Financing with Receivables: Factoring, Securitization and Collateral

Ioana Benea [1], Florin Duma [2]
[1] *PricewaterhouseCoopers Audit S.R.L.*
[2] *"Babes-Bolyai" University Cluj Napoca*
ioana.z.benea@ro.pwc.com, fduma@euro.ubbcluj.ro

Abstract: *Short term financing is vital for the financial survival of any company, because very often they are facing deficits of cash during their activity. Therefore a company has to identify the optimal solutions in order to cover those (temporary) deficits. A good solution to this problem is the financing with receivables using factoring, securitization and collateral. In this paper we try to analyze how this types of financing works and which are their advantages and costs. Also, we developed a reasoning pattern in order to evaluate the best receivables financing alternative for the Romanian companies.*

Keywords: Short term financing, financial management, liquidity, credit

JEL Classification: G21, G23, G32, G39

1. Introduction

Financing decision, together with the investment decision, should represent the main concern of any financial manager.

Financing decision is not just about the funds that a company needs and about their costs, but is also about ensuring the optimal combination between equity and borrowed funds and between long term and short term financing. Those are important not just for the good functioning of the financial mechanism of the company, but also for the risk management.

Therefore, short term financing is an important area of the financial management, but very often is somehow neglected by the Romanian companies. Short term financing has as objective not just to cover the temporary shortage of cash flow, but also should have a preventive objective, meaning the identification of those financial resources that are available to be used in case of necessity, otherwise those resources being involved in the financial mechanism of the company.

Short term financing has to start with estimation of the cash needed and with the preparation of a cash-flow statement, in order to see the cash deficits which have to be covered. In order to be truly relevant, this cash flow statement has to be prepared for short periods of time (weekly), and in some cases even daily. This cash flow statement will analyze prospectively the payments and the receipts of the company, in order to show the cash surplus or the cash deficits. The solving of this last problem belongs to the short term financing.

The main sources of short term financing for a company are the following:

- Payables;
- Resources generated by the operating activity;
- Short term loans;
- Overdraft loans;
- Factoring;

- Securitization;
- Collateral.

Among those sources of short term financing we choose to focus on this paper on those which are related to accounts receivables, namely: factoring, securitization and collateral.

2. Literature review

Financing with receivables was growing worldwide very fast in the past years, both in quantitative and qualitative terms. In her paper 'Factoring a perfect solution', Kathryn Young indicated two reasons: big buyers are asking for more and more time to pay and more buyers want open account terms, rather than lines of credit.

The principles of the factoring activity, the way it works, business which can benefit, the risk management tools and some best and worst factoring case studies, can be found in two books of the same author, Callender Jeff, dedicated to this issue: Factoring Fundamentals: How You Can Make Large Returns in Small Receivables and Factoring Case Studies: Learn and Profit from Experienced Small Factors.

In their worldwide well known book "Principle of Corporate Finance" the author Brealey and Myers are stating the importance of the factoring especially for the small companies. Gar Thompsons is viewing the factoring as a marketing-wise solution for sale expansion and profit increase, in his paper: "Factoring the opportunities. Capitalizing on Nontraditional Lending in Difficult Times".

Giurgiu and Duma in "Management financiar pentru start-up" are considering that the factoring is not important just as a financing option, but also as a credit collection management tool, especially for the start-up companies and despite the fact that the factoring costs can be high, the benefits are greater.

In his paper "Asset securitization as a risk management and funding tool", Andreas Jobst is stating that the collateral can be perceived as a simplified form of factoring, because in this case the invoices are pledged as bulk. The securitization is a process that allows companies to increase liquidity by converting illiquid existing or future assets into tradable debt and equity obligations. This financial tool is analysed as well by Altman and Saunders in their paper "Credit Risk Measurement: Development over the last 20 years".

3. Research methodology

We looked in this paper at the different forms of short term financing with a focus on the receivables. Then, we analyzed the different possibilities of financing with receivables: factoring, securitization and collateral. We tried to identify their advantages and disadvantages, as well as their specific costs.

Finally, we developed a reasoning pattern in order to evaluate the best receivables financing alternative for the Romanian companies.

