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The Evolution of Factoring

From its humble beginnings as the mainstay of rag trade and lender of last resort, factoring has reinvented itself to remain an important financing alternative for manufacturers and service providers alike. In the following article, Howard Brod Brownstein speaks with several industry professionals and traces the evolution of factoring.

By Howard Brod Brownstein, Contributing Editor

The story is told of the client who called his factor one day in the midst of a huge snowstorm. “Boy, it’s snowing like crazy out here at the plant! Is it snowing in Manhattan?” The factor replied, “How does that affect whether I check your customer’s invoices?”

This old-fashioned image of factoring is one of inflexibility, tunnel vision, and usurious costs: the lender of last resort, mainstay of the rag trade, and patient victim of countless frauds. In the current world of high technology, seamless global markets and the Internet, how is it that factoring has remained such an important financing alternative? To understand that, one has to study a little history, with the help of one of the deans of the factoring business: Harvey Gross, currently the president of HSG Services and managing director of the New York Institute of Credit and a former VP in Charge of Credit at NationsBanc Commercial Services.

“Back in the 1930’s, factoring was perceived as exclusively for weak, typically undercapitalized businesses, especially suppliers to retail customers. Retailers were less concentrated then, with many store chains in existence that today are only a distant memory. In particular, apparel suppliers whose business was highly seasonal needed help assembling inventory for orders in order to meet shipping schedules, and couldn’t afford a lot of office overhead devoted to credit and collections. Such overhead would have been wasted, anyhow, with sales committed to relatively few key customers. What the supplier needed was cash flow support and insulation from credit risk, not better in-house credit management. And the banking community wasn’t interested in extending their traditionally unsecured lending products to such businesses. So factors filled a critical gap, and without factors many suppliers to the retail trade would never have been founded, much less grown and prospered.”

In the postwar decades, banks realized that they were missing out on lending opportunities. But factoring clients didn’t fit into the mold of asset-based lending which was still relatively new and designed as a stepping-stone to unsecured lending. Sales were too seasonal and concentrated, and inventory was mostly WIP and largely unsaleable in event of foreclosure. But banks realized that they were financing the factors who provided the financing for such businesses anyway — so why not disintermediate?

Hence, banks bought up many factoring organizations, small and large: CitiBank bought Huebschman, Chemical Bank bought Dommerich, Chase Manhattan Bank bought Shapiro Brothers, Bank of New York merged with Irving Trust which had acquired United Virginia Bank’s factoring businesses, Bankers Trust bought Coleman, Rusch was bought by Associates whose factoring operations were acquired by Irving Trust. The list is much longer and consolidation was rapid, and the result was a more competitive factoring involvement, with banks’ direct involvement in factoring contributing to a lowering of costs.

Perhaps as the result of the entry of banks, factoring grew in respectability and legitimacy. As the apparel and other industries globalized, letters of credit increased in importance as an adjunct of factoring services. Inventory liens became more of a feature of factoring. Factoring broadened to cover not only textiles and apparel, but also electronics, building products, toys, and many other products as well as services. Factoring powerhouses emerged like CIT, GMAC, HSBC, Heller and FINOVA, some of which themselves were acquired. Today, together with factors that have remained independent such as Rosenthal & Rosenthal, Merchant and Millburg, they provide an amazing breadth of factoring services. Even with the consolidation of the past, according to Gordon LaHaye of Summit Financial Resources writing in the November ’02 issue of the Commercial Finance Association’s Secured Lender, there are still hundreds of factoring companies.

One interesting phenomenon is the accumulated and concentrated credit exposure that factors may have to a customer through multiple clients. The industry knowledge of factors is often considered unparalleled and their credit decisions can have a strong impact upon the industries served by their clients. In fact, there have been past allegations that factors improperly shared information and unfairly affected account debtors, however today factors must be careful to limit their disclosures to what they have in fact done, and not delve into what they plan to do. It is widely believed that, because of the perceived credit power of factors, customers are inclined to provide better payment performance and be more reasonable in resolving disputes when the factor is involved; hence, the factor as “cudgel.”

