Two Types of Alternative Financing to Help Bridge Cash Flow Gaps

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

With the supposed economic recovery still trudging along in fits and starts, many Los Angeles and Southern California business owners and executives are finding that it's still difficult to obtain working capital financing for their companies. This is true even though we are now nearly five years out from the onset of the financial crisis and resulting credit crunch.

It's not uncommon for manufacturing companies and distributors to experience cash flow "crunches" due to the time lag that exists between when cash is paid out for raw materials and inventory and when accounts receivable are collected. Service providers can also experience a cash flow crunch between the time when salaries and other overhead are paid and receivables are collected. Cash flow shortages can threaten the very survival of small firms that do business with large customers who are stretching out their payment terms to 60 and even 90 days or longer.

Typically, such businesses use a bank line of credit to carry them through these cash flow crunches. But with banks continuing to maintain strict underwriting guidelines for small business credit, some small businesses are unable to qualify for a bank credit line. This is especially true for start-up firms and firms that have experienced financial difficulty, excessive losses or high leverage. Even businesses with strong bank relationships have had their credit lines reduced or eliminated due to poor short-term financial performance.

An Alternative Solution
One financing option such businesses can turn to is alternative financing solutions. These include asset-based loans (ABL) that are secured by the business' equipment, machinery, inventory or accounts receivable. Most types of asset-based loans fall into one of two broad categories:

1. **Full-Service Factoring** — With factoring, a commercial finance company (or factor) buys the outstanding accounts receivable of a business. The factor will typically advance the business 70-90 percent of the value of the receivable when it purchases it, and the balance (less the factoring fee) once the full receivable is collected. Factoring fees depend on the collection risk of the receivable and how many days the funds are in use, among other factors, and typically range between 1.5-3.0 percent.

   Businesses can usually decide which outstanding receivables they want to sell to the factor. The factor, meanwhile, is responsible for managing and collecting receivables it has purchased until they are paid. The factor performs credit checks, analyzes credit reports on account debtors, and mails and documents all payments and invoices — tasks that are usually performed by a business' A/R department or credit manager.

2. **Accounts receivable financing** — A/R financing is more similar to a bank line of credit than factoring is, but there are a few key differences. The main difference is that the business' outstanding accounts receivable serve as collateral for the line, while a bank line can usually be secured by other kinds of collateral as well (e.g., real estate, equipment, the owner's personal assets, including his or her primary

residence). Unlike with factoring, businesses must submit all of their outstanding invoices to the finance company when utilizing A/R financing.

With an A/R line of credit, the finance company will establish a borrowing base the business can draw against. It will charge a collateral management fee and assess interest against the amount of money borrowed by the business. Invoices usually must be less than 90 days old to count toward the borrowing base. The finance company may also perform credit checks on account debtors to determine their creditworthiness before including these invoices in the borrowing base.

A Transitional Financing Source

Factoring and A/R financing tend to be more expensive than traditional bank loans and lines of credit, so companies usually look to transition away from them to bank financing once they have improved their financial situation and are “bankable” again. However, ABL is viewed as a more permanent type of financing in some industries, including trucking, import/export distribution, apparel manufacturing and some service industries.

Due to its relatively high cost, many business owners and executives look at asset-based lending as a last-resort financing option. While it’s true that ABL isn’t the perfect financing solution for every situation, it can provide a much-needed working capital boost for businesses facing a cash flow crunch that don’t qualify for a bank loan or line of credit. And if the alternative to ABL is a severe cash flow shortage and possible business bankruptcy, then the cost really becomes irrelevant.

Concluding Thoughts

Many Los Angeles and Southern California businesses are still feeling the effects of the credit crunch nearly five years after the financial crisis first hit. Those needing a working capital infusion to help bridge cash flow gaps, but that don’t qualify for a traditional bank loan or line of credit, may want to consider alternative financing solutions like full-service factoring and A/R financing. While more expensive than bank financing, these types of alternative financing solutions can provide much-needed cash to help businesses make it through a cash flow crunch.

About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives at small and mid-sized companies in Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we’re passionate about helping our clients create, grow and sustain value. For more information, please visit www.cfoedge.com or call 626.683.8840.