

Case Study – The Merchant View of Working Capital

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Merchants and businesses everywhere are looking for capital for expansion and operations. Business owners use to rely extensively on banks for their financial solutions, yet more and more merchants are denied funding by their bank. Often, banks seem willing to take a merchant's money but not so willing to provide it back when the merchant needs funds for operations or expansion. In fact, last year, 2/3rds of all businesses spent days and days filling out applications and submitting documents for bank financing, but a staggering 86% found themselves outside the bank's narrow box. Not only does this not seem fair, it doesn't give the merchant many options.

Let's explore one option that does exist. Working Capital Advances, a cousin of the long-established receivables factoring, is one option to gain funding and liquidity for merchants. Many merchants have found that of a working capital advance solves their capital needs, and its extremely wide credit window makes it available for the majority of all businesses. For strong, well-established businesses, rates are very competitive and terms flexible; for newer or less entrenched businesses, working capital is sometimes the only viable option. In any case, we'll explore how a working capital advance works and why a merchant may be interested in WC funding.

What are working capital advances?

Working capital advances are defined as the purchase and sell of future receivables by the merchant. The merchant is saying that they will earn \$xx in the future, and are willing to sell that income stream today for a discount on the future value. In this way, working capital advances are like AR factoring, except that AR factoring is tied to the future receivable of a specific invoice whereas WC advances work for any future receivable in a general sense.

AR factoring works great for merchants who create and deliver a tangible product to be paid for in the future (e.g. I'll ship you tires today and you'll pay for them on terms in 30 days; I'll submit that invoice for factoring and receive payment today from the factoring company, who will then be paid off when you pay for the tires in 30 days, less a transaction cost of course). But what about the purveyor who sells cheeseburgers? They deliver your delicious Angus burger in about 10 minutes, so invoice factoring doesn't seem viable. For a working capital advance, the funder would instead look and say, "I see you collect about \$50,000 each month from selling juicy burgers, so I am willing to purchase a portion of your future burger sales and pay you for that today at a discounted rate. I will then collect a portion of your sales until I receive back the amount I purchased."

What interest rate will I pay?



The short answer is none. That is because a working capital advance is not a loan. Any business that can fit through the bank's narrow credit window would have already received a loan from them, but 86% of all business did not make the cut last year. Despite the bad news from the banks, merchants still need liquidity and funding solutions.

A working capital advance considers the amount of future receivables to be sold, called the purchased amount, and the amount of money advanced to the merchant today, called the purchase price. The ratio between the purchased amount and the purchase price is called the factor rate. For example, if the funder tells the merchant he will purchase \$15,000 of his future sales and pay him \$10,000 for it today, then the purchased amount is \$15k and the purchase price is \$10k, yielding a factor rate of 1.50. While many merchants will want to try to convert the factor rate into an APR, it isn't directly convertible, and in any case the funder will never ever call it a percentage rate, since APRs apply to loans and the purchase and sell of future receivables is not a loan.

In any case, clearly working capital is expensive capital. If a bank loan was available, the merchant would take it. The question is whether it makes sense to engage in a working capital advance transaction or not. Factors that drive the factor rate include term length, how credit worthy the merchant is, how big the advance is relative to their revenue, industry, the existing of other advances or liens, time in business, and other similar factors.

Are working capital funders loan sharks?

Well, they may not oppose to being called a shark, but they don't want anything to do with loans! We say that tongue in cheek, but on a serious note it is important to remember, they are buying your future receivables and advancing you funds for your future work now. The difference may seem subtle now but the details will matter later. The funder will be happy to share details with you and answer any questions you have.

Does it makes sense to take a working capital advance?

The first thing that every merchant considering an advance needs to do is to consider how profitable their own business is. Working capital is not cheap money, but if you don't earn a cheap margin then an advance can make sense, sometimes lots of sense.

Consider Lacy, the owner of a woman's clothing boutique. Her sales are suffering because her racks are bare and she doesn't have enough selection for her customers. Ladies come shopping, but when they can't find their size, they leave disappointed. Lacy knows that if they leave disappointed too often, they'll quit coming back.

