Funding the Cyclical Business

Post Pandemic

Acquiring the necessary working capital a business needs to grow and thrive in an uncertain economic climate.

OVERVIEW

This white paper will discuss how small to mid-sized businesses can obtain the working capital they need when they need it, and how Capstone assists businesses by offering Contract Factoring or Single Invoice Factoring ("SIF") funding options.

Step 1

In this section, we provide an updated perspective on the lending industry eleven years post the passage of the Dodd-Frank banking regulations as well as post worldwide pandemic and discuss what finance opportunities still exist.

Step 2

In this section, we discuss how businesses can use Contract Factoring or SIF as a Cash Management Strategy to bridge the working capital gap for firms in a cyclical business.

Step 3

In this section, we discuss SIF, its benefits and advantages alongside a flow chart of how SIF works.

Step 4

This section provides a case study of how SIF benefited an actual client of Capstone.

Step 5

The last and final section of this white paper discusses who Capstone is and what financial products and services it offers to its clients.

The Pandemic proved that Dodd-Frank banking regulations were effective. ***There have been less bank loan defaults during the Pandemic than during any other economic crisis in the past.***

Part 1: A FOLLOW UP POST DODD-FRANK AND POST PANDEMIC:

WHY THIS IS STILL A BIG OPPORTUNITY

The Dodd-Frank banking regulations are now eleven years old and have been fully implemented by the government regulators. The impact of Dodd-Frank on the small business community, as we predicted in 2014 and 2018, has significantly reduced the amount of bank lending to small business owners. Small business loans from banks are only made available in small amounts assuming that the borrower is willing to pledge all of their business and personal assets to the bank. These loans generally range from $50,000 to several hundred thousand dollars and are highly dependent on the quality and value of the small business owner's balance sheet. Loans of this size are generally sufficient for small businesses to maintain their existing operations, but during times of growth or expansion these businesses will find these facilities lacking very quickly.

The small business lending void created by Dodd-Frank has been filled by third-party hedge funds and commercial finance companies like Capstone. These multi billion-dollar hedge funds tend to lend to smaller business lenders who can aggregate and service a portfolio of small business loans and direct lending to larger operating companies where the loan size can be $50,000,000 or higher.

> **Sales-based financing like factoring allows small businesses to grow to the extent they can increase their sales even if their balance sheets do not have sufficient equity...**

Large hedge funds that provide funding to small business lenders are one of the reasons why hard money lenders, credit card advances, and business payday loans, such as merchant cash advances ("MCAs"), have become so popular and readily available to any small business that has been in business for at least six months. These options may have a fast and easy qualification process, but in the long-run, they generally harm businesses financially as they come with high-interest rates and create a never-ending cycle of debt. It is common for businesses in these situations to end up with multiple MCAs which only compounds the problem.

Capstone and other alternative commercial finance companies operate by purchasing accounts receivable and purchasing goods on behalf of their clients when the goods have been presold to a creditworthy third-party. Sales-based financing like factoring allows small businesses to grow to the extent they can increase their sales even if their balance sheets do not have sufficient equity to support the need for increased borrowing.

During the COVID-19 pandemic, very few banks had serious issues with their loan portfolios because the majority of their loan books consisted of substantially sized companies, and the other loans they made were typically guaranteed by the U.S. Government. This proves that although Dodd-Frank has made it harder for small business owners to borrow from banks, the depositor's money is safe from another financial crisis which was the goal of Dodd-Frank, i.e. to de-risk the national banking system in the event of third-party economic events.

What is the Dodd-Frank Act?

The full name of the bill is the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), but the name most often used is Dodd-Frank.

Dodd-Frank is a law that placed major regulations on the financial industry and changed the way banks are legally allowed to operate. The act grew out of the Great Recession which began in 2008 and its intent was to prevent another collapse of major financial institutions which left unchecked would devastate the world economy again.

Dodd-Frank is also geared toward protecting consumers. Provisions of the act aimed at protecting borrowers from abusive lending and mortgage practices by banks and mortgage lenders.

