

## **The Entrepreneur's Guide to Financial Maturity ®** **Factoring - Financing for Companies Seeking Fast Cash**

A healthy cash flow is an essential part of any successful business. Some entrepreneurs claim that a healthy cash flow is even more important than a business's ability to deliver its goods or services. That may be viewed as obsessing on cash flow, however, if a company fails to satisfy a customer and loses that customer's business, it has to work harder to satisfy the next customer. If a company fails to have sufficient cash to pay its employees, suppliers, creditors, or, they are out of business.

One cannot overemphasize the importance of proper cash flow management when establishing, growing, or positioning a company for sale. A financing option available to companies of all sizes, whether a business is growing, "holding its own" or having a cash crunch, is factoring.

Factoring, the process of purchasing accounts receivable from a business at a discount, has been utilized as a cash management tool for generations. Most business people are involved in factoring almost every day, if they use or accept credit cards. Visa® and Mastercard® are the world's largest factors. When a customer purchases a good or service using a credit card, the merchant immediately discounts the invoice by 2% to 5% and immediately receives funding.

Widespread usage of factoring in North American started in the 1600s. Colonist understood that in order to sell cotton, furs, and timber in the European marketplace, they needed to shorten the cash flow cycle. The entrepreneurial Colonists recognized cash outflows (payment of expenses) and inflows (collection from a sale) occur at different times, with cash inflows generally lagging behind their cash outflows. This was especially true when

goods were being shipped to Europe. The long collection cycle left the Colonist in a dilemma, should the Colonial entrepreneur:

- Stop shipping to Europe, thereby limiting the size of the business's market and potential profitability
- Find a financial partner and potentially loose control over the business
- Find other solutions

Many Colonists looked to European Merchant Bankers to advance funds against the receivables, thereby providing the enterprise with cash to continue operations.

Many of today's entrepreneurs face similar cash flow issues. Many companies, especially small businesses, are unable to obtain bank loans, since many are undercapitalized, have a negative net worth and a history of losses. These companies may have accounts receivables that can be financed, thereby providing resources enabling the entrepreneur to focus on implementation of the business plan, not on crisis management.

Factoring is perfect for companies that are fast growing, or companies looking to seize market opportunities. By using factoring, the entrepreneur can meet increasing sales demands. It is almost impossible to outgrow a factor's credit facility, whereas fast growing companies do outgrow bank and other lending institution credit facilities. Outgrowing a credit facility is disruptive; it will strain a company's resources and will be detrimental to the company's financial condition. An entrepreneur's ability to factor is based upon the amount of qualified receivables, and not limited to the line of credit.

Factoring allows a company to obtain financing without selling part of the company. Factoring should be viewed as a bridge to growing a company, an interim step to obtaining a traditional credit facility or an equity capital. Conventional financing will substantially reduce the company's financing costs.

Alternatively, if a company is having cash flow problems, factoring should be viewed as a method to "buy time" to correct cash flow problems. Otherwise, the entrepreneur may have to sell part of his/her company, in a distress sale, or face the prospect of going out of business due to lack of funds.

As we all know, cash flow problems can cripple a business resulting in temporary cash crunches with the inability to pay employees, trade creditors and suppliers. Everyday operations suffer because management's focus is shifted away from operations to collecting receivables on current and past due invoices. Typically, sales, morale and productivity suffer. Factoring reduces these cash crunches and enables the entrepreneur to pay bills in a timely manner, enabling the entrepreneur to build their credit score. Good credit can translate into obtaining conventional financing quicker. Factoring also enables a business to improve its Balance Sheet, further increasing the likelihood of qualifying for conventional financing.

Factoring has helped tens of thousands of entrepreneurs build value in their companies. Many entrepreneurs delayed selling their companies, bringing in new partners, shareholders, or other capital, specifically because they could retain more equity in their business. Most of the time, factoring can be without any personal guarantees (non-recourse). On the other hand, most conventional lenders will require a small business owner to be "at risk" and guarantee a credit facility.

Since factors typically control the billing and collection of invoices factored, a business' customers will know that the receivables are being factored. Many entrepreneurs are concerned as to what their customers will think if receivables are factored.

Will the customer view factoring as a sign of financial weakness? These concerns can be addressed easily, by looking at the services factors provide. Factoring provides for the professional collections of accounts receivable, therefore, they are more effective than the bookkeeper or untrained person. Factors are not in the business to harass or coerce a customer to pay, they want to assist the entrepreneur maintain their relationship, after all, the factor wants to continue to purchase those receivables.

The factor can be a customer relations manager, for example, before the factor funds a receivable, the factor will call the customer to verify that the order was shipped out, and that the quality of the service met or exceeded the client's expectations. When there are quality control or delivery issues, the factor is made aware of it, and this information is immediately conveyed to the entrepreneur. As a result, problems tend to be addressed at an earlier point in

time, before the entrepreneur loses the client.

