FACTORING, A TOOL FOR TRADE FINANCING

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SUMMARY

Farmers and traders of agricultural and food industry products on the domestic and external markets have recently became familiar with a new financial expression. Factoring, as a tool for commercial financing, provides attractive benefits to suppliers, and has now been integrated into state subsidy programs. Yet many people often mistakenly identify factoring with the purchase of overdue receivables, or simply use it to resolve sudden or one-off liquidity problems. But this activity really comes into its own in providing genuine benefits when it is used as a long-term technical solution for financing.

Factoring means the assignment of invoice receivables determined in a commercial agreement between a supplier and a customer under deferred payment conditions, for a set fee, to a third party – the factor. Factoring involves slightly more than simple assignments in that the factor providing the service continuously purchases invoice receivables from the supplier, undertakes to handle the recording, accounting and collection of the client's claims and does this with loan insurance if required: under certain conditions the factor also assumes the risk derived from non-payment. This is practically always the case for export factoring transactions, while for domestic factoring transactions the involvement of loan insurers is required. Larger companies are offered a special form of factoring, "finance factoring", in respect of which the financing aspect dominates while the task of customer records and collection remain at the given company. Looking at the international trend in countries that have a developed factoring culture, this form of invoice financing is offered with an integrated pre-financing opportunity.

Companies in various industries, including the agricultural sector, can use factoring as an extremely diverse financial service to turn their outstanding claims immediately into cash and thus finance continued growth in their turnover. This financial framework helps small and medium-sized enterprises to achieve the necessary degree of liquidity and it provides them with the opportunity of obtaining further price discounts from suppliers, not to mention the fact that the risk of non-payment by buyers can also be eliminated. What should also not be forgotten is that this sale of receivables helps to improve the balance sheet structure of companies to a significant extent.

FACTORING IN HUNGARY

Factoring in Hungary has in recent years become one of the forms for financing turnover. Its ever more frequent application coupled with the volume of factored transactions which has been rising steadily for years now forced Hungarian factoring companies to establish the Hungarian Factoring Association in

the middle of 2003, which currently numbers 17 members.

Volume of factoring transactions in Hungary:
1999: HUF 60 billion
2000: HUF 104 billion
2001: HUF 135 billion
2002: HUF 180 billion
2003: HUF 282 billion

The rising volume that is evident over the last five years can be attributed to several reasons: on the one hand, awareness of factoring has undoubtedly grown in recent years, yet at the same time this has not been sufficient to enable any larger market breakthrough so far. On the other hand, the banks have evidently not yet shown enough willingness to adopt factoring among their traditional financing products as an obvious, necessary, supplementary form of financing. The ratio of factored receivables in the European Union in terms of GDP is substantially higher than in Hungary; while the EU average is 2-3%, in Hungary this figure sits at well below 1%.

The leading factoring companies in Hungary offer their services to business entities using various marketing methods. The Hungarian Factoring Association has not been able to play a major role in this work because the Association was only formed a short time ago. In the coming years it must undoubtedly carry out more intensive work in relation to communicating information to improve the efficiency of this marketing work.

TARGET CLIENTS

Factoring is a financial product that favors small and medium-sized enterprises, but is a benefit especially for companies who have relatively large volumes of short-term receivables derived from goods deliveries and services. Factoring is therefore tailor-made for the majority of companies operating in the Hungarian agricultural sector. Essentially it is ideal for enterprises with a turnover of between HUF 0.5–10 billion, that is for medium-sized enterprises with the exception of perhaps construction and transportation companies. What is important is for the company to have a relatively large portfolio of claims, a wide client base and for payment deadlines to be between 30 and 120 days. If such conditions prevail then there is nothing standing in the way of factoring. The receivables are sold to the factor, who pays an advance amounting to 70-80% of the receivable, and then takes care of registration of the customer receivables, sends payment reminders, collects and settles up with the supplier. In addition to other benefits such as greater liquidity, credit rating and an improved balance sheet structure, this framework also enables the supplier to save on costs.

