

## The New Realities in Equipment Finance

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After the collapse of the leveraged economy in 2008, small business owners are wondering what will happen next. While uncertainty and disagreement abound with regard to which public policies are most appropriate and what the characteristics and timing of a recovery will look like, lenders, brokers and borrowers of commercial equipment transactions are looking for the new rules of small business lending today. Here are my two cents on this subject.

While the new rules are continuing to unfold and evolve, this is where I think we are today in the small ticket arena:

### 1. **Credit scores have lost predictive power.**

No data pooled over the past ten years is of much help during a severe, unusual and structural downturn like this. Fair Isaac may insist that their commercial and consumer scores still “rank order risk” but that is not much help when so many entities and consumers with good credit scores suddenly file Chapter 11 or 7. In fact there is some evidence that higher FICO scores were somewhat correlated to worse delinquencies and defaults during this cycle. As optimistic risk takers, many owners of small businesses leveraged up on easy real estate mortgages by the peak in 2006 whereas those with lower FICO scores had fewer opportunities to do so.

Because all of off-the-shelf scores available now have not incorporated delinquency and loss data during the current downturn, a case can be made that they will have to be completely recalibrated using post 2008 data in order to provide acceptable levels of predictive power going forward. This is especially true of commercial scores. It may take quite a few years before the predictive power of such scores becomes credible again. Hopefully the new models will be improved by incorporating a wider scope of risk factors.

### 2. **Balance sheets are more important.**

Cash is king and low leverage is queen. Tangible equity and collateral are as important as ever. An experienced management team is a requisite when making a credit decision. At Allegiant we look at these attributes before we pull credit reports. We review complete bank statements showing all accounts. We ask business owners to explain their cash flow

and capitalization and to address the biggest risks in their businesses. We are adept at analyzing full commercial credit packages instead of application-only transactions.

3. **Fraud is rising.**

Bad times make people desperate. Whether it is misrepresentation, the fraudulent conveyance of assets, double financing or theft, we're seeing a lot more of it. We've had strong high quality borrowers suddenly turn into crooks. Sometimes they do this with the aid of their attorney. If opposing counsel runs interference against our efforts to collect and enforce our agreement, the costs can mount up quickly. This makes borrowing more costly and problematic for everyone. So these days we are taking extra care to avoid fraud. If the transaction doesn't make sense we won't approve it.

4. **Rates are high.**

Some small business borrowers still think they are living in 2006. With lower revenues and too much leverage they think they should qualify for very low rates. But there is simply not the same amount of liquidity and credit available today. If small business owners are serious about acquiring new equipment they will have to pay higher rates and agree to tighter contract terms.

5. **Small business owners are hesitant.**

Many are delaying their next equipment financing until they can get better terms. They are unsure whether they should acquire more equipment under current economic conditions. This may be smart or this may be a lost opportunity. We have asked brokers to please obtain an adequate upfront fee to cover our due diligence costs for complicated applications that may be get approved but never funded.

6. **Banks will be banks.**

We believe some banks will resume lending soon (at least temporarily) because they have to show real earnings at some point this year. We hope their decisions are rational (not excessively tight or excessively loose in their credit policies) but we expect their participation to be uneven. Some will continue to avoid lending altogether for certain industries, types of equipment and geographic regions. Some will impose covenants that are too restrictive. This provides opportunities for Allegiant and our customers. Regardless of the approach that banks may take, at Allegiant

we are succeeding to meet the demand for commercial equipment financing in a positive and consistent manner.

## **Summary**

There are definitely new realities at work in small business equipment finance today. There are new requirements for getting deals done. Over time these will evolve. We can't predict how and when the economy will begin to recover. But all of us at Allegiant know that a sustained recovery will happen. We are continuing to improve our functions and our level of service. We are doing our best to prepare for the upswing on the horizon.