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Looking for a Funding Partner?

What You Should Know About Your Company Before Finding a New Funding Source

BY HUGH SWANDEL

Preparing to negotiate with existing funding sources or to solicit new ones, should be treated as the most significant undertaking in your company's existence. Even the most consistent performers are being held to a much higher standard of performance and transparency. The expectations from sources of capital extend beyond financial strength and into detailed operational assessments.

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Over the years our firm has represented many leasing companies looking to secure additional funding capacity. Most companies have a very good understanding of their business model, but surprisingly, they are often unprepared for the questions and expectations of lenders that are viable sources of additional funding or equity. The purpose of this article is to remind those firms seeking funding of the traditional expectations of the funding and capital markets. The market has a renewed respect for the need for due diligence.

Preparing to negotiate with existing funding sources, or to solicit new ones, should be treated as the most significant undertaking in your company's existence. Prior to the current crisis, we were in a very long cycle of excess liquidity and it created an oversupply of capital. In some cases this oversupply led to complacency among borrowers and a lack of respect regarding the diligence and expectations of the providers of capital to our industry. Many firms where able to obtain high leverage and low pricing with little more than a good story about their ability to originate sales volume. The last year and a half have seen a purging of the weak business models and created a huge challenge for the remaining players to prove to the lending community that they have what it takes to remain healthy and strong. Even the most consistent performers are being held to a much higher standard of performance and transparency. The expectations from sources of capital extend beyond financial strength and into detailed operational assessments.

Making it easy for a third party to review files and gain confidence in the consistency of decision making will give capital providers more confidence that your business style is predicated on transparency and discipline.

Background

At the moment it remains to be seen what will be the norm in terms of the leverage and pricing that will be available to finance companies going forward. It still appears that few new financings are being closed and most finance companies are seeing a reduction in the number of existing funding sources willing to provide capital on an ongoing basis. If you have not lost some of your funding partners in the past 12 to 18 months, chances are you have seen a dramatic change in pricing and covenants from your providers. Many long-term providers of capital to leasing companies have halted all lending to "third-party originators." In addition, the asset-backed security market has ground to a halt. The TALF program in the U.S. and the secured credit facility in Canada appear to be starting to generate some new liquidity but it is too soon to tell if the impact will be short term or long term.

Until it is clear what leverage will be available to the industry, this is a time when those remaining in business need to focus on internal operations and make certain that they can clearly articulate their value proposition and why they excel. Once the new norm for leverage is determined, those that remain will be able to source funding with new terms and considerable market share will be available. Some of the firms will not survive the current environment for reasons other than the performance of the portfolio and historical profitability. Firms with a nominal amount of equity that have lost the high-leverage providers of capital will not be able to succeed if low leverage becomes the new norm. In the near term, it appears that healthy deposit-taking institutions are going to be the biggest winners as we come out of this downturn. With a stable source of funding and with limited competition, bank leasing companies are in the best possible position to capture market share over the next several months — provided they have a strong parent bank.

The lessors that are able to secure funding with acceptable terms will have the potential to create a business that will have strong value when the "new normal" is established. Historically after periods of low liquidity and consolidation the remaining players are often sold at very strong premiums. As liquidity returns, banks once again will face an issue of needing to increase origination in order to put their money to work quickly. In the past this has led to increased M&A activity and strong competition to acquire independent lessors. Firms that do not sell often see dramatic increases in profits and are able to gain from improved liquidity and better pricing. In either scenario the key to making it to the next level is surviving the current environment.

What it Takes to Stand Out From the Crowd

Looking for funding these days is a bit like looking for work as an actor. You go through many auditions and are often rejected for reasons other than talent. If you are looking for funding you need to become your own harshest critic. Engage in the activity of performing due diligence on your own company well in advance of soliciting a lending facility. Review performance and internal operations and provide a detailed report of what areas or aspects of the business require attention prior to negotiating with lenders.

Lenders are currently only working with the best operating and best performing lessors. Being able to articulate why you have succeeded is just as important as being able to show reporting and statistics that back up your claims. It is also important to state clearly your company's areas of weakness and what you have done to overcome these issues. It is far better to proactively show the best and worst of your business model instead of letting the lenders due diligence team find the issues on their own.

