

Overview of Financial Solutions



- The Etra Advisory Group provides solutions to businesses for growth, expansion, cash flow, refinance and acquisition.
- We cover the world of business financing that banks *cannot* or *will not* cover (marginal credit, rapid growth, quick financing, mergers and acquisitions, different asset classes, start-ups, debtor in possession, or current market conditions!)

Alternative Finance

The alternative finance industry is massive, employing some 35,000 people at U.S. commercial banks, thrifts, credit unions, independent finance companies and hedge funds, among other lenders.

Source: Forbes.com URL:

http://www.forbes.com/2009/01/29/finance_e-factoring-debt-entrepreneurs-finance_0129_finance_print.html

Businesses Require Capital

- Start-up
- Expansion
- Strategic Opportunities
 - M&A
 - Better terms through quick payment
 - (2/10 Net 30 – 2 % discount if paid in 10 days and no discount for 30)
 - Volume/Discount pricing from suppliers
- Restructure/Refinance
- Turnaround

Four Key Business Metrics When Obtaining Financing

- **Net Worth:** $\text{Assets} - \text{Liabilities} = \text{Net Worth}$
- **Leverage:** Borrowed funds are (re)invested with the intent to earn a greater rate of return than the cost of interest.
 - Debt-to-equity ratio = $(\text{Total debt}/\text{equity})$
- **Profitability:** Net Income (bottom line on the company income statement)
- **Working Capital:** Can the cash flow handle the debt service?

Why an Intermediary?

- Lenders often do not want to talk directly with borrowers
- Knowledgeable – can ‘make the case’
- Collect info/interpret/mediate – both sides
- We talk the lender’s language on one side, and the business owner’s on the other

Working Capital Considerations

- Working Capital = Current Assets – Current Liabilities
(Current Ratio)
 - CA = cash and cash equivalents
 - CL = All liabilities due within 1 year
- As CA decrease and CL increase your WC diminishes and your business risk increases
- Your goal is to ensure you have adequate liquidity to enable your business to service your debt while **EFFICIENTLY** investing excess cash.
 - Your creditors love it when you have extra cash because it protects your credit rating and lowers your risk
 - Your equity holders love it when you are putting that cash to work on growing the business.

Trade Credit – A source of short term borrowing

- Trade Credit
 - Ex: 2/10 Net 30 (pay in 10 days take 2% discount, if not the full amount due in 30 days)
 - Should you find ways to pay in 10 days to take advantage of the discount?

Evaluating Use of Trade Credit

The cost of a foregone discount



- Trade Credit Cost

$$\text{Trade Credit Cost} = \left[\left(1 + \frac{\text{Discount}}{1 - \text{Discount}} \right)^{\left(\frac{365}{\text{Number of days beyond discount period}} \right)} - 1 \right]$$

Trade Credit – short term interest free loans

Evaluating Use of Trade Credit

- Trade Credit Cost

$$\text{Trade Credit Cost} = \left[\left(1 + \frac{\text{Discount}}{1 - \text{Discount}} \right)^{\left(\frac{365}{\text{Number of days beyond discount period}} \right)} - 1 \right]$$

- Pay on the last day - day 30

$$\left[\left(1 + \frac{.02}{1 - .02} \right)^{\left(\frac{365}{\underbrace{30 - 10}_{20}} \right)} - 1 \right] \approx 44.6\%$$

- Pay within discount period if cost of funds < 44.6%

The cost of the foregone discount decreases as the number of days beyond the discount period increases. For example, paying on day 20 the cost is 109%.

• Lesson: IF a business offers you a discount for paying early, ALWAYS TAKE IT! OR pay as close as possible to the net period expiration

Financial Tools Available

- **Cash-Flow Solutions**

- Factoring of accounts receivable – *selling your A/R for immediate cash*
- Purchase Order Financing – *using a PO as collateral for short-term funds*
- International Trade Financing - *Import/Export, Letters of Credit, Trade payable funding*
- *Consumer Receivables Financing – sell your consumer contracts*

- **Commercial Equipment Leasing** - *buy what appreciates, lease what depreciates*

- Operating lease or capital lease of equipment or software
- Sale-leaseback financing - *sell equipment to a leasing company, then lease it back to raise capital*

