INVOICE FINANCE

In 2016 asset based finance grew by 13%, representing a record £22.2bn. According to the Asset Based Finance Association ("ABFA"), invoice finance represents the majority (80%) of this amount. The balance being finance raised against tangible assets (inventory or plant & equipment). [1]

This has been driven by not only SME'S but larger businesses complementing traditional sources such as overdrafts and loans, to finance working capital, new projects, growth opportunities and even M&A activity (which allows a successful acquirer to borrow against the value of the target firm's invoices).

This growth exceeds the first estimate of Q4 2016 economic growth published by the Office for National Statistics of 0.6% and by 2.0% for the full 2016 year.[2]

This guide will primarily focus on the 2 most common types of Invoice Finance: Invoice Discounting & Factoring. We will identify the key distinguishing features and the relative merits of each. By doing so we hope that you are able to identify which product may best suit your business needs.

OVERIEW

Both **invoice discounting** and **factoring** are available to small & large businesses who sell goods or provide services to other businesses with no staged payments on an open account basis. Both help businesses release cash which are tied up in trade debtors.

Such secured financing will bridge the funding gap between the date of sale & issuance of an invoice to the time that a buyer pays for the goods/services. Consequently, it reduces the amount of cash tied-up in working capital and lowers the cash conversion cycle.

The invoice is provided as security & the facility operates on a "revolving" basis, i.e. new invoices received will make new funding available. The source of income for repaying the loan will be the debtor settling an outstanding invoice.

In general, most lenders will provide facilities of 80-90% of the full invoice value, but in practice the level advanced will depend on a variety of elements. The balance of the facility (10-20%) is paid by the factor either by reference to a fixed maturity date or, more usually, when customers make a payment. The **lender/funder** may be a bank, alternative financier or specialist invoice factoring company.

When the funds are collected from the customer, the funder will receive their fees and the rest will be sent to the company.

[1] ABFA - Asset based finance to businesses jumps, 13 March 2017
[2] ABFA Quarterly statistics, December 2016

The **primary difference** between factoring and discounting is who has responsibility for the administration of the sales ledger and collection of the payment from the customer.

With **invoice discounting**, the seller/borrower manages the sales ledger and collects payments as normal. The primary advantage is that the end customer is not aware that the business has a financing arrangement in place, which may otherwise adversely impact the reputation of the company. Although in our opinion it should not do so. While invoice discounting allows you to keep your credit control in house, it still requires a monthly reconciliation with the invoice financier.

Under **invoice factoring**, the financier is responsible for the business's sales ledger and collection of debts so customers may be required to pay the factoring company directly. The funder will also have full visibility of your sales ledger and maintain this by chasing debts on your behalf.

<u>Is it suitable for me?</u>

Invoice finance is most suitable for businesses that provide tangible goods or services to other businesses (B2B) and have high levels of working capital tied up within debtors. It is also extremely useful for growing businesses who are seeking to finance large purchase orders, have little tangible security to provide a borrower and transact with larger buyers who may have a stronger credit standing than they do.

In order to "qualify", borrowers should be able to demonstrate the following:

- a reasonable 'spread' of debtors, either UK domestic or international;
- open-account payment terms up to 60 days from the date of invoice;
- a record of consistent customer payment with few disputes;
- a profitable track record or at least potential;
- creditworthy end customers.

Advantages	Disadvantages
• Approval criteria for invoice factoring is low relative to a traditional loan from a retail bank and may not require collateral • Facility is based on the end customer rather than the business applying • The seller can offer better payment terms to customers • Lower working capital needs • Once the facility is established funds are usually available in 24-48 hours • Scalable funding caters to rapid growth of a business • Available to start-up businesses • Facility may be greater than an overdraft	• Cashflow implications are often misunderstood (*<u>see below</u>*) • Potential relationship risk between the business and the customer with factoring • May require setting up a new bank account • Funding availability will decline with decline of sales • May not be suitable for all business sectors (e.g. retailers) • Ongoing administration is required to ensure funding is available

Ultimately, whether invoice finance is suitable for you will depend on your trading type and the size of your business. It is a **short-term financing solution** and can be useful to bridge cashflow and should not be considered as an alternative to an overdraft or business credit cards. In the long term, a loan or a commercial mortgage may be more appropriate.

Discounting & factoring can reduce working capital constraints, reduce uncertainty of receiving payments, ease cash flow constraints and ensure guaranteed payment; however we would encourage all borrowers to undertake detailed cashflow modelling before proceeding. This is most relevant for start-ups and businesses growing rapidly. At Broadoak we can help you with such an assessment.

INVOICE DISCOUNTING

Invoice discounting is purely a financial product whereby a business can receive funds soon after sending out an invoice, secured against that trade debt. It is simple to operate, has limited administration and you retain complete responsibility over managing customer payments and credit controls. Invoices should be raised with typical payment terms of 30, 60, 90 or 120 days.

This financing is usually not disclosed so customers are unaware of a lender's involvement. The business remains responsible for customer credit risk and the lender may also offer credit protection. This allows cash to be released for working capital or general cash flow purposes and removes uncertainty of timing.

The amount is often geared to the level of debtors, therefore, the facility can grow with the company's requirements. While the borrower pays a lower service fee reflecting the reduced workload involved, the cost will increase if the facility is non-recourse (i.e. the funder takes the risk of non-payment from the end customer). Discounting facilities can fit and work alongside accounts payable, finance and accounting teams within the company.

If a **master invoice discounting facility** is entered into (this governs entire the process), then it allows the company to discount invoices with specific customers and up to the maximum value levels that are agreed.

