How to Get More Capital For Your Business

Asset-Based Loans

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Advantages of Asset-Based Loans

- The interest cost of an asset-based loan can be less than on a straight line of credit or term loan.
- The percentage loaned (advance rate) on company assets is usually higher than with conventional financings.
- Temporary or seasonal cash needs are more easily financed.
- Periodic cleanups of the loan are avoided.
- Notification to customers for payment of the accounts receivable is not required.
- Increased sales are automatically financed through higher receivable and inventory levels.

Advantages of Stretch-Out Loans

- Interest rates are locked in on future capital needs.
- Average amount of available capital is increased.
- Loan terms are unaffected.
- Borrower has more flexibility on repayment schedule.

A rapid growth in sales can cause just as many problems as inadequate growth.

Asset-Based Loans

Too many of us lock into standard loan contracts when we need capital for personal or business needs. But term loans and conventional mortgages are not the only option when it comes to accessing capital. The problem with these loan contracts is that they commit borrowers to a specific repayment amount on a firm repayment schedule for a specified number of years. Some borrowers don't want to be paying interest on money they may not be using and don't want to be making fixed, level repayments when their business revenues typically experience wide swings.

This **Resource Report** explains two other types of loans that offer special appeal and special advantages to borrowers whose capital needs are more flexible or cyclical.

The first option: An asset-based loan is especially appropriate to finance growth — whether seasonal growth that occurs on a regular annual basis or sudden growth from an unexpected surge in sales. The advantage is that the loan amount is tied directly to the company assets such as inventory and as those assets turn over into sales, the loan is repaid.

The second option: A stretch-out loan stretches loan repayments over a longer time period while giving the borrower the security of locking in an interest rate and the flexibility of accelerating or pulling back on repayments, depending on capital needs and market interest rates.

Here, then, are other options to consider the next time you need capital.

Sometimes, a company can be victimized by its own success. Sales can grow too much, too quickly, and backlogged orders can pile up. Old customers lose their patience and new customers take their business elsewhere.

The problem is that rapid, dramatic increases in sales often produce an equally rapid, dramatic growth in a company's need for cash — to finance accounts receivables, to buy new equipment, or to increase inventory levels. For a business in this situation — as well as companies who don't qualify for *unsecured* borrowings — traditional sources of capital are not always an appropriate alternative. But another financing method, *asset-based lending,* just may be.

Some Definitions and Advance Rates

An *asset-based loan* provides a *revolving* line of credit against the liquid value of a company's assets, rather than against its cash flow. And because availability of capital in asset-based loans expands in proportion to the growth of these assets, a company's access to capital keeps pace with its growth rate.

The *advance rate* is the percentage a borrower receives on the assets pledged to a lender to secure a loan. For example, an 80% advance rate on $100,000 of eligible accounts receivable results in an $80,000 financing. *Eligible* accounts receivable are usually those due up to 90 days (sometimes 60 days) of the invoice date and the percentage advanced ranges from 70% to 85%.

The *advance rate* on eligible inventories, usually raw materials and finished goods, can range from 25% to 50%, principally depending on the type, aging, and mix of the inventory — the more liquid (readily salable) the inventory, the higher the amount loaned. Work-in-process may be excluded from advances since, in its unfinished state, it would bring very little liquidation proceeds, if any.

The *advance rate* on equipment ranges from 50% to 75%, depending principally on the age and resale value of the equipment.

Why and When to Use Asset-Based Loans

Asset-based borrowers are highly varied. They include manufacturers, wholesalers, distributors, and sales rep agencies, in just about every domestic industry that generates inventory and accounts receivable. The common client characteristic, however, is the need for leverage (more debt capital) resulting from sales growth that has outpaced a company's capital base (stockholders' equity).

It's different: Asset-based loans are an alternative to conventional bank lines of credit and term loans, long-term debt, straight equity (e.g., sale of common stock), or quasi-equity capital, such as subordinated debt which may give the lender or investor an option to acquire an ownership position in the business.

Here are four *actual* examples of situations in which asset-based loans have been used:

1. *Expansion:* A distributor must choose between expanding its warehouse facilities or adding to its fleet of trucks. Both would be advantageous if sufficient cash or additional bank credit were available.

