With finetrading, the factoring turnover increases

The changing landscape of SME financing

Sven Koch, Tim Schade. This contribution makes it clear, that through the growing interest in alternative financing instruments and the significant re-financing requirements of so-called SMEs, the finetrading and factoring instruments need not necessarily be in competition with each other. Financing using finetrading and factoring lead to the optimisation of the customer's working capital and, in the opinion of the authors, can open up further growth potential for the factoring sector.

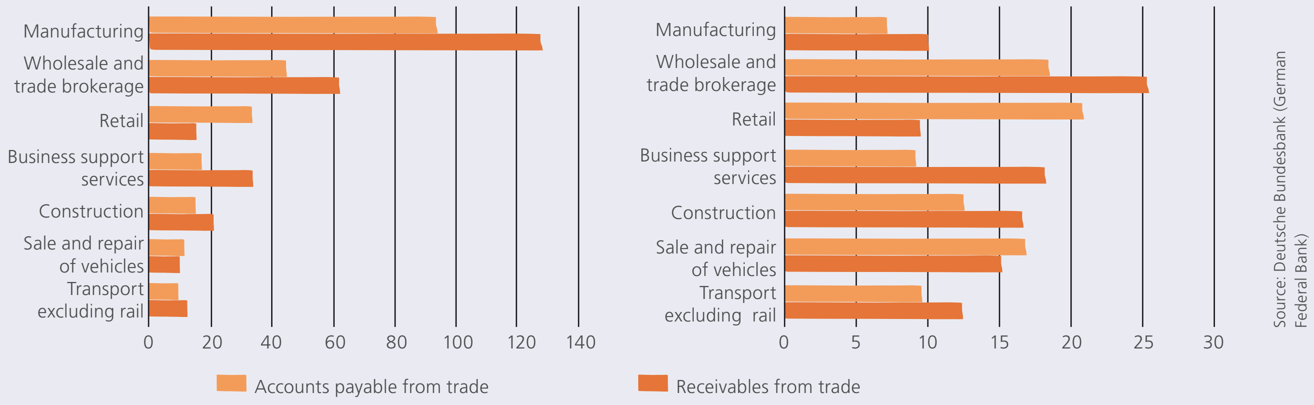
The financing of small and medium-sized companies in Germany is changing. The classic bank credit continues to form the core of third party financing but is increasingly supplemented by alternative and bank-independent financing instruments (for example factoring).[1] The total volume for the German factoring sector was €189.8 billion in 2014 and showed an increase in turnover of 10.8 per cent in comparison with the previous year. This means that the German factoring sector is heading toward the €200 billion mark.[2] However, after the classic bank credit, commercial credit is the most important financing instrument within the context of short-term third party financing for small, medium and larger companies (cf. Figure 1, page 2). This supplements or substitutes short-term bank credits, which are often available in the form of an overdraft.[3]

The significance of commercial credits

In a special assessment of company accounts, the Deutsche Bundesbank (German Federal Bank) verified the significance of commercial credits for company financing in Germany. In regard to wholesale trade and trade brokerage, the results show that the average amount of receivables from trade accounted for 25.4 per cent of the balance sum

1) cf. Ernst & Young: Agenda Mittelstand, Wege zum Wachstum, Finanzierungsverhalten im deutschen Mittelstand (Agenda Mid-Sized Sector, Ways to Growth, Financing Behaviour in the German Mid-Sized Sector), 2013, pp. 9 ff.
2) cf. Press release by the Deutsche Factoring- Verband e. V. (German Factoring Association) of the 16th of April 2015.
3) cf. Deutsche Bundesbank: Die Bedeutung von Handelskrediten für die Unternehmensfinanzierung in Deutschland, Ergebnisse der Unternehmensabschlussstatistik (German Federal Bank: The Significance of Commercial Credits for Company Financing in Germany, Results of the Company Accounts Statistics), Monthly Report October 2012, 64th Year, No. 10, pp. 53 ff.

Figure 1: Average amount of commercial credits from 2002 to 2009 according to economic sector in millions of Euro (left) and percent of the balance sum (right)[5]



(€62.6 billion) and the average amount of liabilities from trade accounted for 18.5 percent of the balance sum (€45.4 billion) and varied greatly depending on the sector of industry and the size of the company (Figure 1).

