Export in Focus

‘Factoring & Forfaiting’

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Factoring & Forfaiting

While the business opportunities associated with international trade are many, financing such an initiative is a huge challenge. The report looks at how factoring and forfaiting can oil the wheels of export and help finance the additional investment necessary to make such an initiative a success.

Getting paid and the length of time that this takes is perhaps the most crucial factor when planning an export campaign, but it is not the only one. There is also the question of:— (a) researching new markets, (b) carrying out comprehensive credit checks on potential new customers, and (c) addressing the issues surrounding packaging and transportation of goods.

This all makes the prospect of dealing with foreign customers a lengthy process that is more fraught with potential pitfalls than domestic transactions. Yet export remains an attractive option for many KSA companies looking to grow their businesses, even though it represents a real headache for those managing their finance functions as they struggle to make sense of:— (i) foreign exchange implications, (ii) the need for export credit insurance, (iii) appropriate methods of payment, and (iv) most importantly, how to finance the entire initiative. The backing of a sympathetic, knowledgeable and experienced financial partner is essential and since traditional sources of finance, like the banks, are often reluctant to become involved in export initiatives, many exporting companies overseas have been turning to alternative suppliers such as factoring and forfaiting specialists for the financial support they need.

Financial Products

Hence, as the volume of overseas trade increases, so demand for financial products and services to facilitate these transactions grows. Two such financial products available are factoring and forfaiting— the main thing to determine is what is the differences between them and is one product better than the other at delivering the goods. Perhaps the clearest way of explaining what factoring and forfaiting are, and the differences between them, is to look at how each works in practice.
The Differences

The differences between factoring and forfeiting are clear. Factoring releases funds to the exporter after the goods are despatched to the importer and the factoring partner then collects payment once the invoice has been raised. Forfaiting releases funds to the exporter prior to the goods being released and then draws payment from the importer on the back of a letter of credit.

FACTORING

The main appeal of factoring is that funding levels are based on the future potential of a business rather than on past performance and because a factoring facility releases working capital back into the business, companies are more easily able to fund their export and other initiatives.

Thus, factoring is a mechanism that exporters use to reduce pressure on their cashflow and guarantee payment. It reduces many of the risks associated with the challenges of cross-border trading by releasing as much as 85% of the value of an invoice back to the exporter as soon as the invoice is issued.

At the same time, a good factoring partner will work with its export customer to allay many of the fears and potential hazards associated with trading overseas - i.e. foreign customs, legislation, unfamiliar trading conditions, currency fluctuations and exchange rates, language barriers and time zones, for instance. Further, they will take responsibility for their export customer's credit management function - which means payment of invoices is guaranteed - and the exporting company has the peace of mind of knowing that its export debts will be successfully collected by a global network of highly trained people who understand local customs and language and operate within the legal framework of the local jurisdiction.

This also means that businesses can leverage these worldwide resources to help them address some of the other issues associated with exporting, particularly sourcing credit information on potential clients and securing suitable credit insurance. It is add-on services like these that make factoring so appealing for so many businesses and the service providers will go out of their way to help for a number of reasons.
Firstly, it is a very competitive market and the ability to offer these value-added capabilities is important for competitive edge and secondly, because good factoring partners try to build a close working relationship with their export customers, they view the ability to deliver advice and support, on all aspects of exporting, as an integral part of the relationship.

Hence, not only can a good factoring partner take responsibility for its customer's credit management functions, but it can also help clients address some of the other issues associated with exporting, particularly sourcing credit information on potential clients and securing the essential credit insurance all exporters should have when trading overseas on "open account" terms. Further, it provides the exporter with the opportunity to develop a long-term relationship with a financial partner who is willing to support their export initiative and add value to the process through their experience in, and knowledge of, the relevant markets.

**FORFAITING**

Forfaiting works somewhat differently, although the end result is still the same in that it eliminates the risks associated with overseas trading and guarantees payment. However, the process differs considerably from that involved with factoring. Here, an exporter identifies a potential overseas customer. However, having carried out his research, the exporter decides that he is not prepared to ship the goods until he has received payment. He may view the commercial risks as too great, or the political climate in the customer's home country too volatile, or perhaps there might even be a possibility that there will be problems converting the local currency into the currency required by the exporter. For whatever reason, the exporter is not prepared to part with his goods until he has been paid for them in advance. Obviously, this could lead to a total breakdown in negotiations.

Alternatively here, the exporter could turn to a forfaiting partner to oil the wheels for him. This partner will purchase the goods on behalf of the importer and take on the responsibility of recovering the debt from him. He will expect to receive a substantial discount from the exporter in return for paying cash up front for the goods and this will be a matter of negotiation between them. While they negotiate on this aspect of the deal, the importer will approach his bank for a letter of credit
(or the equivalent) obliging him to pay the forfaiting partner in full at an agreed time in the future.

**THE CHOICE**

Both products guarantee that the exporter will get paid, though in each case there is a price to pay for eliminating the risk factor associated with potential non-payment. How much is a matter for negotiation between the exporter and his financial partner. It is true to say that factoring generally results in a longer-term relationship, with good factoring partners who are keen to add value to their export customer's businesses by providing add-on services in the shape of advice and research facilities made possible by their local expertise in overseas markets.

On the other hand, forfaiting may be quicker. The money is with the exporter before he parts with his goods, thus, eliminating the risk factor altogether. The exporter then has no further interest in the transaction and it is up to him to decide whether the size of the discount he has had to accept for this peace of mind is worthwhile.

It is, therefore, down to the exporting company to decide which financial option works best for it. The company needs to do the sums in the cost versus risk and return equation. This may come down to the value of the transaction and the nature of the goods being shipped. Forfaiting is often associated with high value goods where there is capital investment involved - e.g. plant and machinery - or transactions with buyers in developing countries. Factoring facilities are enormously flexible and can accommodate a wide range of circumstances and clients across the world. The key is to match the product to the situation, so the facts need to be matched with an exporting company's needs - more appropriately to the products at its disposal.