SUBCONTRACTORS
THE HEARTBEAT OF CONSTRUCTION

Factoring: A Cash-Flow Improvement Tool

Bottom Line Comparisons

	Present Situation	With Factoring
Sales:	$2 million	$4 million
18% Gross Margin:	$360,000	$720,000
Overhead:	$150,000	$200,000
Cost of Factoring:	Not Available	$80,000
Net Profit:	$210,000	$440,000

by Howard Chernin
Senior Vice President
Quantum Corporate Funding, Ltd.
New York City

Poor cash flow not only affects existing and well-managed subcontracting firms, but new ones as well. As a result, the first inclination to resolving the problem is to turn to a bank - many of whom may not be receptive to the immediate cash flow needs of the subcontractor.

Therefore, an alternative must be found and found quickly. That alternative for a growing number of subcontractors is factoring — the process of selling accounts receivables to a funding source rather than waiting to collect the money from a general contractor.

"Factoring is a fancy term for a basic concept that has been around for centuries," according to Craig Sheinker, president of Quantum Corporate Funding, Ltd.

"A receivable, or a requisition, which has not yet been paid, has value," he explained, adding it is a debt that your general contractor has agreed to pay in the very near future."

Elaborating, he said "factors are investors who will pay cash now for the right to receive the future payments on your requisition."

Factoring offers a number of benefits to cash-starved subcontractors, he noted, adding that "instead of having to wait 30, 60, 90 days or longer for payment on work performed on a construction project that has already been completed, a subcontractor can factor or sell its receivables for cash at a slight discount off the face amount of the invoice. When an invoice is sold, it becomes 'instant cash' that can be used to meet payroll, pay suppliers and union benefits or provide working capital."

Sheinker said he has seen factoring provide the means for a subcontractor to take on new work. "It's not just a cash management tool," he explained.

Elaborating, he said that a typical business that extends credit will have from 10 percent to 20 percent of its annual sales tied up in accounts receivable at any given time. "Just think for a moment about how much money is tied up in 60 days' worth of receivables, and then think about what you could do with that cash if you had it on hand," he continued.

"You can't pay the power bill or meet this week's payroll with a customer's invoice, but you can sell that invoice for the cash to meet these obligations," he added.

"Most people," he said, "consider the discount a cost of doing business—and it is a small cost at that—just four percent for a 30-day invoice. Compare this benefit with the problem of not having cash when you need it to operate. In the global view of things, that four percent is negligible."

Sheinker said "Most businesses treat the factor's discount as if they had offered the customer a discount for paying cash. It works out the same. I have heard of other companies that consider the discount the same way they treat a sale price - it's just the cost of generating cash flow. It is almost like discounting merchandise to generate sales."

Factoring is appealing to young and rapidly-growing companies because the process shortens their business cycle. The shortened business cycle and increased cash flow enables the firm taking advantage of factoring to grow even faster."

Banks do not offer businesses this advantage, he observed, noting that getting a loan from a bank is difficult today, if not impossible.

However, there are benefits to factoring versus a bank loan, according to Sheinker. "A loan places a debt on your balance sheet, and it costs you interest. In contrast, factoring puts money in the bank without creating any obligation."

In addition, he said that "loans are largely dependent on the financial soundness of the subcontractor. Factoring, on the other hand, relies on the financial stability of the general contractor."

Speaking of general contractors, they, like subcontractors, have also turned to factoring to help fund their business.

There are many scenarios relating to the benefits of factoring which Sheinker or I could tell you about. One of them which comes to mind was when a subcontractor called and wanted to explore whether factoring might help him with his cash flow problems. After evaluating his situation, it became evident that he was a candidate for factoring.

He inquired about points, the percentage he would be charged to factor, and how soon he might be able to receive funds. In this scenario, the subcontractor would be able to receive an advance, under a no term contract, with no credit risk, equivalent to 60 percent of a specific single invoice totaling $100,000 or $60,000 in cash that would be directly wired to his bank account. He agreed to pay four percent of the total for the first 30 days as a fee on the $100,000. In other words, he would pay $4,000 to factor a $100,000 invoice for one month. He would receive the balance of the money — equal to $40,000 less the $4,000 fee — amounting to a total $36,000 upon receipt of the funds due toward payment of the invoice.

The subcontractor, reluctant at first, said that he was operating in an extremely competitive market - as most are. Further inquiry revealed that his gross margin was 18 percent and that his annual overhead was $150,000.

He also maintained that if he had "unlimited funds," he would be able to double his business.

He told me: "I would be doing $4 million in sales if I had unlimited funds. I'm turning away business now because I don't have the cash flow to handle it."

The question often asked is if he doubles his sales, would he double his overhead? The answer is no. Actually, the extra $2 million in sales would only cost him an additional $50,000 in overhead expenses.

A doubling of sales for most small businesses does not lead to a doubling of overhead. A business does not need twice the space or twice as many employees. It is the economy of scale that allows for such an increase in net profit. The realization of how he could benefit from factoring conjured up an image of another subcontractor smiling ear-to-ear - an image I have seen so many times in person.

Without factoring, this subcontractor made $360,000 gross profit on $2 million in sales. With factoring of his 100 percent of his receivable, he would only have to factor $2 million out of a projected $4 million in sales in order to generate a gross profit of $720,000. His yearly cost for factoring would be $80,000.

Factoring would give him the funds necessary to grow his business, take greater advantage of discounts offered by suppliers; and take advantage of sales opportunities he might have missed out on that could have substantially increased his bottom line.

For more information, contact Quantum Corporate Funding Ltd., 90 Park Avenue, 16th Floor, New York, N.Y. 10016, (212) 856-9520; FAX: (212) 856-9439.

FACTS ON FACTORING:

WHEN YOU BORROW

- It limits your flexibility
- A lender will secure assets equal to a minimum of three times the amount of the loan
- you can not secure additional funds without re negotiating the loan
- You must meet monthly payment obligations

WHEN YOU FACTOR:

- You don't borrow money
- You make no monthly payments
- You receive funds in 24 hours or less
- You control your cash flow by determining how much to factor and how often