FACTORING 101

BY RACHEL HERSH

Factoring is an age-old form of financing providing companies with much-needed cash.

It takes money to make money, as any business owner knows. But many small businesses also know what it's like to be turned down by a bank for a loan or line of credit, not get as much as they need, or simply not get the cash quickly enough to take advantage of an opportunity.

It's not just start-ups that run into financing difficulties. Even an established company that is growing rapidly will frequently have financial challenges. To make matters worse, owners of small businesses have an especially difficult time getting business credit without relying on their own personal credit and assets as guarantees.

The most familiar method of alternative financing is "accounts receivable" financing. Other terms for this type of financing are factoring or invoice financing or invoice discount financing. Whatever term you may hear, the most important thing to understand is that it means the selling or financing of an invoice or group of invoices to obtain cash quickly.

Invoice financing accounts for about $4 trillion a year in lending in the U.S. It uses the assets of the business — namely a business's accounts receivable — to secure financing by a financial organization. The financing company examines an aging report of the client's debtors, looks at their creditworthiness and does a search of the client's business and its owner's past history. In many cases funding can be provided in as little as five to seven days after application, much faster than traditional forms of business funding.

Invoice financing is a simple and fast way for a business to have cash flow. I created a term to help crystalize this method of financing. Think of it as "An ATM machine for invoices."

Companies "put an invoice through" the finance company and get cash out. The finance company charges a fee for their service, like an ATM charge.

Here's an example:

A client has an invoice for $100,000 and needs an advance. The client sells the invoice to the finance company. Once the client's customer's (account debtor) credit is approved and the invoice is confirmed (goods have been delivered and accepted and/or services have been rendered) then the finance company will advance typically between 75% and 80% of the invoice immediately to the client.

When the client's customer (the account debtor) pays the invoice, they send the money directly to the finance company. Once the finance company collects the funds, they release either the 20% or the 25% reserve minus the finance company's fee directly to the client. The fee structure is usually based upon the anticipated annual sales being funded as well as the strength of the client's customer base. The actual fees are calculated on the number of days the funds are employed on a particular invoice. Invoice finance companies typically buy invoices that pay within 30-90 days from invoice date.

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Example:

Client sells invoice of $100,000 to the finance company.

The finance company confirms that the client's customer (account debtor) has received the product or the service.

The finance company advances 75% or $75,000 to the company.

Once the invoice is paid to the finance company by the client's customer (account debtor) then the finance company releases the 25% reserve, in this example $25,000 minus the fee.

The fee chart may look like this:

Example:

0-30 days from invoice date 1.8%

Each additional 10 days fee rises by 1/3 of the initial fee - .6%

Therefore, if the invoice is paid in 37 days, the fee would be 1.8% plus .6%= 2.4%

In this example, it would have cost the client $2,400 to have immediate access to $75,000.

If the invoice is paid in 49 days, the fee would be 1.8% plus .6% plus .6%= 3%

In this example it would have cost the client $3,000 to have immediate access to $75,000.

For companies that need immediate cash to pay their suppliers, or to make payroll, this cash advance is a lifeline for their business. It is a fast and simple way to grow a business.

Many businesses think that they need to raise equity to grow their business. But why dilute equity when what is truly needed is cash flow? Think of it this way: "Who says you need equity when all you need is liquidity?"

Rachel Hersh is the sales director, North America for Prestige Capital. She has over 20 years of experience as a financial executive in the areas of commercial finance, factoring and business development. Hersh has a successful track record of working with hundreds of companies, from start-ups to high-growth companies to turnarounds, to increase their working capital and growth capital as well as provide debtor-in-possession financing needs.