

# BusinessWeek

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## The Pros and Cons of Factoring

When you sell your accounts receivable to a financial institution, financing costs can exceed 20%, but that's better than no financing at all

by [Tom Taulli](#)

The [breakdown in the credit markets clearly isn't limited to the financial industry itself](#) (*BusinessWeek*, 10/02/08), and [some businesses](#) (*BusinessWeek.com*, 9/26/08), particularly owners with bad credit, unproven ventures, or companies tied to troubled industries, are having difficulty. As a result, there is heightened interest in alternative sources of financing, which can range from [peer-to-peer loans](#) (*BusinessWeek.com*, 12/21/07) to businesses securing [money from their own customers](#) (*BusinessWeek.com*, 5/5/08).

Another option I've been getting a number of questions about is a type of internal debt financing known as factoring. Simply put, this is when a company sells its accounts receivable to a financial institution or investor known as a factor. While factoring has been around for hundreds of years, the traditional banking industry considers it a backwater for struggling companies—mainly because financing costs on factoring can easily exceed 20% of the value of the receivables. And let's face it, banks usually focus on mature companies that have solid asset bases.

To understand factoring, consider this example: Suppose you have \$100,000 in receivables. A factor will advance funds to you at a certain percentage of the total amount, often ranging from 75% to 80% (this is called the reserve), based on a variety of factors, including:

- The quality of the receivables. If the customers include biggies like Wal-Mart ([WMT](#)), then the percentage will be higher.
- Historical average outstanding period of invoice. If the receivables are often paid late (say by 15 to 30 days), then this could mean a lower reserve.

### CASH IN LESS THAN 10 DAYS

The factor has procedures to ledger (account for the transactions) and administer the accounts receivable as well conduct credit assessments and [handle collections](#) (*BusinessWeek.com*, 7/11/08). Once the receivables are paid off, you will get the difference between the face amount and the reserve. However, for this service, a factor will get a fee of 2% to 5% of the first 30 days the invoice is outstanding. Typically, there will be a 1/8th% to 1/15% fee for each additional day. Yes, the financing can get expensive fairly quickly.

But there are benefits. First of all, you can receive cash in about five to 10 days. In some cases, it could be within one to two days. This can be critical when your company is in a crunch. Additionally, there is no requirement for your company to have a credit check. That's because factors normally only want to evaluate the ability of your customers to pay.

Still, you need to be mindful of the fine print. For example, a factor may want customer checks made payable to

itself. Needless to say, this can scare your customers. The good news is you can negotiate this away, according to factoring expert Marty Nason, a partner with [B2B CFO](#), a firm that provides part-time chief financial officer services. Nason also says you should avoid having to submit high minimum levels of receivables. The minimums can easily start at \$75,000 to \$100,000 per month. In other words, he recommends you don't factor too much.

### **TRY AN ONLINE MARKETPLACE**

Where do you find factors? The factoring industry itself is fragmented and made up of many players, many of which may want onerous terms. Thus, I would consider established entities, such as [Liquid Capital](#).

Another approach is to use an online marketplace, such as [The Receivables Exchange](#), where you can post your receivables on a private Web site and have financial institutions bid on them. As a result, you are likely to get more competitive financing rates (there are also no minimum post amounts). The Receivables Exchange says it has access to about \$8 billion, though your company must meet the following requirements: two years of operational history, \$1.5 million in annual revenue, and no tax liens.

Yes, factoring is far from perfect. And if your own customers are having problems paying you, the financing costs can be significant. However, in the current economy, it's certainly getting tougher to secure capital from traditional lenders. Factoring should allow your company to get cash fairly quickly.

For more on other forms of alternative financing, check out the stories in the related items box on the upper-right side of this story.

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