Freight Factoring:

Pros and Cons for Trucking Companies

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Introduction

This paper focuses on the trucking industry against the backdrop of the freight factoring option. We will begin with a brief overview of the US trucking industry, followed by an analysis of the key issue facing the trucking industry and then an overview of freight factoring and how freight factoring companies operate. Finally, we will look at the pros and cons of freight factoring for trucking companies.

The Trucking Industry

Growth
Economic growth and development is directly linked to commercial transportation. The trucking industry forms the backbone of freight transportation. So, one can not overstate the importance of trucking companies to any economy.

The trucking industry has been expanding rapidly. According to the American Trucking Association's American Trucking Trends report for 2007-2008, the trucking industry hauled 69 percent of the total volume of freight transported in the US in 2006. With this, carrying load reached a record high of 10.7 billion tons. In terms of revenue, this equated to $645.6 billion, or almost 84% of the country's freight bill (ATA from http://www.truckline.com/NR/exeres/CAF1D1A6-EC72-40C7-BAD4-50DE99FD841D.htm).

Characteristics
The two main characteristics of the trucking industry are:
Low barriers to entry
Few efficient substitutes

These two characteristics have resulted in the trucking industry being highly fragmented and having still competition. The industry includes about 40,000 companies and 30,000 independent contractors (*First Research from http://www.marketresearch.com/browse.asp?categoryid=913&g=1).* The industry has big companies, such as YRC Worldwide, Schneider National, Con-way and JB Hunt.

The industry benefits only marginally from technological advances and has high exposure to fuel prices.

Latest trend
Fuel prices have skyrocketed over the past five years. In September 2003, crude prices were under $25 per barrel. The following year saw prices rise to $50 per barrel and then to $60 per barrel in 2005. Crude prices jumped the most last year to over $90 per barrel and have now surged past $120 per barrel.

The rise in diesel costs has severely impacted trucking companies, especially hurting the smaller players. While costs have risen, trucking companies are unable to pass on these costs to customers due to stiff competition in the industry. In fact, it may be said that the trucking industry is characterized by hyper-competition. According to Richard A. D'Aveni, Professor of Strategic Management at the Tuck School of Business at Dartmouth College, under hyper-competition firms could become more and more efficient, but not increasingly profitable.

Due to hyper-competition and surging diesel prices, companies are struggling with liquidity issues. In the first quarter of 2008, 935 trucking companies with at least five trucks filed for bankruptcy, according to transportation analyst Donald Broughton of Avondale Partners. The total number of failed trucking companies was much larger since the report did not take into account those trucking companies that operate less than five trucks. The nation has about 3.4 million truck drivers and approximately 9 percent of them are independent owner-operators, according to the US Department of Labor.

Trucking companies, like any other company, could determine the value of a service by applying the Impact/Value framework, presented by Michael Hammer and Glenn Mangurian. (Hammer, Michael and Mangurian, Glenn from The changing value of communications technology).

Trucking Industry: The Key Issue

The key issue facing trucking companies is a liquidity crunch.

Credit periods
All trucking companies have to offer their clients a credit period. Under normal circumstances, a client will make a payment against a trucking company's invoice in a period that varies from 30 days to 60 days or in some cases even 90 days. Sometimes, payments may be held up for extended periods.

Operating during the credit periods
All trucking companies have cash flow problems. Running a transportation company can be a lucrative business only if one knows how to make cash flows consistent even while payments from clients usually have a waiting period of 30 to 60 days.

Transportation companies, especially trucking businesses, often find it difficult to keep the business running profitably. Expenses, such as employee pays, fuel costs, loan/lease installments, repairs and other day-to-day expenditures, have to be dealt with in a timely fashion. For this, ongoing liquidity is a major need.

While calculating the rates to be charged in order to break even, many small fleet owners ignore the overhead and fixed expenses incurred to keep their fleet of trucks running. Again, office staff salaries, rent, utilities, general insurance, depreciation on equipment and bad debt expenses also need to be taken care of. These are ongoing expenses that persist through periods when the trucking company is waiting for payments to come in.

Creditworthiness of customers
A large number of trucking companies go bust every year. The reason poor credit quality and a high level of bad debts. Also, small truckers lack the business background essential to ensure that their business runs profitably. Although it is easy for small truckers to get new clients, it is difficult for them to check the creditworthiness of these accounts due to the limited infrastructure available.

