Factoring – financing alternative for SMEs

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Abstract

Financing is necessary to help SMEs set up and expand their operations, develop new products, and invest in new production facilities or human resources.
There are a variety of different sources for financing SMEs, internal and external. The insufficient internal resources determine the European SMEs rely heavily on access to external finance in order to run, and particularly to expand, their businesses.
There is a range of external financing products available to SMEs which include bank loans, overdrafts, leasing, factoring, venture capital, business angels etc. In the last years, factoring has gained more and more importance taking into consideration its main advantages. Thus, factoring offers more than simply finance: through matching finance with professional credit management services, and in some cases credit protection, factoring stands out as unique from the other competing sources of external finance.
Being a simple financing technique, based on invoices, not being necessary the collaterals, with the immediate payment, the SMEs can use factoring in order to improve their cash-flow, without increasing the debt level. Besides, in the condition of financial crisis, the restrictive conditions imposed by the banks and the low level of liquidities on the market makes the factoring an important financing alternative for the SMEs.

Keywords: financing, factoring, advantages, limits, SMEs, Romania

JEL Classification: G32, L25, M13

Introduction

SMEs are vital in promoting economic growth, competitiveness, entrepreneurship and innovation, and in creating new jobs. Ensuring adequate access to finance so that SMEs can grow and develop their full potential is central to achieving the objectives of the renewed Lisbon partnership for growth and jobs.

Most of the European SMEs consider access to finance as a barrier to growth. The problem is strongly exacerbated by the financial and economic crisis as SMEs and entrepreneurs have suffered a double shock: a drastic drop in demand for goods and services and a tightening in credit terms, which are severely affecting their cash flows.

The suitable financing source remains an obstacle especially for the growth of innovative SMEs, a problem known as the "SME financing gap" (OECD, 2006). There are significant numbers of SMEs that could use funds productively if they were available, but cannot obtain finance from the formal financial system because the lack of track record and collateral against which to raise debt finance.

Addressing the "financing gap" is increasingly important in the context of a knowledge-based economy in which innovative SMEs with high growth potential are key in raising productivity and in maintaining competitiveness. One of possible solutions is using the financing alternatives (such as leasing, factoring, trade credit) to cover the SMES' financing gap.

The studies revealed the fact that the use of trade credit (Van Horen, 2004) and the potential for factoring services (Demirguc-Kunt and Maksimovic, 2002) is higher in countries with greater barriers to SME financing, particularly during periods of financial distress.

Factoring is used in both developed and developing countries. Although absolute factoring turnover (and relative to GDP) is smaller in emerging markets than in developed countries factoring might play a relatively more important role for SMEs and new firms in emerging markets that often have difficulty to access bank financing.

Clearly, stimulating a competitive financing environment for all companies is an essential element in promoting an entrepreneurial economy and strengthening economic growth.

2. External financing sources for SMEs

Financing is necessary to help SMEs set up and expand their operations, develop new products, and invest in new staff or production facilities.

There are a variety of different sources of finance for SMEs. A distinction can be made between internal and external financing sources.

While many SMEs are reliant upon internal sources of financing, including cash-flow, to fund investment in their development and growth, particularly at the start-up and early growth stage, they will necessarily have to consider external financing sources as they progress through the development phases of the SME lifecycle.

The external financing sources can be differentiated in:
- informal financing sources (for example money raised externally through the so-called three F's – "friends, families and fools" and/or through Business Angel investment)
- formal sources of external financing that include:
  - o traditional debt finance in the form of loans from bank and other financial institutions, micro credits (loans of less than € 25,000) leasing and hire purchase;
  - o other external financing sources include risk capital (venture capital, equity financing and mezzanine instruments), which may be appropriate for high-growth firms, factoring and trade credit.

Often, SMEs will need to use a combination of financing sources, depending on the sector, and the stage in their growth and development. A key consideration in choosing the source of new business finance will be to strike a balance between equity and debt to ensure the funding structure suits the businesses needs.

Whilst marked differences occur between Member States, SMEs typically rely on external financing for more than 50% of their balance sheet value. Traditionally, this external finance has predominantly comprised bank loans and overdrafts (figure 1).

