

## Think Partners, Not Competitors

### In Good Times and Bad, Banks and Factors Should Collaborate

BY EINAT STEKLOV

**Not so long ago, small- and mid-sized businesses** had an all-you-can-eat buffet of capital. Investment, regional and community banks, asset-based lenders, hedge funds, factors and individuals all vied for the entrepreneur's business — holding out carrots of competing rates and lighter terms. Banks competed with banks, and banks competed with alternative financing firms. Maybe it's time for factors and bankers to work together...



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**W**e knew that this lending bonanza would come to an end, but we stretched it out as long as possible. And, of course, in 2008, the bubble exploded and it all came crashing down. Today there is far less financing to go around, and small businesses seeking capital have few — if any — choices.

When times get tough — and boy, it is rough out there — it can make sense to turn your competitors into partners. In this case, it behooves banks to stop competing with factors for small business clients, and instead support this alternative financing source by referring entrepreneurs to factors, as well as offer loans to factors themselves. By collaborating with factors, banks strengthen their relationship with small businesses while retaining and growing their deposit accounts. Small business clients, meanwhile, gain fast access to much-needed capital from a financing source that often specializes in their industry and has the capabilities to nurture small businesses.

#### Small Businesses: A Challenging Task for Banks

Today, banks are under tremendous pressure to wipe their balance sheets clean of bad credits, anticipated defaults and other risky loans and customers. Small businesses are often the first to go. Historically, these vulnerable enterprises have presented a higher default risk than their larger counterparts. When small businesses breach their loan terms, there are usually few other capital sources available. As a

result, small business loan defaults can quickly turn into liquidation. In fact, the rate of Small Business Administration (SBA) borrowers that claimed liquidation jumped to 17.1% in 2009 from 8.4% in 2007, according to the *Coleman Report*, a weekly newsletter on SBA activity.

In this post-recession environment and just before entering into a double-dip recession, banks are returning to their core competency of relying on conservative loans to established and profitable businesses. They are also driven to boost their deposit accounts — including those of established small business customers, even though loans to these entities are no longer approved by their credit committees. This conflicting mandate creates a pickle for both the bank and small business owner. At best, banks stand to lose small business deposit accounts. At worst, failure to lend to these entrepreneurs can sabotage long-standing relationships, collection on existing loans and hard-fought reputations. Small businesses in need of capital can feel they've been left high and dry.

This is where factors can be a beneficial partner to both banks and small businesses. Factors not only provide working capital to small enterprises, but administer the costly and time-consuming collection process, improving the stability of the business, and in effect, helping to create a more attractive bank deposit customer. True, financing from a factor is typically more expensive than a traditional bank but much cheaper than equity or liquidation. However, this higher rate is offset by value from the factor's services including checking debtors' credit, managing the collection process and reorganizing the small business's back office.

Despite banks' historic reluctance to work with this financing source, factoring is a long-standing, established industry. In 2009, U.S. factors financed a total of \$116.6 billion in receivables and backed \$480 million in loans, according to the Commercial Finance Association's 2009 Annual Asset-Based Lending and Factoring Survey. Yet banks accounted for just 16% of referrals for new factoring clients that year, according to the report.

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## Win-Win-Win

When factors offer capital to small business bank customers, they create a win-win-win situation.

**FOR BANKS:** By referring new or existing small business clients to factors, banks can grow their deposit accounts and continue their relationships with small businesses for sunnier days. Meanwhile, the factor's working capital financing, A/R management and collection services add value to businesses' daily operations. Such added value is especially critical to small businesses where management capacity is limited. The net result is an improved balance sheet, better cash-flow management and long-term stability of the business — improving the quality and stability of the bank's deposit account customer.

**FOR BANK CUSTOMERS:** Bank customers benefit from access to otherwise unattainable working capital without the hassle of switching banks. In many instances, factoring the receivables is the only way to keep the small business running and prevent liquidation by providing much-needed breathing room for a turnaround of the business. As factors tend to be more forward looking than traditional lenders, they are willing to underwrite current bank clients and manage the financing of riskier businesses — thereby offering working capital lines at times when a bank will not.