4. Factoring, Securitization and Collateral

A company investment in receivables is influenced by several variables, including sales target, the nature of the product or service sold, credit and collection policies. Trade credit can be turned into a source of market power for the lender, as it enables the lender to enhance market share (price discrimination), to reduce operating costs and to build up a reputation. But receivables bear a high risk and produce no revenue as they await collection. The amount of money tide-up in the form of accounts receivables can be minimized by using one of the following financial tools: factoring, securitization or collateral.

Factoring. A factor is a financial institution that buys receivables for cash, handles the collection of receivables and charges a fee for this service. Traditionally it was used by manufacturing companies with poor credit ratings, but lately it has picked-up not only in the business environment.

According to financial analysts, factoring has grown worldwide for two reasons: big buyers ask for more and more time to pay, and more buyers want open account terms, rather than lines of credit (Young, 2009). If we perform a trend analysis of the factoring volume transaction presented in the chart below, we notice that the volume of factoring productivity started to decline during the financial crisis. This fall tends to be unusual, if we take into consideration that the financial crisis represented a growth potential for the factors as the credits shrunk and companies were stimulated to reduce the impaired receivables. We must also consider that financial crises lead to recession, business cycle contraction and activity slowdown. In other words most of the companies faced sales decreases that impacted negatively the accounts receivables balances.

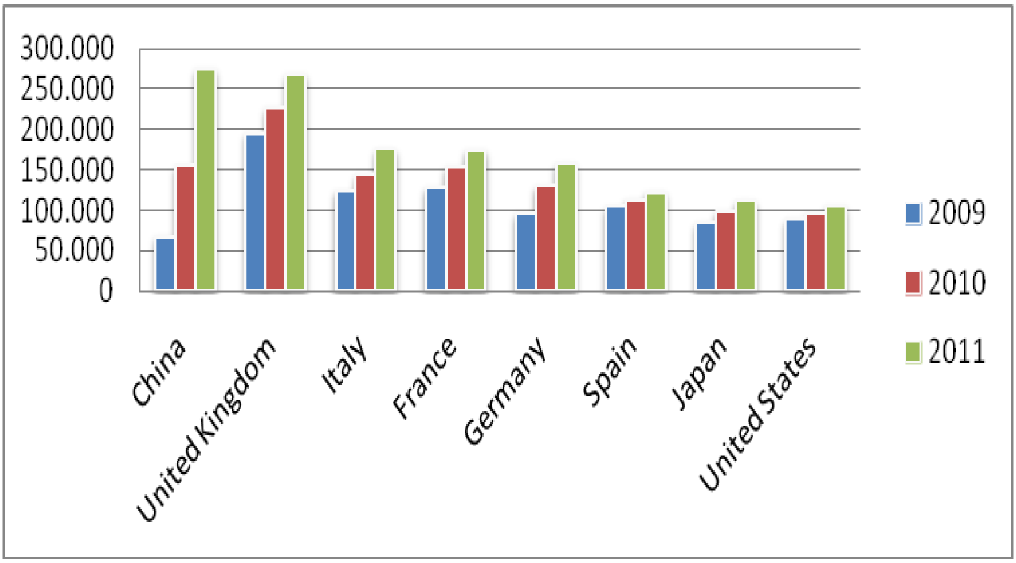

Chart 1: Biggest factoring volume transactions for 2009-2011 period
Source : Factor Chain International, http://www.fci.nl

Globally, Europe is the leader in terms of factoring volume, followed by the United States of America and Japan. For 2011, in Europe, the highest factoring volume transactions were register in the United Kingdom, France and Italy.

If we refer to Romania, we can say that factoring is a recently introduced financing technique. As per statistics published by the Factor Chain International the growth rhythm of the domestic factoring operations has increased year after year, which confirms the harmonization of the Romanian market with the international market trend.

