

The Evolution of Factoring: New Competition for B2B Payments

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Graber Associates LLC

- Founded in 2002
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Why Banks Don't Factor

- Myths versus the realities of working capital lending.
 - Collateral is “invisible”.
 - There are too many regulatory minefields in working capital lending. FDIC or State exam, lines of credit loans are pulled and criticized more often than other hard collateral based loans.
 - Perceived risk (troubled businesses factor) greater than reward.
 - Administrative nightmare.

Factoring

- Buying and selling accounts receivables for less than their face value is called factoring.
- Businesses selling their business-to-business and business-to-government invoices, companies can obtain cash quickly without going through a bank loan process.

Pros

- Businesses can obtain cash quickly without going through a bank loan process.
- Exporters can get cash from an export sale, particularly an “Open Account” sale, without showing a liability on their books like a bank loan. That’s if a factor purchases AR without recourse
- Very attractive to young rapidly growing small and medium businesses, that need to preserve their cash flow and eliminate payment risk.

Factoring Background

- Practiced for centuries were Romans were known for selling promissory notes at a discount.
- Today, \$150 billion dollar industry, more well known in Europe than in U.S..
- Businesses that factor routinely:
 - Garment industry in New York
 - Large businesses
 - Small businesses as a funding alternative.

Factoring Industry Focus on Big Business

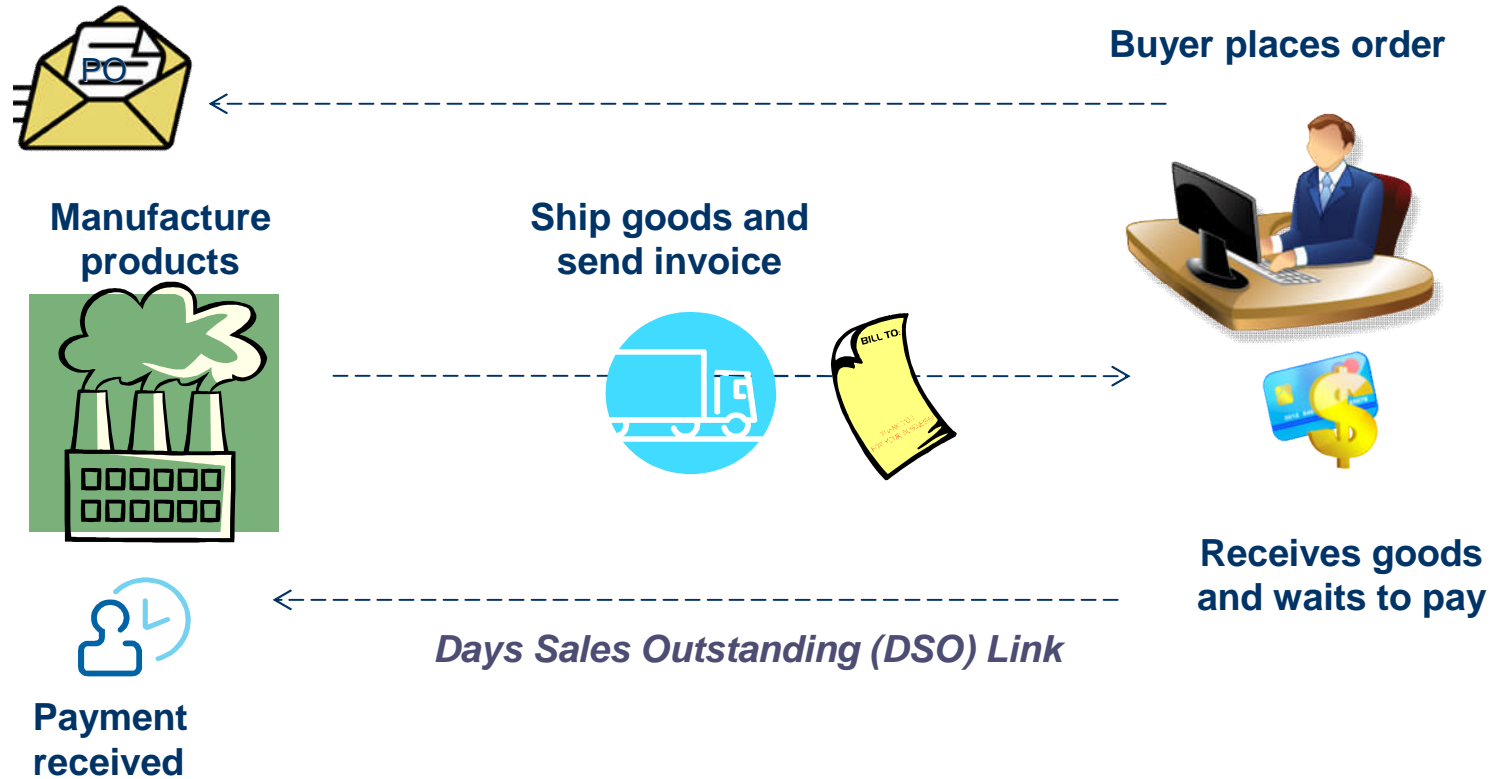


Source: TowerGroup based on Small Business Administration, Dun & Bradstreet, and BizStats

Fragmented Market Place

- Lack of liquidity.
- Many more large factors service large corporate clients.
 - Metro areas, check the Yellow Pages
 - Commitment of \$10,000 a minimum month
 - GE Capital, CIT, Bibby
- Regional factors.
 - Millennium, Riviera, LSQ, Gateway
- Small local factor.
 - Part-time business have low overhead to be profitable
 - Savvy independent investor can make money easily
- New Internet alternative companies, “Spot Factoring”.
 - ReceivablesExchange, auction site
 - Alivia Capital (IOU & Trade Financing), SaaS custom factoring solutions

Business Cycle Mechanics



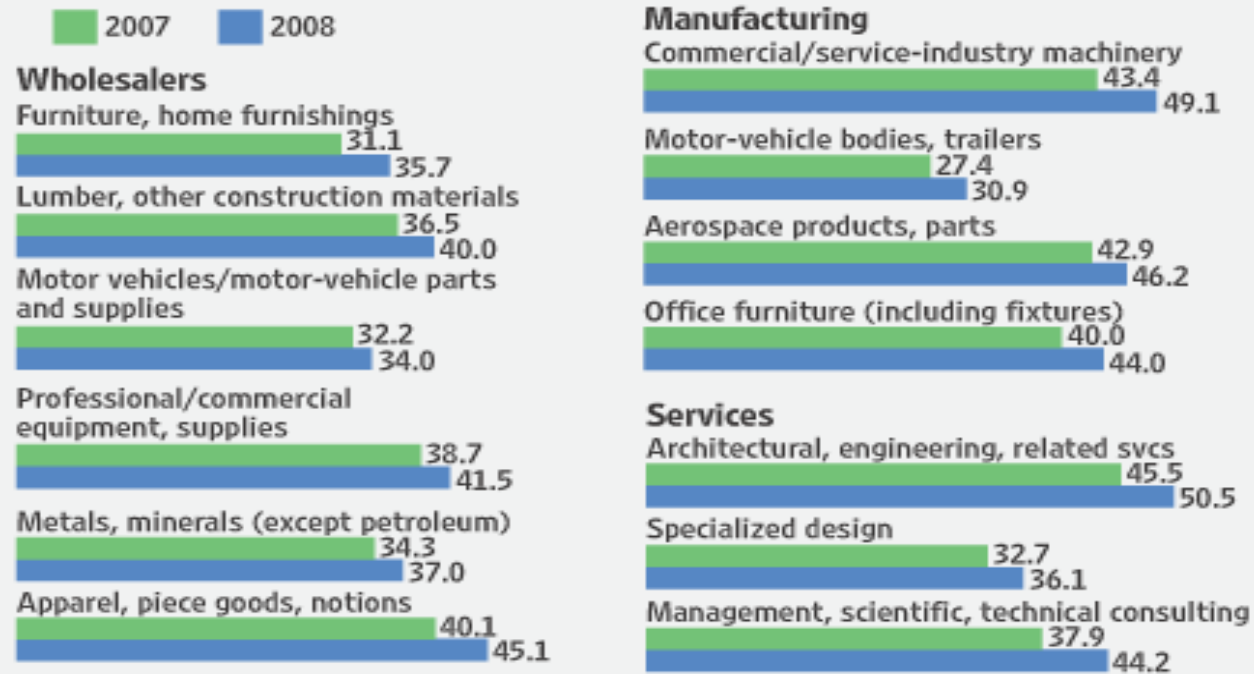
Commercial Paper (CP)

- Each stage of the business cycle (supply chain) generates paperwork, evidence of completion. This paperwork carries a definable monetary value with rights that can be transferred to a third party is commercial paper.
- Evidence of indebtedness from supplier to buyer, is a receivable.
- CP is a very liquid type of asset that can be used to secure working capital loans.