We must, however, guard against medium-sized companies looking on factoring as being a cure for all ills. It is merely an alternative way for a company to increase liquidity, which can constitute a particularly flexible solution in the field of liquidity management for financing the expanding turnover of a company. Consequently, it is a form of financing that is only suitable for creating a positive outlook in terms of corporate growth for healthy enterprises, with the insurance against non-payment of receivables providing client management with a special, new opportunity.

SEEKING GREATER LIQUIDITY

There are various factors that are encouraging Hungarian companies to search for other tools of improving liquidity besides traditional bank financing. In the case of agricultural companies this demand is becoming increasingly

prominent, as access to bank financing has always been more difficult for them owing to the particular risks inherent in the sector or perhaps the lack of sufficient security. Searching for solutions alternative to forfeiting and leasing is all the more urgent for them.

However, the evident rise in interest towards factoring should also urge caution. Companies must beware that many financial services are offered on the market under the name of factoring, products that do not comply with the conditions of factoring and are not identical to the service provided by the members of the Hungarian Factoring Association. Factoring is a product that requires an experienced financier who apart from possessing the qualities necessary for being active in the financing sector is also able to put himself in the shoes of the company. However, this means that before accepting a factoring transaction the factor must analyze the potential client and its customer under the strictest of conditions, in order to obtain a clear picture of the anticipated risks. The creditworthiness review of the supplier and its customer must be self-evident, being as it is in the interest of the client, since the result of the review constitutes the basis for setting the financing costs and the limits.

With factoring it is possible to sell outstanding claims that are otherwise included in the balance sheet as "idle capital", and therefore positively influence the liquidity situation of the company. This is not only a crucial benefit for the company selling the receivables, but also for the financing bank as well, since this tactic both improves the balance sheet structure of the company as well as its general economic situation, making it a "more attractive" target for other banking loan products too.

FACTORING AS A BANKING PRODUCT AND BASEL II

When searching for supplementary financing opportunities, medium-sized companies primarily turn to their own account-keeping bank. The crucial factor here is always how prepared the client manager of the given bank is, as it largely depends on him whether factoring is included in the range of corporate financing options on offer. In my experience, client managers are more willing and used to turning to old "tried and tested" general financing frameworks (e.g. current account overdraft, or the so-called multi-purpose credit lines), as opposed to looking thoroughly into the specific loan requirements of the given company and drawing up a tailor-made solution. Nevertheless, encouraging progress is being made in this field, with Hungary possibly being able to catch up in a couple of years time with some countries that are still well ahead, such as Poland or the Czech Republic.

Basel II will bring substantial changes to the market of corporate financing. This change will lead to the exploration of further financing resources, which will be based on traditional lending yet which will have to align themselves far more effectively to the structural demands of the companies. Alternative forms of financing combined with advisory services aimed at increasing credit ratings are already present as part of the "Integrated Corporate Finance" offered by some Hungarian banks, and on occasion the attention of banking clients is expressly drawn to the opportunities provided by factoring.

With the Basel Recommendations likely to be introduced in the perhaps not too distant future, improved credit ratings and balance sheet structures are of particular importance for banks. Selling receivables results in a better debt equity

ratio for companies and thus the conditions for a positive rating are achieved, without which it is not certain that the entire financing requirements of a company will be fulfilled. In the future the recommendations of the Basel Committee on banking supervision will strengthen the new trends, which prescribe, in relation to the Basel II provisions on equity, that risks must be taken into greater consideration in lending procedures. As experience shows that these risks are greater for small and medium-sized enterprises, the Basel II recommendations essentially result in more stringent lending criteria and consequently the emergence of other lending costs, which the banks will attempt to shift onto borrowers. It is important to note here that a potential loss from a factoring service should not hold a bank back. Indeed, it should be emphasized that factoring results in the creation of the conditions for an optimal client rating, which is in the interests of not only the client but also its bank, the bank that in the future wishes to co-operate with the client in the field of corporate lending.

