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Factoring

With financing from traditional sources becoming more difficult to obtain due to the current economic conditions, companies need to consider other forms of financing for their businesses. Factoring is an option that often gets overlooked but can be a good alternative in certain situations.

One of the most simplest and concise explanations of financial factoring can be found at Wikipedia.org which states that factoring is:

a financial transaction whereby a business sells its accounts receivable (i.e. invoices) to a third party (called a factor) at a discount in exchange for immediate money with which to finance continued business.

Practically speaking, a factor will purchase some (or all) of a company's receivables and immediately advance anywhere from 75% to 95% of the face value of the invoices purchased. The amount advanced will depend somewhat on the financial condition of the company but mainly on the credit worthiness of the company's customers (i.e. the "debtors"). Factors earn their fees in a number ways. Some earn fees simply on the spread between what they advance to the company and what they collect from the debtors. Others charge a fee on the face value of the invoices purchased plus interest on the amounts advanced until the debtor pays the receivable. The combined effective interest rate charged by factors can be anywhere in the range of 15% to 30% per annum.

A key component in a factoring arrangement is whether the factor can "sell" receivables back to the company due to non-payment of invoices by a debtor. If this is the case, the factor is said to have "recourse" against the company for non-payment. Recourse factoring facilities are really loans in disguise with the receivables being used as collateral.

The advantages of factoring include:

1. Immediate availability of cash from sales in order to finance growth. When a company is better off investing in its own growth vs. acting as its customers' bank, factoring can make a lot of sense.

2. If a company's cash flows are irregular or seasonal in nature, factoring can be an effective solution to address its short term working capital needs.

3. Factoring is cheaper than equity and can be put in place in a matter of weeks whereas an equity investment will take a minimum of three to six months to consummate.

4. There are no financial covenants and personal guarantees are not required.

The disadvantages of factoring include:

1. Most factors notify debtors that they have purchased the company's receivables in order to facilitate payment directly to them rather than the company. This can cause confusion with some debtors who may delay paying invoices until they know with certainty where payment should be remitted.

2. Administration of debtor accounts and cash application may be more cumbersome and challenging.

3. Factoring is expensive relative to other forms of debt financing.

The use of a factor during a turnaround situation can be very challenging for a company. This is especially the case in situations where the spread between the profit on the sale to the customer and the fees paid to the factor is small. If the spread is not sufficient to cover supplier payments and overheads, it will only be a matter of time before cash runs out and the company is insolvent. In addition, customers and suppliers may interpret the use of a factor as the final "nail in the company's coffin".

But in the proper scenarios, factoring can be a very effective solution during a turnaround. Factoring can provide management the time needed to execute a restructuring plan and obtain more traditional debt or equity financing. It can provide immediate cash to address short term working capital requirements. And it can reduce overhead costs if the entire credit function is outsourced to the factor.

Aries Advisory Group has significant experience in assisting clients in obtaining financing during turnarounds. We can determine what type of financing is ideal given your company's circumstances. We can then assist in the sourcing and facilitation of a financing agreement with the appropriate lender or factor. We can also assist in the development and preparation of a restructuring plan if necessary. If you have a restructuring or refinancing need, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.