There is a common belief that companies factoring their receivables do so only when they are in trouble. Nothing could be further from the truth. Since Colonial times, factoring has been a useful financing tool used by many profitable and well-capitalized companies. Firms in the textile, apparel, home furnishing and many other industries have historically sold receivables; the trade-off of discounting accounts receivable in return for immediate cash provides a significant working capital advantage. As important, the selling company transfers the risk of collecting from obligors.

Until the 1960s, factors were mainly small enterprises, focusing on small and middle market relationships. In order to expand cross-selling opportunities, banks began acquiring factoring operations and, with their lower cost of capital, banks helped reduce pricing and often justified the business case for the expanded use of factoring as a primary source of corporate finance.

Factoring has become almost universal for retailers throughout the world. Although rarely thought of as factoring, credit card programs are exactly that – the selling of accounts receivable at a discount to the credit card company, which then takes the risk of collection. Without these credit card “factors,” all but the largest retail establishments would be cash and carry.

Today, factoring has evolved considerably. Specialty finance companies have taken a different approach to factoring and have developed or are developing new methodologies to meet rapidly-changing capital needs for firms of all sizes.

The Many Aspects of Factoring

In its simplest form, factoring is the transfer of risk – selling accounts receivable at a discount in exchange for immediate cash. While the basics are similar for most parties to the factoring contract, there are some nuances worth mentioning.

Accounts Receivable Purchasing

In non-recourse factoring agreements, the factor accepts all the risks of the purchased accounts receivable. The factor reviews and approves the underlying credit; hence, if a client ships an order to one of its customers without the factor’s credit approval, the resulting receivable would be full-recourse to the client. Because such occurrences are common, one might reasonably conclude that some clients have recourse under certain conditions in factoring agreements. Note that some specialty finance companies “purchase” receivables on a full-recourse basis; this is not factoring.
Customer Notification

Most factoring agreements require customers to be informed of factor’s invoice purchase, for which obligations the customer then becomes responsible to the factor. Such notification is typically included in the invoices sent to customers. Companies that factor, but do not want their customers to be notified, can negotiate a non-notification agreement. Under such an agreement, the selling company bills and collects customers directly. However, if a loss or identified slow pay invoice arises, factors will intercede and bill and collect directly.

Commonly Used Funding Arrangements

- **Advance Arrangement**: Invoice assignment and approval establishes a fixed advance rate.
- **Maturity Arrangement**: Invoices are assigned a specific maturity date, at which time the factor will pay for credit approved sales.
- **Collection Arrangement**: Factor pays client only when the customer pays the invoices.

The All Sales Factoring Contract

The “all-sales” provision requires that all client sales be factored, whether credit approved or not. House sales on the client’s books become property of the factor as well.

Partial Factoring

Partial factoring allows the client the right to select which of its sales are assigned to the factor. In addition, more than one factor is involved in the factoring agreement.

Re-Factoring

Re-factoring has developed over the last twenty years to accommodate the needs of smaller volume sellers (typically, annual sales under $5 million). A re-factor generally manages the relationship with the small company but sells off the risk to a larger factor. The process is the same as a straight factoring arrangement in most cases, but outside lending may be utilized. Re-factoring volume today exceeds $1 billion in the US alone.

Purchase Order Finance

Purchase order financing enables a vendor to have inventory available for their customers’ orders. Such purchases are based on confirmed orders for a credit-worthy customer. Factors facilitate Purchase Order Financing in several ways:

- Factor Guaranties
- Letters of Credit
- Over-Advance Loans
Re-factors also negotiate purchase order financing of their clients (and non-clients as well); some companies negotiate purchase order financing without factoring services.