Opportunity - WSJ Getting What's Due 5/11/09

The Check Is in the Mail

Average number of days it takes private companies to collect money owed by customers, by selected industries



Source: Sageworks Inc.

Days Sales Outstand (DSO) Metric

Receivable's Management Link

- Businesses have discovered that effective management of receivables can boost company profitability. Two simple methods for managing receivables:
 - **Supplier offer early pay discounts.** However, businesses are not equipped or inclined to take advantage of early pay discounts.
 - **Supplier factor receivables.** Quick cash.

Two Widely Know Alternative Forms of Factoring

- Merchants who accept credit cards.
- Payday loans.
- Both have different “clients” and “customers” than B2B transactions, but the concept is the same.

Why Offer Factoring Services

- Consistent annualized double digit returns.
- There's more market demand than supply.
- It's a recession proof business.

When Should Businesses Factor?

- Need cash flow (immediate payments).
- Cost of capital is more than factoring.
- Don't want to create more debt (loan).
- Can't get bank financing.
- Can't wait for bank financing.
- Cash management strategy to build up cash reserves.

Why Businesses Factor?

- Waiting for payment can put pressure on a business' cash flow.
- 60% of cash is tied up in receivables.
- Selling receivables at a discount is how to bring in cash quickly.
 - They offer 2% net 10 terms, however, customers take the 2% and still paying 30 days or more.

Factoring Basics

- Factoring is the “purchase” (not a loan) of a “clients” accounts receivable, or invoices, at a discount.
- Unregulated business, factors charge whatever market will bear.
- Factors are more concern about the creditworthiness of their clients “customers”.
- In credit restricted markets factoring booms.
- Use independent agents to keep sales costs low.
 - Earn 10% commission on what factor makes.

Factoring Terms

- Client (seller)
- Customers (buyers)
- Account receivable (Invoices)
- Advance
- Reserve
- Recourse / Non-recourse
- Contract period
- Fees
- Pool

Advance and Reserve

- Factors will advance a portion of the receivables and hold back a reserve.
 - Typical advance is 80%, reserve 20%.
 - Competition will reduce advance.
- When factor is paid by clients customers, fees are deducted from reserve and the amount left is returned to client.

Recourse Options (Risk)

Recourse

- If clients customer fails to pay, factor can go back to their client for payment.

Non-recourse

- Factor has no recourse back to their client.
- Wait for clients customer to pay.

Factoring Contract

- Contract relationship between factor and client.
- Contract period of a year to 18 month commitment, client agrees to factor a minimum \$ amount each month for contract period.
 - Exception to this if client finally gets bank financing.
 - Most factor leads are bank referrals.

Fees and Rates

There is a base discount for the first few days.

- Initial 3%
- Incremental discount for following days.
 - 1% for every additional 10 days
- Large factors also require application or due diligence fees.
 - 1% up front
 - As well as billing fees

Maintaining a Pool

- Good rule is 150% to 200% of anticipated cash needs per client.
 - If a client factors \$5,000 per month, pool should be \$7,000 to \$10,000.
 - To increase pool capacity factors broker deals.
 - You need more funds because:
 - People don't pay on time.
 - Clients will need more funds to fuel their growth.

Calculating Returns

Factoring \$100,000 per Month

Factor 1

- Advance 80%
- Discount 3% for first 30 days
- 1% for every 10 days
- Annual return = $3\% \times 365/30 = 36.5\%$
- Monthly commitment for 1 year of \$100,000 = \$3,000 per month
- Discount / Advance = Monthly Return on Advance amount (\$80K) = 3.75%
- **APR: $3.75\% \times 365/30 = 45.625\%$**

Factor 2

- Advance 85%
- Discount 2% for first 15 days
- 1.5% for every 15 days
- 30 day discount 3.5% = \$3,500
- 30 Day Return % $\$3,500/\$85,000 = 4.1177\%$
- **APR: $4.1177\% \times 365 /30 = 50.00987\%$**

As you can see, you can make remarkable returns

New Factoring Features

- Web based, electronic transactions, no paper.
- Transaction based (invoice at a time, credit card model), perceived lower risk.
- Auction sites.
- Low rates.
- Smaller reserves
- No long-term contracts.
- No recourse.

Summary

- Factoring (working capital lending) is a vital component to any successful lending program within a bank's structure.
- For businesses selling their receivables factoring becomes in essence an unlimited line of credit.
- For banks a lucrative short-term with double digit APR source.