

Case Study – The Syndicator’s View of Working Capital

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Merchants everywhere are looking for funding sources for their business, but 86% of them did not fit the bank’s narrow box last year. Credit markets remain tight for all but the most golden of borrowers, thus even profitable, successful businesses often find themselves looking for alternative sources of capital.

Discussed in the case study “The Merchant View of Working Capital” is the situation that merchants need funding but don’t have many options. We reviewed the benefits and downside of the merchant borrowing from friends and family. Favorable terms are always desired, but cheaper may not be better. We also addressed the fundamental requirement that businesses know their margins before engaging in any transaction, whether friendly or at arm’s length. As demonstrated, well run business with good margins may greatly accelerate its growth with a working capital advance, but a poorly run business that is not profitable will quickly see its demise. In this regard, working capital advances are like fuel on a fire, but whether the flame is productive or spirals out of control depends on the operations of the business. Working capital funders want to front capital to profitable businesses. Failing businesses means higher default rates and greatly diminished prospects of realizing a return.

What are working capital advances?

Working capital advances are defined as the purchase and sell of future receivables by a 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. Today’s advance is based on the future’s revenue. 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 of the merchant 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. In this case, a working capital advance could be considered. Here, 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 from you each day until I receive back the amount I purchased.” Since there is not a specific invoice, the working capital has claim on all funds received by the merchant.



What interest rates do working capital lines charge?

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 referred to as 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 specifically designed to not be a loan.

In any case, clearly working capital is not the cheapest form of capital. If a bank loan was available, the merchant would take it. But when a bank loan is not available, is tapped out, or needs to be preserved for unknown needs, the merchant seeks alternatives including working capital advances. In deciding whether to engage in a working capital advance transaction or not, the factor rate and term will be considered. 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, some funders may not be opposed 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 that the funder is buying the future receivables of a business and advancing them funds now for their future work yet to be done. The difference may seem subtle now but the details will matter later. The lead funder will be happy to share details with you and answer any questions you have.

What is a syndicate partner?

A syndicate partner, or syndicator, can be many things which we will discuss. It is also important to mention what it is not. A syndicator is not lending money to anyone. A syndicator is not purchasing a security as there is no pooling of assets under common management. A syndicator chooses deals on a case by case basis and is in full control of his own decisions at all time.

In the most basic sense, a syndicate is a loose association of concerns who combine to carry out a particular transaction. When referring to working capital, each syndicator is taking a portion of his investable cash assets and combining them with other participants to fund a working capital



transaction. A syndicator may have a small percentage of the deal, or may take the majority of the transaction.

In working capital transactions, one of the syndicators takes the head position for preparing the transaction, presenting the terms, and executing on all duties and agreements. This person is called the lead syndicator. The lead receives an administrative fee for his duties. This administrative fee is typically collected and deducted from each payment collected from the merchants, and typically ranges from 3% to 8%. The lead may also assume the role of the originator, collecting the documents from the merchant and providing the underwriting report to the potential syndicators.

Each syndicate partner chooses to participate on a deal by deal basis. The participation percentage of each deal is unique, and each syndicator can choose to fund more or less to a deal as they evaluate risk and return potential. Each deal can potentially have different factor rates, term length, admin fees and origination and sales commission costs.

How does a syndicate partner get paid?

The process by which a syndicate moves and tracks his money give fully transparency and full accountability. The syndicate has his own login to the platform software and can see deals including the full underwriting report. He is able to sort and review potential transactions by whatever criteria the syndicator prefers. Once he decides his appetite for a deal, the syndicator submits how much of the deal he would be willing to fund. Of course, often deals are oversubscribed, and in those cases the lead will determine the allocation using established criteria. This always means the syndicate partners may up their participation limit knowing that they may not get as much of a transaction as they would like.

