

Will M&A Activity Pick Up This Year? *To Make it Happen, Buyers of Factoring Companies Must Act*

By Timothy W. Stute

So far in 2006, we have not seen any increase in the number of M&A transactions involving commercial finance companies. While the year has looked to be one of sellers seeing multiple offers and buyers, especially banks, clamoring for assets, so far not much has changed from the prior year. Will the pace pick up?

During 2005, transactions large and small were consummated in the commercial finance sector involving asset-based lenders, factoring companies and leasing businesses. In fact, 29 commercial finance transactions were announced in 2005 representing \$4.6 billion in total deal value, down from 38 transactions for \$8.8 billion in deal value during 2004, according to SNL Financial LC. But as the yield curve flattened earlier this year — the spread between the ten-year treasury and three-month LIBOR is now 23 basis points compared to 124 basis points a year ago — and financial institutions of all types yearned for the asset growth they had experienced in recent years, the table appeared to be set for an increase in acquisition transactions involving high-yielding commercial finance assets.

Through May 2006, however, SNL Financial LC reports that ten commercial finance acquisitions have been announced, representing \$3.6 billion in deal value, compared to 14 commercial finance deals representing \$4.4 billion in deal value in the comparable year ago period.


To be sure, “the word on the street” is that several companies are in the market or

would consider a sale at the right price. But so far in 2006, we have not seen any increase in the number of M&A transactions involving commercial finance companies. While the year has looked to be one of sellers seeing multiple offers and buyers, especially banks, clamoring for assets, so far not much has changed from the prior year.

This is not to say, however, that there has been little action or that there aren't multiple deals currently in the market. The three main constituencies that typically take the hardest look at transactions involving commercial finance transactions — other commercial finance companies, banks and thrifts, and financial investors (private equity firms and hedge funds) — have vigorously sought out transactions in 2006.

Long-time commercial finance players have continued strategies of seeking fill-in or bolt-on acquisitions to complement product offerings. Furthermore, banks continued to enter the asset-based lending market, either for the first time, or to bolster existing efforts through acquisitions. Financial investors, including hedge funds that have typically limited their exposure in

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the commercial finance space to participations in other lenders' transactions, have looked at transactions aggressively in 2006 (and in some cases have started their own internal commercial lending groups), seeking substantial risk adjusted returns. Overall, however, transaction flow has not picked up since the end of 2005.

Perhaps the light transaction volume should not come as such a surprise. The lack of deal flow in 2006 may simply be the result of the fragmented nature of the asset-based lending industry and, to a greater degree, the factoring industry, which has existed for years.

Smaller regional banks and community banks such as Gulf Coast Bank in New Orleans and State Bank in La Grange, TX have built sizable factoring operations, but completely from scratch and without supplementing growth via acquisitions.

Who Are the Asset-Based Lenders for Sale?

Companies that originate asset-based loans backed by either accounts receivable, machinery and equipment or inventory generally fall into one of three categories — large, publicly-traded independents; large, bank-owned units; and smaller (sub-\$200 million in assets) independently-owned lenders. The combination of the first two groups of asset-based lenders mentioned above represent well over 75% of pure asset-based loans originated.

What this means is that the third group — the small independent lenders — comprises a small subsection of the lending community. However, it is generally these lenders who will ultimately seek a sale as the entrepreneurs who founded and operate the businesses seek liquidity. Over the last two years, independently owned and operating asset-based lenders such as Celtic Capital, First Community Financial Corp. and Business Alliance Capital Corp. have all sold in order to seek liquidity for their shareholders and take advantage of a good sellers' market from a pricing perspective.

But how many independents are left to be acquired? Due to the lack of public data showing ownership and size information, it is difficult to tell. But an educated guess would tell you that there are probably less

than 20 independent asset-based lenders that have the critical mass (more than \$25 million in outstandings) to be attractive to buyers. Of those independent asset-based lenders still out there, several factors need to coalesce for there to be a potential M&A transaction.

First, the shareholders must obviously decide to sell, which is far easier said than done given the emotion that comes with selling the business the entrepreneur has grown and nurtured for so long. Second, the commercial finance company must be attractive to a buyer — solid asset

growth, strong credit quality, deep management, and good internal policies and procedures. Finally, and most importantly, the seller must have realistic price expectations. Otherwise, a sale will never happen.

So when you factor in the items that must fall into place for a successful M&A transaction to be completed, you can see how it may be difficult to find a plethora of transactions involving asset-based lenders.

Who Is Buying Factoring Companies?

But what about factoring companies? Are there not hundreds of factoring companies that are independently owned and operated and would consider a sale?

In some ways, the factoring industry landscape is the opposite of the asset-based lending industry. While companies operating in the asset-based lending industry are concentrated at the larger end of the size spectrum, the factoring business is so highly fragmented that most operators fall in the category of being so small that they are really not on anyone's radar. These are finance businesses with less than \$5 million of net funds employed, which make a wonderful living for themselves, but don't have a great deal of franchise value to offer.

But moving up from the small players takes one to a subsection of the factoring world with companies that have anywhere from \$10 million to \$50 million of net funds employed. These companies typically have gross portfolio yields of 25% to 40% and if they have kept credit quality in check, will produce substantial bottom line earnings. These companies, most of which are independently owned and operated, may be of a great deal of interest to potential buyers. But who exactly are these buyers?

For banks and thrifts that have seen net interest margins decline due to the inverted yield curve, an acquisition of a factoring company, or asset-based lender for that matter, seems logical. In fact, banks and thrifts have continued to gain greater knowledge of factoring, while at the same time determining ways to gain entry into or grow an existing business either through organic means or through acquisitions.