Moreover, the results show that trade credits are of particular importance to very small, small and medium-sized companies as well as companies with high sales costs.[4)]

The result of the Atradius Payment Behaviour Barometer survey confirmed an average payment period of 43 days for the German business sector. In total, 65.2 per cent of the companies surveys stated a payment period of between zero and 30 days, 21.7 per cent stated a payment period of between 31 and 60 days and around 13 per cent stated a period of more than 60 days.

Terms of payment and payment behaviour

The current results on payment behaviour indicate what is often insufficient liquidity, as 33.7 per cent of the entire volume of receivables were not paid by the date on which the invoice was due for payment and were overdue by an average of 13 days. A delay in payment can be identified in particular in the areas of SMEs and the production and retail sectors. According to the information provided by the companies surveyed, 50.6 per cent use the delay in payment targets for short-term financing of the working capital. It is therefore no surprise that the greatest challenges include ensuring sufficient liquidity (24.4 per cent) and the risk of non-payment in connection with collection procedures regarding open accounts (29.6 per cent).[6)]

The law passed by the German Bundestag to combat delayed payment to protect medium-sized companies emphasised the framework conditions for financing on the commercial credit market, in particular payment behaviour and resulting challenges for vendors and creditors.[7)]

The framework conditions outlines lead to an enormous re-financing requirement for the financing of SMEs on the part of the company as well as the need for professional management of creditors and debtors as well as liquidity management. This suggests significant potential for growth for the finetrading and factoring financing instruments.

Growth potential

The current deficit in demand for (short-term) bank credits, which among other things is attributable to a changed source of funds in favour of internal financing and innovative working capital management, strengthens this assumption.[8)] Innovative working capital management includes, among other things, the optimisation of payment targets on the sales and purchasing sides in cooperation with customers and suppliers.[9)]

This article shows that, due to the growing interest in alternative financing instruments and the huge re-financing requirements of SMEs, the finetrading and factoring financing instruments are not competitors but rather complement each other. Double-sided financing using finetrading and factoring leads to the optimisation of the customer's working capital and enables the factoring sector to exploit further growth potential, in order to continue on this growth path in the coming years.

Factoring versus finetrading

In the case of financing for medium-sized companies, the factoring financing instrument is considered to be established. It is used to finance trade receivables and is not a financial service according to the German Banking Act (KWG), because all ongoing purchase of receivables is defined on the basis of framework contracts with or without recourse.[10)] Therefore, it is not possible to exploit the high share from

4) cf. Deutsche Bundesbank: Die Bedeutung von Handelskrediten für die Unternehmensfinanzierung in Deutschland, Ergebnisse der Unternehmensabschlussstatistik (German Federal Bank: The Significance of Commercial Credits for Company Financing in Germany, Results of the Company Accounts Statistics), Monthly Report October 2012, 64th Year, No. 10, pp. 57
5) taken from Deutsche Bundesbank: Die Bedeutung von Handelskrediten für die Unternehmensfinanzierung in Deutschland, Ergebnisse der Unternehmensabschlussstatistik (German Federal Bank: The Significance of Commercial Credits for Company Financing in Germany, Results of the Company Accounts Statistics), Monthly Report October 2012, 64th Year, No. 10, pp. 59. The amount of the receivables and liabilities from commercial credits and deposits by listed non-financial companies has further increased since 2009, cf. Deutsche Bundesbank (German Federal Bank), time series BBK01.CEFY01 and BBK01.CEFY10, as of 03 February 2015.
6) cf. Atradius Payment Practices Barometer: International Survey of B2B Payment Behaviour, Survey Results for Germany, Spring 2014, pp. 1 ff.
7) cf. Gesetz zur Bekämpfung von Zahlungsverzug im Geschäftsverkehr (Law to Combat Delayed Payment in Business), Federal Law Gazette 2014, Part I No. 35, published in Bonn on 28 July 2014, pp. 1218. For further notes on the effects on financing practice cf. Krüger, Gesetz zur Bekämpfung von Zahlungsverzug im Geschäftsverkehr, Finanzierung Leasing Factoring (Law to Combat Delayed Payment in Business, Financing Leasing Factoring), 6/2014, pp. 23.
8) cf. Deutsche Bundesbank: Geldpolitik und Bankgeschäft (German Federal Bank: Monetary Policy and Banking), Monthly Report November 2014, 66th Year, No. 11, pp. 38 ff. and Deutsche Bundesbank (German Federal Bank), time series BBK01.OXA8C4, as of 03 February 2015.
9) cf. Deloitte & Touche: Working-Capital-Studie, Flüssige Mittel und gebundenes Kapital (Working Capital Study: Liquid Funds and Committed Capital), 4/2014, pp. 7, 13.

liabilities from trade on the liabilities side for SMEs using factoring (Figure 1).