New and Developing Alternatives

Receivables Management Outsourcing

Recent developments in the business of managing and financing accounts receivable include the use of third-party receivables management firms. By outsourcing credit underwriting, billing and collecting, companies can optimize cash balances without maintaining an in-house receivables infrastructure. This has brought many new firms into the receivables management industry, delivering an array of offerings that can be tailored to client wants and needs. For example:

- Risk Assumption, usually involving A/R insurance.
- Credit recommendations
- Credit process consulting
- Customer care/administrative delinquency resolution
- Collections/charge-off recovery
- A/R System design, consulting, implementation, maintenance
- Cash Applications and lock-box services

International Factoring:

As markets have become global, the importing and exporting of goods and services have opened up additional opportunities for factoring as a convenient and efficient form of corporate financing. When international trade was limited to simple bilateral trade agreements between companies, letters of credit were commonly used to facilitate transactions. In today’s international arena, multilateral dealing is common among companies that utilize many sources of supply and many market outlets across several borders. Factors play a critical role in facilitating a uniform medium of trade acceptance.

Asset Securitization – A Cousin of Factoring

Beginning in the late 1980s, the capital markets began monetizing large pools of contract receivables (mortgages, installment sales contracts, consumer and commercial leases, etc.) by aggregating them into portfolios and selling interests in the portfolios as securities to large institutional investors. Asset securitization has revolutionized the way that companies with large receivable balances finance themselves. Today, virtually all forms of predictable cash-flows are securitized, and trade accounts receivable are no exception.

What differentiates asset securitization from traditional factoring is the sale of the receivables to special purpose entities designed to insulate the receivables from the bankruptcy risk of the selling company. Another difference is that factors typically analyze a receivables portfolio as a single risk pool; in securitization, portfolios are
disaggregated into different tranches of risk. In this way, investors can purchase only the portion of risk that suits their respective investment appetite.

Due to the structure, credit enhancement and risk tranching, the securitization of trade receivables can offer sellers higher advance rates than more traditional factoring or asset-based lending, at a lower cost and often with fewer restrictions and covenants.

**Bringing the Benefits of Capital Markets Pricing to the Middle Market**

As factoring was once limited to companies with large receivables balances, asset securitization has, almost exclusively, been the domain of major banks and corporations. The reason for such exclusivity results from the sources of capital used to fund asset-backed securities – the capital markets – which offer lower interest rates than factors and most commercial lenders. Only the largest issuers with enormous receivable balances to securitize have been able to reap the cost benefits of the capital markets. Moreover, a company’s initial foray into the securitization market requires a significant outlay of legal, underwriting and ancillary costs.

Recently, middle market participation in asset securitization has been restrained by the tightened credit quality criteria institutional investors have applied in the wake of large credit write-downs of the early 2000s. Although the economy continues its recent improvement, it will likely be some time before credit criteria relaxes to accommodate middle market companies. As a mean of addressing the need for more competitive pricing and terms, specialty finance companies have begun developing structured offerings focused on the needs of middle market companies. Such product development focus endeavors to level the cost of capital playing field.

Middle market companies should welcome any opportunity to improve their competitive positioning. The economies of asset securitization can translate into a compelling value proposition:

- Competitive financing, advancing more capital at lower costs
- Flexible financing, allowing for short- and medium-term funding
- Generally, fewer restrictive covenants, i.e., personal guaranties, recourse
- True sale and potential of off-balance sheet treatment
- Improved DSO, cost of funds, liquidity, return on asset ratios

**Market Demand**

Near-term demand for trade receivables securitizations is expected to grow because investors are demanding alternatives to consumer-driven assets; treasurers want alternative sources of capital; and banks are being pressured to increase ROEs. It is also expected that asset-backed commercial paper liquidity facilities will become scarcer and more costly.
Additional demand considerations for these types of financings are expected to be favorably impacted by continued middle market leveraged buy-out and management buy-out activity, and the impacts of ongoing accounting and regulatory changes. The combination of the current state of capital market access to middle market firms and the market demand identified provide a compelling business case for the receivables securitization products offered by specialty finance companies.

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The variety and flexibility of financing receivables continues to evolve. With continuing consolidation of the factoring industry, banking, and asset-based lenders, new opportunities to fill service voids will likely broaden the spectrum of funding opportunities.

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