Why factoring is often the astute solution for the SME Entrepreneur when compared to a traditional bank loan

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Competition today for the select number of entrepreneurs here in the United States that we seek to serve as a traditional factoring firm has never been more intense. There is a wide array of options available to SME's; running the gamut for MCA [Merchant Cash Advances, avoid!] to very traditional bank loan products.

The title of this short article is an interesting one to think about in today's very competitive and unstable economic environment. I believe that in many cases, B2B and B2G Accounts Receivable "AR" factoring can be a superior solution for the entrepreneurial business, if objectively compared to a costs and constraints of a loan from a traditional lender or funding source. Yes, in most cases it is true that the cost of factoring may exceed the costs of a line of credit at a traditional bank. However, the practical reality is that many if not most entrepreneurial SME's do not and will not meet the stringent requirement imposed by traditional banks in the marketplace today.

When compared to more traditional small business capital funding sources, Accounts Receivable factoring is often not nearly as expensive as it appears and is almost always much less restrictive than a traditional bank loan or line of credit. In addition, personal (and corporate) credit cards have been the backbone of capital for many small businesses for years, but conditions are making such sources increasingly costly, thereby potentially making B2B and B2G factoring in many cases a less expensive and more attractive solution for many SME's.

Let's do an apples to apples comparison on a bank line of credit and factoring AR

I think it is important to compare, on an 'apples to apples' basis the benefits and costs of professional B2B and B2G AR factoring to a line of credit or loan from a traditional funding source like a bank. I have identified a range of key points to compare, when examining bank lines of credit and Accounts Receivable factoring. In each case, I will present comparisons between bank lines of credit proposals to our professional B2B and B2G Accounts Receivable factoring model.

- ✓ **Credit facility**. With most bank lines, the credit facility will be a fixed amount, usually expressed on a total $ value basis. This is determined by an in-depth analysis of the profit and loss of the business, net worth, margins, ratio analysis, etc. There is almost always a minimum volume requirement that must be used or drawn on a typical bank line of credit.

With Accounts Receivable factoring, there are usually no such constraints, limits or minimum funding requirements. Due to the fact that the amount of available credit is driven by the credit quality of our clients' customer, bank criteria such a net worth, balance sheet composition or profitability are secondary consideration for the Accounts Receivable factoring firm. This is a

significant advantage for an entrepreneurial business, especially one without a long track record of performance and/or a startup SME.

- ✓ **Maturity**. With most bank lines of credit, there is a maximum maturity that the bank will provide the funding to a SME. It is quite common to see two or three years as a maturity for bank lines. While this might at first glance be a desired length of time, what happens if the SME no longer needs or wants the line of credit? Perhaps a significantly better/lower cost source of capital comes available, or the SME decides to take on a partner or alternative capital source? What then? If or when this occurs in most cases, the entrepreneur could be stuck. Most bank lines have not only a maturity requirement, but a minimum volume usage requirement. If there is not a minimum, it is common that the bank charges the SME an 'unused line fee'. This guarantees they will earn something on the relationship, even if the SME is not drawing down on the loan or line of credit.

With Accounts Receivable factoring, this is not the case. In our unique funding model, there is never a minimum volume or fee assessed for the SME. In addition, the typical length for a factoring contract is one year or less. Most agreements can be renewed automatically, assuming both parties want to continue the relationship. So ask yourself a simple question: Why would I lock my business into a long term line of credit, potentially exposing myself to costs and constraints that I cannot control or predict?

- ✓ **Increase in the credit facility**. With most bank lines of credit, the amount or maximum loan amount available is set or capped. This is done to insure that the bank is not exposed to more risk than what was agreed upon when the line of credit is approved. In most cases, a SME doesn't want this limit any higher than they realistically anticipate using, as closing fees, unused line fees, taxes or filing fees [if applicable] are usually a percentage of this amount. In addition, if the SME hired a broker to secure the line of credit, often their fee is also driven by the approved amount. So it makes economic, although often not long term strategic sense, to have this number be conservative.

But let's take a simple example to illustrate how dangerous this approach could be to the health of a SME's entrepreneurial business. Say they have been working on the 'big deal' for a long time, and one day they land it. Congratulations!

