FACTORING INSIGHTS

The Use of Covenants in a Discretionary Factoring Facility

BY HUGH LARRATT-SMITH

SFNet's March 30th Crucial Conversations webinar, "The Value and Effective Use of Covenants in a Factoring Transaction," focused on why covenants are needed in a discretionary factoring facility; covenant types and reporting frequency; the art of picking the right covenant(s); the value of compliance certificates; whether covenants imply a lending commitment; the value and importance of a good "market" factoring agreement and more. Here, panelist Hugh Larratt-Smith provides a recap of the webinar.

Moderator: Peter Hughes, sr. vice president, Merchant Financial

Panelists:

Jeanne Siegel, partner, Business Finance, Thompson Coburn Hahn & Hessen LLP

Hugh Larratt-Smith, managing director, Trimingham

Elena Goynatsky, managing director, Commercial Services, Webster Bank

Brad Stanza, senior vice president, Wells Fargo

In 1928, the newly constructed The Lefcourt Clothing Center, a massive block-long building on 7th Avenue that housed hundreds of garment companies, was the epicenter of New York's garment industry that stretched from 13th Street to 42nd Street, with Seventh Avenue – Fashion Avenue – as its spine. It was one of the first fire-proof industrial loft buildings in New York, an attractive feature for garment companies, coming on the heels of The Triangle Shirtwaist Company fire in 1911. One of the central figures in the development of the garment district was Abraham Lefcourt, a dynamo whose rise to riches from poverty is the story of the American garment industry.

This compact industrial area, less than a mile and a half mile long, housed nearly 7,000 garment shops and employed nearly 200,000 workers. Unlike Chicago's garment district with its gigantic factories that employed eight to ten thousand workers, the majority of New York's garment companies employed less than ten workers and only 200 had more than 50 workers. Despite this difference, these Manhattan garment shops comprised the biggest manufacturing industry in the largest industrial city on earth at the time. In 1927, over 50% of the dresses made in America came from the garment district in Manhattan.

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The vast majority of these companies were owned by Eastern European immigrants who arrived in America with little money. Factoring was the only financing available to many of these entrepreneurs.

Many got their start in home production in Lower East Side tenements, but by 1910, new state laws prohibited home production. This led to migration to the area around Madison Square at Fifth Avenue. Problems soon arose, however. In 1914, the owners of the large department stores, backed by leading banks of the area, mobilized to force the garment companies away from Fifth Avenue. The fear was that the garment companies' cut and sew operations would move further up Fifth Avenue to 34th Street, home to Macy's and Gimbels. The retailers pressured New York City banks to stop financing the construction of buildings for the garment companies. In 1921, the store owners and garment entrepreneurs reached a city-shaping agreement: Seventh Avenue would be the new center of the garment trade. However, one of the lasting legacies of these seven years of acrimony was that many New York City banks became reluctant to finance the garment industry.

Factoring became the jet fuel for a massive number of New York City garment entrepreneurs in The Jazz Age.

Fast forward 100 years.

Factoring has proliferated into many tributaries in the American economy. And factoring has, in many cases, increased in complexity. With complexity comes the need for legal frameworks that have vastly evolved over the decades.

In a recent SFNet Webinar, Peter Hughes from Merchant Financial moderated a panel entitled "The Value and Effective Use of Covenants in a Factoring Transaction". The following are the highlights from this Webinar.

Peter Hughes: Hugh, how have the events in the banking industry affected the outlook for factoring?

Hugh Larratt-Smith: Federal Reserve Bank Chair Powell has said that credit is tightening, as have several chief risk officers that I know. U.S. bank lending contracted by the most on record in the last two weeks of March 2023, indicating a tightening of credit conditions in the wake of several high-profile bank collapses that risks damaging the economy. Commercial bank lending dropped nearly $105 billion in the two weeks ended

March 29, 2023, the most in Federal Reserve data back to 1973.

I think this will trigger a migration to factoring. Many bank borrowers will discover they have nowhere else to go other than control rescue equity. This is good for banks that offer both ABL and factoring to avoid asset run-off as ABL borrowers are forced to pivot to factoring for working capital financing. These borrowers will typically be accustomed to covenants in their loan agreements.

In the face of tightening credit, I think the factoring companies which use bank lines to fund their portfolios will face greater portfolio scrutiny by the lender finance groups at banks – so, the more factoring relationships with covenants, the better. With greater OCC scrutiny, bank-owned factoring groups which don't currently require covenants may face pressure from the OCC to strengthen their factoring relationships with covenants.

Bradley Stanza: We typically require covenants on larger deals. Call it "belts and suspenders". I think that covenants keep the customer a little bit more engaged and, as long as they stay within those "guardrails", they know they are doing something right. We try to keep it simple, since many of our customers are entrepreneurs or family- owned businesses. Our usual covenants are minimum net worth or a minimum increase in net worth. We like it to be "cut and dried", so there is no ambiguity. On legacy and smaller deals, we don't usually have covenants.

Hughes: Elena, talk to me about "The Art of Selling the Right Covenants."

