Tough Questions---REAL Answers

What ***YOUR*** lender needs to know

> *"I have found no greater satisfaction than achieving success through honest dealing and strict adherence to the view that, for you to gain, those you deal with should gain as well."*
> Alan Greenspan

As is evident at any IFA event, the factoring industry is a business of entrepreneurs with a passion for our industry and a desire to conduct business in a manner suggested by Mr. Greenspan. The owners and senior managers of IFA member organizations have diverse backgrounds, but are very similar in their concern about building a company that services the needs of clients, employees, investors, stockholders, and lenders. In pursuit of this goal, there are critical milestones that must be crossed as you grow and manage your business. These include the very basic of challenges *(your first hire, fire, client, and wire)* to the more dramatic *(the first participation, litigation and fraud education)*. Somewhere within these events you will probably consider external financing from a financial institution. That is, a Lender Line of Credit from an institution that specializes in the factoring business. Like most things in life, proper planning ensures a smoother process and just maybe, more options. This article is written to help you prepare for that time so that the challenge of obtaining financing can be a painless process as you strive to achieve your business goals.

Typically, a start-up factoring company is financed by owner contributions and/or friends and family debt. Possibly, a small bank line is obtained from a community bank *(usually a long-time acquaintance of an owner or board member)* to augment the capital and subordinated debt base. For some, this type of financing is sufficient for both the short and long term as they serve their immediate marketplace and fulfill their ownership dreams. For others, their business plan and eventual operational reality, requires the need for a larger credit facility from a lending institution specializing in lender finance. Whether you are months away from this process or years, it is always beneficial to be aware of the critical elements that will give you the opportunity to prepare for what might come.

From a lender's perspective, there are four essential elements that must be considered in each lender finance transaction. It will be difficult for you, as the factor, to obtain institutional financing unless each essential is fully addressed at your time of loan application.

Essential Element 1: Operational Procedures

This is a very broad topic that covers contract documentation, verification, collection, assignment, lien monitoring, asset recovery, and other related functions. It all starts with your **Operations Manual!** Your lender is going to rely on this manual as a representation of what you personally, or as an organization, are executing daily. The way you perform these functions is the basis by which your lender can tangibly measure you or your organization's level of industry knowledge or competency. It is a critical element in your lender's decision to do business with you. Remember, under a typical scenario, your lender does not want to lend directly to your clients. They need to have a thorough understanding of your portfolio management procedures which mitigates the obvious risks that are inherent in lending to your typical client.

There is no substitute for sound policies and procedures which are executed on a daily basis. But be advised, your operations manual must truly represent your practiced procedures. A common occurrence is to find a factor that has adequate operational practices as well as an acceptable operations manual. However, many times the actual practices vs. the published procedures are not congruent. Your operations manual should be your map by which you guide the daily management of the portfolio. You can develop your own manual *(a monumental process)* or you can hire professional companies to assist you in the preparation *(feel free to email me if you would like names of companies that can assist in this process).* Either way, your manual needs to represent reality, not what you hope to do or will ideally accomplish. So take the time to make sure your manual specifies reasonable procedures that are executed daily. Remember, your lender is likely to conduct initial and subsequent field exams which will uncover conformance with your operations manual. Don't wait until an examiner points out the discrepancies; rather look for them yourself.

Essential Element II: Management

Management experience and character are critical. This is particularly true in the factoring industry where the 'school of hard knocks' is a costly, but an invaluable degree. Does management have specific industry experience and have they dealt with the daily problems that occur in the Factoring business? If not, has management hired experienced staff to supplement any lack of experience?

> *"The most important thing is to establish credit…
> a reputation, character."*
> John D. Rockefeller

Additionally, the credit rating and financial condition of owners can add substantial value to the transaction. If you have experience, and have a good personal financial history, you should be promoting that to your specific lending source. If not, address the issue early, as it can be a knock-out factor *(no pun intended)* for some lenders.

Essential Element III: Capitalization

Lenders have different philosophies on the amount of required capitalization, the computation formula, and the overall borrowing base format. Be assured, capitalization is required either in the form of equity or subordinated debt. The level of capitalization will be a determining factor as it relates to concentration limits, servicing requirements, and the amount of the facility. In a typical scenario, a 4:1 debt to capital relationship is common. That is, for a $1mm facility, subordinated debt and equity would need to be maintained at $250,000. The debt to capital ratio will vary depending on your specific circumstances. For example, a start-up may require much more capitalization verses a well aged and diversified portfolio that may qualify for more aggressive leverage ratios.

