Worth the Effort

A Line of Credit Might Be the Largest Financial Commitment of Your Life, But It Can Unlock the Full Potential of Your BHPH Operation

By Paxton Wright

One of the keys to operating an auto dealership – or any small business – is planning.

It's always a smart move to reflect on our past successes, identify opportunities for improvement and create a plan to seize those opportunities.

In doing so, there are several items to consider.

- What changes can you make that will give you the best chance for success in the future?
- Do you need to review and update your policies and procedures?
- Where should you focus your staff training efforts?
- Do you have the right pay plan for your employees? Do the incentives match your goals?
- Do we have the right inventory for your customers and your portfolio?
- Will you have the capital you need to execute your plan? Is cash flow holding you back?

In the process of forecasting your capital needs, it's important to consider changes in the marketplace that are likely to impact your business.

Over the past several years, the volume of the opportunities and high returns have created an increase in the amount of capital available in the subprime auto finance market.

Point-of-sale lenders who traditionally stayed away from the deep subprime market increasingly moved in that direction, creating heighted competition for the BHPH dealers who traditionally served the needs of those customers.

"We have seen a lot of competition from subprime finance companies working with other independent and franchise dealers," said Ace Christian, owner of Rock Solid Auto Center in Mesa, Ariz., expressing what many dealers have experienced.

"Consumers with FICO scores between 500 and 600 used to be our target customers, but today we are lucky if we see 400-500 scores coming to our store."

Well capitalized and seeking rapid growth, point-of-sale lenders adjusted their model to capture a larger share of the auto finance market. Loan approvals on newer, higher-cost vehicles led to longer loan terms and higher payments, even for deep subprime borrowers.

Affordable vehicles with manageable payments and shorter terms have shifted to newer vehicles with higher AVCs, higher payments and 60-72 month terms.

That shift has predictably resulted in increased credit losses for indirect lenders that expanded their reach into the deep subprime credit spectrum. Now independent dealers who had enjoyed the benefits of overly generous point-of-sale approvals are feeling the pinch as those finance companies begin to tighten their approval criteria or, in some cases, exit the space altogether.

Many dealers who depend on point-of-sale financing have noticed that, increasingly, the same deal that received a generous approval two years ago is difficult to do at all today.

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There is also statistical evidence that the tide of capital is beginning to recede from the subprime auto market. Recent data from Experian Automotive indicates deep subprime financing for used vehicles has dropped by 5.3 percent to the lowest level since 2007.

That emerging market adjustment is welcome news for BHPH dealers. With fewer financing options, deep subprime customers are likely to return to BHPH dealerships, which should lead to a recapture of lost market share and increasing sales and finance opportunities.

BHPH operators have many reasons to be optimistic about the rest of 2018.

The expected surge in opportunities as POS lenders recede from the deep subprime space should not only increase sales numbers, but also improve collection performance as BHPH dealers regain more financially stable borrowers.

With the right collateral, sound underwriting principles and a sensible deal structure, BHPH financing can still be an incredibly profitable business model.

A typical BHPH deal usually has a substantial markup and an interest rate in the low-to-mid 20s. But it can also present a serious cash flow challenge for dealerships.

Let's consider the cash flow impacts of a typical BHPH deal structure:

Cash Out		**Cash In**	
Auction Cost of Car	$4,000	Sales Price	$11,000
Reconditioning	$500	Down Payment	$1,000
Transport/GPS/Detail	$500	Amount Financed	$10,000
Total Cash Out	**$5,000**	**Total Cash In**	**$1,000**

Cash impact is negative $4,000

In this example, the dealer has a negative cash flow of $4,000, which will generally take 13 or more months to recover through principal and interest payments.

Now multiply that by 20, 40 or even 100 sales per month.

Combined with overhead expenses such as rent, payroll and marketing, it becomes clear that a consistent and reliable source of capital is critical to the healthy growth of your business and portfolio.

There are several ways to address that cash flow challenge. Each has its pros and cons.

Local banks: A profitable dealership with a good reputation can sometimes find support from a local bank.

The obvious advantage to borrowing from local banks is the low cost of funds. The downside is they often do not understand the BHPH space or the market value of your collateral, which can lead to an advance rate that is too high.

It might seem strange to consider a higher advance as a negative. But if there is a change in management or strategy at the bank and it decides to reduce its exposure by moving your portfolio off the balance sheet, you could end up trapped by that overly generous advance, putting your entire business at risk.