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Among the broad offerings by factors is collection factoring, whereby the factor posts the client’s sales on the factor’s books, and is responsible for collection and provides the client with risk protection. The client is paid upon collection of the customer invoice or upon the customer’s insolvency. With a maturity arrangement, the client is paid on the invoice due date.

With an advance arrangement, sometimes referred to as “old line factoring”, the factor pays its client an advance when the invoice is issued, based upon an advancement formula, taking credit returns and allowances and other causes of “dilution”, as well as sales concentration into account. One rule of thumb that is often encountered is for the advance rate to be 100% of invoice value, less two times the rate of dilution, e.g., five percent dilution might suggest a 90% advance rate. Some factors will provide an overadvance, such as where the client needs to build up a supply of its

product for seasonal deliveries or large orders.

Factors may employ procedures to verify whether the customer received the delivery and that there are no disputes, although in many cases the factor will not contact a customer unless the invoice is overdue. These verification procedures support the factor's extension of credit or risk protection, but also benefit the client by helping to "keep customers honest." Factors also regularly conduct field audits in order to eliminate any temptation to "create availability" by generating invoices that are not based upon deliveries, or by issuing planned credits that were not booked at the time of the invoice.

One interesting aspect of factoring is that a client's secured debt to the factor may unwittingly be enlarged to include the client's accounts payable to its supplier, if that supplier is a client of the same factor. This is referred to as the factor's right of offset, and can apply to personal guarantees of the client's shareholders as well.

Sometimes factors share a client, such as where the exposure is too large. While this is less prevalent today, smaller factors still get together to share risk. Walter Kaye of Merchant Factors helped create "refactoring" whereby smaller factors bundle risks for their clients and resell the package to larger factors.

Globalization has operated to increase exports as well as imports, with many U.S. companies requiring factors for their exports. While the largest factoring organizations have their own offshore offices so that they can directly handle export accounts receivable, through Factors Chain International smaller factors can deal with each other across national borders, reducing the need for the export supplier to require a letter of credit.

In some cases, the factoring client doesn't want its customers to know that a factor is involved, even though visible involvement of a factor can be beneficial. In such "non-notification" cases, the factor only emerges if there is an insolvency or past due invoice, but not necessarily in the event of a sales dispute. In such "agency accounts" the factor has a tougher time keeping track of its exposure since the sales remain on the client's books, not the factor's, and so the arrangement is a form of credit insurance.

Since the factor usually retains the right to "check," i.e., approve a particular customer of the client for credit, the client may decide to take any unapproved credit risks itself. Such "client risks" may still involve the factor posting the sales to its books and assisting with collections and dispute resolution.

While most factoring arrangements involve all of the client's sales invoices, "spot factoring" arrangements are sometimes available. Purchase order funding is a financing arrangement whereby the client finances its purchase orders with the factor. The factor takes a lien on the inventory as well as the value added through labor, and this security interest is converted to the accounts receivable when the goods are shipped, and finally the factor is repaid when the customer makes payment. Obviously, the factor needs to have confidence in the reliability of the purchase order and the underlying customer. This can be an expensive arrangement and typically requires that the client have a gross margin of 30% or more inherent in the deal.

In contrast, the basic factoring cost which is the factor's commission, is traditionally about 1% of sales invoice but can be as high as 3%. In addition, the client will have to pay interest on funds utilized, as well as other service fees that may apply.

