Secured Short Term Financing

by Sophia

WHAT'S COVERED

What are some other options available to a business for short term financing if they don't want to use unsecured short term financing? This tutorial will cover the topic of secured short term financing. Our discussion breaks down as follows:

1. Secured Short Term Financing

Secured short term financing is an option when a business may not be able to get the money it needs through unsecured financing means.

Companies with less than great credit ratings will need collateral in order to get secured financing. Almost any asset that a business has can be used or considered for collateral. Typically, though, inventories and accounts receivable are the most common assets that businesses use as collateral to secure short term financing.

Types of Collateral	Description
Loans secured with inventory	Can be used by any business and is typically used with the products that the business has on hand. This means that you won't typically see this used by a service company. For instance, a business that provides a service like counseling or massage wouldn't have a lot of inventory on hand, so they wouldn't necessarily be securing short term loans with inventory.
Loans secured with accounts receivable	Can generally be used by any business, and may, in fact, be best for companies with longer sales and production processes, because the receivables are more secure at this point. You typically won't see this with startups because there are not a lot of receivables on the income statement.

2. Factoring

Factoring is a financial transaction where a business sells its accounts receivable (invoices) to a third party, called a factor, at a discount. A factor is a business that exclusively buys other firms' accounts receivable for the purpose of making money. The firm that's selling its accounts receivable will receive less than their full value, but is going to obtain the funds it needs immediately.

Companies often have outstanding invoices from customers (accounts receivable) that represent money owed for sales made on credit. When short-term debts exceed revenue from sales, companies may face cash flow shortages. To address this shortfall, companies can sell their receivables to a factor.

Then, the factor is responsible for collecting the receivables. The factor assumes the risk of default by customers, and so charges a fee to the business to compensate for the risk. Typically, a percentage of the receivable amount is retained by the factor.

This process is typically used by firms with a large number of credit customers to offset the risks on this type of loan. It is used by manufacturers to provide money needed to fund manufacturing processes and bridge gaps just prior to the sale of goods.

> **IN CONTEXT**
> A manufacturing business may use a factoring account to temporarily get the raw materials they need to produce an item, like the fabric or the labor, or perhaps the thread needed to produce a large order of t-shirts that they've already sold. It's in the receivables column of their income statement, and it's going to be used to create the t-shirts for that particular order. They already know the money's coming in.
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> Now, the factor is going to buy off of that accounts receivable. The factor will give the manufacturer slightly less than face value, so that the factor makes a little money. The shirt manufacturer, then, receives the money they need upfront to buy everything and fulfill their order on time. Then, when they collect the money for selling those shirts, they factor is paid back.

This is a fairly low risk situation because all the borrower has to do is sell something that, in essence, has already been sold. Being a type of loan that is secured by receivables, the borrower knows that the money is coming in—they just need a certain amount of money right now.

Loans that are secured by inventory, on the other hand, are slightly different. Circling back to the t-shirt example, the t-shirt manufacturer would have a lot of money sitting in their warehouse in the form of t-shirts, and is taking a loan based on the amount of inventory they have. As they sell those shirts in the warehouse, they can pay back the secured short term financing.

SUMMARY

Today we learned about **secured short term financing**, referring to short term loans that are secured through both inventory and accounts receivable. We also explored different **ways to secure loans**, noting that borrowers have to put up some type of collateral to obtain a secured short term loan.

The collateral can be almost anything, though typically, it is inventory or assets that a business has on hand, or a business borrows against the accounts receivable it is bringing in. They know the money is coming—it's just a question of getting it at the right time to pay the loan back.

Lastly, we learned about **factoring**, or securing that short term financing on something that's already been sold. In this case, for instance, a business may just need to get the materials together in order to make a product. Then, it can sell that product to collect the money to pay back the factor.

Good luck!

Source: adapted from sophia instructor james howard