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Does the Cost of a Non-Traditional Bank Financing Solution (Asset Based Loan or "ABL") Seem Too Expensive?

What if you could just "rent" some equity for a year or two?

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The Facts

Your business has hit a bump in the road, such as losing a major customer or incurring operating losses and the bank is getting nervous. Or your business is in distress. You are in special loans at your bank and/or indebted to CRA.

At this juncture, assuming the business is viable, business owners are typically faced with three options:

1. Inject more shareholder equity into the business,
2. Bring on an equity partner, or
3. Refinance the debt, but at higher rates with a non-traditional lender, commonly known as an Asset Based Lender (ABL).

> The harsh reality is your business no longer qualifies for traditional bank financing. It is in the "penalty box" for the next while as you work through these challenges.

Unlike traditional banks, ABL lenders are more focused on the underlying asset values of the business and less on the typical covenants or ratios that traditional banks consider when approving loans.

Business owners understandably experience "sticker shock" when they hear the interest rates and costs associated with ABL based lending, which can vary from 12% to 20% plus lender, advisor and legal fees.

If financially at their limit, they often consider bringing on an equity partner as a way to avoid these financing costs.

The Issue

Stepping back, one needs to ask: Which is more expensive - giving up equity or the incremental cost of a short term ABL solution? In normal operating conditions, the business would still require financing and incur traditional financing costs; therefore, it is the incremental cost of using an ABL solution that needs to be rationalized.

For example: on a $1M loan, assuming your bank charges 5% and the ABL rate is 15%, the incremental cost of an ABL solution would be 10% or $100k for 1 year. This incremental financing cost should be compared and contrasted to the cost of giving up equity.

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Business owners should ask themselves these questions when considering bringing on an equity partner:

- What percentage of ownership would I need to give up?
- Would I lose control of my business?
- Based on the current fair market value of my business, how much am I effectively giving up in value and how does this compare to the incremental ABL costs?
- Do I need a formal business valuation to assess the current market value of my business and what is the cost?
- What are the legal and accounting costs for shareholder agreements, corporate organization and tax planning issues?
- What type of return would the business need to pay a new equity partner?
- Will there be limits on my compensation going forward?
- What role will the equity partner play: day-to-day operator, advisor or silent partner?
- How will we distribute profits going forward?
- Could I ultimately lose my business and be bought out?

There are also a number of non-financial issues to consider: culture, personality fit, operating and communication styles and differences in the vision for the business.

Additionally, you could effect a turn-around of the business within a year or so and refinance with a traditional lender. As such, you may not need an injection of longer term capital.

Lastly, as businesses are typically valued based on earning, given the current financial performance of the business, its current valuation could be at the lower end of the business' real potential.

At today's market values, consider what value the founders of businesses, such as Google or Facebook, would have given up to save 10% in interest borrowing costs for a year or two when they were struggling as smaller private companies?

The Conclusion

What if someone would just lend or "rent" you the equity needed and you could avoid having to deal with all of the financial and non-financial challenges associated with bringing on an equity investor? No equity dilution, loss of control, selling "low" and dealing with many of the issues noted above.

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This is effectively how one should view an ABL solution. It is short-term and the incremental cost should be viewed as an "equity rental."

In making this assessment, however, the owner should also consider factors such as: How confident am I in the execution of a turnaround of the business? Realistically, how long will it take to return to profitability? If you are confident in the plan and the timing of its execution, then over the long term, an ABL solution may well be a much more cost effective option than bringing on an equity investor.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing a wide range of traditional and non-traditional financing solutions for small and medium sized businesses.

For more information on raising financing solutions for a start-up, early stage, growth, in-transition or business in distress, please contact Adrian Isaacs at (416) 835-4511 or aisaacs@isaacsadvisory.ca.