Once the syndicator receives confirmation of the amount of the deal he is funding, he submits his portion of the funds, known as the transaction participation amount. The transaction confirmation will also include notice of any front-end fees that cause the participation amount to be grossed up from the purchase price. These costs are disclosed on the platform software and are also provided in the syndication report, which the syndicator uses to calculate return expectations.

Once a deal is slated for funding and the find underwriting and checks are completed, the merchant is funded, typically via a wire to their account. The lead files the UCC and arranges for the deductions of the merchant's account, usually starting the following day. If a Confession of Judgement (COJ) is utilized, that is also reviewed and filed for safekeeping.

The payments back from the merchant can be received by ACH debit, merchant creditcard processing split, or physical drop box. On most deals, the merchant will pay the daily amount each business day (although custom schedules can be created). After the payment is received, the lead splits the amount according to the participation percentage each syndicate partner contributed.



The syndicator receives their participation amount, called the right to receive, less the lead's administrative fee (typically from 3 to 8%).

The syndicate participant received his funds through a daily sweep which aggregates all amounts received from the various deals the syndicator is participating in. A daily report provides the syndicate partners with all the details, and additionally the syndicate partner has a reporting engine available to fully track his investments and provide reporting on his capital gains to his accountant. Most syndicators will take their returns and syndicate them into future transactions, which enables them to earn tremendous compounding due to the daily payments, but the syndicator can make that determination on a case by case and deal by deal basis.

How transparent is it?

All reputable working capital funders utilize platform software that makes every transaction fully transparent to each syndicate partner. They should be able to see what their Right to Receive is, potential return, actual return, and details on each transaction. Most platforms will also include underwriting modules to allow you to see the details on each potential deal so you can decide which ones you want to participate in and to what degree. Remember, of course, that over subscriptions are common, so you may not receive the full amount you indicate. As each ACH payment comes in, you'll see your right to receive amount, which you receive offset only by the management fee via an ACH credit to your account.

Lead working capital funders want their syndicate partners to have full access to optics so that they can make the best, well-informed decisions possible. Because evaluating, tracking, and analyzing performance is so vital to your return and risk management, consider a working capital lead that utilizes current software that is powerful and easy to use. The lead will provide you with training on how to utilize the platform software.

Are my funds commingled with others?

No! Working capital syndication is about taking a portion of a working capital transaction on equal footing as the other syndicators and the lead. You decide case by case and deal by deal if you want to participate and to what degree you wish to participate. You decide to embark and disembark independent of other syndicators.

Because working capital transactions are designed to be originated, underwritten and funded quickly, you or a designated member of your team will need to be tasked with monitoring your investments, but what you decide to do is fully independent of what other syndicators decide to do. Typically, we recommended not taking 100% of any deal, but even that is a possibility if you feel strongly about the opportunity (typically this only happens at the book ends of the risk spectrum where a funder feels the exceptional return is worth the risk, or where the risk is evaluated to be very low and worth the potential return).



What kind of track record should I look for?

Nearly every sophisticated investor can repeat the mantra verbatim “past performance is no guarantee of future results.” This disclaimer is of course true. Indeed, there are no guarantees! Not on return, not on performance, and not on security. Yet results must be considered to some degree. Investments in securities always include certain standardized results such as average annual returns and 30-day yields. Even private placement securities like hedge funds have results that are shared with prospective and current investors.

Syndication is more difficult at the outset, however, but only for logistical reasons. One of the first consideration is that each syndicator makes their own decisions on which deals to invest in and to what degree. This means that no two syndicate investors will chose to participate in the same underling transactions, and certain not to identical degrees. Because your funds are not comingled in a pool, there is not a standardized result to publish. A lead cannot tell John Doe how much Jane Doe made, since John won't be investing identical to Jane.