But a closer look at the M&A market among banks and thrifts for factoring companies yields contradicting results. While banks and thrifts generally are yearning for assets, especially assets that generate high risk-adjusted returns, not all banks have shown an interest in acquiring factoring companies.

Bank and thrift acquirers generally fall into one of two categories — either financial institutions that already operate a factoring platform or financial institutions that are looking to enter the factoring market. But, how often do we see banks or thrifts acquire finance companies that only provide factoring services without providing asset-based lending? Not often.

Over the last three years, only three acquisitions have occurred involving banks or thrifts acquiring companies that predominantly provide factoring. By contrast, seven acquisitions occurred over that time involving banks or thrifts buying companies that predominantly provide asset-based lending. Even more acquisitions completed by banks and thrifts in the commercial finance space involve equipment leasing companies.

Factoring acquisitions may be infrequently completed for several reasons. First, many banks are simply scared of the factoring business. They either don't understand it, they don't want to understand it, or they see the

high yields that the asset class generates and assume that there must be too much credit risk inherent in the assets. As a result, banks that are interested in buying commercial finance companies often don't make their first acquisition in the factoring sector.

Secondly, the life of an asset-based loan is generally longer than a typical accounts receiv-

cial finance companies such as General Electric Capital Services Inc. and CIT Group Inc. remain actively involved in the merger marketplace. CIT acquired three businesses last year, including Healthcare Business Credit Corp., increasing the buyer's foothold in medical lending. Meanwhile, GE Capital acquired Bombardier Inc.'s inventory finance business last year.

of funds and low leverage, may also continue to explore the M&A market in 2006. To date in 2006, Terra Firma Capital Partners has acquired the aviation lending business of Morgan Stanley. And last year financial players enjoyed a large role in the factoring M&A landscape, as Perry Capital acquired Capital Factors and Greystone & Co. acquired Metro Financial.

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able and therefore may be more attractive. Many asset-based loans sit on a lender's balance sheet for two to five years while an accounts receivable may only be outstanding for 30 to 90 days. Most factoring companies require long-term contracts, but even with the legal relationship, many factoring clients will leave a factor after only one year. Banks often cannot fully understand why it would make sense to acquire a company whose originated assets have such a short life span. What they often fail to comprehend is that buying a factoring company is about buying the human capital and the platform that has shown the consistent ability to generate and service high-yielding assets.

When banks have shown interest in entering the factoring business, they seem more intent on starting a de novo factoring division. Smaller regional banks and community banks such as Gulf Coast Bank in New Orleans and State Bank in La Grange, TX have built sizable factoring operations, but completely from scratch and without supplementing growth via acquisitions. If banks such as these were interested in factoring acquisitions, it would likely be an interest in acquiring portfolios of assets for as small a premium as possible as opposed to paying a premium for a platform acquisition.

Where Will the Buyers Come From?

So who will buy the factoring companies that put themselves up for sale and have realistic price expectations? Large, acquisitive commer-

cial independent finance company mainstays, such as Presidential Financial Corp. out of Atlanta, will continue to make fill-in acquisitions to build out product offerings. Presidential acquired San Antonio-based Alamo Capital Corp., a provider of financing to the healthcare services industry, in late 2005.

Commercial finance companies, whether large firms like GE Capital and CIT, or middle market firms such as Presidential, continue to seek growth via an acquisition strategy in an attempt complement organic growth. While there has been competition from community banks and thrifts that are offering competitive financing to the same small businesses targeted by asset-based lenders and factors, such institutions have had difficulties in maintaining sustained commercial asset growth. Acquisitions of large portfolios or businesses that operate in a niche sector, such as government contracting, temporary staffing or trucking, provide a necessary outlet for continued growth.

Financial buyers, who typically have the most trouble competing for asset-based lending and factoring transactions due to their higher cost

of funds and low leverage, may also continue to explore the M&A market in 2006. To date in 2006, Terra Firma Capital Partners has acquired the aviation lending business of Morgan Stanley. And last year financial players enjoyed a large role in the factoring M&A landscape, as Perry Capital acquired Capital Factors and Greystone & Co. acquired Metro Financial.

While these buyers historically have stayed away from commercial finance opportunities because of a lack of expertise, funding constraints, or perceived high purchase prices, a need to put capital to work and a recognition of the stellar risk-adjusted yields that asset-based lending and factoring can provide has led to this increase in activity.

Still, banks remain the best fit as acquirers of factoring companies and asset-based lenders. In the first five months of 2006, banks large and small continued to actively pursue commercial finance transactions. Wells Fargo & Co. proved to be one of the few banks seeking factoring platform acquisitions as it acquired Commerce Funding Corporation, a specialty factoring operation focused on the government contracting niche. Brookline Bancorp, Inc., a \$2.2 billion asset thrift based in Brookline, Massachusetts acquired Eastern Funding, LLC, a specialty lender to the commercial retail sector.

The benefits of these businesses can extend beyond yield based valuation considerations for banks and thrifts as cross-selling opportunities exist with bank parents that can refer numerous leads that do not meet their underwriting criteria. On the flip side of the equation, commercial finance customers who graduate to traditional bank financing no longer need to go outside of the combined institution.

For increased M&A activity to occur in 2006 and beyond, it will be imperative that banks and thrifts continue to climb the factoring learning curve. Occasional acquisitions of niche factoring companies will

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take place, but for now, it does not appear that banks will often be on the buying end of those transactions. Rather, other commercial finance businesses and financial buyers will likely rule the day. The small number of asset-based lenders that have the scale necessary to attract attention, however, will continue to generate substantial interest among the

bank, commercial finance and financial buyer communities. **abfj**

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