



Purchase order and Trade financing for growing companies

Purchase order financing is a growing field due in part to the Chinese economic boom which makes it financially practical to contract out the manufacture of products overseas. Not that purchase order financing is limited to the importing of product from China, but it is the fastest growing segment of the market. In the past, there were limited outlets for a company that needed to finance 100% of their inventory purchase and old school thinking was that any company that couldn't get money from their bank was in serious trouble. But due to the transition to offshore production, companies discovered they were in a cash flow bind because where they once had open credit domestically, they were now sourcing finished products from Asia or other countries.

What is Purchase order financing and who uses it?

Purchase order funding (aka PO funding) is short term financing for small to medium sized companies engaged in domestic commercial trade, or importing/exporting that allows them to capitalize on revenue opportunities which cannot be supported by their existing capital structure. Funding entails issuing letters of credit or providing funds to finance the purchase or manufacture of specific goods that have been pre-sold by the client to a creditworthy third party buyer in a commercial trade transaction. Working capital is generated by a security interest in existing purchase orders and the eventual proceeds of those orders. Normally the security interest is perfected by the lender taking possession of the inventory or raw materials.

The following types of companies typically use purchase order funding:

1. Wholesalers
2. Distributors
3. Importers and Exporters
4. Assemblers and Light Manufacturers (having strong financials and experience in the type of product for which the purchase order funding is being requested)

There are typically 3 types of PO funding. They are listed below in increasing degree of difficulty for obtaining. For the last two, the financial strength and experience of your company in doing the manufacturing or repackaging plays an extremely important role in securing the funds.

1. Purchase orders for goods that are purchased from a supplier in a finished state (for example, a distributor, wholesaler or importer that simply drop ships the product directly from the supplier to the customer and never handles the product)
2. Purchase orders for goods where the company performs light manufacturing or repackaging (for example, importing of electronic components that are tested and then repackaged before delivery to the customer)
3. Purchase orders of component parts in which in-house manufacturing must be done to produce the end product being purchased by the customer

What are some reasons PO funding is utilized?

Insufficient capital - A company may not be able to get bank financing because its balance sheet or collateral will not support sufficient borrowing. A current line of credit is tapped out. Offshore manufacturer or supplier requires prepayment or a letter of credit posted. PO funding takes no equity or ownership interest.

International expertise – Many companies doesn't have the expertise or experience to structure and complete international transactions. Even established international clients will use Trade finance companies to make a transaction safer.

Disguise identity – Some companies, as middlemen wish to have transactions secured in such a way that the end buyer and manufacturer do not become acquainted.

What transactions do not qualify for purchase order financing?

- Services (only goods qualify; items like custom or semi-custom software would not qualify)
- Goods being manufactured by companies with little or no experience in manufacturing that type of product
- The customer is not creditworthy (your customer must have a strong history of paying their bills)
- Single PO value less than \$100,000 (POs cannot be combined to reach the \$100,000 minimum)
- Goods delivered on consignment or guaranteed sale (buyer cannot have the option of returning the goods)
- Goods with no specific delivery date or to be purchased as stock inventory
- Goods that require long production cycles (90 to 120 days) because the cost of the PO funding becomes cost prohibitive)
- Profit margin of less than 25% (minimum gross margin of 30% is preferred)

Other important factors to secure purchase order funding

- A personal guarantee is always required to obtain purchase order financing
- The importance of the financials of the company and its principals increases as the risk of satisfying the purchase order increases. For example, your company cannot be in danger of becoming insolvent during the term of the purchase order. The amount and complexity of the manufacturing required to deliver the product increases the risk that the purchase order will not be satisfied. Therefore, the financial strength of the company and its principals together with experience of the company in satisfying similar purchase orders becomes more important when deciding to approve a purchase order funding request
- Existing bank liens on receivables will require a subordination agreement on that portion of the receivables generated as a result of the purchase order funding transaction
- The range for standalone purchase order transactions is about \$250,000 to \$2,000,000. The minimum for recurring purchase order transactions is about \$50,000 per month
- The amount that will be advanced on the purchase order will be the minimum required to get the order to an invoiceable state. For example, for finished goods, the advance would be the amount required to buy the goods from the supplier and might also include the cost of freight, insurance, and inspections

How is the purchase order funding advance paid back?

The purchase order funding advance may be paid back in the following ways.

1. Proceeds from a letter of credit to the selling company from their customer, triggered by good being delivered (or shipped depending on the FOB terms)
2. Accounts receivable financing of the invoice when the goods are delivered (advance goes to PO funder to repay portion they loaned)
3. Purchase by a leasing company when the goods are delivered to your customer

Purchase order financing can be done quickly, often in 5-10 business days. Positive results of PO funding are undisputable; it's a win-win-win situation for all parties involved.