ABL ADVISOR
SERVING ASSET-BASED LENDING DECISION MAKERS

An Elephant in the Room ... The Cost of Factoring

Date: Apr 17, 2013 @ 07:00 AM

I've never had a prospect marvel at how cheap the cost of factoring is. Nor have I ever met a CPA that thought factoring was an inexpensive way to finance a business. Now we even have other receivable lenders (who will remain nameless) advertising all over the free world, "Why pay factoring rates when you can finance with me?" The funny thing is that they too are a factor. While it's true that there are other forms of financing that cost less, there is clearly tremendous value in what factors do. Otherwise, why would there be thousands of us all over the planet funding well over $100 billion per year to a client base numbering in the six figures? But just how does one go about "selling" the price of factoring?

The 'No Brainer'

The best part about being in the factoring industry is watching a client grow, and in some cases the growth is simply amazing. Importantly, this growth is impossible without ample access to working capital. The more the growth potential, the more important it becomes for this capital to be practically unconstrained and unlimited. Those last two adjectives apply to only one form of secured lender, the factor.

One of the companies I worked for financed Atari in the late 1970s. No bank or asset-based lender wanted to venture into this then unknown world of video gaming. But a factor was willing. And for this pioneering risk, the factoring company wanted to be properly compensated. Go figure. And the rate at the time: 8% for a receivable that would turn in 35 days. "Preposterous," say some. "No company can afford that cost and stay in business", say others. Sadly, they are all blind. Because the truth is, Atari could not only afford it, but they could also make more money <u>with</u> factoring than they could without it. But how?

Let's assume they are selling $100,000 per month at a 50% margin and losing money at a clip of $10,000 per month. However, they can double their sales if they just had the cash flow. Enter the factor. At 8% of existing sales, they are now going to lose $18,000 per month. The extra $100,000 in monthly sales is going to cost another $8,000 in factoring fees. Now we're really digging a hole, right? This is usually where the nay-sayers stop the analysis. Of course, factors know better. Those extra sales are generating $42,000 more in monthly margin, <u>after</u> factoring. What appeared to be a $26,000 monthly loss is now a $16,000 monthly gain! Even if we dropped the margin to 25% (the kind of margin most small factoring clients earn at a minimum), the client is still much better off. And things can only further improve with each dollar in new sales. We've all seen clients double their business. Some see growth three, four, even more than ten times their existing sales (like Atari experienced). Again, these clients can't afford <u>not</u> to factor. When you're in this most fortunate situation of talking to a customer who needs the money in order to grow, justifying the cost is a "no brainer."

What's the Cost for Buying Time?

The other most common reason clients turn to factoring is to extend the life of their business. In these cases, they are losing money and have no growth opportunities on the immediate horizon. They are past due on obligations to the point where if they don't come up with some cash quickly, they will be forced out of business. Again, no bank or asset-based lender is going to jump into this dire situation. Once again, enter the factor. This situation is very risky indeed. The nay-sayers will ask, "How can a factor justify charging such high fees? This will only make matters worse." Yet again, we know better.

As for the factor, if we are not properly compensated for this high risk, we will surely not provide the needed capital. So the "high fees" are vital to ensure the availability of factored funds. As for the client, things can't get any worse. If they don't factor, they are out of business <u>now</u>. However, if they do factor, they will buy themselves six to twelve more months of life. And during this "bought time," anything can happen. A new customer can be sourced. Higher pricing might be able to be passed on. Or maybe one of their competitors goes out of business creating a bigger need, higher margin or both for their product or service. Entrepreneurs are nothing if not optimistic and they would rather make one more run than throw in the towel. Factors provide that time in which "anything can happen."

I've been asked a million times, "How can you possibly feel good about charging so much as a factor, especially when the client is already losing money"? My answer, "How can I not feel good?" After all, I'm the only one prepared to help these companies. If I go away, so do many hopes and dreams of these business owners. And if I were to try to charge less and make less return at the same risk, I'd go out of business and everybody loses. And in the end, the closing of the business shouldn't leave anyone worse off. In fact, with each extra payment to a vendor, that vendor's profit margin from that payment can be reserved to soften the impending write off. Everyone benefits from my involvement. So sorry, nay-sayers. I'm proud of what we factors do <u>and</u> what we charge. For a wise man once told me, "The most expensive money is that money which you cannot access." Factoring is far less expensive than that!

Ultimately, Peace of Mind

In the final analysis, factoring allows business owners to sleep at night. For those entrepreneurs with growth opportunities but no way to finance them, we take away those worries and allow them to focus on reaching their fullest potential. On the other hand, for those clients who are only buying time, the relief is temporary. But you almost can't put a price on helping someone continue to pursue their dreams.

Speaking of "sleeping at night," what about those receivable finance companies who are making disparaging statements about the high cost of factoring? It's interesting to note that they can't and don't address the majority of our client's needs. This is because they are trying to deliver a lower-cost service which, according to the first chapter of my college finance textbook, demands lower risk. So they can only help the least risky of clients. And many of those clients can qualify for ABL or even financing from their local bank. So in the end, they have this cheaper service which can't help the market at large. To this, I say "Thanks for nothing!"

Conclusion

Remember, no one seeks out the most expensive option first. All companies want to pay the least amount possible for those needed products and services that keep the business running. Therefore, when we are speaking with a prospect, we must by definition be their least expensive option left. Otherwise they would not be speaking with us otherwise. So when a prospect is complaining about the cost, immediately remind them that they are welcome to call that "cheaper" banker. Of course, they'll have to confess that cheaper money isn't available. Now you get to point out what you can do for the price. You can provide money when no one else will. You can practically make more money available than they'll ever need for creditworthy debtors. In addition, you can assume the burdens of credit and collection. You can do all of this quickly and with fewer restrictions (no concentration limits, no financial covenants, etc.) than all of those other, "cheaper" sources of funds. If you're a factor, never apologize. If we didn't charge what we charge, we wouldn't be there when they needed us. They'd have to go on worrying about how to address their cash-flow problems. One shouldn't try putting a price on peace of mind.

No matter what you sell, be it money, desks, telephones, steel or whatever, your prospects will always want it at lower cost. Price, my friends, will always be "The Elephant in the Room." You can't get rid of it, nor can you hide it. On the other hand, what you can do is decide how you will deal with it. In my case, I deal with it proudly. For if the prospect had access to everything I have to offer at a cheaper price, he or she wouldn't be talking to me. Factors are there when all other sources of commercial finance have left the room. All that remains is me and that darn elephant. But rather than apologizing, I just tell the prospect "You're welcome!"