Since Lacy has only been in business 5 months and, last year went through a nasty divorce that ended with a bankruptcy filing and decimated credit, she knows she won't be one of the 14% of business owners that receive a bank line of credit. In fact, she'll be at the higher end of working capital factor rates. Still, Lacy knows she needs to increase her store's \$25,000 monthly revenue or



she won't last long. She considers a working capital advance for \$20,000. Even though she's a new business, Lacy knows her margins and has a plan for how she'll use the capital to better her situation.

With her poor credit and high risk, she receives an offer for the \$20,000 she sought, but at a 1.50 factor rate and a 90 day term. She contemplates her strategy. She knows she'll take \$18k and purchase additional tops from the fashion district of LA which she sales at an average markup of 3x and a retail value of \$54,000. She also uses \$1k for marketing to make sure her shoppers know about her 20% Off Spring Sale and \$1k is held for reserves. The sale works and she's able to move the goods quickly, increasing her sales by \$43,000. She takes \$30,000 to pay back the advance and \$3k for labor, pocketing a nice \$10,000 profit.

When summer comes, Lacy obtains a new advance, this time for \$30,000 to reflect her increased sales and increasing credit profile. Using the \$30,000 advance plus her own \$10,000 profit, she applies the same ratios and strategy, her Back to School sale increases revenue by \$91,000. After paying back \$45k on her advance plus overhead, she . same ratios, she increases her profit by \$40,000!

One more time, for the Christmas Holiday, she takes her \$40,000 profit and adds to it an advance of \$40,000. She's able to purchase \$240,000 of goods for a strong seasonal push. Her sales jump \$180,000. After paying back the advance and reasonable overhead, she has marginal profit of \$120,000! She now has enough to add a second location next year. It is hard to believe, but a year ago Lacy was new in business and had no idea if she'd even survive. Now she is making good money and has a bright future.

Yes, Lacy paid a steep fee for capital. But Lacy also runs a good business. She went from barely having any profit to over \$120,000 in 9 short months. Lacy knew she needed to roll the funds back into her business. A working capital advance should not be used for a trip to Hawaii or a new car. Lacy also knew her Gross Margin Return on Investment, or GMROI, was 2.0, and that her standard markup on goods was 3x. Now, who's the shark!?

In any case, the working capital advance allowed her to grow and expand. It was mutually beneficial. Working capital funders want you to be successful. Remember: they won't collect their advance if you are not in business, yet if your business grows, not only do they get paid back but they also may be able to advance you additional funds in the future. Working capital funders will be more flexible than banks 100% of the time, but must also know your business to know if an advance is right for you or not. No banker, investor, funder or employee will ever know your business as well as you do, and only you will know if you run a profitable enough company to make a working capital advance a successful endeavor for you.

Shouldn't I just have my cousin Vinny invest in my company instead?



Maybe. We're not here to provide you with advice on running your company, and we're certainly not going to evaluate whether Vinny makes a good business partner or not. We would not want to talk you into our out of any transaction. Our role is simply educational.

One pro to raising funds from family and friends is that the terms are often better than the general market would bare. Your friends and family know you (and hopefully that's a good thing!), and may view your potential more positively than a stranger would. That means that friendly capital can be cheap capital.

When engaging in business with family and friends, both parties should take the time to discuss what should happen if everything goes right with the investment, and also what should happen when everything goes wrong. Many business owners lament after the fact that when the business is profitable, family wants a huge chunk of the earnings, but when things are tight they want all the cuts to be borne by the owner. Sometimes the personal repercussions can lead business owners to declining friendly funding even if it is on favorable terms. They may feel it is not worth the risk to the personal relationships at any cost. Other business owners have wonderful relationships with family and friends who have invested with them. We can't tell you what is best for you, but what is a fact is that you should always take the most favorable funding you can secure (even though you might need to consider non-financial aspects, such as owning cousin Vinny money).

Summary

Structuring your business finances is complex, and only time will tell if it was done well or not. Whether you have been denied bank lending, wish to keep your bank line open for unexpected future expenses, or are considering Cousin Vinny's offer, working capital advances are an alternative to consider. Before deciding, ensure you know your business's profitability rates and have a plan for how you will utilize and pay for the capital you obtain. We hope this Case Study has been educational and addresses many of the questions you may have. Please remember that this Case Study is not an offer of any time, and please take time to review the important disclaimers below. We welcome the opportunity to answer any questions you may have.

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