Factoring for food service companies—an alternative method by which food service business owners can get through a financing crisis

Like many sectors, food service vendors have been caught up in the recent severe lending credit environment. In large measure, the banks are not responsible as they are merely reacting to the warnings of government regulators. As has always been the case, banks must reasonably comply with both internal and external credit policies and regulations. However, many bankers now believe external policies have resulted in additional tightening. If they fail to stiffen credit standards, this may result in penalties and other consequences that bankers would like to avoid by maintaining a conservative loan portfolio.

An increasing number of food service firms have approached Prestige Capital and other lending sources, with one of these issues:

1) They have been rejected for a loan or credit line from a bank.

2) They lost their existing credit line, or

3) They have seen their credit line reduced with a variety of additional restrictions and covenants imposed.

It is certainly a factor that food service is an industry which has a long history, and some of the enterprises have generational family roots. It has been enhanced by technology which includes new ways of packing, shipping, refrigeration, and more.

In the best of times, food service businesses may pose their own set of unique lending challenges from a bank's perspective. For example, banks are instinctively suspect about those entities that provide a service rather than selling a product. Bankers may have difficulty with the nature of the entity's accounts receivable, oftentimes consisting of restaurants (which are usually considered to have a higher degree of risk as collateral). If inventory consists of perishable food items, generally this is not ideal collateral. Therefore, when combined with this current period of overall economic uncertainty, a bank's concerns may be amplified.

Many food service firms are small entrepreneurial businesses, or start-ups that do not have a consistent history of sales, accounts, payments and profitability. These firms may appear to be undercapitalized with weak leverage ratios and questionable equity sources. The nature of some food service companies may be the seasonal, perhaps temporary nature of the business, which is another element that banks may find unappealing. Also banks often frown upon account concentrations as the loss of that debtor may cause serious detriment to the business.

Weighing these various challenges, "factoring" of invoices may be an option to meet a food service company's needs. Factors are administratively equipped to finance food service firms because the credit risk is primarily based on the quality and strength of the invoices generated. Factors understand that a food service entity often has immediate cash needs, while they must wait, thirty, sixty or ninety days for debtor payments.

Some factors have a greater comfort level with dependency on a major customer so long as that customer is a good risk in respect to their ability to pay the factored invoice.

For example, let's say a food service vendor has an account that owes $300K. A factor may advance $225K to their client in cash upon assignment of the invoice. The cash flow and working capital provided by the factor can then be used by the food vendor to buy product for future orders, perhaps, even allowing the ability for a "purchase discount" because of the advantage of having cash.

When the debtor subsequently makes payment on the $300K invoice, the factor is made whole on the $225K advance. The factor returns the remaining $75K less a fee, to their client. Current industry rates are anywhere from about 2%-5% per month.

When a factor's client generates and assigns an invoice, the factor confirms the terms of the invoice, and verifies delivery of product or performance of service. The factor wants to ensure a "quality" invoice where it receives verification from the client's customer. Other items verified include: 1) payment terms that are not on extension and 2) customers that will not reduce invoices for slotting fees, rebates or discount programs.

The factor then advances cash to the client. The client notifies their customer that the payments are to be sent to the factor. Some factors allow the check to be written out in the client's name. The "clock" usually stops with respect to monies owed to the factor, when the customer's check is received in the factor's lock-box. The return of the "reserve" (gross invoice amount less funds advances, less fees owed to the factor), generally takes place within three-to-ten business days.

A factor requires their client to provide a simple credit application, along with proof of an acceptable minimum of verified invoices, in order to start the relationship (ie-the minimum requirement for Prestige Capital is $100K). The client may pay a due diligence fee (about $1500-$3000) to cover the cost of all credit investigations, legal documentations, and searches. When due diligence fees are not required by some factors, they are often considered in the overall pricing of the relationship.

With respect to food service providers, factors generally want canned, jarred, bottled, or packaged products. Fresh produce may be accepted provided that the factor also has the opportunity to handle the "hard" manufactured products. Both banks and factors have concerns over "PACA", a silent lien to the benefit of farmers and other agricultural sources, which follows the product through to the consumer.

Most established factoring firms are members of either the Commercial Finance Association or the International Factoring Association. Members of these prominent industry peer reviewed organizations have generally subscribed to ethical business practices and high-quality standards.

According to the Commercial Finance Association for 2010, factoring activity for 2010 was approximately $74.3B. The Northeast region alone accounted for 43% of this volume.

Article contributed by: Stuart Rosenthal, Executive Vice President of Prestige Capital Corporation, a 26-year-old national factor based in Fort Lee, New Jersey handling about $300M in annual deal flow. Learn more at www.prestigecapital.com.