<u>Essential Element IV: Portfolio Diversity</u>

The portfolio being financed must maintain adequate diversity on both the client and debtor levels. The question, therefore, is what is considered “adequate”? The obvious answer is: “The more the better”. In an attempt to provide more specific guidance, there are several basic scenarios to consider. Concentration limits can be linked to either the portfolio amount, the line amount, or the capitalization amount. As a benchmark, you can utilize the ten percent or the thirty percent rule. The ten percent rule is utilized when client concentration limits are tied to either the facility amount or the portfolio amount. The thirty percent rule is utilized with client concentration limits are tied to the amount of qualified equity and subordinated debt. The method utilized will vary depending on the lender and the specific circumstances of the factor. An example is shown below:

	Factor 1	Factor 2
Factor Equity	$ 250,000	$ 250,000
Factor Subordinated Debt	$ 300,000	$ 300,000
Total Factor Capitalization	$ 550,000	$ 550,000
Total Factor Portfolio	$ 1,200,000	$ 500,000
Line of Credit Requested	$ 2,200,000	$ 1,000,000
Client Concentration Limit:		
10% Rule (Based on LOC)	$ 220,000	$ 100,000
10% Rule (based on Portfolio)	$ 120,000	$ 50,000
30% Rule (Based on Capitalization)	$ 165,000	$ 165,000

As you can see from the chart, the client concentration limits for these relatively similar factoring companies can range from $50,000 to $220,000 depending on method used and the amount of the facility requested. These numbers are arguable and simply provided as a reference point. The real message is that diversity is essential. A common solution to concentration issues within a portfolio is to develop and maintain solid participation relationships with other lenders. Such arrangements are a necessity in any finance business, no matter how small or large *(more on this later).*

These four elements should be reviewed in preparing your company for the process of obtaining, or replacing, an existing lender. There are certainly other elements which will be important to a specific lender. But with the above elements established, you should have several appreciative lenders at your doorstep in order to entertain your facility request.

For further clarification, below are the common questions that are *(or should be)* asked by those seeking a lender line of credit. We have attempted to be *"Fair and Balanced"* in our responses. That is…***<u>No Spin</u>***.

Will no equity, and all subordinated debt, hurt my chances?

Varies by lender, but typically it won't.

What if the owner has a very successful business background, but it does not include direct experience in the Factoring industry?

Hire an Operations Manager with direct industry experience.

How should I prepare for a field exam?

If you are having it done in the relative short-term, I suggest you check your documentation. Otherwise, if this is a long-term project, I suggest you hire an auditor yourself to have your operations department reviewed. It is a good discipline and can be used as a self-monitoring tool that can be shared with your current lenders or subordinated debt holders *(for a list of auditors, send me an email request).*

What should I expect in the field exam and what are the common deficiencies that are noted?

Generally, the factoring community receives a good grade for legal representation and for general processing procedures like verifying, collecting and assigning invoices. The deficiencies usually involve documentation issues *(typos, wrong dates on the security agreement, no copy of a filed UCC-1, security agreement unsigned by the factor, etc).* Additionally, the most common deficiency includes the proper documentation of verification and collection calls results. In general, I refer back to the age-old question, "if a tree falls in the woods and no one is there to hear it, does it make a sound?" Similarly, if an invoice is verified, but it's not properly documented, is it verified? As your lender, I say no!

What if I fail the field exam?

It is not a pass/fail type report. However, poor results do occur. It will not necessarily prohibit the facility from being approved, particularly if this is your first field exam. What is <u>very</u> important is that the noted deficiencies are corrected and the exam results improve over time.

The financial condition of my clients is poor, at best. In fact, I don't obtain financial reporting from my clients at all. Will my lender be able to adjust to this philosophy?

