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Factoring alternative to usual financing

CREDIT CRUNCH: This lesser known practice lets companies tap into immediate cash.

BY LAUREN MCSHERRY
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With the current climate in bank lending as credit lines have dried up, there are few alternatives these days for small and mid-size businesses in need of capital.

"This is a tough time for anybody to find financing," said Richard Smith, Philip L. Boyd Chair and professor of finance UC-Riverside's A. Gary Anderson Graduate School of Management. "It's not clear where the liquidity is in the financial system. If banks don't have liquidity, that flows into others."

Some companies, however, are turning to a lesser known practice called factoring, or accounts receivable financing, to tap into immediate cash as an alternative to traditional financing.

Here's how it works. The business sells its accounts receivable to a financier known as a factor, who will then take on the work of making sure invoices that have been sent out will be paid. As an example, the factor may give the business 80 percent upfront of what is owed. Then, once the customers pay the invoices, the business will receive another 20 percent minus the factoring fee.

There are a variety of reasons why businesses in need of working capital might turn to factoring, particularly if they are dealing with slow-paying clients.

Carlos Gonzales, founder and CEO of Steele Water Cable in Corona, turned to factoring nearly a year ago when he was having trouble meeting payroll and needed capital to expand his business. His company contracts with Time Warner Cable and Comcast, and his service area covers a large portion of the Inland Empire.

"I invoice weekly to my clients, and I don't receive payment for 30-45 days," Gonzales said. "It was tying up a lot of my money to where I didn't have room for growth."

Last December, Gonzales had about 10 employees. This year, he has 58 employees and is in the process of hiring 10 more.

"I would not have grown to where I am now because it would have capped my capital," he said.

DO RESEARCH

Some critics of factoring charge that the percentage earned by the factor can exceed the interest rates of traditional lenders.

But Gonzales said the factoring fee that he is charged has not negatively impacted his business. He said receiving a loan or a line of credit last year would not

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have sustained him. Even if he had a line of credit for $100,000, it would not have worked as a stop-gap measure because he would have quickly used up the money. This is a result of his payroll, which is weekly, and because it takes more than several weeks for his invoices to be paid.

Gonzales cautioned business owners to be thorough in researching the factoring companies that they sign with because the first company he used did not have good accountability with tracking invoices.

The second company that he turned to, called Oxygen Funding Inc., has an online reporting system that Gonzales said is helpful because it allows him to track accounts receivable, the status of invoices and how many days the invoices have gone without being paid.

CUTS COSTS

One of the attractions of factoring is that it reduces the business costs associated with the collections process because the accounts receivable is basically outsourced, said Donald E. D'Ambrosio, president and CEO of Oxygen Funding in Lake Forest. The company works primarily with small and mid-size businesses that have $5 million or less in revenue.

"They're the people who need the help the most," D'Ambrosio said. "They are running on such a thin margin. The moms and pops can't get a loan from the bank."

Smith said he would not be surprised if, in the current economic climate, more entities were springing up that have cash and are willing to provide financing that is secured by accounts receivable.

"There should be an opportunity if you have cash because the banks don't and the companies don't," Smith said. "They can probably negotiate pretty good deals with companies that are experiencing liquidity problems."

FOCUS ON CUSTOMERS

Banks typically examine a business' assets, the duration it has been in business, profitability and financial statements before making a decision about financing. With factoring, the focus is on the customers that are being invoiced, not the business requesting financing from the factor.

Before taking on a client, a factor will typically examine the credit worthiness of the customers being invoiced, the business' billing volume, invoice amounts and average days of payment. D'Ambrosio said Oxygen Funding runs credit checks on the companies that its clients are doing business with and will advise them about whether to continue doing business with those clients.

He added that since the economic downturn, the company has had to be careful about which companies it takes on. If a company is close to going under, factoring is not going to save it, he said.