EDGE CAPITAL PARTNERS

EDGE FINANCIAL SOLUTIONS

Balancing Both Sides

GAINING CONTROL OVER BOTH SIDES OF YOUR BALANCE SHEET

“Neither a borrower nor a lender be, for loan oft loses both itself and friend.” So said William Shakespeare through his character Polonius in Act I Scene III of the play *Hamlet*. While Shakespeare clearly had a way with words and insight into human psychology, he also was in need of sound financial advice. Owners of financial capital are tasked with its prudent deployment so as to earn appropriate return in support of a family’s or institution’s mission. As such, there is much time and devotion spent on the management of assets. But what about the other side of the balance sheet? After all, many of our clients accumulated significant wealth through business building either as an entrepreneur or as an innovator within a larger organization. In doing so, these business leaders clearly understood the importance of capital structure – that is to say the mix of equity and borrowing that funded the assets needed to achieve their business mission. It is no different after the transition of managing an operating asset to managing financial assets. It is critical to have control over both sides of your balance sheet.

We have helped several people think through the issues of borrowing, many of which are unique to wealthy families. The circumstances at times can be as unique as the people we work for and there is no one-size-fits-all answer. It takes thoughtfulness and experience to navigate the conversation with a lender to translate an understanding of your financial wealth. Our purpose here is to provide a framework for what you should be thinking about if you are thinking about borrowing.

DEFINING THE PURPOSE OF BORROWING

If you are thinking about using the liability side of your balance sheet, there is a need for capital. The question then is how to fund this need. Do you simply sell assets to raise cash? Or do you borrow against your existing assets, keeping them invested, to fund the need? To answer this question, start with the purpose of the loan. Be as specific as you can. Defining the purpose will in turn define expectations that will inform the borrowing strategy. Below we outline four broad categories of needs.

- **Personal:** This is a capital need that is not expected to earn financial return even though financial return is possible; it is for a personal need. Examples include items such as a second home or a ranch.

- **Business:** Perhaps there is a capital need in the operating business you run that is not able to be supported solely by that entity. It requires personal backing from you either as a guarantor or as the borrower.

- **Investment:** Sometimes there is an investment opportunity that _lends_ itself well to prudent use of debt (pun intended!). Examples include stabilized cash-flowing real estate.

- **Structural:** Some advanced trust and estate planning techniques incorporate the use of debt at times which may be best facilitated on a true arms-length basis by a third-party lender.

Basic questions which should frame the purpose include:

- How much money do you need?
- What cash flow back, if any, is expected from the stated purpose?
- If there is cash flow, how variable is it?
- How long do you expect the borrowing to be outstanding?
- When is the capital needed?
- How do you anticipate the debt being repaid in the future?

WHAT LENDERS WILL LOOK FOR

The specifics of what a lender will evaluate depend on the circumstances, but in the world of banking there is often reference to the 5 C's.

1. **Character –** John Pierpoint Morgan famously said "The first thing [in credit] is character…before money or anything else." In modern times, character is most often quantified in the concept of the credit report from one (or all) of the three primary credit monitoring agencies – Experian, TransUnion, and Equifax. A credit report is intended to capture all lines of credit outstanding, recent credit inquiries made (the thought being that the more inquiries the more dire the need), and public records on debt collection, bankruptcy, foreclosure or other significant items. Ironically "no credit" can be worse than "bad credit" which can occur if there is no history of the individual taking debt and then demonstrating repayment (think of a graduating college student who has never had a credit card in their own name as an example).

2. **Capacity –** This refers to the ability to afford the anticipated repayment schedule. Often this takes the form of a debt-to-income ratio. This concept can be tricky as to what lenders will consider "income" as we will discuss further on which is especially relevant for the self-employed or independently wealthy.

3. **Collateral –** Clearly collateral is pivotal in loan arrangements secured by specific assets such as a home mortgage but this concept is just as relevant in lending based upon financial securities. Depending on the circumstances, banks put process and structure around the valuation, title, protection, and control over assets specified as collateral against a loan.

