

## Just Do More: Trade Finance Companies Provide Flexible Solutions By: Joseph Ingrassia

### What is it and How Much Will it Cost Me?

Each time a prospective borrower calls to inquire about asset based financial services, the first question they often ask is how much the financing will cost them. The business development officer's objective in this initial telephone encounter should be to learn as much about the company, its principals and its product so they may determine if the potential borrower is a candidate for typical, asset based financing or an alternative financing opportunity such as purchase order financing or accounts receivable factoring.

Potential borrowers such as licensee's, distributors, or contract manufacturers whose sales are under \$10,000,000 per annum do not typically have access to banks or finance companies because they may be experiencing rapid growth beyond their equity and may lack the proper credit to borrow on the basis of their own credit or balance sheet. Borrowers who fall into this category are almost always well suited for purchase order financing or accounts receivable factoring. Because they are typically working with secondary lenders, their cost of capital will be substantially greater than that offered to creditworthy borrowers. Clients in this secondary market must understand the benefits of incremental sales financing and its positive impact to their bottom line.

In most cases, these borrowers are typically experiencing some form of rapid growth or financial distress stemming from:

- Undercapitalization ranging from the lack of sufficient assets to pledge to a bank or finance company
- A lengthy trade cycle which requires the acquisition of finished goods from a supplier that requires cash in advance or cash upon shipment and then must offer terms of 60 to 90 days to their account debtors
- Products that are in such high demand that the borrower either misses sales opportunities because of their lack of capital.
- Customers terminate the relationship with the borrower because they cannot supply their product line in sufficient quantities to support the customer's demand for their goods.

### Consolidation

Over the last five years banks, non-bank financial services companies, retailers and industrial companies have consolidated to the point where most banks and top tier financial services companies want loan transactions above \$10,000,000 and the opening orders from the chain department stores, chain discount stores and industrial companies are in the millions of dollars. The opening order is often followed by a second order in the millions of dollars creating further difficulty for the undercapitalized distributor, licensee or contract manufacturer. Their own success can put them out of business or forever leave them in the category of having permanent potential. These

companies may have the opportunity to post substantial growth charts but because they lack new technology or significant product differentiation they cannot access the public or private equity markets for the capital necessary to support the growth of their business. In years past an executive who once worked for a large company who had saved over his career and possibly received a package to retire early could parlay his savings and retirement package into a distribution business. However as a result of the consolidation described above there is a limited the chance of this happening.

### Go Against Conventional Wisdom

In order to succeed, talented executives and energetic entrepreneurs starting their own companies and energetic entrepreneurs must find a financial solution that will support them in sufficient scale so that they can compete in today's consolidated marketplace. Conventional wisdom would suggest that they seek out an accounts receivable factoring company who will create liquidity for them once they deliver their merchandise to their account debtor. In theory, this makes very good sense, but often in practice it does not work. The limitations of factoring are such that the goods must be delivered before a business owner can create leverage on the asset and see any liquidity. This leaves a large gap in the trade cycle that is the acquisition of the goods which is essential to creating the invoice that provides the liquidity to pay for the goods. Most foreign suppliers will not provide trade credit to small companies that pose a significant credit risk to the manufacturer.

The reasons why they are unable to provide credit to smaller companies are obvious. To be successful, the undercapitalized talented executive or energetic entrepreneur needs assistance at the time they are acquiring their finished goods from their supplier. Some factors will provide this service by issuing a letter of credit against availability of approved accounts receivable balances and call this purchase order financing. Trade finance companies and trading companies actually provide direct supplier credit facilities to growing companies when they are able to sell their merchandise to approved buyers.

### Credit Risk

Trade finance companies differ from factors in that the two companies look at risk very differently. Factors typically look to the account debtor credit risk in a given transaction and if they are able to mitigate the credit risk they will factor a company's accounts receivable. That is why they accommodate a clients' request and assist a client in the purchase of goods by issuing some form of trade credit against account receivable availability. This form of purchase order financing limits a clients' growth by its ability to create accounts receivable. If the client has limited capital and the factor restricts the trade credit based on accounts receivable availability the client is faced with either no working capital or haphazard growth prospects.

