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THE IMPACT OF THE CREDIT CRISIS ON EQUIPMENT DISTRIBUTORS AND THEIR CONTRACTOR CUSTOMERS

STATEMENT OF TIMOTHY WATTERS, PRESIDENT & CEO, HOFFMAN EQUIPMENT CO.,
PISCATAWAY, NEW JERSEY
ON BEHALF OF THE ASSOCIATED EQUIPMENT DISTRIBUTORS
BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS

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Good afternoon Chairwoman Velazquez, Ranking Member Graves, and other distinguished members of the House Small Business Committee. My name is Tim Watters and it is my pleasure to

Executive Summary:

- Construction equipment distributors rely on credit to operate their companies and the vast majority of equipment purchases are financed.
- Tightening credit has taken an enormous toll on equipment distributors and their customers. The overwhelming majority of AED members report that they have lost equipment sales over the past year because customers have been unable to get financing. AED estimates the value of those lost sales at more than \$700 million.
- While the construction industry credit crisis is reflective of the problems plaguing the broader economy, Congress and the executive branch could alleviate some of the pain by quickly reauthorizing federal infrastructure programs, tailoring SBA loan programs to the construction industry, and improving access to capital for the captive finance companies that serve our industry.

come before you today both in my capacity as a small business owner and as a spokesman for my industry.

I am the president and CEO of Hoffman Equipment Co., a family-owned business headquartered in Piscataway, New Jersey. Hoffman sells, rents, and services Case, Liebherr, Terex, JCB, Grove, Manitowoc, and other leading brands of construction equipment from five locations in New Jersey and New York. Our distribution territory includes New York's 12th congressional district.

I am also the northeast region director for the Associated Equipment Distributors (AED) and serve on AED's Board of Directors. AED is the national trade association representing authorized, independent distributors of construction, mining, forestry, and agricultural equipment. AED has more than 1,000 members, the overwhelming majority of which are small businesses. Approximately 48 percent of our distributor members report annual revenues of \$10 million or less.

I appreciate the opportunity to come before the Committee to discuss how equipment distributors are being affected by tighter credit and to suggest ways to improve access to capital for small, construction industry firms.

Credit and the construction equipment industry

The construction equipment industry runs on credit. Distributors borrow to finance equipment in their inventories and rental fleets, and to operate their companies on a day-to-day basis. Credit is also critical for equipment purchasers.

Contractors seeking to acquire a piece of equipment may choose to buy it, lease it, rent it, or rent it with an option to buy. When buying equipment, contractors generally pursue one of three financing or payment strategies. The first is to simply write a check and buy the machine outright. However, given the relatively high cost of construction equipment, this is the least common approach. The second (and slightly more common) option is for the purchaser to independently seek financing (e.g., through a local bank or other third party lender). The third and most common way to buy equipment is to borrow funds for the purchase from a captive finance company affiliated with a manufacturer that the dealer selling the equipment represents (e.g., CNH Capital, CAT Financial, Volvo Financial Services, John Deere Credit, Volvo Financial, Doosan Capital, etc.) Captives provide distributors and their customers with more flexibility than third party lenders. As a general proposition, captives owned by manufacturers are willing to accept more risk than independent banks because the manufacturer can (at least to a certain extent) offset potential losses on the lending side with profits from the sale of equipment.

Impact of the credit crisis on the construction industry

With the foregoing in mind, it is no surprise that the construction equipment industry has been hit hard by the global credit crisis. AED members report that it has become considerably more difficult for customers to get financing to buy equipment and for the dealers themselves to get credit to run their companies.

This spring, AED conducted a member survey to, *inter alia*, clarify what impact the credit crisis has had on equipment distributors and their customers. The 2009 AED Government Affairs Survey was conducted over a four-week period from mid-March to mid-April. Multiple e-mails inviting participation in the survey were sent to primary AED contacts at dealer member companies. Respondents were representative of AED's overall membership: 46 percent had between 20 and 99 employees and 57 percent had between \$5 million and \$75 million in revenues. Ultimately, 107 distributors (approximately 17 percent of AED's dealer members) completed the survey, resulting in a survey margin of error of 8.6 percent.

Key survey findings were as follows:

- Eighty-one percent of survey respondents reported that they had lost sales in the last year because qualified purchasers had been unable to get financing.
- Survey respondents reported losing more than \$120 million in sales because qualified customers were unable to get credit. When the survey results are projected across the association's entire membership, AED calculates distributors have lost more than \$720 million in sales because credit was unavailable.
- Fifty-six percent of distributors who responded to the survey reported an increase in their own credit costs. And,

- Forty-four percent of respondents said their companies had difficulty securing credit.

The findings illustrate that the lack of access to capital is undermining equipment markets and increasing the costs of doing business for equipment distributors.¹

The staggering value of lost sales is particularly vexing considering current industry market conditions. Given the well documented drop-offs in housing and commercial construction, in some regions of the country the sales market for new equipment has fallen by as much as 85 percent from peak levels in 2006. Dealers are struggling to keep their heads above water and credit issues are in some cases preventing the only people who want to buy equipment from doing so. As one AED member recently put it, "It's hard enough to find a deal, then a whole new fight begins in trying to get it financed. It's brutal."

What's behind the credit crisis?

The credit woes plaguing the industry are apparently the result of a number of factors. First, given that the construction industry has been among the hardest hit by the economic downturn, in an effort to minimize risk, some of the large, independent, asset-based lenders have reduced construction lending or simply stopped writing loans for the industry. At the same time, captive finance companies have found it more difficult to raise money. Wall Street currently has a dim view of asset-based lending and the cost of money for captives has therefore gone up in many cases. The captives are passing the cost increases along to customers and, in some cases, are quoting interest rates for equipment purchasers at well above ten percent.

