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Using a Factor to Grow Your Business

by Dan Sullivan

Like nearly every business, yours needs working capital. The problem is your cash receipts from customers tend to come in more slowly than your expenses need to be paid.

If you sell goods or services to other companies, you probably invoice your customers on 30-day terms. Customers, however, often don't pay until 45 to 60 days. In the meantime, employees, suppliers and landlords won't wait to be paid. You need cash to cover the gap. This funding gap may prevent your company from growing as fast as it could.

Many companies look to bank loans for the funds they need. Unfortunately, banks can be very particular about to whom they lend money. So, many business owners use credit cards, home equity loans, equipment leases, personal loans from relatives, and "stretching" their vendors to cover that gap.

Other types of financing are available. Many businesses that sell to other businesses have found that a financing tool called "factoring" provides an attractive, accessible alternative to bank loans and other sources of working capital. Factoring provides your business with cash, based on your receivables. You sell your invoices to the factoring company, and receive much of the value immediately.

Banks tend to have stringent requirements for lending, such as three years of profitability, which a growing young company sometimes cannot meet. Businesses that cannot obtain a bank loan often take advantage of factoring. It fits in well with the needs of a company on the rise, three- to five-years old, that has lots of receivables. Also, service businesses, from temporary staffing to trucking, are well-suited to using factoring as a financial tool.

Though long a traditional financing method in Europe, factoring has not been well-known in the United States until recently. However, it is becoming much more widely used here, showing growth from $65 billion per year to $112 billion between 1995 and 2005.

What is factoring?
Imagine that your customers paid their invoices right away. What would that do for your working capital?

Factoring gives you the same advantage. You sell your invoices to a factor—the company providing the factoring service. The factor immediately gives you 70% to 90% of the value of the invoices. After the factor receives payment, you receive the remainder of the invoice, less a fee. This fee, or "discount" usually is a small percentage of the original invoice amount. This is the factor's profit.

For example, your trucking company hauls a load for XYZ Manufacturing, and you invoice XYZ on 30-day terms for $1,000. You sell the invoice to the factor, and the factor immediately pays you $850. The factor then collects the invoiced amount directly from XYZ, per the terms on the invoice. Then, the factor pays you the remaining amount on the invoice, $150, less a small discount fee.

How does it work?
Technically, factoring is not a loan, it is a purchase of the invoice. In practical terms, however, it works like a loan, with each invoice being used as collateral.

You apply to a factoring company in much the same way you apply for a bank loan. Since the factor will be receiving payment from your customers, not from you, the factor will be looking at the creditworthiness of your customers.

Approval tends to be quicker than it would be for a bank loan, and may come as soon as two weeks.

After you sign the agreement with the factor, you will be able to sell your invoices. Some factors receive invoices by fax, some electronically. Then, the factor pays you, most often by electronic funds transfer, so the cash can be in your bank account the day after the factor receives the invoice.

When you factor an invoice, your customer will be paying the factoring company, not you. This can be confusing to a customer (see sidebar). Part of the factor's job is to explain the process to customers and help make a smooth transition. However, you or your company's staff should also personally tell your customers what to expect.

Once you establish a factoring relationship with a finance company, you can sell some or all of your invoices, depending on your need for cash.

Besides the direct financial transactions, a factor can also provide a whole range of "back office" services. If you don't have a controller, a credit manager and sophisticated accounting software, you may find it convenient to leave many of those functions to the factor. Many factoring companies can provide a wide variety of services relating to receivables: checking customers' credit, creating invoices, collecting on the invoice, even making collection calls.
What happens if the customer doesn't pay the invoice? Your factoring agreement will likely require you to pay the factor for any invoice that goes unpaid for 90 days. Depending on your agreement, you may also be able to replace a bad invoice with another of the same value issued to a different customer.

How to get started
Where can you find a factor? Most banks don't offer this service, but your banker can refer you to a company that does. Business colleagues may also have recommendations.

Whether you get a referral or find a factor on your own, carefully evaluate the factoring company before signing with it. Important qualifications include:

Experience—Does the finance company have many years of experience in processing invoice advances?

Capacity—Does the factoring company fund its invoices itself? Or does it just broker the transactions to another source?

Technology—Does the factor have the ability to receive invoices electronically and process them rapidly, so you can have payment quickly?

If you sell to other businesses, factoring may prove to be a useful financial tool to help you take advantage of your strong sales to help your company grow. When you start to think that you could sell more if you had more working capital, that's a good time to take advantage of factoring as a financing option.

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Common misconceptions and concerns about factoring

Since factoring is not widely understood in the United States, a number of misconceptions have grown up around this type of financing.

In some areas, factoring may be regarded as a less worthy financing option than others, such as bank loans. In truth, it is simply one of many financing tools from which a growing company can choose, according to its needs.

When customers find out you are using factoring, they may worry that you are having financial difficulties, or even going out of business. You can explain to them that, on the contrary, factoring is the financing of choice for many strong, growing companies that use it to provide working capital to achieve their growth potential.

Another concern is that customers may be confused when told they should pay the factoring company. You can explain the arrangement to customers so they are not caught by surprise. An experienced factor knows how to carry out a smooth transition and make sure customers understand the process. Also, factoring may be done under a “non-notification option,” so customers do not know a factor is involved.