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Sizing the Invoice Finance Market

Management Summary

- The aggregated European invoice finance market was worth over €1 trillion in 2011.
- This market is mainly composed of factoring and invoice discounting, supply chain finance and trade receivables securitisation.
- In addition, the invoice finance market embraces a variety of other specialist activities such as forfaiting and asset based lending, as well as more recent variations on the invoice finance theme, including distributor finance and the funding of selected obligor receivables within a supplier's portfolio.
- The invoice finance market is economically significant. It represents some 8% of EU 27 GDP, more than 8% of EU 27 total bank lending to business and is five times the size of the European leasing market.
- The market has grown steadily since 2009, at a compound annual growth rate of over 10%.
- This is believed to be the first time that the total market for finance based on outstanding invoice debt has been aggregated in this way.
- While a wide variety of relevant sources have been aggregated to 'size' the European invoice finance market, a proportion of invoice-based transactions will always remain hidden from external analysis. The figures published in this report should therefore be taken as a conservative estimate of the market's size.
- European banks and commentators expect the growth trend for invoice finance to continue, as banking organisations look for ways of providing funding to customers that do not increase the need to set aside additional reserve capital.
- International and national regulators are increasing banks' capital adequacy requirements, predicated on the institution's portfolio risk profile.
- Invoice finance offers low or unrated organisations the possibility of affordable funding as the credit conditions are based on the risk of the outstanding pool of debt, rather than the organisation to which the debt is owed.

Introduction: the Rise of Invoice Finance

Interest is steadily growing in financing products outside of traditional bank credit, not least from banks seeking to provide their clients with funding that does not require them to set aside the increasingly punishing levels of reserve capital demanded by local regulators and looming internationally in the form of Basel III. From the corporate perspective, lending volumes in Europe have fallen as banks look to clean up their balance sheets in the quest for more effective capital adequacy management[1]. In a world of suppressed liquidity, companies have been eating into their own cash reserves[2], but this cannot go on for ever and alternative lines of finance are required to fund economic recovery. This is especially the case with highly leveraged firms facing refinancing renewals, who are finding that spreads have widened so considerably that affordable finance is simply not available through traditional products and channels[3]. One UK commentator has identified a £191 billion 'credit hole' in business lending in their country[4]. Similarly, in the same country, a recent government-commissioned report into non-bank lending has highlighted the growing need for more diverse sources of finance[5].

Since the financial markets crisis of 2008, attention has been turning to a number of alternative approaches, including various forms of finance based on trade receivables[6]. According to one Dutch commercial bank, "Banks' risk departments are keener to get loans collateralised. This of course is good news for receivables finance as risk departments see this as an excellent risk mitigator. And this push towards receivables finance is supported by pressure from outside the banks. For example, in Holland the finance ministry and others who see themselves as stakeholders in the success of SMEs are taking a keen interest in receivables finance whilst CEOs of businesses in structured finance and leveraged deals are looking to see an asset based lending product to be included as part of the deal."

How, then, to quantify the level to which corporates are taking up invoice-based financing? The various forms of invoice finance have, up to now, tended to be viewed and analysed in isolation from one another. The result is that their collective significance tends to be under-estimated by financiers, and their collective advantages under-recognised by corporates in search of imaginative financing solutions.

This research report collates data on all the different forms of invoice-based finance in order to understand the size and growing significance of this segment of the commercial finance world. The report has also interviewed a selection of leading banks from around Europe about their views on this developing marketplace and selected comments from these interviewees are included within the report's text.

It should be noted that, even though a wide variety of public and private sources have been consulted and analysed, the nature of some forms of invoice-based transaction means that they are unlikely ever to be subject to outside scrutiny. As such, readers of this report should view its market size figures as a conservative calculation of the size of the invoice-finance market. However, it is noteworthy even this conservative sizing of the market reveals it to have major economic significance,

First, it is necessary to describe the component parts of the invoice finance market. The main components are 1) factoring and invoice discounting; 2) supply chain finance and 3) trade receivables securitisation.

Factors advance a proportion of the value of monthly outstanding invoices in return for a discount on the collections. Invoice discounters do the same, but leave the responsibility for collections to the client, so that end-customers are not aware that this financing method is being used. Supply chain financing schemes use the collateral of outstanding debt from a large buyer organisation to offer cash flow advances to suppliers in that company's supply chain. Corporates can issue their accounts receivable to the market as a securitised instrument (asset backed commercial paper), usually through a bank 'conduit' where the bank provides liquidity support.

