



**Small-Business Financing:
Why are companies choosing to
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Your company just received a big order from a major retailer but, due to a shortage of cash, you may not be able to purchase the necessary materials or pay employees to produce the product. You have thought about reaching out to the banks, but the bank will require more than a promise of increasing sales and a good credit rating. Turning to investors is an option, but you are not sure you want to give up a percentage of your business. If you want to maintain control and secure the cash you need to fill the order and expand, factoring may be an option for you to consider. Many business owners don't realize how factoring works or when it may be a good fit for overcoming cash flow challenges.

During the past two decades, small and mid-sized companies have started using factor financing more and more as a practical source of working capital. Factors are flexible and understand entrepreneurial challenges, while banks and other secured lenders are more restricted by regulation and law. Factors provide cash infusions through lines of credit similar to a bank, but the factor is underwriting the future of the business, not the past. When reviewing risk, factors look at the quality of the asset being purchased instead of the underlying financial condition of the seller/client. As a result, factoring can be an ideal financial option for growing businesses that find traditional commercial borrowing impractical or simply unavailable.

What is Factoring?

The factor advances against a portion of a company's outstanding invoices, usually 70–90 percent of the face amount of the invoices, after reviewing the credit-worthiness of the billed customer. When the bill is paid, the factor remits the balance, minus a transaction or factoring fee. Factors have the right to collect payments directly from the account debtors (e.g., customers) who then become legally obligated to pay the factor. Factoring can be a good source of capital for high growth or start-up companies, but it is not always the best method of financing for a company that is shrinking or losing money.

What Types of Companies Make Good Candidates?

Factoring is not a financing solution for every business, but it can be an excellent cash flow alternative for the right company. Companies that benefit from factoring are:

- Start-ups
- Fast-growing businesses
- Companies faced with tax liens
- Companies with little or no equity
- Companies offering business-to-business or business-to-government goods or services
- Companies with a base of customers with good credit
- Companies financing an acquisition or merger

Most companies in a high-growth or start-up phase turn to factoring seeking a good source of capital in order to fund growth and expansion. Companies with strong sales but challenged with slow-paying customers often find themselves in a cash crunch. A previous or current net loss or limited equity are also reasons a company may want to explore factoring.

What to Do When the Bank Says No?

Bank loans are a good source of capital for mature businesses with a proven positive cash flow. The decision to issue a loan will be based on a number of things, including historical cash flow and the personal credit of the owner. To secure a bank loan, the lender will also want to know the reason for the loan, the specific amount of money needed, the age of the business, the business's assets, the number of employees, and the legal structure. If the necessary criteria cannot be met, the bank may be forced to turn you down.

Fortunately, a positive cash flow history and a strong personal credit rating will not be a requirement for factoring if a company has credit worthy customers and strong sales.

Unlike banks, factors are not focused on the company's credit. Instead, factors look at the credit quality of the company's customers. These elements help factors determine how much funding to provide.

The Factoring Process

A factor will ask a company to provide:

- Detailed accounts receivable and accounts payable aging reports along with samples of invoices
- Current and historical financial statements and tax returns for the previous year
- Business organization documents

After a company has been approved for funding, there are two types of factoring options to consider:

- **Non-recourse factoring** occurs when the accounts receivables are sold at a set price and the factor assumes all of the risk for collecting the accounts. Non-recourse factoring is a more expensive form of factoring, but the seller has no credit risk. Thus, if the invoice is not paid, the seller has no obligation to pay back the factoring firm.
- **Recourse factoring** occurs when the factoring firm does not guarantee the credit-worthiness of the client's accounts and the client sustains losses from any uncollected receivables. Recourse factoring is less expensive due to the fact the credit risk stays with the seller. However, if the seller has strong, credit-worthy clients, this is the best factoring option.

Once an option is selected, the factor can determine fees. Fees will range from 1¼–5 percent of the invoice amount for each 30 days an invoice is outstanding. In other words, if a customer typically pays its invoices in about 40 days, the business would take, on average, about a three-percent discount on its invoices in exchange for the factoring company advancing 75–85 percent of the invoice amount shortly after it is issued.

