FINANCE & COMMERCE

Need cash fast? How factoring works

Posted: 6:25 am Wed, May 15, 2013
By Dan Emerson

When businesses need short-term operating capital, banks and asset-based lenders may seem like the only viable sources of cash.

But there's another source, albeit a more expensive one. Factoring offers an alternative for companies that need to improve their cash flow but don't have access to bank financing or don't want to increase their debt load.

In its simplest form, factoring occurs when a company sells its accounts receivable to a third party, called the "factor," who then takes over the collection of the money due.

The business then receives an advance on the receivables — paying an interest charge on the advance — and avoids having to wait 30 days or longer for its customers to pay for goods or services.

Still, factoring is more expensive than bank loans or asset-based loans for operating capital, according to Tom Geisen, a principal with Hamilton Associates Inc., a Minneapolis-based consulting firm. A 1.5 percent monthly fee based on the invoice amount can run the equivalent of an annual 18 percent interest rate, for example.

Even so, there are situations in which a small business would be better off working with a factoring company rather than a bank, Geisen said.

One example would be a business anticipating rapid revenue growth. By using accounts receivable as collateral, a business may be able to acquire more capital to work with than it would through a bank loan, he said.

Factoring firms finance loans to two types of clients — high-growth, emerging businesses or financially distressed businesses, said Kristin Erickson, a senior vice president with the St. Louis Park office of Princeton, N.J.-based North Mill Capital LLC. In either situation, their historical cash flow (which banks use to determine credit-worthiness) does not support their working-capital needs, she said.

Factoring is intended to serve as "bridge" financing, Erickson said. Her firm might work with a client for a few months or a few years; the average period is about 18 months.

How much money a business can receive in advance varies, Erickson said. For North Mill clients, advance amounts can range anywhere from 70 percent to 85 percent of the receivables and will vary by how much the client needs, she said. Companies in certain industries can obtain financing at higher percentages, depending on the situation.

Commission rates are partially driven by dilution — the discounts, credits or other kinds of allowances customers might take. For example, as an enticement to buy, customers might receive an advertising allowance, thus lowering the amount they pay for the product or service. A factoring firm would slightly increase the commission to compensate for those kinds of "shortfalls."

Commission rates on the sale of receivables vary with the credit-worthiness of the clients' customers, volume and the number of invoices.

Another advantage of factoring is that it won't increase the borrowing firm's debt load and hamper its ability to obtain other financing. Factoring represents a "self-liquidating" loan, meaning that the money is repaid to the lender when the customer pays the invoice, Erickson noted.

A factoring firm typically takes a "discount" (in effect, a fee for its services) ranging from 1 percent to 2.5 percent of the invoice amount, Erickson said, with smaller discounts on larger loans.

For example, on a $1,000 invoice due to be paid by a client's customer in 30 days, the client can get an $800 advance from the factoring firm instead of waiting 30 days for payment. When the customer pays the $1,000 invoice, the factoring firm uses $800 of the $1,000 payment it receives on the invoice to cover its own cost. Then it returns the remaining $200 to its client firm, minus a 1.5 percent discount or $15. In this case, the cost to the client firm is 1.5 percent for 30 days, or the equivalent of an 18 percent annual interest rate.

While factoring costs more than a bank loan, "our clients are 'unbankable,'" Erickson said. "They borrow from us in hopes of becoming bankable. We're there to help them grow and develop that consistent track record of profitability that a traditional lender needs to see in order to lend them money."

North Mill offers asset-based lending and factoring. One primary difference between asset-based lending and factoring is that in asset-based lending, receivables, inventory and/or equipment can be used as collateral, Erickson said. In factoring, receivables are the only form of collateral used.

Another difference: North Mill has a minimum amount of $750,000 for asset-based lending. For factoring, Erickson's firm has a minimum loan amount of $100,000, and can lend as much as $10 million to a single client.

Another difference is that, in underwriting a loan, an asset-based lender evaluates a pool of receivables, by doing quarterly or semi-annual "field exams," Erickson said, whereas factoring involves evaluating the credit-worthiness of each individual invoice.

North Mill allows each of its clients the option of either turning over all of its invoices for factoring, or "picking and choosing" which invoices they will use for financing, she said.

Factoring companies not only lend money but they also provide clients with accounts receivables management (including collections) and credit-management services, according to Kraig Gunwall, senior vice president of sales and business development manager for Burnsville-based TCI Business Capital.

Although businesses may initially call on the services of a factoring firm because of a short-term need, those client relationships frequently become long-term ones because small companies often those need other services to augment their in-house capabilities, Gunwall said.

One value-added service is helping companies improve the efficiency of their billing process, to minimize accounts receivables.

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This entry was posted on Wednesday, May 15th, 2013 at 6:25 am and is filed under Small Business Resource Guide.