

Non-Traditional Factors — Slicing & Dicing Their Way To Success

While one end of the factoring market continues to consolidate, as witnessed by the recent exits of some long-standing players in the industry, the other end is now facing its point of saturation. Over the last few years, many non-traditional factors have seen their margins erode and credit quality weaken. However, there are areas where factors can focus to come out ahead.

By Thomas G. Siska

The traditional factoring market (serving the textile, garment, and furniture industries) became saturated over a decade ago and the number of participants has slowly declined ever since. 2003 saw at least two more long-standing operations disappear from the landscape: GE Commercial Services (the old First Factors out of Highpoint, NC) and HSBC's Factoring Division (the old Republic Factors unit of Republic Bank, New York, NY). So while this end of the factoring world continues to consolidate, the other end is now facing its point of saturation. Over the last few years, non-traditional factors have seen their margins erode and credit quality weaken. This has occurred because the number of direct participants in the business has multiplied and, at the same time, the pool of potential clients has gotten shallower due to competing products picking off prospects around the edges of the market.

The Competitive Threat

Competing Products: Back in the nineties, clients that factored under \$100,000 per month had accompanying personal credit scores that were all over the board: some were great, some good, some not so good, and some bad. Today, finding a small factoring client with great personal credit is like finding a needle in a haystack. The likes of American Express and GE Capital now issue corporate credit cards to small businesses in need of cash flow. The single biggest determinant in the decision process of whether to issue the card is the business owner's personal credit score. Great personal credit gets the card every time. And the cost of borrowing is the same as all credit cards, 18 to 21% APR, much lower than any factor would offer for the amount of volume generated.

Even account debtors (the factoring client's customers) have thrown their hat into the arena. CH Robinson, the largest truck broker in America, now offers a quick-pay program for their haulers. This helps the trucker obtain cash sooner, thus eliminating some of the need for factoring. The trucking company may still need to factor their other accounts, but now their biggest, most creditworthy broker is 'off the table'. This certainly doesn't pose a major threat to the industry. It is, however, a further example of the 'chipping away at the rock' that once was the total market available to non-traditional factors.

Direct Competitors Multiply: The non-traditional factoring business is experiencing a sort of deja-vu from the leasing industry. Leasing, which gained popularity in the 70's as the up and coming form of asset based lending, saw 'everybody and their brother' enter the market in the 1980s, lured by the attractive yields. By the end of the decade, the market was so saturated that two layers of brokers developed. The fairly inexperienced

'brokers' sent their prospects to the more experienced 'super-brokers', who then forwarded the business to the leasing company deemed the best fit for the situation. By the time the nineties rolled around, lessors were leaving the business like 'people from a burning building'. Most were complaining that the brokers were now earning considerably more than the lessors themselves, especially on a risk-adjusted basis, where the lessor had all the risk and the broker had none.

Non-traditional factoring was the Cinderella of 1980s. And, as could have been predicted, the nineties saw everyone jump on the bandwagon. First, it was Heller Financial in Chicago. Then, community banks all over America tried for a tiny slice of the pie. Finally, GE Capital opened up a non-traditional factoring division with the aim of becoming 'the new sheriff in town'. While none of these new entrants ever made a serious dent in the market (with both Heller and GE exiting), each wreaked a little havoc along the way and some continue to maintain a small share of the market. And like its leasing brethren, the non-traditional factoring business is now watching as brokers begin to dominate the distribution channels. Today, there is even a broker (or two) that does nothing but search UCC filings for firms that are already factoring and shop these firms to other factors with the promise of lower factoring costs (even if the factoring company is less suited to service the client). This certainly makes sense to the broker. It does not exactly bode well for the factors themselves or even some of the clients.

The reasons for the parallel between leasing and factoring derive from both the similarities in the businesses as well as the similarities of the times in which both industry segments matured. Leasing and non-traditional factoring started outside of the Banking world and commanded healthy risk adjusted returns initially, luring entrepreneurs in to develop the respective niche. Neither financial vehicle possesses a true 'barrier to entry'. Thus, anyone with a little money can become a factor, and those with more money (such as banks and large, diversified finance companies) can do so even easier. Finally, the number of potential customers is large and widespread, making it ripe for intermediaries.