When the factor and the client have executed a formal agreement, the factoring relationship begins and a 10-step process is initiated.

1. The factor approves account debtors' credit

The factor encourages advance notice of pending orders so it can establish account debtor credit limits before the invoices are generated by clients. It does this so clients know prior to shipment whether the factor can approve a given invoice.

2. The factor notifies debtors

The factor must notify debtors it has a security interest and assignment on a client's invoices to preserve the factor's collection rights against the account. This notification usually comes in two ways. First, the

factor requires clients to have specific notification language on invoices. Second, the factor will send separate notification letters to the account debtors. The factor usually sends notification letters only once to each account debtor. While notification letters will state an assignment of invoices has taken place, they will avoid making reference to the term “factoring.”

3. The client submits invoices

In most cases, the factor requires clients to generate invoices with the factor’s remittance address and assignment language clearly printed on the face of the invoice. The client submits a factoring package, which consists of a summary of the invoices, invoice copies, supporting documents (purchase orders, contracts and bills of lading). Most factors will accept electronic copies of the factoring package.

4. The factor processes and verifies invoices

Once the factor receives the client’s factoring request, the factor enters the detail of the request and begins the verification process. Email contact is fast becoming the communication method of choice when attempting to verify invoices and balances with the client’s customers (“debtor”). Direct telephone contact is still a common method but is used less and less. When total verification proves impractical due to an excessive number of account debtors, the factor may instead choose to perform random spot checks. During the verification process, the factor seeks to satisfy that 1) the account debtor has received and accepted delivery of the goods and/or services indicated on the invoice(s); 2) the debtor’s payment is not contingent on the fulfillment of any additional conditions; and 3) the account debtor intends to make the payment in full without asserting any offsetting claims or credits. The factor may also verify the account debtor will be remitting invoice payments directly to the factor. It is important to note that factors often cut back or vary the method of their verification activities for long-standing clients whose receivables consistently perform well.

5. The factor disburses advances

Once the factor has processed the invoices and completed verification, it will typically issue an immediate advance to the client via electronic wire or ACH (Automate Clearing House). After receiving client invoice submissions, the factor will generally try to disburse advances as soon as possible.

6. The factor tracks invoice performance and collects payment

The factor tracks client’s aging invoices and places follow-up inquiry calls to account debtors as invoices become due. The factor can act as a third-party accounts receivable department but will be reluctant to take on the full collection process. Instead, the factor will work with clients to ensure invoices are paid in a timely manner.

7. The factor deposits and posts payments

Most factors will require factored debtors to remit all payments to the factor’s address or lockbox. Once the factor receives the payment, the factor applies the payment as directed by the debtor (as referenced on a check). Note: some factors require a company to factor all invoice QUESTION: “ALL INVOICE” COULD MEAN “ALL OF AN INVOICE” OR “ALL INVOICES” --- WHICH IS CORRECT? and some do not.

8. The factor disburses rebates to client

Under most factor arrangements, clients accrue a reserve account balance as the factor collects account debtor payments. The rebate or reserve is basically the amount of the invoice not advanced to the client less any accrued factoring fees. After deducting factoring fees and any other agreed-upon charges, the factor then remits these reserve account balances back to the client in the form of rebates. The factor will generally follow one of three policies with respect to issuing rebate payments:

- a. The factor pays rebates as individual invoices are collected, subject to a processing lag. In some cases, the factor will make such payments periodically, such as once a week.
- b. The factor pays rebates only after collecting sufficient amounts on individual invoice batches to recover advances and fees.
- c. The factor pays rebates only after collecting full payment for all invoices in individual batches.

Regardless of which policy a factor employs, most impose a standard waiting period to allow for clearing of account debtor checks. In some cases, the factor may also continue to accrue fees during this period.

