

Research Report:
Invoice Discounting –
Factoring in the Change

issue no.

06

A research study on the evolving
factoring & invoice discounting
market in Northern Europe.

Key findings

- Respondents predict that by 2007, 86% of factoring companies will offer an invoice discounting / asset based lending solution.
- The survey revealed that 62% of companies currently using factoring services are predominantly motivated by the access to non-bank finance, rather than the need to outsource collections.
- When respondents were probed into why companies are increasingly opting for invoice discounting, the issue of client confidentiality was highlighted as being significantly important – (receiving an important rating 7.5 out of 10).
- Survey respondents held the view that there would be a significant increase in the number of factors and invoice discounters relying on reporting technology to access “invoice level payment performance” over the next two years - predicting a rise from 59% to 83%.
- There is a perceived gap in the market for real-time solutions that will enable efficient “exception management”, facilitating the early identification of potentially problematic transactions.
- 77% of providers of factoring and invoice discounting solutions indicated that their business would require significant technological investment between now and 2007, to allow companies to facilitate further business growth, while simultaneously manage risk.
- 23% of respondents are principally looking to technology to deliver economies of scale and increased profitability.
- To reduce refinancing costs, 20% of the factoring and invoice discounting providers surveyed intend to securitize a portion of their invoice portfolio over the next two years.

Introduction

Factoring and invoice discounting companies across Europe now turnover in the region of €612bn and the market continues to grow¹. Finance secured against invoice debt is increasingly popular in a business community that has been subject to a tightening credit squeeze. The availability of unsecured lines of credit, especially for firms with pressurised cash flow cycles and/or significant leverage, has simply dried up or become unaffordable. Availability of lower cost unsecured credit in the UK and France has tightened in the market over the last few years. Germany in particular has been subject to a slowdown, as artificially inexpensive borrowing through the state supported Landesbank has been with drawn countrywide.

Until recently, across Northern Europe, with the exception of the UK, full factoring (where the lender also assumes responsibility for collections) has remained the core non-bank cash flow finance product available. This is due to the concerns regarding establishing primary legal title to invoice debt in continental European civil code jurisdictions in the “arms-length” invoice discounting process. However these legal problems have now been overcome, and both factoring and invoice discounting are both strong receivables financing products throughout the region.

Whilst the take-up of both factoring and invoice discounting is growing, it is invoice discounting (where the borrower assumes responsibility for collections) that is experiencing the strongest growth. In the more mature UK market, full factoring makes up around 15%² of the overall market. The balance between full factoring and invoice discounting is reversed in other Northern European countries. Growth in the total market varies between the major Northern European economies¹. The UK is the largest marketplace (turnover in 2004 – €184.5bn) with a 14.7% growth rate.

France starts from a lower base (turnover in 2004 – €81.6bn) but is growing at an annual rate of around 11.5%. Germany, where the market is not as quite as developed as the UK or France, (turnover in 2004 was €45bn) is booming at a growth rate of 28.5% per year.

In times of rapid market growth, solution providers first to market with a compelling business case for their products have the potential to attract the lion’s share of emerging customers demand. Market players will seek business solutions that reduce the overall cost of business and promote superior risk management, such that previously untenably risky companies may be financed, broadening their overall potential customer base.

Research Results

In order to further comprehend the market trends in the factoring and invoice discounting industries in Northern Europe and in particular the growing popularity of invoice discounting, Demica commissioned research across key industry service providers.

The research, which was carried out in November 2005, looked at three specific areas. It explored the financier and customer motivations for invoice discounting over factoring. The report also looked at capabilities of existing marketplace technology as well as future development potential. Finally, the report examined the specialist area of securitization in order to calibrate the likely use of this refinancing technique and asset based lending over the next two years.

¹ Factors Chain International - 2004 Stats (FCI)

² The Factors and Discounters Association (FDA)

Growth Drivers for Invoice Discounting

According to this latest research, over the next two years approximately 86% of factoring companies will offer an invoice discounting option. For the remaining 14%, there is the potential to offer confidential factoring, (where the factor still assumes responsibility for collection under the client's company name).

The primary motivation behind the demand for factoring and invoice discounting were clearly evident in the survey results. Only 21% of customers were thought to be principally interested in an outsourced collections service, whereas 62% were motivated primarily by access to non-bank cash flow finance (17% were interested in both to an equal extent.)

Hence it is apparent that the collections element of full factoring is not the main driver for the adoption of invoice discounting. When queried why invoice discounting is growing at a much greater than full factoring, respondents cited the lower cost of invoice discounting (45%), the saturated and fiercely competitive full factoring market (37%), and the increasing desire for companies to keep control over their sales ledgers (28%).

Access to invoice discounting services has traditionally been limited to firms with a turnover in excess of €2 million per annum, however competitive pressures have forced financiers to significantly lower this threshold limit to €750,000. This subsequently requires more sophisticated technical and systems support to better manage risk when dealing with smaller, less established companies. At the other end of the spectrum, invoice discounting is also beginning to appeal to larger firms. In recent years, the average turnover of invoice discounting clients has risen considerably and is now between €8 and €10 million and approximately 90

invoice discounting clients have annual turnovers in excess of €130m, according to FDA (Factors and Discounters Association) quarterly figures.

The confidentiality element of invoice discounting is often cited as another key advantage for the client, however is this really the case? The answer from our research is a resounding "Yes". On a scale of 1 to 10, (where 1 = not important at all and 10 = of vital importance), respondents gave the confidentiality element of invoice discounting an importance ranking of 7.4.

