

COMMERCIAL LENDING REPORT



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Lend to win

*Score big with an approach
that exceeds profit and loss*

**Cost segregation studies,
your clients and you**

Asset vs. stock sales

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Professional practice pointers

LEND TO WIN

Score big with an approach that exceeds profit and loss

Mortgage fiascos, rising bankruptcy rates, and industry regulations have forced banks to revise their lending criteria. But savvy lenders resist the herd instinct. Instead of considering only a business's credit scores and end results, they look at the full range of quantitative and qualitative factors when approving credit so they can ensure themselves of a winning team.

STRIKE ONE

In this fictitious example, Doe Bros.' batting average was subpar. They needed cash to ramp up summer production of holiday merchandise for a new \$2 million contract with a big-box retailer. So, owners Jon and Don Doe turned to their bankers for a line of credit.

First was Darryl Doolittle, whose bank had financed the company's equipment purchases since the early 1990s. After reviewing 2008, 2009 and interim 2010 financial statements, Doolittle was surprised by a decline in profits. Revenues and profit margins had fallen significantly, as the industry struggled through the recession. Doolittle also was alarmed that the owners had cut their own salaries by 50% to preserve profits and cash flow.

Doolittle's bank has an internal scoring system for loan applicants that emphasizes profits over other indicators. Doolittle declined the Doe application, because the company failed to meet the bank's new (stricter) underwriting criteria.

HOME RUN

Fortunately, Doe Bros. had a backup plan. The company had used Cheryl Starr's bank when

they upgraded their manufacturing facilities in 2004. Jon and Don also conducted their personal banking with Starr, and she regularly met with the brothers to discuss business operations and financing needs.

Starr already knew of the company's P&L weaknesses before Don called about the line of credit. But she recognized the upside of Doe Bros.' new contract. So, she reviewed the company's *complete* financial picture. Then she went to bat for her borrower before the bank's review board.

The bank decided to take a chance on Doe Bros. for several reasons. First, they had a signed exclusivity contract for the new business, significant working capital on hand, and a stellar loan repayment history. Additionally, both owners had decades of industry experience and strong personal balance sheets.

But the deciding factor was the company's open line of communication with Starr — both borrower and lender had taken the time to build



FACTORING: THE GOOD, THE BAD AND THE UGLY

Some borrowers turn to factoring as a way to access instant cash. Lenders can help them by explaining the differences between factoring and traditional bank financing — and the potential pitfalls of selling off receivables.

In a factoring arrangement, a company sells trade receivables to a third party (the factor) at a discount from the book value. The advance rate depends on the type of factoring arrangement (recourse or nonrecourse), backend fees and perceived risk of default. The factor takes over responsibility for collecting the receivables and the company gets cash.

Factors are unregulated, and some take advantage of capital-starved businesses. In addition to paltry advance rates, they might pursue debtors (the company's customers), thereby compromising future earnings. A contract's fine print also may camouflage adverse clauses, such as excessive fees for processing and early termination. Some nonrecourse factoring arrangements even require the company to assist the factor with collections.

trust. Thanks to their strong relationship, Starr's bank approved the line and Doe Bros. was on its way to a holiday windfall.

A STARRING LINE-UP

A comprehensive loan review — like Cheryl's — looks beyond the P&L statement. Here are solid criteria that you can "take to the bank":

Trends. Look at historic operating trends and growth prospects. The duration of a company's lending relationship with your bank should factor into the equation, as does its relative size and market share.

Important to the lineup are qualitative characteristics, such as management strength, key-person risks, and the credit standing of a borrower's customers.

Liquidity. Evaluate a borrower's working capital, which equals the difference between current assets and liabilities. Even in tough times, good management is exemplified by how the company manages its working capital. Proper attention to accounts receivable, inventory and accounts payable can

create an abundance of liquidity even if the company is in a loss position.

Turnover. How efficiently a company manages its assets — as well as its fixed asset condition — can be predictors of future performance. Watch out for mounting receivables compared to sales (or payables compared to the cost of sales).

Leverage. Consider how a company finances its operations. Equity financing gives owners a vested stake in future operations. Excessive debt obligations put lenders at risk.

Equally important to the lineup are qualitative characteristics, such as management strength, key-person risks, the credit standing of a borrower's customers, goodwill, pending lawsuits and employee turnover.