9. The factor reports to client

Reporting occurs continuously throughout the factoring relationship. Certain reports are triggered by specific events, such as the collection of invoice payments and the generation of rebates. Other reports are issued periodically to keep clients aware of their overall account performance and costs.

10. Clients should expect the factor to provide the following information on a regular basis:

- a. Invoice Aging Report of Factored Invoices
- b. Reserve Account Report showing the balance of the reserve account and detailed charges and credits
- c. Purchase and Advance Reports, which indicate the detail of factoring requests and advances (OR, IF THIS IS A SINGLE REPORT: Purchase and Advance Report, which indicates the detail of factoring requests and advances)
- d. Factoring Fees Report detailing fees paid by the client and accrued fees currently due to the factor
- e. Collection Reports detailing invoices collected; collection dates, including breakdowns (by invoice) of funds advanced to client; fees earned by the factor; and rebates due to the client
- f. Detailed “net out” reports showing the net amount, which would be due to the factor if all outstanding invoices were paid off on a given day

In addition, the factor should have standard and timely procedures for keeping clients informed regarding disputes, unexplained payments and other routine anomalies.

When to Factor

Here are real-world examples of three companies that utilized factoring during different stages of the business cycle.

The Start-up

In 2008, Mr. D. received his first glass-cutting kit, which sparked an idea for a small business. The company transforms bottles collected from businesses and individuals into an array of products that include glasses, decorative bottles, carafes, planters and candles, which are sold to the public.

After launching the business and securing a few customers, Mr. D. tried to secure a small business loan. While he showed good credit and a promising business plan, the banks were unable to loan him the money he needed. On the recommendation of his banker, Mr. D. forged an agreement with a factor in October of 2009. The company factored 12 accounts for the company over a three-year period and was able to secure a \$200,000 line of credit. The factoring relationship ended in November 2012, when Mr. D. secured private equity to finance his working capital.

A Growing Business

A fast-growing company was gaining momentum with its customized software. The software successfully connects cost-effective, skilled software engineers located in northern Mexico to mid-market companies in the U.S. Unfortunately, the software firm was faced with a pending tax lien issue, and as a result, no bank was willing to issue the company a loan.

After a review of their customer and business model, it was clear the growing firm was a good fit for factoring. The company was initially approved a \$250,000 line of credit, which grew to \$1 million in the course of three years. The infusion of cash allowed the firm to successfully grow and clear up tax lien issues. After three years of factoring, the company qualified for a traditional bank line of credit.

Company in a Cash Crunch

A precision sheet metal and machining service company launched in 1983 began showing a decline in profits in 2005. The decrease came after losing a major customer due to a price increase.

A year before the loss in profits, a national bank approved a \$500,000 line of credit (LOC), which was cross-centralized with a real estate loan for a separate company with the same guarantor. In late 2005, the bank required the company to convert the balance on the line of credit to a term loan and obtained a second deed of trust on the owner's residence as additional security.

By early 2006, sales started to improve, but the company was still short cash to meet its operating expenses. As a result, the company was unable to repay the bank term loan and the bank initiated the default process, which put further financial pressure on the company.

The company was in desperate need of cash to meet its increasing sales. In mid-2007, the owner met with a factor that looked at the company's customer base and determined it was suitable for funding. By 2008, the company was showing a healthy profit and was sold to a larger competitor in Phoenix.

Benefits

There are a number of benefits to factoring. First and foremost, it is one of the quickest financing options for turning invoices into cash and it allows the business owner or manager to maintain greater control over the cash conversion process. Also, factoring is cheaper and more dependable than offering customers a cash discount. Finally, rather than hiring additional staff, the company can use the factor as its credit department.

In simple terms, factoring is another form of financing. Like a bank, factors are selling a commodity: cash. The main difference is that factoring is more flexible and has fewer covenants or strings attached. The price for that flexibility is the fees paid to the factor.

The end goal for a factor is not to provide cash simply for companies to survive. The goal is to help companies thrive. When cash flow has stabilized or the start-up has grown, the company can look to other sources of capital, no longer needing to factor.



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