So what exactly are the perceived obstacles to financiers in their mission to convert customers from factoring to invoice discounting? With 25% perceiving no obstacles to this customer conversion, the majority of respondent opinion (39%) focused on the view that there would remain a significant group of customers who were simply too risky (either in terms of credit status or collections processes) to be in receipt of an invoice discounting service. Other obstacles cited were merely temporary ones: 21% held the view that more sophisticated technology and reporting improvements would be required before offering invoice discounting. A further 15% felt that a staff skills gap would also have to be addressed.

Technology Requirements

This latest research investigated the current and future capabilities of business systems performance. Critical to any factoring and invoice discounting business, is the ability to understand how well invoice payment is performing, down to the level of each individual invoice (so that rapid remedial action can be taken where necessary). 32% of the industry is thought to have real-time information systems that offer a real-time view of debt collection. 55% have the facility to view this data on a daily updated basis, while only 13% report on payment performance on a weekly basis. However, these statistics do not offer a real insight into the extent of how well automated these viewing facilities are.

There is evidently an appetite in the industry to take on board increasingly sophisticated technology support to improve business effectiveness and efficiency. Respondents felt that 60% of the industry is currently using technology to report invoice level payment performance data, a proportion which is expected to rise to 83% over the next two years.

When asked what principal advantages technology investment would provide over the next two years, we received two main views. The majority of respondents (79%) cited the notion of superior risk management, in particular the ability to receive early, pro-active alerts in order to predict impending bad debt or spot potential fraud. This reflects concerns described by BCR Publishing in its regular reports on the industry:

“Cases of fraud are still on the up. There are a number of reasons for this; firstly more companies are using invoice discounting, a service more commonly used in fraud; secondly, increased competition means that factors may be responding to the race to sign up new customers by cutting back on due diligence and underwriting more marginal business, although there is little evidence to support this view.”

The remaining 21% of respondents indicated that they were seeking technology to deliver greater efficiency, lower cost of doing business and compressed payment cycles. In other words, the majority of respondents are seeking technology that will allow them to extend their ability to take on clients and conduct additional business with them, whereas the smaller (but no less important) proportion are focusing on improving profitability from their current market share. In all events, the technological capability required by the majority already exists in the capital markets, and is known as exception management. However, this is not sufficient for the growing number of invoice discounters that will require the facility to view transactions and obtain aggregated reports. Most transactions pass straight through the business process without a hitch. The problematic (or potentially problematic) transactions however, are those which demand speedy resolution as they could potentially end up costing significant sums. It is therefore apparent that the key technological capability the industry will demand is the ability to automatically identify and escalate the early signals of impending bad debt or fraudulent cases.

Securitization

This leads us to our final area of enquiry – namely the securitization of the invoice pool. In the last two to three years, a number of solutions have been developed to facilitate the pooling of invoice debt (from multiple companies over multiple geographies). These pools may then be transferred to a legally independent vehicle and subsequently issued to the capital markets as notes or bonds. As the credit rating of the debt is determined by the rating of the debtor (rather than the company that issued the invoices), this pool may be offered to the capital markets with an A rating which would attract a considerably lower financing cost over alternative refinancing methods.

The technology required to achieve a successful securitization facilitates the stringent data entry and reporting standards required by the market regulators. This technology underpins pro-active bad debt/fraud alerts and escalation features, which are likely to emerge as prerequisites in the factoring and invoice discounting industry over the next two years. Our survey did indicate the presence of a significant ‘early adopter’ community, interested in proceeding with a securitization transaction, with 20% of factors and invoice discounters expecting to securitise all or at least part of their invoice portfolio over the next two years.

Methodology

- Research Pool – Factors and invoice discounters in the UK, France and Germany (142 respondents)
- Representative sample size – 20% of industry players
- Receivables Financing Research Period – November 2005
- Method – Telephone interviews on asset based lending

Third party research sources included:

- Association Française des Sociétés Financières
- BCR Publishing
- Deutsche Factoring Verband
- Federal Statistics Office (Germany)
- Factors and Discounters Association
- Factors Chain International
- National Institute for Statistics and Economic Studies (France)
- Office of National Statistics (UK)

www.demica.com

Demica provide market leading expertise in trade receivables securitization and invoice discounting solutions. Advising the world's leading investment banks, private equity firms and global corporations, Demica enable clients to arrange and execute optimal financing structures based on real-time reporting of trade receivables portfolios. Combining expert consulting with market leading reporting solutions, Demica advise on the feasibility, structuring and implementation of trade receivables financing transactions.

Demica's technology platform Citadel® is deployed internationally, currently running in excess of €9 billion of rated transactions. Demica is a wholly owned subsidiary of the J.M. Huber Corporation, one of the largest privately held companies in the United States. Demica currently has offices located in Dublin, London, and Tokyo.

For further information visit www.demica.com



Demica Limited, Crowne House
56-58 Southwark Street,
London SE1 1UN, UK

T +44 (0) 20 7450 2500
F +44 (0) 20 7407 5825
E info@demica.com
www.demica.com

Demica (Ireland) Limited
4th Floor, 1 North Wall Quay, IFSC
Dublin 1, Ireland

T +353 (0) 1 670 2366
F +353 (0) 1 670 2377
E info@demica.com
www.demica.com

Demica, Level 18,
Yebisu Garden Place Tower,
4-20-3 Ebisu, Shibuya-ku, Tokyo 150-6018

T +81 (0) 3 5789 5390
F +81 (0) 3 5789 5757
E info@demica.com
www.demica.com