Liquidity
For all the factors noted above, liquidity is one of the prime concerns of any transportation company. A company can determine whether it is facing a liquidity crunch by calculating the current ratio, or the working capital ratio. Broadly speaking, a current ratio of 1.5 is acceptable.

The Business Scorecard method publicized by Robert S. Kaplan and David P. Norton emphasizes a strategic approach that enables an organization to transform its vision and goals into implementation. In order to achieve this, the BSC method works from four perspectives, including the financial perspective. (Kaplan, Robert and Norton, Davi from The BSC: Translating Strategy into Action).

Factoring

What is Factoring?

Factoring services involve the purchase of accounts receivables of a business at a discount.

How does Factoring Differ from a Bank Loan?

Factoring services differ from a bank loan since the emphasis here is on the value of the receivables. The transaction involves three parties the seller, the buyer and the factor. A loan adversely impacts the company's debt to equity ratio. Creditors and investors are particularly sensitive about this ratio and avoid companies with excessively high debt to equity ratios.

Evolution of Factoring

Although factoring services have been in existence for many centuries now, the concept has evolved over time and gained significant popularity in the last couple of decades. In the initial days, the factoring services provider used to take physical possession of the goods invoice and only then provide cash advances to the seller. However, the concept of funding the credit provided to the buyer and insuring the credit strength of the buyer has been the basic premise of factoring services from the very beginning. Although factoring services find their origins in England, they have now emerged as a strong medium of meeting the working capital needs of industries in the US and Canada as well.

Services offered by Factoring Companies

The basic service offered by factoring companies is that of providing cash. Factoring companies purchase accounts receivables of a business. The business can use these proceeds to carry on with its operations.

A large number of freight factoring companies are operational and most of them have a comprehensive data base of various brokers and customers and their credit ratings. Access to such a data base offers a business the benefit of choosing the best clients those who honor their bills on time and are really credit worthy, while avoiding slow paying clients. Some factoring companies also provide direct deposit cash advances into a variety of fuel card accounts, such as Comcheck, EFS, Comdata, TCH and T-Check.

Freight factoring companies use a database that provides a daily list of billing follow-up calls to be made. These calls provide early identification of documentation, delivery or damage problems. They also identify receivables that may be hard to collect on, while helping a trucking company's carriers avoid any additional potential problems. The services eliminate the need for and costs of permanent skilled staff found within large firms.

Freight Factoring for Trucking Companies

Trucking companies can follow Robert Kaplan's Time-Driven Activity Based Costing (ABC) as an alternative to the traditional method of accounting in order to boost its performance. (Kaplan, Robert from Time-Driven Activity-Based Costing, Harvard Business Review).

How Freight Factoring Companies Operate

There are several steps involved in freight factoring. First of all, the trucking company needs to submit the freight bill that it wants to be funded to the factoring company. This is the case when the trucking company does the invoicing on its own. In some cases when invoicing is also done by the factoring company, the trucking company only needs to inform the factor about the deal with a client. The trucking company can get an advance of 80%-97% of the invoice or the bill of loading, depending on the credit tenure and the creditworthiness of the client. The remaining amount is kept as a reserve by the factoring company and paid after the invoice is cleared by the trucking company's client. The reserve is a provision to cover short payments, payment of less than the full amount of the invoice by the debtor, or a payment received later than expected. The factoring company also deducts its monthly charges from the reserve kept by it. These charges are decided on the basis of the credit rating of the trucking company's client, the number of days of credit involved and the total volume of business given by the trucking company to the freight factoring company.

A freight factoring company generally provides its factoring services on a contractual basis. Before signing a contract, the freight factorer seeks detailed information about a trucking company, its owners, financial details, customers list and some documents that can verify this information. A factoring company generally tries to determine the creditworthiness of the trucking company's customers, independent of their credit history with the trucking company's business.

Pros of Factoring Services

1. Improves working capital: Freight factoring companies aim to resolve the working capital needs of trucking companies by converting their slow paying truck bills to immediate cash, thus eliminating the waiting period. Factoring services provide cash to trucking companies when they need it the most. This allows the trucking company to continue its operations, without facing a liquidity crunch.

2. Keeps the debt to equity ratio in check: If a company used loans to overcome liquidity problems, it debt to equity ratio would rise. This is not a good sign for creditors and investors.

3. Pay bills on time: Factoring services a trucking company to pay its bills on time and avoid any interest from accruing.

4. Focus on growth: The trucking company can use the money provided by freight factoring companies to invest in expansion and growth.

