The New York Times

Salvation at a Very Steep Price

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August 3, 2006

When small businesses run into financial troubles, banks can be especially unforgiving. David Ayer, chief executive of Ayer Sales, an industrial plastics distributor in Woburn, Mass., got a taste of just how unforgiving in 2003, when a harsh down cycle took its toll.

Ayer Sales, a $10 million-a-year business that sells directly to clients in a variety of industries, including semiconductors, pharmaceuticals, biotechnology and waste water treatment, has 35 percent of its business tied to the semiconductor industry.

In 2003, Mr. Ayer said: “We lost nearly half our business. We hit a high in 2001 and today, we’re at just 45 percent of that sales level. We had 52 employees then. Today, we’ve got 28.” As the company’s fortunes declined, its lender — Citizens Bank in Providence, R.I. — sent a financial consultant to try to steer Ayer Sales through the crisis. But before the company was turned around, the bank called in its loan.

“It was painful,” Mr. Ayer said. “But when you start losing money, the banks shy away.”

The financial consultant pointed Mr. Ayer to several banks, but all said the same thing: “Show us six straight months of profit and we’ll talk.” Rather than close the business that his father had started in 1961, Mr. Ayer turned to an alternative that most small-business owners prefer to avoid: an asset-based loan from a commercial lender.

Asset-based lenders use a company’s assets as collateral. The loans to distressed small companies can be $50,000 to $1.5 million, and because the lenders are willing to bet on a company’s assets as collateral, they embrace the very risk that banks avoid.

After providing the loan, the asset-based lender typically takes control of a company’s accounts receivable (money owed by its customers) and all invoices are paid to the lender rather than the company. As the payments come in, the lender holds back part of the money in escrow — 20 percent is a typical amount — to pay down the loan. The lender gives the remainder to the company. If customers are late with payments, the company pays a fee to the lender.

Asset-based lending is not a new option for small businesses. The Commercial Finance Association, a trade association of such lenders, has 256 members and has been around since 1944. But while these lenders have saved thousands of companies with few financing alternatives, salvation comes at a steep price.

Mr. Ayer, who received asset-based financing from Systran Financial, a division of Textron, is paying 1.25 percent over the prime rate for the loan and that, along with the various nonnegotiable fees, are costing the company about $200,000 a year. “It is much more expensive than a standard bank relationship,” he said.

But while the costs are high, small-business owners strapped for financing are grateful for alternatives other than borrowing from relatives, using numerous credit cards with far higher interest charges, or simply shutting the business.

For most entrepreneurs and business owners, the demand for capital comes quickly and leaves little time for the lengthy process of a bank loan. Most small companies do not have the means to hire accountants who can create slick financial presentations and business plans. Start-ups, for example, often find themselves in dire need of capital with few options. Venture capital firms are an option but often demand large equity stakes that dilute the entrepreneur's ownership of the business.

"You can put more money in yourself, but if your business is on the rocks, it is hard to raise money at a decent valuation," said Thomas C. Tremblay, president of Guardair, a small industrial tool manufacturer in Chicopee, Mass. "If you go to the venture guys, you might have to give away the company and you don't want to do that."

Alternative financing companies have grown in popularity and the industry's rise has attracted a raft of entrants. The Commercial Finance Association counts among its members not just asset-based lenders but also inventory-based lenders, large and small independent finance companies, corporate subsidiaries like GMAC and GE Credit, and even business credit units of domestic and foreign banks. Bruce H. Jones, the executive director of the association, estimates that its members have more than $400 billion in loans outstanding this year, up from around $250 billion five years ago.

Mark Belzowski, chief financial officer of VitalStream Holdings Inc., a streaming media technology company in Irvine, Calif., said: "They are an important part of the financing chain. When you really need the money, you do what you can."

Several years ago, VitalStream was a struggling start-up and found itself in need of cash. It turned to the Boston Financial and Equity Corporation, which provides asset-based lending and equipment financing. VitalStream arranged for several million dollars' worth of equipment lease lines with Boston Financial.

"At the time, we weren't in a position to go to a bank and say, 'Here's what we want,' " Mr. Belzowski said. "Boston Financial was expensive but we were a struggling company and we survived a difficult funding period because of them."

Deborah Monosson, chief executive of Boston Financial, a commercial lender founded by her father in 1968, said: "None of my clients are profitable when they come to me. I like seeing them succeed. VitalStream won't come back to us. They are bankable at this point."

Alternative financing allowed John Ovens to make a winning bid for Air Courier, a specialty courier service based in Atlanta, when the company went on the market in 2001. As the only bidder for the company, Mr. Ovens was pursuing equity financing, but the process became bogged down and allowed several other bidders to emerge. Faced with an anxious seller who was about to drop his bid, Mr. Ovens turned to the Presidential Financial Corporation, an asset-based lender in Atlanta. As he began to work with Presidential, the terrorist attacks of 9/11 brought Air Courier's business as well as the deal to a halt.

"Presidential didn't back out of the deal, even with 9/11," Mr. Ovens said. He was able to close the deal, though he acknowledges that the costs are high. Air Courier pays 2.5 percent above the prime rate for its loan, plus a management fee. "It costs us about $150,000 a year more than going through traditional financing," Mr. Ovens said. "In 2005, we paid Presidential $365,000 in interest and fees. But we own the company outright and we manage it how we want to. There are no equity partners telling us what to do."

Mr. Ovens says that this independence is the reason Air Courier has more than doubled in size, to $38 million in revenue, since 2001.

"We could move in another direction now," Mr. Ovens says, referring to his financing relationship with Presidential. "But I haven't seen a traditional bank that would give us the flexibility to run with the business."

Ayer Sales is thriving again and Mr. Ayer expects to secure a new round of bank financing by the fourth quarter. He says his experience with Systran has been positive, even with the steep cost of the loan. “It certainly instills a level of fiscal discipline,” he explains. “And it was a small price to pay to keep the business going.”