The second practical issue is that in most investments, investors look for a substantial track record. Yet in working capital transactions, the performance is often so exceptional versus competing investments that the working capital funder quickly finds himself no longer interested in additional external syndicators. From internal and established external sources he has sufficient funds, and so the lead is then only interested in syndicators that bring additional ingredients to the recipe mix, such as established deal flow (for additional enlightened reading on this unique concept, see Sean Murray's article “So You Want to Participate” in the March 2014 deBanked magazine). Once a lead is established, they typically turn syndicators away, with some leads reporting that they receive hundreds of calls a month offering millions of dollars – offers for which they have absolutely no interest. This phenomenon unique to working capital means that a potential syndicator spends time getting familiar with the potential of the lead instead of evaluating the performance of the lead. Luckily, since the syndicator remains in control of his funds and in driver's seat of his deal participation, there is greatly reduced risk in those areas.

What is protecting my funds?

First, we must reiterate that every investment contains risks. There are known knowns, and known unknowns, but it is the unknown unknowns that have the biggest potential to hurt you. For example, financial planners will tell you that there is a significant risk of placing all of your assets in FDIC insured bank accounts. What is the risk? The risk is that saving accounts and CD's are virtually guaranteed to not keep up with inflation. Even with “low” 3% inflation, your purchasing power will decrease by over 60% over a typical retirement period. Surprise high inflation will wipe away wealth even faster. This means that a well-designed portfolio must have both conservative assets to protect against valuation swings and more aggressive assets to protect against inflation and longevity risks. Working capital syndication should be considered the type of asset class used to potentially protect against inflation.



Working capital syndication is an alternative asset class that in many ways is a hybrid between equity and debt investments. The purchase and sale of future receivables is a capital investment. The returns will be taxed as capital gains, not as interest, and any losses can be used to offset the gain amounts on a one-to-one basis. On the other hand, there is an intrinsic and relatively predictable revenue stream from working capital.

When evaluating a working capital syndication opportunity, it is important to calculate for a degree of default. Some merchants will not make the payments, and sometimes the payments will come but just slower than anticipated. While this is also true of investment grade bond investments, the risk here is more certain, which in some ways helps in addressing the risk. In any case, diversification should be mandatory.

The lead should also carry a professional liability policy against errors and omissions in the execution of their duties. We recommend the policy to be at least \$250,000 face value and should be in addition to any property or casualty insurance the lead may carry. The E&O policy should be reviewed for coverages to ensure you are protected against errors on the part of the lead.

Finally, protecting your assets is the underwriting of each specific transaction. The lead will provide you with the underwriting and origination criteria and results. Each syndicator may decide on the risk and return profiles that fit their portfolio. The platform system should enable the syndicator to decide on investment based on factors such as industry, capitalization rate, geographic location, transaction size, time in business and performance of prior transactions. With more aggressive transactions, a Confession of Judgement (COJ) is often used by the lead to propel the collection to the front of the line should the merchant undergo difficulties. Thankfully, a COJ usually helps in resolving advances to struggling merchants prior to legal proceedings by aligning the interests of all parties.

If I think I'm ready, how do I begin?

It may well feel overwhelming, yet the return structure and investment potential may be compelling. A good lead will help you with this conundrum by providing you with all the help you need, including a road map. Typically, the potential syndicator will provide an indication of interest and proof of funds to the lead. The lead will then provide the potential syndicator with a due diligence package, which will contain model contracts, a list of service providers and partners, insurance policies, and numerous conversations to address any questions.

As the potential syndicator gets closer to engaging, he'll need to make sure his own team is in place, including competent accountants, legal advisors and financial planners. He may also need to designate a member of his team to be the point for the syndicator portal for the group and performing duties such as deal review and approval, cash flow analysis, portfolio strategy and structuring, and reporting. A good lead will provide you with much assistance on learning how to ride this new bike, but ultimately, you'll need to pedal for yourself. The tools will take you far, but



your own legs will take you the distance. The preparation required of the syndicator is not hard or burdensome, but it is important to do it right.

Summary

We hope this Case Study has been educational and has addressed 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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