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MONITOR PODCAST SERIES: *NAVIGATING THE CURRENT ECONOMIC CLIMATE WITH CAUTION, DISCIPLINE & PATIENCE*

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MONITOR PODCAST SERIES: *Navigating the Current Economic Climate with Caution, Discipline & Patience*

Equipment finance companies haven’t had to deal with a volatile economic climate in more than a decade. As the Fed works to curb inflation with a series of calculated interest rate hikes and as supply chains continue to recover from the COVID-19 pandemic, equipment finance companies must prioritize caution, discipline and patience. John Vande Moore talks about how to do that in today’s podcast.

Rita Garwood

Hi, everyone. I'm Rita Garwood. I'm editor-in-chief of Monitor. Joining me on the podcast today is John Vande Moore. John is Chief Financial Officer of ENGS Commercial Finance Co. John, I'm so happy that you're joining me today on the podcast.

John Vande Moore

Thanks for having me, Rita.

Rita Garwood

The first thing I wanted to talk about is the current interest rate environment. Everybody's talking about it. The Fed has already started raising interest rates. They're expected to continue doing so throughout the year. It's the most volatile environment we've seen in a long time. How are you seeing the trend impact the industry?

John Vande Moore

Well, as you mentioned, the Fed telegraphed 2022 pretty well in late 2021 that they were going to be increasing interest rates. And we kind of saw a mixed bag here in the first quarter of the year. As we saw benchmark interest rates going up, we saw customers taken by surprise that they were getting increased rates compared to what they were getting in 2021. We also saw kind of a mixed bag from our competitors. Some of them were a little slower to respond to interest rates moving up. And so it caused kind of a little bit of a disruption and a little bit of chaos here, really in the first quarter, and I would say even into April and May. But as we're into June, our customers understand that interest rates are going up. They're seeing it in the news. They're seeing inflation numbers, and we're seeing our competitors also kind of falling in line with the market. I think things have kind of settled in, if you will, a little bit as we head into the latter half of the second quarter.

Rita Garwood

That's good. For the last few years, we've been hearing a lot from people who wanted them to go up since they've been so historically low. So for the business in some ways can be seen as a good thing. So when it comes to setting interest rates, what can equipment finance companies do to ensure that they're looking out for their best long term interests and then also keeping their rates low enough to be competitive, knowing that they're probably going to be going up later this year as well?

John Vande Moore

Well, it's been a great ten years with pretty stable interest rates going up in and through 2021, and then we ran into 2022. So I think some companies were caught a little bit flat footed or were a little complacent. I would say that there's really two things that finance companies can do at ENGS. And I think most of our competitors, we're lending money at a fixed rate. We're borrowing at a variable rate. We hedge that exposure. So we turn our variable rate into a fixed rate. We used to do it quarterly, I would say. And I would suggest other finance companies do the same thing, and that is hedge your interest rate exposure instead of, let's say, quarterly or even less frequently to more frequently. So that could be different for different companies. At ENGS, we're hedging our exposure monthly now because interest rates are moving so dramatically, really, on a weekly or even a monthly basis. So that's one way where they can eliminate some of their risk. Another is pricing to customers. So as benchmark interest rates move updating your pricing to your customers on a weekly basis. That way, if interest rates move down, the customers get the benefit of it.

John Vande Moore

You're within market. If interest rates move up your pricing with the market and you're maintaining your margins. So a little more frequently and a little more paying attention to both your cost of capital as well as the rates that you're charging to your customers will ensure that you're keeping your margin healthy and better for the customer and better for the finance company.

Rita Garwood

That's great advice. Another challenge we're facing today is inflation, something that we keep hearing about. We see it everywhere we go in the stores. From your perspective, how is inflation impacting the industry?

John Vande Moore

Well, I think we all remember early 2021. Janet Yellen and the Fed insisted that inflation was transitory and would go away pretty quickly. I think we've all realized now a year later that it's pretty persistent. It's caused by supply chain issues. It's caused by increased labor costs, caused by increased raw material inputs. So remember that inflation in 2021 and the persistence of inflation has caused the Feds to take action, which is what's driving interest rates up now. So they're really correlated, right. Inflation is causing us to have this interest rate environment that we're in today. Companies need to understand that right now with inflation, some of it, I would say, is permanent and some of it is kind of temporary, even today. So the supply chain issues have elevated cost of new equipment, but even more so, used equipment. So we're seeing in all of our markets used equipment because customers can't get new equipment, used equipment is at all time highs. So as we're pricing transactions, we need to keep in mind kind of the inflation aspect of the equipment and understand whether it's permanent or whether it's kind of temporary. And by temporary, I mean, where is it going to be six months, twelve months, 18 months from now?

