

WHEN IS 'INVOICE DISCOUNTING' NOT 'INVOICE DISCOUNTING'?

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How to improve working capital and how to finance company growth are questions that cross the lips of many business owners and directors. Without dipping in to retained profits or taking out bank loans, an increasing number of companies are recognising the benefits of other ways of obtaining finance. The three types of commercial finance that companies are increasingly warming to are factoring, invoice discounting and asset based lending. This article focuses on the factoring and invoice discounting markets.

Factoring is the earliest of these methods of commercial finance to become established, originating in the United States some 200 years ago. Despite the early development of this product overseas, it is only in the last 20–30 years that the reputation of factoring has grown in stature in the UK. Much of this early enhancement in reputation can be attributed to the formation of the Association of British Factors (ABF) in 1976 and the fact that many of the UK's clearing banks bought in to the market at this time.

The problem with factoring has always been the fact that disclosure of assignments of debt to the factoring house is required. Many companies perceived that by using factoring as a source of enhancing working capital, they were actually spotlighting weaknesses within the business. The stigma attached to showing such weakness meant that factoring has often been ignored as a source of corporate finance, despite the fact that it is an ideal funding source when looked at from many other perspectives.

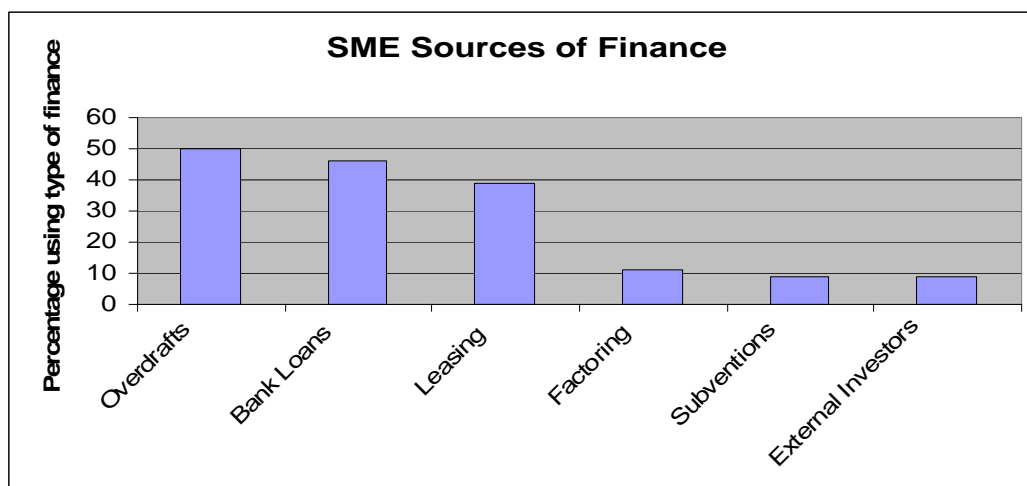
In the 1980s finance providers addressed this stigma through product innovation and introduced invoice discounting to the UK. Not only did the product introduce the concept of confidential financing against a receivables ledger, but it also made obtaining finance from factoring houses a lot cheaper for businesses. With both of these facts in mind, it is easy to see why the invoice discounting market has achieved an annual growth rate of 20% since its inception and why it soon overtook factoring volume. According to DG Enterprise, invoice discounting currently equates for 81% of the domestic factoring market¹.

Many new entrants have been attracted to the UK market in recent years, including some foreign owned companies, as this sector increasingly develops international stature. Two of the big name entrants to the UK market in recent years are GMAC Commercial Finance PLC and GE Capital Commercial Finance, both of whom have since made a significant impact on this side of the Atlantic. Overseas entry into this market by larger players is a continued trend in the European market, and I expect this trend to continue.

I feel that the Brumark ruling is a primary cause of banks and lenders entering the European factoring and invoice discounting market as they seek to enter our area of rapid growth, and decrease the levels of exposure that they were subjected to as a result of this ruling. The increase in exposure that banks and many other lending organizations felt in the light of this ruling is due to the fact that they are no longer deemed to be preferential creditors on the main types of finance they offer. This is due to the way the way charges are operated on these particular products (bank loans and overdrafts) and the fact that at no point in time do the banks hold control over the customers' book debts.

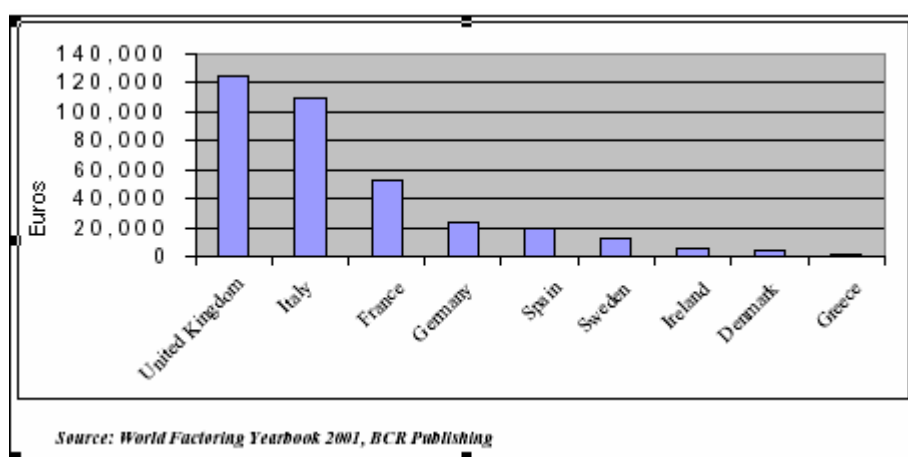
¹ DG Enterprise – Access to Finance unit (2003) “Analysis of use of factoring”
Europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/factoring_en.pdf pp.64

