

## Venture Merchant Banking: Financing 'Sales' vs. 'Assets'

**B**anks have continued to change with the sophistication of the capital markets — arguably, U.S. capital markets are the most sophisticated in the world — but continue to fail small-to-medium-sized enterprises (SMEs) by not providing loans without a Small Business Administration (SBA) or U.S. Department of Agriculture loan guarantee.

Typical asset-based loans don't work for the majority of SMEs because the firms lack the current assets to leverage, as required by typical asset-based lenders. Most asset-based lenders and factoring companies are focused on current assets (otherwise known as accounts receivable) as the means to provide leverage to borrowers. However, with globalization and the direct extension of the supply chain to 150 to 180 days, conventional asset-based lenders and banks can no longer support SMEs' borrowing needs.

So, how does the typical SME that sources its products domestically or internationally purchase its pre-sold goods without having a surplus of accounts receivable?

### Funding Growth, Not Current Assets

There are only two options. SMEs can attempt to raise equity — an uphill battle, at best. Unless the firm is a high-tech or biotech company, most equity investors will not be interested because most SMEs can't provide the return on equity that makes an equity investment possible.

The second option is to seek financing from a venture merchant banking firm. Merchant banks differ from traditional banks by assisting the SME with purchasing its pre-sold goods, as well as assisting in the management of

company growth. Most companies are forced to borrow from Peter to pay Paul to finance their growth. This results in uneven growth, and in most cases, a loss of credibility with vendors who are promised payment — only to be disappointed after credit terms are extended and promises go unfulfilled.

Merchant banks typically support clients with purchase order, trade finance and factoring services. This vertical integration, as well as a staff that works with growing companies every day, is like a breath of fresh air to firms in need of funding. Once a client transfers from a bank or typical asset-based lender to a merchant bank, it's common that their business gains significant momentum. As a result of the financing, their backlog of orders is filled, their vendors are paid in a timely manner and their customers begin to depend on them more by placing larger orders with them.

The merchant banking model works well for most smaller domestic companies because they are likely to have limited assets, with those assets more closely aligned with their business volume. Banks and asset-based lenders do not take performance risk.

To reiterate, banks and asset-based lenders are unable to support growing SMEs because the latter have an abundance of purchase orders, but lack assets to leverage and finance those orders. In contrast, merchant banks will use the purchase order to finance an SME's growing sales, while providing the ability to earn incremental profit using 100 percent leverage.

### Venture Merchant Banking: Measured and Organized Growth

The merchant bank typically works off a

profit-participation model versus a conventional interest rate calculation. In the end, the SME makes more net income because the firm is able to take on even larger customer orders; that's a result of the firm having the required financing in place, geared towards "sales" versus "assets."

To qualify for a specific merchant banking program, a typical client needs a gross margin of between 20 and 30 percent on its products and sales of at least \$1 million a year. Most SMEs that participate in programs grow rapidly and — since they are able to increase their incremental profit opportunities — build up solid balance sheets. In addition, the smaller company must be willing to work within a structured finance framework designed to help the SME to grow in a measured and organized fashion.

As an SME financing source, the venture merchant banking model works for a variety of companies in various stages of development. Some firms are simply growing rapidly, while other firms are experiencing financial difficulty due to strong demand for their products but no working capital to fund that growth. Others are young, undercapitalized companies that already have an accepted product with an experienced management team in their market areas.

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