CAPITAL OF MANUFACTURING CONCERNS

Manufacturers and Bank Loans—Underlying Principles —Classes of Borrowers

In every period of monetary stringency a number of the manufacturers find the question of bank loans troublesome or irritating. Rates of interest payable thereon have a tendency to rise; and the cost of manufacture may thus be sensibly increased. Again, the banker in such a period is apt to be more exacting as regards the security backing his advances; he is more particular about discounting weak paper, and he may press for reduction of loans when his customer is making arrangements to expand his business. Then, as a rule, the manufacturer attaches a greater value to the capital which he himself owns; the bank loans do not appear quite so valuable or desirable in his eyes.

Perhaps it can be said that friction is most likely to occur in those cases wherein the manufacturer has been tempted to apply the proceeds of bank loans towards the acquisition of equipment or of an enlarged plant. When such a disposition has been made of the proceeds, the loan granted by the bank is likely to be characterized by permanency.

When money is easy and the various banking institutions are competing hotly for discount accounts, there may be no vigorous objection raised against the long-standing loan.

Underlying Principle of Bank Act.

But just as soon as conditions change, it is probable that the head office of the bank will begin to press the question of reduction of liabilities. This change of front may occur at an awkward season for the borrower. He may have to re-shape entirely or reconstruct his plans; and such reconstruction may prove very costly, suggests Mr. H. M. P. Eckardt in Industrial Canada.

That being the case, the manufacturer usually finds it advisable to give timely attention to the question of his relations with bankers. Up to what point should reliance be placed on his own capital; and to what extent is it safe and profitable to depend on bank loans?

It should be said at the outset that the chief reason why bank loans represented by plant and equipment often give trouble is that they are not founded on sound principles. One of the cardinal rules governing the banking business is that all loans or advances shall be represented by assets realizable in a short time. Loans based on saleable merchandise or securities, collectable accounts, notes, and bills, conform to this banking rule. Loans based on immovable property, such as land and buildings, and loans on machinery, when in use, as factory equipment, are obviously in contravention of the rule. This principle or rule underlies the whole of the Canadian Bank Act, and the experience of the past shows that it usually pays both the bankers and their borrowers to keep it respectfully in mind.

Perhaps it would conduce to pleasant and profitable relations between the manufacturer and his banker if it were remembered on all occasions that the bank is, so to speak, a little off its natural grounds when making direct loans to a customer. In discounting good trade bills for solvent customers the bank is in its natural element; and when the manufacturer's liability account consists entirely of good trade bills, which are paid in due course, there is scarcely any occasion for friction or disagreement. When, however, the bank is requested to make direct loans the openings for differences of opinion or disagreements tend to increase. The question of security, of disposition of the proceeds, and of the term or currency of loan all have to be settled.

In the practice of manufacturers as regards the use of bank credits, there are wide variations. In some cases the manufacturer depends so largely on his own capital that he does not even require to discount his bills receivable. They are passed through the bank on collection; and trade bills are discounted only when some exceptionally large payments exhaust temporarily the funds carried in current account. This condition of affairs may also exist in the case of an industrial corporation which has supplied itself with an ample amount of working capital through the issue of bonds or preferred stock.

Divide Into Two Sections.

In other cases the manufacturer will perhaps be able to finance himself altogether through discounting his receivables. This usually means that he will have a reserve of undiscounted bills on hand during a part of the year, and that all available paper will be under discount in the season of heaviest demand for funds. This class of manufacturers, again, will be divided into two sections. In the first section would be the parties who financed themselves solely through discounting trade bills and who had practically no liabilities apart from the line at the bank. The second section would be comprised of parties who perhaps acquired their raw materials on credit, and discounted trade bills to meet the weekly wage sheet and to retire maturing bills drawn by the outside creditors. Other things being equal, a less investment of their own capital would be required on the part of manufacturers comprised in the second section.

Next we come to the manufacturers who depend on direct loans made by their bankers. It should be said, here, that when the bank makes a direct loan on the manufacturer's bills receivable lodged as collateral, the transaction is essentially the same as if the receivables were discounted. The bank may advance only a certain percentage on the face value of bills hypothecated. In effect, it is discounting trade paper up to that percentage.

So far as direct loans, apart from loans on bills receivable lodged as collateral, are concerned, they are of various classes. Thus it is of common occurrence for the manufacturer to secure loans from his bank to pay cash for raw material—said raw material being a staple article with broad and steady market. This loan may perhaps be secured by endorsement of individual partners or of directors; it may also be secured by pledge of the raw material. Afterwards, further loans may be granted by the bank for the purpose of paying wages and other expenses. Then, in the ordinary course, the loans are retired through discounting trade paper. In that case the manufacturer has no liabilities of consequence excepting that represented by his line at the bank.

Circumstances Will Rule.

The banking transactions so far considered are all perfectly legitimate. When granted to capable and trustworthy parties such credits should cause no great trouble to borrowers or lenders.

Now let us see what is implied as regards the capital investment of the borrowers. The manufacturer's banking transactions could not well proceed as here outlined unless he himself provided the capital represented by the mill or factory, the land on which it stands, and the machinery and equipment. That represents practically the minimum investment by which it is possible to carry on the bank account without risk of friction and trouble. Then it would be almost impossible to work the account through merely discounting trade bills, unless a further investment to represent working capital is made.

When the manufacturer provides his building and its equipment with his own funds, and when he has a reasonably ample supply of working capital, he is thoroughly independent; and he can frame his policy to suit his circumstances. If he looks to the bank for only a moderate part of his working capital, he may still retain his independence in large measure. But if he asks the bank for the greater part of his working capital and for funds to buy machinery and build extensions, he is placing himself largely at the mercy of circumstances. One might guess that the manufacturers who have been experiencing trouble with their bankers during the recent stringency are mostly in this condition. And one arrives at the conclusion that in the long run it is advantageous for the manufacturer to provide his own capital up to the point of acquiring that building and equipment and a part at least of the working capital. When he does that he has the best chance to prosecute his industry successfully and independently. In the larger cities there are a number of manufacturers occupying leased premises. While they are in this position they are relieved from the necessity of providing expensive buildings of their own, and the requirement for capital investment is consequently less. But recent developments have shown that unless the rented premises occupied by them are large enough to give room for expansion, and unless they can also count upon having possession of the premises for a long term of years, it is usually advisable to be forehanded in providing funds which can be used to acquire buildings of their own.

Cramping His Working Capital.

For the bankers state that every little while some manufacturing customer who has been in leased premises wakes up to find that the building has been sold over his head, or that he has entirely outgrown it, and he is compelled to go to the bank and ask for a large building loan. As previously remarked, a building loan, represented as it is by fixed or unmovable assets, contravenes the best banking principles. And the bank will agree to make such a loan, even to one of its best customers, only with great reluctance. When he is obliged to use his credit for that purpose the customer may be seriously cramping himself for working capital. But if the manufacturer, with this eventuality in mind, begins to prepare for it several years beforehand, he may be able to provide premises of his own, when it becomes necessary or advisable to do so, without unduly stretching his credit at the bank.

While it is the case that the banks expect their manufacturing customers to buy their machinery and equipment with their own funds, in actual practice it often happens that the manufacturer uses his bank credit for the purpose; and this can be done in a perfectly legitimate manner. Thus an order is given for some new machines. They arrive and are installed. After the test is made and the machines are finally accepted by the purchaser, the draft for same comes along, is accepted, comes due, and is charged up to the manufacturers' account at the bank. If he covers it through discounting trade papers, the matter is closed and the bank does not lend money for acquisition of equipment. If, on