2. *Seasonal business:* To prepare for its heaviest summer selling season yet, a manufacturer of lawn mowers needs to finance its inventory build-up.

3. *New product line:* When an importer of kitchenware introduced a new line, sales increased by 50% within six months, sending inventory and receivables soaring and depleting the company's cash supply. Additional financing was needed to increase production to meet customer demand.

4. *Operating losses:* When a distributor of school equipment incurred operating losses over six months and didn't qualify for a conventional bank financing, it used its accounts receivable and equipment inventory to meet its temporary cash needs.

Who Makes the Loans and How?

Asset-based loans are principally available from commercial banks, finance companies, some insurance companies, and specialized lenders, such as GE Commercial Finance and GMAC. Collateral consists primarily of accounts receivable, supplemented by inventory and select fixed assets, such as equipment.

By using these assets to secure loans in asset-based lending arrangements, a business can obtain the early use of cash in advance of its industry's turnover cycle. This is possible because the borrower receives cash for the current assets as soon as they are available for collateral.

In contrast, under normal trade terms, most businesses take months to convert their inventories and accounts receivables into cash as products are produced, sold, and paid for. By pledging assets to the secured lending organization as soon as they are available, a borrower has access to a revolving line of credit that expands as the supporting collateral increases.

Obtain More Capital

Asset-based lending can provide greater borrowing capacity than traditional loan arrangements because the lender takes a security (collateral) interest in a company's assets, including, many times, its equipment, and monitors them on a regular basis to calculate their current market value at any given time. Monitoring procedures are carried out without the knowledge of the borrower's customers.

Asset-based lending differs from factoring arrangements, in which a company's receivables are actually *purchased* by the factor, and *notification* is usually made to the customer/receivable to make payment directly to the factor. In asset-based lending, the borrowing company continues to own its accounts receivable and to perform its own credit checking, bookkeeping, and customer collections.

Advantages of Asset-Based Financings

- *Greater liquidity:* Companies obtain additional cash and borrowing ability to finance increased sales and take advantage of opportunities. For example, using cash from asset-based lending, borrowers can save money by taking trade discounts of 1% to 2% on invoices paid within 10 days. They also can finance sporadic increases in sales which require interim financing, not permanent capital.

- *Flexible loan structures:* Borrowing against inventory is attractive when sales are concentrated in a short season and cash is needed to build inventory and support production *prior* to the company's selling season. During the high sales season, inventory loans then can be converted into borrowings against accounts receivable, which are repaid through customer payments.

- *Evergreen financing:* Because this is a form of non-amortizing lending, periodic cleanups of the loan are avoided. A company repays its borrowing through the normal course of business, as customer payments are received and applied to the outstanding loan balance.

- *Constantly growing base:* Since asset-based loans are tied principally to accounts receivable and inventory, loan availability grows as the company's sales and assets expand.

What Are the Costs?

Although the stated interest rate on asset-based loans may be above the company's usual borrowing rate by one to four percentage points, the actual dollar cost of asset-based lending often approximates or is less than that of a comparable unsecured loan. This is because cash advances against assets are taken *only when needed,* and interest is charged *only* when borrowings are taken.

Conversely, interest on a conventional term loan, usually the prime rate plus one or two points, is calculated on *all* cash borrowed, whether it is used or idle in the company's checking account.

Lost opportunities are another hidden cost factor. When the lack of cash availability forces a company to turn down sales or other business opportunities, that lost profit also should be included in any cost-of-capital decision.

Negotiating Ideas

- Negotiate hard for a high advance rate, e.g., 80% on accounts receivable rather than 70%. The 10% difference represents $10,000 or 10% more capital per $100,000 loan amount.

- Pay interest on the *average* monies advanced each month. As indicated, that will reduce your annual interest cost.

- Know how much you need to borrow. Project your company's sales, accounts receivable, and inventory. Be sure the *contractual* advance rate on these assets meets your working capital needs. If it doesn't, you will have difficulty raising more capital since a lender already has a lien on the company's most liquid assets.

- If there are other lender charges, e.g., audit fees for verifying and monitoring the assets, don't leave the amount open; spell out the exact fees and how often they will be charged. Also build in these added costs when comparing your financing alternatives.

