

# Incremental Sales Finance: A Vehicle for Small Business Growth

By Joseph Ingrassia

A case study of company growth rates with incremental sales finance.

For most small business owners, the choice of financing runs the gamut from financing one's business on personal credit cards to factoring accounts receivable to conventional asset-based financing. As more companies become virtual, however, in that their strategic assets are typically supply relationships with offshore low-cost-labor countries, asset-based loans are increasingly difficult to use fully unless significant inventories are held in the United States.

The trend has moved away from holding inventory; operating as a just-in-time supplier of goods and services is more typical. Companies go through predictable development cycles: They are financed through the means of the principal owners until such time that they have established a balance sheet that can be leveraged with a bank or finance company in the form of an asset-based loan. Along the way, they may be financed through accounts receivable factoring, which creates more rapid cash flow and can assist a growing company in developing larger trade credit relationships.

This article demonstrates how using an incremental trade finance facility can rapidly increase the growth of two development-stage companies that are in two different phases of growth. In these cases, access to incremental sales finance facilities accelerated the growth of these companies without creating excessive leverage.

## Digital & Wireless Group, Inc.

Digital & Wireless Group, Inc. is a small business that has targeted the consumer travel electronics market. Digital sells its products in duty-free shops throughout the world, in airline catalogs and in-flight.

The company was capitalized with approximately \$270,000 borrowed from a 401k account. First-year sales were approximately \$44,000. The seed capital was invested in market development, product development and a small amount of inventory. Since the owner elected to spend the seed capital instead of leverage it with a bank, he quickly ran out of operating capital and did not have the capacity to increase sales. In order to work through his first year in business, he was forced to make individual financing arrangements with short-term investors who took most of Digital's profit in the form of profit participations. Suppliers who were providing trade credit on a limited basis further reduced profit margins.

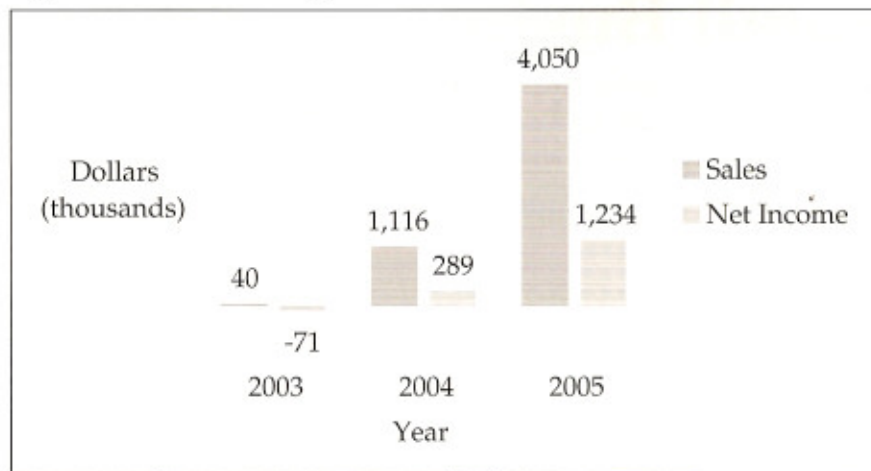
Digital sought the services of a factor to accelerate cash flow, reduce dependence on the profit-participating investors and increase trade credit availability by paying suppliers more reliably according to the negotiated terms. This solution did not resolve the cash crunch. Although sales opportunities dramatically increased, Digital still lacked the capital to support the sell-through of the product line and increase new products to existing customers. Since Digital could only leverage its 22-percent profit from the factor advances and collections, it still did not have enough cash to meet increased demand.

Digital's cash flow could only increase to the extent that it created accounts receivable that qualified for a factor advance at 80 percent. The majority of the factor advances proceeds had to be used to retire the advances made by the profit-participating investors

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Exhibit 1  
Digital & Wireless Group, Inc.



and to pay vendors. This method of financing did not lead to balance-sheet growth. In fact, it had a negative impact, since the cost of funds was so high compared to the prime rate. Digital had consumed the proceeds of the 401k loan and traded the profit-participating, short-term investors for a factor. But in the face of greater demand from customers, Digital's own success and lack of capital was about to put it out of business. (Remember, all of the principal owner's retirement assets were consumed by the business.)

