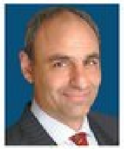
Innovations in Factoring — Limited Subordination Agreements

BY JOSEPH F. INGRASSIA

To assist the growth of small businesses in a flat economy, Capstone Capital developed the concept of a limited subordination agreement. As Joseph Ingrassia explains, the financial structure is rooted in factoring that combines a modern mix of PO finance and trade finance to help the lender get paid and provide working capital to the small business.



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The financial crisis and resulting slow recovery continue to have a negative impact on various business and industrial sectors, limiting the ability of affected companies to grow. Access to capital for growth is restrained by balance sheet issues and the limitations that have been placed on banks as a result of Dodd-Frank financial legislation. It is the 'law of the land,' but the actual regulations are still a work in progress.

As a result of these uncertainties, the financial industry must adapt to these realities and create new structures within the factoring industry to maintain strength in the backbone of our economy — small businesses.

Factoring has often been a dirty word in corporate finance. Its connotation was out of a desperate need of capital, unable to borrow from a bank or finance company. However, with the economic and legislative realities of the current economy and what the Fed has on tap for the foreseeable future, factoring is poised to become a central part of a company's capital structure.

In fact, factoring is set to become more mainstream than ever before. Why? This phenomenon is a result of borrowers' balance sheets recovering as slowly as the economy. In order to grow, entrepreneurs need capital and in many cases their existing bank lines are limited or have been terminated because of the loss of equity. The choices are quite stark for small companies that are facing reductions in working capital availability because of required pay downs, restrictions on advances for working capital from their banks and not having access to the equity markets. The entrepreneur can either put more cash into the company (if it is available) or shut its doors.

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A New Era for Factoring

What if a financial structure existed that could help both the lender and small business owner simultaneously? A structure rooted in factoring that combines a modern mix of purchase order finance and trade finance that helps the lender get paid back and provides working capital to the small business to grow.

At Capstone we developed a program where we can participate in the capital structure of a growing or struggling company by entering into a limited subordination agreement with a client's senior lender. We have found this was just what many of the clients in our portfolio needed to grow and increase their profitability.

Transactional Lending: Growth Capital for the Overleveraged

To assist our clients' growth in a flat economy, we developed the concept of a limited subordination agreement (LSA). Under an LSA, the forbearing lender does not subordinate all of its security to the transactional lender. The forbearing lender only subordinates the accounts that are identified by the transactional lender as accounts it intends to finance or factor.

Our experience reviewing thousands of funding requests from companies that are highly leveraged with insufficient assets to collateralize their debt has been to decline the funding request. Any rational lender or factor would have to classify the funding request as hopeless or as an excellent candidate for a bankruptcy filing.

This exact situation has created an opportunity for a new transactional lending structure to meet the needs of both the entrepreneur and the lender's credit committee. The current market challenges include the need to accomplish three objectives:

- *Growth: Help the over-leveraged company grow*
- *Pay back debt: Help the over-leveraged company pay off its lender*
- *Manage unintended risk: Grow our portfolio without adding unintended risk*

Most forbearing lenders will not agree to a subordination agreement, so a new lender or factor can get a first lien on the assets of the borrower as this would defeat the purpose of the forbearance. At Capstone, we know that the lender's goal is to be paid in full whether or not the business survives. Our new solution would have to be novel enough to get the lender's credit committee to go along with the proposed financing structure.

Case Studies: How the LSA Strengthens Balance Sheets

The overall benefits of this structure apply to many different types of companies. Within our portfolio, we have used the LSA with an outerwear company, an electrical contractor and a watch company. Let's take a practical look on how the LSA has helped each of the clients to grow:

Outerwear

Sales at the outerwear company when we began funding the company four years ago were \$2.5 million and it had licenses for a couple of tertiary brands augmented by contract manufacturing for large consumer brands. Sales the following year were approximately \$11 million, and a new license agreement was entered into while the tertiary licenses were phased out and the contract manufacturing business wound down. Sales in year three were \$23 million and a second lender was brought in to manage the increase in sales volume. By the end of 2012, the company had booked \$52 million in sales and began negotiating for two additional licenses that will allow the company to reduce seasonality and increase its sales further. This was accomplished during the worst economy since the Great Depression.

Electric Contractor

For an electric contractor in our portfolio with sales of approximately \$7 million per year for the last several years, we entered in to an LSA with its bank and began to factor its slower paying general contractors. The increased cash-flow has led to a \$2 million per year increase in business because the owner can now bid on additional work without having to be concerned about paying his suppliers and employees. This client banks at a small regional bank and likes the customer service and attention that is paid to his account. As he builds up his balance sheet, he will have no obligation to factor with Capstone, as we have no minimums or financial penalties in our agreements should the client not meet certain factoring volumes. In an uncertain business environment, our flexibility gives comfort to our customer base, while we provide the appropriate level of funding to help them grow and stay within their covenants at their bank.

Watch Company

Sales at our watch company client were on a downward spiral as a result of the financial crisis, where longtime customers of the company had not paid for the merchandise they received and sold. Its bank had classified the loan and moved it to workout. The owner had put in additional equity to the point where he had no more personal liquidity. The company's overseas and domestic vendors would not ship new merchandise unless they were paid in advance and sales were at a standstill. We engaged in a lengthy due diligence process because we

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CHALLENGE: Small businesses are expected to finance their goods or services sold for an additional 60 days to 90 days. This puts significant working capital stress on the company to meet payroll and production costs while also reducing participation in bids for future orders.

SOLUTION: Single Invoice Factoring

TOP FOUR BENEFITS OF SINGLE INVOICE FACTORING

- **CASH-FLOW MANAGEMENT:** Single Invoice Factoring provides a customer with the flexibility to manage its cash-flow now. A borrower could sell a single invoice or a schedule of invoices to a spot factor in exchange for much needed working capital that will provide staying power until cash-flow catches up with expenses. Astute small business owners will increase the cost of their goods to take into account the cost of factoring their invoices.
- **EXTENDED PAYMENT TERMS:** In today's competitive marketplace, there is more pressure than ever to step in front of a competitor by offering extended payment terms. The working capital burden associated with these extended terms can create a host of problems. Larger customers expect extended terms and prefer to do business with those vendors that can provide them. Providing extended terms facilitates positive cash-flow and lowers the costs of borrowing for larger customers.
- **BANKS GET PAID BACK, TOO:** Factors are also adept at working with banks that are unable to extend more credit to a business owner by entering into legal agreements in which the bank permits the factor to purchase accounts receivable that would have otherwise been part of its collateral. This insures that the business owner has sufficient working capital with which to operate until its credit line is paid down.
- **MANAGEMENT & RELATED SERVICES:** Invoice factors also assist in providing accounts receivable management services, credit information on accounts and, in some cases, trade finance or purchase order financing.

(Source: Capstone Business Funding, LLC)