

Whitepaper – A Case for Working Capital Syndication

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Politicians will claim that the credit crunch of the recession is over, but ask any business owner and they will tell you otherwise. Obtaining credit, even under less-than-favorable terms, remains extremely difficult. A review of bank's own results paints a far bleaker story. Last year, nearly 2/3rds of businesses sought financing, but 86% found themselves outside of the bank's narrow box. Only 14% were approved for the funding they applied for. Business owners spend precious time away from their businesses filling out bank forms, submitting documents for underwriting, and meeting with bankers, all to be told "no" far more often than not.

In the past, many business have received funding from Small Business Administration SBA loans. These were often the best option for liquidity. The federal government would underwrite some of the risk of making loans to small business, making it much more palatable for banks to grant these loans. However, increasing paperwork for compliance regulations have made it unprofitable for banks to issue small balance SBA loans. From the bank's standpoint, it takes almost as much effort to underwrite and comply with regulations for a \$500,000 loan as for a \$15,000 loan. Thus, the small dollar credit window is barred shut.

What is a business to do then? If a business owner has savings or can rely on family and friends for capital on favorable terms, then they should often pursue that first. But what if they don't have preferential access, or have otherwise exhausted resources including personal credit cards and retirement accounts, yet still find themselves in need of capital for expansion or operations? This is where the asset backed lending (ABL) market excels and provides a solution for disadvantaged business owners.

Asset backed lending is flexible funding that uses a company's balance sheet to underwrite funding. Nearly everyone is familiar with the ABL segment of mortgaged real estate lending. Most are also familiar with equipment lease financing, a trillion dollar a year business. Factoring refers to the process by which a funder purchases the future receivables of specific invoices and fronts that capital to a business before the client actually pays, providing additional liquidity. All of these options provide capital to a business and are typically preferable when these superior assets exist.

Sometimes, though, businesses don't have a lot of hard assets that are unencumbered. Yet, it is easy to see that the greatest asset of such a business may be the fact that customers come back again and again to purchase that company's goods and services. A regular, steady flow of customers may actually be a stronger piece of collateral and more predictable in value than archaic equipment, encumbered real estate, or questionable invoices.

Working capital financing seizes on this fact, and uses the future stream of revenue as the basis for lending. Formally, working capital funding is a purchase of the company's future receivables at a



discount. For example, the working capital funder may offer to purchase from Sadie's Boutique \$15,000 of her future receipts to be received over the next 60 business days, paying \$10,000 now for a portion of that future AR payment stream. The funder fronts Sadie's Boutique the \$10,000 in an ACH funding to Sadie's Boutique's account. The funder will then debit from Sadie's account \$250 each day for 60 business days. With this \$10,000, Sadie can do anything she likes. In this example, she uses it to buy inventory in advance and at a significant discount for an upcoming sale she has advertised. That \$10,000 of inventory is sold at her typical mark up of 2.5x, or \$25,000. After deducting \$2,500 in internal expenses plus the cost of the advance, Sadie nets \$12,250 in additional profit from the transaction. She can then use her profit to self-fund her next big sale, or can engage in a working capital line again to gain additional leverage and have the potential for increasing her profits even more.

The rates of working capital advances are expressed as a factor rate and a time period. In our example, Sadie received \$10,000 now for \$15,000 in future receivables. This is a 1.50 factor rate. The time period in our example is 60 business days, or 12 weeks. The payment for most working capital advances is paid through a daily ACH deduction. The calculated deduction is figured by multiplying the funding amount by the factor rate then dividing by the number of business days and processed as a daily ACH, which is \$250 in our example. It is important to remember that a working capital advance is not a loan and there is no interest rate, APR or loan documents. It is buying future receivables at a discount. It is expensive, and business owners need to realize that it is much like pouring gasoline on a business's operations. If the operations are going great, the advance of capital well deployed at positive net margins can supercharge profitability and enable growth and expansion far quicker than organic growth would allow. But if a business is not well run, if the capital is squandered, or if the owner is already in peril from running at insufficient margins then the advance will only serve to accelerate the company's demise. It was already in trouble, and the advance only accelerated it.

When underwriting a working capital advance, funders will look at factors such as bank beginning and ending balances, number and amount of deposits, nature of deposits, average ledger balance, number of negative days or NSF's, time in business, industry, credit profile of the principals including FICO scores, liens, judgements, child support status, bankruptcies and home ownership status, and the performance of prior advances and loans. In the higher risk spheres, funders will often rely on the underwriting of more mainstream funders, feeling like they can add a margin of additional funding in subordinated position to other funding without much additional risk. Interestingly, the default rates are pretty consistent across credit profiles, but seem to depend most on the length of the advance. Thus, higher risk funders can preserve their default rates by condensing the time frame of the receivables collection. This term contract also does wonders for the IRR of the portfolio.



Funders incur the most risk when originating a new transaction. Funders seek to maintain clients by renewing funding or increasing funding lines. Care must be exercised, however, since imprudent stacking can sink an otherwise well performing business and can lead to unexpected defaults.

The factor rates collected by working capital syndicators can be attractive. On the low end, A-credit clients with strong balance sheets and income statements may receive factor buy rates (the rates before broker commissions and origination fees) with one year terms as low as 1.12. Clients with subpar credit and financials may be receive 90 day buy rates in excess of 1.60, and brokers may add as much as 20 points or more onto the factor buy rates.

With defaults driven more by term length than any other factor, risk can be managed by making shorter term advances in reasonable increments. Short term lengths also benefit the syndicator by increasing the turn on funds, and thereby the IRR.

As an example of accelerated return via compounding, if a syndicate were to enter into 10 transactions like Sadie's example, the syndicate would advance \$100,000 to 10 clients in exchange for \$150,000 of receivables over the next 60 business days. That means \$250 would be collected each day from each of the 10 clients, or \$12,500 per week. But at the end of the first week \$12,500 would be ready for additional transaction and could be placed with a new client origination. So, the 2nd week, \$12,500 would be collected from the original 10 clients plus \$1562 from the new client for a total collection of \$14,062. If this \$14,062 were again advanced in week 3, then the 3rd week's collections would rise by an additional \$1758, and each subsequent week the collections would rise by another 12%. Of course, this is an overly simplistic example as allowances need to be made for broker commissions, originations, collections, default rates, and friction against full portfolio engagement, but the principle of rapidly increasing weekly collections that can be re-syndicated is a powerful concept and one that can cause the IRR to increase dramatically.

In summary, there is an urgent need for working capital funding. Banks are not lending to a wide spectrum of American business who need the capital for operations and expansion. Business owners will seek the most advantageous terms they can secure, but with banks withholding solutions from Main Street merchants, business owners remain in need. Working capital, even with high factor advance rates, can be profitable for well run businesses, adding a bit of gasoline to the fire of properly managed businesses. Working capital syndicators may receive superior returns from the purchase of receivables via working capital advances, and can compound their return by redeploying capital into additional transactions as soon as possible after each day's collection for merchant clients. Risk is present in all transactions, but via proper asset backed lending to well-designed client models and modern portfolio management, many risk factors can be mitigated.



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