

COMMERCIAL LENDING REPORT



JULY/AUGUST 2009

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RISKY CUSTOMERS

Watch out for signs of disappearing cash

Forget net income and book net worth. When it comes to monitoring creditworthiness, cash is king. Every business experiences occasional cash shortfalls — that's why they need lines of credit — but borrowers with chronic cash deficits may be on the brink of default.

CHECK OUT THE STATEMENT OF CASH FLOWS

Although business owners and lenders tend to cast it aside, the statement of cash flows can reveal clues about an existing or prospective borrower's performance, especially the owner's ability to manage cash. The statement of cash flows typically consists of three sections:

1. Cash flows from operations. This section converts accrual net income to cash provided or used by operations. All income related items flow through this part of the cash flow statement, such as net income; gains (or losses) on asset sales; depreciation and amortization; and net changes in accounts receivable, inventory, prepaid assets, accrued expenses and payables.

2. Cash flows from investing activities. If a company buys or sells property, equipment or marketable securities, the transaction shows up here. This section could reveal whether a company is divesting of assets for emergency funds or whether it's reinvesting in future operations.

3. Cash flows from financing activities. The third section shows transactions with investors and lenders. Examples include Treasury stock purchases, additional capital contributions, debt issuances and payoffs, and dividend payments.

Below these three categories is the schedule of noncash investing and financing transactions. This portion of the cash flow statement summarizes significant transactions in which cash did not directly change hands: for example, like-kind exchanges or assets purchased directly with loan proceeds.

INQUIRE ABOUT SIGNIFICANT CHANGES

The statement of cash flows shows changes in balance sheet items from one accounting period to the next. Lenders should inquire about significant balance changes. For example, if accounts receivable were

\$1 million in 2007 and \$2 million in 2008, the change would be reported as a cash outflow from operations of \$1 million. That's because more money was tied up in receivables in 2008 than 2007.

An increase in receivables is common for growing businesses, because receivables generally grow in proportion to revenue. But a mounting receivables balance also might signal cash management inefficiencies. Additional financial information — such as an aging schedule — might reveal significant write-offs, which is important information if you're a lender that relies on accounts receivable as collateral.

Also beware of businesses that continually report negative cash flows from operations. There is a limit to how much money a company can get from selling off its assets, issuing new stock or taking on more debt. When operating cash outflows consistently outpace operating inflows, it's time for intervention.

FIND HIDDEN SOURCES OF CASH

Outside financial professionals can breathe new life into a cash-starved business. And their expertise is in high demand during economic downturns. Here are some ways they can help borrowers stave off the cash crunch:

Control growth. Companies that grow too fast experience growing pains. Cash shortages result from the operating cycle: Before they receive payment from customers, they must fork out substantial sums to pay employees, rent facilities, build product, etc. Out-of-control growth also can impair quality, which, in turn, hurts goodwill and long-term viability.



Putting the brakes on growth may be a hard pill for entrepreneurs to swallow. But slow sustainable growth usually is better over the long term. An accountant can help borrowers compute their “fundable growth rate,” the growth rate at which cash inflows equal cash outflows. He or she also can offer ways to decrease demand — such as increasing the selling price — that maximize the bottom line.

Trim fat. Struggling companies can restore cash reserves by curbing quasi-business expenses (such as luxury vehicles and business trips), laying off non-essential workers, avoiding advance purchases, selling off nonoperating assets or repaying shareholder loans.

Convert expenses from fixed to variable. For example, borrowers might consider outsourcing, temporary labor and equipment leasing to generate cash. They also might re-evaluate their tax planning strategies, which may be outdated under current economic conditions and the new U.S. administration.

Upgrade asset management. A financial professional can identify weaknesses in asset management and offer solutions. For example, accounts receivable collections might improve with tighter credit policies, early-bird discounts, collections-based compensation programs and dedicated collections personnel.

Conversely, some companies carry too much inventory. (See “Lean companies are healthy borrowers” below.) In addition to tying up working capital, inventory incurs hidden costs, such as interest, storage and insurance expenses.