Factors and Invoice Discounters do take assignment of their clients' book debts thereby assuming legal title to the debt and its proceeds². The terms of Brumark therefore do not affect the security held by Factors and Invoice Discounters. As a consequence of this, in practical terms, where possible the clearing banks have taken steps to transfer many of their clients from more recognised forms of funding, such as business development loans and overdraft facilities, to their factoring and invoice discounting arms.



In 2001, factoring and invoice discounting was used by 11% of SMEs as a source of finance³. I feel that as a result of the Brumark ruling (2001), we will see this figure increase year on year as banks are now more likely to educate their customers as to the benefits of both factoring and invoice discounting.

Europe accounts for two thirds of global factoring and invoice discounting, with the UK and Italy the main players in the European market. The US is the other major global player in this sector, but statistics on invoice discounting are difficult to obtain due to the fact that they are recorded as bank loans overseas, hence the reason US statistics have been omitted from this article.



² Factors and Discounters collections are also received into blocked accounts. This further highlights their control over the book debts.

³ Source: Exco Grant & Thornton survey of SME's 2001, cited in DG Enterprise – Access to Finance unit (2003) “Analysis of use of factoring”
Europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/factoring_en.pdf pp.2

Although the UK, Italy and the US have the largest market sectors and are experiencing rapid growth, the region experiencing the most rapid growth is that of the former Eastern Bloc. Growth rates such as the 73% experienced in Ukraine⁴ between January and August 2004 are difficult to ignore, which is why many companies are expanding into these regions, with acquisitions again being cited as the main strategy for international expansion.

Further market development will also take place domestically as companies seek to develop additional ways of competing, other than on price. I believe that this will happen rapidly in the UK due to the high market concentration that prevails, with the ten largest companies in the market accounting for almost 90% of total advances in 2000⁵. These are the companies that are better positioned to generate economies of scale. This means that most of the suppliers in the factoring and invoice discounting sector; of which there are over 80, individually have quite small market shares and will therefore be unable to generate such significant efficiencies and compete on price. This will therefore stimulate product innovation.

One such innovative product is the Managed Invoice Finance (MIF) product developed by Sovereign Credit Management in partnership with Eurofactor (part of the Credit Lyonnais group). The product builds upon the collections strength of Sovereign Credit Management and the funding capabilities of Eurofactor and offers what is essentially invoice discounting with a supporting credit management platform. As with standard invoice discounting, this product gives the client a confidential funding facility which is cheaper than factoring⁶, but provides the service levels and collections expertise associated with a factoring product.

DSO Q1 2004	Factoring clients	56.4 days	Discounting clients	58.4 days
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Source: FACTORS & DISCOUNTERS ASSOCIATION QUARTERLY STATISTICS TO MARCH 2004⁷

From the table above, we can see that factoring products have a lower DSO than invoice discounting products, which can be attributed to the use of a collections platform. I believe that DSO rates from the MIF product will be equal to, if not lower than that of a factoring product as in this instance, the specialist collections ability of Sovereign is able to build upon the working relationships already established between the client and its customers (due to the confidential nature of the product). I think that the performance comparison statistics of MIF versus invoice discounting and factoring will make interesting future reading.

Not only does MIF provide enhanced performance for the consumer when compared to other invoice discounting and factoring products, but it also provides significant benefits to Eurofactor (the funder). Through this product, Eurofactor receives the added benefit of having an invoice discounting collections platform, whilst also gaining full access to the sales ledger information at all times. With extra security being achieved in these areas, it means that MIF can be offered to clients that would

⁴ http://www.factorscan.com/tempmain_menu.asp?folder=32&showNews=1

⁵ <http://www.keynote.co.uk/Insight/Factoring.pdf>

⁶ Mid range recourse and non recourse factoring prices are 2-3% above base rate. Mid range invoice discounting costs are 0.5 – 1.5%. DG Enterprise – Access to Finance unit (2003) “Analysis of use of factoring” Europa.eu.int/comm/enterprise/entrepreneurship/financing/docs/factoring_en.pdf pp.45

⁷ <http://www.factors.org.uk/Members/Statistics.htm>

not normally meet the requirements of an invoice discounting product, particularly those that do not want factoring.

I foresee that many other commercial finance providers in this sector will produce similar innovative products in order to fill niche markets, as opposed to tackling the competition solely on price. Those market participants that do not innovate will either be left behind, or will have to generate significant efficiencies in order to keep pace. Efficiency generation will continue to be a strategy used in this sector, but will be a strategy primarily used by the larger market players. They will continue to use mergers and acquisitions in order to generate economies of scale, thus causing further market consolidation.

More than ever before, UK plc would be best advised to shop around for sources of finance. Not only are businesses able to select factoring products by price, but they can now benefit from added value in the niche products being introduced to the market.