the financial institution's guide to working capital finance

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introduction

Modern credit markets allow for numerous variations of revolving and short-term working capital finance. From large commercial banks to alternative and online lenders, there is no shortage of competition for this business. For community banks and credit unions, though, this market represents a significant opportunity. Such financing often leads to long-term lending and investment relationships that can last years or even decades. However, meeting the challenge to make loans available in today's changing credit environment requires good data and responsive financing systems to address volatile credit risk while striving to address client demand and help local communities. Revolving lines of credit are often the first form of financing a business owner seeks, after using business credit card services.

underwriting young and emerging businesses

As our economy and small businesses continue to recover from the events of 2020, businesses will need access to short- term working capital. Here's the typical evolution of financing most lenders see when they underwrite young and emerging businesses:

Business Start-Up (0 – 12 Months From Inception)

These are often financed by personal credit cards and home equity. At this stage, the business may still be nothing more than a hobby. The business owner may still be employed outside of the new proprietorship.

The Road Ahead

As our economy and small businesses continue recovering from the events of 2020, businesses need access to short term working capital.

Formalization Of Business Strategy (Typically 6 – 24 Months From Inception)

This is typically the stage where a business owner may seek some permanent working capital for start-up expenses. Tired of floating the business on their own, entrepreneurs at this stage have five options:

- Family investors
- Outside investors (if willing to give up partial ownership)
- Government guaranteed forms of lending
- Traditional financial institution lending based on guarantor strength
- Alternative, online, and marketplace lending options

Young And Emerging Business (Typically 2 – 5 Years In Business)

At this stage, the business may have utilized a permanent working capital loan and is seeking a true revolving line of credit to help manage growth as well as vendor discount opportunities. This is also the stage where the business owner may seek financing for vehicles, equipment, and inventory.

Maturing Business (5 – 10 Years In Business)

At this stage, the growing business may utilize increasingly larger revolving lines. The business owner may also seek to finance larger inventory lines. Another key opportunity for the financial institution at this stage is the ability to provide loans for owner-occupied real estate.

Fully Mature Business (10 + Years)

While many forms of financing may still exist at this stage, such as large asset-based lines, the business is typically transitioning to investment services, becoming a net depositor in the institution rather than a net borrower. Other services such as employee banking might become an opportunity.

To accommodate the fluctuating nature of the financing need, all forms of working capital financing are now taking center stage. The question for your institution is: what options are your lending officers armed with in order to meet the demands of the market? If we overlay the above business stages with the types of working capital finance, a picture emerges that will help lead you to an overall strategy. In general, here are the options open to commercial banks and credit unions:

Business Credit Cards

These are generally used, as a matter of credit policy, for revolving working capital needs of less than $20k. It is usually not worth your institution's time to offer anything other than credit card options for this amount.

Short-Term Notes

As lenders, most of us have been here. We have seen the business owner frequently request short-term secured or unsecured notes to bridge a gap in working capital that occurs in the start-up and formalization stages of operation. These short-term notes are symptomatic of the disparity existing between the operating cash cycle of a business and its growth rate. A lender's goal should be to structure a long-term solution rather than the Band-Aid these facilities offer.

Key Questions:
What options are your lending officers armed with in order to meet the ever-changing demands of the market?

Unsecured Revolving Lines Of Credit

When the financing need is less than $150k, and the business is supported by strong guarantors, unsecured lines may offer flexibility for evening out unpredictable operating cycles.

