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Where to Go When Your Bank Says No

A bank isn't the final word on financing. Here are other options business owners have to raise cash.

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It takes money to make money, as any business owner knows. But many small businesses also know what it's like to be turned down by a bank for a loan or line of credit, not get as much as they need, or simply not get the cash quickly enough to take advantage of an opportunity.

It's not just start-ups that run into financing difficulties. Even an established company that is growing rapidly will frequently have financial challenges. To make matters worse, owners of small businesses have an especially difficult time getting business credit without relying on their own personal credit and assets as guarantees. But there are alternative financing methods that business owners should know about: accounts receivable financing (also called "factoring"), purchase order financing and merchant card (or credit card) receivables financing. These are all alternatives to traditional asset-based lending or bank financing. They are frequently used as "bridge," or short-term, financing until companies can qualify for bank financing, although some companies choose to use these techniques on a longer-term basis. Because these tend to be higher-cost ways to raise funds, they're best used by firms that operate with good profit margins.

For many business owners, these alternatives help them avoid taking the route that strapped business owners take: selling a share of the business to an investor or partner. With alternative financing, an owner doesn't dilute his or her ownership stake or control of the business.

Unlike in traditional lending, where the company's financial strength is a determining factor in getting a loan, in these alternative financing methods, invoices, purchase orders, credit card receivables and the quality of the client's debtors or suppliers are the determining factors in providing financing. These methods can provide financing quickly and simply.

The most familiar method of alternative financing is "accounts receivable" financing, often referred to as factoring. Factoring, which accounts for about $4 trillion a year in lending in the U.S., uses the assets of the business — namely a business's accounts receivable — to secure financing by a financial organization. The financing company examines an aging report of the client's debtors, looks at their creditworthiness and does a search of the client's business and its owner's past history. Funding can be provided in as little as three to seven days after application. Factoring is the most commonly used method of alternative financing, and we'll examine it in more detail below.

Purchase order financing (sometimes called purchase order factoring) involves financing before a company has accounts receivable to factor; at this earlier stage, a business has received a purchase order. Often it's used if a company gets an order that is much larger than the orders it typically receives, and doesn't have a sufficient line of credit with a bank or sufficient terms with a supplier to cover such an order. Usually purchase order financing is used in conjunction with accounts receivable financing. A purchase order financing company provides the cash to complete production of an order, and when it's finished (and an invoice has been generated), the invoice is sold to an accounts receivable financing company, which finishes the transaction.

Typically purchase order financing companies charge about 2.5% to 4% in fees per 30 day period. (For a case study on how one New York area food processing company has successfully used purchase order financing click here.) Another alternative funding source is merchant card receivables financing (also called credit card factoring or merchant advances). This is a newer form of alternative financing. Credit card factoring companies focus on the restaurant, catalog and other merchant categories where credit card payments account for a large percentage of total sales but cash flow is irregular. Basically, the company sells future credit card receivables. The financing company will typically advance a business owner up to one month's average credit card receivables. Typically loans are in the $10,000 to $30,000 range. Fees are steep, often about 35% of the amount borrowed. To qualify for this type of financing, a business generally needs at least $5,000 a month in credit card receivables and must have been in business for at least six months. According to Dean Landis, president of Credit Cash, a Manhattan financing company, there are other types of credit card receivables financing, with lower rates, available for companies with higher levels of monthly credit card receivables.

By far the most common type of alternative financing used is accounts receivable financing or factoring. Accounts receivable financing is often referred to as "transaction financing." Combined with purchase order financing, it is a useful way to increase sales volume without the obligation of a loan or the need to pursue venture capital when the size of the orders that a company receives grows more rapidly than does the company's available traditional financing.

Within this world of factoring are two main types of financing. Traditional factoring, which has been a cornerstone of the apparel industry, is typically done on an "all-sales contract" where all the firm's invoices must run through the factoring company. In traditional factoring, a company's accounts receivable are used as an asset to borrow against. The factoring company charges an interest rate, generally anywhere from the prevailing prime rate to 5 percentage points over that rate. The factoring company provides credit protection for the borrower, as well as back-office services such as performing a credit check on the debtors. In non-traditional factoring (sometimes called discount factoring), which is mostly used for the manufacturing, distribution and service industries, the financing is not a loan but rather an advance against the value of the invoice. Credit protection is provided as well; however, the client can actually pick and choose which invoices to sell to the factor and does not need to sell all of them. It is typically termed a "pick-and choose contract." See the illustration at left for an example of how this works.

