participations

A SLICE OF A DISCUSSION

his corner of *The Secured Lender* invites you to eavesdrop on a conversation between several industry players about a different hot topic each issue. Pull up a chair and get ready to find out what Patricia Burns, Maria Chiang and Lee Haskin had to say about 2009 and what to expect in 2010.

BRIAN COVE, EDITOR-IN-CHIEF, *THE SECURED LENDER:* 2009 was a tumultuous year for the financial services sector as the economy reversed direction and credit markets froze. Some positive signs of recovery are apparent, and, hopefully, that will continue. How would you say the asset-based lending and factoring industries performed in 2009 in face of all the turmoil?

PATRICIA BURNS, PRESIDENT, PRIMARY FUNDING CORPORATION: I believe the factoring industry did remarkably well, even with the times that were so challenging. Due to the deterioration of trade credit and the underlying financial woes of our clients, it was challenging, it just was. We still did well, come year-end. The first two quarters were difficult. Our outstandings dropped, and our revenue did, as well. It was difficult to find new clients, and the clients that we had, their sales dropped off. So it was a difficult year, but I still think we had a great year overall.

LEE HASKIN, PRESIDENT & CEO, CROSSROADS FINANCIAL, LLC: I would tend to agree with what Pat said. It was a positive year, but it was a positive year, more so for those factors or asset-based lenders who had access to availability of funds, as we saw a number of very established factoring companies go out of business and move their entire portfolios to financial factoring companies and asset-based lenders who had the availability on their lines to put on the business. So, as you said, there's been certainly a deterioration of credit approvals, limitations on what credits they're extending to. As obligors became more questionable as far as their creditworthiness, that slowed down the growth of the existing portfolio, but putting on new business was governed by someone's ability to access money.

COVE: That is something we've heard throughout the year from CFA members.

HASKIN: The tolerance from the lending institutions who lend to these factors and asset-based lenders is almost at zero. One loss, one potential problem, all of a sudden they want to close the whole portfolio out. So, certainly, there were great opportunities in '09 for those that have the availability, but with a very cautious attitude towards the people they're extending credit to. You know, we saw that from the standpoint as an inventory lender to the factors that we do business with.

MARIA CHIANG, SENIOR VP, BUSINESS DEVELOPMENT, FGI FINANCE: I would have to agree with both Pat and Lee by saying that 2009 definitely was very, very challenging. We had an increase in business as well, but I thought that doing what we're doing in foreign receivable financing, we would have tremendous amounts of opportunity, since the banks and asset-based lenders were not as willing to take as much risk on the foreign receivable side. But, because of the whole economy and the downturn, it was a lot more difficult for us to approve the credits. And even though we had a great year, it wasn't as good as I anticipated. We looked at tons of opportunities, but it took a lot longer to get those deals approved and closed. It seems like, all across the board, other commercial finance companies and factors I spoke to experienced the same thing— that there was just a lag time in trying to get the deals approved. So, it definitely was challenging, but we still had a good year.

COVE: My impression is lenders had to work a lot harder to get deals done this year, wading through the deal flow to find the customers they could work with and devoting more time

and resources to due diligence and underwriting. Is that your perception of the way it was this year?

HASKIN: We found it very much the case as well. Credit approvals from factors for us to provide purchase order funding became much harder to obtain as everybody was much more cautious of when the next pending doom may be; the Circuit Cities, Sharper Image and many others created a lot of worrying about whether or not they're going to be in business next week.

BURNS: It was a very difficult year in terms of the credit that we looked at.

The other thing we found is that our referrals that came in oftentimes were just junk, to begin with. People didn't know what to do with the turned-down loans, and so they would say "Call the factor".

The other thing that we saw was many of the trade terms were extended; they were no longer the typical net 30 or maybe net 60 but now 120 days. The other problem that we saw was that many of our prospects should have called sooner. They waited too long. We found that when I looked at the cross-aging, they had stuff that was already 120 days old, and they were still providing credit. It was just too late. They needed a collection agency, but they weren't willing to cut off their customers. They were so scared that they were going to lose the account, they just continued to extend credit. And I think that was one of the biggest challenges that we had in the factoring industry.

CHIANG: We found that it took us longer to get the deal approved because, even though it was referred to us by other lenders and banks, the prospects were in denial. Even though they were speaking with us, they were still searching and shopping the deals with other banks. And that's what added to the lag time in trying to get the deal done because the access to capital was more expensive, and they still were looking for the bank financing that they couldn't get. That, in addition to not being able to approve a lot of the credits because of the economy, just made it harder to get the deal done.

