FEATURE
STORY

# Factors: Prepared for Uncertainty Ahead

BY EILEEN WUBBE

*Factors discuss what surprised them in 2022, California's disclosure laws, rising interest rates, the move from ABL to factoring and what they expect 2023 will bring.*

**T*he Secured Lender*: Have you diversified your product line during the past year? Or plan to in 2023?**

**Dickens:** Our product line has stayed consistent in the past year, and we expect it to remain the same in 2023. We expect our growth to be organic and from the industries which we already serve. We are however targeting expansion into new geographies both inside and outside of the USA and we are opening up Sallyport UK in Q1 2023. With regional variations we would expect to see some potential offshoots in terms of new products which may be specific to each environment. We know where our strengths lie as a business and we focus on those, if a client is seeking a product or service we cannot offer, we will utilize one of our many funding partners to put together a complete package.

**Efron:** We continue to offer a full range of factoring products to serve the marketplace. From traditional AR-only non-recourse factoring all the way to credit facilities that include also lending on other assets such as inventory, M&E, intellectual property and real estate. We also offer recourse factoring, which has been very positively received in the marketplace for the last few years.

**Franz:** Culain Capital Funding is in our first year of business. We are a privately held, specialty finance company focused on providing accounts receivable financing facilities from $250,000 to $5 million in credit commitments nationwide. With our originations, we have more than ever tried to stick with our knitting, meaning traditional factoring, and not underwrite receivables relating to progress billings or medical billings. We are focused on the quality of the accounts receivable, the account debtors and the companies that we feel can make it through an economic downturn. The one industry that we have considered frequently, and that we have staffed up accordingly with the proper expertise, is the funding of government contractors. We feel that if we properly mitigate our risks, these prospects will provide us with growth opportunities and differentiation from the competition. We are routinely approached by companies with complex financing needs, and we recognize that we will need to complement our factoring solution with the addition of asset-based lending facilities.

**Merritt-Parikh:** Yes, we continued to build out our junior revolving lines of credit for factors and lenders into our product base of participation funding and senior lines of credit. In the third quarter of 2022, we also launched a new division, Lead Line, focused on deal sourcing for our lending partners. For 2023, our plan is to continue to expand that division and possibly add another 'value add' division that will further help the lenders we work with grow their platforms even more.

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**Yang:** Rosenthal & Rosenthal has been diversifying product lines for several years now. Most recently, we launched Pipeline, our newest division focused on providing growth capital solutions exclusively for high-growth direct-to-consumer and e-commerce brands.

Diversification is also taking place within our established divisions, as we continue to adapt our offerings to address our clients' changing needs. For example, Rosenthal created a dedicated export factoring team this year to enhance the capital solutions we have in place for our clients and prospective clients.

**What surprised you in 2022 in the factoring industry?**

**Dickens:** The long-expected recession and flurry of bank exits did not materialize as we expected probably in late 2021. 2022 was more of a return to normal for the industry, and, certainly for Sallyport, we saw some solid organic growth in the portfolio which continued the trend from 2021. We expect that 2023 will see more of a correction in the markets and we expect 2023 to be a strong year for the factoring industry.

**Franz:** While we knew interest rates would rise, we felt that the economy would cool down quicker. We need to be more vigilant in pricing our deals.

**Efron:** The two main things that surprised me this year were how significantly many large retailers missed in the indications they gave to their suppliers (our clients) at the beginning of the year in terms of how much product they would be ordering in certain categories. Retailers apparently didn't have the ability to realize that most of the product categories that did extremely well in 2020 and 2021 during the pandemic would not continue to grow the way they did during those two years, namely products such as home textiles, furniture, kitchen appliances, etc., which were all the products we were purchasing in 2020 and 2021 while spending most of our time at home. The retailers' miss created all sorts of issues for suppliers and their lenders (factors included) as inventory positions increased significantly and created challenges at the cash-flow level and the warehousing level.

The second issue that surprised me this year was how much the Fed raised rates. Prime was 3.25% at the beginning of the year and is ending 2022 at 7.50%. I truly never imagined we would see such a sharp increase in just one year. This will create challenges for companies, both large and small, to be able to absorb their financing costs. We will see the effect of this throughout 2023.

