Public Relations, Marketing, and Research
27 Maryvale Road
Burlington, MA USA 01803
+1 781-221-0018
www.graberassociates.net

Sarsha Adrian, Senior Consultant
+1 978-369-7553
Sarsha@graberassociates.net

Followup to Call Topic Conference Presentation

The Changing Face of Factoring

By Sarsha Adrian
November 19, 2009

First, I would like to thank all who participated in our conference. I hope you found it informative. The number of attendees, as well as the quality of the follow-up questions, indicate to me that factoring is finally getting the attention it deserves from “mainstream” financial institutions.

Factoring has re-emerged as a way for fast-moving, aggressive businesses to meet the critical need for working capital financing. As I hope I made clear in my presentation, a growing number of non-bank firms and sophisticated investors already “get it” and are meeting that need.

I believe that instituting or expanding a factoring division is an excellent opportunity for banks to diversify their portfolios, spread their risk, and make an excellent return. I would welcome the opportunity to meet with you and discuss factoring, working capital financing, and the financial supply chain. Please feel free to contact me.

Sarsha

Questions Submitted During and After the Onsite Conference Presentation on November 19, 2009

Why have banks been so slow to take advantage of the factoring opportunity? Is it primarily a risk issue?
Banks like to loan money. They like collateral. But in factoring there is no collateral. Factoring is a purchase of receivables. It is not a loan. And there lies the problem.

Banks think companies that can’t (or don’t) establish a traditional bank relationship are risky and find factoring solutions. But I think things are changing. I think banks should take this opportunity to offer another business-to-business payment (pay the supplier and collect from the customer) solution. But again, it’s a mindset. That’s got to be overcome first.

Is this an opportunity primarily for a national bank, or is it better suited to a community bank?
If you look at the pie chart in the presentation, you’ll see that smaller businesses will go to their local banks, or credit unions, first. That’s typically where their relationship is. There’s the

opportunity, the bank can say “I can do this for you.” If their bank can’t do it for them, then that’s when these businesses will go out and find a small factoring company.

There’s no one significant large factoring company. So there is an opportunity for large banks to service this community, as a whole, both the large companies and the small businesses.

The biggest opportunity is in the small- to mid-tier business space. And surely a large bank should be able to come up with a factoring offer and capture a large segment of the small business market.

What about the opportunity for card companies?

The credit card is a factoring model. So the card companies are almost already there, if they can deal with the paperwork, to be able to capture those receivables. That’s a huge opportunity for them. They could do the same thing.

I know it’s not their complete model. Companies like Master Card and Visa, haven in a sense, been offering extended payment terms. If they could price those products competitively, I think there’s a huge opportunity for the card players.

Do you have any data about businesses’ opinions about factoring? You’ve indicated that companies move to factoring in the absence of bank credit, but what about when bank credit is plentiful? I’m thinking about what will happen when credit comes back.

Great question - I’d like to know who asked that one! Interestingly enough, there’s a change of opinion going on now, a mind shift about what factoring is. It’s almost like factoring is changing its name to business-to-business payment financing.

There’s a huge difference now in the way people in business are looking at this. They want some predictable way of understanding their cash flow. They’re looking at factoring as part of payments. They are interested in an instrument that will finance their transactions.

If I’m a buyer, I want an instrument that I can use to make payments and get extended payment terms. If I’m a supplier, I just want to get paid right away. They both want a standard instrument that they can use to get what they want – predicable cash flow or longer payment terms.

Even when credit comes back, a wholesale return to the banks is not going to happen. I talk to many businesses right now – and when they’re looking for financing, they tell me that banks come back to them after they’ve cut their line of credit. They’re raising the interest rates again and telling the businesses to take advantage of early payment discounts. That’s not what businesses want. They want an actual program. They want an instrument that will facilitate B-to-B payments. And factoring is a reasonable solution.

Related to the foregoing question – do they look at factoring as expensive, as compared to bank credit?

It depends how you look at it. Factoring is a fee-based transaction business. You’re looking at discounts off the invoice amount as the fee. That’s different from a loan from a bank, which is an APR rate. It’s apples and oranges. If a business can qualify for a bank financing and it is their best financing option, then it’s a moot point.

What businesses like about factoring is that it’s not a loan, you do not borrow money. It doesn’t tie up collateral to secure the loan. It doesn’t increase the leverage ratio on the balance sheet. So while it may seem expensive to some businesses, the tradeoffs in their minds are far greater. They’re getting immediate cash, and they avoid doing all the paperwork associated with bank financing. They see factoring as being much more convenient where bank financing is painfully slow.