According to FCI, there are 13 companies that perform factoring in Romania with a total turnover of 2.582 million euro for the year 2011. Only the following six companies are members of the FCI: Banca Comerciala Romana S.A (Factoring and Trade Finance Division), Bancpost S.A. (Factoring Division), BRD - Groupe Société

Générale (Factoring Department), UniCredit Tiriac Bank S.A. (Factoring Department), Compania de Factoring SRL, ING Commercial Finance IFN S.A. As we can notice, the Romanian factoring market is dominated by banking institutions, only two factoring companies being from outside the banking sector. In terms of market share, BRD Factoring department is the market leader.

Table 1: Factoring Turnover in Central and East European Countries (Mil. EUR)

Country	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Russia	2,540	8,555	13,100	16,150	8,580	12,163	21,174
Poland	3,700	4,425	7,900	7,800	12,000	16,210	17,900
Czech Republic	2,885	4,025	4,780	5,000	3,760	4,410	5,115
Hungary	1,820	2,880	3,100	3,200	2,520	3,339	2,817
Romania	**550**	**750**	**1,300**	**1,650**	**1,400**	**1,800**	**2,582**
Croatia	175	340	1,100	2,100	2,450	2,793	2,269
Slovakia	830	1,311	1,380	1,600	1,130	981	1,171
Bulgaria	0	35	300	450	340	550	1,010
Ukraine	333	620	890	1,314	530	540	955
Serbia	0	150	226	370	410	500	926
Slovenia	230	340	455	650	650	650	650

Source: Factor Chain International, http://www.fci.nl

Collateral. Accounts receivables can be used as collateral to obtain short-term loans. The lender offers a short-term loan against the outstanding invoices at a rate of 65% to 85% of the fair value for invoices aged under 90 days (Jobst, 2006). The lender does not own the invoice and does not assume responsibility for collecting the outstanding debt. The company continues to manage them as always, except there will be covenants specifying standards of aging, concentration and reporting requirements. In fact, collateral is somehow a simplified form of factoring, because in this case the invoices are pledged as bulk.

Securitization. Securitization is a financing tool that allows companies to increase liquidity by converting illiquid existing or future assets into tradable debt and equity obligations. In a traditional transaction structure, the originator sells the assets to a SPV (Special Purpose Vehicle) which takes legal title of the assets. The value of the asset does not change when it is transferred from the balance sheet of the originator to the SPV (Altman, Sauders, 1997). The SPV collateralizes the purchased asset portfolio and refinances itself by issuing multiple classes of asset-backed securities with different degrees of risk to capital market investors (Jobst, 2006). Once the security is issued by the SPV, the asset will increase in value. This is because the assets of the originator are worth more outside the company to investors than within it.

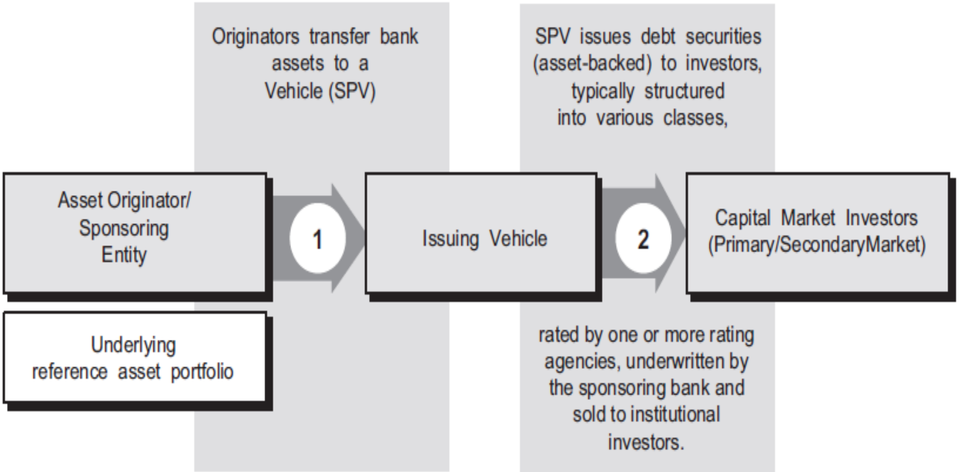

Fig. 1: The securitization process (Jobst, 2006)

If we refer to Romania, the securitization market is far from being a mature one. Concerning the legal framework, a special securitization law (Law No. 31/2006) was adopted in Romania in 2006 to expressly allow local sale securitizations. The number of securitization transactions is low and originators are usually banks that choose to securitize loan receivables portfolios. In other words receivables securitization for Romanian companies is not a real alternative as the market is just being developed.