Rita Garwood

So taking a look at that, what are the factors that you would look at to consider? Is this a permanent thing? Is this more temporary?

John Vande Moore

Well, I would say there's one thing that we should all keep in mind, and that is let's not fight the Fed. The Federal Reserve is taking action this year for the sole purpose of cooling asset prices, bringing inflation down. So whether it's cryptocurrency real estate, the stock market, or even what we're seeing in the equipment finance market with these elevated prices, we're going to experience some alleviation of some of these pressures because the Fed is going to keep raising interest rates until they see the results. We're starting to see it already in the stock market, in the real estate market and the crypto market and we are starting to see some of it actually in the equipment finance market in the equipment areas that we service as well. I think when our underwriting team is looking at equipment, they're looking at really where are we going to be twelve months from now? So we're at elevated prices today as we underwrite good credit quality, our best credit quality customers. We're not as concerned about the equipment value in the current elevated pricing. As you go down the credit quality spectrum, you're more worried about, let's say default over the life of the transaction.

John Vande Moore

So that means you're reliant on the value of the equipment. And so as we price transactions, we're thinking about the equipment value, Especially as we go down to the lower credit quality area.

Rita Garwood

And that was going to be my next question. How is inflation coming into play when you're determining the asset value? What can equipment finance companies do if you're leasing or financing a piece of equipment today and perhaps it has an elevated value Because of the supply chain issues? What would that look like if you're financing to a better quality customer Versus a lower credit quality customer?

John Vande Moore

Great question. The reality is the better credit quality, they're going to have less of an impact and the lower credit quality more of an impact from our underwriting and our structuring of the transaction. I think there's a couple of ways that you can address kind of a disparity and historic values Versus the values today. One of them is obvious. Right. Let's have an increased down payment to get the equipment value to more normalized levels. The second thing is to the extent that the customer doesn't have the money to put a larger down payment, you can have step down payments. So what that means is the customers obviously understands that they're paying an elevated price, but their business is good now, for whatever reason, whether they have a contract, a customer contract or pricing is good in their market. So while they're doing well financially, you can elevate the price of the payment for the next twelve or 18 months So that the transaction amortizes more quickly and then after that twelve month period, you can step down the payments. So that way when the customer has increased cash flow transaction amortizes and then hopefully in that twelve month or 18 month period, the equipment value is more in line with normalized values of that equipment. So you're lost given default. If that's point is more normalized, that.

Rita Garwood

Sounds like a great way to mitigate some risk. So we started talking about the supply chain impacts that we've been seeing. There's been shortages of equipment. Semiconductors are affecting so many pieces of equipment and cars. How does that impact affecting the industry today? I know it's been really bad. Are you seeing any improvement there or things about the same as they were a year ago?

John Vande Moore

Well, I talk to some of our dealers and some of our sales leaders here at ENGS just to see what is the current state of the supply chain. I think when we went through 2021, we saw the supply chain issues increase throughout the year, and those issues still existed in the first half of this year and even today. So what we're hearing from some of our dealers and some of our customers is as we look forward, some of the supply chain issues are modestly decreasing where some of our dealers are getting more equipment than what they were told, let's say earlier in the year. They're still running into supply chain issues in other areas, but predominantly they are starting to get some relief from the manufacturing getting more equipment. I think on the flip side of that, again, with the Fed cooling off the market, some of our customers are saying being a little more cautious, whereas they were very aggressive in 2021 and early 2022. For the first time, we're seeing cancelation and orders where we didn't see that really for the last two years. So I think these two factors as we look forward over the next six or twelve months, hopefully the supply chain issues will start to alleviate and I think the Fed will do their job to cool the economy, which is going to alleviate some of the demand from customers for equipment.

John Vande Moore

Those two things combined may or may not alleviate the supply chain issues, but I'm hopeful that they'll somehow start to fix themselves. We obviously have these unusual things that happen periodically, which is China shutting down because they have a zero COVID tolerance. So entire cities closed down, which disrupts the supply chain. And then we've got the Russia Ukraine war, which is also another disruption which is unforeseen. So I'm hopeful that the supply chain will start to fix itself as we go into 2023. But there are other things that are unexpected that could come up that are unknown at this point.

Rita Garwood

Those wild cards of the ELFA always puts on their hot list for the year. It seems like there's so many of them happening right now.

Rita Garwood

So with all of these factors put together, the short supply of equipment demand has been through the roof is starting to taper off and then inflation and interest rates on the rise. How do you determine the best pricing?