4. **Capital –** Even if the loan is secured using specific assets, a lender may also wish to review the overall financial savings of the borrower to assess where repayment may be made even if the collateral is insufficient. Accessibility to assets is key in the bank evaluation. Consider a situation where an individual is the beneficiary of a trust, but is not the trustee or is limited by the trust document to how or when the borrower can access funds.

5. **Conditions –** The environment matters. A lender will want to know why you are borrowing money and that the purpose makes sense. They will look to the economic and regulatory environment they are facing. Lenders will think about their current portfolio and whether additional exposure makes sense.

WHAT TO LOOK FOR IN A LENDER

The options of who to partner with in a lending relationship are as varied as the needs! Here we will outline some high level considerations of what to look for in a potential lender.

- **Stability and Cost of Funds to the Bank:** The interest rate that a bank can offer a borrower is directly impacted by their ability to access capital. This means the ability to attract stable depositors as well as issue instruments in the debt and equity markets.

- **Specialized Knowledge of Collateral:** Where collateral is required, working with a lender that understands the asset can smooth the process and avoid circumstances where an extra "risk premium" is built into the interest rate based on a bank's inexperience. This concept is as true for financial securities (think publicly traded stock with a legend) as well as hard assets (such as an operating ranch).

- **Experience with Client and Loan Type/Size:** Ultra-high net worth borrowers often have incomes driven through investments communicated through reporting documents like K-1s. Sometimes there are significant assets but little income which requires a lender to consider "asset annuitization" (or calculating an implied income stream from an accessible asset base). You may also be borrowing through an entity such as a trust or a family limited partnership. You want to make sure that the lender has experience working with the type of borrower you are; otherwise you may face the hard work of educating them and their underwriters. The size of the loan matters too. Being in the lender's sweet spot of loan size means that they will deliver the service and attention you deserve and avoid delays from having to escalate approvals beyond the normal bank channels.

- **Willingness to Think:** Every lender has a structured process around information collection, verification, underwriting, and approval. This is to be expected from a quality institution. That said, common sense should not become a victim of process. In seeking prudent risk management, banks can fall victim to being "box checkers" where any data point outside the straight and narrow creates a negative outcome. You want a lender who sees this as a partnership instead of a transaction.

- **Portfolio versus Securitized Lender:** To understand whether a bank is lending for its own book of assets (called a Portfolio Lender) or is simply a conduit for securitization will instruct not only a lender's motivation, but also the level of flexibility they will have. The process of securitization requires that the pools of underlying loans have some degree of standardization across borrower metrics (loan-to-values, debt-to-income, FICO scores, etc.). A Portfolio Lender can often exhibit more flexibility.

- **Flexibility and Variety in Terms:** You will want options. With and without collateral. Floating and fixed rate. Interest-only and amortizing, and so forth. A loan's structure should be driven by your circumstances and the use of proceeds. A good lender will have a range of facilities so that you can determine the best fit as you undergo one underwriting process.

COMMON TYPES OF LENDING

While there are many types of materials used when building a house, there are a couple of common materials such as cement or lumber which set the structure and carry the load. The same is true for building your balance sheet. There are a couple of common types of lending that meet most investor's needs. Below we briefly summarize three types of lending that our clients use most often.

Margin lending is perhaps the most frequent form of borrowing using financial assets.

What is it?
Margin lending is where a custodian uses qualified securities in an account as collateral to lend.

How does it work?
Not all securities are eligible for borrowing and not all eligible securities have the same requirements. Securities specified as collateral in a brokerage account can be used by the custodian for securities lending (which is a profit source for the custodian). The maximum amount you can borrow (initial margin) as well as the required level of margin equity (i.e. how much money you have if you closed all positions in the account, stated as a percentage calculated as the value of assets less the loan divided by the assets) to maintain the loan (maintenance margin) is regulated by the Federal Reserve Board (Regulation T). Custodians often set rules that are more stringent based upon circumstances to create further protection for themselves. A common initial margin is 50% and a common maintenance margin is 30%. Should the margin equity percentage fall below the maintenance margin threshold you must post more collateral or face the risk that the custodian sells the securities in the account to repay the loan (margin call).

What is the interest cost?
Interest cost for margin is floating-rate in structure with the Fed Funds rate being a common base (example Fed Funds plus X%). The spread over Fed Funds is another profit source for the custodian. Interest cost can be added to the debt balance (up to the regulated threshold).

