

Finance High Sales Growth; Retain Control and Equity

Introduction

Fast-growth businesses and seasonal businesses find it hard to raise the financing they need to get to the next level. Commercial banks like 1-2:1 debt-equity levels and smooth revenues. Venture capitalists like boat-loads of equity and tons of control. Are there other alternatives?

The focus of this report is working capital finance, a source of financing that allows growth-hungry entrepreneurs and executives to flexibly grow their sales. After reading this short report, you will have a good understanding of how to (1) finance your high growth business, and (2) increase your sales all without giving up control of your business or watching your equity disappear.

This easily-digested report is arranged in a case-study/Q&A format so that you will get the most out of it in the least amount of time with very little effort.

Case-Study

Jack Johnson, the founder and CEO of XOtech, was stressed. He'd just received good news – a colossal order that required XOtech to increase production 200%. But, as the saying goes, with the good comes the bad. In Jack's case, the bad was XOtech reaching the limit of its revolving line of credit. Jack spoke with Mr. Smith, XOtech's bank loan officer, and was told that yet another extension was out of the question. Jack was not about to allow XOtech's low cash balance to dictate XOtech's ability to complete a sale. If XOtech didn't accept the order in 3 weeks, some other company would benefit at XOtech's expense and that didn't sit well with Jack.

Five years ago, Jack had started XOtech as a supplier of cutting-edge egadgets. After two years of strong sales, the egadget business went into a serious slump. Parts and labor cost a fortune and pricing seemed to erode by the minute! Jack immediately put XOtech into crisis mode and settled on a solution: XOtech would unite the egadget technology with old-tech and become the only producer of the "we-gadget." This "new" product was marketed as a next-generation solution that cut one step out of a process by uniting two related steps. After three years of investment and painful improvements, the we-gadget finally took off.

Learning from his egadgets experience, Jack had lowered his labor costs by shifting production of the we-gadget old-tech component to a Chinese manufacturer. To increase sales, Jack spent an incredible amount of time building non-U.S. sales. If only he could solve the financing problem. XOtech's bank refused to increase its credit. Mr. Smith thought Jack was moving too fast, didn't know how to quantify the increasing foreign risk, and overvalued the we-gadget technology.

Exploring his options, Jack had approached a few venture capitalists. They were receptive, but Jack wasn't comfortable with the idea of giving up 30% or so of XOtech, even in exchange for cash, contacts and management "advice." Besides, from what he knew, it would take six months just to negotiate a deal, and XOtech couldn't afford to wait six months.

Massaging his temples, Jack went over XOtech's situation again. If XOtech could deliver on the order, XOtech would gain a marquee customer and would be set to exceed growth targets. If XOtech passed on the sale, XOtech might very well miss its opportunity to dominate the we-gadget market before it matured.

Jack needed help; he decided to call his friend Dave. A good guy, Dave was an old college buddy. Very reliable, business savvy and financially experienced. Dave had taken his company, midCO, on a whirlwind ride and the rumor was that midCO was on the fast track to an IPO. Dave said three words to Jack, "Working Capital Finance," and then prepared for Jack's questions. Jack fired away:

What is working capital finance?

Working capital finance is a way to grow your business by adjusting your company's mix of current assets to increase the cash that is available (liquidity). Let me explain.

Working capital = *current assets* (cash + accounts receivable + inventory) – *current liabilities* (accounts payable)

In a healthy company, current assets exceed current liabilities and working capital is a positive number. A rapidly growing company, such as XOtech, may have a situation where cash is low, but there is a large amount of accounts receivable or inventory that is covered by purchase orders and waiting to be shipped. A company in this situation may be able to receive cash advances based on the strength of its accounts receivable, inventory or purchase orders.

So, working capital finance helps me to increase my liquidity?

Jack, in your case, let's say you decide to move to the purchase order stage with that excellent, credit-worthy customer. Although XOtech is short of cash, because you have such a large order from an excellent customer, you would be able to use that purchase order to receive an advance on the total sale amount. In a relatively short time period. Here's a quick example –

Let's say XOtech's working capital is as follows:

Working capital = \$1 = *current assets* (cash [\$1] + accounts receivable [\$1] + inventory [\$1]) – *current liabilities* (accounts payable [\$2])

Using its purchase orders, XOtech receives \$1 in financing that is secured by a commercial finance company's (CFC) claim on XOtech's inventory. The inventory [\$1] + the CFC's claim on the inventory [-\$1] nets out to zero [\$0]. Here's how the working capital changes

Working capital = \$1 = *current assets* (cash [\$2] + accounts receivable [\$1] + inventory [\$1-1 = 0]) – *current liabilities* (accounts payable [\$2]).