Factors accelerate the collection process. For example, many companies have two accounts payable departments, one for companies that factor (and report slow paying customers to credit rating agencies) and a separate department for bills that are not factored. Invoices that are factored are generally paid faster, especially when customers are experiencing their own cash flow problems. Faster paying customers translates into reduced factoring costs.

The entrepreneur using a factor specializing in their industry or similar industries can take advantage of their market knowledge, and can serve as an early warning system for customer credit problems. Factors screen your customers' credit, monitor it, and will not want to be at risk if a customer's financial position deteriorates. Factors reduce the entrepreneur's bad debts. Factoring is utilized to strengthen the company.

Many entrepreneurs do not consider factoring because of its "out of pocket costs", ignoring opportunity costs. Too often the entrepreneur will begin the factoring decision by looking at factoring discounts (the percentages of the factor will pay for a receivable) on an annualized basis, like a car loan or a mortgage. An entrepreneur may take a discount of say 3%, and annualize it (multiply by 12) and assume they cannot afford to pay 36% per annum to a factor.

Many entrepreneurs are focused on what's going into someone else's pocket, ignoring the economic benefits entrepreneur receives. For example, can a retailer that doesn't factor (accept credit cards) effectively compete against a retailer that accepts credit cards? In today's economic environment, can a retailer that does not factor become a national chain? Will it thrive? Will it barely survive? Will it fail? Obviously, definitive calculations of opportunity costs are impossible. However, if we make reasonable assumptions, such as those shown below, a compelling case can be made for factoring.

	<b>Monthly Profit and Loss</b>			
	<b>Without Factoring</b>		<b>With Factoring</b>	
Estimated Monthly Gross Sales	\$ 50,000	100%	\$ 100,000	100%
Cost of Goods Sold	\$ 35,000	70%	\$ 70,000	70%
Estimated Monthly Gross Profit	\$ 15,000	30%	\$ 30,000	30%
Fixed Costs	\$ 10,000	20%	\$ 10,000	10%
Variable Costs	\$ 5,000	10%	\$ 10,000	10%
Factoring Fee	\$ -	0%	\$ 3,000	3%
Total - Pre Tax – Expenses	\$ 15,000	30%	\$ 23,000	23%
Estimated - Pre Tax - Monthly Net Profit	\$ -	0%	\$ 7,000	7%

Utilizing this simple calculation based upon reasonable assumptions, it would indicate that this company could barely stay afloat without factoring. With factoring, and the increase in sales, the company is very profitable. This calculation does not assume any cost savings attributable to purchase discounts or any other favorable terms one can negotiate when a company can pay its suppliers immediately.

Why is factoring so expensive? Unlike long term financing, each receivable purchase is short term and labor intensive. Factors provide services that traditional lenders do not: credit screening, credit monitoring, invoice processing, customer relationship management, absorption of credit risks, while providing the entrepreneur comprehensive reporting. These services frequently enable the entrepreneur to reduce his/her overhead. Factoring is volume driven, the more you factor, the lower the costs.

Ultimately, the decision to factor is a business decision. What are the benefits of this money if it is going to cost 2%, 3%, 4% or more? Most entrepreneurs weigh the costs of factoring against the costs of not factoring. Most often the decision is between factoring and putting up with cash flow problems. If the entrepreneur loses sales opportunities, or backlog order are canceled because of the entrepreneur's ability to deliver due to a lack of cash flow, this will decrease a company's growth and profitability.

Generally, documentation required to factor is simple. The entrepreneur begins by filling out a client profile containing such information as the company's name and address, the nature of the business, and customer information. The entrepreneur will be required to supply an accounts receivable aging report, existing customers' credit limits, or other related documents. The factor will attempt to determine the clients' creditworthiness independently. The factor conducts due diligence by researching the entrepreneur's customers' credit and any liens placed against the entrepreneur's company.

During this initial stage the entrepreneur will also cover basic financial arrangements with the factor. For instance, estimated monthly volume of invoices to be factored, estimated advance rate and the discount rate and how many days after approval will it take the factor to fund. In most cases, the answers to these questions will vary depending on the financial strength of the receivables and the anticipated monthly sales volume to be factored. For example, a long list of high-risk clients will cost more in factoring fees than a short list of government agencies with a slow-pay history.

A question that continually arises is "Should the entrepreneurs use a financial intermediary for factoring?" Intermediaries generally help the entrepreneur obtain financing faster, by:

- Identifying the right factor and directing the company to it
- Providing a higher comfort level

Assembling a professionally prepared financial package, allowing the transaction to close quicker

Further, intermediaries often act as the eyes and ears of the factor and therefore factors feel more comfortable. The intermediary provides deal flow to factors, and therefore an entrepreneur will pay the same or less for deals they bring in. Most importantly, the intermediary's presence in factoring, negotiation and the process provides the entrepreneur with a comfort level to complete the transaction.

During the negotiation process, the entrepreneur will become aware of the cost

of factoring accounts receivable. After an agreement is reached with the factor, funding begins. The entire process can take less than 10 days from the factor's receipt of application.

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