But what happens if the amount of money they need to purchase the raw materials, hire people, produce the product or afford the increase in payroll is woefully short of what they have? The obvious answer would be to go back to the bank and request a significant increase in your line of credit. Unfortunately, in the nearly 20 years of serving our entrepreneurial clients I have seen over and over again that while in theory this should be easy to do quickly and cost effectively, it rarely happens. Too many times the decision-making process at the bank and the required timeframe for the SME to mobilize are weeks or months apart. In most cases, a significant, or even small, increase in the credit facility requires a complete new application, underwriting, out of pocket costs to get an approval/increase by the bank.

In addition, there are usually fees to reapply with the bank. So if the SME's capital, already stretched by this new client get further depleted, causing additional risk and worry. Granted, if the SME plans ahead and cues the bank into what is happening, it should be able to avoid this chain reaction from occurring. It has been my experience again that few businesses have or take the time to constantly court their bank.

On the other hand, with Accounts Receivable factoring, no such protracted decision making process or time constraints usually exist. This is due to the fact that all current or potential clients can be pre-approved by the Accounts Receivable factoring firm well before/if the 'big deal' is landed. This way, the SME is in the driver seat and can insure that when they need the capital, it will be there. Finally, there are usually no fees to ever have an increase in the total factoring relationship, preserving precious capital for use in running the day to day operation of their SME.

- ✓ **Collateral.** With most bank lines of credit, the collateral requirement, or assets pledged to secure the line of credit are significant. From the bank's perspective, the more collateral, the better. So in most cases, the collateral required is global, or 100% of all currently owned assets of the business. In addition, this commonly includes all future assets acquired, for the term of the line of credit.

While this might sound reasonable, the approved amount of the line of credit can be a small fraction of the value of what is required to be pledged as collateral.

The other very important fact to consider is that once assets have been pledged to the bank to secure a line of credit, it is nearly impossible to get them released. Coupled with the fact that most lines of credit agreements require two or three years terms, this can eliminate any future borrowing on pledged collateral without prior approval by the bank. Again, there are very few banks that ever release previously pledged collateral without some other asset being added to replace the asset. This can seriously impact the SME's ability to expand or cultivate other funding sources, such as equipment leasing firms, commercial mortgage providers and other sources of long term capital.

On the other hand, with professional B2B and B2G Accounts Receivable factoring, the only collateral that is required to use this flexible funding tool is the purchased accounts receivables. This allows the SME maximum flexibility and does not eliminate the possibility that other assets [such as real estate, fixed assets, etc.] can be used as collateral in the future.

- ✓ **Personal Guarantees**. With most bank lines of credit, the bank will require that the owner, owners, significant outside shareholders and maybe even the Directors personally guarantee the loan. It is true that in some cases, the bank will not require owners to personally guarantee the loan. However, particularly for SMEs, this is the exception rather than the rule.

It is common for many businesses to have more than one, or even many owners. Many may have different goals, financial needs, and capacity to repay a loan if the business has to, or is forced to at a less than desirable point in the year. If the SME has multiple owners, it is imperative that they understand and confirm exactly what they are getting yourself into before they sign any loan or line of credit document. Don't assume that what you have been told, or believe the financial strength of your fellow owners is accurate. The bottom line is that if the bank calls your loan, all who signed may need to [individually and collectively] come me up with the money.

Unfortunately, these kinds of discussions rarely occur, and if they do, can be a source of conflict and angst. If family is involved, there is another element of stress and anxiety that often prevents owners from discussing openly and honestly such issues.

The statement of the obvious is that when anyone personally guarantees any loan or line of credit, everything they have worked hard to achieve is at risk. Even the most creative asset protection strategy could potentially leave them exposed. So carefully consider this as you research funding options for any business.

With factoring, the contrast between the line of credit required to be personally guaranteed could not be starker. With most factoring agreements, there is not a true personal guarantee required. What is required would be a reasonable validity statement signed by the owners of the business. This states that those receivables to be sold/acquire are valid, accurate and constitute a final sale to the purchaser.