Yes, as long as you are conducting your operation in that vein. For example, if you argue that the only significant source of repayment are the debtor invoices, then you should be doing complete verification and also thorough debtor analysis. As previously mentioned, usually the verification is done well by the factors. However, you must also be doing credit analysis on the debtors. That is, you should be performing some level of credit review on all debtors above a certain credit limit *(depending on your capitalization)*. While policies should reflect thorough credit review; ensure practices reflect the same (sound familiar?).

I have a large client concentration that is participated with another lender. How is that viewed?

This is a good thing! In fact, participation relationships in general are good. Among other things, it represents that others are comfortable with your ability to manage their assets which can make a prospective lender look positively towards your organization. Furthermore, lenders want to know that you have the means to obtain participation financing for growing credits. So even if you don't have an immediate need for such financing, you should be having regular dialogue with possible participation partners. It will show your lender that you value diversity and are planning for the eventual probability.

What if I do PO funding and construction?

Usually the lenders that specialize in Lender Lines of Credit offer their programs to a variety of specialty lenders. So if your specialty is something outside the pure factoring industry, you are still a good candidate. The important element is that you are lending within your market expertise and have each of the four essential elements.

> *"Those who have succeeded are those who have chosen one line and stuck to it."*
> Andrew Carnegie

Will each subordinated debt holder have to sign a subordination agreement?

Not always, but may be required by concentrated subordinated note holders, if any.

How about owner guarantees?

Almost always required.

Does my personal credit matter?

Yes. However, marginal credit is not an impossible obstacle. It just needs to be discussed up front with your lender.

What is the difference between refactoring and rediscounting?

To ensure a correct answer, I referred this question to Sidney Rutberg, industry expert and author of "The History of Asset Based Lending" *(must reading for all Factors)*. According to Mr. Rutberg, refactoring is the process utilized by smaller factors of laying off the credit risk of invoices to larger factors. By refactoring, the larger factor guarantees the payment of the receivable. Rediscounting involves transferring the receivable to another factor, with recourse. Refactoring is a form of credit insurance and rediscounting, in essence, is a form of lender financing.

Should I hire an investment banker to identify potential lenders?

That's a tough question, as they can add significant value to a transaction. They do help in preparing a professional package, in gaining access to decision makers, and in preventing the transaction from being overly "shopped". In general, it will depend on your specific circumstance *(for a list* *of investment bankers that specialize in lender finance, send me an email request).*

How much daily control of my business am I sacrificing?

Not much. Generally, you will have more reporting requirements, which can be a positive. Lenders may want to review new clients that exceed a certain size threshold. However, the most notable difference for most of our clients is the regular field exams by the lender. You typically continue to verify, collect, document, and fund transactions as you currently do. Funds will flow through a lender control account and, depending on the maturity level of your factoring company; you should be prepared to provide borrowing certificates as much as daily, weekly, or with each draw request.

Pricing? How much should I pay?

Prime plus 1% to Prime plus 5%, depending on size, complexity and experience.

Other fees?

Yes, closing fees range from 1%-2% *(inclusive of administrative fees)*. You will be responsible for the cost of field exams *($750-$1,000 per man day expended plus travel costs).*

What if I have had historical credit losses?

Recurring losses are problematic. However, occasional losses may be viewed favorably. A tested and proven loss recovery system is, in fact, a positive. For any large or unusual losses, you should prepare a "case study" so that the lender can understand the circumstances, the actions taken, and the procedural changes that have resulted.

What if I just turned profitable?

Usually a company that is at, or near, break-even is acceptable.

What should I look for in a lender?

Primarily, attempt to determine their commitment level to a lender finance program. You don't want to be with a lender that considers lender finance the product *de' jour* and will look to exit the industry at the first sign of trouble. Likewise, look for a lender that knows the industry and has stable resources. Don't be afraid to ask their financial backing and inquire as to what happens to your relationship if the Lender, or the respective division, is closed.

Best of luck in your pursuit of the perfect financing partner and in fulfilling your overall business goals. This process is not always easy for you, or for your lender. Hopefully this information is helpful and will assist you in a smoother transaction and allow for greater success for you and for those that deal with you!

"It doesn't matter how many times you fail. It doesn't matter how many times you almost get it right. No one is going to know or care about your failures, and neither should you. All you have to do is learn from them and those around you because... All that matters in business is that you get it right once. Then everyone can tell you how lucky you are."
Mark Cuban

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