SMEs use commercial credits to finance working capital. Repayment often does not occur on the defined maturity date. It can be assumed from this that SMEs need longer payment targets. Within the context of sales financing, factoring sets individual payment targets and protects the customer by assuming the default risk (del credere function) and with debtor management (service function) for receivables defaults. On the right, Figure 2 shows how sales financing works using factoring.

Here, the finetrading financing instrument is of interest, because from the factoring perspective, the supplier of the finetrading transaction facilitates the transformation of the liabilities from trade into factorable receivables from trade and provides the customer with extended payment targets against a deferral charge.

The less well-known and therefore not yet established finetrading financial instrument is a financial drop shipping transaction and is, as a rule, offered by bank-independent companies (finetraders). In contrast to factoring, a finetrader is not a credit or financial services institution according to the German Banking Act (KWG). The finetrading business is therefore not a business subject to authorisation in accordance with the German Banking Act (KWG) or to other regulations, so that for finetraders there is no supervisory obligation by the German Federal Financial Supervisory Authority (BaFin). The finetrading business includes the processing of commercial through the provision of supplier credits with a volume of up to €15 million and a payment term of up to 120 days.

Thus, finetrading is used to flexibly finance the purchase of goods, whereby the finetrade takes over the advance financing of tradable goods purchases by the customer. A fee applied for availing of finetrading, which is generally covered by the discount in the case of a term of payment of up to 30 days.[12)] Around 65 per cent of the receivables with a term of payment have a term of between zero and 30 days. Therefore, finetrading can be a cost-efficient alternative form of financing for SMEs. It is to be determined that this financial instrument is an alternative to substantial commercial credit or short-term bank credit. On the left, Figure 2 shows how financing for the purchase of goods works using finetrading.

Reverse Factoring

In addition to finetrading, the factoring variant, reverse factoring, presents a further option for financing the purchase of goods. Reverse factoring is a suitable financial instrument for large companies because, as it is less flexible in regard to the customer's frequently changing supplier relationships, it is often the case that only large purchase volumes are financed and a relatively powerful market position in comparison with other suppliers can be advantageous.

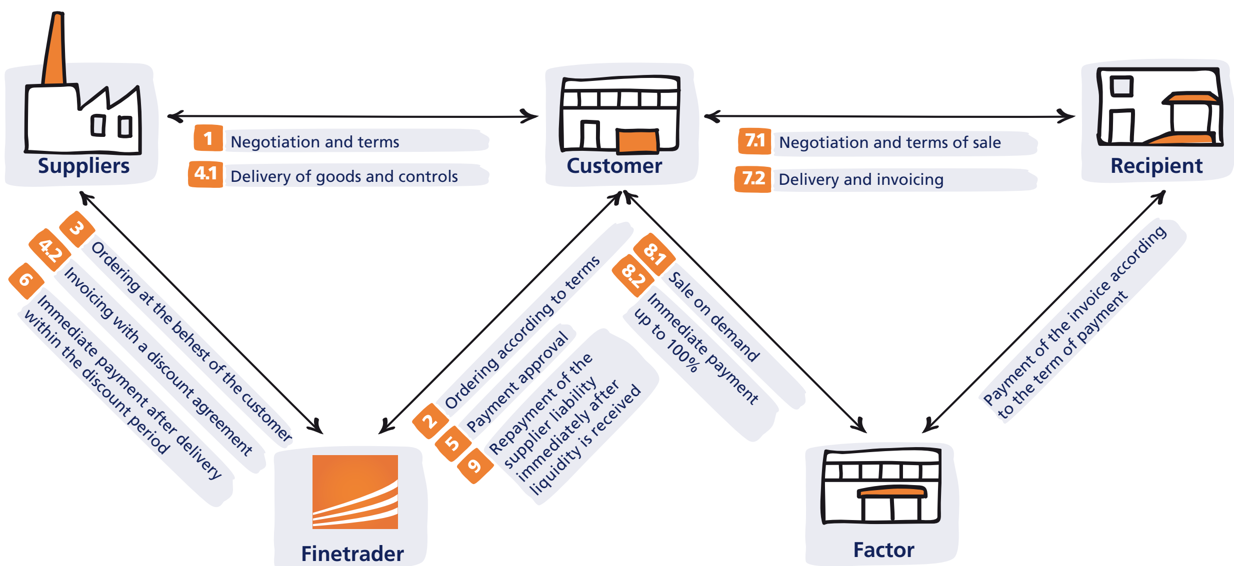
Furthermore, in the case of reverse factoring, receivables are purchased from the supplier by the factor, so that the liabilities from trade remain with the customer.[13)] In the case of the combined use of finetrading and factoring, the growth potential from the asset/liability sides for a joint customer should be exploited.

