Taking Stock: Strategies When Bracing for a Pandemic-Created Recession

Downturns are part of the economic cycle, but few were prepared for the swift decline brought on by the coronavirus pandemic. Steven N. Kurtz of Levinson Arshonsky & Kurtz says for factoring companies to stay above water, it is important they take stock of deals and business partnerships.

As of the submission deadline for this article, the effects of COVID-19 have hit hard. Within a week, a global pandemic has been declared. Nations are on lockdown, travel bans are in place, cities are issuing curfews and "stay home" orders, businesses have shut down or are suspending operations, sports leagues are on hiatus, and people are social distancing and isolating themselves.

Meanwhile, the equity markets have plummeted. The sudden halt in regional and global trading will obviously have significant repercussions. Unlike the Great Recession, when the problems started from the top of the economic food chain, the negative

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effects and problems this time will start with individuals and small businesses and work their way up the ladder. I'm certainly no economist and do not know if this will trigger a significant recession or if this will be a blip and things will sputter along.

Because of this sudden pandemic, this recession-focused article, which has been sitting in my "idea queue," is being launched earlier than anticipated. Not surprisingly, the factoring and ABL industries tend to do better in a recession. This article will focus on running a financing portfolio in a downturn from the perspective of an individual factoring or ABL shop, recognizing that these shops have borrowers to monitor and lenders to which they must answer. This article also will apply to the bank-owned factoring and ABL shops, whose numbers have significantly increased.

Because factors and asset-based lenders tend to finance businesses that do not fit a traditional bank, this industry has more demand in recessionary times when banks become more conservative in their credit decisions. Unfortunately, based upon my experience in a few up and down business cycles, not all factors and ABL companies survive a recession, but the best, strongest and luckiest do.

OPPORTUNITIES AND CHALLENGES

The first step to thriving in a recession is understanding that there will be significant opportunities and challenges. One must be able to identify the problems and opportunities and be prepared for both. From a big picture perspective, the opportunities seem to come before most of the challenges.

The opportunities start with the bank kick-outs. During expansionary times, banks want to put on deals that they would not do in a downturn. The instant the economy contracts, banks tend to identify and kick-out the deals that do not meet traditional banking criteria. The kick-outs may be slightly delayed because nobody was expecting a global plague to suddenly hit, so there will be some "understanding" between banks and their borrowers before the banks take action. However, the "nice waiting" period won't last long. In addition, you can expect an increased demand for financing from existing factoring clients and borrowers, which will include overadvances and advances not in compliance with borrowing bases.

Opportunities also will come up in the identification of acquisition targets, such as factor and ABL shops that do not weather the storm. This opportunity is something that's hard to quantify, but those with good instincts will identify potential acquisition targets.

TAKING INVENTORY

Although taking inventory of your deals is always advisable, it is essential when the economy contracts. One can start by taking a survey of the portfolio. Who is in trouble now? Who will be in trouble soon, based upon the factor client/borrower's business as it relates to the market? Are there deals you need to wind down now or ask to leave? If so, those should be identified now and a plan should be put in place. If there are multiple deals that are problematic and you need to either liquidate or ask someone to leave, develop a strategy on how to accomplish that goal. Sometimes, factor clients and borrowers tend to do bad things when they know the source of funding will dry up. So, while you always have to be paranoid about your portfolio, it's more likely that bad actors will come out when they know their financing source is going away. If you have multiple deals that you need to exit, you may not want to terminate them all at once. The plan should identify who should leave and in what order.

For factor clients/borrowers who have issues but still fit your deal appetite and can make it, now is a good time to identify and fix problems. If a client has not been performing as well is it should be, but you are letting it operate business as usual, it's a good idea to fix what needs to be fixed, and put that factor client/borrower on a simple forbearance agreement — one which identifies the default, gives you a one-way release, acknowledges all obligations owed to you and has a plan to fix the problem. It is also a good idea to identify what may need to happen with more serious defaults. Also, as alluded to earlier, you may be asked to make advances which are "out of formula," which might be a good opportunity, if you can make it work on your end.

