

Client Briefing 6

Factoring and invoice discounting

Introduction

Many businesses are finding that their banks are seeking to move their borrowings away from overdraft and on to invoice discounting (or factoring) and other forms of lending. Banks are doing so as a way of reducing the risks and cost of management time involved in overdraft lending.

Both invoice discounting and factoring allow you to raise money against your outstanding debtors by in effect 'selling' the invoices to the lender who will advance you a nominal 65% to 85% of the approved invoices immediately. As the lender takes over the debtors as security which are then not available for a bank to secure its overdraft, completion of a factoring deal usually involves paying off the overdraft out of the proceeds of discounting the exiting ledger being taken over.

Factoring or invoice discounting?

In factoring, the lender takes over management of your sales ledger and actively chases in payment, which can in itself be an advantage if your credit control has been poor. In some cases factors will allow a CHOCs arrangement for key accounts (client handles own customers) whereby you retain control of the contact with the customer and some have also developed confidential factoring.

Invoice discounting is usually only available to businesses with turnovers of greater than £1m and differs from factoring in that you continue to run your own sales ledger and collect in your own debtors. As you are continuing to do the work, it is therefore possible to have a confidential invoice discounting arrangement (CID) which means that your customers will not be aware of the arrangement.

Some invoice discounters take finished goods stock or confirmed orders into account and can then offer higher levels of advance against invoices (sometimes exceeding 100% of your debtor book).

Lenders

This has been a rapidly expanding market and there are therefore a wide variety of lenders falling into three main categories:

- bank owned firms who obtain much of their work by their in house bank referrals;
- large independents who provide both factoring and invoice discounting facilities as well as now being able to provide funding packages for use in MBO/MBIs, for example covering property and plant and machinery as well as debtors; and
- smaller players, generally focused on factoring but who may well have developed particular niches such as construction debt, architects' practices, government debt, or care homes which can require particular expertise in lending.

Issues to consider

The issues we at Creative Business Finance Ltd believe you need to consider are:

- With factoring you will lose control of how your customers are chased for payment unless you opt for a CHOCs arrangement.
- Your facility will be based on a percentage advance against approved invoices. The actual (effective) advance you receive as a percentage of your total debtors can be significantly less than

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this nominal headline percentage as the factor may disallow debts over three months old, sales to suppliers, overseas debts, or may set concentration limits where individual customer's debts cannot be more than a set percentage of your sales ledger or credit limit per customer. You need to look at the nature of your debts and ensure that you will not run into such problems.

- Some debts are difficult to factor. There are only a limited number of factors who will deal with contractual debt involving stage payments (such as construction contracts) and sales which require extensive after sales service or warranties (eg bespoke computer software) may not be fundable.
- If you hold customer tools, expect some difficult conversations with funders as to whether this is a good or bad thing in respect of securing payments from customers.
- As the advance is tied directly to invoicing, factoring is well suited to fast growing companies as the financing automatically expands as the business grows reducing the danger of overtrading.
- However, as the facility is tied to sales volume, if sales fall, so does the funding available (which may be just the moment that you need finance the most!).
- Once you have this type of facility in place, it can be extremely difficult to get to a position where you can exit the arrangement.
- There is still a stigma attached to factoring in some circles as it has been seen as financing of last resort, however as banks have moved more customers to this form of financing (and it becomes a normal part of almost every MBO/MBI transaction), this stigma is disappearing (and of course is avoided with confidential invoice discounting).
- Fees will include a cost for an initial audit (which may be refunded against the normal charges if you go ahead), a take on fee for setting the facility up, and an ongoing service charge for running the facility as well as interest on the funds borrowed. Factoring and invoice discounting are often perceived as expensive, however when comparing costs against bank facilities it is important to compare against the total cost of equivalent bank facilities including interest, management charges etc, to reach a fair comparison. Particular issues to consider in any arrangement are:
 - contract length (usually 12 months) and any exit penalties;
 - minimum charges built in (so you end up paying even if you do not draw down cash); and
 - extras where they may be charges for TTs of funds etc. Some lenders appear to quote low on the basis that they will make up revenue on extras, some try and give an all in price, so ensure you are comparing like with like.
- Given that the credit control function is part of what you are paying for in a factoring deal, make sure you understand what level of service you are buying. Are all debtors to be chased or just a top slice? How effective is the chasing? Be sure to take references and ask to meet the operations team who will be handling your account as the sales person you are dealing with now will usually not be involved in the relationship going forwards.
- Not all lenders are as efficient as others. For example some lenders are still not set up to collect data on your sales on a same day basis electronically and rely on you to post/fax a schedule of sales against which you can then draw down, thus building a delay (and uncertainty when the post goes astray!) into the process.
- Finally, ask to see copies of the statements that you will receive on your account. Ensure that these are fully explained to you so that you understand how to follow them once the arrangement is up and running.

A 44 page guide to all aspects of this type of finance can be downloaded at www.creativefactoring.co.uk or for introduction to an appropriate funder please complete the attached fax-back.

Block discounting

Where you have a long term stream of income such as a rental income from property or machinery that is rented out, then you may be able to borrow what is in effect an advance against this future income through block discounting. This is a specialist market where each deal is very much a one-off so you are likely to need to use an independent broker such as ourselves.

Debtor finance enquiry

Your Business

Company name	
Nature of business	
Annual turnover (£ 000)	

Your debtor book

Total debtor value	
£ Over 3 months old?	
£ To overseas customers?	
£ To suppliers?	
£ Stage payments?	

Your existing facility (if applicable)

Lender?	
Type (e.g. factoring)?	
Current advance (£ 000)?	
Advance against stock?	
Current interest rate and service charges?	
Any particular concerns or problems with your current facility? (or use current lender service assessment below)	

Optional current funder service assessment

- | | Yes, I'm happy | No, I'm not |
|--|--------------------------|--------------------------|
| • Easy to understand statements, so that I know where I am? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Free from hidden charges that have made it more expensive than I was expecting? | <input type="checkbox"/> | <input type="checkbox"/> |
| • An actual cash advance that matches the level that I was promised at the outset? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Easy and efficient communication with the lender's operations and a good working relationship? | <input type="checkbox"/> | <input type="checkbox"/> |
| • A good competitive rate without an onerous monthly minimum charge? | <input type="checkbox"/> | <input type="checkbox"/> |
| • An advance against stock as well as debtors, to maximise the funds available? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Efficient and effective collection of debts by my factor, that doesn't upset my customers? | <input type="checkbox"/> | <input type="checkbox"/> |

Creative Business Finance Ltd terms of business

In completing this enquiry form, the Client hereby instructs Creative Business Finance Ltd (hereafter Creative Finance), to attempt to arrange a secured finance facility from any provider of factoring and/or invoice discounting services ('Lenders') who will be approached by Creative Finance on behalf of the Client.

Creative Finance makes no guarantee of the procurement of a finance facility and accepts no liability whatsoever to the Client or any third party in the event that a facility is not obtained. Creative Finance will make no charge to the Client for this service and the Client hereby confirms that Creative Finance is fully entitled to receive remuneration from Lenders and is under no duty to account to the Client for any such remuneration.

The provisions of this Agreement may be changed only with the written consent of both parties. If any condition of this Agreement is held by a Court of competent jurisdiction to be invalid the rest of the Agreement shall remain in force and shall then be read as if such invalid provision had been omitted herefrom. This Agreement shall be governed by and in accordance with the Laws of England.

Your contact details

I confirm that I have read and understand the above terms of business, and as a Client accept these terms.

Name	
Telephone number	
Email	
Signature	
Date	

When complete, please fax back to 0870 420 8317