Exploring alternative funding options: Diversifying funding strategies for SME growth

By Ramone Pillay

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In the current dynamic business environment, entrepreneurs and small business owners encounter a multitude of obstacles when seeking financial support to fuel their growth ambitions.

Source: Unsplash

Traditional high-street bank financing may not always be accessible or suitable for every business. However, by exploring alternative financing solutions - such as invoice discounting, purchase order (PO) funding, and reverse invoice discounting - businesses can discover new avenues to fuel their growth. In this article, we will explore these three types of funding mechanisms and shed light on their potential benefits and considerations.

Invoice discounting: By harnessing the value of outstanding invoices, invoice discounting offer businesses a means to access immediate funds. Selling invoices to a lender at a predetermined fee allows companies to obtain instant cash flow and even early payment settlements.

A finance house may immediately advance up to 80% of the aggregate value of a company's invoices, recovering the value from the customers or from the company itself by a prearranged date. Whole book invoice discounting typically covers all customer invoices on a business' debtor book, while the term selected debtor invoice discounting refers to individual invoices to be funded.

PO funding: Imagine having the ability to fulfil large orders and secure lucrative contracts without straining your cash flow. PO funding makes it possible. This arrangement allows lenders to pay suppliers on behalf of borrowers, based on POs from potential customers.

This empowers businesses to seize growth opportunities by providing the necessary financial support. Payment to the supplier could be made for the full amount of the PO or be concluded in partial payment. After the funds are transferred to the supplier the financier will issue the borrower with terms inclusive of their fees.

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Reverse discounting: In a symbiotic relationship between businesses and their suppliers, reverse discounting emerges as a financing tool that benefits both parties. Suppliers receive advanced payments on approved invoices, enabling them to overcome cash flow challenges, while businesses solidify their supply chain and foster strong relationships.

This can drive growth by facilitating smoother transactions and improved supplier partnerships. Suppliers who accept this type of financing solution generally acknowledge and grant/ accept a discounted percentage of their invoice, due to the early or immediate payment structure.

Within the realm of invoice discounting and purchase order funding, businesses face the decision of financing 'with' recourse or 'without' recourse. Imagine a scenario where small business A employs invoice financing to sell a significant invoice of R1m to a lender under an invoice financing agreement.

The lender advances 80% of the invoice value upfront, with the remaining 20% held as a reserve by the lender. Now, suppose Company A's client fails to pay the invoice within the agreed terms, leaving the outstanding amount of R200,000.

Since Company A opted for financing with recourse, it bears the responsibility for the outstanding debt and must repay the lender that amount out of its own funds. If the agreement had been without recourse, the lender would bear the risk. Financing with recourse may offer lower fees or interest rates, but businesses must be prepared to assume the risk of non-payment by their clients.

Understanding when and why to explore alternative financing solutions is key to leveraging their potential benefits. A business would usually approach a second-tier financier when their primary bank has either declined a lending request or offers only a limited facility, and resulting cash flow constraints threaten growth prospects.

They may also be used as a savings mechanism to qualify for early settlement discounts with suppliers, thereby serving as strategic tools for businesses to optimise their operations and fuel expansion plans.

While alternative financing solutions offer flexibility and access to funds, they also come with their own set of considerations. Costs in the second-tier funding environment are typically between 2.5% to 5% of the transaction value - and in some cases may be even more so – which is considerably higher than typical fees from first tier commercial banks.

I would consequently recommend that businesses carefully analyse their reasons or their need for the use of such funds before considering invoice financing. Primarily, businesses should foresee a positive or profitable return through the use of alternative financing solutions by ensuring that the intended use of the funds outweigh the lender's fees.

Owners should certainly refrain from using this type of financing method for the repayment of outstanding debt or salaries.

Once these considerations have been assessed, businesses still opting to use one of these alternative sources of funding would be wise to prepare themselves beforehand, as follows:

- Lenders consider businesses that have been in existence for a period of two years or longer.
- On your debtors' book, identify those that pay regularly and hassle-free.
- Maintain your own good credit record status for when financiers conduct background checks on your business.
- Maintain a healthy age analysis which demonstrates a solid customer base that pays on time.
- When approaching a lender, provide them with detailed information regarding each debtor, facilitating best-informed decision-making by the lender.
- Consider security measures such as credit insurance or sureties in the event of payment default, business rescue or liquidation.

Embracing alternative financing solutions opens up a world of possibilities for businesses seeking to expand and thrive. By exploring invoice discounting, purchase order funding, and reverse discounting, entrepreneurs can access the funds necessary to seize growth opportunities, strengthen supply chains, and foster sustainable partnerships.

However, it is crucial for businesses to approach these financing options with a clear understanding of their specific needs and goals, weighing the potential benefits against associated fees and risks. In doing so, businesses can unlock their true growth potential and embark on a path towards lasting success.

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