MONITOR CAPITAL SOURCES

While taking stock of your factor clients/borrowers, it's also important to understand any potential issues with your own sources of capital. Most businesses are financed with equity and debt. On the debt side, most factor/ABL shops are capitalized with some form of rediscount lending agreement or a refactoring agreement with either a bank, other commercial finance lender or a hedge fund. The equity piece of a factor/ABL lender is typically capitalized through self-funding, friends and family, a hedge fund or a family office. There is often sub-debt involved in the capital structure either as debt or disguised equity. You will need to take stock of your capital structure and analyze the players and components. Has your main lender been in a downturn before? How well does your primary lender really know the factoring and ABL industries? Also, lenders have their own issues, so your lender should be monitored to ensure that it is not incurring significant losses because if it is, then its business problems may turn into your own problems.

Before the Great Recession, without naming names, there was a dominant player in the rediscount/refactoring business who was lending to and factoring other finance companies. Many of this lender's factoring company/ABL borrowers anticipated problems and found new lenders. Some stayed with this huge lender out of loyalty. Unfortunately, loyalty on the part of this lender's side was not reciprocated. A decision was made to get out of the lending to lender business. The lender found "problems" or refused to work through issues which it would have overlooked had it been healthier.

Virtually all loans to factors and lenders are on strong documents which have formulas, financial covenants and/or borrowing base certificates. Rediscount financing facilities are either structured as a committed facility or a discretionary facility. A committed facility requires the lender to lend as long as there is no default. A discretionary facility allows the lender to make or decline loans in its discretion. This means the discretionary lender can refuse to fund for any reason, much like a typical factoring deal. The large unnamed lender took advantage of its discretionary facility language and found "reasons" not to lend to its finance company borrowers. This essentially killed the finance companies and forced the owners to sell their portfolios for the benefit of the lender or otherwise restructure their business, killing off otherwise good and healthy factoring and ABL shops.

The lesson to be learned is to take stock of your financing arrangement. If you have a good lender, work through issues now. This means relaxing covenants and working through anticipated issues. You will likely experience slow-paying account debtors. Your lender will need to understand this and not choke you with borrowing base restrictions that won't work for now. It also means preparing for possible portfolio hits as well.

REGULATORY CONSIDERATIONS

Bank-owned factors and ABL shops have their own unique set of issues which mainly center on federal and state banking regulators. On paper, bank-owned factors and ABL shops are great. Banks have low costs of funds, but don't typically get high yields and returns on traditional banking loans. Factoring and ABL is different.

Bank-owned factoring and ABL shops have the potential to be very profitable; however, banks are carefully monitored and audited, both at the state and federal levels, depending upon the bank's charter. There are capital requirements that must be met. The capital requirements are monitored by reporting requirements, and are often addressed by regulators who visit the banks for regular audits. These audits often are done by people with little to no understanding of factoring and the ABL business. You often have to spend time explaining deals and why they work for factoring and ABL when they may not for traditional banking. Banks are required to essentially label their deals and if they are not good enough, have to set aside capital to reserve for losses. For factoring and ABL deals in a recession, that means financing accounts that don't pay as quickly. A regulator can easily insist upon a different level of capital reporting when reviewing slow paying, but otherwise good account debtors. That requires a back and forth at the audit level.

One solution that I have seen work in factoring is to label the transactions as true sales. If you can get this done, it works better for bank regulators because you won't have to reserve or downgrade a deal because of slow-paying account debtors. Bank-owned factors and ABL shops must be ready for the eventual regulatory audit and headaches.

As mentioned, there can be good acquisition opportunities. Some will be deals that have to leave the current lender or factor but can work for you. Some factoring and ABL shops may run into issues with their lender. A rediscount lender or refactor who lends to smaller factors and ABL shops may experience a case of lender fatigue. That can lead to the opportunity to take on several new deals through a buyout agreement or asset purchase agreement.

As an optimistic person, it's never fun to write about grim subjects, but the economy is cyclical, and this is a business that thrives in downturns and recessions. It remains to be seen what will be the ultimate effect of COVID-19. We are dealing with an unprecedented and sudden plague that quickly turned into a global pandemic. We will know more about the results of this pandemic soon and will ride this out, but it's important to take stock in all aspects of your business and stay financially healthy because our industry will be an integral part of a recovery and will be called upon to help jump-start a lot of businesses. Hopefully, this article has provided some helpful hints. •