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Reprinted from the April 2003 Issue

Now You See It...

Has Non-Recourse Factoring Performed Its Final Disappearing Act?

As many factoring firms scramble to differentiate themselves, the service side of factoring provides the best route to accomplishing this goal and has some factors taking another look at non-recourse factoring. While the pendulum may never fully swing back to pre-1990 levels, a company can still find full credit protection from its factor.

By Thomas G. Siska

Traditional Factoring

Over the last decade or so, the traditional or old line factoring business (historically serving the apparel and textile industries) has experienced a gradual shift in emphasis. Traditional factoring's roots are based on providing unparalleled accounts receivable credit and collections services to its clients. The expertise gained over many years serving a concentrated industry group allowed these factors to provide "credit guarantees", backing up the credit decisions they were making on behalf of their clients. This is known as "non-recourse factoring". If the client's customer could not pay due to insolvency, the factor had no recourse against the client and therefore had to make good on the receivable. Factors would look at a client's book of receivables and set a price to provide the credit and collections service. The greater the percentage of highly rated customers the client sold to, the lower the risk and therefore the lower the fees. Additionally, the more fees that were generated from highly rated customers, the more risk the factor would be willing to take regarding some of the lower rated, or even non-rated accounts. Today, while non-recourse still represents greater than 50% of a traditional factor's receivables, it is down from near 100% in the early-70s when a factor wouldn't even service a receivable on recourse. Three main reasons explain the disappearance of credit guarantees.

Flat Industry Growth

No industries have been affected more by manufacturing moving offshore than the apparel and textile industries. As the total pie began shrinking, the competition for a bigger share (just to stay even) got fierce. Lower pricing was rampant. In order to stay profitable amidst falling margins, the old line factors had to cut costs. The extension of non-recourse credit to the lower and non-rated customers was the first cost/risk to go.

Diversification Beyond Textiles

Starting in the early 90s, the traditional factors began spreading their wings into new industries in an effort to make up for the lost "traditional" business. While this seemed to make good business sense at the time, these factors now faced a risk profile that was unfamiliar to them. To make matters worse, payment information of these new customers was widely available. The traditional factors no longer enjoyed the propriety of credit information that they still possess today regarding apparel and textile customers. With less to offer, margins had to come down to attract clients. With less margin to work with, risk (non-recourse) had to be reduced.

Greater Use of "Finance"

Since these factors have control over the client's A/R, and since the factor is making all of the credit decisions, it is a natural extension to make advances to the clients against their receivables. According to Joel Peckerar, president of SCR Consulting, LLC, and an industry veteran, "When I broke into this business some 30 years ago in New York, it was rare for one of our clients to request advances up to 100% of the availability against the A/R we were managing. Today, there is only a small percentage that do not require 100% of the availability."

The increasing focus on "finance" has had an effect on the non-recourse credit guarantees offered by traditional factors. "In the past, finance was such a small piece of the business that when we did make an advance, it was at our risk [funded against A/R that the factor guaranteed]. Now, with so many clients using factoring as their primary source of working capital, factors are forced by competitive pressures to advance as much money as possible. Consequently, they are advancing more and more against A/R that is at the client's risk [not guaranteed]." Peckerar estimates that as much as 20% of the money advanced by factors is against A/R that is at the client's risk, up from near zero only fifteen years ago.

Small Business Factoring

While the old line factors have seen their focus changing, the effects have been even more severe on the small business factors (those targeting small businesses NOT in the apparel and textile industries, also known as "California Factoring"). This segment has always been viewed mainly as a source of financing. Small, undercapitalized businesses selling to larger, creditworthy customers find these factors eager to provide A/R funding. In order to monitor and control the collateral, A/R credit and collections services were a necessary part of the package.

In the early, adoption stage of this niche ('70s and '80s), non-recourse credit guarantees were mostly the norm. One reason was because "That's what factoring was all about", says Vince Narez, president and CEO of Bay View Funding in San Mateo, CA. "We bought the invoice, monitored the aging, and performed collections when necessary. As owner of the receivable, we were at risk if the customer couldn't pay. Naturally, if the customer wouldn't pay because there was something wrong with the product or service rendered by my client, the invoice got charged back to the client."