- Don't give a lender a *general lien* on all of the company's assets without first determining how much money you need and what can be borrowed on each asset. For example, equipment loans can many times generate additional capital of up to 60% of the equipment's appraised value.

- Try not to personally guarantee the asset-based loan, particularly if it's already *adequately* secured by the company's assets.

- Be aware of an *after-acquired clause* in the loan agreement. This gives the lender an *automatic* lien on future asset purchases, e.g., equipment acquired after the original date of the loan agreement. This clause will lessen your ability to raise capital for future equipment purchases.

- Pursue several sources of capital. The interest rate, fees, and loan conditions differ greatly among lenders.

Lastly, agree to let a lender *buy* your accounts receivable *only* in extreme cases, such as when your company has losses and serious cash flow problems. In those cases, customers are usually notified of the arrangement by the lender, which can seriously affect your customer relationships.

Stretch-Out Loans

In stretch-out loans, the maturity date of the loan stays fixed as a term loan but the repayment terms are structured over a longer period. They are appropriate in a variety of situations:

- if you need more time to repay a loan than a lender typically grants in your situation,
- if you want to lock in a source of capital and an interest rate for the future,
- if you don't want the hassle of renegotiating loan agreements over the next few years, or
- if you want to maximize cash flow in the next few years.

Stretch-out loans are available from most lenders for both business and personal needs, including some mortgage financings. One frequently-used version is called the *five-year loan with a seven-year payout* which can even be designed with a balloon payment due at loan maturity. Stretch-outs are principally used by borrowers when a lender has policies prohibiting loans that extend beyond a certain period, e.g., no more than five years on equipment loans. But they also can be advantageous on level term loans where the interest rate is substantially higher or lower than current rates. Here you want the flexibility of stepping up or stretching out repayments without penalty if interest rates change substantially from the rate you're paying.

The use of stretch-out loans can greatly increase the *average* amount of capital available to a business. In the example below, the borrower has 19% more capital available to him than with a straight five-year loan. *Here's how it works.*

Let's assume you want to borrow $140,000 on a term basis. If the loan is repaid equally over five years, the principal repayments are $28,000 a year. However, if the principal repayments are structured as a *seven-year* loan with a balloon payment, the following table reflects the increase in the total amount of capital available for a business' use. (For simplicity purposes, we will assume the repayments are made at the end of the year; thus, the loan balance at the beginning of each year is available for the entire year.)

Comparative Repayment Schedule

	5-Year Loan		**7-Year Payout**	
Years	Repayment	Capital Available	Repayment	Capital Available
1	$ 28,000	$140,000	$ 20,000	$140,000
2	28,000	112,000	20,000	120,000
3	28,000	84,000	20,000	100,000
4	28,000	56,000	20,000	80,000
5	28,000	28,000	60,000	60,000
	$140,000	$420,000	$140,000	$500,000
Average Capital Available Annually		$ 84,000		$100,000

Get 19% more capital: The total capital available to the business with a level term loan is $420,000 for the full 5-year period. In contrast, $500,000 is available with the 7-year payout arrangement — an increase of $80,000 or 19% additional capital. *Another way to calculate:* In the straight 5-year loan, the borrower has the average annual use of $84,000 (total capital of $420,000 divided by five years). With the 7-year payout, the *average* available capital is $100,000 ($500,000 divided by five years); again, 19% more capital.

What to do: If you can earn more on your borrowed money than the interest rate you're paying, then make liberal repayment terms a priority in your loan agreement negotiations to obtain the maximum amount of capital. As illustrated, the emphasis should be not just on the loan amount, but on the average annual capital available for your company's use.

List of Asset-Based Lenders

If you are contemplating an asset-based financing or already have one, there is more information on the subject available from the *Commercial Finance Association* (CFA), an association of asset-based lenders. CFA also publishes *The Secured Lender,* a bimonthly publication on asset-based lending.

To obtain the name, address, and telephone number of more than 250 asset-based lenders, visit CFA's website at www.cfa.com. For the list of lenders by state, **click** Find a Lender and complete the information requested. ☐

Negotiating how the loan is to be repaid can be just as important as the interest rate.

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