Asset backed lending in the small business space of the Americas

Savile Finance Group (www.savilegroup.com) - Savile Opportunity Fund (Delaware) and Savile Opportunity Fund International (Bermuda)

Focus: Asset-backed lending. Providing credit through investments that range from $350k-$500k to small businesses in the Americas (US, Latin America and some of the Caribbean). Deals are structured as non-committed one year revolving loans secured with receivables that turn every 60-120 days. Relationships with borrowers typically work as a revolving line of credit that may last 2-3 years.

“Lending money is not all that hard – the trick is getting it back,” J. Pablo Mariño, CEO

Current small business lending environment - US

During the financial crisis The US Treasury Department started to track lending in the small business space. According to research by the NY Times, lending by the 22 largest recipients of the bank bailout has decreased significantly. “During a seven-month period ended in November 2009, the banks reduced their small-business lending by $12.5bn, an overall decline of 4.6%. Wells Fargo and Bank of America, the two biggest small business lenders cut their lending by 4.4% and 6.2% respectively, during that time.”

For Savile Finance Group, which launched the Savile Opportunity Fund in October 2006 supplying credit to small businesses, the continuing illiquidity within this portion of the economy has provided opportunity. Savile pursues an asset-based lending strategy with a strong bias toward lending against self-liquidating assets (over 90% of the programs’ collateral is comprised of 60-120 day receivables) secured with short term borrowers who have temporary or chronic working capital imbalances. These cash flow imbalances typically arise when a company is experiencing a ramp up in production and they require financing to meet their needs.

Has your performance through the financial crisis been driven by opportunity set? (2006 – 2009 performance was +5.21% (3 months), +13.77%, +8.21%, and +11.44%)

The opportunities that have arisen out of this market have allowed us to marginally increase our portfolio yields and allowed us to grow the portfolio at a faster pace than would have otherwise been possible.

But, stable performance is really a function of the kind of business we’re involved in. We shouldn’t ever be the fund that returns +20%, nor should we be the fund that returns -10%. We should be a relatively steady asset because we’re loaning money out at a relatively steady interest rate. I don’t view our returns so much as a function of the opportunity that exists today – it is a function of the business we’ve chosen to be involved in. What I think today’s opportunity gives us is the opportunity to deploy a significant amount of capital over the next few years.

However, even if we are fortunate and raise additional funds, our deal size would not increase dramatically. As part of the risk management process we make sure that a single event default within the portfolio is not going to be a lights-out event for our entire program.

In addition to the risk management of evaluating borrowers what are some of your other risk management parameters for transactions?

Lending money is not all that hard – the trick is getting it back. Origination of transactions is only the first step in a cycle where the entire focus is on getting the money back. We do that quite well.
If you’re going to be involved with lending there are certain aspects you need to be very involved in. The most critical element is a credit evaluation process and methodology where you can get comfortable with and evaluate credits; specifically, we focus on transactions backed by self-liquidating collateral – with collateral that turns into cash as a natural part of a commercial cycle getting the money back in the event of a problem is that much easier. We try to stay away from situations where we would have to sell or refinance assets to get our money back. Credit approval is based on two critical elements; collateral value – we typically advance funds based on a percentage of the borrowers’ receivables - and the borrowers’ capacity to manage debt. .

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If for some reason the receivable does not get paid we then have recourse back to the borrower, as well as other parties. Part of the risk management process is to be sure that our loan is not so large or expensive to the company that they would not be able to repay the loan. A borrower's ability to manage debt is a function of a company's Debt to cash flow and interest coverage ratios. We are constantly assessing what and how our borrowers are doing, through quarterly or semi-annual financials analysis; we also have a field audit team that is constantly on the road ensuring that verification and servicing procedures of loans is in compliance with the requirement of our credit group

Importantly, we evaluate and have formal credit scoring for all parties involved in the transaction: borrower, counterparty or customer of the borrower (off-taker), and source of the transaction. The off-taker (buyers) of the goods or services are often companies that we are able to secure credit insurance on. Approximately 60% of the portfolio's off-takers are covered by credit insurance. These are often companies that are publicly traded so we can get the information we need for a credit review, or governments where financial information is available.