- **Business Loans**

- Asset-based lending - *loans secured against general business assets (accounts receivable, inventory, machinery or equipment)*
- Bridge loans – *short-term funding to take advantage of opportunities*
- Acquisition loans – *based on business valuation – requirement that buyer and seller together take back 50% of financing*
- Credit score loans – *loans based on personal credit score – no collateral required*
- Mezzanine loans - *collateralized by equity in the company rather than the property itself*

- **Commercial Real Estate Loans (construction, permanent or re-fi)**

- Bridge Loans/hard money - *higher risk secured by value of collateral property. Short-term financing enabling a borrower to close on a project in a timely manner, until permanent funding is in place.*
- Refinance of real estate – *cash out to use for reinvestment in the business*

Factoring

- Factoring is where a business sells their receivables at a discount for immediate cash flow.
- As a business, you may not be able to afford to wait 30, 60 or 90 days (or more) to get paid for your invoices.
- What you can expect in a factoring relationship is to be able to sell your invoices and receive an advance of 75%-95% of the value of the invoice within 24 hours into your account. After your customer pays the invoice 30, 60 or 90 days later, you will receive the balance of the invoice minus the factoring fee.
 - Ex: \$10,000 invoice with 80% advance rate = \$8,000 immediate cash
- There are multiple ways the factor's fee can be calculated, and this is all negotiated up front when the relationship is established. They can charge a daily rate for days outstanding, an every 10 to 15 day rate, or a flat fixed fee; there are numerous other options.

Factoring

- What is of most concern to the factor is the creditworthiness of the end customer, not the business or its owners.
- The reason many businesses make this move is to ensure the continuous flow of cash to the business. Essentially, businesses who use factoring are focusing on having most of the money now rather than all of it later.
- Get money faster without the hassle of the collection process.
- The alternative is to chase the customer for the invoice payment and defer everything else while the money is tied up in collections.
- The immediate cash can be invested into new equipment, used to pay bills or toward payroll. It can also be used to take advantage of trade discounts or volume purchase discounts from suppliers - a **VERY IMPORTANT** consideration!!!

Purchase Order Finance

- Purchase Order Finance is a short-term financial solution used to finance the purchase or manufacture of specific goods that have been pre-sold by the client to its creditworthy end customer.
- Funding involves issuing letters of credit or providing funds that allow clients to secure the inventory they need to fulfill pending orders.
- Most commonly, these transactions start in the form of a written purchase or sales order from your customer for specific goods.
- Potential PO financing clients find themselves in one of three situations:
 - Sales growth is outpacing available working capital or bank credit lines.
 - Seasonal sales spikes or growth spurts put a sudden strain on cash flow.
 - Working capital must be preserved for other mission-critical operations such as R&D, manufacturing, capital equipment or marketing.

Purchase Order Finance – typical requirements

- Must be in business with revenue for at least one year.
- Must have experience and previous transactions with client or other similar clients.
- Must have a viable purchase order from a creditworthy customer or a Letter of Credit
- Must retain a minimum of 25% profit.
- Must be a **U.S. company**.
- Project funding for the following costs:
 - Deposits
 - Raw Materials
 - Components and Sub-Assemblies
 - Project-specific Labor
 - Finished Goods
 - Direct Manufacturing
 - Shipping
 - Letters of Credit
 - Letters of Guarantee
 - Capital equipment

How PO Financing gets done

- **Supplier Guarantee**. Issued by Lender, it ensures that the liabilities of the client toward the supplier are met. Supplier guarantees are generally used as evidence of debt and are just that; a guarantee that Lender will pay the supplier in case your business doesn't. This is a lender's preferred finance method.
- **Standby Letter of Credit**. Lender's irrevocable obligation to pay a supplier on behalf of your business in the event you do not pay the supplier when certain conditions are met. Standby is regulated by the state of issuance and the International Chamber of Commerce (International Standby Practices 98).
- **Cash Payments**. Direct payment to supplier. Least desirable and most expensive option.