**Merritt-Parikh:** There have been so many changes in the past year that factors have had to contend with, such as gearing up after the pandemic with clients and employees, garnering capital and resources waiting for a credit wave that was once again delayed in expectations, seeing ever-increasing rate hikes and higher cost of funds while competition remained high, experiencing more instances of fraud, identifying process and control breakdowns after hiring more people that were trained remotely or new to the space, losing equity or seeing other capital/bank tightening, and more. I don't feel like any of it's a surprise individually, but it's definitely a lot for factors to deal with all at once in a very short timeframe – the amount of continued change.

**Yang:** As much as it has been in the works for a few years now, I am still surprised that the regulators managed to push the CA disclosure law to take effect this year considering all that has been crowding our world and the ongoing bigger challenges businesses are facing. It's also interesting that the regulators could not understand that a non-borrowing factoring arrangement is simply not a lending product and are forcing factors to disclose an APR that's just not applicable. *(Editor's Note, please refer to The SFNet Guide to the California Commercial Finance Disclosure Laws and Regulations available on our website www.sfnet.com/home/industry-data-publications/advocacy/california-compliance-guide.)*

Another standout is the longer, extended time it takes to perform due diligence. Between hybrid and remote field exams, we've hit some record-long exams this year and there are no indications that this dynamic will change much in the near term.

**Factors often say they can offer more flexibility and have strong relationships with clients. Can you explain more? How often do you check in or visit clients? What is your company's approach?**

**Dickens:** We look at every new factoring facility as the start of a new relationship and every one of those relationships is unique and different. For some clients, they are factoring for growth and their goal from the relationship is maximizing available working capital; for other clients they could be factoring as they are too small or new to have a full-time accounts receivable department and so they utilize our facility as a true extension for their business, seeking advice on credit worthiness for existing and potential customers. Every entrepreneur and business have a different "why" which brought them to factoring and it's our job as their finance partners to understand that and provide a bespoke solution for their business. Gaining that understanding starts with our sales team and the initial introduction; wherever possible and feasible our salespeople will endeavor to visit the business location and meet face-to-face. We have offices in Texas, California, and Canada; and salespeople coast to coast, so our geographic footprint helps bring us closer to our prospects and clients. Once the relationship is up and running, we will have our client relationship manager visit the client on-site 1-2 times per year, we find this helps for deeper and ultimately more mutually beneficial relationships in the long-term, clients are more open with us and speak to us about their successes and failures, which becomes both a client retention tool and a risk management control.

**Efron:** We maintain very close relationships with our clients. Account executives speak to them every week, and we also visit them very frequently. In addition to that, we factors have a "live" view into our clients' businesses as every day we see how much they are shipping to their customers, we know how much they were planning to ship and/or how much they need to ship to break even, and we can monitor sales on a "live" basis. This allows us to react very quickly,

to speak to our clients when we see any early signs of a slowdown, to understand the reasons, how they are planning to address any issues and to be able to offer them the help they need during those times.

We also aim to become more than just the lender to our clients, and, in most cases, we can achieve a "trusted advisor" role, which is truly beneficial to our clients.

**Franz:** Our account executives are very hands on and in constant communication with our clients, which is critical as businesses face the challenges of rising interest rates, material costs and labor. Equally important for our clients is that our leadership team regularly taking a temperature check with our clients to stay out in front of any potential problems as well as identifying potential new opportunities.

**Merritt-Parikh:** Factoring companies are very close to the collateral and the businesses they finance. As a factor, it's about the paper ultimately, but that means truly understanding how the billings work and what is needed to ensure completion and collection, while maintaining controls. To do that, often, factors build close relationships with their clients with ongoing discussions, sometimes on a daily or weekly basis depending on the transaction. Although not all factors perform field examinations or visit their clients, many do when the exposure is over a certain dollar or portfolio percentage amount, or if there is complexity in the nature of the invoicing or collection thereof.

**Yang:** Most days, it seems like our account executives talk to their clients more than they talk to their own families! I joke, but there is definitely a sliver of truth to this.