Secured Revolving Lines

When secured lines are less than $150k, they are often heavily supported by guarantor financial strength along with a blanket lien on all company assets. This reduces the financial institution's reliance on short-term collateral assets such as accounts receivable and inventory. As the line grows, however, a more structured approach to collateral management is necessary. No longer can the guarantor or blanket lien support the obligation. These eventually become monitored lines of credit ranging from simple borrowing base solutions to fully structured asset-based lines of credit, as their need exceeds six figures. In its most recent Comptroller's Handbook - Asset Based Lending, the OCC outlined very detailed expectations for monitoring collateral values within larger revolving lines of credit.

borrowing base lines of credit

These lines, often secured by accounts receivable and inventory, begin to require a more significant investment in monitoring. Monthly reviews of borrowing base certificates become normal operating procedure. Borrowing base lines generally exist in the range of $150k through $1 million, but can be larger as well. Institutions that offer monitored borrowing base lines of credit hold a distinct market advantage by affording the opportunity to help businesses unlock those frozen assets. As with asset-based lending, regulators are expecting close monitoring of these relationships as line sizes and the institution's reliance on working capital assets increase.

Asset-Based Lines Of Credit

Typically reserved for larger lines, exceeding $1 million or even $2 million, these facilities serve business needs when there is a significant reliance on accounts receivable and inventory. These lines are typically structured so that the financial institution enjoys dominion of funds and requires regular field audits to confirm billing integrity as well as inventory values. While once considered labor intensive, technology within the last ten years has automated a significant portion of both the collateral management and the payment control aspects of asset-based lending. According to the Commercial Finance Association, asset-based lending within the 35 largest lenders exceeded $281 billion in commitments in recent years, with line utilization rates around 37%.

Weighing cost vs. benefit of any given financing solution

Regardless of the financing benefit of each option, business owners and lenders should evaluate the costs and risks associated with each form of financing.

hybrid lending solutions

In addition to more traditional revolving line options, several lending solutions have thrived for the past 20 years. These solutions deploy technology, training, and structural credit enhancements to help the financial institution track the value of collateral assets over time. Some are account purchase vehicles, while others are structured revolvers.

Factoring Of Accounts Receivable

This option is deployed by larger commercial banks and is primarily the territory of private factoring companies throughout the U.S. and abroad. According to recent statistics offered by the Commercial Finance Association, factoring in the U.S. is a $78 billion industry, increasing 18.7% from 2020 to 2021.

industry-specific solutions

These include short-term working capital finance options for very specific market segments such as healthcare, transportation, energy, and more.

managing risk

When deciding which credit structure is the most appropriate, it's important to weigh the benefits to the potential borrower against the credit controls that should be in place to manage risk.

Every credit structure has seen significant enhancements in technology in recent years, as it relates to an institution's ability to track collateral values, covenants, and exceptions relating to loan agreements.

Without a clear credit policy, you could end up with 10 lending officers with 10 different methods of managing your lines of credit.

So which is the best financing option for the business that is sitting in your lobby right now? As with most things in life, the answer is, "It depends." There is no one-size-fits-all standard when it comes to working capital financing. Every business is unique, and the lender must examine the characteristics of each before recommending a course of action. Lenders and credit officers who simply throw a secured revolver at the problem of cash flow management are doing their clients a disservice. They should take the time to consider all of the following characteristics while considering the loan requests:

- Level of business acumen as evidenced by past usage of revolving lines
- Operating cash cycle (not just operating cash flow and debt service coverage ratio)
- Projected rate of growth
- Seasonality of sales
- Vendor relationships (volume and trade discount opportunities)

The ideal solution for your institution would be to have several options in your lending arsenal. Since no one loan structure can serve every business, why would you allow yourself to be trapped into being a one-product shop? Rather, you should deploy technology that allows your lenders to cater the loan structure to the specific lending needs of the business. It is also important to note that your loan applicant, whether a client or a prospect, probably has no idea which solution is the best fit for their business. All they know is that the timing of their cash flow is an issue. It is taking longer for them to get paid by their clients than they can afford. As a result, they are losing growth and discount opportunities. **Here is a questionnaire your lending officers can use to determine which loan structure might be the best fit.**

Lending Structure Questionnaire

1. How long have you been in business?
2. What are you currently carrying in accounts receivable less than 90 days from invoice date?
3. Do you have any contra accounts, affiliate company relationships, or foreign accounts?
4. What are you carrying in inventory?
5. Do you currently have a revolving credit line? How often is it used? What is your line limit?
6. During the past 12 months, have you lost new business opportunity due to cash flow constraints?

