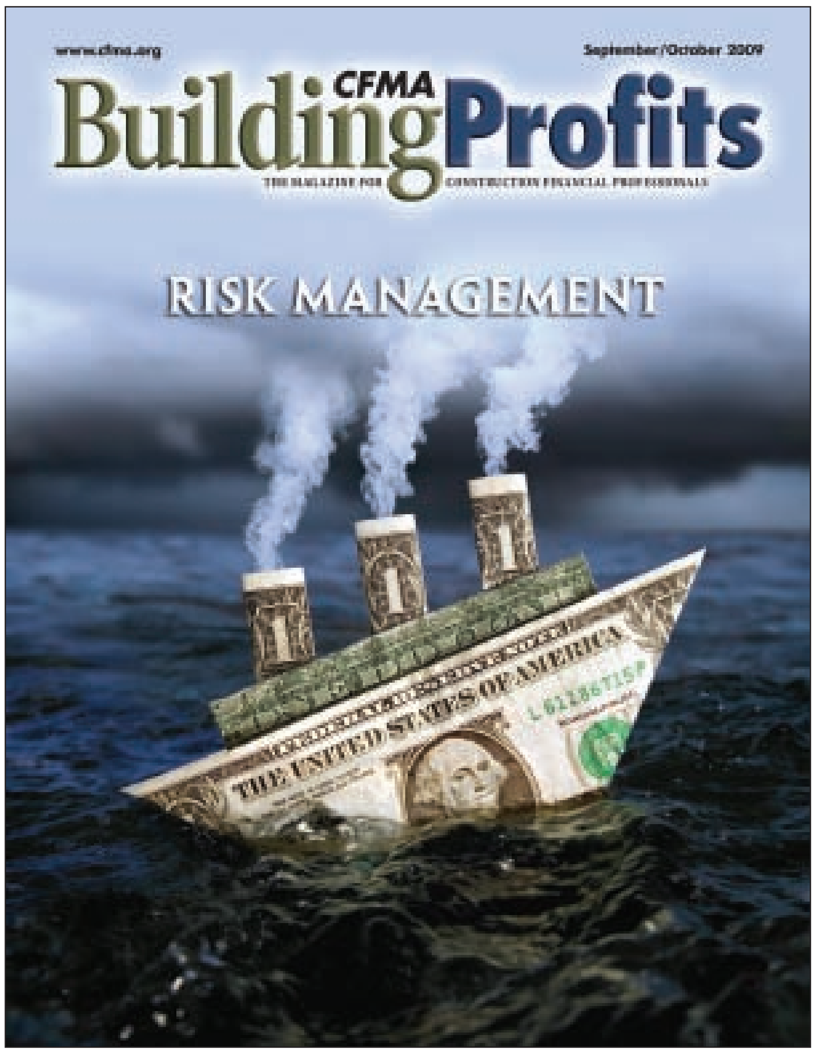
CFMA Building Profits
THE MAGAZINE FOR CONSTRUCTION FINANCIAL PROFESSIONALS

REPRINT



September-October 2009

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

The Source & Resource for Construction Financial Professionals

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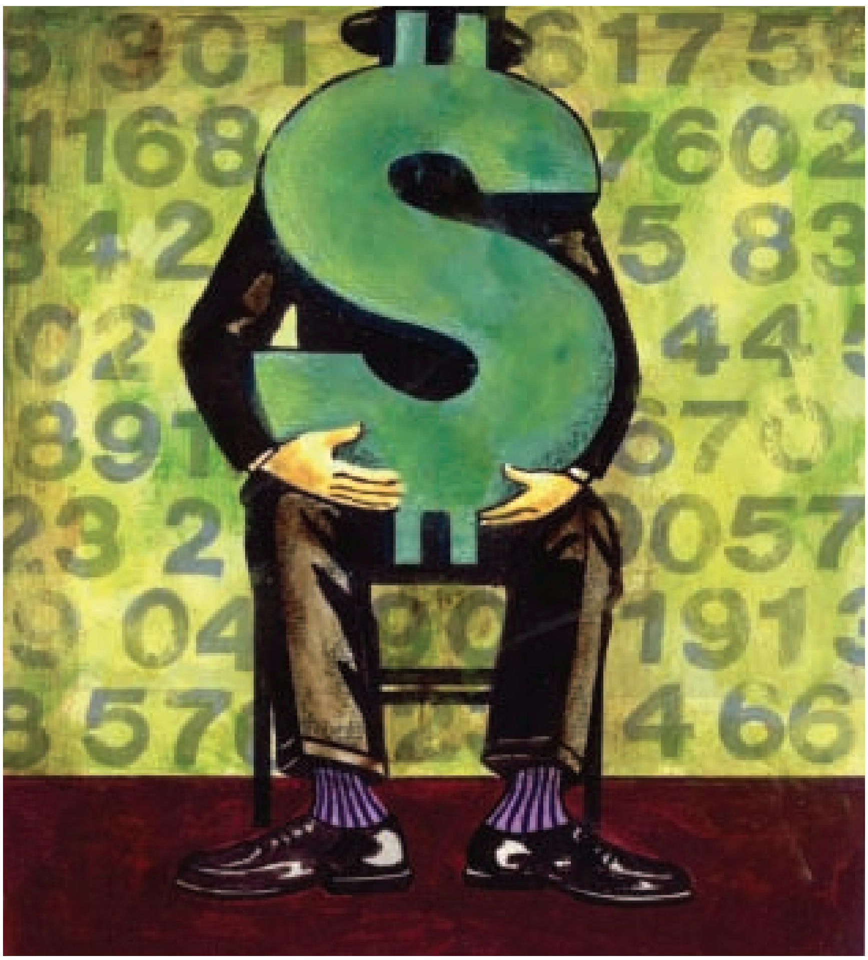
Factoring: A Source of Working Capital for Contractors