Combination to increase revenue

Figure 3 shows the combined use of the finetrading and factoring financial instruments. This is a suitable financing combination for SMEs with good credit ratings, which display "healthy" business processes and are subject to potentially seasonal business.

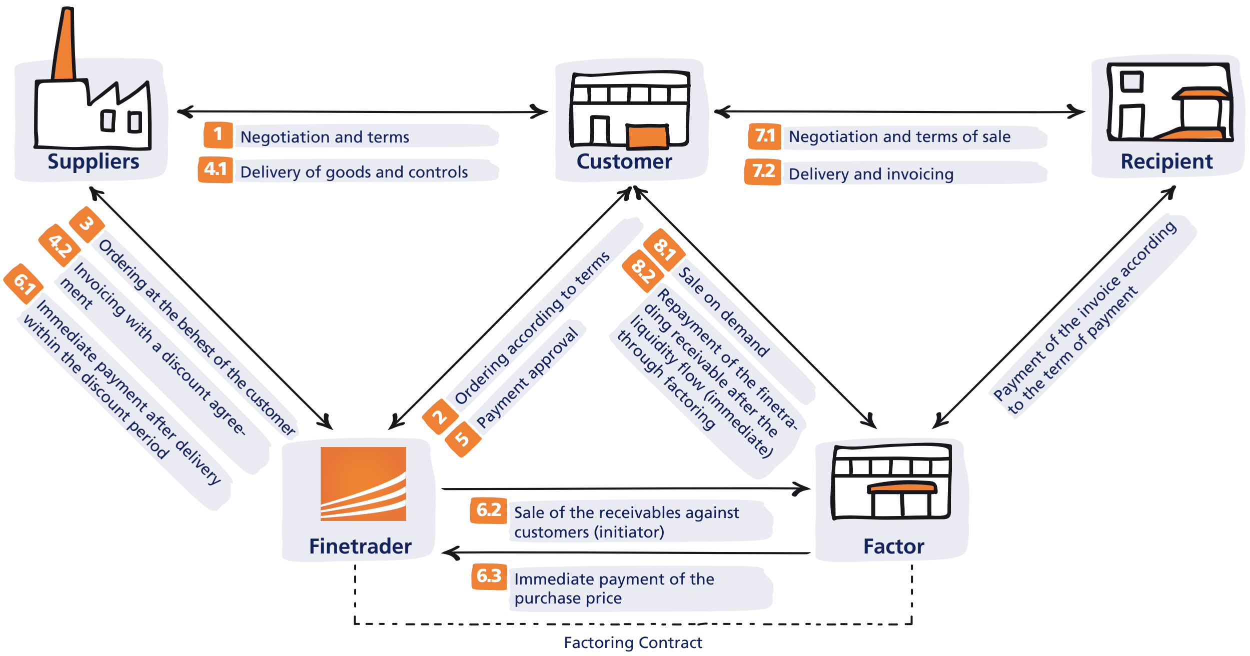
Furthermore, the companies have short terms of payment (30 days) on the purchasing side and cannot avail of supplier credits or discount allowances by paying within the discount period. In addition, the liquidity of these companies is encumbered with high capital commitments regarding warehouse stock.