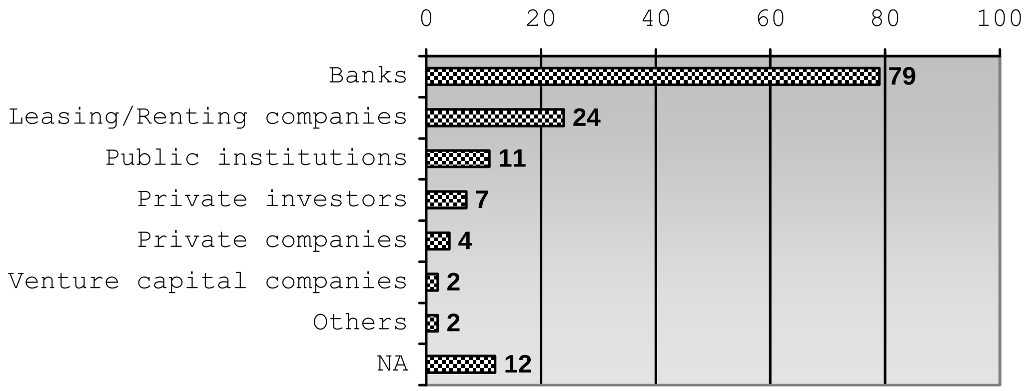

Figure 1. Institutions used by SMEs for external financing EU-15
Source: EOS Gallup Europe, SMEs Access to Finance, Flash Eurobarometer, 174, Oct. 2005

Banks take a dominant position regarding external loan finance. Bank loans are used for financing investments, working capital and stock financing. Bank lending may be secured or unsecured and will depend on the credit rating of an SME.

The second largest source of external finance is leasing and hire purchase. Hire purchase or leasing represents secured financing - based on the existence of a tangible asset. By its nature the finance is secured on the leased asset so it can provide an effective source of finance to a SME. Leasing improves cash flow and it is easier to finance than purchases. Before extending a capital equipment loan, banks will usually want to see two to three years of financial records – which most new companies do not have. Leasing companies, on the other hand, usually require only six months to a year of credit history before approving a car, furniture or office equipment lease.

Trade credit is an important way of financing stock inventory held by SMEs. By using trade credit, SMEs are able to postpone payments for goods and services purchased, which is useful in managing cash flow.

Venture capital is provided by full-time, professional enterprises (venture capitalists) or private persons who invest both capital and management expertise in ambitious, fast-growing companies with the potential to develop into significant businesses.

Factoring is a financial transaction whereby a business sells its accounts receivable (i.e., invoices) at a discount. The factor usually charges the seller a service charge, which is interest based, depending on how long the factor must wait to receive payments from the debtor.

Factoring differs from a bank loan in three main ways:
- First, the emphasis is on the value of the receivables (essentially a financial asset), not the firm's credit worthiness.
- Secondly, factoring is not a loan - it is the purchase of a financial asset (the receivable).
- Finally, a bank loan involves two parties whereas factoring involves three.

Many SMEs confront problems when attempting to gain access to external funding because of the difficulties faced by financial institutions in producing consistently reliable risk-assessment processes. Particular problems for firms may be experienced in the management of working capital. In an attempt to alleviate such problems many firms have considered alternative forms of finance – factoring - by pledging an important element in their working capital, that of accounts receivable. The incidence of asset based finance – including factoring – has been increasing rapidly over the past decade and factoring is specifically targeted and suitable for smaller businesses.

3. Factoring – financing alternative for SMES

3.1. Factoring: characteristics, types, evolutions

Factoring is an alternative route to the other external financing sources available for SMEs (banking loans, leasing, venture capital) by which a business can increase its cash flow to fund expansions.

Factoring is a form of commercial finance whereby a business sells its accounts receivable (in the form of invoices) at a discount.

Factoring is a complex financial operation, which supposes the participation of three parts, such as:
- the factor is the factoring company;
- the customer, also called "adherent";
- the debtor.

