CURRENT CHALLENGES OF INVOICE FINANCE MARKETPLACE PLATFORMS

By George Shapiro

What is Invoice Financing?

Long-term business loans are not always the best solution for small and medium sized enterprises (SMEs), especially businesses that require funding for sudden working capital increases and unbudgeted short-term investments.

While banks and independent traditional financial services firms dominate asset-based lending and factoring, Peer-To-Peer (P2P) invoice finance platforms have recently entered the industry. Similar to traditional invoice finance providers, these companies provide solutions that allow SMEs to get immediate advances on trade receivables, rather than waiting for customers to pay invoices with long remittance terms.

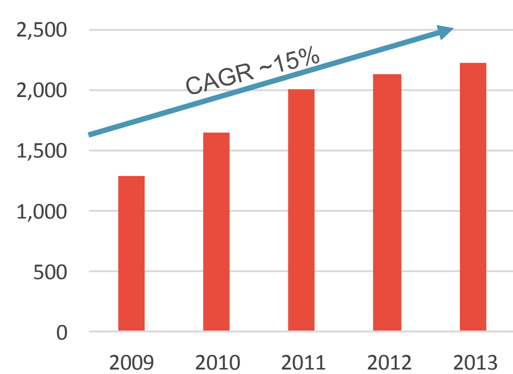
"Invoice Finance Service offers capital 'just in time' to SMEs when typical business loans can't be secured."

With the rise of P2P lending platforms, invoice finance marketplaces are becoming more accessible to businesses. The total invoice finance market has been growing rapidly and reached over $3 trillion USD worldwide. Over the last few years a number of firms entered the P2P invoice finance sector: Market Invoice and Platform Black in the UK and The Interface Financial Group, FastPay, C2FO and P2Bi in the US.

For institutional and retail investors on these platforms, this asset class provides a number of advantages: (1) increased liquidity due to the short-term nature of the product and (2) diversification of portfolio risk in the P2P lending space.

However, invoice financing represents a sophisticated and structured specialty finance service and there are a number of unique challenges for new P2P players that investors should be aware of.

Global Factoring Volume: 5 Year View



All figures in Euro billions

Special Consideration for Credit Underwriting and Risk Management Process

A lack of deep credit and underwriting expertise can create serious financial risk for P2P platform operators and investors. General credit and underwriting experience in commercial lending is often not sufficient for building a successful and sustainable invoice finance operation.

For example, one of the main beliefs of new invoice finance operators, investors and clients is that, if the client's customer (the "account debtor") is a mid to large sized, reputable entity with solid credit history, non-payment risks are largely mitigated. Seems like a logical conclusion, right? Not really. Even though the account debtor is creditworthy, this alone is not enough to mitigate the major risk of default. Most non-payments (over 95%) occur due to disputes between account debtors and clients over the quality of services or goods provided by clients and not due to the account debtors' financial inability to pay. To fully assess the situation, the credit underwriters have to perform intensive and deep credit evaluation of the client as well as its account debtors.

Another common misconception is that credit insurance can protect the investor against all types of risks. While the investor can insure default due to an account debtor's (client's customer) bankruptcy, non-payments resulting from disputes of any nature between the client and account debtors are not covered.

Also, depending on the industry the client is operating in, sector specific risks have to be addressed, particularly in construction, trucking, advertising, IT, and healthcare.

These and many other examples show the importance of thoroughly qualifying clients, assessing their credit profile and structuring transactions in order to mitigate risk embedded in the transaction.

What if Invoices are Pledged as Collateral to Banks or Other Secured Parties?

Frequently, banks and other lenders provide financing from a second or even third position. Invoice finance providers approach credit in a different manner and instead structure transactions as asset purchases, i.e. the invoice finance providers purchase specific accounts receivables. However, surprisingly some invoice finance P2P platforms end up purchasing accounts receivable that lack clear title and are still pledged as collateral to another secured party. In instances such as these, the invoice finance P2P platform does not own the receivable and may not be entitled to the funds to be received from the account debtor. To properly purchase the accounts receivable, the funder should obtain a full release of these specific invoices from the secured party. Unfortunately this is not always the case.

Investors should carefully consider investments that do not fully address these issues to determine if the reward is sufficient for the amount of risk.

INVOICE FINANCE SERVICE FOR SME'S

Invoice finance allows SMEs to quickly access working capital when other traditional and alternative sources of funding are not available.

While traditional invoice finance and invoice factoring services have been in existence for thousands of years, the industry has been undergoing a rapid transformation for the last few years.

Obtaining working capital by quickly turning outstanding invoices into cash is becoming more prevalent among SMEs.

Is "Big Data" a "Big Deal" for SME Lending?

Lately, it has become a common perception that "Big Data" technology integration plays an important role in lending operations, regardless of whether the customer is a retail consumer, established enterprise, or SME with limited or no credit history. Invoice finance providers have followed suit and try to utilize "Big Data" for making credit decisions. Many P2P platforms leverage "Big Data" solution providers to help automate risk management processes.

However, despite the availability of sophisticated algorithms that aid credit decision-making for consumer and commercial lending, reliance on "Big Data" as an effective tool to assess SME credit risk is not there yet.

Financial information is rarely available. Other sources of data such as social media sites do not produce much useful data in the small business sector. For example, tracking the amount of time the owner of a small plumbing company spends on social networks, and other online activities, is unlikely to help a lender improve its default risk assessment. Small businesses such as plumbing companies just don't spend enough time on activities to generate useful credit data. Owners of SME's are more focused on running the business, ensuring availability of working capital for suppliers and employees, trying to generate cash flow, etc.

Thus while the jury is still out on the importance of "Big Data" to evaluate small businesses' credit profile, there is no real substitute for a stringent underwriting process, including importantly on-site due diligence of clients (e.g. verifying the physical existence of the business, meeting in person with the owner, and assessing the local business environment).

The Interface Financial Group leverages its 150+ local offices, to conduct local site audits for each and every new client. The site audits allow for an in-depth assessment of the business, its management team, the level of integration into the local business community and the surrounding social environment. IFG believes that being local is a "must" for any successful invoice finance business. In addition, IFG's local partners always invest their own capital in each and every transaction alongside investors. "Skin in the game" is a "Big Deal" for IFG as it creates alignment between IFG and its platform investors.

As the invoice finance industry undergoes a rapid transformation, new business opportunities will emerge for existing and new marketplace lending platforms. However, there will always remain a number of critical success factors. To emerge as industry leaders, the ability to scale one's platform, rapidly originate a significant volume of transactions and create deep, smart and thorough credit underwriting processes will be vital for building a long-term successful invoice finance marketplace platform.

IFG INVOICE FINANCE MARKETPLACE

The Interface Financial Group's Invoice Finance Marketplace provides a unique opportunity to institutional investors. It is the only P2P marketplace where the originator and underwriter share default risk with its investor base by participating in every transaction.

Investors benefit from portfolio diversification and above market returns through IFG's 40+ years of experience and presence in 9 countries.

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About the Interface Financial Group

Founded in 1972, The Interface Financial Group (IFG) is one of North America's largest alternative funding sources for small business. The company serves clients across more than 30 industries in the United States, Canada, Singapore, Australia, New Zealand, UK, Ireland, Mexico and South Africa and offers cross-border transaction facilities. With more than 150 offices and over 40 years of experience, IFG provides innovative accounts receivable funding services and solutions by offering short-term working capital to growing businesses.