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Diligence & Creativity Go A Long Way in High Risk Leasing

Blend high risk financing with a wobbly economy and you could be creating a recipe for disaster. However, ingredients such as thoroughness, diligence, flexibility and creativity can go a long way to closing high risk deals.

BY JAMES L. BEAUREGARD

The fundamentals of credit analysis are returning to high risk leasing. Gone are the heady days of the late nineties when seven figure deals were recommended on little more than a transaction summary and the venture capitalist that was backing the deal. Old school credit analysis is making a comeback. What do I mean by old school credit analysis? Old school credit analysis is exercising thoroughness and diligence in making investment recommendations. Old school credit analysis is having reasonable and adequate basis supported by research, investigation and appropriate records. Finally, high risk leasing recommendations require a modicum of creativity to cement a deal that provides an acceptable risk adjusted return to the lender.

Boston Financial & Equity Corporation's core business is providing equipment financing to early stage companies or non-bankable credits. We have always regarded thorough analysis of both credit and collateral and creative lease structures tantamount to making investment decisions.

The basis for these investment decisions usually starts with the same common denominators. A business plan or executive summary, the most recent year to date financial statements and comparative prior year financials (if applicable), a quotation and vendor contact on the equipment to be financed or a wish list of the capital needs of the firm for the next twelve months. One of the more overlooked, but equally if not most important part of any deal is the company contact. Having direct contact with a decision-making or decision recommending person is crucial to learning the objectives and constraints of the prospective client. Too often a contact is offered that provides little guidance to what the company is seeking. It is important to determine early in the process how the decision to finance the equipment is made. Interfacing with the right company contact can make the difference between a deal that takes 4-6 weeks to fund and one that takes 1-2 weeks to fund.

The business plan/executive summary is then reviewed, a detailed financial analysis of the firm is conducted, which normally focuses on cash flow and forecasts and an examination of the collateral is made. A call is subsequently made to the company as an introduction and to learn more about the firm's unique value proposition, current liquidity and future financing. It is also helpful to determine the firm's anticipation of funding the transaction. A due diligence call is placed to the prospective client's investors to gauge their pulse of management, the firm's target market, competition, and the investor's longer-term expectations. Finally, a conversation with the vendor/manufacturer of the equipment is critical to determine the collateral's remarketability, installed base, and specific function within the firm.

With this knowledge and basis in hand, a proprietary risk model software program is used to create an acceptable risk adjusted return based on inputs of risk assumed by the underwriter in their initial due diligence. Next, a proposal letter is generated to the prospective client, typically within forty-eight hours of receiving and making the prerequisite phone calls. We have found that a quick response and proposal to the client can make the difference between winning and losing a deal.

Creativity in high risk leasing recommendations emerges by listening to the prospective client.

A follow-up call is placed to the company within twenty-four hours to discuss the proposal letter. A lot can be gleaned from the follow-up call depending on the exchange with the company. For instance, if the company asks "How quick can we turn this around?" Confidence on closing the deal increases. However if the question is "I have a few proposals, is this the best you can do?" Optimism begins to wane.

Inevitably, when we hear that a company has a few proposals, our next question always is "Are those proposals from a funding source or a financial broker?"

Since the latter part of 2000, the number of high risk finance companies has decreased. Companies like Comdisco Ventures, GATX Ventures, LINC Capital and Greyrock Business Credit have all exited the high risk finance business. Technology banks such as Silicon Valley Bank and Comerica have also become more risk averse. However, there seems to be no shortage of finance brokers willing to quote a proposal on a high risk deal with little to no options to fund the deal.

While many companies might have attractive proposals, it is wise to caution the company to discern whether the proposal is coming directly from the lender that would be funding and holding the paper or from a source that will look to sell the paper. Given today's economic climate and aversion to risk, many of the deals quoted to higher risk companies will unlikely be funded based on the proposal letter.