The factoring involves the followings operations:
- the existence of certain receivables (materialized in invoices) which the supplier has to recover from his clients;
- the transfer/sale of these receivables to a commercial bank or a specialized financial institution;
- services provided by the factor in exchange of a fee, which may include the following services: financing invoices, transferred receivables management, recovering debts from debtors and hedging against the risk of accounts not being settled.

The factor has three main functions:
- financing (pay their clients for their invoices as they are issued);
- provide services (collect payment from their customers, provide advice to clients on credit management, pursue late payers);
- protect the client against bad debts.

This means that the benefits of factoring do not simply include an immediate cash payment. If the factor provides credit management services too, then there is also the prospect of an improvement in the speed at which debts are collected, giving a further positive impact on cash-flow, and reduced interest charges.

There are different types of factoring products on the market which can be classified from various criteria.

a. Depending on method of collection and debt management, there are the following types of factoring:

- Partial Factoring – the invoices are selected, not all are accepted for buying; the obligation to cash the invoices belongs to the customer because the factor do not take their administration;
- Total Factoring – al the invoices are taken by the customer and administrated by the factor. The factor will cash the invoices from the debtor, finance the operation and cover the credit risk.

b. Depending on the moment of payment the debts by the factor, there are following forms of factoring:

- Old-line factoring (classical factoring)– the factor pay the invoices in the moment he takes them;
- Maturity factoring – the debts of customer are paid in the moment of their maturity;
- Mixt factoring – the factor pay a part of the invoices value as advance (not less than 85% from their value), the difference being paid at a later date.

c. Depending on the participants to the factoring operation, there are:

- Domestic factoring – at the basis of this operation there is not an international trade contract, it is done on the same country and there is a single factor,
- International factoring – suppose the existence of a international trade contract, in the operation will be two factors (the import and the export one). The export factor buy the exporter debts.

d. Depending on the recourse weight of the bank on the adherent, there are:

- Non-recourse factoring - offers the client full credit management service cover on approved debts against the eventuality of the factor being unable to secure full payment of factored invoices;
- Recourse factoring - involves a factor taking responsibility for their clients' debt collections but retains the right to seek full recourse from the client for any bad debts. The client may buy credit insurance separately but no cover is provided by the factor;
- Invoice Discounting - this enables SMEs to borrow on the security of invoices addressed to customers. Since the invoices are drawn on customers which may be larger, more credit worthy organizations, this source of financing can be attractive to SMEs.

Two alternative, but related and similar products were also mentioned as being used by some Member States (DG Enterprise, 2003):

- Discounted Bills of Exchange – is an unconditional order in writing addressed by one person (the supplier) to another (the buyer). It is signed by the person giving it (the supplier) requiring the person to whom it is addressed (the buyer) to pay on demand (or perhaps at a fixed or determinable future time) a sum of money to a specified person.
- Confirming - is a type of finance where a financial body confirm orders placed by buyer to the seller – i.e. funding the purchase ledger rather than the sales ledger. The financial body guarantees payment to the seller whilst offering credit to the buyer.

Neither Bills of Exchange nor Confirming are substitutes for factoring. In the case of the former, it is simply factoring using "bills" rather than invoices as assets. In the case of the latter, Confirming is used for the financing purchases, rather than sales.

At the global level the domestic factoring registered an increased turnover in the period 2004-2008, sign that these operations became more attractive for the companies and for the financing institutions table nr.1).

Table 1. Accumulative Factoring Turnover (for FCI members) - mil. Euro

	2004	2005	2006	2007	2008
Invoice Discounting	97,543	160,141	193,829	219,914	206,915
Recourse Factoring	89,808	116,626	139,978	168,683	167,860
Non-Recourse Factoring	191,467	232,683	247,818	237,585	243,413
Collections	15,549	13,120	12,604	13,934	25,940
Total Domestic Factoring	394,367	522,569	594,229	640,116	644,128
Export Factoring	32,405	42,073	59,302	68,424	88,244
Import Factoring	11,160	13,190	14,944	17,416	22,363
Export Invoice Discounting	13,997	21,716	24,179	32,430	33,801
Total International Factoring	57,562	76,979	98,425	118,271	144,408
Total Factoring	451,929	599,548	692,654	758,386	788,537

Source: FCI Annual Review, 2009

Given the fact that the factor takes over non-payment risks in the case of external factoring and only in some cases for the internal one, it is interesting that worldwide has the largest share from the total – 82%, in 2008.

