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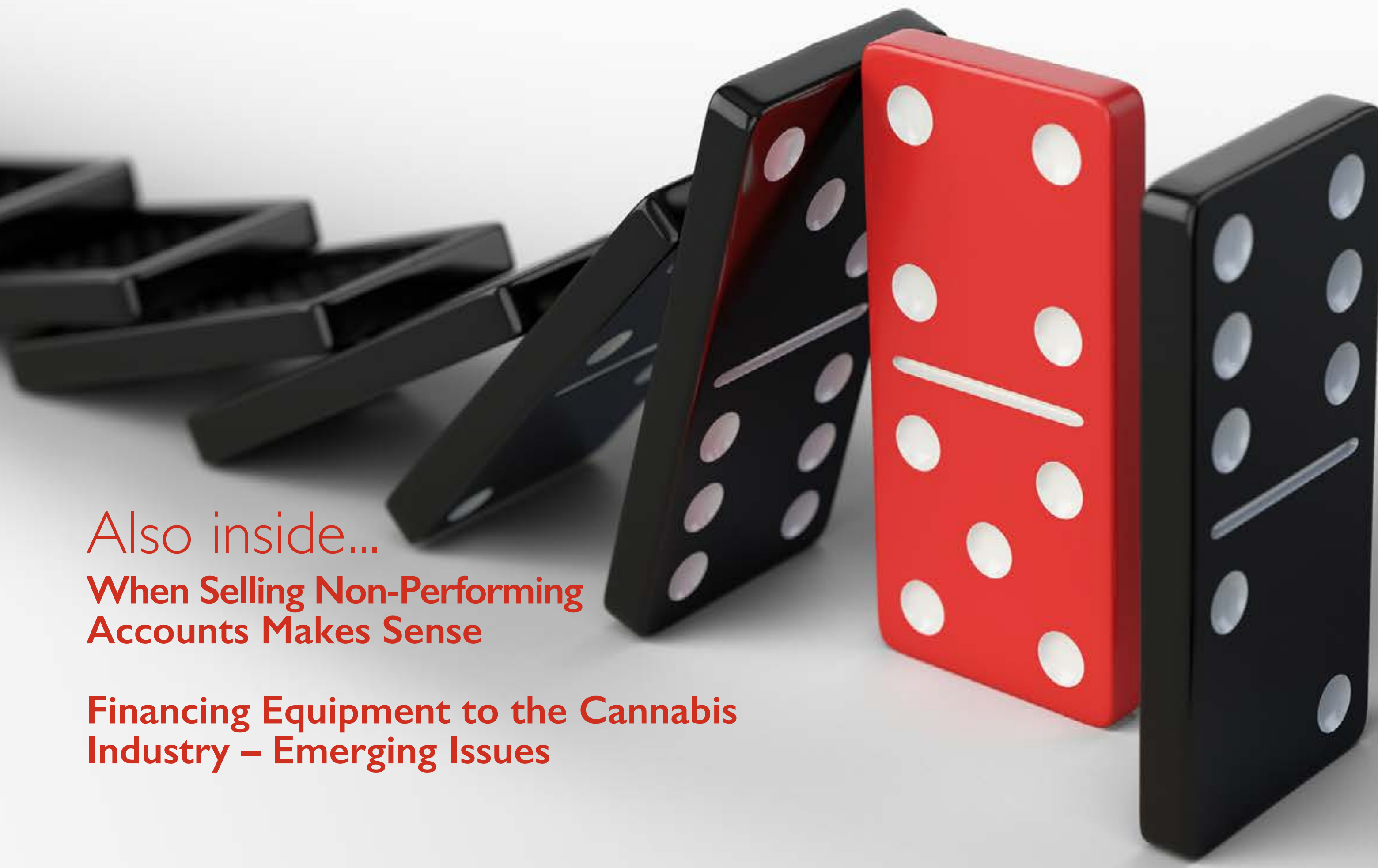

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When Selling Non-Performing Accounts Makes Sense

Financing Equipment to the Cannabis Industry – Emerging Issues

Risk Management Strategies: When Selling Non-Performing Accounts Makes Sense

Commercial debt selling is an effective strategy for managing risk via the selling of non-performing accounts. TBF Financial's Brett Boehm explains the key issues to consider in this process and important steps to making it successful for all players.

By Brett Boehm

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Most corporate customers enter into a lease or loan agreement intending to honor the terms. A business that later defaults on its agreement may, over time, return someday as a customer in good standing. These are important points to consider when evaluating options for handling non-performing accounts. Your goal is to improve return without permanently severing the customer relationship if possible; or damaging your company's reputation. For many businesses in the equipment finance industry, a smart way to do this is by selling off non-performing paper.

Sounds a bit counterintuitive, doesn't it? How can selling off non-performing accounts help protect customer relationships and corporate reputations while increasing revenue?

It can if you understand how commercial debt sale works, are cognizant of the pros and cons, and know what qualities to look for when vetting commercial debt buyers and their brokers. The question of when to sell in the lifecycle of an account is another important consideration for equipment finance companies.

How It Works

Commercial debt selling is a way of selling off non-performing accounts for cash at closing. U.S. equipment finance companies have been using this option since 1998, and today it is an accepted practice. Details of the process can vary from buyer to buyer. So can a seller's desired timing and criteria for selling.

Determining what to sell can be based on several factors. Some sellers designate specific product categories that will be part of the sale. Others select specific geographies, specialties, balances, pool size and/or other criteria. Then there is the question of when to sell, based on the vintage of the accounts. The diagram to the right illustrates the main categories typically used to decide what to sell and what to keep.