These various parts of the invoice finance market may sometimes overlap. For instance, an invoice discounter might refinance by securitising the pool of invoice debt they are currently financing. In another example, supply chain finance schemes that are using invoices as collateral might be regarded as a form of factoring and are in fact sometimes referred to as 'reverse factoring'.

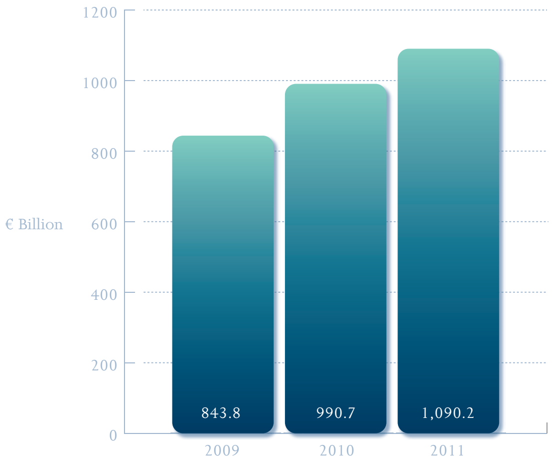
[1] *See Bank of England and European Central Bank quarterly reports in Credit conditions and Trends in lending.*
[2] *The Economist, Markets for minnows, 15 August 2010.*
[3] *See, for instance: Print Week, Press giant Man Roland files for insolvency, 25 November 2011; BBC News, Clothing retailer Peacocks enters administration, 18 January 2012.*
[4] *The Daily Telegraph, Alternatives to banks needed to close £191bn credit hole, 16 March 2012.*
[5] *Industry-led Working Group on Alternative Debt Markets, Boosting finance options for business, March 2012.*
[6] *See, for instance, GE Capital Europe, The AR factor, October 2011.*

Sizing the Invoice Finance Market

This report has collated data on these various segments of the European invoice finance market into a consistent single yearly figure for the period 2009-2011. 'Europe' is strictly defined as the EU 27 and therefore excludes markets, such as Turkey and Russia, that are often swept into statistics issued by financing associations representing the various niche elements of the invoice finance market. As such, it is therefore important to look at the invoice finance market as a whole, not only to understand its composite significance in relation to the European economy as a whole, but also to avoid any double counting or geographical 'stretch' that may *artificially* inflate its significance.

Total European Invoice Finance Market 2009 - 2011

Figure 1



Take a glance at the totals in *figure 1* and the economic significance of the total invoice finance market becomes much clearer. While European bank lending overall has been declining[7], invoice finance has been growing significantly. In 2011 the volume of finance delivered to clients by the invoice finance sector is seen to be over €1 trillion.

To put this in perspective, the 2011 invoice finance market represented some 8.1% of the EU 27 total GDP (measured at Official Exchange Rate, but 9.1% if measured in terms of Purchasing Power Parity)[8]. Invoice finance also represents around 8.4% of corporate bank lending in the EU 27[9]. And in one further illustrative comparison, this study shows the European invoice finance market to be approximately five times the size of the European leasing market in 2011[10].

A major Scandinavian bank has summarised the importance of the invoice finance market thus: "Invoice finance is a growing market. The reasons for the growth are: banks are not performing that well in some European countries; regulations demand higher capital requirements; and in the absence of standard credit products, corporates have to look at all financing channels. Receivables purchase has no capital requirement for the bank, and corporates cannot put up other collateral every time they want a line of credit. Therefore using invoice assets is much easier and it is attractive for the bank (less risky for them to offer invoice finance). The result is more efficient working capital management for companies."

This view is echoed by another British respondent. "The type of secured financing we provide is an attractive use of capital for banks, given the Basel III changes ahead of us. This is reinforced by the internal push towards efficient capital funding which can be realised by invoice financing. Companies used to focus on earnings, now they are looking at the optimisation of liquidity and trade receivables securitisation and invoice discounting are very sensible way to maximise working capital. Bankers and investors now give credit to this, which they might not necessarily have done prior to the crisis in 2007."

