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Development of Equipment Financing

TECHNOLOGICAL PROGRESS and business competition have been the basic conditions promoting the growth of instalment equipment credit. Rapid advances in technology made possible the mechanization of industry, while competitive conditions gave strong encouragement to the actual introduction of cost-reducing and product-improving machinery and equipment. By widening the market for income-producing equipment, these persistent factors in the economic system have provided a broad foundation for the growth of equipment financing. Technological change has been operative over an increasingly wide area, greatly increasing the market for both equipment and the financing services frequently required for its acquisition. In the retailing and service trades as well as in manufacturing industries, machinery and equipment has become more and more essential to the successful operation of business.

The modern automobile service station, beauty parlor, barber shop, medical or dental office, to cite but a few examples, all utilize many units of equipment, much of which is quite expensive. Retail outlets such as restaurants, drug stores, bars and taverns, and food stores also use substantial amounts of equipment, without which their competitive position would be very adversely affected. These same outlets dispense an ever-widening variety of goods and services through the automatic coin machine, which is peculiarly suitable for instalment equipment financing.

While large as well as small companies in all industries are affected by the trend towards mechanization of production facilities it is notable that concerns in the retailing and service trades, where equipment financing facilities are widely used, are typically *small*. This must be taken into account in explaining the wide use of the instalment purchase method in acquiring equipment in these

trades. Data for 1939 from the Dun & Bradstreet *Retail Credit Survey*, which includes unincorporated as well as incorporated business units in retail trade but excludes chain companies, show that the typical (medium) annual net sales per store in various lines were as follows: dairy and poultry products stores, \$37,500; drinking places, taverns and bars, \$17,700; combined grocery and meat stores, \$31,400; meat markets, \$29,800; restaurants and eating places, \$20,500; garages (with repairing), \$16,800; drug stores (with fountains), \$23,200.¹

Retailers in all of these lines use machinery and equipment commonly sold on an instalment payment basis. While their relatively small size does not necessarily require that they seek instalment credit for the acquisition of equipment, their small size is doubtless a factor contributing to this practice. Full cash payments for modern equipment would make such a drain on the capital resources of many small concerns as to substantially retard its introduction. It was reported by Jerome in 1934² that one of the primary reasons restricting the use of machinery in industry was the heavy initial cost of acquisition; instalment selling is essentially a means of overcoming this restriction and thus of widening the market for equipment.

The problem of appraising the credit standing of small retail and service units seeking instalment credit is further complicated by their purely local character and wide geographical dispersion. This does not, however, preclude the use of the instalment payment plan by such companies. The reason for this is the special protection provided by the conditional sales contract, bailment lease or chattel mortgage under which the instalment sale or financing transaction is made. These contracts provide the vendor with title to the equipment, or a lien on it, and rights of repossession. In contrast, under an open-book sale title passes to the buyer and the vendor enjoys only the rights of a general creditor. Since the equipment is of continuing usefulness and value, these vendor repossession rights permit the spread of equipment financing, even among concerns of limited credit standing and to buyers on whom readily available credit information is necessarily scant.

¹ From *Standard Ratios for Retailing*, by W. L. Mitchell, Jr. (Dun & Bradstreet, Inc., New York, 1940).

² National Bureau of Economic Research, *Mechanization of Industry*, by Harry Jerome (New York, 1934).

A second important reason for the growth of equipment financing is that the instalment payment plan makes it possible for the machine to pay for itself over a part of its service life without requiring a substantial depletion of the buyer's capital funds. This is, as indicated above, of special importance for smaller concerns but it has relevance even to the case of enterprises of greater financial strength. If the machine, say a self-feeding loader used in coal mining, reduces operating costs by an amount sufficient to cover the instalment payments, the machine may be acquired and paid for without tying up any more funds than the amount required for the down payment.

A third reason, and one of great importance, is to be found in the fact that manufacturers and distributors have sought to increase sales by the offer of instalment payment arrangements. It was only by offering goods on this basis that a broad market could be found for them. Also, liberal instalment terms provide a method of stimulating demand in times of reduced economic activity. Equipment financing was a natural development of this pressure to increase sales by offering longer credit terms to buyers, especially where the sales market was chiefly composed of small concerns of limited credit standing. The use of title retention documents made it possible to extend credit to such companies with a maximum of protection to the seller.

The conditions that have been discussed above appear to account for the growth of instalment purchasing of equipment but quite different considerations have to be raised to explain the emergence of the special financing agencies that extend credit in this field. If manufacturers and distributors selling equipment on an instalment basis carried the resulting receivables among their own assets, there would be no scope for the operations of special instalment financial agencies. It is important, therefore, to consider the reasons why many vendors do not carry their own instalment receivables.