Most equipment finance companies that use commercial debt-buying services sell off accounts after they have gone into default and been charged off. This is the point when collection attempts have been exhausted and additional in-house efforts would waste time, money and resources. Some businesses prefer to sell off all accounts after they are charged off. Others opt to litigate accounts valued above a certain threshold and sell off the rest.

So how does an equipment finance company get involved in commercial debt selling, or at least consider it? The following are key steps in the process.

- Learn more about commercial debt buying and vet potential buyers. Important questions to ask potential buyers and their brokers will be covered later in this article.
- When contacting the potential buyer to move forward, you will be asked to supply basic information on the pool of accounts being sold. The buyer may request a simple spreadsheet that includes each obligor's name, address and phone number; guarantor's name, address and phone number; date of last payment; outstanding balance; and a copy of sample media to be provided upon purchase, such as the agreement and pay ledger.
- The commercial debt buyer determines the value of your pool of accounts and offers a purchasing price. If the price is accepted, a purchase agreement is signed by all parties, and the buyer wires the funds to your company on the specified closing date.

Categories for Evaluating Commercial Debt Sales

- **By Product:** small and mid-sized equipment leases, merchant cash advance (MCA), online loans from alternative financiers, bank products, etc.
- **By Vintage:** pre-charge-off, post-charge-off, zero agency, post-agency
- **By Geography:** national vs. state-by-state
- **By Specialty:** Chapters 7 & 13, judgments
- **Out-of-statute vs. In-statute:** OSS accounts sell for basis points; ISS have option of being litigated, increasing their value
- **By Quality:** prime vs. sub-prime
- **By Balance:** any balance segment can be packaged together for sale or entire pool of non-performing accounts can be sold
- **By Pool Size:** one-off vs. pool

- The buyer works on their own to collect the debt, over time, using their own name without representing themself as part of the equipment finance company.
- Many equipment finance companies establish a forward-flow relationship with their buyer that includes regularly scheduled transactions, typically monthly or quarterly, at a predetermined price.

So, how does the buyer make money on the back end? Commercial debt buyers have more flexibility than equipment finance companies in discounting payments and offering extended terms. If an equipment finance company were to provide the same flexibility, word could get out that it is lenient, diminishing the incentive for other customers to honor their agreements.

Pros & Cons

In looking at the pros and cons of commercial debt selling, we need to also consider the alternatives, which include third-party collections agencies, attorneys or continued in-house efforts.

Compared with all three of these options, commercial debt selling delivers immediate monetary advantages, since debt is replaced by cash at closing and a $0 recovery is transformed into money on the balance sheet. When an equipment finance company has an established forward-flow relationship with a buyer, sellers can project receivables and budget appropriately. Compared with continued in-house efforts, commercial debt selling also frees up collections staff for more profitable pursuits.

However, with commercial debt buyers and any other third-party entity (a collections agency or legal firm, for instance) you must take steps to ensure the company you are dealing with is ethical. Make sure the buyer's processes work to your advantage and provide safeguards should you wish to buy back an account later.

Vetting Buyers & Brokers

Every profession has its good eggs and bad apples. Commercial debt buyers, and the brokers they use as middlemen are no different. This checklist will ensure the companies you are dealing with are the real professionals.

- Talk directly to the commercial debt buyer about his/her philosophy, collection process and security procedures.
- Contact references who run companies that are similar to yours.
- Ask the buyer if they will be collecting debts over time, in a sensitive way, using his/her own company's name and not yours. The answer should be "yes."
- Determine whether the buyer will resell the debt? The answer should be "no." This means your company can always buy back an account should an issue arise post-sale.
- Insist that the buyer (and their broker, when applicable) have signed nondisclosure agreements (NDAs) before providing them proprietary information.
- Don't do business with a broker until you verify that he/she has an established relationship with a specific buyer and has done business with that buyer recently.
- Make sure brokers use NDAs to protect the confidential information of all parties.
- Ask the broker how he/she plans to share portfolio information, who will see it, how non-performing accounts will be collected and if they could be resold at any point. Again, the answer to the last question should be "no."
- Make sure the closing transaction goes directly from buyer to seller and does not flow through the broker.

Notice throughout this article we have used the term commercial debt buyers. You want a partner who has extensive experience collecting business-to-business debts. Commercial debt buying is a whole different animal from consumer debt buying, with different requirements and customer sensitivities.

Evaluating Offers

So, you've zeroed in on a reputable commercial debt buyer. How do you evaluate if the price offered is fair? First, do not be tempted to accept an unusually high price. Think carefully about what constitutes a fair offer. Buyers and brokers who offer too high a price to win your business will be desperate to collect debt on the back end and may apply untoward pressure on customers.

Know what factors the buyer will consider when setting a purchase price and think about whether the offer seems fair given these considerations. What is the likely recovery on the non-performing assets? In other words, what is the estimated total net recovery once expenses like costs out, personnel, necessary equipment and asset depreciation are factored in? What is the value of guaranteed money now versus a payment several years from now? The size of the account balance also affects recovery and therefore the purchase price. Larger balances carry more risk and there is a lower percentage of recoveries; smaller balances are more likely to be recovered and carry less risk.

Plan Now

After climbing to a record high in recent history — 6.3 percent in 2009 — default rates plummeted as finance companies purged non-performing accounts from their books and tightened lending in the aftermath of the Great Recession. PayNet data show default rates in 2017 averaged just 1.8 percent, well below the 2.9 percent historical average. If an equipment finance company is experiencing unusually low default rates with customers, however, it can be a negative indicator that signals a business is too risk-averse for healthy portfolio growth. So, we expect to see the current numbers rise closer to the historical average. PayNet forecasts default averages nationwide will rise to 2.1 percent this year and 2.2 percent in 2019.

The current market gives equipment finance companies an ideal pause to reevaluate their processes for handling non-performing paper. Defaults are low now, but they are destined to rise.

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