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MACHINE FINANCING OPTIONS[1]

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INTRODUCTION

Over the past fifteen years, and particularly over the past five years, the New Zealand logging industry has become more and more orientated towards the owner-operator, to the extent that the major forestry companies now have very little capital invested in this area. Finance companies can provide initial start-up capital, additional capital for replacement of equipment and expansion of operations, and provide financial advice when required.

START UP CAPITAL FOR THE NEW LOGGER – WHAT DOES A LENDER LOOK FOR IN APPROVING A LOAN?

Finance Companies are in the business of lending money. Many clients believe that my job is to make it as difficult as possible to get a loan approved. The opposite is in fact true. Like any Company, budgets must be met and a loan will be approved whenever an acceptable level of risk is apparent.

Before formally approaching a finance company for a loan to start a logging operation, the contractor should first try to determine what involvement that finance company has in the industry. This can be easily done by telephoning the Company and asking them direct, or asking other contractors who may have approached them themselves. As the logging industry is classed as a high risk industry, some finance companies will not lend money to purchase logging equipment. More importantly, a finance company which is heavily involved in the industry will have a better feel for a contractor's needs, and will be able to give financial advice based on their experiences with their existing logging clients.

Any prudent lender will assess a loan application according to three basic criteria.

Security

In most cases the lender will require security for his loan to protect himself in the event of default. The security can take many forms but will usually involve the machine being purchased. Ideally the lender will want to be able to sell the security and get his money back, plus outstanding interest, if required.

The lender will normally only lend up to a proportion of the purchase price or value of the machines being purchased. This takes into account the fact that it is rarely possible to realise the full value of the machines in a forced sale situation. It is similar to pur-

[1] A paper presented to the 1988 LIRA Seminar on "The Business of Logging."

chasing a brand new car for $35,000. Drive it off the lot and it is only worth $30,000. The lender will take account of this by only lending $30,000 against that car.

As a result, the lender will require the applicant to provide part of the purchase price by way of a cash deposit, or alternatively to offer additional security, such as a house, or another machine as collateral security for the loan.

As a rule of thumb the financier will lend up to 75% of the value of machines without requiring additional security for the loan.

Servicing or Repayment Ability

A lender will require evidence that repayments on the loan can be met, as the last thing that he wants is to have to repossess machines because of a loan default. If the machines being purchased are for an existing contract, the lender will want to see financial accounts for the existing operator. These will enable the lender to assess how the proposed repayments will fit in to the existing income of the contract.

If the machines are being purchased for a new contract, then a budget will be required, preferably prepared by a chartered accountant, showing anticipated contract income, expenses, and surplus available to meet repayments. The lender will need to satisfy himself that the proposed repayments are not too high for the contract being taken on.

The Applicant

The third aspect the lender will look at is the applicant himself. He will determine what experience the applicant has in the logging industry, and will evaluate whether he appears the type of person able to successfully run a business on his own account. The applicant will have to be a good man manager, a good financial controller and will need to know a lot about the machine he is operating.

A lender will always obtain a credit report and possibly a bank report as well on the prospective client and will want to see a good record of financial management in the past.

A bad credit report will not necessarily preclude the lender from approving a loan to the client. However he will want to discuss the report with the client and will want to know why difficulties have arisen in the past. It may be from a disputed account, which should not concern the lender unduly. However, if a client has a record of unpaid bills then it is unlikely he will have a loan approved.

A client should always mention any items likely to appear on a credit report, along with reasons, before the lender finds this out from his own sources.

In most cases the lender would like to see the applicant have a close relationship with his accountant to the extent that the accountant controls all of the finances of the business. That way the logger can concentrate on what he knows best, maintaining production in the forest.

In summary a lender will assess a loan application by addressing three criteria; security, servicing, and the ability of the borrower, and if all of these are satisfactory, the chances are that the loan will be approved.

EXPANSION CAPITAL FOR THE EXISTING CONTRACTOR

By the time a contractor requires expansion capital he will probably have been in business for over twelve months and will have established himself as a good operator or otherwise. After twelve months of operations the logger will have a set of financial accounts for his business and these along with some background as to the need for extra capital are usually all the lender will require to approve additional funds.

The importance of establishing a track record with a financier can not be overstressed. Once you have found a finance company you are happy with stick with them. A good understanding with the local manager will result in fast track loan approvals which are far more important than a half percent saving in interest rates which may be achieved by going to a new finance company.

This track record is also important if repayments fall behind. A manager will be more lenient with a client with whom he has been dealing with for five years or more and who misses a repayment, than with a new client with whom he has only been dealing with for six months.

TYPES OF LOANS – HIRE PURCHASE AGREEMENTS, CHATTEL SECURITIES, LEASES AND DEBENTURES

By far the most common agreements that you will come across are the Hire Purchase Agreement (or the Conditional Purchase Agreement) and the Chattel Security (or the Instrument by Way of Security). There is little basic difference between the two except that Hire Purchase Agreements are normally used at the point of purchase, while the chattel security is used where funds are being advanced against a machine already owned, or where collateral security is being taken.

