

## Is It Good, When It's Bad?

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The conventional wisdom has it that Factors and Asset Based Lenders - businesses that provide working capital finance primarily by leveraging accounts receivable assets – are countercyclical. That is, they perform best when the rest of the economy is doing poorly. The theory is that in a down economy, fewer businesses will qualify for the less expensive conventional bank lending, those borrowers will still need to get their business done, and they will therefore seek increased amounts of Factoring or Asset Based Lending as the next best alternatives.

Our current environment offers the first opportunity to test that rule of thumb in nearly two decades. The last time the availability of credit was broadly and significantly restricted was in the S&L crisis of the very early 1990s and even then markets did not display the scope and depth of today's retreat. The Tech Bubble pop of 2002, being fairly isolated as to industry sector, did not broadly change lending practices or the availability of credit and was very short lived. There was no real bump for Factors and ABLs there.

With things as they are today, Factors and ABLs with a strong capital base, a strong and proven business model of performance and control, and access to well-priced leverage borrowing should be seeing an increase in referrals and interested prospects and could be enjoying excellent growth and profitability. However, consider the qualifiers:

**Strong Capital Base:** There are still a lot of investors out there with capital. There is a lot of money on the sidelines. But the easy money days are over. Many former players having been burned in other investments are less aggressive and there is broadly a heightened concern for risk.

**Strong and Proven Model of Performance and Control:** It is tempting to look at factoring and ABL rates and fees and conclude these are, and always have been, extraordinarily lucrative businesses. But it must be remembered that nearly all Factoring or ABL clients were turned down by banks. There is a greater level of risk associated with this client base. The cost of controls necessary to mitigate this higher risk tends to bring returns down to levels only

impressive in the best firms. Cost aside, few institutions manage the consistent rigor of transaction and process control required to mitigate this higher level of risk. Those firms have seen write-downs balloon as their already struggling clients have followed the economy down.

**Access to Well-Priced Leverage:** Inexpensive leverage is the only way to make money in Factoring and Asset Based Lending. None of us could sell very many loans or factoring facilities priced to cover the cost of capital plus the cost of processing. The broken credit and leverage markets affect everyone in the food chain, not just the banks, insurance companies and hedge funds. In the end, the smallest firm in the industry relies upon those up-stream giants. Affected by these greater forces, the providers of leverage to Factors and ABLs have shrunk in number and the survivors are more selective, restrictive and/or expensive. Only the strongest Factors and ABLs have avoided compromise to their volume and profitability models from changes in the pricing or structure of their leverage finance.

**Increase in Referrals and Interested Prospects:** Broadly, activity is up in the Factoring and ABL industry. But prospects' situations are increasingly troubled and complicated requiring more work and presenting greater risk to close. And there is a wrinkle to this particularly important to Factors and ABLs. Fundamentally, Factors and ABLs rely upon the credit strength of the customer's customer or "Account Debtor" as the industry calls them. The economy is so broadly challenged that one of the great concerns for Factors and ABLs today is the degradation of Account Debtor quality. Even if the Factoring or ABL customer is acceptably strong, their formerly strong, larger customers and therefore the accounts receivable may not be.

In conclusion, the "Countercyclical" rule of thumb is like most rules of thumb. It is easy and intuitively appealing but not consistently true. Factors and ABLs aren't finding it as hard to compete for prospects and customers but those challenges have been exchanged for others. It is not "good when it's bad"... just different.

**Federal National Payables, Inc.** has been in business since 1992 and provides accounts receivable financing to more than 100 small and medium sized businesses throughout the country.

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