**FOR FACTORS:** The factor gains new clients that may stay with the factor for a short/bridge type of financing, or for a longer period of time until such client graduates from factoring and returns to the bank.

## Bank-Factor Collaboration for Good Times, Too

While banks may see partnerships with factors as a short-term solution for down markets, it makes sense to consider this alternative for a stable economy, too. Managing small business customers requires a lot of handholding to ensure the borrower sticks to evolving loan terms. As most small business owners wear the hats of salesperson, operations manager and CFO, they often do not have the time, the expertise or the inclination to constantly monitor their loan terms.

Further, banks are not equipped to provide the flexibility that their small business customers require. Small enterprises by nature fluctuate rapidly, and require partnerships with nimble lenders that can adapt to their rapid growth or tumultuous decline. Banks, meanwhile, are forced to pit their lending practices against historic data. They simply are not set up to respond fast enough to the needs of small businesses, whose lack of tight monitoring often results in the need for overnight cash infusions. A lending bank will often find out about breached lending terms during a quarterly or annual audit — months after the fact.

On the other hand, factors are set up to monitor small businesses on a daily or weekly basis. As they are focused on the collection process, factors know immediately when a business is declining or growing, and can respond accordingly. Furthermore, the large and dynamic U.S. factoring industry is populated by factors with focused specialties, including those targeting specific industries and very small clients that most banks are not able or willing to finance.

These are just some of the reasons Carter Gibson, assistant vice president of commercial lending at First Alliance Bank in Memphis, has upped his client referrals to factors in the past two years. He cites client benefits including straightforward terms and quick turnaround, growth potential without sacrificing equity (which is often the case with private investment or angel funding), as well as working with financial partners that specialize in specific industries.

Meanwhile, by referring small business clients to factors, First Alliance benefits from a continued and stronger client relationship — and gives the business a finance alternative other than a curt “no” from the bank, Gibson says. “This way we can keep a client's

business and grow them over time with the option to move them to bank financing in the future,” he explains. Gibson offers to make introductory phone calls to factors on behalf of clients and attend first meetings between the parties. “It also allows us to be a business partner to the client, rather than just a bank,” he adds.

In cases when a small business client is in default, or when a bank determines that existing clients do not fit its target portfolio, there are several options for transitioning the client out of a bank's lending practice:

- A banker may give the client a notice period within which to take their business elsewhere, or, more constructively,
- The bank may allow the loan officer or relationship manager to suggest a specific alternative to their services: factoring, which might include a referral to a specific list of factors.

Since small business customers may never have heard of factors, an introduction from a banker can launch a new relationship and provide hope for the deposit customer. Moreover, such a referral may be the only exit strategy for the bank short of liquidation. *Factoring can be the fastest, cheapest and most painless exit for the bank.*

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## Financing the Factors

Meanwhile, banks can benefit directly and indirectly by boosting financing to factors. Indirectly, this is the easiest way a bank can build its clientele and reputation in the small business community without taking exposure to this risky market. Directly, banks can profit from factors by financing this industry. Even at a time when banks are reluctant to finance small businesses, they can still participate in this market by providing loans to factors and asset-based lenders while materially mitigating their risk in several ways.

First, the factor's equity is the first loss piece leaving the bank with a senior and much safer slice of the risk pie. Second, since a factor's balance sheet is an aggregation of thousands of receivables across numerous businesses and industries, the bank's loan to a factor is in effect an investment in a very diversified and cross-collateralized asset pool. Third, as extremely hands-on financiers that specialize in this market segment, factors dramatically improve the operating risk profile of a small business financing portfolio through high-frequency, active management aided by customized systems and staffing. Finally, as niche players, factors see a large volume of smaller deals that may slip below banks' radar or beyond their capacity. By financing factors, banks can still have indirect access to this deal flow. [abfj](#)

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