XOtech has now increased its available cash from \$1 to \$2, putting itself in position to fulfill its purchase orders. The working capital number hasn't changed (it's still \$1) but the overall working capital mix did change!

I need to increase sales. How does working capital finance help me?

Well, now that you have adjusted your mix of working capital (see the previous question), you will have more liquidity to drive sales. Jack, this large XOtech order is the perfect example. Now, I don't know the exact facts of your situation but I can think of a couple of things off the top of my head.

1. You received the order, but inventory is low and the remaining units have yet to be manufactured. Your new liquidity can be used to order parts, pay your employees – whatever needs to be done to produce the remaining units and satisfy that purchase order.
2. I remember you telling me that XOtech had the old-tech portion of the we-gadget manufactured in China and manufactured the high-value we-gadget component at XOtech's current facilities. In this case, XOtech's new liquidity could be used to pay your Chinese supplier and fund final assembly and delivery.

As you can see from just those two examples, working capital finance is a powerful tool that you can use to increase your liquidity and increase your sales by covering items such as staffing, purchasing parts, funding external manufacture, shipping/delivery costs – all the things you need to do to complete your sale.

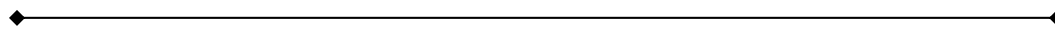
This sounds like venture capital. Do I have to give up equity?

The short answer is NO, you will not give up *any* equity because this is *not* venture capital. Venture capitalists make long term investments in high-growth, high-potential companies with the goal of adding value to the company and then selling their equity at a huge gain.

Companies that specialize in financing working capital, commercial finance companies (CFCs), focus on companies that have high sales growth and customers with excellent reputation and credit quality, and advance those companies funds. CFCs have more in common with commercial banks than they do with venture capitalists.

Venture Capital

Bank Loan



Working Capital Finance

How is it possible that I avoid giving up control?

The key thing that you have to remember is that providers of working capital finance, commercial finance companies (CFCs), have more in common with your traditional lender than they do with venture capitalists or private equity funds. CFCs *advance* you funds based on the strength of your assets – accounts receivable, inventory, purchase orders...maybe even the items that are being purchased. The advance that is made is secured by certain of your company's assets. In the unlikely event something goes wrong, the CFC can claim the assets that secure the advance and, by doing so, make up for any loss. This provides the CFC with a level of comfort. Because CFCs protect themselves by only advancing funds against sound assets, they do not need to take a controlling interest in your company such as voting rights or board seats.



Compare CFCs with venture capitalists and private equity funds. Venture capitalists and private equity funds base their *investment* in a company on that company's projected future cash flow. Their investment is not secured by anything and they risk losing their entire investment. Because of the extremely risky nature of this type of investment, venture capitalists and private equity funds remain very involved in (actively manage) any company they invest in. This "involvement" typically takes the form of voting rights, board seats, etc.

I like not giving up control. Tell me more about these commercial finance companies.

Commercial finance companies (CFCs) are companies that specialize in helping you finance your working capital by advancing you money based on the strength of your accounts receivable, inventory, purchase orders or maybe even the items that are being purchased. CFCs try to meet your company's particular needs by offering a number of different "products." Each "product" is tailored to a particular situation. For example, XOtech would probably be best served by seeking purchase order financing – a CFC "product" that focuses on advancing funds to a company based on the strength of that company's purchase orders. Many CFCs offer a broad range of "products" but typically have developed a specialty in one particular "product." Some CFC's are very specialized and only focus on one "product."

What are some working capital finance "products"?

There are a number of products out there, but let's focus on the products that are most likely to be immediately applicable to your current circumstances. Those products are: (1) purchase order finance; (2) assignment of accounts receivable; and (3) non-recourse assignment of accounts receivable – also known as a *forfait* transaction. Here's a little background on each product:

Purchase Order Finance

What it is: a way for you to quickly raise the financing that you need to complete your sale by using purchase orders from low credit-risk customers to secure an advance.

The best way to understand purchase order finance is to compare it to using a mortgage to buy a house – the bank gives you the money *only* because it knows that if you stop paying it can sell your house to get its money back. In purchase order finance, the CFC acts as the "bank" and advances you funds based on its conclusion that that you are very likely to be paid and various forms of collateral, the purchase order and collateral being analogous to the house in the mortgage transaction.

