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Investors can capitalise on companies' need for cash

Options for decent returns on investments are thin on the ground. Buying invoices is becoming more attractive

Getting a risk-free return may never have been more difficult for investors. Consider the deposit rates on offer – the most a lump-sum investment of €10,000 in an instant access account will earn you at today's rates is 2 per cent from Permanent TSB, while AIB's best rate is just 0.75 per cent.

In such an environment, it's no surprise that savers and investors alike are looking for other options to boost their return and protect against inflation – while not assuming too much risk.

One emerging option is exchange-traded receivables (ETRs), which allow investors to capitalise on companies' need for low-cost credit, and ties in with the rise of non-bank lending.

Crowdfunding, peer-to-peer lending and private equity have all stepped into the space left vacant by the credit-strapped banks, and are increasingly gaining traction in the Irish market. Now invoice finance is hoping to help cash-hungry SMEs while at the same time offering an above average venture for investors.

For Paul Tarpey of Costello & Tarpey Financial Services in Galway, the main reason for the attraction for investors in the product has been the reduction in banks' deposit rates.

"If banks were offering the same rate, people wouldn't move," he says before noting that, as deposit rates have fallen further and further, more people have become willing to look at alternatives such as ETRs.

But what are ETRs, who can buy them, and how risky are they?

What are ETRs?

ETRs are invoices issued under contract for goods and services supplied to investment-quality companies, or credit-insured invoices from investment grade insurers.

The attraction for companies is that invoice financing allows them to bridge the gap between long payment terms and paying their suppliers within 30 days. For investors, buying companies' invoices can offer a greater return than traditional deposit rates and, by opting for blue-chip companies, the risk is reduced…

The Irish option

If you'd like to allocate some of your portfolio to receivables, you also have another option closer to home: Debtors Exchange. Founded in 2011 by Patrick Reynolds, the goal of the exchange is to address two issues: the lack of liquidity in the micro-medium business sector; and providing a "strong, stable, cash equivalent alternative" to bank deposits for investors. Although the company met the Central Bank in November 2011, there is no requirement for it to be authorised and, in fact, it appears that there is no framework under which it would be.

According to Reynolds, Debtors Exchange is different to other receivables exchanges in that it offers more certainty to companies. If, for example, a company posts an invoice on an exchange, there is no guarantee that someone will buy that invoice.

"You can't rely on it that it will always be there at moment you need it," he says.

So, Debtors Exchange strikes agreements to buy 20 per cent of a company's recurring invoices, over a 12-month period, which gives these companies the certainty of generating the working capital they need.

It started operating last summer, and has already traded about €16 million in invoices, with about 100 retail investors allocating money to the exchange so far. In the second quarter of this year, among the exchange's top 10 holdings – companies whose invoices were traded the most - were Heineken, Atradius, Glanbia, Vodafone, Coface, SSE, Avolon and Boylesports.

How do investors make a return?

Put simply, a provider like Debtors Exchange makes a return by purchasing invoices from SME companies at a discount to face value, with that discount (or charge to the

SME) providing the yield to the investor. Costello & Tarpey, which works with Debtors Exchange, offer a return of 3.75 per cent, fixed for a year.

Features of ETR investment

Unlike Marketinvoice's product, investing via Debtors Exchange is not just restricted to high net-worth individuals, as invoices are insured via AIG which offers a wrap of protection for the investor.

Still, it's not for everyone. To invest in ETRs, you'll need a minimum investment of €20,000, and Debtors Exchange is working with about 17 or 18 financial advisors across Ireland who offer the investment product.

Typically, investors will be offered a fixed rate of about 3.75 per cent, but as Reynolds notes, this involves an element of negotiation. Interest will be earned pro rata so, if you withdraw after six months, you will earn 1.88 per cent on your investment. There are flexible, regular income options, and you can take your interest earned quarterly or annually

It's relatively liquid, with investors required to lock their money away for one year, but full or partial redemption may be available on request, and there are no break charges or early redemption fees.

"It's not like a bank account where you can put money in today and take it out in three months' time," says Reynolds.

Unlike the UK's Marketinvoice, you can't select which invoices you wish to purchase. Rather than giving investors the floor to pick their own invoices, investors' money and invoices are matched electronically, so it's still a one-to-one relationship.

"A couple of years ago people might have bought B&Q and Superquinn for example, because they knew the names so well. But they both went into liquidation," says Reynolds.

How is it taxed?

Income from an ETR product is liable to capital gains tax at 33 per cent, which may be a more preferable outcome than income tax, depending on your tax rate. An annual CGT allowance of €1,270 also applies – or double that for married couples – which means that investors may end up with no tax bill.

In addition, such gains may be tax free for pensions and Qualifying Investment Funds (QIF).

Where does my money go?

If you invest in this product with a financial advisor like Costello & Tarpey, your money will be transferred to Danske Bank, from where it is transferred to what's known as a Quistclose account "for the explicit and exclusive purpose of purchasing ETRs".

A Quistclose account is a trust created where a creditor has lent money to a debtor for a particular purpose, and this money does not become part of the debtor's general property. Rather, it can only be used for the agreed purpose.

In the event that the debtor uses the money for any other purpose, it is held in a secondary trust for the creditor. Any inappropriately spent money can then be traced and returned to the creditors.

A cooling off period, of one month from the date you transfer your money to Danske Bank, also applies. If you decide within this timeframe not to go ahead with the investment, you will get your money back within two or three days.

What are the risks?

The biggest risk for an investor is that the company does not meet the terms of the credit line and defaults on repayment. Another risk is that payment is delayed.

According to Reynolds, Debtors Exchange applies a four-tier protection mechanism.

The first thing it does is an invoice/ETR set-off by replacing a "bad" invoice with a "good" one; then it buys invoices at a discount to face value, for example at 90 per cent, and holds 10 per cent as a reserve. Thirdly, Debtors Exchange carries its own loss and default reserve and will repurchase invoices and refund investors if necessary; and finally, it has credit insurance with AIG.

While this offers investors protection, as Tarpey notes, investors should remember that the investment is "not capital guaranteed; but it is insured".

Since launching, Debtors Exchange has had one company go into liquidation.

"We elected in that instance to purchase those invoices back from the investor who owns them, so they got their money back," says Reynolds, adding, "we took that as a loss, but if the loss was substantial and we were unable to do a repurchase, we could call on AIG".

The ABCs of ETRs: How they work

Company XYZ owes Company ABC Ltd €105,000 for goods and services. When ABC goes to XYZ for payment of the invoice, XYZ offers two options: 1) pay it in full in three months' time or, 2) pay €100,000, a discount of €5,000, now.

ABC decides to take the €100,000 now rather than wait three months to get paid in full.

Now XYZ has to get the €100,000 to pay ABC to clear the invoice in full.

Rather than paying this out of its own funds, it goes to the Debtors Exchange trading platform where the invoice will be purchased from XYZ. This means that Debtors Exchange will give XYZ €100,000 now so that they can pay ABC.

Three months later, XYZ will repay Debtors Exchange €105,000. For XYZ, this approach allows them to buy credit at a much cheaper rate than an overdraft or a bank loan.