HASKIN: I totally agree. As an inventory and purchase order lender, the checklist for approval became longer than it had been before, more checks and balances before credit acceptance was obtained.

COVE: What did you see as the biggest challenge for commercial lenders in 2009?

BURNS: I thought some of the biggest challenges we had were really balancing our time. I mean, we were looking for new accounts at all times. We always do that, but this year, particularly, our base accounts shrunk so dramatically. They didn't have sales, so we were looking for new deals. Our existing portfolio had problems so, consequently, the balance was really trying to work on the problems and still focus on putting on new business to keep the operation at least balanced. That was one of my greatest problems.

HASKIN: We spent quite a bit of time protecting and improving our existing portfolios with greater oversight on our diminishing portfolios because of bad credit exposures or the slowing down on sales of our existing client base was a problem. New business helped keep things going, but we became much more selective. What I also saw was the banks' lack of willingness to give up an account until it was already too late. They didn't want to write it off, so they kept it on or they continued to give the client forbearance agreements. And we, as non-banking lending institutions, charge more money than the banks do. So, why would anybody looking to replace a banking relationship pay a higher cost of funds unless they absolutely have to? And the banks thought that they were pushing them out the door by raising it from one over prime to two over prime, when in fact they weren't doing anything more than giving the client more time to continue shopping with all the other banks. Finally at the point in time when Maria, Pat and we could finally look to put on a piece of business, there wasn't much inventory left for us to lend against, and the receivables had aged to the point where the bank had cut off the lines or the availability of capital put the client into position where we didn't want the prospect anymore at that point. Additional challenges will be accessing funds at reasonable rates, as the lending institutions that lend to organizations like ours, have shrunk to a number you could probably count on one hand, if that.

Left Column:
Brian Cove
Patricia Burns

Right Column:
Lee Haskin
Maria Chiang

REGISTRATION NOW OPEN FOR CFA'S ASSET-BASED CAPITAL CONFERENCE AT WWW.CFA.COM

CHIANG: I agree with Lee in the sense that the biggest challenge , not necessarily for FGI, but for most lenders, was access to leverage and capital lines. The banks and providers of capital have become so much more risk-averse and capital has become more expensive that a lot of the lenders have had trouble renewing their lines. Some even lost their lines altogether and couldn't access new lines.

In addition, on the client end, like I said, there's been a lot more credit issues to deal with, and it's been harder to prove the creditworthiness of the customers. And, of course, if we don't feel comfortable approving the invoices, then we can't give as much availability. Across the board, it's just been harder, much more challenging for factors to put on the business and much longer to put it on because of the credit issues.

COVE: How critical is the issue of access to capital for non-bank lenders? Would you say it's a serious threat to a lot of companies involved in lending that are not bank-affiliated? Has it eased up at all?

HASKIN: The availability of money is starting to free up a little bit. Unfortunately, the availability of money is not coming from the banks or the large lending institutions who lend to lenders like Foothill; it's coming from the re-creation of some of these old hedge funds and the equity players.

And the costs that they want for that financing has become so prohibitive with cost of money over 18% that very few can afford to take the money being offered. And if you do, it's going to wind up filtering down to the borrowers, who will wind up paying fees that they can't afford and forcing more failures on the borrowers' side, not to mention, as we touched on earlier, the banks letting go of a transaction. We as inventory lenders have seen deals where we've come in, the bank has finally said okay, I'm putting a line in the sand; they have to leave by this date. We go ahead and commission an appraisal, which many banks had never done on the inventory loan side. The bank had advanced 50 percent loan to value. We come in, we get the appraisal, given the industry trends, et cetera, that illustrates recovery at 30 cents on the dollar, and the bank says: well, now I have to take a haircut or a hit, I'm not willing to do that. After the facts are put in front of them, even then to get them to say I've got to shed this account and I may have to take a loss doing so, is resulting in the banks on the fence post a bit longer.

BURNS: I don't lend to inventory. But I have heard a lot of talk within the industry that the banks have not been willing to take a haircut. I've heard that across the board. And since most of my business comes from the lender, not from special assets department, I don't get into that typically. But I am hearing across the board that the banks are not willing to take a haircut on anything; they'd rather ride it to the ground than take a haircut. Is that what your experience is?