How it works:

- You receive a sizeable purchase order from a buyer who has excellent credit or is a well-known, respected company – this is a "strong" purchase order;
- You approach a CFC with your strong purchase order and make known your need/desire to finance a large sale;
- The CFC makes its own determination as to the strength of your purchase order and its willingness to finance your sale;
- If the CFC agrees to do the deal, you receive an advance of funds up to the full amount of the purchase order.



AbdulJaami, PLLC

International Commercial Transactions

How you benefit:

- Financing – you receive the financing you need to complete the sale, satisfy a customer and increase profits
- A fast decision – the whole deal, from start to finish, can take 2-3 weeks
- Power to grow – your growth is no longer restrained by limited cash on hand or restrictive bank borrowing terms
- Flexibility – Unlike term loans or revolving loans, you are not locked in to debt-service obligations or origination or draw-down fees
- Control – no new shareholders or board members “back-seat driving”
- Maintain equity – you do not suffer an equity dilution because funds are advanced to you

Assignment of Accounts Receivable

What it is: a way for you to quickly raise financing by “selling” your immature accounts receivable to a commercial finance company.

Here’s a simple way to think of this type of financing deal: low credit-risk Johnny owes you \$10 and is going to pay you \$10 thirty days from now; You need money today; in exchange for me paying you \$9.80 today, you give me the right to collect from Johnny 30 days from now; if for some strange reason Johnny doesn’t pay me \$10 thirty days from now, you promise to make good on the debt.

How it works:

- You complete sale transactions and generate strong, immature accounts receivable
- You approach CFC with strong, immature accounts receivable
- CFC examines your accounts receivable and makes a determination as to strength, cost of collection and time value of money
- If CFC agrees to do the deal, you receive the full value of the mature accounts receivable *minus* an amount that compensates the CFC for cost of collection and time value of money

How you benefit:

- Financing – you are able to obtain cash for your immature accounts receivable
- A fast decision – the whole deal, from start to finish, can take 2-3 weeks
- Shorter collection cycle – the faster you turn around your accounts receivable, the faster you can reinvest in and grow your business
- Control – no new shareholders or board members “back-seat driving”
- Maintain equity – your sale of accounts receivable does not force you to issue more equity or sell the equity that you’ve already built

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Forfait Transaction

What it is: a way for you to quickly raise financing by selling your medium-term accounts receivable to a commercial finance company (CFC); you have no obligation for the CFC's inability to collect on the accounts receivable.

Here's a simple way to think of a forfait transaction: low credit-risk Johnny owes you \$10 and is going to pay you \$10 thirty days from now; You need money today; in exchange for me pay you \$9.80 today, you'll give me the right to collect from Johnny 30 days from now; if for some strange reason Johnny doesn't pay me \$10 thirty days from now, it's 100% my problem.

The word forfait comes from the French term "à forfait" meaning to give up the rights to something, and perfectly describes this kind of non-recourse assignment (non-recourse meaning, "You bought it from me and now it's your problem.")

How it works:

- You generate strong 60-90 day accounts receivable from low credit-risk customers supported by a bank guarantee
- You approach CFC with strong medium-term accounts receivable
- CFC examines your accounts receivable and makes a determination as to its strength, quality of any additional credit support (e.g. bank guarantee) and time value of money
- If CFC agrees to do the deal, you receive the full value of the mature accounts receivable *minus* an amount that compensates the CFC for cost of collection, time value of money, and any collection risk

How you benefit:

- Financing – you are able to obtain cash for your immature medium-term accounts receivable
- A fast decision – the whole deal, from start to finish, can take 2-3 weeks
- Shorter collection cycle – the faster you turn around your accounts receivable, the faster you can reinvest in and grow your business
- Reduction in risk – due to the non-recourse nature of the transaction, you immediately avoid any collection risk
- Currency risk – because the CFC will pay you in U.S. dollars, you also avoid any currency risk
- Control – no new shareholders or board members "back-seat driving"
- Maintain equity – your sale of accounts receivable does not force you to issue more equity or sell the equity that you've already built



I'm still not clear on a few things. For starters, what's the decision-making process? How long before I know how much and when I will receive financing? What are the typical costs?

Decision Process and Timing

Commercial finance companies (CFCs) are staffed leanly and don't have the layers of management or elaborate approval mechanisms that bank lenders have. This means that a CFC is able to examine your particular situation and take 2-3 days to decide whether to proceed. After the decision to proceed is made, there is typically a period of time during which the CFC gets a better feel for your company by performing an evaluation of your company's financial strength and growth prospects. Once they are satisfied with the results of their evaluation, funds will be disbursed to you. This entire process can be as short as 2 to 3 weeks. Of course, if a transaction is particularly complex, the process could take more time.