Here are comments from a few factors about the different approaches they take to their business, which illustrate the rich variety in the marketplace:

Nicholas Pittas, EVP of Capitol Resource Funding in Alexandria, VA, explained what makes CRF unique and one of the most successful factoring companies. "We like to say, 'There's more to financing business than business financing.' That's because we approach each client from the standpoint of how our factoring product will help its business grow and prosper and get to the next level." CRF is unlike many of its competitors because it is independently owned and financed. "We try to focus on businesses with revenue of $1 to $20 million in sales, and our clients are located nationwide", Pittas says, "although we operate from offices in Southern California, the DC area, Chicago and Philadelphia. In determining whether we're right for a client, we look at the following eight factors:

1. Can the client provide a secured first lien on accounts receivable and inventory?
2. Are the client's accounts creditworthy?
3. Does the client have a ratio of accounts receivable to accounts payable of 1:1 or greater?
4. Is the client of high character?
5. Is the client at or close to break even profitability, and can it demonstrate expected future profitability, e.g., via order backlog, contract balance, etc.? Companies whose lack of profitability hasn't been fixed yet do not meet requirements.
6. Are credit lines required of less than $1 million? (Clients that need over $1 million should have been financed by one of the smaller ABL shops if they're creditworthy.)
7. Does the client have an understandable product or service?
8. Can the client demonstrate that delivery is complete and verifiable, and the invoice is assignable?"

Stuart Rosenthal, EVP of Prestige Capital in Fort Lee, NJ says that his firm can close transactions extremely quickly, and uses an unusually straightforward and concise factoring agreement that is only three pages in length. Stuart says, "Our motto is WYSIWYG — 'What you see is what you get'." Prestige also has few fees — just an application fee and a single factoring fee that is based on use and services utilized. Prestige is also flexible about the term of the contract, making it easier for clients to "graduate." Prestige is active nationally and accepts customers with factored sales of $75,000 to $5 million annually. While third-party healthcare accounts receivable are not accepted, Prestige is notable among factors for accepting construction receivables.

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Mike Clark heads an office in the DC area for Troy, MI-based Crestmark Bank as its national VP of Business Development. Crestmark actually downplays the term "factoring", preferring to call its product line "accounts receivable financing." Since Crestmark is a bank with an active asset-based lending department, Crestmark can offer its factoring clients a transition to ABL without termination fees, and with immediate repricing and restructuring of the financing arrangement. "We're the 'Solution Bank'," Mike says, and adds that Crestmark can handle annual amounts factored down to $600,000 and up to $2.5 million.

Patricia Burns is president of Primary Funding in San Diego, and heads a regional factor that she says can "reach out and touch our clients." Her company focuses on businesses with annual sales under $5 million, including start-ups, and is willing to factor as little as $250,000 annually for its clients. In addition to factoring any type of invoice except for healthcare and construction, Patricia recently established a factoring facility for charge card receipts used in connection with military contracts, where billing may only be done once per month.

In contrast to some of the factoring organizations listed above, giant GMAC Commercial Finance is number two nationally behind CIT. Harold Dundish is senior EVP of the Commercial Services Division of GMAC and its west coast Regional Manager in Los Angeles. Dundish is also well-known in NYC where he was formerly the head of FINOVA's office there. Harold says, "GMAC is eager to do business. We have the finest and most experienced people, and a smooth approval process whereby we really service our clients. As the growth in the textile and apparel markets has slowed, we're looking at new markets for our services. In particular, we're unbundling our services so that we can customize what we offer each client."

Finally, John F. Daly, president of CIT Commercial Services (who is profiled in this issue of *ABF Journal*), doesn't make the claim that it is the largest factoring organization, although this view is widely held. With offices in Charlotte, Dallas, Los Angeles, Hong Kong, and soon — Shanghai, as well as its headquarters in New York, CIT has long been identified as a leader in factoring. CIT believes that its size can be a competitive advantage when it comes to the range of services it offers, from import and export financing to (through CIT sister companies) equipment finance, leasing, acquisition and DIP financing, just to name a few. CIT specializes in servicing customers with $2 million or more in annually factored sales (and some have as much as $500 million). Perhaps most noteworthy is that CIT is a 95 year-old company, and has retained its leadership in factoring through the various changes in ownership of CIT over the years. abfj

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