Although there are some technical differences between the two, as borrowers you should be fairly indifferent between Hire Purchase and Chattel Securities as Instruments for borrowing money.

Leasing is more complicated and a very much misunderstood form of financing even among financiers themselves.

Basically there are two types of lease, a Financial Lease and an Operational (or Full Maintenance) Lease.

A Financial Lease provides for a deposit to be made by way of an advance rental, a number of rental payments to be made during the term of the lease, and a residual value to be met at the end. Prior to 1982, Financial Leases had major advantages over the other forms of financial agreements because the total annual rentals could be charged against income for tax purposes. However in 1982 the Income Tax Act was changed to specifically treat financial lease agreements as Hire Purchase Agreements, thereby eliminating any tax advantages of financial leasing.

In terms of tax treatment, cash flow, and costs of borrowing, there are absolutely no advantages with a financial lease compared with Hire Purchase Agreements or Chattel Securities as outlined earlier.

The other type of lease is an operational or full maintenance lease. Although reasonably common in the motor vehicle industry, it is relatively uncommon in the machine industry.

A full maintenance lease can be likened to a Television Rental Agreement. You lease the machine for a term of 24 or 36 months for a set monthly rental which usually covers all maintenance on the machine for the term of the lease. As long as no rights to purchase the machine at the end of the lease exist rentals are fully deductible for tax purposes. As the machine is not actually being purchased, usually no deposit is required.

Repayments are naturally higher than other forms of financing as they include all maintenance costs on the machine. Rentals are effectively "dead money" as the machine is never owned by the lessee. However it is a viable form of financing for some types of operator, but a detailed financial examination should be undertaken before opting for this above traditional forms of financing.

To illustrate the difference between the financial lease, operating lease and the conventional hire purchase financing option, the following table has been prepared for a machine with a purchase price of $185,000 and a resale value of $55,000 after 5 years (Table 1).

Financing Option	***Terms***
Hire Purchase *- Monthly repayment $5,690*	*Paid off over three years at 22.5% interest rate, with an initial deposit of 20%. The machine is sold in year five.*
Operational lease *- Monthly repayment $6,107*	*Normally these leases are only over a three-year period but for comparison it has been extended two further years under the same terms. At the end of year five, the machine is handed back to the leasor. Leasee not liable for repairs.*
Financial lease *- Monthly repayment $4,654*	*Using a five year term interest is paid on 100% of the purchase price. 70% of purchase price is also paid back with the remaining 30% being recouped with the sale of the machine at the end of year five.*

Table 1

Net Present Value of After-Tax Expenditure to Year Five
(Discount Rate = 10%)

	28% Tax Rate
Hire Purchase	*$139,295*
Operating Lease	*$232,968*
Financial Lease	*$180,984*

Although, for the terms given above, the financial lease offers the lowest monthly repayments, it incurs the highest level of after-tax expenditure. The conventional Hire Purchase agreement is found to offer the lowest level of after-tax expenditure.

Where a company has been formed it may be possible to borrow funds by way of a Debenture or Floating Charge over the assets of the company. However this form of financing is currently out of favour with Finance Companies, who usually prefer specific charges as security for their loans.

FORMING A COMPANY — DOES IT MAKE IT EASIER TO BORROW MONEY?

Whether a contractor operates as a sole operator (or partnership) or forms a company is more a tax planning decision than anything else.

As previously discussed, forming a company does give the option of raising funds under debenture, but most financiers would normally provide funds under other securities by preference.

Any prudent lender will require personal guarantees of major shareholders for any advance made to a company thereby eliminating the limited liability advantage that would otherwise apply.

In short, forming a company does not hold any advantages in terms of raising capital in the logging industry.

THE ROLE OF CONTRACTS

In the past it has been usual for a contractor to be offered a formal three, four or five year written contract. This has many obvious advantages over the contractor with no written contract, as the operator has some surety of continued work and can plan accordingly. He can for example purchase new equipment at the beginning of the contract, finance it for up to five years, and then when his contract is renewed he can repeat the procedure. Compare this with the contractor who is required to purchase one or two hundred thousand dollars worth of equipment with no definite assurance of continued work.

A financier definitely prefers lending money to a client with a written contract. However, financiers accept that most of the large forestry companies no longer issue these and have continued to provide finance to the industry nevertheless.

Experience suggests that even without a written contract the good performers will always be provided with work, while a written contract will not necessarily protect a bad performer.

INTEREST RATES

Whenever money is borrowed there will be an interest rate associated with it, be it bank overdraft or finance to purchase plant and equipment.

Finance companies are margin lenders, whereby they raise money from the public, add on a margin of say 5%, and then lend the funds to clients such as yourselves. The margin is relatively fixed, so when deposit rates are high, say at 20% plus, the Finance Company will have to lend funds at interest rates of 25% plus to maintain its margin. Finance Companies do better when interest rates are low as more people borrow money. Unfortunately we have had little success in convincing our depositors to take 5% for their investments, and so 10% lending rates are still some time away and current lending rates are in the region of 20%.

As interest rates are constantly changing some lenders will include a clause in their documents providing for a review in interest rate during the term of a loan.