Through a business associate, Digital arranged for a sales-based finance facility with Capstone Business Credit, a New York City merchant banking firm. A sales-based financing facility differs from factoring in that a factor purchases accounts receivable after the goods or services have been delivered and accepted by the account debtor. With a sales-based finance facility, also known as trade finance and purchase order finance, the lender makes an advance against the purchase order to acquire the goods, which are then delivered to the account debtor. Once this process is complete, the customer can then factor the accounts receivable from the account debtor.

This financing provides for rapid growth because the customer does not need the money in the form of equity or credit available to purchase the merchandise required under the purchase order.

The sales facility is designed to provide liquidity to Digital's suppliers when Digital has a purchase order from a factor-approved account debtor. Although the merchant banking firm charges on a profit-participation model (such as the short-term private investor

described above), the merchant bank has significantly greater capital available to develop Digital's markets and support the company's vendors—without asking the vendors to provide additional trade credit. The merchant bank checks credit before the sales call is made, so the account person can focus on the more credit-worthy prospects.

In addition, Digital benefited from its increase in sales. Because sales began to increase rapidly, the merchant bank assisted Digital in renegotiating its cost of goods from suppliers. As a result, Digital's gross margin increased from 22 percent to

48 percent within six months of having access to the sales finance facility. The increase in the gross margin greatly enhanced Digital's profitability and more than covered the cost of the incremental sales finance facility. Sales for the first year using the incremental sales finance facility increased to \$400,000. Sales in year two increased to \$1 million. Sales for year three were projected for \$2.5 million, but booked orders and contracts signed for goods to be delivered in the first half already exceed \$2 million. Management is recasting its projections for sales to top \$4 million in calendar year 2005.

In addition to increasing profitability, the incremental sales finance facility resulted in improved relationships with vendors. The result: Digital's standing with its customers improved because goods were delivered on time and in the quantities ordered. The reliability rating of Digital as a vendor dramatically increased, resulting in larger semiannual contracts and increased store penetration (percentage of a retailer's locations that carry Digital products). This allowed Digital to offer more product SKUs to its customer base and to increase market penetration and sales.

Exhibit 1 shows the growth rate by year and the impact on Digital's bottom line. In year one, the company had an operating loss of \$71,000 on sales of \$400,000. In year two, the company had an operating profit of \$290,000, its cost of goods sold was reduced to 55 percent from 78 percent and the principal was able to return \$100,000 of the \$270,000 loan to his 401k account, leaving net cash of \$190,000 per year.

The capital was used to create a small safety stock of inventory to fill recurring customer orders when demand is greater than expected or shipments from Asia are late. Digital added one staff member in 2004, and the principal began receiving a regular salary. In 2005, Digital added a second employee. If 2005 sales projections are met, Digital will be able to trade its factoring facility for a less expensive accounts receivable financing arrangement and will be less reliant on the merchant bank for financing, since retained earnings after retiring the balance owed on the 401(k) loan will be approximately \$1.1 million.

The impact of the incremental sales finance facility for Digital & Wireless was extremely positive. Since the company has low overhead, the incremental profits generated were significant for such a short period of time (three calendar years). The company is better positioned to take advantage of more conventional financing and to use the incremental sales facility when it expects to increase the size of its business through new product introductions or because its customers increase the size of their market by opening new stores or acquiring competitors.

A bank officer that has a depositor who is undercapitalized with a great business opportunity should have already developed relationships with nonbank financial services companies that could help. Industry trade publications, for example, *ABF JOURNAL*, are a good source of information. The bank officer should contact potential funders and understand what industries and types of transactions they prefer and catalog this information. When the banker cannot assist a customer with a loan, he or she can quickly make a call in the presence of the customer to a potential funder and discuss the transaction and introduce the client.

### Increase Operational Flexibility

Many business owners find that incremental sales finance increases operational flexibility. Borrowing base certificates as they relate to inventory revolving lines of credit can limit sales because the credit facility is typically structured at a percentage of inventory

cost. In comparison, incremental sales facilities cover the cost of goods sold and are immediately turned into accounts receivable upon delivery to the end buyer. Most banks, asset-based lenders and factors enter into intercreditor agreements to facilitate the repayment to the incremental sales financier of the cost of goods purchased and the related fees. Often, business owners retain the incremental sales facility because of the advantages it provides to take on opportunities that would be outside of their asset-based lending or factoring formulas.