Benefits of Leasing

- Leasing saves working capital -You can finance 100% of your equipment costs; there is no down payment.
- Leasing establishes additional credit lines -Your existing bank lines remain intact for other financial needs.
- Leasing includes all costs of acquisition -Your lease payments can also include the costs of delivery, installation, software, and other service charges.
- Leasing offers tax advantages -Your lease payments may be deductible as operating expenses. Check with your accountant.
 - Leasing eliminates the need for complicated depreciation schedules since lease payments are generally a line item expense on your P&L statement, and since lease payments can usually be treated as a pre-tax business expense you may even reduce your taxes. Paying cash for equipment automatically adds 30-40% to the cost when you realize that cash = profits and taxes are paid on profits.

Benefits of Leasing (cont.)

- Leasing gives you long-term flexibility - When your lease expires, you can either return the equipment or purchase it.
- Leasing expands your budget – Taking advantage of monthly payment plans can mean the difference between improving your business now or waiting for future cash availability.
- Leasing is a hedge against **inflation** -Tomorrow's dollar may not have today's purchasing power, so it makes sense to use tomorrow's dollars to pay for today's new equipment.

ABL – Asset-Based Lending for Working Capital

- Also known as revolving credit, revolving financing, receivables financing
- ABL is a secured line of revolving credit supported by the borrower's fluctuating value of eligible accounts receivable and also sometimes inventory and other assets
- Inventory alone is rarely financed without receivables. One reason for this is that lenders file under the UCC against inventory or “proceeds of inventory”. Proceeds = cash or A/R so there could be a clash between lien holders.
- Unlike some other types of lending, borrowers usually do not have a “cleanup” period required by the lender during the ABL contract.
- ABL is for companies that need to maximize their borrowing capacity using accounts receivable and inventory as collateral.
- Receivable-based financing combined with inventory finance has become a useful tool for many undercapitalized businesses.

Asset-Based Lending Versus Bank Financing

- Unlike traditional bank debt that relies heavily on balance sheet ratios and cash flow projections as loan criteria, asset-based lenders will evaluate a client's business assets as its primary focus to establish the borrowing base. The result is usually far greater borrowing power than can be achieved from a traditional cash-flow banking approach.
- Asset-Based Lenders will work with companies with limited earnings, rapid growth or no growth, a negative net worth position or even a debtor-in-possession (DIP) situation. As well, they will often look at many different types of assets as collateral other than the traditional.
- There are often no covenants as with bank financing, and sometimes no personal guarantees necessary.
- In the event where the client already has a bank line of credit and wants to pursue ABL, an Inter-creditor agreement is made between the bank and the asset-based lender where the receivables are assigned to the ABL company.

Asset-Based Lending Benefits

- The majority of prospective ABL clients are undercapitalized companies that have good performing receivables and are growing faster than their cash flow intake or who have seasonality issues.
- Asset-based financing works well with manufacturers, distributors and service companies with a leveraged balance sheet whose seasonal needs and industry cycles often disrupt their cash flow.
 - ABL
 - Accelerates cash flow – daily borrowings usually permitted against invoices prepared
 - Can improve the timely payment of accounts payable and other debt obligations
 - With improved cash flow borrowers can take advantage of purchase discounts
 - Grows with your business – higher sales and increasing inventory and growing A/R = growing borrowing base
 - Non-notification – Borrower's customers are not aware that receivables are financed by a lender
 - Interest is paid only on the daily outstanding balance

ABL Costs and Considerations

- Financing rates are based on a borrower's financial profile and market conditions.
 - Pricing is typically “X” percentage points over the prime interest rate (or LIBOR for larger deals) plus a monthly maintenance fee
- Advance rates for lines of credit secured by accounts receivable depend on creditworthiness, and the amount of dilution (returns, uncollectible, etc.) that the borrower’s company experiences, but typically range from 60% to 85% of the outstanding accounts receivable.
- Advance rates for lines of credit secured by inventory depend on the future orderly liquidation value (OLV) of your inventory and the level of inventory relative to the amount of your accounts receivable outstanding, but typically range from 30% to 65% of the cost of inventory.
- ABL requires on-site audits by the lender.
 - Fraud is a big issue; problems can be bogus invoices and shipping documents, overstated inventory values etc...

Bridge Financing

- There is an *immediate* need – typically less than 1 month
- Needs to be very well collateralized – as much as 2 – 3 times
- Client has an opportunity or a savings that is too good to pass up – it is expensive!