5. Prevents hassles of extracting payments from clients: Retrieving money from clients can be a rather tedious task. Freight factoring companies take the responsibility of collecting the necessary payment from clients, while providing the trucking company a significant portion of the billed amount.

6. Invoicing: Some freight factoring companies also perform invoicing on behalf of their clients.

7. Reduces credit failures: Freight factoring companies provide access to its database for creditors and their rankings, thus reducing credit failures.

8. Cost savings: Factoring services reduces the need for a trucking company to appoint full time staff to ensure clients with high credit ratings, speedy invoicing, timely follow-ups sending and extracting payments from clients.

9. Risk reduction: Some freight factoring companies assume a part of the risk arising from the failure to pay by the trucking company's customer.

Cons of Factoring Services

1. Recourse: Everything runs smoothly till the time that a trucking company's clients pay their bills on time. What happens when a client delays the payment beyond the normal 30-60 day cycle or refuses to pay up at all? In such cases, the factoring company can withhold the trucking company's reserve and charge back the full amount. This is known as recourse. So it is important that you choose a customer that has a good credit record.
2. Misuse: Factoring can be misused by some companies to "dress up" their balance sheets by showing cash instead of accounts receivable at the end of their financial year.
3. Over 90-day invoices: What happens when a trucking company's invoices are for over 90 days? There is a problem here because most factoring companies do not purchase invoices or account receivables that have a timeframe of more than 90 days. Most factoring companies borrow funds from banks at a much lower rate and then lend this money to trucking companies at higher rates. They earn a good fee if the credit period is less, while their margins come under pressure with an increase in the credit period.
4. Higher costs: Factoring services are costlier than bank funding. Hence, businesses with a small spread between revenues from a sale and the cost of conducting that sale should not resort to this funding option. Small spread outfits need to make sure that the charges being made by a freight factoring company are not higher than the benefits derived from the quick receipt of funds.

The Profit Pools method of Orit Gadiesh, James L. Gilbert can be used to focus on profits. This method helps companies create strategies for profitable growth. (Gadiesh, Orit and Gilbert, James from Pools: A Fresh Look at Strategy, Harvard Business Review).

Choosing a Good Factoring Services Company

Freight factoring has become fairly popular and a large number of players are operational in this segment. A trucking company can either search for a factoring services company through the internet or contact a factoring services broker who will help it get in touch with an appropriate freight factoring company after accessing its business needs. But what criteria should a trucking company should keep in mind while choosing an appropriate freight factoring services provider?

First of all, cost should not be the only criterion. A freight factoring company's track record and the type of services offered by it are important. This can be checked by getting in touch with some of the freight factoring company's existing clients or discussing the issue with the freight factoring company itself.

A factoring company that provides related services, such as invoicing, is certainly better than a company that provides only advance payment facilities. Again, the provision of online services is an added advantage.

Before making the final decision, it is important to check whether a freight factoring company is providing the following list of services:

Immediate cash
Quick processing
No set up fees
Collection services
Credit management services
Credit information services
Easy contract terms
Online services
Credit research services

Once a few freight factoring companies have been short-listed, a trucking company can start negotiations with them; check the terms and conditions of the contract offered by them. A trucking company should check whether the fee charged by them will remain the same over the contract tenure despite the number of invoices or business or will it vary in proportion to the number of invoices. It is important to try to enter into a contract that calls for a change in the fee rates according the trucking company's business cycles.

Some freight factoring companies even provide their services to trucking companies with financial problems, such as tax liens and bankruptcies. But one needs to be aware that they are going to charge very high fees.

A wide range of freight factoring services is provided by the Phoenix Capital Group. This reputable company offers equipment financing with high advances, low fees, same day funding but without any long-term contracts. Phoenix Capital Group has a track record that engenders confidence in its services. You can visit the website of this company for further details at http://www.phoenixcapitalgroup.com.

Trucking companies should conduct a cost-benefit analysis (CBA) prior to such decision making. (Boardman, Anthony from Cost-Benefit Analysis: Concepts and Practice).

References

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Freight Bill Factoring. Retrieved June 13, 2008, from http://people.umass.edu/ifranzen/freight-bill-factoring.html

Conclusion

Most trucking companies in the USA are small. They do not have huge cash reserves and find themselves in a tight spot if customer delay payments or getting payments released needs several follow-ups. These trucking companies do not have the resources or time required to extract outstanding payments. The rewards of using freight factoring services seem to far exceed the costs. Freight factoring has the potential to play an important role in the trucking company's wellbeing and growth.