### Complete Flooring Systems Corporation

Complete Flooring Systems Corporation is a U.S.-based wood flooring company that sells bamboo flooring, hardwood flooring and laminated flooring products. A related company in China manufactures the products. Payment for container shipments is required within days of issuance of the ocean bill of lading. The owners of the company had invested

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*The supply chain could last as long as 180 days from the acquisition of raw materials to the final account settlement from the big box retailer.*

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significant sums of money in plant and equipment in China. They operate two plants there, one that manufactures the wood flooring products and a second that finishes the flooring with stains tailored to the U.S. and Japanese markets. The company also offers a complete line of millwork custom colored to match its flooring products.

The capitalization of the U.S. distribution company was completed through a business loan that was secured by the business assets in the United States and a first mortgage credit line on the principal's home in Georgia. The credit line was \$150,000. Because of the requirement to pay upon issuance of the ocean bill of lading, Complete Flooring had been having its customers prepay. This inelegant solution severely reduced sales volume, since customers were required to pay as much as 45 days before receipt of the goods. Because of the prepayment, Complete Flooring was making price concessions. Complete Flooring became a low-cost supplier to very well-capitalized home improvement product

*Exhibit 2*  
*Impact of an Incremental Sales Finance Facility*

	2004	2005 (Projected)
Sales	10,000,000	30,000,000
COGS	8,000,000	24,000,000
Gross Profit	2,000,000	6,000,000
Total Sales Expense	150,000	900,000
Profit Before Cost of Operations	1,850,000	5,100,000
Operations Expense	1,300,000	2,955,000
Net Income	550,000	2,145,000

distributors and homebuilders. These cash buyers are typically high-volume purchasers that order multiple 40-foot containers.

The product line had been featured on HGTV and is in great demand because of its high quality and low cost. The company could not distribute through big box chains and large retail lumber companies because these retailers are accustomed to 60-day payment terms. Such accounts increase significantly the length of the supply chain, which begins with the purchase of bamboo in China or the acquisition of hardwoods in South America or Eastern Europe. The supply chain could last as long as 180 days from the acquisition of raw materials to the final account settlement from the big box retailer.

The company has been in business for two years and in 2004 achieved gross sales of \$10 million. Sales from January through October were \$5 million. Because the goods are not delivered for 45 days after payment is required, a conventional factor or asset-based lender could not lend on the business collateral. The amount of domestic inventory held was approximately \$500,000, \$250,000 in Georgia and \$250,000 in California. This inventory was used to fill gaps in the drop shipping from Asia and to fulfill orders of less than a full container. This inventory turns monthly. To an asset-based lender, the inventory loan was not very attractive without accounts receivable; hence, the small line provided by a local bank cross collateralized by the principal's home.

The company arranged for an incremental sales finance facility with Capstone Business Credit, a New York-based merchant bank to provide the liquidity required at the time of shipment of the goods from China. The credit facility was established at a line limit of \$8 million. To draw down funds, Complete Flooring has to provide a copy of the ocean bill of lading, the invoice to the account debtor and the account debtor's purchase order. During the months of November and December 2004, Complete Flooring was able to double its sales from the prior 10 months to gross sales of \$10 million. At the time the deal closed, back orders exceeded \$3.4 million and the funding provided for the immediate shipment of

these goods. The merchant banking firm was able to negotiate with the local bank to subordinate its \$150,000 line of credit to the merchant bank, since the incremental profit created from offering payment terms to customers would have a significant positive impact on Complete Flooring's net worth.

Sales for 2005 are projected to triple to \$30 million. Management believes that with the incremental sales facility it will be able to close a distribution deal with either Loews or Home Depot using its proprietary brands or a special brand created for the chain. This will account for approximately one-third of the increase in sales for 2005. Now the company is able to satisfy the liquidity requirements of the manufacturing facility and at the same time increase its customer base to accounts that typically require 60-day payment terms from the time of delivery. The company has repriced its product to reflect the added cost of the merchant banking company's finance charges. Some customers are still paying cash in advance to take advantage of the price concession the company continues to make on payment in advance.

Exhibit 2 shows the impact the incremental sales finance facility has had on the company's net profit for 2004 and expectations for 2005. Without the incremental sales finance facility, the company would have had a break-even year. In addition, Complete Flooring is beginning to distribute marble and granite kitchen counters, bathroom vanity counters and

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