

# Factoring for future success

## How invoice discounting can protect your financial viability

By Michael Bogin and Mark Borkowski



A familiar but difficult scenario unfolds. You are the owner of a manufacturing company (or distributor/importer) that is growing rapidly. Sales are up 25% over last year. Success is causing stress. You need a source for some quick cash to keep the company on track. Business is booming, but you are experiencing a cash flow crunch. A cheque expected from your largest customer has not arrived and your payroll is due tomorrow. The phone rings and your call display tells you that your key supplier is phoning you for the third time this week. You know what he wants, so you avoid speaking with him. Your banking facility and your charge cards are maxed out. What do you do?

When timing is tight and access to working capital is critical, invoice discounting (also known as factoring) is a practical alternative to traditional methods of financing. Factoring is a huge and widely accepted practice; however, its benefits and mechanisms are often misunderstood or known only to professionals in the financial services industry. Factored sales for 2001 were over \$3 billion in Canada, US\$116 billion in the U.S., and more than US\$600 billion worldwide.

The rapid growth of invoice discounting in North America and its extensive penetration into almost every industry means that virtually all your major accounts will forward some or all of their cheques to factoring companies. Customers generally pay faster to an invoice discounter than to independent suppliers. The enhanced financing package provided by invoice discounters allows for smoother supplier relationships and offers the ability to lower purchasing costs by taking advantage of trade discounts and volume purchasing.

### What is factoring?

Factoring involves purchasing business-to-business (commercial) invoices at a discount. Factors buy and the client sells invoices. Clients are advanced funds on invoices due from creditworthy customers/account debtors, and advances range from 75% to 90%.

There are two types of factoring products available — recourse and non-recourse. Most Canadian invoice discounters are recourse factors. Recourse factoring means that the client is liable for advances made in the event that its customer doesn't pay in full. Recourse factoring is a more flexible service than non-recourse factoring and is better suited for manufacturers, importers, or distributors that need a variety of financing options. Recourse factors accept the factoring of some sales, as opposed to the "all sales" mandate of most non-recourse factors.

Non-recourse factoring means that the factor assumes the risk of the customer not paying undisputed invoices up to the credit limit/expiry dates approved. Non-recourse factors tend to charge more for their services, but provide a more comprehensive accounts receivable management system, which includes credit guarantees (similar to bad debt insurance provided by insurance companies) and collections. Clients are often required to factor all of their sales.

## **Why use invoice discounting?**

We are living in volatile economic times and traditional lenders are reducing their exposures. A slow motion credit crunch is underway. Banks are tightening their credit standards in the face of problem loans and declining credit quality. Small- to medium-sized enterprises (SMEs) are most vulnerable to the reductions or withdrawal of operating facilities for working capital in this environment. This means that SMEs may need to find another bank to support their operations or may need to work with an invoice discounter for a short period.

Invoice discounters provide more funds or availability than traditional lenders, and a regular and predictable cash flow as and when required. Factors often provide advances by working behind the bank as a source of secondary working capital. Factors can improve banking relationships, as clients can remain in covenant and in margin. By contrast to the banks, high growth, highly leveraged clients are attractive to invoice discounters, who can supply some or all of their financing needs.

Invoice discounting facilities are higher because they are linked to sales and not to rigid balance sheet criteria. Your business and the variables affecting your normal course of business, including seasonality issues, are better understood by decision makers within factoring companies. Factors inherently offer a more favourable risk assessment. There is a reliance upon the quality of the product or service rendered and the credit quality and standing of the customer to repay advances, not the strength of the client's balance sheet. Quality of accounts receivable (A/R) is the common denominator, not equity base, liquidity and cash flow. Customer credit limits are established through pre-screening, so that clients of the invoice discounter stay away from potentially problematic accounts.

Factors have a proven history of leveraging assets, leading to accelerated sales growth and greater profits, which offset invoice discounting costs. This allows you to promote your business with confidence. Opportunities to do more business are not lost to competitors.

## **Terms and conditions**

Invoice discounting terms and conditions vary, but generally speaking the following practices apply:

- Proposals/term sheets can be issued to potential clients in as little as two days upon receipt of the required information. Processing fees to set up a client's account vary widely from nominal to one per cent (or more) of the facility. Advances vary between 75% to 90%, less invoice discounting fees on eligible, fully earned A/R due from creditworthy customers less than 90 days from the invoice date. Export or other insurance on A/R is optional; Export Development Corporation (EDC) coverage is helpful. A factor may provide some inventory financing if it is the sole lender.

- Invoice discounting fees vary from 2% to 5% (or more) for each 30 days calculated on the gross sale value. The factor may require minimum purchase terms of up to 30 days, daily discounted fees beyond 30 days or pre-determined fees for 15-day increments. Fees are closely linked to the size of the transaction, the size and scale of the invoice discounter, ease of administration, and the risk assessment of the client and account debtors/customers. Holdbacks (the reserve amount held by the factor not advanced to the client initially) are either credited or released back to the client immediately on collection of A/R from customers or on a delayed basis (most likely 15 days).
- No minimum term contract is required. This means that a client can work on a "spot" or as needed basis. Lower rates may be available for longer-term contract commitments. Certainly there is a preference for clients that wish to be financed on an on-going basis. Advance requests typically require a copy of an invoice, proof of shipment and a copy of purchase orders, subject to discretion regarding the minimum threshold requirements, (for example, it may be that all invoices above \$2,500 must have proof of shipment only). Some factors require the receipt of original invoices, which they then stamp and mail to customers.
- Notification is given to customers so that they are aware of the invoice discounter's involvement. Customers agree to send their payments directly to the invoice discounter. Non-notification financing (where the factor is invisible to the customer) is generally discouraged. Collection calls to customers can be made by the client or factor, but most factors call customers directly. The collateral required varies, but the invoice discounter always has a first charge on receivables purchased.

Though invoice discounting may not be for everyone, when financing becomes a challenge there are enough advantages to it that it is worth serious consideration.

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## Who qualifies for invoice discounting?

- Turnarounds with a loss history but a profitable future
- Start-ups with little or no profit history
- Vendors with heavy customer concentrations
- Principals with marginal credit history

## When is a good time to use it?

- During periods of rapid growth; transactions financed are generally \$20,000 to \$2,500,000
- When assets (A/R) exceed a company's current lender's appetite to provide more financing
- When a company has a strained banking relationship due to non-compliance with leverage and liquidity ratios or margining requirements

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