5. Benefits and shortcomings of receivables financing alternatives

Factoring basically encompasses three types of services: finance, risk control and sales ledger administration (Silbert, 1999). However, not all factoring contracts provide this full array of services. The most important distinction between factoring contracts is that between recourse and non-recourse agreements. A non-recourse agreement implies that the factor makes the credit extension decision, monitors and collects the accounts receivable and bears the credit risk. Under a recourse agreement the firm selling on credit retains the risk of non-recovery of the debt.

Factoring enables the client to meet promptly its own accounts payables and maintain a high credit standing with its creditors, being a marketing-wise solution for sale expansion and profit increase (Thompson, 2009). For example, an exporter who intends to factor his receivables can say to a buyer somewhere in Greece that will provide the requested product, plus will offer 60 days to pay. Using factoring, the exporter gets an advantage over its competitors asking for a letter of credit, avoids the risk of non-payment and gets paid immediately. Another advantage is the fact that the capital received is not subject to an established destination as in banking financing.

The main drawback of factoring is the high cost. The factor’s fee is usually arrived at after taking into consideration the volume of sale, terms of sale, class of customer and the average size of invoice.

In our opinion, factoring is a ”silent partner” who invests in the business, implying no management control or share disposal, with the stipulation that silence has always been expensive.

Securitization substitutes credit finance with capital market-based finance. It allows issuers to raise funds and improve their liquidity position without increasing their on-balance sheet liabilities.

Corporations that securitize assets obtain several benefits. First, the asset is removed from the balance sheet. This allows for recognition of the gain or loss immediately, intentionally improving the originator's current-year operating results. Second, the use of securitization reduces reliance on unsecured debt. Third, it increases liquidity. Securitization is accepted as a low-cost/low-risk method of financing, but unfortunately is not an option for Romanian companies.

6. The costs of factoring and collateral

Receivables' financing - like any form of financing in this world – is not free. Actually the costs in this case are high, but taking into account the advantages that we just mentioned we think is still a smart solution of financing for companies. Since securitization is not yet an option for the Romanian companies, and collateral we will discuss here the costs for factoring and collateral.

Concerning the factoring the costs are different depending on types of services that are demanded: finance, risk control and/or sales ledger administration.

In Romania, in general, the cost of factoring consists of:

- a factoring fee, which is a flat percent (ad valorem) of the total amount of the invoice, including VAT (this percent can vary from 0.5% to 2% depending on the invoice quality);
- an operating fee per document – usually a small fixed amount per every invoice which is submitted for factoring;
- an interest rate calculated over the amount of financing (usually, at factoring a company can get maximum 80% of each invoice). The interest rate is calculated as ROBOR plus a margin and has to be paid monthly, usually on the last working day.

The level of the factoring fee may vary depending on several issues such as:

- the quality of the receivables,
- the estimated yearly turnover,
- the estimated number of invoices;
- the period of time until collection;
- the type of the factoring contract: recourse or non-recourse agreement.

As we already mentioned, a company can get maximum 80% from one invoice, but for some can get much less, culminating with situations in which some invoices are denied at factoring.

As numbers are more relevant, we consider the case of SME Company with a turnover of 500.0000 ron per annum and a receivables collection period of 45 days.

On the Romania market the financing option are limited to an overdraft facility of with an interest rate of 12% per annum and a factoring agreement with an interest rate of Robor 1M + 5% pp / annum and a commission on 0.7 % (e.g. BRD-SG). Therefore by using the factoring service the company can obtain a better liquidity at a cost of 44.000 Ron (500.000*80%*11%)[1] plus a commission of 2.800 Ron. The same amount, 400.000 lei could be obtained thought an overdraft facility at a cost of 48.000 Ron. Comparing factoring and overdraft cost we reach to the conclusion that factoring ensures a cheaper financing for working capital deficiencies.