On structure, the non-recourse factoring represent 38% from the domestic factoring, followed by the invoice discounting (32%) and recourse factoring (26%)in 2008.

The international factoring increased 2.5 times its turnover in the period 2004-2008 that demonstrates a major development of financing by this technique. The export factoring registered a fast increase and represent 61% from the international factoring in comparison with 15% registered by the import factoring.

Regarding the geographical distribution of the factoring operations, the FCI (Factors Chain International) reports indicate that the most developed factoring market is in Europe, holding 67% of the world volume. Following in the top there are Asia-Pacific area with 20% and the Americas with 12% in the world volume (figure 2).

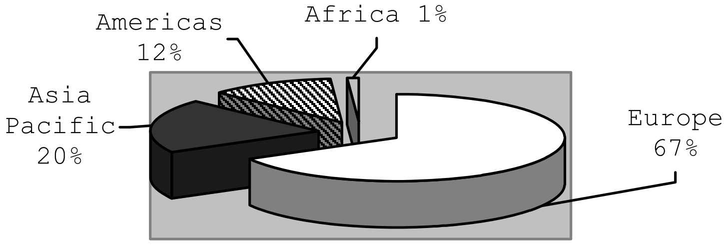

Figure nr 2. Total factoring volume (2008)
Source: Factors Chain International, Annual Review, 2009

During the past years a strong increase was noticed of financings by factoring, especially in expanding economies in the Central and Eastern Europe.
In the actual global context, when financial crisis drills into the companies' profits, the main risk for the factoring market is fund costs' raise up to a level that invoice payers may consider prohibitive.

3.2. Advantages and disadvantages of factoring

Using of factoring offers many advantages to the firms. In fact, factoring offers more than simply finance. Through matching finance with professional credit management services, and in some cases credit protection, factoring stands out as unique from these other competing sources of external finance.

The advantages of factoring are the followings:

- the possibility to obtain financing on a very short term, without taking into consideration the debt level of the company and without supplementary guarantees. Thus, factoring companies give the funds on the day the invoice is handed, after signing the factoring agreement;
- the improvement of the cash-flow, because the period of getting the cash shorter than for a credit;
- unlike banking credits, the funds obtained by factoring should not be used for a specific destination, they could be invested in function of the immediate needs of the client;
- the number of documents that must be filled out in by the adherent and presented to the factoring company is much smaller than it is in the case of applying for a regular bank credit;
- after analyse the documents, the factor can refuse the services only in the case of existence of a shareholder relation between adherent and debtor or in the case of conditioning the payment on sales;
- through factoring, the companies benefit from the fact that they can concentrate on the development of the business by expanding the production and sales, while the factor deals with tracing the settlement of the account and the records of the debtors;
- protection against the risk of invoices not being paid, which is taken over by the factor entirely; factoring can be a powerful tool in providing financing to high-risk, informational opaque sellers;
- protection against the exchange rate fluctuation risk, in the case of international factoring;
- factoring can provide important export services to local SMEs. Factoring companies can provide exporters with credit protection, working capital financing and collection services. These pooled services might also allow local exporters to enter new, riskier markets.

There are also some disadvantages of the factoring for both the SMEs and for the factoring company.

For the SMEs the main disadvantage is the high costs involved; the amounts allocated for this operation could be used by the SMEs for their business.

One solution to these barriers to factoring is the "Reverse Factoring" **W**hich allows SMEs to receive more financing at lower costs. In this case, the lender purchases accounts receivables only from specific high-quality buyers and the factor only needs to collect credit information and calculate the credit risk for selected buyers.

During the debt collections, especially if there is delay on the payments, the factoring company can have a tolerant attitude regarding the debtors and this can lead to loss of customers on long term.

Factoring is a contract with some imposed conditions and there is not too much place left for negotiations.