> **If any of the banks get too big, they could end up regulated by the Federal Reserve**

How do the provisions of Dodd-Frank affect banks?

One of the main goals of the Dodd-Frank act is to have banks subjected to a number of regulations along with the possibility of being broken up if any of them are determined to be "too big to fail."

To effectuate this, the act created the Financial Stability Oversight Council ("FSOC"). The FSOC looks out for risks that affect the financial industry as a whole.

If any of the banks get too big, they could end up regulated by the Federal Reserve, which can ask a bank to increase its reserve requirement—the money it is legally required to retain from earnings (capital requirements) in the event of a crisis to maintain the bank's liquidity and is not able to be used for lending or business operating costs.

Additionally, Dodd-Frank has placed strict capital requirements on banks and increased scrutiny over credit decisions. Most large companies that rely on bank financing have had a relatively easier time accessing credit than most small to medium-sized businesses.

The Effect of Dodd-Frank on Credit Facilities

Small and medium-sized businesses that needed to rely heavily on bank credit, have come to experience tighter and tighter credit requirements in the wake of Dodd-Frank. Accordingly, banks have begun dealing with a wave of corporate refinancing. Some experts believe that with demand for debt capital outstripping bank-lending capacity, an increase in competition for those funds will certainly lead to a rise in interest rates and lending to only those companies with the strongest balance sheets.

Larger, higher-rated corporations, that typically have more refinancing options available to them, may not feel the squeeze. Smaller and middle-market companies, however, particularly those with weaker balance sheets may find they have fewer traditional options for refinancing their debt. Community Banks still consider small business lending their main focus, but rates are typically higher and lending thresholds lower. Further, many Community Banks have been forced to merge with larger financial institutions to cope with the Dodd-Frank legislation, thereby eliminating an important source of capital for small businesses.

Bank lending has become increasingly costly and banks are now requiring even more of the businesses they lend to. Among the typical requirements involved in underwriting most state and Federal SBA loans, the prospective borrower will be required to submit at least three years of audited financial statements and demonstrate an annual net income and profitability. Most of these loans can take anywhere from a couple weeks to 6-12 months to process.

More recently, many banks have determined that businesses which received Payroll Protection Program ("PPP") funding had cash flow issues and are subject to third-party economic events which makes them riskier to lend to. Even with all of the excess liquidity generated by FED borrowing, banks remain very conservative with their lending decisions.

Small businesses can no longer rely on banks as their primary liquidity source. As traditional financing becomes increasingly unavailable and more costly, many businesses must seek out lenders who operate in the alternative market space like factoring companies and purchase order finance companies.

Part 2: FACTORING AS A CASH MANAGEMENT TOOL

As discussed earlier, Dodd-Frank has greatly impacted the ability of banks to provide credit facilities to many businesses, including those within certain industries, e.g. the construction industry. While maintenance of operational expenses wasn't quite an issue in years past when the real estate market was at its peak, construction firms have turned to alternative financing options in order to sustain and grow their businesses in the current environment.

For companies in the $2-$20 million in sales range, obtaining working capital to sustain operational expenses and execute growth initiatives is only getting more difficult. There are solutions. One of which is invoice factoring.

Factoring as a cash management and growth strategy

The use of factoring as a cash management strategy is an effective tool to bridge this significant working capital gap for construction firms. Through factoring, companies are able to self-sustain, take on higher volume contracts to grow, and strengthen their firm's ability to operate with increased cash flow.

Currently, most construction firms finance projects on their own, as most contracts specify "paid-when-paid." In order to maintain their business and manage increased costs, these firms need significant working capital lines of credit in order to maintain their existing customer base.

Private finance companies, like Capstone, have created finance programs around factoring. These programs are specifically designed to help construction firms and similar businesses by assisting them with their working capital needs. Factoring allows construction firms to take on a higher volume of contracts, grow their business, and retire debt more quickly. In addition, factoring helps strengthen the firm by increasing its cash flow.