1. An important reason is that by discounting receivables the sellers of equipment are able to gear their use of financing facilities to the exact amount of their financing needs and possibly to obtain the use of a larger amount of outside funds than would be possible under other arrangements.

The nature of these advantages can be illustrated best by

reference to the type of equipment financing procedure in which the vending company assigns its receivables as security for a bank loan. In this case the loan balance for which the vending company is indebted and on which it pays interest is automatically increased and decreased in accordance with changes in the amount of its receivables outstanding. On the other hand, if the company were to carry its receivables and borrow on a separate unsecured basis the loan balance on which it would pay interest might at certain times be greater than the amount of its outstanding receivables; at least the current running balance on which interest is paid would not be automatically adjusted to its financing needs. This may produce substantial economies in interest cost.

Aside from this element of flexibility and possible economy, there is a certain convenience attached to the assignment procedure in that it is not necessary to negotiate a succession of loans. All that is required is that a credit line be established and an agreement reached as to the amount that is to be loaned against the assigned receivables, an arrangement exactly similar to that followed in the accounts receivable financing arrangements whereby open-accounts receivable are used as collateral for short-term loans. Once the financing arrangements have been drawn up, the procedure is on a nearly automatic basis; the amount of the vendor's debit or loan balance increases if new credits on instalment purchases exceed repayments of outstanding receivables and declines if new credits fall below repayments. The amount of the debit balance arises not from any particular loan negotiation but rather from the ebb and flow of outstanding receivables. If other credit elements are equal, the interest rate which will be paid on a secured loan of this type may be in certain circumstances lower than the rate required on an unsecured loan. But even where the secured loan rate is not lower (for example, where there are differences in the credit elements involved and in the costs incurred by a bank lending on a secured revolving credit basis) the vendor may prefer it because of his ability to get more credit on a secured than on an unsecured basis.

These elements of flexibility, economy and greater borrowing potential are important also where the procedure involves the actual sale of the instalment receivable to a financing agency as contrasted with its assignment as security for a bank loan. But in

this case there are additional elements, as will be indicated below, that are of importance in determining whether or not an outside financing agency will be used.

2. Concerns seeking to sell their instalment receivables to an equipment financing agency may be influenced primarily by a desire to avoid an increase in indebtedness. With insufficient working capital they have the choice of borrowing the necessary funds or selling the receivables in question. The latter may be preferred because by selling instalment receivables assets these are transferred into cash without any change in the debt position. Furthermore, any increase in the short-term debt element of the financial statement is avoided although there may be a contingent liability on the receivables growing out of a recourse or repurchase agreement.

3. By offering customers a financing plan which involves the use of a finance company or bank, the seller of the equipment is able to make a clear separation between manufacturing and financing functions, and especially to avoid having a credit department dominated by sales considerations, to the possible detriment of the collection record. Under an external financing arrangement the manufacturer or distributor achieves a more complete degree of specialization and avoids the assumption of functions with which the company's officers may be unfamiliar. Furthermore, though it would be possible for the company's officers to acquire sufficient experience to undertake these financing functions, it may be a settled matter of corporate policy for the company to maintain as simple a functional organization as possible. If the manufacturing or distributing company decides to carry its own instalment receivables it also assumes the problems and expenses of credit appraisal, collection, and accounting that are performed in connection with instalment contracts. Beyond the fact that this involves special costs and calls for an organization staffed by specialists in the credit field, it has the effect in practice of putting the manufacturer into the financing business, an activity that the manufacturer may want to avoid. The specialization of function achieved by the interposition of a financing agency between the manufacturer and the user of the equipment may produce economies that could not be realized in other arrangements. Some of the larger manufacturing companies have attempted to obtain

these economies by the organization of separate financing subsidiaries, the largest of which is General Motors Acceptance Corporation.

4. Especially where sales are made through dealers, the services of outside financial agencies may be necessary because of the limited working capital of vendors and their inability to carry their own instalment paper. This is almost certain to be true of small distributors with a substantial sales volume but it was important also, especially in the early years of equipment manufacturing, for the manufacturing concerns selling on instalment terms. Competition required terms of up to, say, three years and these could be offered without outside financing only if the manufacturer had a strong working capital position. Lacking this financial strength the manufacturer sought out finance company funds when bank loans were unavailable to supplement working capital.