For the factoring company, it assume the risk of debtors insolvability which can generate difficulties in recuperate the money. In the case of classic factoring, the company should assume the credit risk, too.

Factoring relies less on collateral and is particularly attractive in financial systems with weak commercial laws and enforcement. The use of factoring services is higher in countries with greater barriers to SME financing, particularly during periods of financial distress.

Factoring may still be hampered by weak contract enforcement institutions and other tax, legal, and regulatory impediments. For example, factoring generally requires good historical credit information on all buyers; if unavailable, the factor takes on a large credit risk.

Another problem in the factoring industry is fraud and weak legal environments and non-electronic business registries or credit bureaus which make it more difficult to identify these problems. An alternative usually used in emerging markets is for the factor to buy receivables with "recourse", which means that the seller is accountable in the event that a buyer does not pay its invoice and the seller of the receivables retains the credit risk. However, this may not successfully reduce the factor's exposure to the credit risk of the seller's customers, since in the case of a customer's default, the seller may not have sufficient capital reserves to repay the factor.

4. Romanian factoring market

The opening of Central and Eastern Europe to the international financial and credit market has brought factoring operations into participants' attention. Even the factoring market is still emerging, is noticed an increase in the interest for this financing source in many Central and East European countries.

But despite the numerous advantages of this financing alternative, the Romanian firms did not use these products till 2001 when the factoring turnover registered 98 mil. Euro (FCI, 2006). Since then, the factoring volume registered an upward trend and in 2008, the total volume was 1,650 mil Euro, from which domestic factoring represents 79% and the international factoring 21% (table nr. 2). The growth rhythm of the domestic factoring operations increased year by year, which confirms the harmonization of the Romanian market with the international market trend.

Despite the positive evolution, in the region, only Bulgaria is less developed. In the same time, other countries such as Poland, Czech Republic, Hungary registered a better situation regarding the transaction volume.

The main causes of this gap are the macroeconomic conditions and the offer of the banking system. In fact, the lack of the banking offer represented a serious barrier against the factoring expansion. Also, a proof of the use on a small scale of the financing mechanism through factoring is also the gap in the local legislation. But in the last years, the fast growth rate of the revenues obtained by banks from factoring operations indicates both the intensification of trade and the firms' need for liquidities, as they are facing an ever more fierce competition.

Table 2. Total Factoring Volume by Country (mil. EUR)

	2002	2003	2004	2005	2006	2007	2008
Belgium	9,391	11,500	13,500	14,000	16,700	19,200	22,500
Bulgaria	0	0	0	0	35	300	450
Croatia	0	0	28	175	340	1,100	2,100
Czech Republic	1,681	1,880	2,620	2,885	4,025	4,780	5,000
Finland	9,067	8,810	9,167	10,470	11,100	12,650	12,650
France	67,398	73,200	81,600	89,020	100,009	121,660	135,000
Germany	30,156	35,082	45,000	55,110	72,000	89,000	106,000
Greece	2,694	3,680	4,430	4,510	5,230	7,420	10,200
Hungary	580	1,142	1,375	1,820	2,880	3,100	3,200
Italy	134,804	132,510	121,000	111,175	120,435	122,800	128,200
Norway	7,030	7,625	8,620	9,615	11,465	17,000	15,000
Poland	2,500	2,580	3,540	3,700	4,425	7,900	7,800
Portugal	11,343	12,181	14,700	16,965	16,886	16,888	18,000
Romania	***141***	***225***	***420***	***550***	***750***	***1,300***	***1,650***
Russia	168	485	1,130	2,540	8,555	13,100	16,150
Spain	31,567	37,486	45,376	55,515	66,772	83,699	100,000
Sweden	10,229	10,950	14,500	19,800	21,700	21,700	16,000
Turkey	4,263	5,330	7,950	11,830	14,925	19,625	18,050
United Kingdom	156,706	160,770	184,520	237,205	248,769	286,496	188,000

Source: Factors Chain International, Annual Review, 2009

Factoring represent an optimal solution for the Romanian companies which can have one of the following characteristics:

- they are small and medium enterprises,
- they are new established firms with stable commercial relations;
- they are firms that lack collaterals;
- they are developing and growing companies;
- they need cash urgently,
- they have insufficient access to other financing sources,
- they are exporting firms.