Dealers also report that the finance companies still serving equipment markets have raised their creditworthiness standards. While a tightening of credit terms is not surprising given the recent subprime meltdown, some dealers have suggested that lenders have over-corrected and told us that it has become difficult to find financing for equipment purchases even for credit-worthy borrowers. As one dealer put it, we've swung from "easy credit" to "no credit". Other AED members suggested that what we are seeing in the marketplace is simply a return to a more sustainable level borrowing after an extended period of loose credit. However, the availability issue aside, AED members have expressed near universal concern about the high cost of credit for the construction equipment distributors and customers at a time when interest rates in general are so low.

Easing the pain. What can the federal government do?

We recognize that the challenges that our industry is facing are symptoms of economic problems plaguing the broader U.S. and world economies. However, the following actions by Congress and executive branch could help speed the industry's recovery and alleviate some of problems we are facing:

¹ Construction equipment distributors are not the only ones who have lost sales as a result of lack of access to capital. Forty-eight percent of the respondents to a spring 2009 survey of members of the North American Equipment Dealers Association, a trade association primarily representing farm equipment distributors, reported they had lost retail sales because customers had been unable to get financing.

- **Quickly reauthorize and increase funding for federal infrastructure programs.** Numerous government and private studies² suggest that the federal government is spending less than half of what it should be to maintain our current, woefully inadequate surface transportation infrastructure. Traffic congestion resulting in large part from inadequate capacity costs the U.S. economy \$78 billion per year in wasted time and fuel. Our sewers and drinking water systems are in equally deplorable shape. The pending reauthorization of federal highway, sewer, and drinking water programs provides an opportunity for Congress to address this national crisis. The reauthorization of water programs is many years past due. Additionally, all signs suggest that the highway reauthorization will not be completed by the end of Fiscal Year 2009 and that the Highway Trust Fund will run out of money this summer. Given the massive impact that federal infrastructure programs have on the construction industry, the uncertainty surrounding reauthorization is contributing to instability in construction markets. Contractors and distributors are caught between the proverbial rock and hard place. Lenders are avoiding the construction industry because of current volatility and Congress is only making matters worse by dragging its feet. One of the surest ways to speed recovery in the construction industry, address the staggering 18.7 percent unemployment rate among construction workers, and restore lender confidence in the construction industry is to reauthorize the federal highway program and ensure the long term solvency of the Highway Trust Fund.
- **Tailor Small Business Administration loan underwriting to better serve the construction industry.** A widely-held perspective in the construction equipment industry is that loans underwritten by the Small Business Administration (SBA) take too long to get approved and that there is too much "red tape" attached. As one dealer put it, "Buying a piece of equipment is an event; SBA involvement would turn it into a process." Our interviews indicate that captive finance companies generally do not offer loans underwritten by SBA. This is likely attributable in part to the fact that captives are sometimes willing to bear higher risk to facilitate a sale and that those borrowers might not meet SBA requirements. Even so, we suggest that SBA work with captive finance companies and banks serving the industry to develop loan products that meet the unique needs of small construction contractors, particularly those perceived as high-risk borrowers. As one industry finance expert pointed, just because a potential construction industry borrower is "subprime", does not mean the company will not pay its bills on time, it just means they are a higher risk. Unfortunately, it seems that credit is effectively unavailable for smaller, higher risk companies. Additionally, SBA should reexamine its size standards to determine whether they are preventing companies that otherwise fit the definition of small business from benefiting from SBA programs. If so, the standards should be adjusted. If appropriate SBA products and programs already exist, our research suggests that the industry is largely

² See, e.g., the most recent report on the economic impact of congestion from the Texas Transportation Institute (<http://mobility.tamu.edu/ums/>), the National Surface Transportation Policy and Revenue Study Commission's report explaining the need to double investment in highway infrastructure (http://transportationfortomorrow.org/final_report/), and the National Surface Transportation Infrastructure Financing Commission's report explaining the need for a gas tax increase (<http://financecommission.dot.gov/>).

unaware of that fact and SBA should conduct aggressive outreach to the construction industry.

- **Investigate allegations of SBA bias against non-titled vehicles.** Some in the industry perceive that SBA underwriting requirements are biased against construction equipment because, unlike motor vehicles, equipment is generally not titled. However, the Uniform Commercial Code (UCC) filing system for liens against movable assets is actually superior in some ways to motor vehicle titling because there is reportedly less variation in registration rules from state to state. The Committee should inquire into whether SBA's loan programs are biased against non-titled assets and, if necessary, clarify the applicability of the SBA underwriting to loans for those types of assets.
- **Improve access to capital for captive finance companies.** While the credit crisis has eased somewhat on Wall Street, looser credit has not necessarily trickled down to Main Street (or "Industrial Boulevard" where many equipment dealers are located). While we expect conditions to improve as the economy recovers and financial markets correct themselves, Congress and the President should look for ways to further assist the commercial and asset backed paper markets to help lower the cost of funds for the captive finance companies. As one distributor told AED, "The Fed has set the prime rate at near zero. So we somehow need to have a contractors' finance rate that is reasonable. Fourteen percent is not reasonable, and thus, not stimulative."

Conclusions

In sum, tight credit is making it more difficult for equipment distributors to sell equipment and to operate their businesses. While much of the problem is attributable to broader economic problems that are beyond the control of government, there are steps that Congress and the president can take to help alleviate some of the pain. We appreciate you organizing this hearing to focus attention on the small business credit crisis. AED and its members stand ready to work with the members of this committee in a bipartisan manner to find solutions that promote rapid economic recovery.

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