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SFNet Factoring On Demand Series

Module 1: Introduction to Factoring

Secured Finance Network

History Of Factoring

Factoring can be traced back to as early as 1400s, where goods and services were traded in exchange for payment by agents who were called “factors”. Up to the 1600s, Europeans continued to use “factors” to increase their sales and trade.

In the US, during the 1800s, when imports from Europe became more and more in demand, factoring was used to bring in those goods and sell them domestically on consignment. The factor, at that time, performed different tasks to earn his commission. They would store the goods, find buyers for the goods and facilitate payments.

As this form of business became more widely used, the more affluent customers were extended credit. In exchange the factor was allowed to place a lien on certain assets of their clients. Eventually firm sales replaced consignment and the factor no longer had to store the goods and could focus on the client/debtor relationship.

Eventually banking systems evolved, technology allowed more efficient ways to extend credit, take security, collect payments and overall improve the system. The practice of the assignment of receivables evolved so that factors were able to facilitate the trade of goods to many debtors and secured their payments in exchange.

Europe and North America used the practice of factoring in many industries and is now one of the most widely used source of alternative financing.

Factoring Today

U.S. market was $80 billion purchase volume in 2019.

Two main types: Maturity Factoring & Advance Factoring

- In Maturity Factoring, the Factor makes no advance on purchased invoice unless it reaches maturity, i.e., 30-60 days. CIT and Wells Fargo target market.
- In Advance Factoring an advance of 75-95% is made against the invoice, with the balance paid upon collection.

Who Uses Factoring?

Types/Industries

Without Vendor Credit Support

- Transportation, staffing, and other service businesses

Seeking Retail Credit Guidance

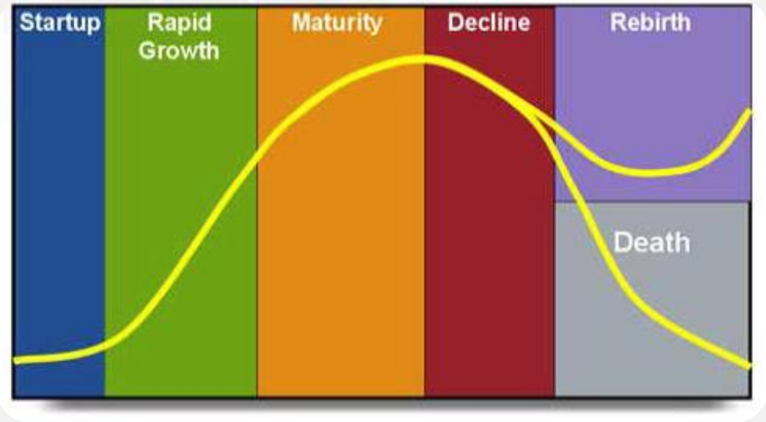
- Apparel, furniture, trade/import goods

Selling to Account Debtors with Extended Payment Terms

- Oil and Gas, metals and chemicals, automotive

Company Phase

- Start Up
- Growth
- Losses / Negative equity
- Turnarounds
- Debtor in Possession (DIP)



Non-Recourse v Recourse

- **Non-Recourse**
  - The factor buys the receivable and assumes the debtor credit risk.
    - Often referred to as traditional factoring
    - Factor assumes credit risk
    - Stringent debtor credit limits

- **Recourse (79% of domestic volume)**
  - The factor buys the receivable but has the right to chargeback unpaid invoices to the client.
    - Client assumes the credit risk.
    - Monitor debtor credit closely because clients are financially weak.

Factoring Foundation

Three legs of the factoring stool:

- **Notification:** Advising the debtor that the invoice has been purchased by and the rights to collect have been assigned to the Factor.
- **Verification:** Confirming, by phone, email or web portal, that the invoice has been issued to and is in the payment processing queue of debtor.
- **Dominion of Cash:** Ensuring that all payments for purchased, and generally non-purchased, invoices are being sent to either an Axiom account or an account with a deposit account control agreement (‘DACA”) in effect.

Structure

Advance Rate and Dilution

- Dilution should drive the advance rate.
- Dilution is non-cash deductions to A/R (i.e., offsets, short pays, billing errors, discounts, disputes, or any reason an invoice is not paid in full).
- You ‘may’ add a 5 - 10% factor into the dilution to determine the advance rate (2x dilution plus 5% is typical).
  - A trucking company with dilution <3%, the advance rate may be 90% or more.
  - A construction company may have dilution of 15%; the advance rate may be set at 70% or more.

Process:

- Client sells invoice to the Factor
- The Factor advances 85% to Client and awaits collection from Debtor (15% is “escrow reserve” – not cash)
- When collected, escrow reserve becomes cash reserve, and The Factor sends 15%, less fees, to Client.

Understanding the Billing

- **Documentation received**
  - Invoices - an invoice is only a reminder of the sale / order
  - Purchase orders, sales orders, client/debtor agreements, bill of ladings, delivery tickets, timesheets, debtor sign off requirements
- **Billing Type**
  - Completed, progress, milestone, time & material, advance, arrears, etc.
- **Industry**
  - Transportation, retail, construction, government, etc.
- **Words to Watch / Potential Offsets**
  - Warranty, guaranteed sale, bill & hold, scan on sale, prepaid, COD, deposits, consignment, contingent, pay when paid, bonding, co-op, rebates, shelf space, restocking fees, open credits, advances, etc.

Glossary

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Definitions

FACTORING also known as invoice discounting, accounts receivable financing, invoice factoring is the sale of accounts receivables or invoices in exchange for a cash payment for a fee.

Wikipedia definition: **Factoring** is a financial transaction and a type of debtor finance in which a business *sells* its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount.

Definitions

Discount – means the amount held of the face amount of such Purchased Account and applied as a reduction of the Purchase Price.

Advance – means the percentage of funds forwarded to the client after the discount and reserves are held

Recourse- means the factor may at any time sell back or chargeback to the client

The invoice they purchased

Non recourse- means that the factor will be responsible for the credit quality of the

Debtor and will assume all credit risk on the purchased receivables

Client- the party who has entered into a factoring arrangement with the factor

Definitions

Debtor- means the customer of the Client

Credit problem- means the inability of a Customer to remit to the Factor the amount due with respect to a Purchased Account as a result of such Customer's financial condition or the occurrence of an Insolvency Event with respect to such Customer.

Default- means breaking the agreement between the client and factor

Dispute- means a disagreement between the debtor and client in the validity of the invoice purchased By the factor

Reserve-means a bookkeeping account on the books of the factor, representing an unpaid portion of the Purchase Price for Purchased Accounts, maintained by the factor to secure Client's performance of its Obligations

Definitions

Reserve escrow-means the amount held from the funded invoice that has not paid

Cash reserve-means the percentage of the funded invoice that has been held in reserve, and Is not available to release to the client

Fee escrow- means the discount percentage held until the payment is received on the invoice purchased

Rebate- means the percentage of the discount returned to the client

Collateral- means the assets that the client provides as security for the factoring arrangement