✓ **Annual Line Fees**. With most bank lines of credit, there are annual line fees that are a standard part of the terms of the loan. These are usually not a negotiable item with the bank. Given that many lines of credit have two or three years maturities, these can add up quickly. It is not uncommon to see annual line fees quoted as a percentage of the total approved credit facility of loan amount. While each bank is different, closing fees seem to average about .25% to 1% of the approved credit facility. In some cases, the annual line fee is a fixed, agreed amount that is not calculated as a percentage of the total credit facility.

In factoring, the contrast between the line of credit and factoring is quite clear. With most firms, there are never any annual line fees or renewal fees of any kind or scope. If you are required to pay these fees with a line of credit, they can significantly increase the true cost of the facility to your business. This is often overlooked by a business. In addition, if the amount of the approved line of credit is not large, the out of pocket costs that the SME could be required to pay initially, and then for each year might dramatically increase the effective cost of the funding.

✓ **Collection related services and costs**. With most bank lines of credit, the bank or lender requires that all payments are sent to them directly, either at the bank or by utilizing a lock box facility. In either case, the bank controls the collection process. This is usually not a negotiable item with the bank. In most cases, the bank passes through the cost of all of the

fees related to the establishment, monitoring and services provided by the lock box. Again, it is quite common for the bank or lock box provider to also assess a per payment or collection fee.

It is nearly impossible to determine or provide an estimate about what these fees could cost. Each bank is different and in the event that the service is outsourced to a third party provider, it is logical to assume that the costs could be marked up by the bank to insure some profit is earned on their relationship. If your business generated a large number of small invoices, beware that if your SME is charged a per collection fee, the cost could be significant.

One other potential thought to consider is that if the bank that provides you the line of credit is sold, merged or goes out of business, this could cause a significant ripple impact upon the SME's business and clients'. While it might not sound like a big deal, if your bank requires that all payments that used to be sent to a specific lock box or PO Box to change, this has the potential to be a real challenge for the SME. This would require that the SME's clients be notified and send all payments to the new address. This disruption, if not handled carefully can be a challenge.

On the other hand, with factoring, the contrast between the line of credit and factoring is again quite stark. With most firms, all costs related to the establishment, maintenance, servicing and use of the lock box are paid for by the factoring firm. So it is very important to look at this saving, which can be significant. In addition, if the size and volume of the SME's revenue increased, the additional costs if required to pay for collection services on a per item basis can add up.

- ✓ **Non usage line fees**. On most bank lines of credit, the bank or lender will impose an additional fee called a non usage or unused line fee. This fee would be charged to the SME on the difference between the approved amount of the line or loan and the actual amount that they have drawn on the line. Obviously, the less the SME draws on the line of credit, the more they could be exposed to this fee. The unused line fee is usually calculated on a monthly basis, and would either be automatically taken from their account or due and payable when they are invoiced.

  A typical structure for this fee might look like this: 1/12 of 1% of the average unused portion of the credit facility for the term of the loan or line of credit, usually three years; to be calculated and paid monthly. The obvious question is this: why should the SME pay a fee, to *not* use the money that the bank agreed to lend them? Good question. The theory from the bank's perspective is due to the fact that these funds have been allocated to the SME, they either need to be employed or they should pay for the privilege to have them to be set aside for current or future use. From your perspective, this fee is another cost that you will have to pay, regardless of whether you use the money or not.

This is usually not a negotiable item with the bank, as this is a pretty much a standard part of a bank line of credit agreement. On the other hand, it never hurts to ask. It is difficult to determine what these fees could cost, until you establish a track record with your bank.

On the other hand, with factoring, the contrast between the line of credit and factoring is quite clear. With most firms, there is never any unused line fee charged. You essentially pay for the capital only when you use it.

- ✓ **Collateral monitoring fees**. On many bank lines of credit, the bank or lender might charge the SME an additional fee called a collateral monitoring fee. This is an additional fee charged by the bank to offset their cost of monitoring and watching your account, including a review of collateral periodically such as B2B and B2G Accounts Receivables, inventory or other assets. This fee is usually calculated on a monthly basis, and would either be automatically taken from your operating bank account or due and payable when you were invoiced.

  The obvious question is this: why should you pay a fee to the bank to watch something that is really their job? The theory from the bank's perspective is the due to the fact that these funds have been allocated to your business, they need to be watched and tracked very carefully. This makes sense, but shouldn't this be a cost should be absorbed by the revenue generated by all of the others fees that they are charging you?