HASKIN: That's exactly my take. In fact, I've met with several bankers who say, as crazy as it sounds, they'd rather hang onto it as long as possible, instead of writing it down and having to build up additional reserves. Regulators are already putting too much pressure on them to have reserves built up for everything, which is why they don't want to make loans. They're in direct conflict. I think we all saw that in an article in the paper where Barney Frank wrote a scathing letter to the regulators asking for some leniency so that the banks can start making loans again. The conflict between the two will continue probably for a year or two before they can work through the problem and start to make loans. And you're right; they don't want to write them off, so they're going to hang onto a bad loan that they know is not worth any more than 30 cents on the dollar as opposed to taking the hit.

CHIANG: I had a particular situation also where the bank had wanted them out. And I contacted the bank to try to help the situation and pay them out The bank wasn't even willing to help me out with that. You would think that they would not want to write off the loan, but they're holding onto it as much as possible, which does not make sense to me.

And then I had another situation where the bank referred me to one of its clients who wasn't doing well. The bank wasn't necessarily forcing them out, but let the company know that they should find another lender. Meanwhile, the bank has instituted higher fees to incentivize the company to leave. However, we all know, that if the bank does not force them to leave, the company will take its time looking for other bank financing. They will entertain talking to non-bank lenders, keeping us at bay until all the other banks have turned them down. They've been shopping for months now, and still are. Usually, by the time they are finished shopping, their situation has turned for the worst and most likely we won't want to take it on in the end, anyway. It ends up being a waste of time.

HASKIN: The first questions we ask are when does the forbearance agreement end, and are you anticipating issuing another one? Because, if the answer is it ends soon but they might issue another one, means it's premature for us to even get involved.

COVE: With regard to the access to capital issue, do you have any ideas or about potential solutions that would free up capital for non-bank lenders?

BURNS: I don't know that the government's going to free up capital to non-bank lenders. I think it's imperative that finance companies identify the lenders that are currently out there like Foothill that provide financing to our industry. I know when I first started Primary Funding, I started out with a bank that really wasn't familiar with my industry, and they were in my face daily. It was just very difficult to operate until that bank was taken over by Wells Fargo Bank. And I still have that line of credit. But if you're working with a lender that understands the business, then the monitoring becomes easier, not only for them, but also it becomes easier for us.

I don't know that there's a real solution for the government providing us with financing. The last thing I think we need is the government to be looking over our shoulder and perhaps putting us in a category that we won't want to be in. I would discourage that personally.

HASKIN: I would tend to agree, Pat. Our experience is that we've got a friend that sits on the House Financial Services Committee who basically--you know, and I'm not going to say that they know all that much about the finance world and what's going on--but their lack of knowledge is a negative to all parties involved, but the one thing that seems consistent is that the government believes that all loans should go out at prime plus a fraction.

Anybody that charges teens for their loans, which is obviously, on a risk-reward basis, the only body that's going to lend to a small business that's barely breaking even or it's a turnaround story, they feel is almost bordering on usury. And, therefore, don't support it. And without the support for it, and from a philosophical standpoint, there's not going to be a change in the government policies and procedures. The government thinks that the CIT lending portfolio is too high, and obviously, anybody who borrows from that likes that type of lender who lends at higher rates with bigger risks, well, to them this is an unnecessary evil. It's necessary, as we all know it, but the government thinks it's an wrong and knows of no viable options other than the SBA which we all know is not the answer.

CHIANG: I agree. I'd say it wouldn't help for the government to be watching over our shoulders. They're not knowledgeable enough about our industry to be able to help out.

COVE: Looking to 2010, do you expect it be similar to 2009 in terms of business and the challenges you faced, or do you think things will be different in 2010?

CHIANG: I'd say, in 2009 there were plenty of fires to put out. Private equity will continue to suffer in 2010. There have been so many articles written about it. And even though capital is starting to come back little by little, we're still going to see this trend of some factors not making it, people not getting the capital that they need, and it's still going to continue to have a huge effect on the economy and lending. But I think by the end of 2010 we'll start to see an upswing in capital and the economy. We'll be able to get back to regular lending again where it won't be as difficult and the challenges will subside after 2010.

HASKIN: Maria, I agree with you. It's going to take time before the acquisitions, mergers and the consolidations level out before, the obligor risks assessments change. But I don't see any big changes in terms of banks entering the marketplace or the establishment of new lending institutions to lend to the companies like ours. But I do see some additional mergers, acquisitions and, as Maria said, I see a lot more failures going forward from the factoring industry and from the asset-based lending industry as their lines become capped or eliminated going forward. We don't see any real change in that. I do expect better quality deal flow as the banks continue to reject transactions through the course of 2010 and there's no establishment of new large asset-based lenders like Foothill to lend to the factoring community.

