Purchase Order Financing vs. Invoice Factoring

www.universalfunding.com

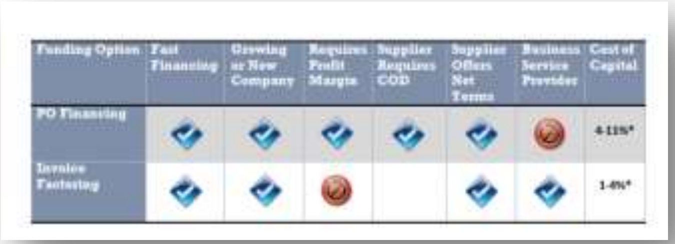
1-800-499-1218

UNIVERSAL FUNDING CORPORATION

INTRODUCTION

If you are a business owner in need of short term financing the concepts of both PURCHASE ORDER FINANCING and INVOICE FACTORING may have come to the surface (especially if traditional bank financing is currently unobtainable). While the two options have the same origins, and are similar in their basic concept, they are two different business financing tools.

If you have ever tried searching, you will quickly find that there is limited information available on the internet for purchase order financing (aka PO financing). You may have encountered content provided by generic sites where the authors confuse PURCHASE ORDER FINANCING with INVOICE FACTORING (a.k.a. Accounts Receivable Financing). In order to dispel the confusion this comparison will clearly lay out what purchase order financing is, how it relates to, and its advantage and disadvantages over INVOICE FACTORING.



Funding Option	Fast Financing	Growing or New Company	Requires Profit Margin	Supplier Requires COD	Supplier Offers Net Terms	Business Service Provider	Cost of Capital
PO Financing	✓	✓	✓	✓	✓	✗	4-11%*
Invoice Factoring	✓	✓	✗		✓	✓	1-4%*

In this comparison we will:

- Define Purchase Order Financing
- Review the 2 Types of PO Financing
- Define Invoice Factoring
- Compare Similarities & Differences
- Provide a Cost Analysis & Comparison Chart

WHAT IS PURCHASE ORDER FINANCING?

PO financing is a short term financing method used to ***cover the cost of manufacturing*** *or purchasing goods that* ***have been presold*** *through a Purchase Order.*

2 TYPES OF PO FINANCING

Funding Finished Goods

This type of PO financing refers to the sales of products that are never touched by a wholesaling company. An example of this would be a wholesaler who receives a large order from a department store. After receiving the purchase order, the wholesaler places the order with the manufacturer. Once filled, the order is shipped directly from the manufacturer to the department store, never touching the wholesaler.

Funding Non-Finished Goods

This type of PO financing refers to sale of a product where a company takes possession of the components and transforms them into the final product. This could apply to a manufacturing plant which transforms raw materials into a product. It would also apply to a business that purchases containers of office supply furniture from China, assembles the pieces here in the States before selling them to another company. Funding non-finished goods through PO financing is harder & more costly than funding finished goods, as there are inherently more risks that go into the equation.

WHAT IS INVOICE FACTORING?

Invoice Factoring is the financial transaction of ***advancing a large portion of the value of an invoice*** *immediately after the product is delivered to the customer.*

Instead of waiting Net 30 to up to Net 90 days to get paid, a factoring company is able to reduce the wait to virtually net zero, by advancing 70-90% of the invoice amount. After the full payment has been received from the customer (after the agreed net payment terms) the accounts receivable financing company will transfer the remaining portion of the invoice, minus the cost of factoring.

SIMILARITIES BETWEEN PO FINANCING & INVOICE FACTORING

1. **Quick to obtain!** Compared to the drawn out process of traditional financing, both PO and AR financing can be obtained in a matter of days, albeit invoice factoring can be faster than purchase order financing.

2. **Credit Worthiness.** Both methods focus on the credit worthiness of your client, not your balance sheet. Traditional lending looks to your past history of managing your company's finances and credit when deciding if a line of credit will be approved. Purchase order financing and invoice factoring, on will look to the future of your company, climate of your industry, and the creditworthiness of your clients.

3. **Great for newer companies**. Without a track record of at least 3-4 years, a young company will not have much of a shot at getting approved for business credit through a traditional lender. Since factoring companies put more weight on the clients' creditworthiness, young businesses are able to get the financing they need!

4. **Both are great for fast growing companies.** Lines of credit can get maxed out rather quickly, especially when going through a growth cycle, thus limiting a company's ability to sustain growth. With both PO Financing and invoice factoring, your facility limit grows right along with your company, providing more funds when you really need it.

DIFFERENCES BETWEEN PO FINANCING & INVOICE FACTORING

1. **Costs of Capital.** While rates will vary, the cost of PO financing typically ranges between 4-11% as compared to 1-4% rates for invoice factoring.

2. **Required Profit Margin.** If your business is one where profit margins can be slim at times, than PO financing may not be an option, as financing companies will require a profit margin around 20% on any deal where purchase order financing will be used. On the other hand, invoice factoring will work well for companies where profit margins are commonly much lower or have seasonal fluctuations.

3. **Service Based Companies Need Not Apply!** One of the down sides to PO financing is that it is not applicable to service based companies. Due to the nature of PO financing, it is a tool that can be used when a physical product is being purchased. However, a financing program with invoice factoring can improve the cash flow of a company that sells a product *or* provides a service in a B2B model.

4. **What Funds Can Be Used For.** While PO financing can finance up to 100% of the cost of producing a product, including materials and labor, funds can't be used for anything else. With invoice factoring there are typically no restrictions on what the advanced capital can be used for.

5. **Purchase Order Financing is Preferred When a Supplier Requires COD**. If a supplier requires payment as COD, instead of net 30 days PO financing can be the best route for a company if they do not have the capital on hand to purchase the materials in full.

6. **Invoice Factoring is Preferred When a Supplier Offers Net Terms**. If the materials supplier is able to offer net terms it is typically long enough to produce the finished product and deliver to the end customer. Once delivered, the company can than submit the invoice to the factoring company who will quickly advance the funds needed to pay off the suppliers, all at a much lower cost compared to purchase order financing.

COST BENEFIT ANALYSIS OF PURCHASE ORDER FINANCING

ASSUMPTION	VALUE	COMMENT
Value of P/O:	$100,000	
Gross Margin:	$35,000	35%
Cost of P/O Financing	$5,000	5%
Cost of Invoice Factoring (A/R Financing)	$2,000	2%
Pre-Tax, Pre-Operating Expense Profit	$28,000	Gross margin less P/O & A/R financing

COST BENEFIT ANALYSIS OF INVOICE FACTORING

Income Statement Comparison		
Revenues	**$100,000**	**$200,000**
Cost of Goods	**$60,000 (60%)**	**$120,000(60%)**
Gross Profit	**$40,000 (40%)**	**$80,000 (80%)**
Overhead	**$38,000 (38%)**	**$48,000 (48%)**
Cost of Funds	**N/A**	**$2,000 (2%)**
Net Profit	**$2,000 (2%)**	**$30,000 (15%)**

CONCLUSION

While purchase order financing and invoice factoring are clearly different, their purpose is the same, create cash flow to support business growth. If you would like to learn more about putting either purchase order financing or invoice factoring to work for your company, request a free consultation with one of Universal Funding's Business Development specialists today.

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*Universal Funding does not have a flat rate for any financing services. We work out the lowest rate possible for each client by looking at their customers' credit worthiness, the climate of their industry, and volume.