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Gaining Steam...
The State of Non-Traditional Factoring

Generally, a poor economy usually provided factors with a double-whammy: more leads as the financial condition of borrowers deteriorates and less indirect competition as banks and ABLs tightened their credit criteria in reaction to mounting losses. The recession of 2001–2003 seemingly provided neither benefit for the individual factor. In hindsight, the reason is clear.

By Thomas G. Siska

The non-traditional factoring market has been experiencing a "uniquely difficult period" recently. In the past, economic recessions were good for this high-risk financing niche. A poor economy usually provides factors with a double-whammy: more leads as borrowers' financial condition deteriorated and less indirect competition as banks and ABLs tightened their credit criteria in reaction to mounting losses. The recession of 2001–2003 seemingly provided neither benefit for the individual factor. In hindsight, the reason is clear.

Equity vs. Debt Bubble

The "Roaring 20s" and the "dot.com era of the 1990s" are the only economic booms during the 20th century that were financed primarily with equity provided through Wall Street. All other periods of rapid growth were financed mainly with debt. When a debt-financed corporate economy heads downward (as witnessed during the late '80s and early '90s), the already "debt-qualified" firms refinance with lenders who are more willing to take risks in order to stave off bankruptcy. However, most equity-financed firms of the mid-to-late '90s never reached the point where they could qualify for any type of conventional commercial loan. So, when the NASDAQ collapsed, the majority of firms had few options other than raising more equity or liquidating. This phenomena contributed greatly to a lack of opportunity for factors during this last recession.

Another by-product of an equity-financed bubble is that the pain of the fallout is borne by the equity holders. As can readily be seen every time the big banks and other publicly traded finance companies announce their earnings to analysts, the commercial lending community was hardly fazed at all. In fact, most of these firms have relatively high reserves, manageable loan losses and increased margins due to the low interest rates. This has resulted in a very low percentage of "defaulted" loans being forced to leave their present lender. So the rush of borrowers moving from lower risk lenders to higher risk providers just simply never materialized. Further, the lower risk lenders have remained aggressive in the niches in which they compete as the pool of "qualified" borrowers dissipated during the recession. So neither did "lower indirect competition" come to pass.

So where does that leave the market today? The recession is "officially" over and most experts say that the economy has "turned the corner." But if the recession didn't create more opportunity for factors, will the pending recovery fare any better?

FactorHelp.com conducted a poll of more than 1,000 factoring officers in June to ascertain what today's trends are. The results were decidedly mixed, with improvement in some areas, continued weakness in others. The full results follow.

Pricing Pressure

23% Yields UP Over '03, 31% Yields DOWN, 46% Yields FLAT

This was one of two categories that showed mostly mixed results. On the negative side, almost one-third experienced further erosion from already depressed yields. The good news was that half of those responding saw flat yields with almost one-quarter seeing less pricing pressure. While no clear trend can be extrapolated, it does appear that with 77% reporting the same or better yields than last year, rates may be at or near the bottom.

Deal Flow

60% Seeing MORE Deals, 18% Seeing LESS Deals,
22% Seeing the SAME as '03

The overwhelming majority of factors are seeing an increase in deal flow from last year. It's about time. This would be expected as the economy rebounds, but increased opportunities were also expected during the recession, so we can't take anything for granted anymore. The small percentage of factors realizing less deal flow should prove quite comforting to sales managers who have seen pretty lean pipelines the last year or two.

Credit Quality

31% Quality IMPROVING, 24% Quality DETERIORATING,
45% Quality UNCHANGED

This is the other category reflecting mostly mixed results. However, once again, we should be able to at least make a case for "finally reaching the bottom." 76% report either better or the same quality of deals. Only 24% see continued weakness in the credit quality. "The glass is half-full" person would appreciate the one-third improvement outweighing the one-quarter deterioration. "The glass is half-empty" critic would point out that credit quality has been going down for some time now, and that any firm reporting unchanged quality from last year isn't exactly saying much. I'd have a hard time arguing with this logic.

Transaction Complexity

52% See MORE Complex Deals, 6% See LESS Complex Deals,
42% About the SAME

This was by far the most noticeable trend. Deal complexity continues to rise. Again, this is not a total surprise. As businesses recover along with the economy, they must first shake off the problems they encountered during the recession. Yet, this was not seen during the last recovery. As borrowers migrated away from conservative banks and large finance companies in '92 and '93, the niche risk takers found the deals relatively simple. In the great majority of cases, the new funding source provided cash availability at closing, thereby easily justifying the somewhat large jump in price. Today, it is difficult to even imagine a situation where there is only one secured lender (or other lien holder, such as a vendor or the IRS) and the payoff amount is well below the available funds.

Competitive Pressure

53% Feeling MORE Pressure, 13% Feeling LESS Pressure, 34% About the SAME

There is no sign yet that competition is abating in the non-traditional factoring space. According to this survey, it continues to increase. Probably the most significant change brought about by the dot.com era was the ability of a prospective borrower in one area to now have the chance to be exposed to products or services offered by firms in other regions of the country. Before the Internet, a factor knew who its competition was and how to position itself against a competitor. Today, a factor in Miami must compete with a term sheet offered by a factor in Seattle, and vice versa. Not only does this situation demand competitive pricing, but neither Factor is quite sure of what the other can or cannot do in terms of structure. Therefore, the competitive wars are fought along every battle line, with every deal point up for grabs.

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Turnaround Time

17% Report FASTER Closings, 30% Report SLOWER Closings, 53% Report the SAME as '03

This measurement is NOT a reflection of how long it takes an individual factor to underwrite and close a new deal. It measures how long it takes a prospect to do everything it needs to do to allow the factor to close the transaction. Over the last few years, this measurement has lengthened to become excruciatingly slow. It is disheartening to see that the trend continues; although, this is more a symptom rather than a cause. With increased competition and complexity, it is easy to see why it takes longer to get the average deal closed today.

The State of Factoring in 2004

First, the good news. The recession is over and the economy appears to be turning the corner. This is evident in the increased number of leads being seen across the sample of factors completing our survey. Unfortunately, that is where the good news stops. Yields and credit quality appear to be at or near the bottom. While that is not bad news, it is far from good news given the fact that these two components have fallen rather consistently since the start of the new millennium.

The bad news, unfortunately, is that it's a saturated market. Competition is not only tough, but there appears to be no geographic limit as to where the competition comes from anymore. This has forced factors to dig deeper and reach further to get a transaction completed, thus increasing the complexity of the average deal. This, in turn, has lengthened the average time to close deals.

Hopefully, the surge in new business activity that has started to relieve the pressure on yields and credit quality will remain for some time to come, and allow 2005 to show improvement in the remaining areas. 2004 may be remembered as the first ray of light at the end of the tunnel. Or, it might only be the next freight train. Stay tuned! abfj

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