Anatomy of a Deal: Participations

BY GEN MERRITT-PARIKH

At Haversine Funding, we take pride in offering unique and flexible alternatives to our clients. The adaptability built into our DNA allows us to provide senior and junior lines of credit - exclusively to factors and lenders - ensuring we don't compete with our clients.

Just as important as those alternatives, we also offer a participation program for factoring, asset-based lending, and other collateral types to provide even more flexibility to companies in the specialty finance space. Participations are a powerful (and sometimes overlooked) part of the funding mix for specialty lenders. To successfully employ participations, it takes a reasonable tactical plan with true collaboration, where each party has clearly defined roles and expertise. Even with the collaboration required to successfully utilize participations, they should not be omitted from your financial toolbox.

Interestingly, participations are a lot like the team working together in *Ocean's Eleven*. Each player's role is intertwined, and without collaboration, the mission would fail. Most importantly, it's not simply about the goal (or the mission, or the deal in this case), but equally as much about the people involved in that partnership and their funding philosophies. For those unfamiliar, participation financing is a mechanism for lenders to manage concentration exposure and maintain a diversified portfolio. Collaborating on a deal has the added benefit of extra layers of review in due diligence and ongoing monitoring, further reducing risk.

It always helps to talk through a real-world example. In one purchase order participation, a distributor of hoverboard and toy products faced a unique challenge. They received large holiday orders from one existing, creditworthy customer. To meet the demand and grow their business, they needed to access working capital almost double the amount of their $40 million bank line of credit. Clearly, the existing bank facility was insufficient for the amount needed, and timing constraints (the holiday season) posed urgent challenges to execute their plan. (As an aside, it helped that the company had a long history in business, as well as strong relations with their key customers and vendors.)

To bridge their funding gap, the company sought assistance from a well-known and respected purchase order finance company. Even with the purchase order company's experience, several obstacles arose to make the financing a challenging project. Given its size, this transaction represented considerable concentration exposure, as the order was from a single customer, and the deal itself was a larger transaction for the lender's portfolio. Moreover, the products carried the risk of order cancellations prior to delivery, which could leave the lender with a significant amount of inventory without a buyer or - even once delivered and sold - rejections by end customers should product quality issues arise.

The seasonal nature of the business complicated matters further. The company needed to invest in the manufacturing of inventory as early as spring for delivery before the holiday season. This extended cycle would last nine months, creating an added risk due to a large outstanding amount during a short period, with funds recovered gradually only after product conversion into invoices and payments occurred. A potential shortfall risk would exist should everything not go as planned.

Administering the transaction would also require quality controls at the vendor before shipment, monitoring of orders at the SKU level, and ensuring proper invoicing online with timely collections. There were so many moving pieces to the deal. Additionally, an intercreditor agreement with the company's bank lender would require meticulous funds management by the lead, as payments were combined with other customer payments, outside of this one purchase order transaction, under the bank lender's collateral and dominion of funds. Because of the potential comingling of funds, it was critical that the lead lender had the infrastructure in place to properly manage the account and provide ongoing, accurate reporting. Haversine and the lead collaborated closely, finalizing due diligence on the transaction, and implementing strategies to mitigate risks effectively.

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With participations, assessing the lender is as crucial as reviewing the deal itself. Factors such as experience, reputation, processes, systems, people, capital structure, and credit philosophy offer vital insights into their ability to underwrite and manage the deal. Even so, ensuring alignment of interests in the exposure is essential, meaning the lead should have their own funds invested in the deal in some capacity alongside the participant. This way, you are "in it" together. In this case, the lead was considered an expert in their field, had a strong team with solid processes, and was taking a large portion of the deal themselves. Our shared credit philosophy on underwriting and managing risks dramatically helped throughout the process.

The collective effort of our combined expertise resulted in a well-structured transaction that enabled the client to fulfill their orders and achieve success. We each played our part in the process and relied on our strengths. We had the right teams involved with a shared goal and credit philosophy. We did our homework, covering every piece of the transaction. We created a plan (if everything goes right) and then a backup plan for the plan (if it did not). Our collaboration together made this a "win" for the lender, the company, and us for multiple years.

The company continued leveraging the purchase order line in subsequent seasons, until their profitability, aided by their bank lender - eventually providing a seasonal line - could provide appropriate capital for future orders.

In this deal's anatomy, the participation aspect extended beyond the transaction itself. Our team diligently addressed risks and mitigants, but it truly was the combined effort of everyone involved, the people, understanding of essential processes and trust in their execution, that made this deal a success. And, as in *Ocean's Eleven*, once the deal was finished, we all celebrated the company's success and our shared experience that fostered a stronger partnership. With a sense of accomplishment, we now can embark on our next mission, secure in the knowledge we will collaborate again on future deals together.

Gen Merritt-Parikh is the president of Haversine Funding. With more than 25 years of experience in commercial finance, she is responsible for originations, underwriting, investment analysis, and management and asset allocation strategy. In 2018, as President of Allied Affiliated Funding, she led that finance company to a successful sale to a nationally chartered bank.