Many businesses benefit from building strong relationships with factors like Rosenthal that go well beyond the working capital support they receive. We often become part of our clients' day-to-day operations and even serve as a sounding board for many business leaders.

Our positive impact on our clients' businesses was even more evident in the last two years or so and has always been one of Rosenthal's strengths. This hyper focus on maintaining constant communication and solid relationships with our clients has positioned Rosenthal well, not only to earn more business referrals, but also to set us up to develop more meaningful offerings to our clients. The Pipeline program that I mentioned before is a perfect example of this – it was incubated after our executive team heard from several of our direct-to-consumer clients that they required a different kind of financing that wasn't yet covered by our existing ABL program. So, from that, Pipeline was born.

**Are you seeing the use of technology in the factoring industry able to better serve clients and get them on board? Can you give examples of how it has evolved in recent years?**

**Dickens:** We are not a technology driven organization and we typically operate using the tried and tested methods; however, use of technology can help reduce friction during the onboarding process; signing legal documents via DocuSign has eliminated the need for printing, signing, and notarizing legal documents, then scanning over copies and mailing original legal documents back to us.

Following the COVID pandemic, it's our default option now to have every meeting as a Teams or Zoom meeting where, although we can't always meet face to face with prospect and clients, we are at least able to see each other's face and have a more personal touch.

We retain an open mind when it comes to utilizing technology if it can help our business or clients in some way, but we certainly don't want to use technology just for the sake of it. We tried to make our onboarding process more online and automated, and we found that prospects did not respond well to that; they much preferred the personal touch.

**Franz:** As a startup, we made a conscious decision to invest in the best accounting and factoring software available to effectively and efficiently address the complex business issues of our clients. The ability to have clients upload documentation and integrate with their accounting systems during underwriting allows us to quickly move through due diligence and execute their factoring facility timely. The same process holds true for funding requests, background investigations, and credit reporting so our decisions can be made in minutes rather than days.

**Yang:** Rosenthal developed an app to complement our online system a few years ago that's been fine tuned over time. Clients can easily access their accounts 24/7 on their phone to get a snapshot of their position and their availability and request same-day funding. We look forward to continuing to explore how we can leverage new technology to make our clients' day-to-day operations more seamless and efficient.

**How are the California Disclosure laws that went into effect on December 9, 2022 impacting you thus far?**

**Dickens:** We issued our first set of legal documents including the APR disclosure forms on the first day the legislation was implemented. It's added some additional workload at the proposal stage and legal documentation stage, and we have added some internal controls around approvals for issuing term sheets/proposals for deals which fall within the scope of the legislation.

The SFNet Guide has been a great resource and we've utilized the sample disclosure forms provided by the SFNet to ensure we are adhering to the legislation. We expect to see other states follow California and over the medium-term there will probably be more legislation at the state and federal level. California specifically is a key market for us; we have an office in California and a significant portion of our clients operate from California, and it's a $3.4TN economy – so complying with the disclosure laws is paramount for us.

**Efron:** We are complying with the California Disclosure laws and keeping a very close eye on what other states are doing.

**Franz:** Currently, we are not providing funding to any clients in California so there is no impact. We continue to monitor the

development of disclosure laws in California and other states and participate in the thought leadership offered by the SFNet so we can make the required adjustments necessary to serve clients in those markets.

**Merritt-Parikh:** We have several clients that are coming to terms with understanding the changes that need to be made internally, while others have chosen to stop doing business with clients located in California, so they don't have to deal with the additional operational components. As this only went into effect recently, it's too soon to see the actual impact of implementation, execution or what the penalties are for those that are not conforming to these new requirements.

**How are rising interest rates affecting your capital structure and how are you dealing with an imminent factoring rate increase?**

**Dickens:** Increasing interest rates are increasing our direct cost of our own banking facilities, however that is being offset with the increased interest costs for our clients. Almost all our facilities are on Prime plus pricing and so there is a natural hedge that, when our borrowing costs rise, so does the cost of borrowing for our clients. The pace and frequency of the recent rate increases have been quite surprising following several years of very low interest rates, and the Fed has certainly made up for its lack of activity with some very aggressive measures to get inflation under control.