Whether this is beneficial for a client depends on what interest rates are doing at the time. If interest rates are reducing then it will be in the client's advantage to have a reviewable rate to take advantage of lower rates in the future. If rates are increasing obviously the reverse will be true.

Unfortunately interest rate trends cannot be predicted with any certainty and because of this I tend towards recommending fixed rate borrowing. This is because contract rates take into account the costs of financing machines at the beginning of each year. To my way of thinking, the advantages of being able to cost a contract in terms of definite financing costs far outweigh the potential gains from trying to predict interest rate trends.

However, it is very much an individual decision and with most experts predicting a substantial reduction in interest rates in the next eighteen months, a reviewable rate may prove advantageous.

REPAYMENT TERMS AND CONDITIONS

Most finance companies offer repayment terms of up to five years, and may offer interest only terms for some periods. Hence a loan can be structured in a variety of ways, but the client wants to ensure that it is structured in the way that best suits his operation.

Interest only transactions and transactions over four and five years have the advantage of reducing monthly repayments and hence have a cash flow advantage.

Loans of 36 months or less have higher repayments but obviously are paid off in a shorter time.

I believe the ideal repayment term is the shortest possible term where repayments can be met <u>without straining the cash flow</u>. For some contractors this may be twelve months, for others it may be five years. It is important that equity is built up in the machines as quickly as possible and interest paid on the loan is kept to a minimum.

RAISING WORKING CAPITAL

Generally it is the Trading Banks role to provide working capital to a business, and the Finance Companies role to provide funds for capital expenditure. However from time to time Finance Companies do provide working capital by advancing funds against existing plant and equipment.

The working capital may comprise funds required to pay tax funds, to pay for repairs and maintenance on a machine or other similar requirements.

The contractor's first approach for such requirements should be to his trading bank, as such requirements are generally short term in nature and would generally be met from normal trading profits of the company.

The contractor generally should resist raising working capital against his machines for two reasons. Firstly it erodes the contractor's equity in his machines and hence may make it difficult to purchase a new machine further down the track, as there may be insufficient equity in the machine being traded to justify the new purchase. Secondly, and possibly the most important, the need to raise working capital in such a manner by definition indicates the contractor has insufficient trading profits available to maintain adequate liquidity. This will normally have resulted from one of two reasons, either the contract is running at a loss, or the contractor has made excessive personal drawings against the business, thereby straining working capital. In either of these cases raising working capital against machines is treating the symptom and not the cause, and the contractor should attempt to solve his working capital problem by improving his trading performance.

CREDIT

For various reasons contractors can fall behind with their repayments to financiers. If this happens several simple rules should be followed.

The first step is to contact the financier, (preferably before payment is due), to inform him that you cannot meet this month's repayment and tell him why. By doing this the financier can try to work through the problem with the client and where the problem is short-term will probably come to an arrangement with the client to catch up the repayment in the near future.

Where the problem is of a longer

term nature, the financier will want to discuss the situation in detail. It may be that the client has overextended himself and that the problem can be easily solved by refinancing the loan over a longer term with smaller repayments.

The financier will make every endeavour to keep the contractor in business as the last thing he wants to have is machines sitting in a yard for sale. However, in certain circumstances a hard decision needs to be made and machines have to be repossessed.

Before a finance company repossesses it will have considered the situation in some detail, will have discussed the situation over with the contractor and will have reached the decision that the contract is not viable. Generally where a contractor does not or will not make this crucial decision himself, he will carry on getting deeper and deeper into debt, prolonging the inevitable. Once the contract has been assessed as not viable the best thing for both the financier and the contractor is for the equipment to be immediately sold, and outstanding loans repaid, leaving the contractor free of debt.

It is inevitable that the odd repayment will be missed, be it due to machine breakdowns, a strike, an act of God or whatever. The key is to keep the financier informed and then the problem can be solved in an orderly way. Being evasive does not help meet these repayments but only serves to panic the financier into taking what may in hindsight prove to be drastic action.

When a logger decides to operate his own contract, his role changes from being an employee to an employer, with all the responsibilities that that entails. He becomes a businessman, who reaps the rewards of his success, or who bears the loss of his failure. In taking this step the logger, whether consciously or not, assesses the risks involved compared with the potential rewards and presumably decides that the rewards are sufficient to offset the risk of establishing his own business.

In receiving a loan from a finance company the borrower is committed to repaying the loan, whether or not the business is a success. If the business fails, the borrower is still liable for the repayment of his loan and in the case of default the borrower may be taken to court and bankrupted if he is unable to meet his obligations.

Many borrowers are adamant that they will not offer their house as security for their loan. However it is important to understand that the lender is quite entitled, in the case of default, to seek to realize on any assets the client may have outside of the business to recover his loan.

A lender is legally obliged to disclose the terms and conditions of a loan to the borrower <u>before any documents are signed</u> and if you have any doubts you should consult your solicitor before entering into the agreement.

REFINANCING

For various reasons refinancing of a loan may be required, and a discussion with your financier can usually lead to a restructuring of a loan to a form that better suits your business.

For further information, contact:

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