

Where to Turn When Your Credit Line Shrinks

By Mike Semanco

Unprecedented losses in the traditional banking community have turned the credit market upside down at the national, regional and local level. Stemming in large part from the national mortgage crisis, investors such as banks and securities, investment and insurance firms have gone from being the lender to the loan recipient. In the meantime, available credit for behemoths such as General Motors and small businesses alike has almost disappeared, with large banks that were loan hungry just a few years ago telling customers, "We are not making new loans now."

Business owners currently find themselves in a catch-22 situation: the best way to climb out of this economic morass is to build new products, offer new services and reach new markets, all of which are typically dependent on the availability of credit at a time when credit lines are shrinking. It's because of this new credit crisis that business owners are increasingly looking at one of the oldest sources of credit on the history books: factoring.

Factoring is the sale of accounts receivable or invoices at a small discount to obtain immediate cash. It is a dynamic influence in funding business growth that has flourished for hundreds of years and gives businesses the ability to ensure growth without diluting equity or incurring debt. Factoring is not a loan; no money is loaned and no interest is paid or earned. Instead, the factor receives a fee for its services based on the dollar amount of the accounts receivable purchased.

With traditional banks temporarily eliminating or severely tightening lending guidelines, many entrepreneurs are seeking out factoring as a viable option to immediately increase their business's working capital. An important distinction between factoring and a bank loan is a company uses its customers' credit strength in factoring, rather than its own, as support for funding. With a bank loan, credit is typically based on assets, equity, profitability, cash flow and liquidity, thereby limiting the amount of funding. Under a factoring facility, available funding is limited only by the amount of a company's receivables, allowing it to meet operating demand and provide for future expansion. Another credit option for cash-starved companies is asset-based lending, a credit line based on various asset classes such as accounts receivable, inventory, equipment or real estate. Asset-based lending is often viewed as a stepping stone to traditional bank financing, with lines of credit secured by a company's accounts receivables and inventory. Asset-based transactions are typically structured with advance rates up to 85% for eligible accounts and 50% for eligible inventory.

A benefit to alternative financing options like asset-based lending and factoring is they are not impacted by the existing credit crunch. That's because the guidelines used to evaluate clients and their customers for alternative financing remain consistent through all credit availability cycles. Working capital lenders look at the credit strength of the debtor. Therefore, if a small business has experienced soft sales or reduced availability from their bank due to tough economic conditions, alternative financiers can help them create additional cash flow in their business as long as their customers' credit remains strong.

There is a cost difference between asset-based lending and factoring and traditional bank funding, with the former types of financing typically more expensive because of the relative ease in obtaining them. For that reason, if a small business can secure bank financing to meet their working capital needs they should do so. Similarly, entrepreneurs should also explore the availability of small business loans from community banks or credit unions.

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