Boring is Good

Stockholm (HedgeNordic) – Businesses facing cash-flow problems or working with slow-paying customers often sell their invoices or accounts receivables at a discount to a so-called factor to get cash faster. Whereas factoring does not appear to be a high-return operation at first glance, just a one percent fee with a 30-45-day cycle would result in an annual gross return of 8 to 12 percent for bearing the credit risk of the businesses paying off the invoices.

Relying on its team's expertise and vast experience in credit risk assessment, Stockholm-based Kreditfonden has managed to deliver attractive risk-adjusted returns from the often-boring factoring business through its young Nordic Factoring Fund. The fund was launched in the summer of 2019, but its origins stem from Kreditfonden's flagship direct lending vehicle, **Scandinavian Credit Fund I**. "The story behind is that we originally had the factoring exposure in the Scandinavian Credit Fund I, but we liked the asset class so much that we decided to launch a separate fund focused entirely on factoring," explains Fredrik Sjöstrand, the founder and CIO of Kreditfonden.

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"The Nordic Factoring Fund and Scandinavian Credit Fund I seek to capitalize on distinctive sources of attractive risk-adjusted returns, which is why we prefer to run them in parallel," argues Sjöstrand. "One benefit shared by both these funds, but that is even more pronounced for the Nordic Factoring Fund, represents the uncorrelation to other asset classes," highlights Peder Broms, Head of Origination at Scandinavian Credit Fund I and portfolio manager at Kreditfonden. "With an annual return between six and six and a half percent, the Nordic Factoring Fund is a seriously boring fund," says Sjöstrand. "With tens of thousands of receivables as collateral that generate very high risk-adjusted returns, the whole package offers investors a fixed-income profile that is very hard to replicate in the bond market."

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Kreditfonden's Factoring Operation

The Nordic Factoring Fund runs a typical factoring operation used by traditional factoring companies, but rather than acting as the direct counterparty to the sellers of invoices, the fund uses one factoring company based out of Northern Sweden as an intermediary. "We are buying invoices from one factoring company that has established relationships and administrative processes in place for collecting payments from the invoiced clients," explains Sjöstrand. "The invoices bought then serve as a pledge in the name of the fund, and we share the gross fees with the factoring administrator."

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"We have done in-depth due diligence on this factoring administrator, which acts as a platform that sources investment opportunities for the Nordic Factoring Fund," emphasizes Sjöstrand. "We have approved all the instructions, policies, processes, et cetera, of this factoring company," continues Kreditfonden's CIO.

“We worked together to improve and adjust all their operational and administrative processes to get them in sync with the demands of our fund.” The Nordic Factoring Fund relies on this factoring administrator to enforce the account receivable eligibility criteria, secure and maintain proper documentation and records, as well as maximize timely repayment and contract enforceability in cases of delinquency.

Peder Broms, portfolio manager at Kreditfonden

The respective factoring company from the north of Sweden mainly focuses on invoice sellers from Finland, with an exposure of about 70 percent to Finnish industrial companies and the remainder to Swedish small and medium-sized enterprises (SMEs). “In Finland, the customers selling invoices are mainly private equity-owned companies, and in Sweden, these are SMEs with an average annual turnover between SEK 20 to 50 million,” says Broms.

Credit Risk Assessment

Because factors such as the Nordic Factoring Fund extend credit to their clients' customers rather than to their clients, they are more concerned about the credit risk of the business that is paying off the account receivables. Credit risk assessment, therefore, is one of the most important pillars of a successful factoring operation. "The team examines a wider range of criteria when deciding whether or not to include a factoring deal into the fund," explains Broms. "These criteria mostly focus on the credit quality of the end-customers, the businesses that must pay off the accounts receivable."

When buying a collection of account receivables from an invoice seller, "we also require that the book is well diversified," says Broms. "We want multiple account debtors in the portfolio." The Nordic Factoring Fund's portfolio tends to reflect between 70 to 90 corporates that sell their account receivables, but each corporate's accounts receivables reflect the invoices associated with an even higher number of end-customers. Even so, the Nordic Factoring Fund does not solely rely on diversification to dampen the risk of one business failing to pay an invoice. "Apart from that, we also do a direct analysis of all the corporations that sell the receivables, and we then look at all the receivables as well to see if they match our credit criteria," says Sjöstrand.

Return Drivers and Risks

The Nordic Factoring Fund aims to generate between six and six and a half percent per annum with low volatility. These returns reflect several return drivers exclusive to the factoring industry. "The factoring business is, first of all, an arbitrage because you are buying receivables from a smaller corporate, but you are primarily facing the credit risk of that corporate's customers," explains Broms. "This means you can charge or earn a higher interest rate than warranted in the process of financing the customers directly."

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"The second arbitrage or return driver is that in many factoring deals with manufacturing companies, apart from the interest rate, certain fee structures apply especially that focus on late payments or because an invoice is received in paper format or other peculiarities," says Broms. "These details enhance the returns of the factorer," he continues. "If we are comfortable with the credit risk of the end-customer and also the risk of the originator, we can fund those transactions and charge rates that translate into attractive gross annualized returns," says Broms. Because the tenor of accounts receivables is between 30 days and a maximum of 90 days, an appropriate velocity of transactions facilitated by its factoring operator enables the Nordic Factoring Fund to keep the money active and keep delivering attractive risk-adjusted returns for investors.

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There are several risks, however, that can eat away from these attractive returns. These include the default of an account debtor and, more worryingly, invoice fraud. "We have a wrapper that protects the seller of the receivables against default by its account debtor, we have a credit insurance wrapper that protects us from the invoiced client failing to meet its payment obligations," explains Broms. "We also have insurance against what we call fraud, which is rampant in factoring and has happened in the factoring market."

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In addition to the credit and fraud risk, a third risk – many would like to face – is "that we can get too much money into the fund and we cannot deploy it at the rate corporates sell their account receivables," says Sjöstrand. "In the past, we closed the fund for new investments when we had too much liquidity," he continues. "As it stands today, we have a pretty good pipeline, and we do not see unused cash balances due to limited reinvestment opportunities as a problem today." According to Sjöstrand, "if we were to do nothing from tomorrow, just maintain the portfolio, we would give a return of six or six and a half percent. It is not going to be much more, and it is not going to be less."

This article featured in HedgeNordic's 2021 "Nordic Hedge Fund Industry Report."