What is Single Invoice Factoring ("SIF")?

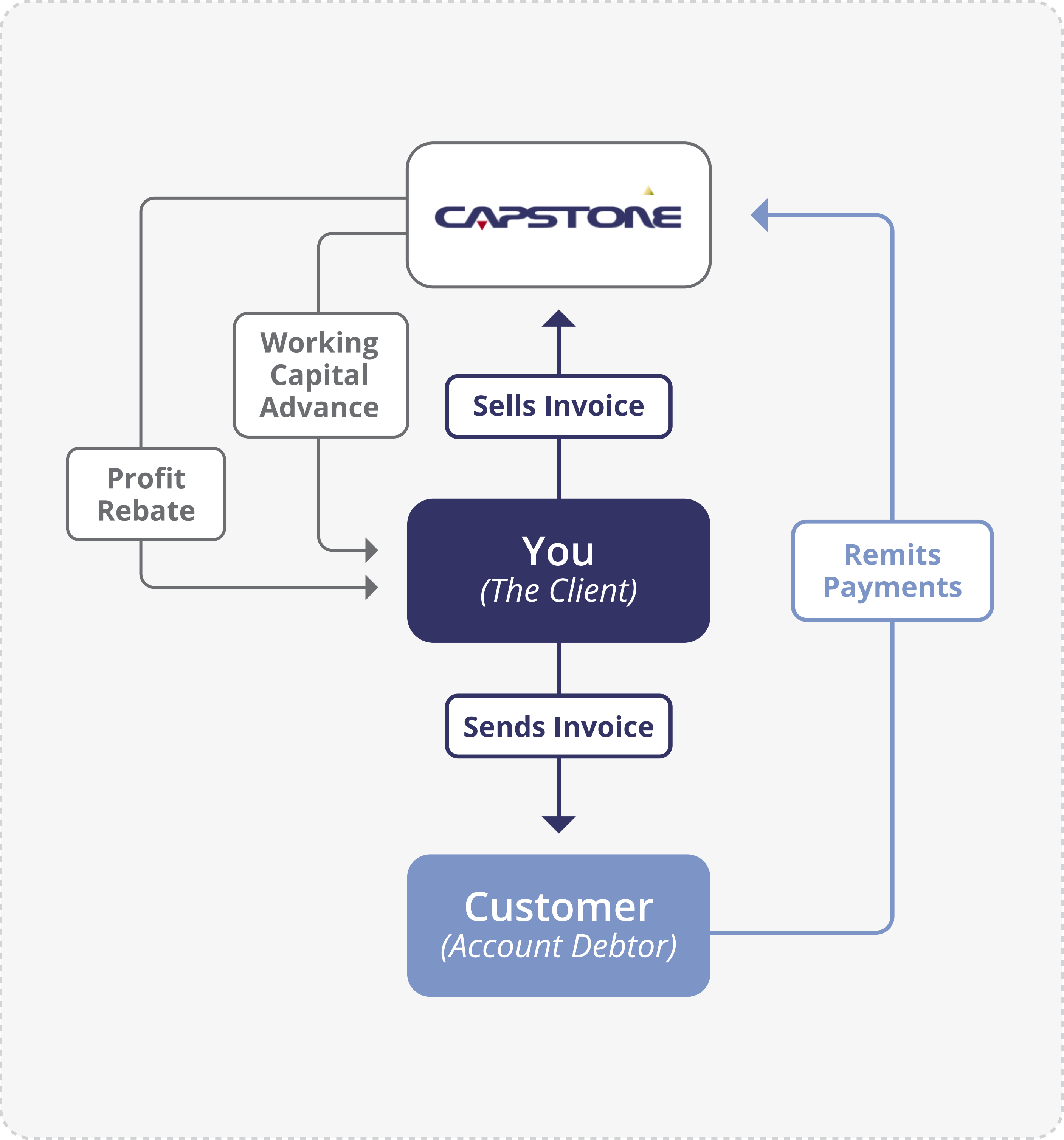
In general terms, SIF is a business funding option that allows businesses to sell their accounts receivable in exchange for a cash advance. This type of financing is helpful when a company is waiting for a large payment from a customer but needs the money immediately. SIF differs from regular factoring services in that only one invoice, or a group of invoices, are purchased versus a typical factoring arrangement where a two or three-year contract is required. Under a traditional factoring program, a client must sell all of its invoices to their factor as they are generated. It lacks in the flexibility offered by SIF wherein there is no long-term contract or obligation. As such, SIF allows businesses to factor their accounts receivable on an as-needed basis at their discretion.