BURNS: I'd like to take a little different approach to that. As I said at the beginning, I thought the factoring industry did remarkably well. We lost very few clients in 2009. But my concern is that the capital in these small businesses has eroded, and I just don't know how they're going to survive in 2010 unless there's a very quick fix. A quick fix for small business is having the flow of new business come into their portfolio sales. We can support it, but my concern is that they've held on by a thread and how much longer can they hold on. So the economists say the worst is over. Well, I'm not so certain that the worst is over. So that's my primary concern in 2010.

With that being said, I also believe that we will see more opportunities in our field. We've talked about banks not letting go, not willing to write things down. I think in 2010 we're going to see the banks willing to write those down. So I think that we're going to see more opportunity. The concern again is with our existing portfolio and whether or not they can hold on through the year.

HASKIN: I totally agree with you, Pat. Also the question, as you pointed out: will the client base that was borrowing from banks be able to afford, without increased sales, the higher cost of funds?

CHIANG: Our company had a strong year in 2009. Pat, you said you had a great year, as well as a handful of other factors; however, on the whole, a majority of small factors that I've spoken to said it has been just horrible, that they just haven't been able to book much good new business. A lot of it is a numbers game, but they haven't been able to put on the business that they've anticipated. As for ones that are hanging on by a string, if they survive 2010 and have access to capital, I think then it will be smooth sailing after that. But if they can't get the capital that they need from the banks or hedge funds, then we're going to have less competition in 2010, and the ones that do survive will make it onto the next step.

BURNS: Maria, I want to clarify something. We had a good year. We didn't have a great year. 2008 was our best year ever. 2009 our sales were off about 25 percent. So, when I say we did remarkably well, it's that we recovered. The first half of the year was horrible, and the recovery that we had was in the second half of the year. So, I just want to clarify that it wasn't a gangbuster year but we fared well towards the end of the year.

HASKIN: We see the same thing. We had a great year as far as increased business because there was fewer availability or direction for somebody to go to to access the inventory side of it. But one interesting thing that I've seen, as being both inventory and purchase order finance company, is we've seen a lot more purchase order financing opportunities coming our way than inventory financing, which is an indicator that the companies out there have been reducing their inventory levels even at the cost of the increased sales because they couldn't afford to maintain the inventory. The banks weren't supporting the loans against it and, because of that, they sold through and didn't replenish as quickly, which will cause sales to suffer down the road, whereby purchase order financing is more reactive, you know, the borrower got an order and now they are going to fill that order, as opposed to having the inventory already in stock and sell it sooner, which will then, unfortunately, transition into less sales because there's less on-hand inventory to sell and more lead time required. It's just a trend we've been seeing.

COVE: How about if we close with me putting everybody on the spot and asking if you think the economy is going to significantly recover in 2010, is it going to get worse, or is it going to stay the same?

CHIANG: Well, as I said, I think the forest is still burning out there. We still see difficulties in access to working capital, and I think this will continue through 2010. But in 2011, and beyond that, I think it will be one of the greatest years in commercial finance, if we make it through 2010.

BURNS: As I said before, the first half of 2009 was horrible, and the second half of 2009 I saw recovery. So if we can go into 2010 with the recovery from the end of 2009, I think we'll have an okay year. As for the term "significantly recover," I don't think so. I think if we maintain the momentum that we have from the end of 2009, it will be an okay year. But I don't think it's going to be a significant recovery.

HASKIN: I believe that in 2010 we are not going to see any significant recovery, and I agree with Maria on the point that I think we're going to see a lot more negatives, losses, unemployments, et cetera, before any kind of stabilization occurs. If our clients collectively sell either goods or services, rising unemployment is going to prevent people from buying as much of those goods or services; it's a natural that the sales will start to diminish and you'll see a lot more acquisitions of the weak being acquired by the strong and with those with the lines of credit. But I don't see any improvement that's going to take place in the coming year. Maybe towards the end of the year things will start to free up, because how long can the banks or the lending institutions or the equity firms hold onto their money without getting a return on it?

I don't see any short-term recoveries. And I do see some more fallout and some more negatives before it starts to stabilize.

COVE: Thanks to all of you for sharing your thoughts on the past year and the year to come. **TSL**