What is the process to set it up?
Since this type of loan is so common and collateralized, the timeline to establish a margin line takes only a day or two upon signing the required form and reviewing the disclosure packages. At that point, margin loans can be drawn and repaid at any point subject to the regulated requirements.

Portfolio Lending (sometimes called an Investment Credit Line) is also very common.

What is it?
Similar to a margin loan, a portfolio of financial assets serves as collateral. However, there are differences (including the specific regulation) which creates broader eligibility of investment assets (including hedge fund and private equity funds). In addition, the release rate (maximum amount of borrow) can also be higher since the underwriting process takes into account diversification of a portfolio of assets versus the security-by-security calculation under traditional margin.

How does it work?
There are margin equity measurements similar to traditional margin but in this language called release rate (setting maximum borrow amount) and watermark (similar to maintenance margin where there will likely be a call for more collateral). In portfolio lending it is important to distinguish the use of funds whether they are for purpose (buying more marketable securities) or non-purpose (anything other than a marketable security) since they are governed under separate regulatory requirements. Once established, you can draw upon a portfolio lending line at any time and repay it any anytime subject to the loan requirements.

What is the interest cost?
Interest rates offered by portfolio lending are also quoted on floating terms (often LIBOR plus X%) but there is the flexibility to use interest rate swaps to fix the interest rate for set terms. Considerable thought must be

applied before entering an interest rate swap (or any lending arrangement at all!) because repayment of the loan prior to the maturity of the swap requires closing the swap at its "then" price which may or may not incur an out of pocket cost. Interest cost can be added to the debt balance up to the loan facility maximum.

What is the process to set it up?
Portfolio lending is a relationship-based loan despite its collateral requirement and as such there is full underwriting including financial statements, prior year tax returns, credit checks, warranties/representations, personal guarantees, and so forth. There are individual legal documents drafted to establish portfolio lending facilities which might incur additional legal cost and it often establishes covenants and ongoing financial reporting requirements that create an administrative burden. The process can take from 2-4 weeks from when the initial documentation request is submitted and may take longer depending upon the circumstance's complexities.

Mortgages are also common when the lending involves real estate.

What is it?
A mortgage is loan where a lender uses physical real estate assets (land plus any improvements) as collateral.

How does it work?
Many people have experience in a traditional mortgage process. It involves a full financial underwriting of the borrower including income/asset verification as well as an underwriting of the physical property including appraisal and insurance coverage. Based upon the property type (i.e. residential vs. commercial, first vs. second home) and the size of the borrowed amount, the lender will extend a loan up to a certain percentage of appraised value (called loan-to-value or LTV). There are many types of real estate and not all lenders are interested in the same collateral type. This is particularly true in more narrow real estate segments where there is environmental or operating business concerns.

What is the interest cost?
There is a large universe of options to loan structures including fixed vs. floating, various maturity lengths, and interest-only vs. amortizing. Structuring the optimal financing terms depends on the intended purpose of the property, the anticipated hold period, and your financial circumstances including anticipated changes to your income/wealth over time (most often from trust and estate planning).

What is the process to set it up?
Once a lender is selected, they will conduct a full underwriting of your financial picture including income verification, tax return review, bank statements, sale of current property if any, credit checks and so forth. They will also underwrite the new property including purchase contract review, appraisals, broker contact, insurance verification and so on. In total the process typically takes 30-60 days to complete.

BRINGING IT ALL TOGETHER

Setting a financial strategy to meet your objectives starts with a clear stated purpose and an understanding of the tools you have to succeed. Too often, families and institutions do not consider both sides of their balance sheet. That is not to say that the use of borrowing is prudent for all circumstances – far from it. Instead, it is important to be aware and thoughtful so that the decision is intentional. At Edge, we have significant experience working with sophisticated families and institutions to access our global network of resources which includes a range of lenders to develop a complete strategy that works for our clients. Contact your Edge team with any questions about your specific circumstances.

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CONTACT EDGE

1380 West Paces Ferry Road
Suite 1000
Atlanta, GA 30327
Phone: 404-890-7707
Email: info@edgecappartners.com