How SIF Works

As a company performs work for its customers, invoices are generated and payment terms are often granted to the customers giving them time to pay the invoices. In factoring, when a business requires the money from that invoice immediately, a third-party, called a factor, comes in and purchases the outstanding invoice. Depending on the business and the nature of the transactions, typical account receivables can age between 30 and 90 days before the customer's payment is received.

From there, it is up to the business to make sure the transaction is completed. Sometimes, depending on the service you choose, the factoring company will manage the collection process of the invoice.

Below is a diagram which details How SIF works:



Some of the Advantages and Benefits of SIF

SIF has been successful at positioning companies for growth as it allows firms to sell one or many invoices for cash flow and only when needed. For construction companies, the proceeds of the invoice purchased are applied by the factoring company, to ensure that all subcontractors, vendors and suppliers are paid in exchange for their lien releases. Depending on the given month, the need to factor may increase, decrease, or not be necessary at all. As there are no volume requirements or associated fees, SIF is a true on-demand cash management tool.

In addition to providing contractors with the ability to fund ongoing operations, factor companies, such as Capstone, give companies the ability to bid with confidence on new opportunities. The clients of Capstone know that when certain underwriting criteria are met, Capstone will provide assistance should the contractor run short of working capital during the course of the performance of their new or existing contract.

For subcontractors, in particular, there are many challenges of managing operating expenses when extended payment terms are routinely negotiated into subcontracting arrangements.

As one can see, SIF provides many benefits. Some of these benefits include, but are not limited to, allowing the business to meet payroll obligations, increase cash flow in order to pay suppliers and creditors in a timely fashion as well as have funds to mobilize on job sites. Additionally, SIF gives the business the confidence to bid on larger contracts and balance multiple projects simultaneously. Unlike other types of credit facilities, SIF is much quicker and easier to obtain. A business can obtain the working capital it needs as long as they have a bonded job in hand or have a customer that is creditworthy. Capstone will purchase a portion of the contract and there is no maximum limit. The terms are fairly straightforward in that the financing is "non-recourse" and full payment is achieved by way of receivable collections. The best part is that the processing time of the initial transaction takes anywhere from 48 hours to 7 business days, with subsequent transactions being able to be funded within 24 hours!

Part 4: SIF A CASE STUDY

Capstone's client, a painting subcontractor located in California, had been operating its business and generating growth potential despite economic challenges without any credit facilities in place. In recent years, the firm began experiencing increased delays in the payment of its invoices.

The firm noticed that their general contractors had gone from paying invoices every other week to a cycle of 45 or 60 days past the standard 30-day invoice terms. As the business continued to grow, the firm had larger payroll commitments with an increasing list of unpaid invoices. The lack of working capital made it difficult to meet its payroll obligations, buy supplies and pay vendors.

Determined to shift the pendulum, firms like this painting subcontractor are driving interest in alternative cash flow solutions, such as factoring to help manage through negative business cycles and the constant, cash flow demands of extended payment terms.

Cash Flow Crunch

More businesses have turned to longer payment terms as a way to manage their own cash flow with some businesses needing to extend their payment terms from net 60 days to net 90 days to help manage their working capital. Supply-chain professionals and economists have observed a growing trend towards extending contract payment schedules. Besides longer payment times, other causes have contributed to later payments. As an example, pandemic-related manufacturing slowdowns and supply-chain issues have also generated long lead times. In turn, longer turnaround times will mean waiting even longer for payments. Waiting months for payment poses a difficult challenge for many subcontractors.