UNDERSTANDING THE OPERATING CYCLE

The cash gap is a financial metric that demonstrates how the operating cycle works — and ways to shorten it. Here’s how it works:

$$\begin{aligned} & \text{Average days in inventory} \\ & + \text{Average days in accounts receivable} \\ & - \text{Average days in accounts payable} \\ & = \text{Cash gap} \end{aligned}$$

The cash gap shows the delay between when companies order materials and pay suppliers and when they receive payments from customers. In general, the shorter the cash gap, the fewer cash deficits a company experiences during its operating cycle. Seasonal businesses and those with long-term contracts are exceptions to the rule.

KEEP A WATCHFUL EYE

Effective cash management can be the difference between staying afloat and filing for bankruptcy — especially in an unpredictable economy. By donning their detective caps, lenders can prevent unwise credit decisions. For existing borrowers, your diligence can identify problems and help find solutions that minimize the risk of default. \$

LEAN COMPANIES ARE HEALTHY BORROWERS

Characteristics of efficient supply chain management

In a downturned economy, operating inefficiencies can push shaky companies over the edge. On the other hand, healthy supply chain management can help avoid inefficiencies. A strong system displays these chief characteristics:

PURCHASING IS CENTRALIZED

Purchasing should be the responsibility of one individual — or a single department for large

companies. This person, or department, is tasked with negotiating with suppliers for the lowest price, greatest flexibility and highest quality.

The procurement manager also tracks the reorder points for inventory, supplies and equipment. Consolidated orders are larger and made less frequently, which results in volume discounts and reduced shipping charges.

INFORMATION IS SHARED

Demand-driven businesses match inventory levels with customer demand. Enterprise resource planning (ERP) software facilitates supply chain efficiency by enabling customers, vendors and middlemen to share information. ERP systems also improve customer service, as well as minimize production delays and overtime costs.

Budgets and forecasts should be updated monthly or even weekly, if possible. That way, everyone along the supply chain knows what will be needed — and when.

“PREFERRED VENDORS” ARE USED

Companies should have a short list of preferred vendors with whom they’ve negotiated the best prices and terms. It’s especially important for lean manufacturers to have suppliers that are flexible and provide reliable quality.

Most vendors stop by annually to renegotiate price and discuss service issues. The procurement manager should prepare for supplier negotiations by reviewing forecasts and historic spending patterns to determine volume, average order size and expected demand. To maximize bargaining power, he or she also should know what the competition offers.

SHIPPING POLICIES ARE TIGHT

Fuel prices affect shipping charges. Depending on the balance of power in a borrower’s supply chain, some companies can pass along increased costs with fuel and shipping surcharges. But many cannot.

Lean borrowers expect suppliers to ship inventory at the last possible minute and then ship finished goods to customers just as quickly.

Efficient borrowers discourage small batch orders of supplies and inventory, as well as overnight and 2-day shipping options, which cost about 40% more than standard ground delivery. To optimize shipping efficiency for finished goods, some companies purchase transportation and logistics software — or they might outsource shipping functions to a third-party logistics provider.

High shipping costs are causing many companies to re-evaluate their offshoring contracts. The incremental shipping costs from, say, China or India may negate any cost savings from cheaper materials and



labor. Moreover, domestic suppliers often are more flexible and provide fewer communication barriers.

INVENTORY PRACTICES ARE LEAN

Lean (or just-in-time) operations strive to eliminate non-value-added activities (such as downtime, setup, inspection and scrap) and minimize the amount of working capital tied up in inventory. Lean borrowers expect suppliers to ship inventory at the last possible minute and then ship finished goods to customers just as quickly.

Lower inventory balances also mean lower storage, security, obsolescence, pilferage and insurance costs. Business owners who worry that decreased inventory levels will compromise customer service can rate customers based on volume and profitability. They then can base safety stock levels on these ratings.

OUTSIDE ASSISTANCE IS SOUGHT

Supply chain efficiency is an important consideration when evaluating the creditworthiness of existing and prospective borrowers. An outside expert can help borrowers reinforce their management skills by forecasting demand, benchmarking performance against industry best practices and setting realistic improvement targets. \$

GREED AND HUBRIS HAVE NO PLACE IN BANKRUPTCY

No one was surprised when Edgy Enterprises filed for bankruptcy. Bankruptcy has become an easy out for homebuilders hit hard by the recession. What was surprising was the owner's spending habits the year before liquidating.

