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CAPITAL
Ambitions Unleashed

Understanding Factoring Solution

Part-2

Introduction

Factoring is a financial transaction in which a business (seller) sells its accounts receivables (invoices) to a factoring company (financial institution) in exchange for immediate funds to meet its working capital needs. The factor makes upfront payment to the seller after deducing the discounting fees.

There are different types of factoring arrangements available in the market depending on three basic criteria:

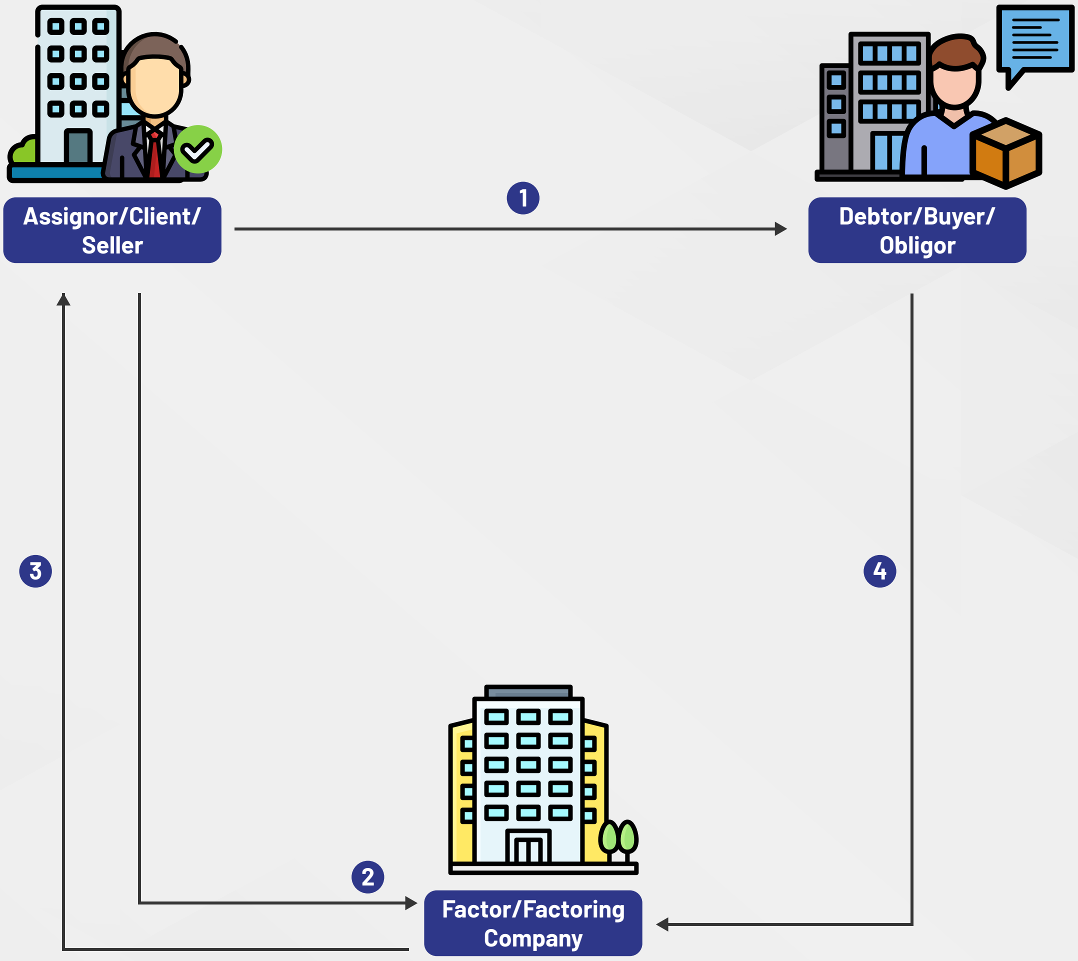
1. Geographic location
2. Risk exposure
3. Initiation of the transaction

Types of Factoring

Basis	Description	
Geography	**International Factoring** • Also known as export factoring or cross border factoring, this is suitable for businesses engaged in international trade. • Here, the businesses sell their receivables to an international factor. • In some cases, there might be an additional party, a domestic factor located in the seller's country who would collect the money from the debtor on due date and remit it to the international factor.	**Domestic Factoring** • In this type of factoring, all the parties involved – the seller, the factor and the debtor are from the same country. • This makes the process easier and faster as the legal, cultural, and financial practices among the trading parties more or less similar.