Figure 2: Financing procedures with finetrading and factoring[11)]



10) cf. Sec. 1 para. 1a No. 9 KWG (German Banking Act).
11) Following Koch, Finetrading versus Reverse Factoring: Fremdfinanzierungsinstrumente zur Working-Capital-Optimierung (Finetrading Versus Reverse Factoring: Third Party Financing Instruments to Optimise Working Capital), Corporate Finance, 11/2014, pp. 462.
12) cfl. Perridon/Steiner/Rathgeber, Finanzwirtschaft der Unternehmung (Company Financial Management), Munich, 16th Edition, 2012, pp. 456. For a financial assessment cf. Koch, Finetrading versus Reverse Factoring: Fremdfinanzierungsinstrumente zur Working-Capital-Optimierung (Finetrading Versus Reverse Factoring: Third Party Financing Instruments to Optimise Working Capital), Corporate Finance, 11/2014, pp. 461 f.
13) cf. Koch, Finetrading versus Reverse Factoring: Fremdfinanzierungsinstrumente zur Working-Capital-Optimierung (Finetrading Versus Reverse Factoring: Third Party Financing Instruments to Optimise Working Capital), Corporate Finance, 11/2014, pp. 463 ff.

Figure 3: Structure of the combined financing through finetrading and factoring[14]



On the sales side, these companies show long terms of payment (up to 120 days) and thus a corresponding difference between invoicing and payment of the receivables.

However, in the case of combined use in accordance with Figure 3, the exclusion of double financing for "one item" must be contractually ensured. The customer must use the liquidity gained from the factoring transaction to immediately repay the liability to the finetrader because otherwise factoring is not possible.

From the perspective of the factor, the finetrade acts as a special purpose vehicle, which enables the transformation of the factorability of the customer's liabilities from trade into factorable receivables from trade. In the case of factoring, the receivables from deliveries and services do not have to be verified again, as a comprehensive check regarding the legal validity of the receivables has already been carried out by the finetrader.

From the perspective of the finetrader necessary re-financing is ensured through the sale of receivables to the factor, which executes immediate full payment of the receivable. The finetrader does not require any further credit lines for the finetrading transaction, as a financially strong factor takes over the re-financing. If the finetrader and the factor are two companies within a group, dual financing of a customer is ensured from one source. For the finetrader, the joint financing of one customer results in potentially better re-financing terms. In the case of group-independent cooperation between the finetrader and the factor, bulk business can lead to more favourable conditions for the finetrader. In the case of a group-internal cooperation between the companies, in addition to bulk business, if the group has a strong equity basis the re-financing terms can be optimised.

Financing costs

Form the perspective of the customer, financing costs are incurred through the combined use of finetrading and factoring in connection with the duration of the capital commitment, the credit-worthiness of the customer and the business volume. In the case of SMEs, these lead to a potential acceptance, if this can be measured in terms of average financing costs or further financial or distributional advantages are created.

A study by the consulting company, Ernst & Young on financing in the German mid-sized sector confirmed that the cost of financing tends to fade into the background and that liquidity and financing security are in the foreground.[15]

Advantages

Trade credit is dominant in the case of small and medium-sized companies regarding short-term third party financing. The finetrading and factoring financing instruments are financing solutions for the purchasing and sales sides of a company and represent alternative supplements to trade credit. By using the finetrading and factoring financing instruments, economic advantages are created for the customer from which company growth can be generated. In the case of combined use of the instruments, finetrading makes the factorability of the customer's liabilities side possible. Here, the exclusion of double financing for "one item" must be ensured. For the factoring sector, the growth potential that is already high is increased through the cooperation, because in addition to the existing receivables from trade, there is access to the equally high liabilities from trade. Both business models show further growth potential.

From the perspective of the factor the cooperation leads to additional growth potential and greater customer loyalty, from the perspective of the finetrader the cooperation guarantees re-financing. In the case of group-independent companies, there is the option of generating revenue from services in the form of commission payments.

Source: Sven Koch, Tim Schade, FLF 3/2015

14) Following Koch, Finetrading versus Reverse Factoring: Fremdfinanzierungsinstrumente zur Working-Capital-Optimierung (Finetrading Versus Reverse Factoring: Third Party Financing Instruments to Optimise Working Capital), Corporate Finance, 11/2014, pp. 462.