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# Receivables Finance as a Rising Asset Class

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Receivables finance, often referred to as factoring or invoice finance, has been utilised by businesses for centuries as a simple way to convert outstanding payments into immediate working capital, which is vital for the survival of any business. Simply, it involves businesses selling their unpaid invoices to a third party at a discounted rate. The primary advantage is that the business can use this cash advance to expand their business, rather than waiting on payments, which, in some cases, can extend up to 90 days.



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There are, predominantly, two primary types of receivables financing in operation, each with variations in their offerings as implemented by various funding providers.

**Invoice Factoring:** In this method, the company sells its entire debtor book to the funder, which includes handing over the responsibility for daily collections. The funder provides an upfront advance, typically a percentage of the debtor book, and holds a portion until the corresponding invoices are paid in full at a later date.

**Invoice Discounting:** In this model, the business retains control of the collections process and maintains direct contact with the debtors. The funder provides an advance against the company's outstanding invoices and typically takes charge of the book debts of the business.

This model has different variations, including selective invoice finance, which operates on a non-recourse basis. This implies that the funder purchases specific invoices or batches of invoices on a true-sale basis and typically secures those invoices with insurance from a reputable credit insurance provider.

**Receivables Finance as an Investment Opportunity**

This funding model has operated similarly for centuries until the recent rise of fintech platforms that have simplified and made the process more cost-effective, particularly for smaller SMEs. As a result, an increasing number of SMEs can now access this funding mechanism.

The main benefit for SMEs is the transfer of credit risk from their balance sheets to the debtors with whom they sell goods or services. Often, these debtors have more substantial credit ratings than the SMEs, positively impacting the SMEs' ability to secure a receivables finance facility.

As a result of shifting credit risk to well-rated businesses, there has been a growing interest from investors looking at receivables finance as an attractive investment opportunity. The following article summarises the reasons and methods funders can benefit from investing in this emerging asset class.

**1. Attractive Investor Returns**

This type of facility can result in higher yields for investors, especially when compared to traditional low-yield investment vehicles such as bonds or savings accounts. Additionally, these assets have a short-term duration (typically 30-90 days) and are self-liquidating, allowing investors to expect a quicker return on investment.

**2. Risk Management**

Receivables finance enables a funder to closely monitor the performance of the SME's debtor book and access supplementary information, including their payables ledger and monthly management accounts. This access allows the funder to develop a risk profile of the business, respond to any negative trends, and adjust the facility size accordingly.

Furthermore, most funders in this sector employ credit rating agencies to verify that the receivables they purchase are facing good quality debtors. Usually, this is backed by credit insurance on the purchased receivables, which serves as a risk enhancer, given that insurance providers are generally AA rated.

In addition to the factors mentioned above, the facility is backed by actual invoices from a company's clients, providing collateral in the event of a default. This feature makes the assets easily understandable for investors. For instance, if an SME sells beverages to a blue-chip debtor like Walmart, the funder can verify that the goods have been satisfactorily delivered to Walmart, effectively shifting the risk to the blue-chip debtor.

### 3. Diversification

Incorporating assets generated through a receivables finance facility provides investors with a unique asset class that can effectively diversify their investment portfolio and enhance the overall return profile. This diversification approach can help reduce the overall risk because this type of investment doesn't necessarily correlate with stock market fluctuations. Instead, it focuses on funding credit-insured receivables facing creditworthy debtors.

### 4. Technology-Driven Platforms

The increasing number of Fintech companies offering receivables finance through online platforms has fast-tracked the adoption of this product, making it highly accessible to SMEs worldwide. This accessibility also extends to investors, who can easily access an existing marketplace of receivables ready for funding. The detailed information available on these platforms ensures full transparency, as investors can access information about each invoice, including risk ratings and expected returns. The emergence of receivables finance platforms has also significantly enhanced the risk management practices in this field, with many providers now using extraction software to access live data for more effective monitoring of businesses.

### Potential Disadvantages

Like any investment opportunity, while the potential for returns is significant, investors must be aware of certain associated risks, such as the potential for default on invoices.

In the event of a debtor failing to pay an invoice, losses may occur if the facility or credit insurance policy has not been adequately managed. This is why conducting thorough due diligence on the funder’s operations is imperative, as is examining their track record in this field. This ensures they possess the expertise and back-office capabilities necessary to effectively manage an insurance policy, significantly reducing the risk.

Furthermore, the potential for disputed invoices can lead to a lack of liquidity. While invoices typically have short durations, disputes can result in prolonged collections processes that that tie up capital, potentially earning no return or even being at risk."

## Conclusion

The benefits of receivables finance to an SME are well-documented and serve as a crucial cash flow source for any business. It is particularly beneficial during high growth phases, as companies can access funding quickly to reinvest into new stock to secure more orders. From the funder's perspective, this emerging asset class is becoming highly attractive. It offers a combination of decent returns, diversification, and a manageable risk profile. Like any investment, due diligence is crucial, so choosing the right avenue to deploy funds is of greater importance. This involves understanding the nature of the invoices, accessing the quality of the debtors, and evaluating the processes employed by the financing entity or platform. With the right approach, receivables finance can be valuable to a well-rounded investment portfolio.

**Glacier Research would like to thank Colm Devine for his contribution to this week's *Funds on Friday*.**

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Colm Devine has almost 20 years of extensive experience in Receivables Finance and Asset based lending products having served as a senior executive in both mainstream banks such as AIB as well as alternative finance companies such as Close Commercial Finance, Aztec Exchange, and Accelerated Payments. Colm led the Sales team in Aztec Exchange as Senior VP and played an integral part in the company achieving Forbes Fintech 50 status. In addition, Colm was a co-founder of Accelerated Payments, a successful selective invoice finance company that has been recognised as an alternative finance leader in the industry. Colm has been appointed as CSO of Teybridge Capital (Europe) with the aim of expanding its successful trade finance business into the European market and offering a complete supply chain finance solution to the market.