  Like many of the other fees we have discussed, this is usually not a negotiable item with the bank, as this is a pretty much a standard part of a bank line of credit agreement. On the other hand, it never hurts to ask. In the event that you cannot get this fee reduced or negotiated down, this is just another monthly expense to add to your budget.

On the other hand, with factoring, the contrast between the line of credit and factoring is quite clear. With most firms there is never any collateral monitoring fee.

- ✓ **Legal and Filing Fees**. On most bank lines of credit, the bank or lender will charge you a fee called 'legal and filing fees'. These fees can be significant and are almost always taken out at the closing of your new line of credit. This is a potential landmine for you, if you do not understand, ask and get in writing an estimate of these costs before you go down the path with the bank.

  It is impossible to estimate what these costs could run to, as each loan, bank and situation is different. However, it is very important to not be bashful and get a firm idea of what these costs from your bank will be as part of the loan closing process. This can increase your potential costs at closing.

  Like many of the other fees we have discussed, these fees are rarely negotiable and just the 'way it is'. When the loan documents are complex, this legal and filing fee exposure can be significant. In addition, the bank will usually also charge you fees to renew, amend or

update documents for the entire term of the loan. Ask for a written estimate for both the closing fees and what, if any costs you will be required to pay for the term of the bank line of credit.

With factoring, the contrast between the line of credit and factoring is quite clear. With most firms there are not any legal or filing fees paid by our client. We absorb all legal and filing fees, and do not assess any other fees for subsequent filings that we either need to renew or amend.

- ✓ **Annual Audit Charges**. On most bank lines of credit, the bank or lender will charge you a fee to perform an audit of your business. These fees can be significant, and are usually assessed annually for the entire term of the line of credit. This fee would be in addition to fees you could be required to pay to an outside CPA firm, in the event that the bank requires you to have audited financial statements. As you can imagine, the combined costs to comply could be significant.

  Even if you already have outside audited financial statements, it is impossible to estimate what these costs could run to, as each loan, bank and situation is different. In some cases, the bank will use outside services to perform some of these audits. This can increase your potential costs at closing.

  Like many of the other fees we have discussed, these fees are usually not negotiable. A recent line of credit proposal we saw had an audit fee structure like this, for the annual and ongoing audit fees: 5 audits the first year, at least 4 each year for years 2 and 3. $650 per person, per day, plus all out of pocket expenses paid by the borrower, estimated to be $19,500 in year one, $15,600 for years two and three. Out of pocket expenses of an additional $5,000 per year, or $15,000 for the three year term of the loan. This fee structure was for a proposed 3 year term line of credit in the $500,000 range.

  It is imperative that you understand how these kinds of fees can dramatically inflate the true cost of the quoted APR. Ask for a written estimate for both the initial and annual audit costs as part of your due diligence with the bank.

In factoring, the contrast between the line of credit and factoring is quite clear. With most firms there are not any annual audit fees. We absorb all audit costs, if any. This makes the quoted cost what you pay.

- ✓ **Reporting Requirements**. On most bank lines of credit, the bank or lender will require that you submit very detailed financial information to them on a scheduled basis - usually monthly - for the entire term of the loan or line of credit. The kinds of information that you will be required could be; periodic collateral reports, monthly borrowing base statements, monthly, quarterly and annual financial statements, and other projections, budgets, sales information, etc. In addition, most banks will require that you or a member of your staff be available to discuss or answer questions on any of the information that you submit to them.

If you are the bank, this requirement makes sense as a way to protect their shareholders capital. But before you "sign on the line" for a bank line of credit, you need to make 100% sure that you are able to do what they are requiring. SME's who continue to miss agreed written deadlines with their bank are headed for trouble. Insure that you have staff to complete and meet the requirements that you have agreed to do. In the event that you outsource this function to another party, this is another monthly cost of the loan that you might not otherwise have with alternate funding options.

Like many of the other facets of a bank loan or line of credit, this requirement is almost never negotiable. No bank will agree to lend you money and then allow you to negotiate away all reporting requirements with them. If anything, due to the pressure on banks from regulators and investors, the pendulum has swung to a trend of more and more reporting, not less. This trend is likely here to stay for a while.