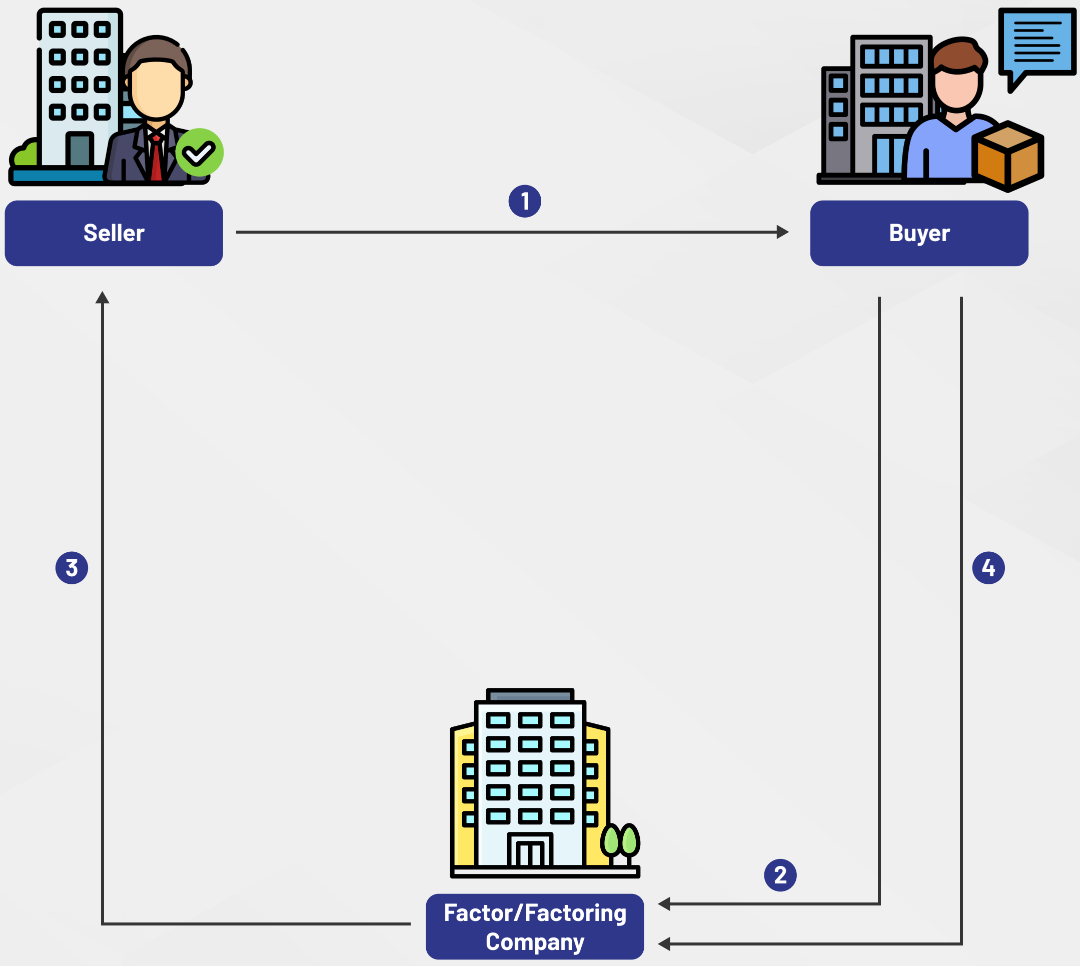
Basis	Description	
Risk	**Recourse Factoring** • In this type, the seller retains the risk of bad debts/non-payment. • If the debtor does not pay the dues at the end of the credit period, the seller has to buy back the receivables from the factor.	**Non-Recourse Factoring** • In this type, the factoring company assumes the risk of non-payment. • If the debtor defaults on the dues, the factor absorbs the losses.
Initiation of the transaction	**Traditional Factoring** • This type of factoring is led by the seller and allows businesses to sell their receivables at a discounted rate to the factor for immediate cash. • The factor gets the ownership of the receivables and will receive the payment from the debtor at the due date.	**Reverse Factoring** • The reverse factoring is also known as buyer factoring since it is initiated by the buyer and not the seller. • A buyer, usually a large creditworthy corporation, leverages its strong credit standing and establishes a relationship with the factoring company. • The factor makes upfront payment to the suppliers for the invoices raised by the buyer.

Traditional Factoring



1. The seller/client company sells goods/services to the buyer on credit and raises invoices.
2. In order to meet its short-term liquidity needs, the seller assigns its receivables to the factor and the ownership of receivables is transferred to the factor.
3. The factor makes the payment to the client at a discounted rate pre-determined in the agreement.
4. At the end of the credit period, the debtor will pay all the dues to the factor.

Reverse Factoring



1. The seller/client company sells goods/services to the buyer on credit and raises invoices.
2. The buyer, usually a large creditworthy corporation, leveraging its strong credit standing sells its payables to the factor.
3. The factor makes upfront payment to the suppliers for the invoices raised by the buyer.
4. At the end of the credit period, the buyer will pay all the dues to the factor.

A credit insurance as a safety measure that can be added to all types of factoring transaction. Recourse and non-recourse are the two main types of factoring, and the factoring based on geographic location and initiation can be either recourse or non-recourse factoring.

Benefits for a Seller

Efficient cashflow management: Factoring provides the seller with immediate access to funds, enabling businesses to meet its working capital needs and focus on core operations. Business can raise up to 90% of the invoice value depending on the agreement with the factoring company. This improves the liquidity position of the company.

Reduces risk: The seller can minimise their exposure to bad debts as the factoring company may undertake the risk of non-payment from the buyer.

Limited paperwork: Since funding is based on invoice, minimal documentation is required. This enables faster approvals and quicker access to funds.

Flexible financing: With factoring, business can raise funds as and when the company generates the invoices without the need for long term loan agreements.

No debt obligation: Factoring is not a loan, so businesses do not incur any debt. Furthermore, it is an off-balance sheet transaction and there is no impact on the company`s leverage ratio.

Collateral free financing: The factoring company assess the creditworthiness of the debtor and the not the seller's business. As it focuses solely on the receivables, no collateral or personal guarantee is required unless the ticket size is large.

Substitute for loans: Factoring can be used as an alternative or as an additional source of financing to bank borrowings as it is a cost-effective solution.

Conclusion

Factoring is an efficient source of financing for businesses seeking quick access to funds to meet their short-term obligation without the need for traditional debt. It is an alternative to conventional loans. With minimal documentation and collateral requirements, it is a convenient tool for mid-market enterprises to raise capital, especially those that face delays in receivables or have limited to no access to other sources of credit.