LOYAL FANS

Darryl Doolittle learned the hard way that a narrow focus on profits and credit scores can lead to hasty decisions and may cause a bank to needlessly lose profitable customers. Lenders who stick by their borrowers in good *and* bad times foster profitable, long-term banking relationships. Just ask Cheryl. \$



COST SEGREGATION STUDIES, YOUR CLIENTS AND YOU

Telling your business customers about the pluses of a cost segregation study can demonstrate what you “bring to the table.” What’s learned in a study allows many businesses to depreciate their property faster. The result is tax savings now — and better cash flow.

By taking time to review a client’s cost segregation study, you’ll gain an in-depth look at the client’s buildings and its components, allowing you to assess potential hidden value. Although a study doesn’t increase the depreciable base of a building, it may highlight additional value that you might not have otherwise seen in an assessment of your customer’s assets.

HOW DOES IT WORK?

Cost segregation studies focus on building components that appear to be real property. But, in reality, they are more accurately classified as personal property depreciable over five or seven years or as land improvements depreciable over 15 years.

Using engineering and tax accounting principles, a cost segregation study identifies building components that qualify for accelerated depreciation. This enables a business to cut its tax bill or claim a refund for missed depreciation deductions in previous years.

Usually, commercial real estate is depreciated over 39 years. This lengthy recovery period applies to *real property*, which includes buildings as well as structural components, such as walls, concrete floors, paint, windows, ceilings and HVAC systems. But the 39-year period doesn’t apply to *personal property*, such as furniture, carpeting, appliances, shelving, cabinets or counters, and PA systems. Such items generally can be depreciated over five or seven years.

Although every business is different, an often-cited rule of thumb says that, for each \$100,000 of assets reclassified from 39-year property to five-year



property, a business could enjoy a net present value savings of about \$22,000. (This assumes an 8% discount rate and a 40% marginal tax rate.)

A CPA, for example, reported that one of his business clients received an additional \$400,000 of depreciation in the year of the study, saving the customer about \$168,000 in estimated tax. This particular study cost \$2,500, so, given the time value of money, it was a smart investment.

WHAT DOES THE IRS CONSIDER?

The IRS and Tax courts examine several factors to determine if an item is properly classified, including whether it’s affixed to the building or land and intended to be permanent. They also consider whether the item can be removed easily without damage and whether its function is more closely related to the building’s operation or the owner’s business activities. But specialized structures and building components — those unique to the company’s activities — often can be classified as personal property.

Other items that your client may be able to classify as personal property include vinyl covering, movable partitions, electrical connections and

wiring for specialized equipment, and removable wall and floor coverings.

The client also may be able to count removable awnings and canopies, window treatments, decorative lighting and millwork, and internal and external signs. It varies, but many of these items can be depreciated over five years.

Many businesses mistakenly subtract the value of the land from the total purchase price and simply depreciate the balance over 39 years. But land improvements, such as parking lots, sidewalks, exterior lighting and fences, are a separate class of property and may be depreciated over 15 years.

WHO SHOULD CONDUCT THE STUDY?

Generally, there are no requirements or certifications necessary to perform a cost segregation study. But a thorough understanding of tax advising and the tax code is a must-have for the study to stand up on audit. For larger projects, professional input may be needed from a contractor, engineer or architect. The “tab” for a cost segregation study varies greatly depending on the scope of the project.

WHAT CAN LENDERS DO?

When talking to your customers, remember that new buildings being put into service always should undergo a cost segregation study unless the tax status of its ownership is such that additional depreciation will produce no tax benefits. And most existing buildings have the potential for accelerated depreciation if a cost segregation study hasn’t been previously performed.

REMEMBER THE BENEFITS

For your customer, the primary benefit of a cost segregation study is an increased depreciation deduction that might be allowed on the business’s tax return. An increased depreciation deduction results in a lower net income, and that will lower the amount of tax owed by the company’s owners.

Additionally, you’ll likely get a better idea of the true value of your customer’s building by understanding its “insides.” And you may be partly responsible for adding funds to their cash flow — and that certainly adds value to your role. \$

Asset vs. stock sales

LET’S MAKE A DEAL

When it comes to mergers and acquisitions (M&As), the selling price takes center stage. But how the deal is structured can make or break the sale. The structure affects not only how much cash the seller receives, but also the business’s future profits, liabilities and banking relationships.

As with any major change in borrowers’ operations, it’s imperative that you stay informed when a borrower is negotiating an M&A deal. The aim is to get to know prospective owners, assess deal viability and seize future lending opportunities.

WHAT’S FOR SALE?

A fundamental choice when selling a corporation is whether to sell assets or stock. In a stock sale, all the outstanding shares of stock transfer to the buyer, and the business continues to operate uninterrupted.

