BY DON D'AMBROSIO

Credit Trends From Both Sides of the Deal

One of the most important aspects in closing any new factoring deal is approving the credit quality of the account debtors. At the end of the day, these are the folks that will be paying you for the invoices your client has decided to factor. As important as stable credit is for the account debtor, our position has always been to apply an equal amount of due diligence on the client as well.

Let's start with applications and client trends. Without sounding overly optimistic, our position has been more favorable than that of years past, but we do remain cautious. The same current economic climate that has created opportunities within the asset based lending industry can also be your worst enemy. Unfortunately, many businesses needing factoring services have taken some tremendous hits over the last few years. We have seen industry declines in apparel, transportation, manufacturing, and staffing, to name a few. On the other side of the coin, we are seeing many new applications from technology, energy, security, and construction. No matter what side of the political spectrum you reside, the uptick in home values over the last few years has played a key role in our economy. By October 2013, home prices in twenty US cities rose by the most in more than seven years, indicating the real estate rebound will continue to bolster household wealth in 2014. So what does all of this have to do with asset based lending? The increased wealth is expected to cause individuals to buy more, which means companies will experience higher revenues and can potentially hire more workers. Our opinion has always been that companies experiencing growth will always need additional cash flow to fill new orders and keep up with customer demand.

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Credit issues have many different faces, but we feel it generally falls back from the hangover of the great recession of 2009. So often, we are seeing applications where the owner or partners had experienced a recent bankruptcy and are trying to take a stab at the business again. This is where your due diligence procedures are worth their weight in gold. The key questions that need to be answered are not just when the company went down, but how and why it happened. Was the cause the poor management within the organization, a sudden decline in sales, or some other unforeseen occurrence? Here are some key steps every factor should take when evaluating a prospect:

• Run current credit reports on your prospect. There are numerous credit reporting agencies you can utilize that will provide as little or as much as your budget can afford.

• Gather the most current quarterly and year-end financial reports available. If the client has audited financial statements, read the auditor's notes to the financial statements. Also, look for trends on both the balance sheet as well as the profit and loss.

• Request the last two years of business tax returns for both the federal and state returns, including payroll tax filings. If necessary, also request personal returns of the owner and/or majority shareholders.

• Check with the state where the business is domiciled to see if they are in "Good Standing." If a business is not in "Good Standing" or "Suspended", it usually indicates they are delinquent with their annual reporting requirements, have not paid their taxes, or have some other form of dispute with the state.

• If the prospect is required to maintain a license to conduct his or her

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trade, check with the local licensing board to see the license is current. If the license is suspended, you may not have a valid claim against the debtor in the event of a dispute.

• Run a UCC-1 search to see if there are any liens against the business. This is extremely important since you, as the factor, will always want to be in first position on all collateral. In some cases, there may be another UCC-1 financing statement already in place. This is not necessarily a negative indicator, as the prospect may have an existing loan with a bank or equipment financing with another lender. In some cases, the other secured party may subordinate their filing to allow you to be in first position on the prospect's accounts receivable.

Account debtor quality varies depending on the industry. For us, the biggest challenge remains in the evaluation of privately held account debtors. Although credit reports furnish ample information, the quality is not as robust as what you will find with publicly traded companies. We've found that recent payment trends and DBTs (days behind terms) fluctuate even among the largest capitalized firms. If you have a hostile account debtor that is unwilling to work with a factor, think twice about moving forward with the prospect. First and most importantly, you will not have the ability to verify your clients' invoices. For us, there is nothing more important than verifying your clients' goods or services have been accepted and approved for payment. Without proper verification, you are basically gambling on an invoice, hoping that it will be paid.

A colleague of mine compared the due diligence process to putting together a puzzle that never gets fully completed. You try to get as many pieces of the puzzle to connect in order to form a clear enough picture to move on to the next step. In the race to get every deal funded, you will find many factors will try to slow the process for very good reason. Unlike banks and other secured lenders, factors advance cash to qualified clients based on a piece of paper in the form of an invoice. Sure, the returns are high, and so is the risk. So next time the factoring company asks for some more information to get the prospect qualified, understand it's not always the first one to finish the race that comes out the winner. •

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