Despite laying off most of his laborers and office staff, Mr. Jones took frequent family vacations using the company jet and its "investment" property in West Palm Beach. He also built houses for several family members at discounted prices. And he was rumored to be padding job cost sheets with his summer home renovation expenses.

Lenders might overlook minor transgressions in good times. But when a firm is contemplating bankruptcy, lavish spending and blatant disregard for corporate/personal boundaries are slaps in the faces of employees, creditors and lenders. Self-serving spending habits not only set a bad example and lower morale, but they also increase the likelihood of insolvency and leave less money for stakeholders to divvy up in liquidation.

WHAT ARE YOUR METHODS OF RECOURSE?

Often lenders are unaware of questionable spending habits. But there are a handful of ways lenders can protect their financial interests before and after bankruptcy strikes, including:

Personal guarantees. If you haven't already done so, require private business owners to guarantee loan repayment with their personal assets. Personal guarantees may be standard practice for some lenders. But other banks relaxed their underwriting standards earlier this decade, and some midsize firms may have slipped through the cracks.

Piercing of the corporate veil. Corporations offer limited liability, which protects shareholders' personal assets from corporate obligations. But if you can prove that the corporate entity has been "misused," a court may disregard it. Then shareholders are treated like partners who have unlimited liability for corporate debts.

For example, you can still go after greedy business owners if they violate legal, fiduciary or contractual

obligations — or if the business serves as the "alter ego" for shareholders, subsidiaries or other related entities.

Fraudulent conveyance claims. If a borrower sells assets or business segments for less than fair market value, it may unfairly transfer valuable assets to a related party or even cause insolvency.

An independent financial expert can perform a solvency analysis to determine whether a transaction has left the company "insolvent" — in other words, unable to service its debt obligations and continue normal business operations. Financial experts also can investigate executive fraud and mismanagement, identify related party transactions and provide comparable arm's length transaction data to help support misuse or fraudulent conveyance allegations.



WHAT ARE THE RED FLAGS?

A more proactive strategy is to stay atop due diligence and catch financial problems before they reach the point of no return. Some early warning signs for bankruptcy include:

- * Alarming industry outlook and trends — for example, homebuilders, domestic car dealers and restaurants may be on the chopping block,
- * Deteriorating financial performance: most notably lackluster sales, mounting expenses, cash shortages, decreased liquidity and sluggish asset turnover,

- * Loan covenant violations,
- * Layoffs and unusually high employee turnover,
- * Fully extended credit lines and requests for extensions, and
- * Late financials, missed loan payments and unreturned phone calls.

Sometimes financial data provides too little information, too late. Early detection requires lenders to tap into the community rumor mill and periodically visit customers.

TIME FOR CORRECTIVE ACTION?

If your efforts reveal these red flags, it may be time for a frank meeting with your borrower. Identify and discuss the perils of questionable spending habits. Good times may have accustomed owners to over-the-top lifestyles, and they might need a reality check.

Owners who cut back demonstrate a commitment to keeping the business afloat. Financial professionals can recommend ways to forestall formal bankruptcy proceedings — if you can catch problems in time. \$

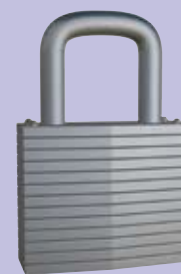
SIGNPOSTS OF STRONG INTERNAL CONTROLS

Internal controls are a system of policies and procedures businesses put in place to protect assets and improve operating efficiency. Internal controls specify how companies direct, monitor and measure their resources. Moreover, they are your borrowers' first line of defense against fraud.

RE-EVALUATING CONTROLS IN A RECESSION

There's no time like the present to focus on internal controls. For many, the recession has slowed business operations. Borrowers can use the downtime to assess and enhance internal controls.