Banks will face more competition even when credit comes back. Right now, this tough period is a tipping point and resourceful businesses are trying out new solutions to keep them growing.

Another on how business owners feel about factoring. Do business owners feel unease about turning over the client list for collections?

That used to be considered one of the drawbacks about factoring, but not at all. A lot of businesses are using payment companies right now, and the customers' names are known to them. It's not an issue.

Also, remember if a bank issues a secured working capital line of credit, the borrowing company has to provide receivables listings and agings. So that client list isn't kept secret in a regular bank lending situation anyway.

Yes, nobody wants a factoring company to call their buyer and beat them up, either. But it doesn't seem to be an issue. What's happening is that companies are using payments companies in the normal course of doing business. And they like the idea that they have predictable cash flow.

Also, it's a professional relationship that we have here. It's a business-to-business relationship, and people seem to understand it. And as long as you're giving your buyer longer payment terms, it's not a problem.

Is factoring generally invisible from the customer side?

The only time a buyer actually feels the presence of a factor would be in a non-recourse event when the factor would be collecting directly from the buyer. But in doing business, the first thing the factor would do would be to make sure the supplier lets its buyers know that they're going to be paying their factor, not them. So the customers do know that a factor is present.

Do you have any examples of a bank doing this well, and – I almost hesitate to ask – any spectacular failures?

Yes and No. Banks are offering factoring, and they typically offer it through their trade-and-credit banks. Wells Fargo has a trade-and-credit bank, and they are looking at new ways of doing these transactions. Bank of America also factors.

Look at Citibank it has a way of transacting factoring deals for their major clients. People like Home Depot or a Wal-Mart are always looking for ways to improve their cash flow. So there are banks in this space right now, and they're working with selective customers niches.

I think once banks understand the need and its potential, they will get into this business more and more. But maybe it won't be called factoring. Maybe it will be called something like "Reverse Factoring" or "B-to-B Payments."

There are lots of not-so-good successes too. There's CIT, and we don't know if they're going to come back or not. GE Capital had some problems, but again, they survived.

It's all a matter of knowing who your customer is. And that's where banks have an advantage, because banks now who their customers are. If you have that relationship already established, then it's just a matter of knowing the other half of that relationship – your customer's customers – a little bit better if you decide you want to get into the factoring business.

In your opinion, why hasn't a national factoring company been built already? Is it because historically, the factor wants to know the company they're financing? Or some other reason?

The answer to this is liquidity. The demand out there is so huge; it's a matter of having enough liquidity. We are seeing consolidation in the factoring business. A lot of small factors, and regional ones, are merging. And I think the reason is liquidity.

Have you heard of a new e-invoicing and financing company called Syncada? It's a multi-bank, cross-border platform for e-invoicing payments

No, I haven't heard of it. I'm interested in it. There are a lot of people trying to do this now. But one of the things you've got to be able to do is to capture the purchase order as well. That's a way to reduce your risk; you've got to take each of the invoices and match it to the purchase order. It sounds like they might have just one side of the solution. But I'd be interested in hearing more about them. The opportunity for cross-border, open-account payments is huge.

Seems like overseas transactions pose tremendous risk. How do factoring companies deal with collections outside the US?

Interesting. I don't think there's all that great a risk any more, because now we have the ability to order online and do e-invoicing. Open Account terms means the buyer has the final say by accepting goods and services. Accepting the goods triggers the payment to the supplier.

The e-invoicing associated with an open account solution is a very attractive mechanism for doing payments. And it's all about knowing your customer. So if you're doing business here and selling sales in China, there is some risk in doing some types of transactions business if you can't look at somebody eye-ball-to-eyeball. But again, this open-payments process is promising, and it's working really well.

Banks, in the past, with letters of credit (LC) would act as an intermediary an issue documents to carry out the buyer's or importer's instructions. The instructions follow a standard format described by the Uniform Customs and Practices (UCP) for Documentary Credits, International Chamber of Commerce (ICC) Publication 500. The LC provides protection for the supplier against payment risk by fulfilling the terms of the LC document. If the paper work isn't filled out correctly delays the process.

Most businesses are not using LCs anymore because they complicate the process. There is still an opportunity for banks in that space, but the open-accounts approach, the smaller transactions between suppliers and buyers, is what I like. It seems to be working fine.

This question is specific to slide 14 of your presentation where it says "Why offer factoring services?" and the answer is "consistent, annualize double digit-returns." The question is, will the returns go down when the market becomes more competitive and bank credit returns.

