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The Science of Lending – How to Get Paid Back

By: Joseph F. Ingrassia
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The failure to properly structure and underwrite a transaction causes the return of capital loaned to be put in jeopardy. In most cases, flaws are found throughout the process and in all phases including: initial due diligence, underwriting, continuing due diligence with the monitoring and maintenance of the loan. These flaws may seem to be minor points however they often lead to an impairment of the loan thereby threatening or limiting the ability of the lender to collect their principal and interest as agreed by the borrower. Isn't the goal of lending to get paid back?

Human nature and dependence on automated systems often lead to gaps in securitization, limited collateral and the ability to collect a loan in full. Additionally, the physical location of separate departments within a firm can be a communications challenge. At many large financial institutions, the underwriting division is separate from the due diligence department and part of the legal department run by in-house counsel. With most communication conducted via memo or transaction summary, people involved in a transaction do not have the entire context of the transaction at their disposal.

Dynamic Communication

In terms of information overload, the lending industry is not without its challenges. Companies that can turn rote processes into a dynamic process will see an improvement in communication and the health of a transaction. A process where questions are generated and answers are provided by the borrower can enrich the entire due diligence process and life of a transaction.

Our firm views standardized due diligence as a living and integral part of the entire transaction cycle. This methodology increases communication and helps identify patterns or new issues as the transaction progresses. Each one must be evaluated and may require modification of the checklist or due diligence process to cover the particular topic in question. The intake due diligence check list at Capstone, for example, consists of six pages of requirements broken down into the ten general and 16 individual categories.

The most important part of actively engaging in the due diligence process is to actually read the collected data. From corporate data rooms to Google Docs and DropBox, it is easier than ever to share information among loan participants. These file sharing options also provide tracking data to indicate how long a party affiliated with the due diligence process has spent reading or accessing the information.

One of the benefits of being a small finance company is the ability to have a significant amount of contact regarding a transaction with the client, as the due diligence phase is ongoing.

Document Reviews: Summaries Don't Count

The written material collected and deposited into the data room provides anyone who is interested the opportunity to learn in great details all of the pertinent information one may need on a transaction.

Often times members who are part of the due diligence team rely on the summarized reports that are prepared by other members of their team. Although summaries are extremely helpful to review, the actual review of source documents is crucial. Points may be missed or past problem areas could affect the current transaction. The writer could be unaware of a potential problem.

By engaging both indirectly and directly with the client in exchanges of questions and answers, it becomes clear how the due diligence materials stack up and where any flaws may exist. Many times understanding the documents determine if the client's responses are in aligned with the meaning of the documents, their obligations in the contracts and their customer expectations.

This perspective is essential when recommending a transaction to any credit committee with the involvement of the legal department, as well.

Post Transaction & Monitoring for Exposure

Once a transaction has closed, the monitoring of the loan begins. For lenders, areas of concern are to insure that the federal tax payments are being made on a timely basis.

Checking filings can uncover many potential problems that can negatively impact the transaction overtime. For example, ongoing checks can insure the borrower has not been trumped by a federal tax lien, the company's name has not changed or that other liens from other lenders or leasing companies have not been filed. Another significant strategy is to monitor the borrower's bank accounts to insure the client is liquid.

When a company becomes illiquid, the equity on the balance sheet may have dissipated or could be tied up in inventory or past due accounts receivable. Exposure to concentrated credits must also be monitored and ineligible receivables must be identified and collected with a plan to insure the concentration or credit limit covenants are not violated again.

Techniques for Account Management

Managing the collateral that is securing a loan or advance is now the main focus of account management and credit teams. Typically, collections should be monitored by dollars or days. This means ranking the portfolio from the largest accounts receivable first and then a second ranking by the number of days an accounts receivable has been outstanding.

From this approach, priority has been determined about how and when to organize collection calls to make sure the accounts receivable are tightly managed and paid as quickly as possible.

The best approach, as in the due diligence phase of the relationship, is to have the collectors use a script and make detailed collection notes so they are available for review by the collections manager, the account manager and any credit committee member who has an interest in reviewing them. This method of tracking facilitates timely collection calls and actual contact between the lending staff and the account debtor.

Another technique in managing collateral is to require an inventory aging report. This report is important because it places focus on inventory that is not moving. Inventory represents working capital that is tied up in potential obsolete products thereby hurting the cash flow of the borrower. Many times the borrower will not sell the inventory at a loss because they don't want to lose money. What they fail to recognize is that after the cost of capital is added, the cost of real estate and the personnel expense required to report it to the lender, it is more cost effective to liquidate and take the loss and move on.

In most cases, the longer inventory is held the lower the value that can be realized. Once this happens during the company's annual audit, the auditors will impair the collateral and require that it be written down. All of this adds to the expense of managing the inventory and all but confirms the client will realize much less than was anticipated. As a lender, it is always good to have contacts in the surplus inventory business that will sell the inventory on a commission-only basis or purchase it and bear the risk of profit or loss. In most cases, the first loss is the best loss.

Notwithstanding the above, these unanticipated events create revenue opportunities for the lender if the loan documentation supports fees and penalties when drafted by legal counsel. Attorneys who specialize in asset-based lending and factoring have provisions that can be drafted into loan documents that increase the rate of return that a lender may earn on a given loan when a default or an unanticipated event occurs. A brief conversation with a transaction attorney about provisions described herein will result in modifications to transaction documents that result in higher profit margins on a lender's portfolio, while at the same time making sure that you are paid in full upon maturity of the loan or transaction.

Lending is unlike many other businesses. It is an art form as well as a science that requires certain skills and tools. However if they are marshaled and employed properly, lending is a very profitable and rewarding business. It is one of the few industries where the fruits of your labor can be seen helping companies grow and expand over time. That is, as long as the transactions are built on solid due diligence and appropriately monitored.

Joseph F. Ingrassia

Managing Member | Capstone Capital Group, LLC

Joseph F. Ingrassia is managing member of Capstone Capital Group, LLC in New York, NY. Capstone is a private finance company that provides single invoice factoring, purchase order and trade financing that is vertically integrated into its factoring platform. Capstone also offers guidance for new brokers to help learn how to find clients, qualify them, and refer them to funders. For more information about Capstone and its services, visit www.capstonetrade.com.

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