The second reason was the nature (or reality) of the relationship. These small business clients turned to factors after the banks and asset-based lenders said no. So the expectation that a client would or could pay

back the factor for any insolvent customers was low. "Back in the late '70s when I started in the small business factoring niche, there were only a few of us in the entire United States," continues Narez. "So if we weren't willing to guarantee the credit, we weren't going to fund the A/R. Period."

Today, it is difficult to find a small business factor that will even offer non-recourse. What happened?

Enter the 800 Pound Gorillas

Prior to 1990, the niche was populated almost exclusively by small, privately held entrepreneurial firms. The average size of a relationship, less than $100,000 advanced, kept the larger financial entities from paying any attention to the niche. During the '90s, however, strong economic growth created "excess liquidity". There was more money to lend than there were borrowers. So banks and the larger finance companies were looking anywhere and everywhere to employ funds. The attractive yields garnered by the small business factors caught their attention.

As these bigger, stronger, lower cost entities entered the market, the established players were forced to lower pricing or risk getting pushed completely out of business. Rates dropped quickly and dramatically.

At the same time, the small asset-based lending (ABL) market was feeling the pinch as well. Middle-market lenders were moving downstream with their excess liquidity. In order to keep growing in the face of increasing competition from above, the small ABL firms were forced to lower their credit standards. This downward movement effectively skimmed off the cream of the factor's client base. The factors now experienced eroding margins and dwindling client credit quality. Something had to give.

The first reaction was to cut costs. While this provided some temporary relief, more efficient operations had their limits. Worse yet, the banks and larger finance companies were simply not going away. Deeper cuts were needed. Now, monitoring and control mechanisms were being affected. This, coupled with the weakening client credit profile, caused an industry-wide jump in credit losses as the 90s were coming to a close.

It was apparent that overall risk had to be reduced to ensure survival. Since the market dictated client credit strength, the factors set their sights on the risk associated with the client's customer. Full recourse relationships quickly became the norm. Even the few firms still offering non-recourse increased the frequency and size of the recourse component of their program. Around this same time, the collapsing stock market was reversing the available liquidity. As a consequence of lower margins, higher risk, and "tight" credit conditions, most of the big money players ran back up-market. Yet, the altered landscape remained. It is extremely rare to find a full non-recourse arrangement, save for a firm that only factors U.S. federal government receivables.

Says Chip Wiley, vice president of JD Factors in Chicago, "JD Factors was conceived as a non-recourse shop. However, with cash availability the number one concern of our clients, we can't compete unless we include a full recourse component. Small businesses need cash first, credit guarantees are a distant second or even third as far as clients' needs are concerned. As long as the competition is willing to advance into low or even non-rated customers, we must also."

Last Call for Non-Recourse

Still, as credit guarantees slowly disappear from the mainstream market, history has shown that someone is always willing to fill the resultant hole. One such non-recourse factor is FreightCheck LLC in Norcross, Georgia. FreightCheck (FC) serves the small trucking market (firms with 1 to 3 trucks). Presently, FreightCheck only factors receivables generated to truck brokers. It is the very small relationship size (less than $20,000) and laser focus (truck brokers as the only acceptable customers of their clients) that allows for the non-recourse approach.

FreightCheck also offers other services not normally provided by factors. This company does the invoicing for their clients, requiring only the back-up documentation to receive advances. FreightCheck doesn't see much growth in the tiny niche they're carving; just a little business that may generate a decent return. If they choose to grow at some point, they know they'll be slugging it out with everyone else, and recourse will be inevitable.

Conclusion

It appears that there are scars left over from the brutally competitive 1990s. Margins are surely never going to return to pre-1990 levels. Most factors, traditional and small business alike, see the finance side as nothing more than a commodity now, and forever a main focus of a majority of their clientele. The market's perceived correlation between factoring and finance means recourse will remain a prevalent way to maximize cash availability.

Yet, most firms are scrambling to differentiate themselves. With money being the commodity that it is, the service side of the business provides the best route to accomplish this goal. This includes taking another look at the non-recourse aspect of factoring. There is even a traditional bank-owned factor offering nothing but credit and collection factoring (no advances). So while the pendulum may never swing back fully, it appears that if a company wants full credit protection from its factor, it will still be able to find it. After all, as Vince Narez plainly stated, "That's what factoring's all about". And, of course, everyone knows a good disappearing act ultimately ends with the subject's re-appearance. abfj

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