Options Abound for Contractor Financing

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by Howard Chernin

A busy construction market demands adequate cash flow but contractors have various tools to keep their operations running smoothly.

Throughout the New York metropolitan area, new buildings are going up, old buildings are being renovated, and highways are undergoing improvement. Just as in the rest of the country, schools are being built or expanded and new health care facilities, municipal buildings, hotels, prisons, and airports are in the works. And the boom has affected every sector of the construction industry, from roofing to plumbing to HVAC.

But chances are good that just about every contractor, subcontractor, and supplier is going to need money to keep their projects going.

One common option is to borrow from a bank. Banks generally insist on securing assets equal to three times the amount of the loan. For such loans, the borrower has to meet monthly payment obligations, and in order to borrow more money, the contractor would have to renegotiate the loan. For some construction industry contractors, these loans can turn into a burdensome process in terms of cash flow and administration.

Asset-based lending is another possibility. Construction companies may use any real estate collateral they have to obtain a loan, primarily through finance companies. Additional collateral such as commercial or residential real estate, stock, or cash value on life insurance can also be used to obtain funding. The finance company may lend money based on the company's accounts receivable minus its accounts payable, advancing funds based on the value of the equity. But as with traditional commercial lending, finance companies are reluctant to lend only on receivables when those accounts involve progress billings, which is the prevalent method for construction industry companies.

A third alternative is factoring, in which a factor financing firm will advance a contractor, subcontractor, or supplier cash on the basis of one or more invoices. The factor buys the invoice, advancing up to 70 percent up front. When the invoice or group of invoices is paid, the balance not advanced is remitted to the customer, less a fee.

With factoring, a subcontractor does not have to borrow money, makes no monthly payments, and can control cash flow by exercising control over how much it factors and how often.

One example was a subcontractor in Brooklyn who was working on a large commercial development project and sought an infusion of cash. Under a factor arrangement, the contractor was able to obtain cash equivalent to as much as 70 percent of a single invoice totaling $100,000, or a sum of $70,000. If the account failed to pay because of credit problems, the factoring finance company would take the loss on the $70,000.

The subcontractor agreed to pay 3 percent of the total for the first 30 days as a fee on the $100,000. In other words, he would pay $3,000 to factor a $100,000 invoice for one month.

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Typically, the parties negotiate additional fees that would apply to invoices that remain unpaid after the first month.

When the invoice was paid within the 30 days, the subcontractor received the balance of the money – $27,000, or $30,000 minus the $3,000 fee. He therefore received $70,000 plus $27,000, or $97,000 of his $100,000 invoice.

The recent boom has lifted every sector of the construction industry. But chances are good that just about every contractor, subcontractor, and supplier is going to need money to keep their projects going.

Eventually, factoring helped this subcontractor grow his business by allowing him to take advantage of work opportunities that he would have otherwise been forced to decline. He was also able to use the extra funds to tap into volume discounts offered by suppliers.

For companies involved in construction, it behooves owners to explore the financing methods that can help their businesses manage adequate cash flow and even to grow dramatically. If the financing is available, the sky is the limit for our construction market. <<