We also widely deploy other risk control methods common in asset-based lending: taking control of the cash through use of bank lockboxes; taking long-term assets into our collateral pool (although we will not lend against them), etc. In addition we limit regional and industry concentrations, as well as concentration to particular off-takers. In general, diversification across all parameters of our portfolio is a major risk control theme for us.

Are small businesses enthusiastic about private firms moving in to provide credit?

There is a truly an acute shortage of financing capital in the economy, so "hesitant" may not the right word. But businesses, and small businesses in particular, are weary of lenders that are not committed to the business of financing operating companies. Small businesses are clearly wary to borrow money from hedge funds because the funds involved in this space 2 years ago really turned on a dime when their own redemptions came in or, as they became more risk averse and abandoned the marketplace. For many of them, supplying credit to this sector of the economy was not a core business and they sort of packed up and left overnight.

Those overnight terminations of loans really caused a lot of chaos for small businesses who relied on the financing. The one comment to make in defense of these funds is that the commercial banks did not behave all that much better.

We are in this space for the long-term, and so we work with our borrowers to make sure that they understand what our objectives are and we understand their businesses very well. Funds that maintained this as a marginal business didn't always understand what they were involved in and the rapid exit hurt a lot of businesses. This was also true of the banking industry, which was involved in so many sectors.

There are some that are very good at this business and that do remain active in it – such as Wells Fargo – but they are targeting loans that are $3 - $10 million in size, which would be huge for us. We are able to service a sector of the economy that they can't reach.

What is your macro outlook in terms of region?

There seem to be a few more people out there that do the things that we do, because they are taking advantage of the situation, but I haven't seen a change in the dynamics of the economy where borrowers or potential borrowers are saying, "I'm fine now, I have a commercial bank that is lending to me." There was a time when small commercial banks would take over a successful relationship but that has not happened the last two plus years. This is allowing us to keep relationships longer and it allows us to cherry pick the best transactions.

We concentrate on Latin America, some of the Caribbean markets, and the US because that is the geographic region that we believe we have particular strength in. We've created loan portfolios in Latin America because we've had a decade of experience there with both the yields being very attractive and the judicial system working as effectively if not better in some cases than in the US.

However, over the past few years, as some of the economies in Latin America have outperformed the US economy, investments there have gone from being a yield enhancer for the portfolio to being neutral on earnings for the Fund. Currently we are getting better yields in the US because of the collapse of the banking markets here. The banking industry in many of the markets in Latin America is still working, and here they are not working at all, providing more US opportunities than I've ever seen before.

Focusing on the US then, what is your outlook for opportunity?

We don't focus on any one sector. We've been involved in the auto industry in the past, and in the healthcare sector and in professional staffing services. One of the things that is different about us is that the turnover of our underlying collateral – about 60-120 days – allows us to make nimble strategic decisions. If for some reason we felt healthcare was going to go through a difficult phase we could begin to move out of that sector. Few asset-based lending strategies have the ability to make that sort of macro-economic strategy shift that we can do because of the short-term nature of our collateral.

We are steering away from certain market places. Construction is a business we like, and where we think we do uniquely well – but we haven't been doing business in Las Vegas and Florida for some time now – and that's more of a macro call. For certain states, being involved in the construction business currently offers a lot of great opportunity to get involved in some of the government projects that are out there. We might not do private enterprise right now, but we're deploying into spaces where the government is a sponsor of the projects.

Temporary staffing in the US rose 9% nationwide over the past 6 months; you mentioned this as an area you source from…

To the extent that any kind of lending supports job creation ours does. The reason we exist is because the firms we work with – small and medium sized businesses – do not typically have the working capital to put to use as they wait for clients to pay on invoices.

For example, temporary staffing has a built in mismatch in cash flow. Temp agencies typically source a worker to a large corporation and for example if they have a two-week placement, they will pay that temporary worker immediately. However, the client firm may not pay the agency for 30-60 days. All of this is a working capital imbalance, and for companies that have these types of needs we are an ideal fit for them.

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