Bulk sale: Another popular way to raise funds is to execute a bulk sale of notes receivable. A bulk sale can be a very quick and simple process. You present your portfolio for pricing and can have a check for the principal balance minus a discount for risk in as little as a week.

The problem is selling your accounts at a discount transfers your profits to the buyer. In addition, notes are usually purchased with reserve or recourse or both, which effectively leaves the risk with you during the most vulnerable stage of the loan, the early months and the collection transition period.

Note buyers tend to cherry-pick the best accounts, which is actually a good thing, because you can raise more money while selling fewer accounts. But the downside is you are left with the accounts least likely to perform, which will degrade the performance of your remaining portfolio. That becomes obvious over time if you sell notes on a regular basis.

Most note buyers will give you a better price for your accounts if you collect on them for 2-3 months, effectively “seasoning” the accounts. The problem, as mentioned previously, your capital needs can easily be $150,000 per month, so there is still a need to carry $300,000-$450,000 in notes at any given time.

Line of credit: If it is your goal to keep and collect your accounts while growing your portfolio, a line of credit is a great option.

With a line of credit, the lender can provide an advance that gets you out of the cost of the car while you keep the profits on the contracts and earn the interest spread for as long as the account is active.

Over time you can grow your portfolio and build an asset base that flows customer payments back into the dealership for operations and eventually de-leverages and pays off the LOC.

A portfolio of only $1 million is likely to provide nearly $50,000 in collections per month.

There are challenges to that approach. Collections can be difficult and your collection challenges grow right along with your portfolio. Also, as a dealer who is collecting your own accounts you will learn to appreciate the importance of keeping the vehicles in good condition. As we all know, the chances of collecting payments go up exponentially while the car remains in the road.

Understanding that the most profitable option as a BHPH dealer is to retain and service your own accounts while growing your portfolio, an accounts receivable line of credit to finance that growth is a viable option.

The process of applying for and activating an LOC can be daunting. In fact, for most dealer principals, a line of credit for your business is the largest financial commitment you will ever make.

With it comes significant responsibility to pay attention to the details in all aspects of your dealership operations, as well as the loan application process and the line of credit itself.

To best prepare you and your business for the lender's due diligence, here are some items you should plan to deliver:

- A loan request letter, including the commitment amount, expected initial funding and a usage plan.
- A company profile, including the dealership's origins and locations, executive and key management bios, your business philosophy, company affiliations such as any state associations or 20 Groups you belong to, the dealership's unique competitive advantages, an organizational chart and any business awards and recognitions you've received.
- Company tax returns (typically for the past two years).
- Business financials, including the income statement and balance sheet for the past two years or more.
- Company bank statements covering the past 90 days.
- Your personal tax returns and financial statements.
- State licenses, including selling and finance licenses, if applicable.
- Company formation documents such as the articles of incorporation.
- Policy and procedure manuals for all underwriting, collections and cash controls.
- A direct log-in so the lender can access your DMS.

On delivery of those items, most lending institutions will evaluate the information provided and review the credit history of you and your business. Finally, they will do a statistical analysis on the collection performance of your accounts to determine whether your business is a viable fit for its program offerings.

If it is, you will likely receive a letter of intent outlining the size, scope and expenses associated with the line of credit. The LOI will show, for example, the loan commitment amount, term, interest rate, anticipated due diligence fees and even legal expenses.

The document will also spell out any key performance metrics and financial covenants you will be expected to maintain.

Once you have negotiated agreeable terms and executed the LOI, most lenders will schedule an on-site visit.

A successful on-site due diligence is paramount in building a relationship with your lender – and ultimately in receiving credit approval.

The purpose of the on-site visit is to validate the documentation you've provided, conduct management interviews and a loan file examination, and complete a payment testing review.

While each step in that process is important, I can tell you as someone on the inside that the management interviews are the most vital. Use them as an opportunity to shine a spotlight on your team's expertise and demonstrate why you will be a solid partner for the lender.

Following the due diligence visit an updated LOI will be delivered, including any adjustments that need to be made as a result of the lender's findings.

It is always recommended that you review the final documents with legal representation that understands your business and how the funds will be used.

Once both parties agree on final terms, closing typically occurs within a couple weeks, depending on the legal team, the lender and any other circumstances.

All of that might seem like a complex and intimidating venture to undertake. But the bottom line is, it is worth the effort.

In fact, all of those required documents should already be part of your standard operating procedures.

If your concern is cost vs. benefit, reach out to any of the specialty lenders in the BHPH space and ask them about it. They will be happy to assist you in completing your analysis and establishing the value of the capital they provide.

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