through 4, the next step is to apply professional judgment to assess the adequacy of the inventory reserve for the Historical Period under review. Two common adjustment approaches are typically considered, and the quantification methodology, along with the associated earnings and net working capital implications, are outlined below:

APPROACH 1:

Apply the current inventory reserve methodology to certain historical balance sheet dates

If the current inventory reserve methodology has been evaluated and deemed sound, but its application was inconsistent during the Historical Period under review, a common approach for normalizing earnings and net working capital is outlined below:

- Quantify the inventory reserve utilizing the current methodology as of certain historical balance sheet dates. At a minimum, you should quantify the reserve as of the book-ends of the last 12 months subject to review, such that you can assess the change in the reserve balance and the related implications on the last 12 months of earnings.

The pros of utilizing the approach above are described below:

By quantifying the reserve balance, both inventory and earnings can be restated historically. This enables an assessment of how changes in the reserve methodology impacted EBITDA and supports the development of a consistent inventory reserve methodology within the Net Working Capital Target.

When calculating the Closing Net Working Capital, the inventory reserve should be computed using the same methodology. As a result, a consistent inventory reserve methodology will have been used for purposes of developing a Target Net Working Capital balance and a Closing Net Working Capital balance, preventing any artificial value creation for the buyer or seller due to changes in accounting methodology.

The cons of utilizing this approach are described below:

The earnings impact and reserve balance depend entirely on the accuracy of the reserve calculation methodology. To the extent calculation methodology does not consider key risks associated with the Target Company's inventory balances, then both the earnings and the reserve balance will be improperly stated historically.

When a portion of the inventory reserve relates to specifically identified inventory, quantifying these amounts for historical balance sheet dates can be challenging. While it may be argued that known write-offs, with the benefit of hindsight, should have been reserved historically (shifting expense to prior periods) the same hindsight is not available for the most current month-end.

APPROACH 2:

Utilize historical write-offs as the basis of normalization

When it is determined that the Company does not have a reliable inventory reserve methodology, a common approach to normalizing earnings is to analyze the Company's historical write-off experience. This approach is outlined in further detail below:

- Obtain historical inventory write-off detail over a sufficiently long period, ideally five years, though the Historical Period under review is generally acceptable. Quantify cumulative inventory write-offs over the period as a percentage of cost of goods sold for the same timeframe.
  - In limited circumstances, it may be appropriate to exclude certain write-offs from the analysis if they can be clearly and supportably deemed one-time or nonrecurring in nature. Any write-offs removed from the normalization population should be subject to heightened scrutiny.
- Apply this write-off percentage to monthly cost of goods sold to quantify the level of inventory reserve expense that should be recorded in the income statement.

The pros of utilizing the approach above are described below:

The resulting inventory reserve expense will be grounded in actual historical write-off activity, rather than subjective accounting judgments, estimates, or assumptions.

Because the monthly reserve expense is calculated as a fixed percentage of cost of goods sold, it will not introduce significant month-to-month volatility in earnings.

The cons of utilizing the approach above are described below:

This normalization approach relies on Management having made timely inventory write-offs historically. If write-offs were not recorded promptly, the normalized reserve expense may be overstated or understated, as out-of-period write-offs will be included in the data set used to develop the normalization percentage.

The historical inventory reserve maintained on the balance sheet is not normalized through this approach. A separate approach will need to be applied to normalize the inventory reserve balance to be included within both Target Net Working Capital and Closing Net Working Capital.


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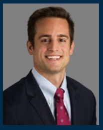
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