Another commentator, this time from a French bank, adds: "After the financial crisis, invoice finance has become more popular – in fact, we believe the rate of growth is now even faster than it was prior to the financial markets crisis. We also believe that the trend will continue (because banks will not be in a position – owing to various factors, not least tightening regulation – to return to the narrow spreads which enabled such easy lending). The trend is global, but more obvious in Europe because of the financial markets crisis."

Our Scandinavian commentator also points to the fact that banks are building up delivery networks for invoice finance products: "We started co-operating with banks in South Africa, Asia, and North America five years ago. So we have partnership banks everywhere to service our clients. Most banks cannot do everything themselves as their presence tends to be limited to certain regions only, so they are setting up partnership banks. We're aware that other Nordic banks are also exploring such partnerships."

[7] *See, for Instance, European Central Bank, Euro area bank lending survey (all recent editions).*
[8] *CIA World Factbook.*
[9] *European Banking Federation, EU banking sector – facts and figures.*
[10] *Comparative figures sourced from Leaseurope.*

Factoring and Invoice Discounting

Looking specifically at factoring and invoice discounting, one large Dutch bank comments that "We see significant growth in factoring, particularly from SMEs (risk mitigation for banks, more security from receivables). Our bank does receivables purchase, but sometimes we also only take the receivables as collateral instead of buying them – in other words, a form of asset-based lending." Growth is also witnessed at another bank with a global network, where our respondent confirmed that the volume of funds provided through invoice discounting at the bank doubled between 2010 and 2011.

There is also a growing fan base for invoice finance amongst UK corporates, with one British bank reporting through its own independent survey that over 85% of its clients would recommend their products to other companies. In fact, a number of national factoring associations confirm this, with one saying, "The UK is the most developed invoice finance market in Europe. Companies use invoice finance in the UK more than they do in any other European country. France is probably second and they only do half or two-thirds of the UK's turnover…. nevertheless, in terms of other statistics that we produce, the level of invoices throughout Europe against which financing is provided has gone up around 10% each year – so there is a very steady growth." Of course, the fact that factoring is less highly regulated than relationship bank lending in various parts of Europe may also have contributed to this growth.

Another factoring association adds, "Factoring in Germany is usually used by medium-sized enterprises – a very big market in Germany. Germany is also a major export market, which also helps to drive the growth. During the financial crisis, banks were reluctant to hand out standard corporate loans because of refinancing difficulties and quite a few customers turned to factoring."

Supply Chain Finance

Supply chain financing (SCF) programmes are increasing in popularity across Europe. These programmes often involve asset-based structures where the key asset is outstanding invoice debt owed to smaller suppliers by a large, highly rated buyer company. Unlike factoring, SCF schemes are arranged between the bank and the large buyer, then offered to participants in the supply chain.

One international banker points to the virtuous circle in SCF programmes, noting that, "Converting receivables into cash, and ensuring that this also results in reducing the day sales outstanding (DSO), means there is more available cash to release working capital trapped in trade receivables and creates additional capacity within the business to self-fund business growth." Another respondent from a Benelux financier notes that banks and customers realise that Reverse Factoring is a win, win, win situation for all parties. Buyers are able to maintain or even improve relationships with their suppliers – who get paid more quickly. Buyers are also able to get commercial discounts for prompt payment, but aren't creating a problem with any bank facility as they are not pledging any assets. Suppliers are happy because in a non recourse contract the risk of non payment disappears, and they receive cash directly and much more quickly from the financier. Banks are keen to migrate to these SCF facilities because they earn a good return on the facility and the debt is low risk.

According to research conducted by Demica, suppliers are typically saving between 1 and 4 percentage points on their cost of borrowing by participating in SCF programmes. Credit arbitrage between buyers and suppliers, however, is not the only factor that makes SCF attractive. The removal of the buyer exposure from the supplier's balance sheet, especially if the supplier has a high concentration of business with that buyer, as well as the fact that suppliers can get finance without having to tap their own funding sources and credit lines, are equally compelling reasons that attract suppliers to participate in SCF programmes even when their buyers are of equal or lower credit profile.