Beside factoring and overdraft facilities, another short term financing alternative used by the Romanian companies is the collateral. This financing option is popular and

[1] represents the sum of average of Robor 1M for 2012 (6%) and 5 % risk rate

practically is a simplified form of factoring. In this case the costs are represented by the interest rate which has to be paid for loan received by the company.

7. Reasoning pattern

In order to evaluate the best receivables financing alternative for Romanian companies we developed a reasoning pattern.

As liquidity level influences management decision regarding financing methods, we stared the analysis with this element. Liquidity ratios attempt to measure a company's ability to pay off its short-term debt obligations. This is done by comparing a company's most liquid asset (or, those that can be easily converted to cash), to its short-term liabilities. A high liquidity coverage shows that a company can pay its current debts. A low coverage rate is a red flag for investors as it signals that the company will face difficulty in meeting its obligations. If the liquidity value is greater than 1.00, it means that the company is fully covered. If the quick ratio is lower than 1, we calculate Debt to Equity.

The Debt to Equity Ratio measures how much money a company should safely be able to borrow over long periods of time. It does this by comparing the company's total debt (including short term and long term obligations) and dividing it by the amount of owner's equity. The higher is the ratio, the greater is the risk to a current or future creditor. A lower ratio means that company is financially stable, being able to borrow now or in the future. As far as concerns the safe zone for debit to equity ratio, it’s generally accepted that industrials should maintain a debt-to-equity ratio between 0.5 and 2.

Any company with a low level of liquidity and high receivables credit, judging by the Debt to Equity level has two alternatives. First, if Debt to Equity ratio is low the best financial option is to extend credit line because it is cheaper than other receivables financing alternatives. Second if the Debt to Equity ratio is high, the company has 3 choices: factoring, securitization and collateral. As far as concerns the Romanian market, securitization is not an option since this financial tool is barely used. In other words, the decision has to be made between factoring and collateral. If the receivables bare a high risk we consider that the factoring alternative is the best decision.

We consider that factoring should be view as an alternative even for companies that have a safe liquidity ratio, especially if the company offers high credit terms for receivables and the uncollectable risk is far from being a low.

The reasoning pattern described in the above rows is summarized in the picture bellow:

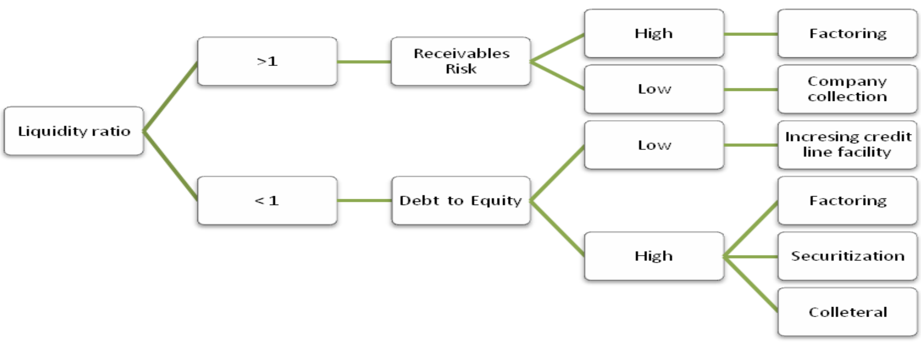

Fig. 2. Reasoning pattern (source: personal input)

8. Conclusions

Receivables' financing plays an important role in the working capital management and the financial health of the company. Trade extension incentives are numerous, including smoothness of product demand, increasing market share and reduction of operating costs, but all these benefits come with a financial burden of delayed payments and bad debt. This risk can be reduced using one of the three main receivables financing options: factoring, securitization and collateral.

Receivables' financing options are not used at their full potential by the companies that are operating in Romania. Currently, the securitization market is very small due to a lack of expertise and knowledge, as well due to an underdeveloped capital market and despite the fact that the legal framework has already been established since 2006. However, the other two financing options are quite popular in the present time, being a solution applied more and more by the companies doing businesses in our country which became aware of the advantages brought by receivables financing.

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