When the company inquires about turnaround time, it is also wise to caution them that while you are reasonably confident you can fund the deal based on the proposal, it is not a commitment letter and final due diligence must be completed. That typically requires standard bank and trade reference checks, customer contacts, personal credit info on management, and more detailed assessment of the collateral.

Creativity in high risk leasing recommendations emerges by listening to the prospective client. There are many variables in high risk financing that are open to tweaking to get to “yes” with the client. These variables hinge on the client’s specific issues and concerns in the proposal. Most clients recognize within reason that given the predominant economic climate, lenders are exhibiting a flight to quality and higher risk deals come with higher costs of capital. At the end of the day, most clients realize debt is cheaper than equity.

Some of the variables used in creating a more palatable deal include getting additional collateral to secure the deal. Whether it is a security deposit, additional equipment, advance payments, marketable securities or real estate of the principals, some or all these can be used to modify the original proposal.

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Another way could be in the deal structure itself. If the client feels a security deposit kills cash flow upfront, consider removing the security deposit and stepping the deal in the first twenty-four months and lowering the last twelve months. Thereby, you reduce the upfront dollar concern at the beginning but keep exposure mitigated by increasing the payout sooner.

The equipment and vendor can also be quite helpful in securing the deal. In these challenging economic times equipment manufacturers and vendors are motivated to close sales, especially at or near quarter end. It is not unheard of to approach these vendors to sweeten the deal to the funding source by requesting blind discounts and/or residual guarantees.

Our experience has shown that if a mutually acceptable deal can be structured and a proposal letter is executed, the probability of closing that deal rises to 90%. Finalizing the last ten percent of the deal after the proposal is signed is usually ninety percent of the effort. It entails speaking with customers. These customers typically give you one of the most unbiased points of view of the client’s business. The lender should be cautious to choose customers he wishes to speak to and not have them provided by the client.

Deeper knowledge into the collateral should also be undertaken. For example, it is typical to speak with end users of the equipment. Important facts to discern from the end users are: What were the main reasons for selecting the equipment? How often do they replace their equipment? Would they consider buying used equipment? If not, why not? What differentiates this equipment from the competition?

Contacting broker/dealers of the equipment provides important aftermarket knowledge. Understanding the equipment’s history is key to forecasting its future intrinsic value. Examples include:

- Is there excess supply or excess demand of this equipment?
- Does the equipment need constant maintenance or are upgrades coming?
- How long has the vendor/ manufacturer been in business?
- Are there important install and deinstall considerations?

Last, but not at all least, is an onsite visit to the client. Personally meeting your client and its team and familiarizing yourself with your client’s operation and culture are most times the intangibles that can provide that gut feeling needed to recommend the deal to the credit committee.

Synthesizing your analysis and recommendation to one page for presentation to the credit committee is the final challenge. The delivery and presentation of the recommendation for the credit committee’s review should be informative but succinct. It should focus on the specific risks of the transaction and how those risks can or will be mitigated in the deal. The recommendation should also establish the basis of exposure and return in the downside as well as the upside opportunity of the deal. Questions will be asked. If you had not anticipated the question, be truthful and find out the answer. Removing the credit committee’s apprehension is needed to close the deal. Should your credit committee reject the deal, understand why, address the committee’s concerns in the deal structure and attempt to rework the deal.

Even with the most thorough due diligence and investigation of the company and equipment, losses occur. It is not unusual in high risk lending that half of your portfolio may restructure before reaching term. Being proactive about the possibility of losses may not remove the risk of a total write-off but may help mitigate the severity.

The high risk lender would be prudent to receive monthly financial statements on clients and periodically monitor the equipment. Has the equipment been moved or serviced? There are no trends to spot in high risk lending. One quarter looks great, the next quarter the company may have restructured. Reactive thinking fails in high risk lending. In short, cover your downside and the upside will take care of itself.

A slow growth economic environment and high risk financing may appear to be a recipe for failure. However ingredients such as thoroughness, diligence, flexibility, and creativity in credit analysis and recommendation can go a long way to closing many high risk deals. **m**

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