The clear and present need for improved liquidity management and diversification of funding sources after the crisis has propelled the growth of SCF. Demica's research from 2011 showed that 75% of bank respondents predicted future growth prospects for SCF to remain "strong" and "very strong". One Swiss banker noted: "As business continues to shift away from traditional trade finance products to open account, the demand for financing will keep growing." Another commentator from a major French bank also believed that SCF will continue to grow significantly, saying: "We have already seen a 20% increase in our SCF business year-on-year over the last five years. Though the same pace of growth is unlikely to sustain itself in the next few years, we are still expecting an annual growth rate of at least 10%." In addition, the proven success of domestic SCF programmes will lead to an increased interest in establishing global SCF programmes by corporates and banks, adding a new dimension to the scale of the service offering, as highlighted by some banking professionals.

There is a common consensus that SCF growth over the next few years will primarily be driven by developed markets such as Europe and the US, and by larger emerging markets such as China, India and Brazil. Annual SCF growth rates are expected to be between 10% and 30% per annum in developed markets and between 20% and 25% in emerging markets. One French banker made the following observation:

"A few years ago there was little requirement for Asian companies to look at working capital financing as they had relatively cheap access to bank credit, but this attitude has shifted, partly because of credit '**rationing**'. Asian clients are desperately seeking ways to improve financial efficiency, which is why we have set up a supply chain finance hub in Singapore to capitalise on the many unexplored opportunities." Another respondent also noted that unlike suppliers in mature markets, who can access working capital through different channels such as factoring, forfaiting, own funds etc, suppliers in emerging markets often have a more limited range of finance products to choose from.

The continued strength demonstrated in the burgeoning SCF market can partly be attributed to banks' continuous marketing efforts. In another Demica research report on the topic, 80% of financiers said that their banks are putting "very significant" efforts into creating and marketing SCF products. This is especially true for top European banks as well as global banking behemoths. "Banks are now getting more efficient at structuring the product, on-boarding suppliers and delivering the service through technology-based solutions that minimise manual effort in the supply chain," said a commentator from one global bank.

Trade Receivables Securitisation

Trade receivables securitisation (TRS) will continue to be an important source of funding for receivables and working capital transactions, according to one UK-based financier. His bank views TRS very positively because of the increased focus on return on equity and top-line revenue figure. "For the whole banking community, TRS is a capital efficient form of providing liquidity and our bank continues to see growth in this area as a safe form of lending, driven by an accelerated shift of unsecured funding to secured funding due to regulatory changes such as Basel II and Basel III." This respondent also highlighted the increasing number of club deals at the moment, with a group of banks sharing receivables transactions. According to him, a potential obstacle to the growth of TRS could be bank appetite, as all conduits require liquidity facilities from banks. It is therefore important to establish a strong investor base for this product in light of the regulatory headwind. His bank is currently working on a publicly distributed TRS for a global company which will be brought to the public asset-backed security market. If the transaction gains traction, it will have the potential of diversifying the investor base.

According to a Demica's research among top European banks, TRS has been one of the great survivors of the financial markets crisis. Even though TRS volumes dropped during the financial meltdown, they are experiencing something of a revival post-crisis. TRS is seen by European financiers as an essential tool in structuring, or restructuring, a corporate finance programme, with 64% of respondents rating the technique as "very important". One respondent called it "a valuable and vital tool – more real in comparison to exotic products and much more secure" while another commentator regarded invoice securitisation as "a vital component in corporate finance".

The main attractions of TRS, especially for sub-investment grade (SIG) companies, are reduced cost of funds and diversification of funding sources, by separating the pool of invoice debt from the issuers' own corporate credit rating. With the underlying portfolio rather than the balance sheet of the originator being the key risk factor in such securitisation, financing is based on the debtor risk profile rather than the creditor's rating, enabling a lower financing cost. "Companies can get financing at a rate which is normally far above their own ratings. As companies have to structure their portfolios in order to achieve a rating level equivalent to triple A or double A, if their own rating is below double A, then they are basically creating funding with a more attractive funding rate," said one Dutch banker. He also stressed the meritocratic nature of TRS in rewarding business growth, saying, "the more business you have, the greater the volume of receivables generated and thus the greater the level of funding they can generate."

