Factoring 101

Understanding the basics

By Howard Chernin

Maintaining cash flow remains one of the most common challenges glass company managers face. Everyone, from manufacturers to glazing subcontractors, distributors to builders, and retailers to suppliers, is subject to the same type of progress payments that characterize nearly every sector of the construction field.

Contractors and subcontractors usually receive payments 30, 60 or 90 days into the project. However, while waiting for those checks to arrive, the business still has to pay workers, buy materials, make tax and insurance payments and finance other costs to keep going.

What can a businessperson who runs into a cash crunch do? Borrow money. Yet a manager in the glass industry once again remains typical of all construction managers in that most bank officers are not likely to consider them as a particularly likely loan prospect.

Even if a bank is willing to loan, glass businesses likely face severe restrictions. Banks usually insist on securing assets equal to a minimum of three times the loan. In addition, a business that has taken out a loan will be obligated to make monthly payments, thereby creating a financial strain of its own. The borrower will not gain access to additional funds without renegotiating the loan or, in some instances, starting over with a different bank.

As a result, borrowing from a bank isn't always realistic. So what's a glass manager to do?

Enter the factor

The construction industry's quirkiness with respect to traditional sources of funding has given rise to other options. One, factoring, is the sale of accounts receivable. A finance company called a factor will advance a small business cash on the basis of one or more invoices that the factor buys. The factor will typically advance up to 70 percent up front. Then, once the invoice, or group of invoices, has been paid, the factor will advance the balance of the invoice to the small business, minus a fee of approximately 3 percent.

A manager facing a cash crunch can secure funds by selling invoices in as little as 24 hours. There are no monthly payments because the company is not actually borrowing money. The company can maintain control over how much it decides to factor, as well as timing.

Factoring also offers businesses the opportunity to grow by giving them access to funds they can use to bid on other jobs.

Factoring began in the garment and textile industry. It shares many similarities with construction in terms of its pay schedules. As is the case in construction, bankers were reluctant to extend loans to companies involved in the rag trade because of their seasonal nature and riskiness.

After World War II, factoring began to expand into other industries. It gained popularity during the 1960s and 1970s, as interest rates reached record highs. In the 1980s, the banking industry became increasingly regulated and small- to medium-sized businesses of all types looked to factoring and other more flexible methods of financing to thrive and grow. During the 1990s, even the technology industry began to take advantage of factoring. Today, factoring has grown to a $200 billion-a-year business in the United States.

And that includes the glass industry. My company, Quantum Corporate Funding Ltd. of New York City, recently provided working capital to a well-known glass company in the New York area. The company, which I'll call ABC Glass Inc., was working with some of the largest construction companies in the nation, including Tischman Construction Corp., based in New York City, F.J. Sciame Construction Co., also in New York City, and Skanska, a global construction services group based in Stockholm. ABC was a successful, solid company, yet because of progress payments, it occasionally found itself in need of funds. Quantum established an ongoing relationship with ABC, buying its invoices on many occasions and enabling it to complete high-profile jobs.

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Cash now, or lose the job

To demonstrate specifically how factoring works, consider the fictitious XYZ Glass Co. installing windows in a residential complex in a metropolitan area. In the midst of the project, XYZ Glass finds itself in need of cash. The managers approach Quantum, whose officers determine that XYZ qualifies for an advance, under no long-term contract and with no credit risk, equivalent to as much as 70 percent of one of its $100,000 invoices. A sum of $70,000 cash is wired to XYZ Glass' bank account. If looking down the road, the account fails to pay because of credit problems, Quantum agrees to take the loss.

In exchange, XYZ Glass managers have agreed to pay 3 percent of the total for the first 30 days as a fee on the $100,000. In other words, the company would pay $3,000 to factor a $100,000 invoice for one month. It would receive the balance—$27,000, or $30,000 minus the $3,000 fee—upon receipt of the funds due toward payment of the invoice. The company would therefore receive $70,000 plus $27,000, or a total of $97,000 for its $100,000 invoice.

Try growth on for size

A manager new to factoring might understandably be apprehensive about trying something unfamiliar. Yet simple calculations can demonstrate how factoring can help any company grow. Let's say a company has a gross margin of 18 percent and annual overhead of $150,000. Assume the manager recognizes, given the demand in his area, he has the potential to double his business from $2 million in annual sales to $4 million, if he had access to greater funding.

In this instance, the company's accountant calculated that doubling sales would not translate to doubling overhead, and that an extra $2 million in sales would end up costing only $50,000 more in overhead.

This quick analysis shows how having access to more funds through factoring can help a business grow. Without factoring, our fictitious business was making $360,000 gross profit on $2 million in sales. But it only had to factor $2 million out of a projected $4 million in sales to generate a gross profit of $720,000. The annual cost for factoring was $60,000. Instead of a net pre-tax profit of $210,000 per year, the net profit increased to $460,000 per year for an increase of 119 percent or a quarter-million dollars. In addition to growing by bidding on more jobs, this company would also receive volume discounts from suppliers.

Factoring has become an important tool for every company in the construction business. And given its long history of helping businesses stay in business, as well as grow, it's one that every construction company should keep in its tool box.