Trade finance companies, on the other hand, look to mitigate performance risk that is a combination of ensuring that the manufacturer or supplier is producing the product in question to the standards of the ultimate buyer and putting sufficient controls in place to control for a positive outcome. In addition, trade finance companies want to ensure that the goods have been sold and that the buyer is not speculating on inventory for a future sale. Further, trade finance companies typically are involved in controlling the goods until they are delivered to the credit approved account debtor. If a client is willing to work within this type of structure -- that requires the loss of some control -- they have an opportunity to substantially grow their business to the extent that their customers want the goods they are marketing. Their growth is no longer determined by their balance sheet or lack thereof or the value of their accounts receivable. Their growth is now determined by their ability to receive purchase orders from creditworthy accounts.

### **Structure of a Deal**

The underwriting process for a trade financing transaction follows a somewhat predictable pattern. After the typical due diligence of meeting the client, analyzing the potential of the sell through of the merchandise, lien searches, management resumes etc. what criteria can make or break a deal? The key elements to underwriting a trade finance transaction are: (1) the gross margin calculation; (2) ability of the supplier to produce a quality product in a timely manner; (3) transaction cycle timing; (4) control of the goods; (5) control of the accounts receivable collections; and, (6) credit risk mitigation.

Capstone Business Credit finds that most clients do not fully benefit from their new-found status as being creditworthy with their suppliers. In many instances because of the clients' inconsistent purchasing patterns they are often paying more for their goods than they should be.

As part of a deal structure, credit support can be provided and as a result, sales volume increases dramatically. At Capstone, we offer, through our contacts abroad, a service at no charge to the client to find an alternative source to manufacture their goods. This often results in an increase in the gross margin earned by our clients. Often times the existing manufacturer is willing to offer the same price we were able to negotiate with the alternate supplier to avoid loss of the client's business.

In terms of reducing risk, the cost of goods sold is lower for the client and the gross margin is greater, (the difference between the wholesale price and the cost of goods is greater). The larger gross margin also allows the client when necessary to provide price concessions to his buyer without compromising his original gross margin. Although the client is experiencing significant growth it is not always evident to him to ask for price concessions from his supplier. Many times the client is still struggling because he is at the beginning or middle of the growth cycle and does not see the rewards from his increase in sales on a net income basis yet.

### **So, What Will it Cost Me?**

The truth is really nothing at all. In most cases without the help of a trade finance company, the client would lose the opportunity to deliver the presold merchandise and forego all profit related to that transaction. With the assistance of a trade finance company, the client will begin to earn incremental profit

from sales that would have formerly been lost. Let's assume for a moment that a distributor has a gross margin of 30% on a \$100,000 transaction to deliver men's pants to a retailer. The cost of goods sold is \$70,000 and the gross margin is \$30,000. Let's assume that the trade finance company earns approximately 1/3rd of the gross margin over the 120 day trade cycle for providing the capital requirements, transaction structure, monitoring, credit and collection services. This reduces the clients' profit to \$20,000 but the client has earned \$20,000 without any capital in the transaction on a 100% leveraged basis and most likely will get a larger order from his buyer because he delivered a quality product on time versus losing the sale and the customer and earning nothing.

While the traditional lending environment will continue to exist, the structure of trade financing is a growing alternative for firms looking to 'do more' now.

### **Electronic Manufacturer Gets Charge From Purchase Order Financing**

Digital & Wireless Group (D&W) is a contract manufacturer and distributor of travel electronics. These products are used on airplanes to charge cell phones, notebook computers, PDA's etc and are used as power converters and inverters at hotels overseas. They market their product line to the duty free market, airlines, airport shops and cruise ships worldwide.

When we first met D&W for the first six months of the calendar year they had sold approximately \$66,000 of their product to the duty free market with very little dilution. Gross margins were approximately 22%. We began to provide trade finance and maturity factoring to D&W in July 2003 and by December 2003 they had shipped \$400,000 of goods to their suppliers. For the year ending December 2004, the company will ship \$1,000,000 of product with an increase in their gross margin from 22% to 40%. The gross margin increase came as a result of our sourcing it to different producers. The client stayed with his original supplier after they agreed to meet the price of the new supplier. For calendar year 2005 sales based on signed contracts with duty free retailers, the airlines and cruise lines will be in excess of \$2,500,000. Once the sale volume approaches \$1,000,000 in 2005 we will again solicit new manufacturers for competing pricing on the product line to attempt to increase the gross margin for 40% to 50%.

### **ABOUT THE AUTHOR**

Joseph Ingrassia is managing member of Capstone Business Credit, LLC, a NYC-based venture merchant banking firm that provides alternative financing to firms involved in the domestic and international trade of finished consumer and industrial products.

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