Typical Cost of Financing

Similar to other forms of financing, working capital finance transactions fluctuate and are highly dependent on the specific circumstances of a particular transaction. With that being said, working capital finance can be expected to be a small percentage (low single or below-single digits) of the transaction amount. The typical breakdown is the interest fee plus any service charges, such as a charge to collect on a purchased receivable.

What can I do to increase the likelihood of my getting financing?

There are certain general characteristics that all commercial finance companies (CFCs) like to see:

- Strong growth in sales;
- Good financial health;
- A company that is growing rapidly;
- Quality customers especially with regard to purchase orders and accounts receivable; and
- An excellent management team that has worked together for several years.

For any particular transaction, a CFC may have concerns that are specific. For example in a forfait transaction, the CFC may be very interested in knowing that the accounts receivable are attributable to a well-known customer that has very strong credit or may require that the accounts receivable be backed by a bank guarantee.

To maximize the likelihood of getting financing from the CFC most suited to being your company's partner, you should seek the advice of a knowledgeable professional. XOTech meets many if not all of the above-listed general characteristics, but unique arrangements, such as manufacturing the old-tech component in China, may increase the complexity of a proposed transaction or even open up new financing possibilities.

How do I go about finding these finance companies and what's the process?

CFCs advertise in newspapers and magazines and can also be found through searches of the world wide web. However, the best way to find a CFC is by either consulting with one of your current professional advisors or contacting a knowledgeable advisor who can assist you in your search by providing helpful insight based on experience.



This working capital finance stuff sounds interesting, but I'm not sure it's the right thing for my company.

Jack, I agree. Working capital finance is an excellent option if your company's sales are booming and putting extreme stress on your cash, or if your business is highly seasonal with wide fluctuations in revenue. A few years ago, many people thought working capital finance was strictly for manufacturing companies; boy has that changed! I used working capital finance to grow midCO's sales 20% -- and we specialize in information technology. Even service businesses are beginning to aggressively use working capital finance to blow through their sales targets.

Now here's where you have to be careful. If XOtech is on shaky financial ground and you want to use working capital finance to pull XOtech through, think again. Commercial finance companies tend to stick to their specialty – financing healthy, growing companies. Similarly, if XOtech's customers are poor credit risks, or are very slow paying invoices, CFCs might pass.

I'll fax you two very simple cash-flow charts that I put together to figure out whether to use working capital finance to take on a huge purchase order.

[This is what Dave faxed to Jack]

Standard Sales Picture – midCO REFUSES “Grand Slam” order

	Month 1	Month 2	Month 3	Month 4
Sales	100	101	102	103
Revenue from Sales			100	101
Expenses	80	80.8	81.6	82.4
Balance	(80)	(80.8)	18.4	18.6
Previous Balance		(80)	(160.8)	(142.4)
Balance Carry forward	(80)	(160.8)	(142.4)	(123.8)

Growth Sales Picture – midCO (using PO Finance) ACCEPTS “Grand Slam” order

	Month 1	Month 2	Month 3	Month 4
Sales	100	101 + 100 = 201	102	103
Revenue from Sales		80 (80% prepay on 100 sale)	100	101 + 18 (remaining 20% – fees)
Expenses	80	160.8	81.6	82.4
Balance	(80)	(80.8)	18.4	36.6
Previous Balance		(80)	(160.8)	(142.4)
Balance Carry forward	(80)	(160.8)	(142.4)	(105.8)

Jack, just so you know, I assumed that:

- from a baseline of 100, we would capture one additional sale per month;
- expenses would be 80% of sales;
- during month 2 we would get a “Grand Slam” order that would require double our monthly output;
- we would not have enough cash on hand to take the “Grand Slam” order;
- we would not be able to get bank financing or venture capital;
- we would be able to get purchase order finance with an 80% advance and the remaining 20% being paid out when the customer paid in full;
- the purchase order finance fees and service charges would be 2%;

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Jack compared the charts for a few minutes, opened his mouth, shut it, and then stood up. “Dave, unless I’m reading this chart wrong, using this working capital finance stuff, you guys did twice the sales and ended up in the exact same position.” Dave replied, “Sort of; except you need to factor in the profit that hit our bottom line at the end of Month 4.”

When Jack finally hung up the phone, he was eager to boost XOtech’s capacity to grow its sales. All he had to do was learn a little bit more about working capital finance...

Get More Information

The author of this report, Saboor H. AbdulJaami, advises on commercial finance transactions. Call Saboor (+1.646.435.0668) to find out how you and your company can use working capital finance to your benefit.

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