The primary benefit of invoice discounting is that the security provided is the value of the invoice, rather than a charge of your business. Consequently, smaller start-ups selling to larger well-established businesses are not only able to finance large purchase orders but are able to benefit from creditworthiness of their customers. Furthermore, invoice discounters not only bring considerable experience to managing a debtor book have a vested interest in ensuring that their clients' sales ledger administration and collection performance is optimised.

The information burden however will be higher as the discounter will require the borrower to provide regular information about the continuing relationship with customers. An aged analysis of debt will also be requested early in the month, accompanied by a sales ledger reconciliation and copies of the customer statements that the client has sent out.

FACTORING

Factoring may be viewed as a mix of services, being both a financial and operational product. A commercial business assigns the invoices to a third party (the lender/factor), which have been raised for goods and services provided on open credit. They will in turn receive, up to 90% pre-payment of the face value.

The factor will provide a **sales ledger service,** offer **credit protection** against the risk that customers will not pay and will collect the debts on an open and disclosed basis from customers. Consequently, borrowers have effectively outsourced their responsibility of running a sales ledger. They still manage sales and delivery but hand over to the factor all the routine administration of customer accounts.

This may be particularly beneficial for borrowers who gain access to the factor’s expertise in credit control and collection services, sophisticated credit rating systems and outsourcing non-core operations. The obvious drawback is that it introduces an intermediary between you and your customer.

The factor’s services, comprising as they do a financial facility backed up by the above function, are purpose-built to enable the company to trade on open-account terms and indeed to allow the effective use of credit as a feature of a company’s marketing policy.

With **recourse factoring,** if a customer fails to pay the invoice the seller, is liable to repay the lender/financier, i.e. the factor has recourse to the borrower. This is often in the form of a direct payment or another invoice of equal financial value.

With **non-recourse factoring**, the funder is liable for bad debts and this structure is therefore more expensive, as credit risk remains with the lender. The initial cash advance will also likely be lower.

FEES

Discount/finance fees - are similar to interest charges, in which a percentage of the loan value will be charged at a margin over a base rate. The fee is applied on a daily basis and applied monthly. Finance charges are debited to the client account as the funds are drawn down and cash is then credited to the account on a daily basis with the net effect ensuring that the client pays only for the money drawn down.

Service charge - is levied as a percentage of the full value of the business sales and covers administration and credit management. It will be significantly higher for factoring facilities and if credit insurance (bad debt protection) is provided. It is a function of sales turnover, average invoice value, customer numbers and the general desirability of the business. Factors will also expect a minimum service charge arrangement if sales fail to meet a certain amount.

Credit management fees - relative to turnover, volume of invoices and number of customers a business may have. This is usually 0.75% and 2.5% of turnover, respectively.

CASHFLOW IMPLICATIONS (and a sting in the tail)

Having looked at all the qualitative considerations, we now turn our focus to the primary objective of invoice finance: releasing cash tied up in working capital. Undoubtedly, we are achieving this but are we getting value for money?

Let us assume, that average debtor days are 47 days and we receive funds from a discounter within 48 hours. Upon commencement of the agreement we have successfully brought forward the cash received from our sales by 45 days.

For the next 45 days our cash receipts are effectively doubled (on average), we receive funds for sales made prior to the agreement and new funds brought forward under the discounting agreement.

While the facility is in place we are no longer accelerating our cash receipts but simply maintaining the status quo (assuming flat or low sales growth). The real sting in the tail is that when (and if) the facility is concluded. There will be no uplift but 45 days with virtually no cash expected to be received (the cash that would otherwise have been received has already been brought forward).

If the facility had been in place for 5 years, all we have really done is borrow 45 days revenue for 5 years and paid a service and finance charge (levied on our total revenue) for 5 years. Quite an expensive proposition!

Ultimately, it depends upon the opportunity cost of those funds and how we spend the proceeds of those funds of the course of the five-year period. If it has paid off a more expensive overdraft, the proposition may be compelling, but if the expected ROCE is less than the total fee, one should proceed with due caution.

Purchase Order Finance

Purchase order finance is a close cousin of invoice finance and for that reason we mention it here. As its name suggests, finance is secured against a purchase order received rather than an invoice. When a business receives a large purchase order that it is unable to fulfil (purchase or manufacture) without additional finance, this product provides the capital to do so. The financing is then repaid either by the sale proceeds or invoice finance.

If the business is a trader or distributor, goods may even be sent directly to the end customer and an invoice raised. A funder will fund a percentage of this invoice that is raised to the end customer and these funds will pay down the trade finance line; which is usually more expensive than an invoice finance line.

When combined with an invoice finance facility, it creates a **sustainable debt structure** so that the company can finance non-trade related, but cash intensive elements, allowing expansion based on purchase orders and corresponding invoices with funding to match these requirements.

Finance in relation to purchase orders is usually short-term and on average is usually 45 days per trade. It will usually be the most expensive element of a trade so the aim is to keep it short.

Export factoring

Export factoring is similar to domestic factoring however, an exporter also benefits from local credit approval and collection in the country concerned. The export factor's correspondent factor will also have facilities which will be at the disposal of the UK exporter. Therefore, a credit line can be established using the knowledge & experience of factors in the foreign country, thus both speeding up the process of credit assessment and in doing so ensuring that the majority of sales are covered by credit approval.

Collection is also eased. Statements will be in the language & currency of the country concerned with local practice. Local advice on appropriate sales terms can be made available. Most export factors, as part of their service, offer currency protection to the exporters.

Factors, like other credit insurers and financiers will also consider sovereign risk as well as commercial risk. Clients wishing to export to developing markets are however best advised to proceed only on letter of credit terms.