We have added mezzanine debt into our capital structure to primarily support our growth plans, but this has had a secondary benefit in that it has also helped reduce our blended cost of capital which is helping us combat the overall rising interest rate environment.

**Efron:** Rising interest rates mostly affect our clients. Commercial factors charge a floating interest rate to clients, usually based on Prime plus an applicable margin. Obviously, this will create challenges for our borrowers, and we will need to work with them. In terms of factors' capital structure, all the large commercial factors in the U.S., such as White Oak, carry a significant amount of equity on their balance sheets and as such higher interest rates have a positive effect on our income statements.

**Franz:** The cost of funds requires our continued attention, especially in a rising rate environment. We evaluate the pricing of each client relationship considering the risks we are taking and our cost structure. More importantly, we look to partner with lender finance companies with the expertise and understanding of financing a specialty finance company and the pricing of our factoring facilities.

**Are you seeing more customers move from traditional ABL into factoring?**

**Dickens:** From the midpoint of the year onwards we have seen several introductions from both traditional bank ABL and non-bank traditional ABL lenders The introductions are typically from businesses which are: (1) in a forbearance situation with their existing lender, (2) the existing lender is unable to support the business growth, for example, the lender reduced the facility size in 2020/2021 and after a slow year the business has seen some return to normality with revenues bouncing back, in some cases the existing lender is not comfortable or able to return the facility to the previous size and so the business is looking for a lender who can generate more working capital or (3) businesses which may be breaching covenants or expected to breach covenants and the lender and the business have agreed to a mutual break-up. When we have clients moving from traditional ABL to factoring there is always the need to educate the client on what the differences are, as a factor we are usually closer to the account debtors than on an ABL facility and for most factoring facilities the account debtors will receive our Notice of Assignment; business owners can be apprehensive about our contact with account debtors however the fear is usually greater in theory than in reality; barring the few customers with ban on assignment clauses; most account debtors have no problem paying to and verifying for a factor. Once our facility is in place and running smoothly, business owners enjoy the flexibility we can provide and the lack of formal loan covenants which may be present with a traditional ABL facility. There are far more similarities than differences, and it's our job to demonstrate that to our customers moving from ABL to factoring.

**Efron:** We are seeing some companies moving from *commercial* banks into factoring and expect to see many more this year. Once 2022 financial statements are issued, we expect many companies to have to move away from banks. In 2020 and 2021 many companies had the benefit of the PPP loans creating significant "other income" on their income statements as these loans were forgiven, which helped many borrowers avoid showing losses on their financials. 2022 figures will not get that benefit for most companies, and hence we expect to see many opportunities to start relationships with previously banked companies.

We are starting to see banks tightening up. They might not be kicking people out yet, but when clients are going to the banks to ask for additional help, because they are holding more inventory and they need their inventory lines increased, they are getting more 'No's' and rejection. That's prompting middle-sized businesses to go out of the banking world and talk to alternative lenders. This is the time for factors to really take the extra steps to understand your clients' businesses and their challenges and how they are dealing with them.

**Franz:** We have not migrated a client from ABL to factoring this year. We expect demand for ABL to continue to increase with manufacturing returning to the U.S. and companies maintaining larger inventory balances than in previous years. All the more reason for us to launch an ABL vertical soon!

**Merritt-Parikh:** In general, we are seeing more bank clients moving to factoring versus ABL due to being able to close and fund quickly in comparison. For those commercial lenders with both ABL and factoring groups, we have also noted an increase in starting companies out in their factoring division then moving them to ABL later after some in-house performance can be evidenced.

**Yang:** Not so much. But we have seen more companies using factoring services for the first time. The challenging retail climate, the associated credit risk, and the difficulties in maintaining and hiring staff have all played key roles in this trend toward companies pursuing factoring. More often than not, Rosenthal is able to offer our clients cost savings by serving as their AR and credit department, all the while improving their cash cycle and extending significant credit protection.