Elena Goynatski: I like to keep it simple and readily understandable. Covenants that are measurable and tested on a timely basis are best. I like covenants that focus on how the business is managed, such as limits on distributions and minimum net worth. When I am discussing covenants with a new borrower, a lot depends on their prior financial performance and business model. For example, a seasonal apparel company needs covenants that mirror the tempo of their business and their business model – that take into account those slow sales months. It is also important to avoid hindering the relationship by requiring a number of overlapping covenants. Many smaller clients don't have a CFO – or sometimes even a controller, so preparing interim and monthly statements is not possible. All we get is the annual tax return of the borrower. That makes testing financial covenants less meaningful. Instead, we rely on borrowing bases that can track accounts receivable and inventory aging. By watching the collateral on a daily or weekly basis, we have almost real - time knowledge of what is happening at the borrower. Since we have full dominion, we can control the risk more closely. Finally, all ABL borrowers are accustomed to covenants, so any factoring company sales reps should ask for them in the first meeting.

Stanza: I agree. If a company is owned by a private equity group, then that borrower will be accustomed to covenants, and the factoring sales rep should always require them. For entrepreneurial and family-owned businesses, I like covenants that limit distributions and related party transactions. In some cases, I will get affiliates and subsidiaries in the loan agreement. Another very effective covenant is testing for accounts payable aging, so that the borrower is prevented from leaning on the trade.

Hughes: I like the accounts payable covenant a lot. Agree, if the borrower sees the covenants as guardrails and knows you won't hammer the company if leverage is 4.5X versus 4X in a quarter because of a hiccup, that creates a positive working relationship. Covenants help us all understand where the business is headed and alert us to problems on the way.

Larratt-Smith: Covenants that are financial tests for borrowers, such as fixed charge coverage and tangible net worth, actually help owner/managers plan and budget. Running a business with no plan and budget is like driving across country with no road map. With a solid plan and budget in place, there is less likelihood of panic, which can lead to fraud – we don't like to see companies driving off the edge of the cliff leaving no skid marks. Covenants can "foam the runway", allowing the factor to help with a soft landing and be a true partner to the borrower. Some borrowers will say that they "steer their boat by looking at its wake" and therefore covenants are useless. In the process of crafting covenants, borrowers may realize the value of a rolling 13-week cash-flow forecast. When companies are migrating to ABL from leveraged finance structures, many realize that the discipline of borrowing base compliance is positive for the management of the business. The same holds true for factoring borrowers, especially when the borrower is signing a monthly compliance certificate. Robust covenants can allow the factoring sales team to back off an unconditional guarantee to a "bad boy/girl" guarantee.

Hughes: Jeanne, do covenants imply a lending commitment?

Jeanne Siegel: No, there is no New York State law that re-characterizes a discretionary facility as a committed facility. That said, one needs to be very careful about putting in things that make it look like a committed facility. When litigation arises, it is usually centered around whether the implied covenant of good faith and fair dealing affects the lenders' rights to exercise discretion.

Hughes: Jeanne, from a legal perspective, if I'm going to bring the borrower to the table who trips a covenant, should I put them on notice?

Siegel: Yes, always put them on notice, maybe through a Reservation of Rights letter. Hopefully, they can correct their course and fix the problem.

Stanza: We call it out immediately, so no one comes back later. We may require a 13- week cash-flow forecast if we are concerned about the collateral and cash flow – more so than the balance sheet at that juncture.

Hughes: Hugh, in a turnaround situation how are covenants best utilized?

Larratt-Smith: Many owner/managers think that "de Nile" is a river in Egypt, not their management style. Many owner/managers have never experienced the type of turbulence that may lie ahead. Covenant defaults bring the owner/manager to the table, may put an end to denial and may force them look in the mirror.

By the close of The Roaring 20s, Seventh Avenue's reputation was firmly established as a style center second only to Paris. New York City's temperament in The Jazz Age was best captured by the entrepreneurial spirits of Seventh Avenue: fast moving, competitive, quickly adaptive, and resourceful. A key driver in the success of Seventh Avenue was the abundance of working capital provided by entrepreneurial factoring companies.

By 1927, Abraham Lefcourt's real estate holdings with Seventh Avenue as its spine, was worth over $100 million. In 1928, he built over $50 million of new buildings in mid-town. By then, he was the largest individual owner of factory loft buildings in the garment district. Like many others, he lost his most of his fortune in the crash of 1929 and the onset of The Depression. The last building he developed - the Lefcourt-Alan Building at Broadway and 49th Street - became the Brill Building when Lefcourt defaulted in 1932. Named after his son, Alan, who died at 17 years of age in 1930, the building had a bronze bust of a young man above the front entrance, looking down Broadway toward the garment district.

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Hugh is on the Board of Directors of the New York (Upstate) Chapter of TMA and was a founder of the Toronto (1992), New York – Upstate (1998) Serbia (2014) and Croatia (2015) TMA Chapters. He was a director of the Secured Finance Foundation in New York for 10 years.

For the past two decades, Hugh has been a contributing author for The Secured Lender and The ABF Journal. He can be reached at Larratt@trimingham.com.