5. A manufacturer, dealer or distributor may prefer to discount instalment receivables rather than carry them himself because of certain ancillary financial services available through the finance company arrangement. It was mentioned above that the financing agency performs the important functions of credit appraisal, collection and accounting; in addition the vendor may dispense with legal counsel on instalment sales problems and depend on his financing agency to supply this special service. Since the financing agency specializes in handling instalment repayment contracts, and since it frequently operates on a regional (if not on a national) basis, its legal department is well equipped to handle efficiently questions growing out of the diversity of state laws on conditional sales contracts and other security devices used in instalment selling. Also, general financial and management counsel may be available from the financing agency.

There are other factors, however, that operate to encourage the seller of merchandise to carry receivables rather than to discount them with some financing agency. The manufacturer or dealer having adequate working capital may feel that he can add to his net income by incurring the cost of operating a credit department and taking the full amount of the finance charge. Some firms have reported this as an important source of income. This could be true, of course, only of those firms having adequate working capital and well-organized and efficient credit and collection depart-

ments. Moreover, such calculations require that the individual seller know the direct costs of operating his credit department, and that other costs be allocated properly. It is quite possible that faulty cost accounting practices may lead a concern to believe that it is (or is not) economical for it to carry its own paper when the opposite is the case.

The vendor of income-producing equipment may desire to carry his own instalment receivables in order to eliminate the possibility of any intermediary financing institution utilizing collection procedures that might injure customer relationships. Also, by holding the paper, or at least by making collections on the instalment receivables, the manufacturer or dealer establishes and maintains a continuing relationship with the purchaser of equipment. This may be very important, particularly if the seller of the equipment expects to obtain additional income through the servicing of the equipment or the sale of accessory commodities.

The fact that a manufacturing or distributing concern carries its own paper may, of course, be due primarily to the inferior quality of the paper and to the unwillingness of any financing agency to purchase it, rather than to the manufacturer's or dealer's desire to carry it. It seems unlikely, however, that this could be an important consideration in very many cases, since the inferior paper can in most cases be made acceptable for financing if a reasonably large volume is available. That is, the financing arrangement may provide for full recourse on the manufacturer or dealer and a smaller percentage advance on each instalment receivable than would be offered if the receivables were of higher quality.

The general question of whether the manufacturer or distributor of income-producing equipment will seek the services of some financing agency is decided by reference to the preceding considerations. There is, however, another set of questions that require attention. These have to do with the type of equipment financing service that will be selected by the equipment buyer. Even if a buyer of equipment has decided to make the purchase on an instalment payment basis, it is not necessary to follow a finance plan offered by the manufacturer directly or through some cooperating financial agency. On the contrary, the purchaser may borrow from a commercial bank and use the funds so acquired to make a cash purchase, possibly giving a lien on the equipment purchased.

This set of alternatives is exactly the same as that faced by a consumer in deciding, for example, whether to buy a car by borrowing directly from a bank, paying cash for the car and repaying the loan in instalments, or to make the purchase on a conditional sales contract basis, in which case the instalment paper reaches a financing agency indirectly, through the vendor. In general, the main considerations that are important in determining which of these alternatives will be selected are (1) the relative costs and convenience of the two arrangements, (2) whether the purchaser has, or can acquire, banking relationships which can be turned to this purpose.

The widening demand for machinery and equipment and the consequent increase in the demand for special financing services have produced significant institutional adaptations on the supply side of the credit market. These take two forms: the development of new specialized financing institutions, and changes in the functional basis of established financial agencies. In each case the changes represent both an accommodation of the financial organization to demands for new types of credit services and an encouragement to the further growth of equipment financing, in that the ready availability of a specialized financing service can contribute greatly to this result.

In the next chapter we shall deal with the volume of equipment financing conducted by these agencies; at this point it may be useful to identify them in a general way and discuss the more important factors contributing to their growth. The three main equipment financing institutions are the commercial finance company, the commercial bank and the manufacturer's financing subsidiary. Some equipment financing is also conducted by insurance companies, through purchases of notes secured by equipment, and by industrial banking companies in connection with their general financing activities.

The term commercial finance company will be used to refer to those non-banking agencies, active in the field of equipment financing, that have no corporate affiliation with manufacturers or distributors of equipment. These companies generally engage in a variety of financing activities and are commonly referred to as sales finance companies or as finance companies.

A combination of circumstances accounts for the development

of commercial finance companies as specialized agencies in the field of instalment equipment financing. Of fundamental importance was the need for a specialized agency, equipped to handle a large volume of individually small credits secured by a wide variety of commodities with only limited resale markets. The credit appraisal techniques, credit standards and collection procedures appropriate to this type of financing were quite unconventional when judged by the usual practices of established lending agencies. Insofar as the financing procedures had a parallel in the market, it was in the financing of instalment sales of consumer durable goods, although these lacked the income-producing characteristics of equipment. It was quite natural therefore that companies experienced in consumer instalment financing should have turned to the financing of income-producing equipment.

