The State of Financing in the Water Industry

By Peter Kanatzar

What the turbulent economy means for our industry

While I remain a long-term optimist about the future of the economy and the water industry, we all know just how difficult the last year has been. The economic problems our country and industry face are serious and unprecedented (for our generation, at least). Overcoming these challenges will test our faith and resolve—and there are no easy answers or quick fixes on the horizon.

The U.S. financial sector remains fragile. Financial institutions, anticipating defaults on a wide variety of loans as the full impact of the recession is felt, are reluctant to extend new credit and are purposely slimming their balance sheets to reflect the new risk-averse environment in which we find ourselves.

Lenders who provided easy credit during the housing bubble fell by the wayside last year as the turbulence in the housing market wreaked havoc on the economy and in no small measure, the ability of their customers to repay loans. Many merchants found themselves without a financing source as various lenders exited the market or went out of business.

By the end of the year, the demand for merchant credit had overwhelmed the lending capacity of the lenders still providing credit to the industry. The result was a dramatic tightening of credit, often coupled with higher pricing, as lenders scrambled to ration what new loan capacity they had. The mismatch between the demand for financing and availability is a serious threat to the water industry. No industry can prosper in a dysfunctional environment in which only the most creditworthy applicants or merchants can qualify for financing. Financing is the lifeblood of the industry and without healthy financial institutions willing to lend, long-term prospects are uncertain at best.

Will it Get Better?

We might see a turnaround in 2009; however, if the stimulus plan does not kick-start job creation soon, then probably not. Government models forecasting higher employment as a result of the stimulus package assume a healthy financial sector willing to extend credit. Unfortunately, that is not the situation today. The billions of dollars in bailout money may have saved the financial system from collapse, but it has not freed-up credit for consumers or small businesses.

The *Wall Street Journal* reported that 10 of the 13 beneficiaries of the Treasury's Troubled Asset Relief Program (TARP) (not all TARP recipients had reported fourth-quarter results when the article was published) saw their outstanding loan balances decline by $46 billion, even after they received billions in taxpayer capital that was intended to help the economy by making loans more available. This decline coincides with a reported industry-wide retreat from consumer lending by many banks and financial institutions.

The retreat from making new consumer loans is fueled by the banking industry's biggest fear: that unemployment moves to a level sharply higher than the current 7.6%. Increasing bad-debt reserves to deal with 10% unemployment—a level at which consumer-related losses could balloon—would decimate the banking industry's already fragile balance sheets and trigger new bank failures. It was not surprising that the same week Capital One Financial increased its unemployment forecast to 8.7% for year-end 2009, they also announced they were exiting the home improvement finance market, including the water industry. Not until home prices bottom out and unemployment peaks will the credit markets begin to thaw.

Financing in the Water Industry

In the near term, be prepared that financing may get a lot worse in regard to availability and pricing before it gets better. Expect more lenders to exit the industry as loan delinquencies move higher and unemployment increases. Do not expect new lenders to enter the market any time soon—balance sheets for financial firms are too weak, capital too scarce and debt too expensive.

Underwriting standards will remain tight as long as money remains scarce. Merchants with underperforming loan portfolios will be at risk of being cut off by their lender. Merchants without a track record in the industry will have a difficult time finding financing and many smaller merchants will go out of business. Mature dealers (10+ years in business) will have an easier time finding financing, but financing will not be cheap.

Longer term, once the infections plaguing our housing and financial sectors are cured, the credit markets will rediscover the consumer; however, the memory of this current crisis will linger and I suspect will change the nature of financing for the industry for some time. Easy credit like we saw during the run up to the current credit crisis is not likely to return anytime soon, although we can never underestimate the propensity of bankers to repeat their mistakes. Why? Because the extent that delinquency and credit losses were masked by home equity withdrawals during the run up in home values is now seared into the collective memory of the credit markets, and that's what happens when market losses exceed the GDP of most medium-size nations.

Although new money and lenders will return to the market, a heightened perceived risk for consumer lending in general by the financial sector will make all loans more expensive, and in particular loans to applicants with less than prime credit, for years to come. *wqp*

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