During this time of extraordinarily tight credit markets – particularly for construction contractors – the availability of working capital through factoring receivables provides a viable alternative to conventional financing.

It's important that all parties involved in financing working capital understand how factoring works.

This article provides basic information on the procedures and protocols a responsible factor uses for underwriting, cash disbursement, and risk management. In addition, it presents two examples of a GC and subcontractor's experience with factoring.

Underwriting Procedures

Like any credible lender, a factor first determines the creditworthiness of a prospective GC or subcontractor borrower. This is done through a comprehensive and thorough underwriting process similar to that followed by sureties.

Financial Checks

A factor reviews a potential borrower's corporate and personal financial statements, in addition to its tax records for the previous two years.

Credit checks are also performed to establish if the prospective borrower meets the minimum scores required to qualify for the program. A factor will want to know if:

- Credit scores are subpar or questionable.
- The borrower pays its bills and its keeps financial promises.
- There are payables and other current liabilities well in excess of receivables and current assets.

To gain a better understanding of how the borrowing contractor operates – and to determine if it may be in a downward spiral – a factor also conducts a judgment and litigation search.

Performance Checks

A factor also underwrites the borrowing contractor's ability to perform the work on the projects it wants to bid on. References are checked and performance reports for previous projects are reviewed in detail. Does the contractor have the experience to perform the work? Is there a history of consistent profits?

Similar to a surety, the factor must be satisfied that the borrowing contractor has the ability to successfully complete the work before agreeing to provide the working capital.

Subcontractors as Borrowers

If the borrower is a subcontractor, then the factor also underwrites the ultimate account debtor (in this case, the GC), particularly if the project is commercial. During these tough times, it's essential that both the factor and borrower determine that the account debtor has the funds in place to pay for the services rendered by the subcontractor for the entire project.

Disbursement Protocol

This protocol ensures that the funds advanced by the factor only pay for project-related expenses. In the past, account debtors (either GCs or owners) opposed conventional A/R factoring because advanced funds could be used to pay expenses that were not job-related. When this occurred, the account debtors wound up paying job expenses twice. Responsible factors now use highly disciplined project and fund control programs that prevent the misdirection of borrowed funds.

For example, as part of its disbursement protocol, the factor sets up a disbursement account in the borrower's name. At the direction of the borrower – and as advance funds become available and A/P is due – the factor disburses borrowed funds by check, ACH, or wire transfer in the borrower's name to pay project expenses. This can take place 30-45 days (or more) ahead of when the borrower would have been able to pay expenses if it had to wait for payment from the account debtor.

In addition, lien releases are required to be picked up as funds are disbursed and all required tax payments are made on schedule. And, advance funds required for job costs for change orders are only approved after they have been entered into the system.

Prior to Project Bid

Prior to bid and estimating, a prospective borrower must submit information on the project requiring financing for the factor's review and approval. If the project meets the factor's criteria and the contractor has the capacity to perform the work (as determined by the factor's underwriting process), then the factor encourages the contractor to bid on the project.

Bid & Estimate

Once the bid and estimate are prepared, the factor's construction project management division completes an initial review to determine the project's viability and the estimate's accuracy. The factor must also confirm that the borrower can complete the project based on the estimate's projected materials, labor, and time.

Factor Approval

If approved, the factor assures the borrowing contractor that the working capital will be provided as advances on project receivables. These advances are approved for payment by the account debtor and are within the borrowing contractor's approved line of credit.

Risk Transfer

Once the contract is awarded, the factor's construction management division works closely with the borrowing contractor to ensure that all contracts (with the GC or owner, as well as with subcontractors and suppliers) meet the criteria established by the factor for risk transfer.

Funds Control Program

Also at award time, all contract information is entered into the factor's construction accounting system and a funds control program is created to manage all project disbursements.

As pay applications are generated by the borrower, they are verified and approved for payment by the account debtor, and a signed copy is forwarded to the factor to generate collateral for an advance of funds. Concurrently, the borrower submits all invoices (including project payroll) to the factor's disbursement office to generate accounts payable.

When the factor's disbursement program functions as the "back office" of the borrower, the factor maintains the books and all records are electronically transmitted to the borrower, its CPA, etc., for uploading into their systems.

Payroll

It's important that a factor's disbursement protocol provide payroll services and that its funds control program ensures that advances only pay factored project-related expenses, including labor costs.