7. During the past 12 months, have you missed a discount (prompt pay or volume) with your suppliers?
8. Describe the seasonality of your business across the calendar year.
9. How long does it typically take your clients to pay you? Give a best and a worst case.
10. What are your standard terms of payment?
11. Do you give any clients special terms?
12. If you could offer extended terms, could you increase sales?
13. Do you offer any discounts to your clients?
14. If you were able to convert your accounts receivable to cash through a revolving financing option, how would you spend the money? (Note: this is an indicator of business acumen. Does the answer match short-term credit with short-term working capital assets? Would they attempt to buy a fixed asset?)
15. What would your life be like if all your clients paid you in one day? How would that impact your ability to manage your business operations?

The answers to these questions will tell you a lot about the borrower sitting across from your desk. The fact is, however, that most lending officers are not trained to ask these types of questions. They are letting the credit application do the work, and falling back on the simplest solution. If your lenders took the time to really understand the day-to-day operations of each business, they would have stronger and longer lasting relationships. These relationships would flow from the first business credit card through the life cycle of the business, and the next thing you know, they have been a client for twenty years. In other words, working capital financing, when done right, is a gateway into more meaningful and long-term relationships. Where will owners find the short-term working capital to fund their new sales?

other considerations

Weighing Cost Vs. Benefit Of Any Given Financing Solution

Regardless of the financing benefit of each option, business owners and lenders should evaluate the costs associated with each form of financing. Cost benefit calculators can help to predict the breakeven for each potential solution based on the cash outflow being created as well as the growth and discount opportunities available. Not all working capital financing solutions offer the same benefits. From price to advance rate to the timing of the advances, each provides its own unique experience for the borrower. Most importantly, the cheapest solution is not always the best for the client. Nor is it the best for the level of monitoring required by your institution.

Avoiding Evergreen Lines And Other Non-Revolving Situations

Most lenders have had the experience of terming out evergreen lines or a portion of a larger line.

These are typically cases where the financial institution does not require dominion of funds (via a lockbox), and the business owner simply failed to revolve the line. This can be a painful discussion, especially since the business may still want a revolving line on top of the loan you just termed out. In cases like this, consider solutions that require account debtors to send payments directly to your institution, so the line will revolve as it should.

Establishing A Clear Credit Policy To Outline Your Approach To Working Capital Financing

By publishing a clear credit policy, you are sending a message to your lending officers that your institution has certain expectations regarding loan structure and monitoring. Key questions can be addressed. What accounts receivable or inventory items are eligible for financing? What industry sectors are eligible for such financing? What approval guidelines should be followed? What are the monthly monitoring expectations? Without a playbook, you might end up in the unenviable position of having 10 lending officers and 10 different methods of managing your lines of credit. Place these expectations clearly in your policy and make sure your lenders follow through. By the way, this is another reason to think about using a collateral management system to track your lines for performance and compliance.

Keep Moving

Your business clients will never stop moving, and neither should you. As they progress through the stages of the business cycle, their needs will change. Often, these changes require more than just an annual review on your part. Make sure your lenders are visiting with businesses on a monthly or quarterly basis to determine if the current financing vehicle is doing its job. Technology can also make the commercial lending experience easier for your borrowers. Securely uploading data directly from existing accounting systems and not re-keying or duplicating information is critical to that experience. Not only can these help with credit risk, it's good for business. You will enjoy higher business retention rates and more referrals.

conclusion

The business of working capital finance can be the most interesting form of commercial lending. It often fosters close working relationships between the lender and the business owner. While technology has introduced numerous advances in this area over the past twenty years, it's still all about creating the best experience for your borrowing client, with the greatest benefit. By understanding the dynamics of the operating cash cycle, the numerous line structures and the stages of business development, your lending officers will be armed with everything they need to be successful.

create limitless possibilities for borrowers

Contact us to learn more about commercial finance solutions from one of our experts.

For more information about Jack Henry, visit jackhenry.com.