No, there will always be a need for factoring. Factors have always had double-digit returns. They haven't changed their model. Their pricing is the same. Now there is competition, with these online services that allow you to factor one invoice at a time. They've very competitive, and they don't really charge that much. But even these online services, the receivables exchanges, are having a problem with liquidity, and factors want a long-term relationship with their clients. So I'll wait to see if these services can survive without morphing into a traditional factoring type of company.

But again, double-digit returns will always be there for factoring.

Slide 15 says "When should businesses factor?" and one bullet-point answer given is "can't wait for bank financing." Would banks really be faster in offering factoring dollars for a basket of accounts receivable than they would be for offering traditional bank-financing dollars?

I like that. I think they could. It's a huge opportunity for banks to be in this space and to offer a great service to their clients.

If they used their lines of credit as a way of factoring these receivables, they could use them in part as a way of financing these receivables. They can be faster. They can be quicker, better. They know their customers better than anyone else. Right now, they don't do this. The banks will want collateral. Or they'll want to do unsecured transactions, and have all sorts of guarantees. And the process slows them down. Banks have a very slow documentation process that is discouraging sometimes.

I talked to a very large, major, manufacturer, and they factor only because it's quicker. That's the first thing that came out of the treasurer's mouth. He said that we know what we're paying, and it's quicker, we know when we need cash, we need to buy something, we need to do something, this is what we do. .

If a bank can figure out how to turn around faster, or package a creative product for their large customers, so they can do this, it would be fantastic.

Slide 10, which introduces the topic of commercial paper, states that each stage of the business cycle generates paperwork as evidence of completion. This paper carries a definable monetary value with rights that can be transferred to a third party as commercial paper. Can you tell us more about that paperwork, and is it actual paper, or electronic information?

I'm sorry if this was a little confusing. In a typical day for a factor a supplier comes and says that he's interested in selling some receivables. Factors have to take time, and do a lot of due diligence, and for that they request all the paperwork from that supplier. They look at the individual invoices; the factor may also look at the financials of the supplier.

But they're more interested in the invoices to the supplier's buyers. And there are legal contracts that the supplier signs in the event of non-payment of the invoice. Factors are getting much savvier to the legal process in case something breaks down. So there is a lot of paperwork, and the really good factors spend a lot of time checking to see if there are liens or other issues. That's what I meant by paperwork there.

In the case of commercial paper – it's a way for banks to improve their own liquidity by taking these transactions and selling them to the commercial paper market. That's what we do with credit cards; Citibank does it with their credit card portfolio. This is something that banks understand. It's not impossible for banks to work with commercial paper companies to improve their liquidity, and if they can prove that their dealings with their business clients are high-quality commercial transactions. That's what I was trying to say, there's a potential opportunity to take these transactions from a bank – especially if it is a highly rated bank – and sell them off to the commercial paper market.

How do bank regulators view the prospect of banks' offering factoring services? Seems like an increased risk flag, if only because it is relatively new and unusual.

You're right. Regulators don't like to see banks take on too much risk. But again, what is a line of credit? It's something that banks clients can use any way they want to. But if banks had a process where they could capture the actual invoices, and to determine their legitimacy, so to speak, then that's a much higher-quality – and therefore lower risk – transaction than a line of credit where a bank has no clue what their customers are doing with it. In factoring, you actually have captured the invoice; you have it in hand. It might not be tangible – not an actual piece of paper, it could be electronic – but you know exactly what you're funding.

Are there markets for evaluation companies, in place, that help determine the value of a company's receivables? Or does a factoring company have to do due diligence on each account? How does it work?

Good question. That's what factors do. Credit analysis and collections, those are supplementary services that the factors actually do. Every factoring company I've interviewed does it themselves. They perceive it as the nature of their business.

We always conclude our Call Topic with the same question. Sarsha, what do you consider the key findings from your presentation today?

I want to emphasize that we know we're in this time of tight credit now. Businesses are going out and seeking ways to get funding. That's what they need to do.

And we're finding that factoring does not hold the same stigma that it once did. People are looking at it as a reasonable financing strategy. If that's the case, then those transactions are never going to go back to the bank. If you have outside companies, capital companies, offering factoring services, there's a chance that businesses will stick with them, unless they can find a less expensive and equally fast and efficient alternative.

Banks need to understand that this is a chance for them to step up and be players in this segment of the industry. They have an edge. They have the relationships already. They would use the same kinds of knowledge and skills – credit analysis, lending, collecting - that they've been trained in. I think it would be a very lucrative opportunity for banks to do this.