John Vande Moore

Well, I say that this is kind of an unusual time, if you will.

Rita Garwood

Right.

John Vande Moore

So I think a disciplined and kind of patient approach ENGS is here through all markets. Right.

Rita Garwood

Good.

John Vande Moore

And bad markets. And I think as we look at pricing going back over the last year and a half, we've seen the best portfolio performance ever. Right? Our customers have been healthy, the economy has been healthy, and their cash flow has been good. But again, with the Fed trying to cool off the economy, as we look forward in the next six to twelve months, everyone's got the same inputs that they put into their credit model. What is the current interest rate environment? What's the current inflation environment? What's the current equipment market? And then what are the risks on the horizon? Do we see an improving economy or a slowing economy? And I think right now, unless we're going to disagree with what the Fed is doing and we think that they're not going to be able to accomplish their goal again, we don't want to fight the Fed. The Fed's going to try to slow down the economy. So these factors all need to come into the pricing model. Everyone's going to have different inputs and assumptions into it. But if you want to be here through all different cycles, you should take those inputs into your model and assess those risks for yourself and just make sure they're pricing transactions right now with your eyes wide open makes a lot of sense.

Rita Garwood

So I have a question about we were talking about how demand has been through the roof in the past and equipment has been in short supply. Let's say someone wants to order equipment or has like a pre order for equipment and it's not available yet. What does that look like in terms of financing that do you need to wait until the equipment is available? Do you work at a deal? Now, how does that work?

John Vande Moore

So I would say this has really been common over the last twelve to 18 months. I think the best thing for customers to do is go get credit approval right now. At ENGS, credit approval is good for 60 to 90 days. That might not be long enough for many customers, but by going through the credit process, they understand, hey, I'm approved now, I understand the pricing so I can budget appropriately. And if the equipment actually is delivered outside of that window, then it's simple. We have all of your information. We just need to update it for your current information. Assuming nothing unusual changed, we can quickly turn around a credit approval. But I wouldn't wait because you might be disappointed. There might be some action you can take between now and actually getting the equipment to make sure that you have a financing lined up. But to answer your question on pricing, if we give you a credit approval today, it's good for 30 or 60 days. So the pricing is good for 30 to 60 days. But if it ends up outside of that window, when we credit approve you, it will be based on the current market conditions. At that time and interest rates could have moved up or down.

Rita Garwood

That makes a lot of sense given everything that's happening. So given all of these factors that we've been talking about today, what actions can equipment finance companies take to protect themselves and their customers and vendors?

John Vande Moore

Well, I would say being flexible, like we talked about with down payment, making sure you're there for the market. Equipment finance companies are really the oil that keeps the sales process moving, right? There's a vendor that wants to sell equipment. There's a customer that needs equipment. At ENGS, we try to be there for the customer again through all different market cycles. In this one, we try to be flexible, as we mentioned, with down payment, with pricing, we try to be responsive to where the benchmark rates are going. If rates move down, we pass those on to the customer. If they move up, obviously, we need to maintain our margins Because our costs are going up. And as we mentioned before, Hedging your interest rate exposure to make sure that your margins are locked in. So as you go through 20, 23, 20, 24, you're not getting squeezed if interest rates continue to move up, if you're borrowing at a variable rate. So there's a variety of things. I think right now it's just being disciplined; it's being patient. It's trying to be as flexible as you can to meet the needs of the vendor and the customer.

Rita Garwood

That's great. Any final thoughts?

John Vande Moore

Well, I'll say it's been an unusual year. We've had a couple of these headaches where the fed threatened to raise interest rates throughout the last ten years, but it kind of fizzled in the most recent time because COVID hit. The fed was going to raise interest rates in 2020, and then they did the opposite, right? They brought interest rates down to zero. So once again, we're in a market, it seems a little more predictable Where the fed is going to raise interest rates, where inflation is going to be here for the foreseeable future, Where the supply chain issues will be here for at least the next six months and maybe longer. And so it's an unusual environment, and I think on top of that, we're starting to hear the recession word. And so that makes 2023 and 2024 a little more unpredictable, A little more risk than what we had. Maybe when it was last year and everything was just fine, Interest rates were low, economy was humming along, and we thought the party wouldn't end. But I would say in 2022, caution, discipline, and patience is kind of the keywords for 2022.

Rita Garwood

Patience, caution, and discipline. Those are great. Thank you so much, John, for talking with me today. I really appreciate okay, great.

John Vande Moore

Thank you, Rita. I appreciate it.

Rita Garwood

Thanks.