Perhaps of equal importance was the reluctance of established banking institutions either to enter into this specialized and relatively high-cost credit area on a direct basis or to finance equipment manufacturers and dealers to the point where they could extend long instalment credit terms to their customers. The volume of instalment paper available to the smaller banks was scant at best and the larger banks were better satisfied by wholesaling credit to the specialized financing agencies than by lending to equipment manufacturers on an unsecured basis or by discounting their instalment receivables directly. Commercial banks were generally unreceptive to instalment equipment financing in its early stages, as they had been to consumer instalment financing. Commercial finance companies operating with equity funds, and also with substantial bank borrowings, began to supply the credit for which the market showed a strong demand. It was not until the credit problems of the field had become better known and credit standards better established that, under the impetus of declining income on other assets, commercial banks undertook to engage actively in equipment financing.

A second factor that served to encourage the growth of commercial finance companies and to favor their early entrance into the field of instalment equipment financing was the fact that, unlike commercial banks, these companies were able to operate branches on a national or regional scale. While it is true that the actual equipment financing operations tend to be conducted from a few

central offices, the existence of a network of branches or field agencies has been a strong selling argument for the commercial finance company seeking to discount and collect the receivables of manufacturers selling nationally. This advantage doubtless increased the volume of business that could be acquired by the commercial finance company as contrasted with that available to the local commercial bank. In this type of financing profitability depends so much on volume of operations that this advantage was a significant element in the combination of circumstances that produced the present structure of market facilities. Furthermore, the nation-wide operations of the commercial finance company also facilitated the appraising of credits and, especially, the work of credit collection.

The commercial finance companies active in equipment financing are almost all engaged in diversified financing activities. In some cases equipment financing is the main division and in others it assumes a subordinate position. This suggests that to some extent activities in equipment financing have been undertaken mainly as a result of the intensification of competition in other sales financing lines and in an effort to find new and possibly more profitable uses for funds. However, the executives of commercial finance companies are at variance on this point. One executive stated that his company had gradually liquidated its equipment financing business because it felt this was less stable than open accounts receivable financing. An executive of another concern reported that his company had decided to withdraw from accounts receivable financing, and to increase its activity in equipment financing because the latter offered a higher quality of risks and was more profitable. An executive of a third company pointed out that equipment financing was an essential part of a plan of diversification set up to protect the company from a sudden decline in demand for other types of financing.

The activities of commercial banks in financing acquisitions of commercial and industrial equipment have not been extensive enough to exert any considerable effect on the development of equipment financing. However, to the extent that commercial banks are entering this business, there is a broadening of the financial facilities available and a further stimulation given to the whole industry. The principal factors accounting for the interest of com-

mercial banks in this type of financing are first, the experience obtained in financing consumer instalment purchases of durable goods, second, the example of profitable operations of commercial finance companies and, third, the pressure that banks have felt during the thirties to find new uses for their funds, as their lending capacity increased and the gross income earned on assets declined sharply.

The primary factor accounting for the development of manufacturers' subsidiaries has been the advantage that manufacturers saw in instalment selling as a means of increasing sales. A number of companies entered the field at an early date, particularly concerns selling relatively expensive units of equipment. Notable examples are found in printing machinery, tractors and farm equipment, office machinery, mining machinery, shoe, textile and bottling machinery, laundry equipment, transportation equipment and dental equipment. This is by no means a complete list but it illustrates types of equipment that have been sold on an instalment payment basis for from twenty to fifty or more years. In some cases the sellers conduct their time-sales activities through the medium of a subsidiary finance company but more frequently the seller functions directly as the financing agency. In any event, it was the pressure to promote sales of equipment and to meet competition that produced manufacturer financing facilities.

Summarizing, the primary factors promoting the growth of equipment financing have been the wider use, by small as well as by large concerns, of machinery and equipment, and the demand for some kind of financing facilities to make equipment acquisitions feasible for companies of limited financial strength. Given this essential basis, the development of financial agencies equipped to extend the credit services needed has grown mainly out of the unwillingness, or inability, of the manufacturers and distributors to extend instalment credit on their own resources. Thus, financial agencies active in this field can be viewed as responding to an underlying demand for a particular kind of financial service, although their existence and their effort to expand business has in turn served to stimulate the growth of equipment financing. Finally, the particular institutional pattern that has been assumed by the supply side of the market is to be explained mainly in terms of the gradual attainment of experience in other lines that has proved

relevant to equipment financing, the legal conditions under which the various types of institutions have operated, competition in other financing fields that has served to encourage the wider use of funds in the equipment financing market, and, for manufacturers, the prospect of increasing sales through instalment financing facilities.