Credit Underwriting Policies and Procedures

Lessors often have spent a fair amount of time analyzing and monitoring credit performance but little time documenting the policy and procedures. In the event that a detailed credit manual does exist, it is often out of date and contradicts current policy and practice. Many of our clients are quite surprised when a lender reviews the policy manual and audits files to determine if policy and practice are one and the same.

Even if current practice shows a tighter credit policy than the ones that are documented it is far better to update manuals and show consistency than to have a potential lender point out that current practice has not been accurately documented. Lenders are incredibly fickle and increasing their confidence in your abilities at every possible turn will give you the best possible odds of success.

Another area of weakness with many lessors is the inconsistency in the content and presentation of the actual funded lease transaction. Lessors should be establishing a standard order for the documents in each file and adhere strictly to an identical order of paper work. We recommend that the first document in each file be the credit approval, which shows simply and clearly how a decision has been assessed and met the stated credit criteria. Obviously this is not necessary with small-ticket transactions that have been adjudicated using a scoring model unless the decision was made by a credit officer. Making it easy for a third party to review files and gain confidence in the consistency of decision making will give capital providers more confidence that your business style is predicated on transparency and discipline.

If your firm has revised credit policy based on performance of certain geographic regions, SIC codes, asset types or other significant criteria, be prepared to provide reporting on these changes. Few firms have escaped increased loss and delinquency from sectors related to housing construction or transportation. Be able to present your past portfolio performance with and without the amendments to your credit policy. You want to demonstrate that you have clear knowledge of what losses were created by past credit policies.

More importantly you want to show that you have eliminated these areas of credit approval from your model and that a new provider would not be exposed to these areas of risk. Once again transparency is critical when seeking new partners. Again, it is far better to show your weaknesses and how you have dealt with them than have these issues uncovered during the due diligence process.

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Documentation

A good practice for a lessor is to perform a regular review of all lease documentation. In the event that your firm has not had a recent review of all lease documents, it is wise to engage an industry experienced firm to carry out a review and make recommendations on changes or updates. Remember to then update all policy and procedures manuals accordingly. This effort shows lenders that you have been proactive in updating possible areas of concern a new provider of funding may have with your contracts. This is a far better action than having the potential new funding source explain that your documents are out of date.

Billing and Collections Policy and Procedure

This is another area that is often under documented or inaccurate when reviewed by a third party. Considering all of the changes in the economy and related portfolio performance, it is to be expected that your company may have changed collection tactics over the past 18 months. One specific area of policy that has often changed is credit rewrites and extensions. In good times, many lessors were often more inclined to repossess, sell equipment and sue for damages.

With the greater level of delinquency and default lessors have become much more willing to accommodate extending or rewriting the terms of a lessee transaction in order to avoid additional repossession work. The critical point is to make certain that current document policies and procedures are updated and documented. Reporting must be current and specifically detail leases rewritten or extended.

Reporting

Static losses are a measurement of losses over time against a group of assets originated during a specific period of time. This approach is used to determine the expected losses over the life of the assets rather than on an annual basis. Static pool loss analysis is perhaps the key indicator many lenders evaluate to determine the true picture of the health of the portfolio. This report provides solid evidence of your knowledge of where your performance has slipped and more importantly demonstrates the ability to work through defaults and optimize recoveries. The longer you have tracked static pool statistics the greater evidence of how lessors have learned from mistakes and adapted to changes in credit quality from different sectors.

A lack of transparency and due diligence is at the root of what destroyed many lenders in the past two years and because of this everyone remaining in the finance business will be held to a higher standard. Putting your company through due diligence in advance of pursuing new funding partners will dramatically increase your potential for success.

All reporting is critical; management must be well versed on demonstrating knowledge and understanding of the data.

Conclusion

This article provides a very high level and general set of comments regarding how to pursue new sources of funding in the current market environment. It is critical for lessors to recognize the circumstances that have led the financial services industry into the current predicament and what providers of capital are expecting as a result of these events. If you do not demonstrate a willingness to provide knowledge and insight of your company's weaknesses, you will most likely be quickly dismissed.

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