Another difference between traditional factoring vs. discount factoring is the way fees are charged. A traditional factoring firm charges a fee for all the invoices that it handles in addition to the interest rate charged on the loan. In discount factoring, the fees are generally about 2.5% to 3% of the amount advanced to the small business for 30 days of funds outstanding. (If fees are outstanding longer, there are additional costs.) Those fees also include credit protection and back-office services, such as performing a credit check of the debtors, verification of the receivables and handling wire transfers, as well as, of course, making the funds available to the client.

These alternative financing methods can seem like an expensive way to raise funds. But business owners who can't get bank financing need to weigh that against other considerations. Could you get better terms from your suppliers — and save money — if you paid cash up front? Do you turn away business because you cannot finance its growth? Do you lose out on good purchase opportunities due to a lack of cash flow? Are you constantly dipping into your personal assets to finance your business beyond your own comfort level? Has your business stagnated due to lack of cash for marketing programs?

A factoring firm provides another service to business owners by thoroughly investigating the credit history and credit strength of your customers. An accounts receivable financing firm will also provide back-office service such as placing calls to your clients to make sure that invoices are paid when the invoice is due for payment. Some industries that typically are good candidates for factoring (besides the garment industry) are heavy and light manufacturing companies, construction companies — in short, any business that carries accounts receivable and cannot grow its business due to a lack of cash. If you've decided to go with a factoring firm, how can you find a good one? There is a trade association, the Commercial Finance Association (cfa.com), which has a directory of members on its website. As with any professional service, it helps to ask business associates for recommendations on firms. You want to look for an alternative financing firm that has plenty of experience in your industry and in doing deals the size you need. Most firms do tend to specialize in both categories. Ask for references — and check them — for any firm you're considering.

Because a factoring firm may be dealing directly with your customers when it verifies receivables or collects them, you want to make sure you're comfortable with how it deals with your clients.

Look for a firm that's willing to be flexible about its terms. Many factoring companies want to lock you in to a contract that requires certain minimum monthly fees for a period of time (perhaps as much as a year or two), even if you don't want to use accounts receivable financing every single month. There are companies out there that won't insist on this. How long do business owners need to use alternative financing? It varies: Some need only to cover a short-term gap, while for others, it's a permanent part of their business plan. One longterm client of our firm has said he prefers to continue to use factoring, even though his company qualifies for bank financing, because the bank would still require his personal credit guarantee. "Why should I put my personal assets on the line?" he says. "The business should pay for itself."

It's clear that on an annual percentage rate, credit line financing from a bank is cheaper. Once a company fully qualifies for a large enough credit line with a bank, this may be the preferred route. But until then, consider alternative financing as a way to quickly and easily grow your business.

THE MECHANICS OF FACTORING

Below is an illustration of how factoring, or accounts receivable financing might work in a small business.

THE ORDER

Your business receives $1 million order for your product. The order will cost you $750,000 to fill and you only have credit with your supplier for 30 days. The client who placed the order won't make payment until 45-60 days after the order is received.

THE PROBLEM

Since there's a 15-30 day gap, you can't fill the order, as your supplier won't extend terms. You have a $100,000 credit line at your bank, but the bank won't extend that to $750,000 (or can't do it quickly enough.)

THE SOLUTION

You fill the order, and then sell your $1 million invoice to a factoring company. After verifying the receivable, the company advances you 75% of the invoice (or $750,000) to pay your supplier.

When the customer pays the factoring company, it deducts its fees – approximately 2.5% to 3% of the invoice for this 30 day gap in payment, or $25,000 to $30,000, and sends you the remainder of the invoice amount. Your gross profit margin of 25% has been reduced to about 23%, or $220,000 to $220,500 .