As for the eras of maturity, leasing was reaching its peak when the banking industry was consolidating in the late 80's, early 90's due to the tough economic climate. Factoring is now in its later stages of maturity at a time when financial consolidation is once again rampant. What happens during these periods is that as more and more financial professionals find their careers derailed, they look to the financial products that are in vogue as a safe harbor; especially those with low barriers to entry and decent margins. The people with money enter the business directly, the ones without money become brokers.

OK. So there's more competition from other factors (which has been easy to see lately) and even more from similar, but not directly competing products (less obvious, but just as damaging). What am I supposed to do about it? Well, going about 'business as usual' is sure to result in 'no business' at some point real soon. It is times like these that separate the sheep from the goats. Non-traditional factors must take action, as waiting to react bears the risk of waiting until it's too late. Leasing saw its ranks dwindle by the hundreds shortly after the fall. Here's where factors need to focus to avoid becoming an unfortunate statistic.

Addressing the Threat

Deliver Client's Basic Expectations: Factoring is expensive under any pricing scheme. Prospects know this. That is why they delay the decision to actually apply for factoring until it is already too late. Speed to turnaround an application package into cash is their first, and most basic need. They choose non-traditional factoring because they have to, not because they want to. Even if your turnaround time isn't the fastest in the business, your prospect must at least believe that you're trying.

Maximize cash availability. We all say our service is the best. Our prospects care, they just simply don't care all that much. They need cash. They need the cash yesterday (see above). They need as much cash as they can possibly get their hands on. To many factors, this means 'let's raise the advance rate'. To others, it means 'let's give them availability on inventory or equipment'. However, both these scenarios raise risk. So let's take a step back for a moment. At its most basic, factoring is renowned as a tool that allows clients the opportunity to increase sales using credit terms. The traditional factors understand this. In fact, they live, eat, and breathe debtor credit. Of course, the competitive nature of their business thrust this awareness upon them years ago. However, the non-traditional factors see debtor credit as a necessary evil to the business, not as a competitive tool. Simply stated, if one wants to maximize cash flow for one's clients, one must be able to approve the maximum availability against the client's customer base. Done prudently, this meets the expectation without increasing risk.

Establish an Efficient Operation: Maturing industries become less profitable 100% of the time. Gross margins suffer as the greater supply of competitors drives down prices. Net margins suffer even more as the cost to operate increases due to the force of more competition fighting for a somewhat limited pool of resources (employees mostly). It takes an efficient operation to succeed when prices are dropping simultaneous to costs increasing. Every area of the business, from sales & marketing to accounting, must trim the fat. Leave no stone unturned. Allow no sacred cows. Any attempt to increase revenue is no sure thing. Cutting wasted expenditures is a guaranteed plus to the business. As always, be sure not to 'cut too deep'. The goal is an efficient operation, not a cheap one.

Carve out a Niche: Before the fall of leasing, most participants tried to be as many things to as many prospects as possible. This made sense when risk adjusted returns were healthy. Leasing companies knew that the more business they brought in, the more money they could make, regardless of how good they were at it. After the fall, the industry had been sliced into ever increasing niches. This allowed the surviving entities to focus their operations more succinctly, yielding efficiencies. This same focus allowed them to deliver more benefits to the specific market niche they targeted, resulting in some ability to charge more for these 'extra' benefits.

Today, the niches of transportation, staffing, and medical are well established. There are now tiers of price stratification where the factors within each tier compete evenly on price. The large, institutional non-traditional factors, such as Textron and Wells Fargo, target the larger, more established, price sensitive clients. Small, local factors trade speed and 'the personal touch' in service for the highest price possible. Finally, the regional factors go after the meat of the market with whatever combination of price and service they can sell.

The market will continue to slice itself into smaller pieces for some time to come. Already, there exists a company that just targets large, price sensitive trucking firms and one that targets only the smallest, least price sensitive truckers. Another firm appeals to the large, more established, price sensitive staffing firms. Each of these three has carved a niche within a niche within the factoring segment of the asset-based industry. And the slicing and dicing will continue until there comes a time when the next further slice no longer achieves efficiencies in the factor's operation or extra benefits that the client is willing to pay for. [abfj](#)

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