FA$T CA$H

How factoring works

Some typical terms that apply when a contractor assigns a finance company the right to collect a $100,000 invoice

Contractor receives

- $60,000 to $70,000 immediately upon sign-off of debtor
- $26,000 to $36,000 if factor collects invoice within 30 days

Finance company receives

- $0 to $250 initial application fee
- $4,000 to $5,000, or 4% to 5% of the face value of invoice paid within 30 days
- $3,000 to $4,000, or 3% to 4% of the invoice face value plus 3% to 4% for each 30 days past due; or 3% for first 15 days, 2.5% for each additional day
- Additional contractor charges for expenses, such as wiring fees, express mail charges, credit investigations and lien and tax lien searches

Forgive Howard Chernin if he is brash about cash, but it's his business. Cash is spelled out in big letters on his company's brochures. It's the word that comes to Chernin's lips when he needs to smile for a photographer. And cash is what he and other small financial firms offer construction companies.

Chernin is senior vice president of Quantum Corporate Funding, Ltd., a New York City company that purchases the right to collect another company's invoices in exchange for a cash payment. The practice is known as factoring and has grown into a $50-billion-a-year business in the U.S. Quantum and a handful of niche factors around the country are bringing factoring to small construction companies, filling a void left by more conventional lenders.

"They need cash flow," says Chernin. Quantum recently has factored invoices for a stucco finish contractor on a Dodge dealership near Columbia, S.C.; a drywall contractor at NASA's Ames Research Center at Moffett Field, Calif.; and the steel erector on a New York City grade school.

Construction is ripe for such a service because its pay practices are among the worst of all industries. Construction companies rank at the bottom of all industry groups in speed of payment, according to a recent quarterly survey performed by Dun & Bradstreet, New York City. Prompt-pay statutes are routinely ignored, subcontractors complain.

Sitting. Predatory tactics abound, with owners and prime contractors sitting on invoices for months or making only partial payments. When a contractor needs to meet payroll, cash-flow problems can be acute. Factoring's relatively high cost of about 4% per month is better than bankruptcy.

Traditional lenders are not flexible enough to help small prime contractors and subcontractors iron the wrinkles out of their cash problems. To qualify for a commercial bank's line of credit, a typical borrower must produce financial statements and tax returns that prove a minimum of three years of profitable operation. Personal guarantees and pledged collateral also may be required. Non-recourse factors work without these requirements.

Full value. In addition, bankers say they typically will not recognize the full value of a company's accounts receivable when using the receivables as an asset to secure a loan. For example, a bank willing to lend against receivables that are due within 60 days may give the contractor only 75% of the total value of the receivables.

Livingston, N.J.-based CIT Group is the largest finance company in construction and, through a separate operating subsidiary, the largest factor in the U.S. But CIT does not provide factoring to construction contractors. "It's something new," says Tom Camphire, a CIT marketing vice president.

Yet some contractors already have made factoring a regular practice. Carmody Inc., a Mt. Kisco, N.Y.-based masonry and concrete subcontractor, sells selected large invoices to Quantum in order to ease the cash crunch involved in meeting payroll on large projects. Because the general contractor must sign an agreement with the factor stating that the subcontractor has finished the work, factoring increases the likelihood the prime contractor will pay.

"It secures your funds and in today's environment you have to be wary of the general contractor," says Carmody's project engineer, Michael A. Giannasca. "This makes it harder for them to get out of paying." Carmody recently factored a $70,000 requisition for a school job in Sullivan County, N.Y.

Factoring often is portrayed as a fancy form of loan-sharking. Some management experts warn that factoring is too expensive for contractors that operate on thin margins and that some factors have been known to hit customers with undisclosed fees. "Contractors who must resort to factoring are taken to the cleaners," claims Chris Thompson, an electrical contractor who is president of the Construction Financial Management Association in Princeton, N.J.


Sheinker, Chernin: We know construction.

Yet others say factoring is just another form of business finance to be compared to all others. Before making a judgment for or against factoring, "I would want to know the whole scenario," says Steven Boren, vice president of Contractors Adjustment Co., a Glenview, Ill.-based credit advisor. That includes whether the work falls within the mechanics lien act or if the subcontractor is barred from any position.

Still others say that factoring fills a vital role in helping small businesses that cannot yet qualify for bank financing. Vincent Marino, a painting and wallcovering contractor in Jacksonville, Fla., says he was turned down for credit by two banks. He now factors invoices on larger projects and says the practice has helped his company grow. Marino's 30 to 35% markups make the relatively high cost of factoring acceptable. "On a receivable, that 5% is not so bad," he says.

Factors say they are overcoming an aversion to construction, which some considered too risky. "We look at construction more favorably than in the past," says Jose R. H. Trujillo, accounts manager for Cambridge Factors, Boca Raton, Fla. By the same token, factoring "is not something from the back alley," adds Quantum President Craig E. Sheinker. "This is an accepted product that has not been fully applied." ■

By Richard Korman, David Kohn and Stephen H. Daniels