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**Leadership and strategy**



**17 October 2007**  
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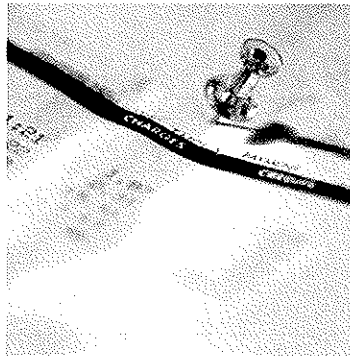


**The X factor?**

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**Factoring and invoice discounting are increasingly favoured by SMEs, reports Colin Chinery. But, as with a good suit, look for a good tailor and make sure your product is bespoke**



Once tainted by stigma – slated as expensive and the last loan saloon – factoring is eclipsing the traditional bank overdraft as a funding facility for SMEs.

Funds borrowed last year increased 22 per cent to £13.65 billion according to the Factors and Discounters Association. And the pace is accelerating with manufacturing accounting for 30 per cent of total borrowings – second only to the service sector.

Nine out of 10 MBO, MBI or similar transactions include factoring and invoice discounting in the financing structure. And banks are increasingly moving customers off traditional overdrafts and on to factoring and invoice discounting – because they're easier, less costly to manage and provide better security.

For the manufacturing client, factoring and invoice discounting can provide funding similar to overdrafts while offering greater flexibility at a higher value. "Overdrafts are going in one direction while our lending is moving in the opposite – going up. Traditionally manufacturers have had to wait so long for customers to pay, and overdrafts just don't work any more," according to Richard Pepler, managing director of Bristol-based Ultimate Finance.

Payment terms for most manufacturers are lengthy – typically between 60 and 90 days – and, as Ian Wilson, invoice finance partner for Clydesdale Bank and the Yorkshire Bank says, it can take perhaps 30 days or more to manufacture goods and get them to the customer.

"In the meantime suppliers, wages and overheads have to be paid which means that when cash can be drawn down against invoices it improves cash flow, particularly when the manufacturing business is expanding. Current trends show the manufacturing sector is bouncing back with strong growth."

But hedging against slow payers is not always the main attraction. "It's very difficult these days to get a bank overdraft," says John Watson, financial director of Dust Extraction of Pudsey, "and we decided some years ago that we wanted cash injections into the businesses. So we turned to invoice factoring. There were no slow payment problems and our customer base is blue chip. But factoring gives a kick start to the working capital, and we had some very large orders that needed some book front payments to get the projects going."

The big attraction of factoring, says Mark Blayney, joint managing director of Creative Business Finance of Darlington, is cash on the nail – normally 70 per cent to 85 per cent of

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VAT inclusive invoices, paid within 48 hours. "An overdraft with the bank has a set limit, generally based on the level of security they perceive your business has got – in practice your debtor bill plus plant and property – and will probably be based on 50 per cent of your debtor bill. That's done once a year, that's your limit and that's it.

"With factoring and invoice discounting, because it's based on specific and outstanding invoices, if you get busy, and your turnover goes up – and with it your requirement for working capital – your funding goes upward. So for a business that's growing, factoring can be extremely flexible."

But while the stigma has gone, factoring and discounting can be tainted by stories of bad advice, ill-matched deals and hard selling. So beware salesmen bearing glib prescriptions. "You can waste a lot of time dealing with people who are not appropriate, and conclude a deal that is very wrong for your business," cautions Blayney.

"The key thing we come across time and again is that when manufacturers are talking to factors they are speaking to the sales side who will be talking about 75 per cent advances. Fine except this is very much a nominal figure. By the time the operations department has decided how much risk they want to take with you and begin knocking off reserves for things like overdue debtors, and concentration limits, the real advance can be significantly lower."

Blayney cites a business that sleepwalked into a factoring deal ignorant of the concentration limit – disallowing debt from any customer with more than 25 per cent of total ledger value. "They got into bed with somebody who provided completely the wrong facility. Four weeks later the business failed. You can't get more wrong than that."

The concentration factor can be critical agrees Pepler. "It is all too easy for a manufacturer to chase turnover and pay insufficient attention to the credit management of their business. Suddenly they are enticed by a customer to take on a big order and end up with a concentration in their sales ledger. That's a huge risk to a business."

Last month Dust Extraction (£3.5 million turnover) took a £850,000 windfall order, a clear candidate for the concentration filter. "It would cause issues normally but we are talking with our factors, State Securities of Southampton, about ring fencing that order and getting separate funding against it," says John Watson. "We had some bad experiences with companies before we signed with State Securities, who have been very supportive and offer flexible solutions."

Failing to take advice can be a major problem says Pepler. "There is a huge source of information that a factoring company can make available to its clients. And most of the manufacturers that we have seen ceasing to trade have ignored the very very good and sophisticated information now provided by the factoring industry.

"A manufacturer ignores this vast source of information – freely offered as part of the whole facility – at its peril. But the manufacturer needs to be aware that we are not telling them how to run their business, we are just giving them good, very sophisticated, up to date sources of information. We provide it and then let them choose how they analyse that and fit in into the future growth of their business.

"And we don't even tell them how they can use the money we provide. And this is another peril I have seen cause the demise of a manufacturing business. They get these much bigger sums of money from a factoring company and then spend it on things they shouldn't be spending it on."

So what are some of the core issues for a manufacturer considering a factoring or invoice discounting arrangement? "First of all talk to people who have factored to find out what sort of relationship they have with their factoring companies," advises Watson. "Make sure you are getting on board with people who understand your business and its issues, and are supportive. Explain clearly how your business works and make certain they fully understand, otherwise when it is processed at head office it may not fit their operational templates."

Know the terms of the contract, says Pepler; its duration and length of notice. "You might find that the facility has worked and you no longer need it, so do not be tied in for years. Then again who's going to make the decisions on your behalf? Make sure you will be treated as an important customer with access to the decision-makers. This is really key."

Compare like with like is another basic, says Blayney. "Factoring and invoice discounting will have an interest charge, a rate above base rate which ought to be directly comparable to your overdraft rate, and there is also a service charge which tends to be run as a percentage of turnover.

"Invoice discounting tends to be cheaper than factoring because with factoring you are getting not only a lending facility but an additional service, provisionally a credit control department – effectively bad debt protection – so you are buying a range of services in addition to the funding you are getting. And these have a cost to be paid for.

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"So take a look at what you are getting and decide if this is appropriate. The other thing that can make it look more expensive than other forms of lending is that in a sense it's much more transparent and up-front. If you are dealing with your bank manager you may well get a facility fee, management and transaction charges and costs that come through the year. And while these may well mount up to quite a sizeable sum, they creep up on you or just appear. With a factoring agreement it's all laid out."

"Look at costs, terms, and negotiate," says Ian Wilson. "And a local, flexible relationship with the provider is vital."

"We are not funders of last resort, we are not a lifeboat and never have been," says Pepler. "Part of the problem is that businesses have used factoring and invoice discounting in the past and ceased to trade. People have pointed the finger and asked how could this happen when they are using this new, fantastic working capital facility? And this comes back sometimes to a mis-use of the money."

"But we are not actually lending any money; there is no loan, no investment. We are just giving them money they would otherwise get from their customers and will only fund businesses that are in a growth phase. The stigma has long gone and we are now mainstream funders having overtaken banks with overdraft lending. So I think we've proven the point."

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