With the economy now improving, analysts predict increased opportunity for both residential and commercial construction, providing more work for painters. Even with increased demand, firms struggle with continued cash flow demands to meet obligations while working to increase bids and work volumes.

Pendulum Shift with Factoring

In the construction industry, any payment disruptions from the general contractor to subcontractors have a ripple effect through the subcontractor's firm. Cash flow demands run throughout the lifecycle of construction projects and continually involve many companies.

For subcontractors, factoring has become an integral part of an overall financial strategy.

Painting Subcontractor + Single Invoice Factoring

The painting subcontractor chose factoring as a business strategy to increase available working capital. Within ten months, the firm factored 52 invoices ranging from $7,000 to $75,000 and was able to increase business volume by an additional 15%. In fact, with the additional working capital available through factoring, the firm was able to secure an additional $300,000 in contract backlogs.

According to a manager of the painting subcontractor, "Traditional financing can be a slow-reacting process, whereas factoring can provide a quick response when needed."

The success of implementing single invoice factoring offered by Capstone on large commercial contracts has allowed the company to expand into other factions of the painting industry, including custom homes and homeowner associations. The firm now focuses on planning the execution and performance of contracts, while bidding on new work as opportunities are presented.

Financial Strategy

While the COVID-19 pandemic's long-term financial impact on businesses is still largely unknown, many businesses are faced with steeper than normal challenges securing funding. Moreover, there continues to be a void of capital available for medium to small-sized construction companies, inclusive of painting contractors. Temporary relief in the form of PPP loans were provided to small businesses that were able to secure them, but they have not been sufficient to sustain businesses in the long term, nor were they ever intended to.

Under current market conditions, most subcontractors wait between 45 and 90 days for payment from their general contractors or project owners. With such dating, subcontractors are essentially financing the project, as most contracts specify that they will be paid only when paid by the owner of the project. In order to maintain their business and continue from job-to-job, subcontractors need significant working capital lines of credit to sustain themselves.

Capstone's factoring program is structured to reduce or eliminate the typical financial covenants found in most factoring programs while providing the needed working capital to subcontractors. As a business strategy, single invoice factoring not only provides sustenance for subcontractors, it has positioned Capstone's construction clients for growth.

> *"Single invoice factoring allows us the flexibility to choose which invoices we want to factor during the month, if any at all," according to the painting contractor. "This allows us to grow our business without worrying about additional payroll costs prior to funding, which can be 90 days on a new job," he continued. "It can be especially important on prevailing wage jobs where payroll costs skyrocket."*

Part 5: CAPSTONE-WHO WE ARE AND WHAT WE OFFER

Capstone is a private finance company that focuses on accelerating client cash flows and providing client-specific solutions through Factoring Services, Purchase Order (PO) Financing, and Domestic and International Trade Financing. The services provided offer results to a wide range of companies including:

+ *Construction Trades*	+ *Wholesalers*
+ *Contract Manufacturers*	+ *Staffing and Temp Companies*
+ *Service Companies*	+ *Consumer Products*
+ *Green & Renewable Energy*	+ *Telecommunications*
+ *Environmental Companies*	+ *Mining Coal, Oil and Gas*
+ *Suppliers and Distributors*	+ *IT Services*
+ *Advertising and Public Relations*	+ *Engineering and Design*
+ *Movie Productions and Publishing*	+ *Mobile Game and App Developers*

Capstone specializes in Single Invoice Factoring (SIF) or Spot Factoring for firms in need of immediate cash. SIF provides flexible, no-contract invoice selling in exchange for working capital. For clients in need of Trade Financing and PO Financing, Capstone has the ability to deliver guaranteed bank payment instruments to global manufacturers and suppliers in exchange for the promised distribution of presold merchandise to its clients.

For more information on how Capstone can help, please contact us:
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