**What do you think the supply chain impact will be in 2023?**

**Franz:** Though supply chains are starting to untangle, the ongoing disruptions will continue well into 2023. The start of the pandemic saw unprecedented labor shortages and shipping backlogs that created delays for retailers and manufacturers. Labor shortages are still a huge issue and manufactures and distributors will build inventory to avoid the shortages they experienced last year.

**Yang:** Between the pandemic and inflation concerns, the supply chain slowdown continues to plague the retail sector in a multitude of ways. We're still seeing labor and raw material shortages, port inefficiencies and freight cost increases, all of which were impacted from the shutdowns in ports in Asia and the ongoing West Coast labor dispute. These complicated factors have led to a major ripple effect across the globe and have created a tremendous amount of uncertainty among importers. While we all hoped the supply chain would normalize in 2022, we're now looking ahead to 2023 for some glimmer of hope. But we should expect to see much of the same in terms of supply chain challenges, in the coming year, certainly at least until the middle of 2023.

**What are your predictions for 2023?**

**Dickens:** I believe 2023 will see a mild recession, the labor market remains tight and there may be upward pressure on wages, which could lead to even more inflation. If the inflation remains supply side driven which it has been in 2022 with energy price shocks, then a more settled energy market outlook may see prices and inflation normalize providing some relief to the American consumer. 2023 should be the peak year for interest rates and I expect the US dollar to remain strong in the currency markets. Let's hope that the high interest rates can get inflation under control by the end of 2023, and the Fed doesn't overshoot with their rate increases and raise interest rates more than is needed. Thankfully, at the time of writing this in late December, it appears the Fed is reducing the magnitude of their interest rate increases and we may see one or two rate increases of 0.25% in the first half of 2023.

The expectation of a mild recession and rising interest rates, offers a very favorable environment for factors and asset-based lenders. There will be some attrition in the capital markets and businesses may be looking to new sources of financing as they navigate a tricky economic environment. After several years of low interest rates and massive government intervention, a return to a traditional credit cycle environment should be welcomed by factors and 2023 should be a fruitful and productive year for factors and the wider factoring industry.

**Efron:** 2023 could be a very challenging year because of the significantly higher interest rates we are seeing now. This could affect our clients in two very important fronts: Not only will they result in higher financing costs for them; but also – if the Fed is successful – might result in a slowdown in the economy and higher unemployment rates, which would drive demand and sales lower.

**Franz:** Commercial and community banks are contracting, resulting in less credit being available for businesses. Business owners are becoming more aware or directly experienced the unscrupulous behaviors of predatory lenders. Factoring companies will see increased opportunities, but with that comes the possibility of great fraud and losses. It's a double-edged sword.

**Merritt-Parikh:** Factoring and ABL should have more opportunities as the 'credit wave' everyone expected last year and then earlier this year seems to have finally started. Pipelines are already building. With that, though, comes increased client concerns in the existing portfolios requiring heightened focus and vigilance on underwriting, monitoring and processes. Additionally, fraud has increased over the past few months and is expected to continue moving into 2023. Someone once said, "If you don't think there is fraud in your portfolio, you just haven't looked hard enough," and unfortunately, I think that would be a good quote to remember in the coming year. Also, capital will be a high focus point next year as lenders have started tightening (lowing lines, concentrations and eligibility, increasing rates, requiring additional equity or capital). I think that means the other famous quote, "Always Be Closing," will now be "Always Be Raising Money…" not that the acronym fits in this case, but you get the gist.

**Yang:** While the latest reports show that inflation may finally be slowing, consumer prices are still climbing, as are interest rates. Supply chain challenges continue to disrupt the flow of products from overseas and delay shipments to retailers and customers around the country. There are few, if any, indications that any of this will drastically change in 2023. We always tell our clients that in uncertain times like these, it's important to balance innovation with delivering value, while also paying close attention to diversifying supplier relationships and distribution channels. Any company that is not carefully managing the increased costs of doing business in this volatile market will face some difficulties in 2023. If nothing else, this complex and challenging environment is keeping us on our toes and very busy!

*Eileen Wubbe is senior editor of The Secured Lender.*