Unfortunately, recessions also entice some employees to commit fraud. For example, a CFO may feel pressured to achieve unrealistic performance goals. Or a part-time clerk may be living beyond his or her means. Strong internal controls not only detect fraud, but they also prevent employee dishonesty from the get-go.



COVERING ALL THE BASES

Lenders should be on the lookout for these three basic controls that differentiate strong internal control systems from weak ones:

1. Physical restrictions. Employees should have access to only those assets necessary to perform their jobs. Locks and alarms are examples of ways to protect valuable tangible assets, including petty cash, inventory and equipment. But intangible assets — such as customer lists, lease agreements, patents and financial data — also require protection. Passwords, access logs and appropriate legal paperwork help serve this purpose.

2. Account reconciliation. Management should confirm and analyze account balances on a regular basis. To illustrate, strong borrowers reconcile bank statements and count inventory on a regular basis.

Interim financial reports, such as weekly operating scorecards and quarterly financial statements, also keep management informed. But reports are useful only if management finds time to analyze them and investigate anomalies. Supervisory review takes on many forms, including observation, test counts, inquiry and task replication.

3. Job descriptions. Another basic control is detailed job descriptions. Company policies also should call for job segregation, job duplication and mandatory vacations. For example, the person who receives customer payments should not also approve write-offs (job segregation). And two signatures should be required for checks above a prescribed dollar amount (job duplication).

TAKING MATTERS INTO YOUR OWN HANDS

Sarbanes-Oxley requires auditors to attest to the effectiveness of their public clients' internal control systems and report any material weaknesses. Although private companies aren't bound by these requirements, every business benefits from reinforced controls. A financial professional can help private companies evaluate internal controls and remedy any apparent weaknesses.

EVALUATING A FAMILY AFFAIR

About nine out of 10 businesses are family owned or controlled, according to the Small Business Administration (SBA). Although some are Fortune 500 giants — such as Ford and Wal-Mart — most are small private firms with limited resources to weather an economic downturn.

INFORMALITIES

Family businesses generally operate with relaxed management styles and minimal internal controls. Owners tend to trust employees. But unscrupulous friends and relatives can take advantage of an owner's naiveté and resort to fraudulent activities.

Choose family businesses with a proven track record over startups. For established firms, compare 2008 business plans and budgets with the actual results for last year. If management has demonstrated strong forecasting skills in the past, there's a better chance that future budgets will be realistic and achievable. If no business plan or budget exists, the owner likely makes decisions based on gut instinct, rather than formal analyses.

NEPOTISM

Hiring, promoting and paying employees based on familial relations rather than on skills and achievements is a turnoff to unrelated employees — and it promotes complacency among family members. When family and friends receive sweetheart deals and above-market compensation, it also drains cash flow and impairs debt service.

If the recession has caused cash shortages, family members may have to accept more responsibility, fewer perks or pay cuts. Not only will it free up cash, but scaling back also sets a fiscally responsible example. Personal guarantees from shareholders provide extra protection when owners can't keep their hands out of the cookie jar.

Family feuds can lead to stalemates and hostile work environments. Inquire about turnover among nonfamily workers — they may jump ship if the family business limits their advancement opportunities, engages in nepotism or suffers from excessive family conflict.

SUCCESSION

Less than one-third of family businesses survive into the second generation, according to the SBA. That's because many owners procrastinate succession planning.

Of those who plan for the future, many focus on minimizing estate tax. But comprehensive succession plans groom next-generation management and develop detailed plans for business continuity. Succession planning should address who will assume a deceased (or retired) owner's duties and how.

Although many owners dream of handing the reins to their children, some may not be qualified or interested. Realistically, some family businesses are more viable in the hands of an unrelated CEO or management team.

Key person life insurance policies provide breathing room if an owner unexpectedly dies. Consider requiring family-owned borrowers to obtain life insurance and list your bank as beneficiary. Adequate coverage is a function of business value, outstanding debt, and replacement costs.

SELECTION CRITERIA

Get to know the family before you make a loan. Look for candidates that maintain professionalism and operate like other businesses. Once you've welcomed a family business into the fold, identify and avoid potential pitfalls by means of personal guarantees, life insurance coverage and extra due diligence. \$