FACTORING AND EQUITY RATIO

In terms of the balance sheet, factoring reduces the balance sheet total: the trade receivable portfolio falls in proportion to the advance on sales revenue (generally this totals 80% of the claims) and if the sales revenue paid in advance is used to reduce liabilities, for example to reduce trade payables, then further price discounts can even be achieved with suppliers. As the equity does not change in such a situation, the equity ratio rises, as it is now compared to a lower balance sheet total.

For example: a company has a balance sheet total of HUF 1 billion, equity of HUF 150 million, and thus an equity ratio of 15%. If receivables totaling HUF 500 million are sold, 80% of which is paid as an advance by the factor, then this HUF 400 million advance is used to reduce the level of liabilities (e.g. loan repayments, decreasing trade payables), resulting in a balance sheet total of HUF 600 million. With equity remaining at HUF 150 million the equity ratio in turn rises to 25%.

FACTORING AND STATE SUBSIDIES

Factoring has not gone unnoticed by the state, with the Ministry of Economic Affairs launching a tender in 2003 called the Chain Bridge Factoring Program under which interest subsidies of HUF 700 million were awarded principally to small and medium-sized enterprises that complied with the requirements. This sum rose to one billion forints in 2004, although applicants used barely half of the amount earmarked for last year up. This is worthy of note because the state budget finances five percent of the interest expense in the program, therefore in certain instances financing can be obtained at interest levels that even undercut the BUBOR.

The other state subsidy that applies to factoring is aimed expressly at companies in the agricultural sector. On behalf of the Government the Minister for Agriculture and Regional Development signed an agreement with agricultural interest groups and representatives of agricultural producers to improve the situation of farmers. Amongst various things this agreement included a consensus on subsidies worth a total of HUF 46 billion being announced as partial advances for the so-called national supplements to direct subsidies from the European Union. Entitled farmers based on the land they farm and the cow and ewe stocks that

they have as well as their milk quota can claim these subsidies. It is anticipated that around 250,000 farmers will participate in the program, with the smallest disbursed subsidy being HUF 8,000.

Farmers could submit their applications until 15 April 2004 to the county agriculture offices, which verify entitlement and the amount of subsidy. With this verification the entitled farmers can claim their subsidies from the Tax Authority from 10 December 2004. The payment deadline is 31 January 2005. However, the liquidity situation of agricultural producers may necessitate earlier access to these subsidies if required. The answer to this problem was advance payments through factoring.

For a set factoring fee, the factoring companies taking part in the system started to make advance payments on the entire subsidy amounts from 1 June. The actual payment of the budgetary subsidy in this case can be made until 31 January. Part of the costs related to the factoring will be reimbursed to the farmers by the state budget. If this solution is selected then the factoring company may claim the amount of the subsidy from the Tax Authority.

SUMMARY CONCLUSIONS

Besides greater liquidity and improving credit rating, cost cutting represents a crucial advantage for a company. It is simply cheaper separating the management of receivables and their collection by means of factoring, than employing a person specifically for these tasks. What is more, separating collection has the benefit that you do not need to "bargain" with a business partner in the morning on collection before discussing new business with the same partner in the afternoon: because the strict debt-collecting role is taken on by the factor.

Many still look at factoring as being a tool that a company resorts to in crisis situations, at a time when no other financing opportunities are available. Purchasing short-term receivables – factoring – has only been part of the range of financial services in Hungary for a few years. At the outset this was treated by companies with a certain degree of moderation, however, financial experts are today convinced that this restraint is becoming a thing of the past. Factoring as a form of financing and rationalization is not a new opportunity, it is just one that has not been sufficiently exploited. In comparison to before, the reality that factoring helps a company improve its credit rating is coming increasingly to the fore: the reduction in the balance sheet total improves the capital adequacy of the company. The credit rating and the internal rating set by credit institutions engaged in corporate finance is taking on an increasingly important role for companies and for this very reason the importance of the benefits derived from factoring is also rising. The prediction that factoring will continue to increase in significance in the future is without doubt a sound forecast.

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