The domestic factoring in our country is a product addressing the Romanian suppliers of goods and services with partners within Romania's territory and from whom payments are received within a maximum of 180 days (the situation is different from one bank to another). The size of the cash advance is established according to the documentation handed in, by observing the ceiling of maximum exposure established for each debtor – a maximum of 80%-90% of the gross value of the factorized receivables. In order to accept the debtors, the bank's inspectors will analyse the creditworthiness of buyers: the financial-economic situation, the clearance indices, as well as the non-financial aspects that characterize their activity (Duca, 2009).

The new restrictive credit rules applied by the banks in the context of financial crisis and the low level of liquidities on the market determined many SMEs to not be able to get a banking credit, which decrease dramatically their possibilities to develop and even their chances to survival on the market. In these conditions, the factoring can be a solution for the firms with a viable business plan but which can not finance from their own resources.

The main disadvantage of factoring for Romanian companies is represented by the high cost. The factoring firms have to consider the risk and the commissions depending on the contract conditions.
The cost required for the factoring operations is formed by two commissions (Moraru, 2006), such as:
- ***factoring commission*** that applies to the nominal value of the paid invoices and represents 0.5-1% for the domestic factoring services (in national currency) and 1- 2% for the export factoring ones (in foreign currency). The commission for the export factoring services relies on the size of the activity that will develop through factoring, the number of debtors and the number of traded invoices;
- ***financing commission*** applies to the financed value, namely to the 80-90% of the invoices counter-value, for the contract period. This is comparable with the interest applied to short term credits (in national or foreign currency) and it is negotiable accordingly with each transaction.

The lack of liquidities on the market affects the factoring companies, too. Therefore, many of them have to reduce their clients' portfolio or to limit to the permanent clients. Because the lack of financial resources, some of the Romanian factoring companies focused more on the debt recovery.

The factoring market in Romania has quite a high potential but still remains at a reduced and undiversified level, with a small amount of activity and an insufficient number of companies offering these services (10 companies in 2008 accordingly with FCI), mainly due to the banking institutions' lack of experience and tradition, the legal provisions in the field and also the restrictive conditions regarding the access to this form of financing small and medium-sized enterprises.

5. Conclusions

Factoring is a complete financial package that combines working capital financing, credit risk protection, accounts receivable bookkeeping and collection services.

Factoring is now universally accepted as vital especially to the financial needs of small and medium-sized businesses and start-ups. Factoring can be a replacement for the classical banking credit and the most important advantage is that it allows the firms to cash their debts. Thus, factoring is a simple financing technique, based on invoices, without being necessary the collaterals.

Being a financing source with the immediate payment, the SMEs can improve their cash-flow, without increasing the debt level. This means that they can concentrate on their business development and take the competitive advantage.

Even in the case of a start-up, but with a viable business, with growth potential, can beneficiate on this financing type because the factoring company takes the financing decision based on the viability of the business plan of the client not only the financial analysis. Thus, if the firm will use the factoring, they will beneficiate on complete services of debt collection, consulting and juridical assistance on the commercial contract, as well as the debt risks.

Although factoring companies remain highly specialized institutions, nearly all major banks now have factoring subsidiaries. This has enabled the industry to promote its services with great success and to work for businesses of every size.

Factoring has become well established in developing countries, in particular in those that are highly industrialized. In various Asian countries, the growth of factoring has been dramatic while in Latin America, financial institutions continue to join the industry. Similar growth has occurred in Central Europe, the Baltics and the Middle East.

At present, almost every industry can profit from factoring. Textiles and clothing are the most popular but manufacturers of industrial and farm equipment, office equipment, electronics and processed food are increasingly turning to factoring.

The opportunities for the factoring industry increase accordingly with the trade transactions. There is plenty of evidence to suggest that fast-growing, sales-driven organizations appreciate the improved cash flow, efficiency and profitability that factoring can offer.

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