For factoring, the contrast between the line of credit and factoring is quite clear. With most firms, there very few additional reporting requirements for you to comply with as part of the Accounts Receivable factoring relationship. In almost all cases, current financial statements submitted on an annual basis are all that is required.

- ✓ **Termination fees**. With many bank lines of credit, the bank or lender will require that you pay a fee if for any reason, the line or loan is paid off before the agreed to term. This fee is structured to make it difficult, if not impossible for you to leave the bank early. Or in the event that you have to or want to, it could be expensive. Keeping in mind that most maturities on an approved loan or line of credit run for two to three years, this fact is important to factor into your due diligence process when analyzing this form of funding.

  Each bank has a different method of determining and charging a termination fee. It is impossible to make any blanket statements or present rules of thumb regarding what a typical termination fee might cost. A recent line of credit proposal I reviewed had this structure; for year one of three, a 3% fee to terminate the line of credit, or $75,000. For year two, 2%, or $50,000 and for year three, $25,000. This was for a line of credit in the amount of $2,500,000 with a three year term.

  Is a quoted termination fee negotiable? Maybe. Are you likely to be successful in getting it eliminated entirely? Unlikely. Your ability to negotiate this will depend on how much the bank is willing to be flexible and your leverage with them. The current environment is not favorable for most small businesses to be successful in these kinds of negotiations.

The contrast between the line of credit and factoring is quite clear. With most firms, there is no termination fee for the entire term of the factoring relationship.

- ✓ **Required Deposit or retainers**. With many bank lines of credit, the bank or lender may require that you pay an upfront fee to them as part of the application process. This can be called an Application fee, deposit, retainer or underwriting fee. Regardless of what it is called, it is rarely refundable and is used to pay for the research and Due Diligence that is required by the bank to review and approve the line of credit.

  Each bank has a different method of determining what, or if a deposit will be required. Like many aspects of applying for a loan, this is usually not a negotiable item with the bank. Also keep in mind that in the event that the loan is not approved, or you do not close for any reason, the deposit is usually not refunded. This makes your ability to negotiate somewhat less effective, as items that might be a deal breaker to you could result in the loss of the entire deposit. Your ability to negotiate a deposit or retainer will depend on how much the bank is willing to be flexible and your leverage with them. Again the current environment is not real favorable for most small businesses to be successful in these kinds of negotiations.

On the other hand, with factoring, the contrast between the line of credit and factoring is quite clear. With most firms, there is no deposit, application fee or retainer to be paid by you to close the relationship.

- ✓ **Services provided other than capital**. With most bank lines of credit, the bank or lender agrees to provide you working capital to help run or grow your SME. For providing the capital, you agree to pay the bank a quoted interest rate, and all of the numerous other fees we have discussed. It is very important to make sure that you accurately determine or estimate what all of these other fees will cost you over the term of the loan or line of credit.

However, it is important to consider this concept: what do you pay for all of the other services that the bank doesn't provide as part of their line of credit? For example, most factoring companies provide a wide menu of other services, at no additional cost as part of their professional service menu. These services might include, but are not limited to: credit reports that you might request on current or potential clients, comprehensive accounting and documentation record keeping, unlimited, free online access to information about your invoices, Accounts Receivable and collected accounts, professional quality control follow up and collection efforts on your accounts, credit insurance if needed and the ability for you to streamline your internal process and payroll needs.

In conclusion, as you compare a factoring relationship to a standard bank line of credit or loan, ask these simple but important questions:

- ✓ How much will I spend, in addition to the bank line of credit cost, to do all of the important tasks outlined above?
- ✓ What will my payroll cost be, including the benefits of having someone to do all of these tasks and how am I sure that they are being done correctly?

- ✓ What will it cost me to establish and maintain systems to monitor my accounts receivables, and to track all collection and follow up efforts?
- ✓ How much time will I (or someone else) spend managing, monitoring and guiding this stuff?

With most factoring relationships, all of the above services are included as part of the menu. Your time is valuable and it is very important to ensure that all of these services either need to be done internally or outsourced if the bank line of credit is the path that you select.

In conclusion, when viewed on a comparative basis to a traditional bank loan or line of credit, a relationship with a professional B2B and B2G firm for your SME might not only be an astute choice strategically but also financially over the long run. Food for thought, for sure.