



ILL BLOWS THE WIND: A Turnaround Manager Looks at Opportunities for Factors

BY HOWARD BROD BROWNSTEIN, CTP

Shakespeare wrote, “Ill blows the wind that profits nobody.” What does the rapidly worsening economic climate mean to factors? It is during an economic downturn that the resources and skill of factors can really be seen most clearly. Indeed, without factors, an economic recession could be a depression for some industries.

Each day’s newspaper seems to carry more doom and gloom. The depths of the subprime mortgage crisis have yet to be plumbed, and appear to have spread offshore as well with the takeover of troubled mortgage lender Northern Rock PLC by the UK treasury.¹ The intractable war in Iraq seems to go on and on, with no clear end in sight. The Federal Reserve has been slashing interest rates in a futile attempt to avoid a recession, even as retailer after retailer announces retrenchment and the closure of stores on a large scale. Export-driven industries are enjoying the weak dollar, but without consumer strength the economy is sure to go into a ditch. The presidential election primary season is in full-swing, with what appears to be a resurgence of voter interest and clear choices among candidates for the first time in recent memory; indeed, the Democratic candidacy may not be decided until its convention. The curse “May you live in interesting times!”, misattributed to the Chinese, appears to apply to us in spades. Shakespeare wrote, “Ill blows the wind that profits nobody.”² What does the rapidly worsening economic climate mean to factors?

The factoring industry has long served key industries such as apparel and building products, even during strong economic times. The superior knowledge and experience of factors in such industries have made their financing, credit insurance, adjustment and collection services the cost-effective and efficient choice for customers large and small. But it is during an economic downturn that the resources and skill of factors can really be seen most clearly. Indeed, without factors, an economic recession could be a depression for some industries.

Increasingly, financing from banks, which are regulated depository institutions, becomes more restrictive or unavailable during an economic decline. While regulators are no doubt at a heightened alert level to protect the interests of bank depositors and the health of the banking system, bankers themselves typically need no prompting from Washington to start pulling in their horns. One industry after another shows up on the banks' "Watch List", and Chief Risk Officers search out consequential and indirect sources of risk that may not be superficially apparent from the loan portfolio. Traditional finance companies, some of which are larger ABL players than most banks, are usually not far behind, adding to the forces of economic contraction. The hedge and equity fund community—those pesky erstwhile and unregulated founts of easy cash—may be the last to get the message, but eventually even they stop pushing money out the door. The liquidity game of musical chairs may already have ended, and there are far too few chairs to go around.

Enter the factor. With surgical skill, factors focus on real collateral value—starting with the client's accounts receivable aging, but then delving much deeper into the account debtors' financial health, coupling each client's experience with its accounts with those of many other clients. The result is a far deeper understanding of the true credit worthiness of the client, and—the client hopes—the much needed liquidity to weather the economic storm.

From the viewpoint of the corporate renewal community, turnaround professionals such as myself expect increasingly to turn to factors in the months ahead for financing for our clients. Traditional asset-based lenders are already becoming more stringent about the eligibility of accounts receivable, getting tougher on standards, dilution and cross-aging. Industries in which customer adjustments to accounts receivable are

typical, will likely see the strongest push-back from asset-based lenders. What was acceptable in the past may no longer pass muster, as asset-based lenders try to ratchet down their risk. The opportunity is clear for factors to step into this breach.

J. Michael Stanley, Managing Director of Rosenthal & Rosenthal, Inc., the nation's oldest privately held factoring institution, says, "2008 promises to be a banner year in which the factoring industry contributes substantially to keeping the economy liquid and moving. At R&R, we are well-prepared to meet what we expect will be the growing and increasingly challenging needs of our factored clients this coming year. We will stick to basic principles of credit even as we work creatively to help our customers build and maintain their growth."

Now, the Chinese ideograph for "crisis" is a combination of the symbols for "danger" and "opportunity". An economic downturn will be far from carefree for factors, with perils lurking at every turn, and even as successful factors crank up their activity levels, risk management will be more important than ever. A Japanese proverb says, "As the water level in the pond drops, the rocks appear." As businesses experience economic stress, the risks inherent in factoring rise. Companies push products out the door, load up their distribution channels, and are slow to make and record adjustments to their invoices. Production quality often suffers as manufacturers make expense cuts, giving rise to an increase in customer claims and complaints. All of this adds up to an increased risk of dilution in accounts receivable, and an increasingly unsaleable inventory. Account debtors are suffering their own economic stress, and may be slower to pay and more assertive (and inventive!) in their claims. Retail customers, in particular, become even more unforgiving than usual about late and partial shipments, holding back payments until adjustments are resolved completely.

And let us not forget the "F" word! Malefactors likely do not wake up one morning, look in the mirror, and say, "I know! Today I'll commit fraud!". Rather, one day they're under extraordinary pressure: maybe they can't meet payroll, maybe their vendors have them on COD and they'll have to shut down the plant without a delivery. So, they advance-bill an order that's still in production, or maybe it's a sale that one of the reps just called in. Or they tell the bookkeeper to hold off posting credits and adjustments for awhile. Maybe they "refresh" the accounts receivable

aging by crediting older receivables that are ineligible anyway, and rebill them with a new date. If they're clever, they might inflate invoices by sprinkling bogus items among authentic ones. Or maybe they just turn on the printing press and invent invoices out of thin air! (Why not?—our government prints money everyday even though it could not possibly repay what it already owes.) One way or another, your factored customer crosses the line, and—lo and behold!—lightning doesn't strike, the earth doesn't open up and swallow them, the feds don't jump in the windows—they get away with it! So, maybe the next week, they do it again. And again. It becomes a way of life, a line item in their mental revenue budget.

Is this a tune from a familiar opera? Within your potential success—the growth opportunities offered by current market conditions—is the possibility of failure. So even as you hit your growth targets this year, before you crack open the champagne, make sure you ramp up your risk management alongside your business development. Your auditing and confirmation capabilities must keep pace with your activity level; these may have atrophied during the recent period of easy credit. We've all seen the workout departments at some lending institutions being dismantled and their organizations reassigned. The best factoring organizations never lose their sense of vigilance, even as they take advantage of market growth opportunities. So, given the "interesting times" in which we live, get ready to take advantage of a strong market for factoring, but never forget the basics, and be watchful for the risks and excesses that can accompany the underlying growth in demand for factoring. ■

¹"Northern Rock Takeover Marks Risky Bet for U.K.," The Wall Street Journal, February 18, 2008.

²Henry VI, Part 3

ABOUT THE AUTHOR



Howard Brod Brownstein, CTP is a Principal of NachmanHays Brownstein, Inc., a leading turnaround and crisis management firm (www.nhbteam.com) which is regularly engaged by

factors and their customers, and also often presents financing opportunities to factors. Howard can be reached at 610-660-0060 or hbrownstein@nhbteam.com