To protect its ability to receive full payment for purchased invoices, the factor must have an assurance that all payroll

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and labor burden (such as FICA, FUTA, workers' comp, union dues, etc.) are paid only for the project being financed. The factor's in-house payroll system is essential to ensure that these payments are made, and in a timely manner.

Risk Management

Once a factor accepts a project and work begins, its construction risk management team ensures that the borrower performs the work in accordance with the contract, schedule of values, estimate, and production schedule.

Under this process, all change orders are approved by the account debtor before any action is taken. Periodic site visits and inspections are performed, and pay application details are verified. If the borrower fails to meet the standards of the contract, then the factor's ability to be repaid by funds generated by the financed receivable is jeopardized – a serious encouragement for the factor to manage that risk to the fullest extent possible.

Real-World Examples

Let's take a look at two real-world examples of a GC and subcontractor who have recently benefited from using a factor.

General Contractor

This new GC has specialized in steel frame construction for two years and has a working capital line of credit of $3 million. Each project averages $6-8 million, with 2-3 projects per year.

The owner had an opportunity to substantially grow his business. However, his working capital was extremely limited and he lacked the back-office support necessary to properly and accurately administer projects.

The use of working capital financed through a factor, coupled with the factor's funds disbursement program, enabled this GC to negotiate "net thirty, 50% cash with order" discounts with several major suppliers – something he had previously been unable to do, since the owner never paid in full in less than 45 days after an approved pay application was submitted.

As a result, this GC got ahead of the curve on pricing, material cost escalation, and any interest on unpaid invoices. The project was completed lien-free, on time, and within budget. In addition, all change orders were properly executed and all subcontractors, suppliers, and employees were paid at the time work was performed.

This GC also used the factor's resources to underwrite subcontractors and required many of them to participate in its disbursement program, thus eliminating the need to issue joint checks to subcontractors with marginal financial management capacities.

Subcontractor

This plumbing subcontractor specializes in new school construction and renovation, with work in the $2-3 million range and projects averaging $600-800,000. Even though this subcontractor's work was excellent, he was severely challenged in the areas of financial administration and profitability.

A GC who wanted to continue working with this subcontractor on a new, large contract referred him to a factor, since the GC was not interested in buying the subcontractor's materials for him.

The factor's working capital financing program enabled this subcontractor to successfully complete the new project, and concurrently pay tax liens through a program negotiated with the IRS using the factor's funds disbursement program.

For the first time, the subcontractor maintained accurate financial records and was provided up-to-date job costing information on a weekly basis. This enabled him to monitor all costs more closely and achieve real profitability for the first time.

The efficiencies achieved, as well as the money saved in materials and reduced labor costs, more than paid for the cost of financing and back-office support.

Who Benefits from Construction Factors?

Owners

Project owners are assured that there are very tight controls on project funds management – after all, a financially vested third party is working to ensure that contract standards are achieved and maintained. In addition, an owner benefits from the assurance that its GC has been thoroughly underwritten and qualifies for financing (and, if the borrower is a subcontractor, the same applies to the GC).

General Contractors

If a subcontractor is the borrower, then the GC benefits from knowing that control mechanisms are in place for both job cost payments and contract performance. So, CFMs who work for GCs can rest easy knowing that their subcontractors are paying project expenses.

Subcontractors

Subcontractors are able to increase their amount of work by being fully capitalized based on their ability to perform. In addition, access to capital to pay job costs in less than 30 days allows them to negotiate for prompt-pay discounts with suppliers anxious to do business with contractors who can pay early.

Finally, since many subcontractors do not have adequate administrative support, they also benefit by having a third party perform all back-office financial administration functions as part of their disbursement protocol. This reduces overhead and further increases a subcontractor's capacity to take on additional projects.

Sureties

Sureties are typically averse to working with contractors who are required to finance their working capital, since the availability of working capital is often a prerequisite to qualify for bonding. However, if the factor provides all of the control mechanisms previously discussed, then the surety's payment and performance risks are dramatically reduced.

And, since a surety is the first to receive funds from a bonded construction project, the fact that all subcontractors and suppliers with lien rights are paid with advanced project proceeds (and that lien releases are collected as payments are made) further increases the benefits sureties derive when their construction clients participate in a factoring program.

Conclusion

Contractors interested in factoring as a source of working capital must be satisfied that the entire process (including the factor's financial and program resources) will work for them. And, both the borrower and the account debtor must sign off on all arrangements before factoring can take place (including the service costs).

So, if your company needs additional working capital and its usual sources of funding have disappeared, the prudent CFM will look for a factor that provides: 1) thorough underwriting procedures, 2) a disbursement protocol that ensures contract advances only pay project-related expenses, and 3) a detailed construction risk management program that provides additional value to a company's construction program. BP

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Earl is Co-President and board member of CFMA's Central Texas Chapter. He is also a member of the AGC, ABC, the Hispanic Contractors Association of San Antonio, and the Central Texas Surety Association.

Earl earned a BS in Political Science from Iowa Wesleyan College, Mt. Pleasant, IA, and is a graduate of the U.S. Army War College, Carlisle, PA.

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