

Bon Appétit!

A Menu of Outsourcing Items

actors, due to the nature of their product offering, are accounts receivable servicing experts. When the A/R is "less than perfect", ABLs can utilize the resources provided by factors to both "make the deal happen" and lower the overall risk of the transaction.

By Thomas G. Siska

Factors do not approach A/R as if it were part of a pool of collateral against a loan, as asset-based lenders do. They act as if the A/R was their very own asset. In the case of a non-recourse factoring program, it is the factor's own asset. In the further case of a small business factor, it is usually their only asset (and only source of repayment against advances). So factors have evolved into the best judges of A/R "collect-ability" in the finance industry. Their systems are capable of monitoring and tracking every individual debtor and every individual invoice; and the capabilities go far beyond the simple tasks normally associated with these functions.

Asset-based lenders, more now than before given the tenuous economic situation, can look to the valuable knowledge base of factors in order to help grow their portfolios safely. The factor's involvement can be utilized before the loan is booked, as part of the ongoing servicing of certain transactions, and as a much improved monitoring device for troubled loans. Factors also remain the fastest and easiest exit strategy for A/R lines of credit. The menu of services offered reads something like this:

APPETIZER (Pre-Approval)

- ~ Determine Invoice's Legal Rights
- ~ Account Debtor Approval
- ~ Would Factor Approve Take-Out

MAIN COURSE (Daily Monitoring)

- ~ Full A/R Management
- ~ Foreign Receivables
- ~ Advances on Debtor Concentrations

DESSERT (Non-Performing Loans)

- ~ Manage Troubled Loans
- ~ Take-Out A/R Loan

Determine Invoice's Legal Rights

Asset-based lending is an exceptional product for basic manufacturers, especially those involving heavy equipment and highly liquid inventory. The entire collateral pool offers the lender "excess cushion" from which to find value in a liquidation. However, new industries, such as high tech manufacturing, pose challenges never before experienced. Further, service industries put much more reliance on the lender's ability to cash out solely on the A/R. So it is critical in these situations to be an expert on the issues relating to the accounts receivable.

In the case of high tech, almost all sales through distributors are contingent or "guaranteed" sales. Most sales to retailers have restocking rights

at least once a year. Regardless of the product's history, a 'next generation' version from a competitor will cause 100% of retail inventory on hand to be returned.

As for services, the transportation sector has changed dramatically. Most trucking companies now rely on owner operators and other firms to move a significant portion of their freight, leading to questions as to who has the legal right to the freight payment. A thorough understanding of bills of lading and issues relating to the "carrier of record" are vital. Temporary employment firms now outsource an ever increasing share of their employees from competitors, utilizing "pay when paid" or contingent pay contracts. Factors are astute at understanding these issues and will even assist the client in renegotiating their contracts to make the resultant A/R eligible for advances. An even greater concern with these transactions is the failure to pay the "subcontractor". This can result in payroll claims against the A/R, much the same as a mechanic's lien.

Account Debtor Approval

The process of accepting and denying Account Debtors (ADs) in a typical ABL environment proceeds as follows:

- Deny all ADs where > 25% of their total A/R is over 60 days past due.
- Credit Approve or Deny all ADs that represent a concentration of > 10%.
- Limit the eligible A/R from a single Account Debtor to no more than 20% of the total eligible A/R.

These rules are sufficient when there exists a total pool of collateral (A/R, inventory and M&E) from which to find excess in a liquidation. However, in a situation that is 100% A/R based, it is imperative to have a solid understanding of the entire debtor base. It only takes two ADs between a 5% and 9% concentration to stop paying and the lender now has no cushion left. This becomes even more important for deals with little to no excess availability. Further, contingent pay-when-paid contracts demand credit analysis be performed on both the direct AD and the ultimate customer.

Would Factor Approve Take-Out?

Of course, the single best piece of information an asset-based lender would want to know from a factor is: "will the factor take me out of this deal if it begins to go south?" All lenders have an exit strategy prior to closing a loan. ABLs assume that there will always be a factor willing to take-out the A/R facility. While this is a good bet in most situations, an asset-based lender may want to get this confirmed upfront when treading into an area that they admittedly aren't experienced in.

Full A/R Management

Factoring is most prevalent in the garment industry, especially those firms that sell to retailers. Historically, most garment manufacturers would factor their A/R whether or not they needed advances or a loan against the A/R. They simply wanted the superior credit and collection services provided by these traditional factors. Many firms found it easier to obtain a line of credit against their A/R when they had a third party factor managing the collateral for the bank or ABL. Today, there still exists a market for these credit and collections services provided to lenders on behalf of factors.

While there hasn't been much servicing activity beyond the garment and apparel businesses, new industries, such as the high tech arena, demand a more thorough monitoring level than standard asset-based lenders. The previously cited distributor channel is wrought with pitfalls. Sales should be considered inventory until they have sold through to OEMs and retailers. Factors can monitor and confirm on a daily basis what product has sold through the distributor. This level of serviceability can be utilized for many other situations beyond the expertise of the asset-based lender.

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Foreign Receivables

Most lenders exclude foreign accounts receivable from the borrowing base. Factors, because of their account debtor specific focus, have an easier time approving foreign eligibility. In addition, there is a factoring organization called Factor's Chain International, where factors from different countries work together to provide credit protection, collection and even funding of foreign A/R for other member firms. As more and more U.S. companies begin to take part in the global economy, lenders will have to find a way to create availability against these receivables.

Advances on Debtor Concentrations

Most factors are comfortable advancing on receivables that represent concentrations of 30%–50% and higher. Some factors will even advance against single debtor concentrations. Using constant credit monitoring, pre-funding invoice verification and post-funding collection services, factors can usually spot a problem long before it becomes a serious hit to the collateral value. Many banks and ABLs turn to factors when a borrower needs availability against a significant concentration exceeding the lender's comfort level. This works particularly well when the debtor concentration is caused by a totally new customer. The lender's deal remains basically the same. Now, however, there is a new and significant source of revenue, which should improve the overall risk of the transaction.

Management of Troubled Loans

The full A/R management service offered by factors is very well suited to assist with problem loans. As all lenders know, borrowers act differently when they are under financial stress. Factoring leaves very little room for errors in the A/R borrowing base. Better still, the factor can pay off or pay down the loan and still allow the borrower to grow present concentrations and new business.

How to Order

Most factors are capable of providing each of these services. Some have formal, unbundled pricing structures to address the specific need(s) of lenders. The great majority of both big, traditional factors and small business factors advertise such possibilities informally, since they all frequently market to the asset-based lenders for lead referrals.

The most popular item on the menu is for the factoring of highly concentrated account debtors. This is due to the triple win nature of these transactions. The lender keeps the relationship (which should now be stronger due to the added source of revenue), the borrower obtains the needed availability (which always leads to increased sales and profits), and the factor gets a new customer. The factor also solidifies the relationship with an important referral source. This explains why finding these services should be fairly easy for lenders.

The item that should be "moving like hotcakes" is the managing of troubled loans. Not only are there more troubled loans presently, but factoring can also keep the loan from going completely bad. Once the factor gets a handle of the receivable base, some significant pay-down on the loan should occur. Understandably, this is not a selection the lender can unilaterally choose. Borrowers dislike the taste of the increased cost and need to be coaxed into trying it, even when factoring is in their best interest. Kind of like green vegetables, only this green is money in the form of a reliable and secure cash flow. Bon Appétit! **abfj**

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