The growing recognition of the importance of having a diversified funding portfolio on the part of companies has prompted them to examine structured types of facilities in obtaining capital. A French banker pointed out: "If companies only finance their working capital needs through bank facilities, they will be far too reliant on their core banks. One of the attractions of TRS is that it allows companies, especially lower-rated companies, to access the capital markets. By obtaining funding through different providers, companies often continue to enjoy the credit lines they have with their core banks while accessing more diverse funding sources."

From the banks' perspective, TRS presents them with a safer, more secure way of allocating capital while allowing them to continue to provide funding through revolving bank facilities. The above mentioned Dutch banker further explained: "You do not create a new exposure on your clients because you can provide them with funding while taking exposure on the underlying portfolios receivables. In other words, you are dealing with the risks of your clients and the risk of the portfolio. That means you can grow your exposure to your clients but maintain the risk at the same level." Even though seller risk still has to be taken into account, if their portfolios have large exposure to corporates of good creditworthiness, banks will be much more willing to provide financing on this secured basis.

An international bank commentator added that "Receivables financing solutions can take the form of bespoke solutions covering specific counterparties, or a portfolio based approach covering an entire pool of receivables from multiple counterparties with different size and risk characteristics." For instance, one German bank has a successful Mittelstand (medium-sized company) receivables financing pool that has been steadily growing since 2002. These programmes usually securitise the invoice debt and issue it to the public capital markets in the form of commercial paper.

Other Forms of Invoice-Based Finance

Asset-based lending (ABL) – a business loan secured by collateral (assets), often in the form of account receivables, inventory, machinery and equipment – is slowly emerging as a mainstream form of debt financing in the UK. According to a financier from a British global bank, his institution has gained significant traction in this area, in particular in the mid corporate market, but also among large corporates. The huge potential of ABL in the corporate sphere is evidenced by a year-on-year growth of 60% at his bank. As the respondent puts it, ABL is a capital efficient means of financing from the banks' perspective and customers also enjoy a level of flexibility that contrasts with traditional bank lending products. In light of persistently tight credit conditions and the mountain of debt due for refinancing in the next couple of years, he is confident that ABL will increasingly establish itself as a mainstream form of finance.

He points out that at the moment, 40% of debt deals in the US have ABL as a component part of the capital structure. As the UK tends to follow the US market, and given that US-based private equity sponsors, advisors and lawyers are increasingly setting up shop in the UK, appetite for ABL debt financing facility is set to grow in the coming years.

Also worth a mention is the emerging area of distributor finance. This topic is to be the main subject of a forthcoming Demica report. Suffice to say at this stage that supply chain financing needs to cover not only the purchasing of materials or components into a large buyer organisation, but also the distribution chain that will take the large organisation's finished products to market. A few pioneer SCF professionals are currently developing models to expedite distribution through receivables-based finance.

Conclusion

By bringing together the disparately reported types of receivables-based finance (including factoring and invoice discounting, SCF and trade receivables securitisation), this report demonstrates the overall significance of the invoice finance market in Europe. It is important and timely to recognise this market as it is growing at a time when traditional credit continues to undergo a substantial 'squeeze'. Commentators also believe the current sustained widening of traditional credit spreads is likely to be permanent. Scrutiny and pressure from national and international regulators is imposing more stringent capital adequacy provision and banks are looking for ways of funding customers without escalating the cost of doing so. Invoice-based finance is increasingly being seized by banks and corporates alike as an alternative to traditional credit as the risk associated with funding is predicated not on the creditor's company rating, but on the aggregated quality of the outstanding debt (and debtors), which is often better than that of the invoice originator. As a result, the invoice finance market is growing and is expected to continue doing so in a world of increased regulation which is likely to persist in the longer-term.

Methodology

A wide variety of public and private sources were consulted and analysed to 'size' the European invoice finance market. The geography of this study was strictly limited to the EU 27. Because some invoice-based transactions will remain private, and therefore cannot be incorporated into any analysis, the findings of this report should be taken as a conservative model of the market's size.

Primary research used to construct this report was conducted with three main groups:

- Selected European top 50 banks
- European specialist invoice finance providers
- Various European invoice finance trade associations

Third party sources consulted include:

- Factors Chain International
- BCR Factorscan
- Moody's
- Standard & Poor's
- Fitch Ratings
- GE Capital
- Bank of England
- European Central Bank
- European government statistical offices
- World Bank
- International Monetary Fund
- The Breedon Report
- European Banking Federation
- The Economist

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