Asset sales are more complex. The buyer purchases all (or most) of the corporation’s assets and liabilities, renegotiates contracts (including bank loans) and applies for new licenses, titles and permits.



Asset sales enable the buyer to report assets, such as equipment and furniture, at fair market value. The value allocated to each fixed asset provides a fresh basis for depreciation, thereby lowering taxable income in the future.

ANY OTHER OPTIONS?

S corporations have a third option that may serve as a middle ground between asset and stock sales. By electing IRC Section 338, borrowers may be eligible to treat a stock sale like an asset sale for federal tax purposes. Although the election won't save sellers any tax, buyers will reap the tax benefits of an asset sale.

From a tax and liability perspective, sellers generally prefer a stock sale. Buyers prefer an asset sale.

WHAT'S IN IT FOR THE SELLER?

When transferring stock, sellers currently pay capital gains tax on the difference between the selling price and their basis in the stock, as long as the seller has held the stock for more than 12 months.

But asset sales trigger double taxation for C corporations. The shell corporation — which the seller retains and winds down in an asset sale — pays tax on the gains from selling assets. And the shareholders pay tax on cash distributions.

Asset sales also can leave sellers vulnerable to future lawsuits, such as employee discrimination or intellectual property claims. Another consideration is depreciation recapture — although it has the potential to significantly reduce the amount of cash taken away from the sale, it's often overlooked.

HOW ABOUT THE BUYER?

When buyers purchase stock, assets stay at book value, and existing depreciation schedules apply. Although simpler to execute, stock sales typically result in higher taxable income for the buyer than do asset sales.

To make a 338 election, the buyer and seller must sign and jointly file Form 8023. Then each must file Form 8883, which allocates the purchase price among seven categories of assets, including cash, inventory and goodwill. Some of these categories — for example, inventory — are taxed as ordinary income. Others are subject to a capital gains tax. So, this allocation has important tax consequences for the seller.

Asset sales can leave sellers vulnerable to lawsuits, such as employee discrimination or intellectual property claims.

WHO CAN HELP?

How an M&A deal is structured is complex. Both parties' legal advisors and CPAs should be intimately involved throughout the process. From the lender's perspective, poor decisions can compromise future debt service. And you may be out in the cold if the parties opt for an asset sale and the buyer switches banks — or if you don't get involved in the entire M&A process from the get-go. \$

PROFESSIONAL PRACTICE POINTERS

Lawyers, accountants and other professional services firms occasionally need financing to purchase equipment or fund seasonal shortfalls — just like any business. But they differ from retailers, contractors and manufacturers in noteworthy ways.

FINE-TUNE FINANCIAL STATEMENTS

Professional practices use the cash method of accounting or blend accounting methods, while others choose the accrual method. Using different methods can vastly change the appearance of a firm's financial position, so you may need to adjust a practice's financial statements to benchmark its performance.

For example, a cash method practice generally will have a higher net income in a period when they're collecting their receivables. An accrual method practice will show a higher net income in the period in which the work is actually performed and the collection of the receivables is assumed. Blending these methods can yield a number of different results.

Another important difference is the way professional practices report profits. Many firms are flow-through entities, such as partnerships, limited liability companies or S corporations. Because the firm's income flows through to the owner's personal tax returns, some owners may draw a significant portion of profits from the business.

Other firms use the owner's compensation to provide

cash flow for income obligations, and some practices distribute cash directly to the owner (which doesn't affect profits). So rather than focusing on net income, lenders should evaluate operating income or distributable income per owner.

QUESTION CONTINUITY

Most professional firms are well aware of the need to develop succession plans to recruit and train second-generation owners and transition key accounts. But it never hurts to inquire as to whether your professional service borrowers have such a plan in place.

Firms can further mitigate this risk with life and disability insurance policies, employment and non-compete contracts, and buy-sell agreements. So also ask whether your borrowers have implemented these safeguards.

EXAMINE EARNINGS TRENDS AND MORE

A professional practice's debt service depends on its future earnings. Historic operating trends are a good first indication, especially for established firms. Smooth, upward growth provides peace of mind; erratic revenue patterns should cause concern.

Finally, inquire about the firm's client turnover rate and composition of revenues. Clients that represent more than 10% of annual revenues present a concentration risk, which can be offset with signed contracts.

ADAPT TO YOUR SURROUNDINGS

Each professional practice offers its own risks and rewards to lenders. If you understand the unique attributes of professional practices — and modify your due diligence efforts accordingly — you'll be ready to make wise lending decisions. \$

