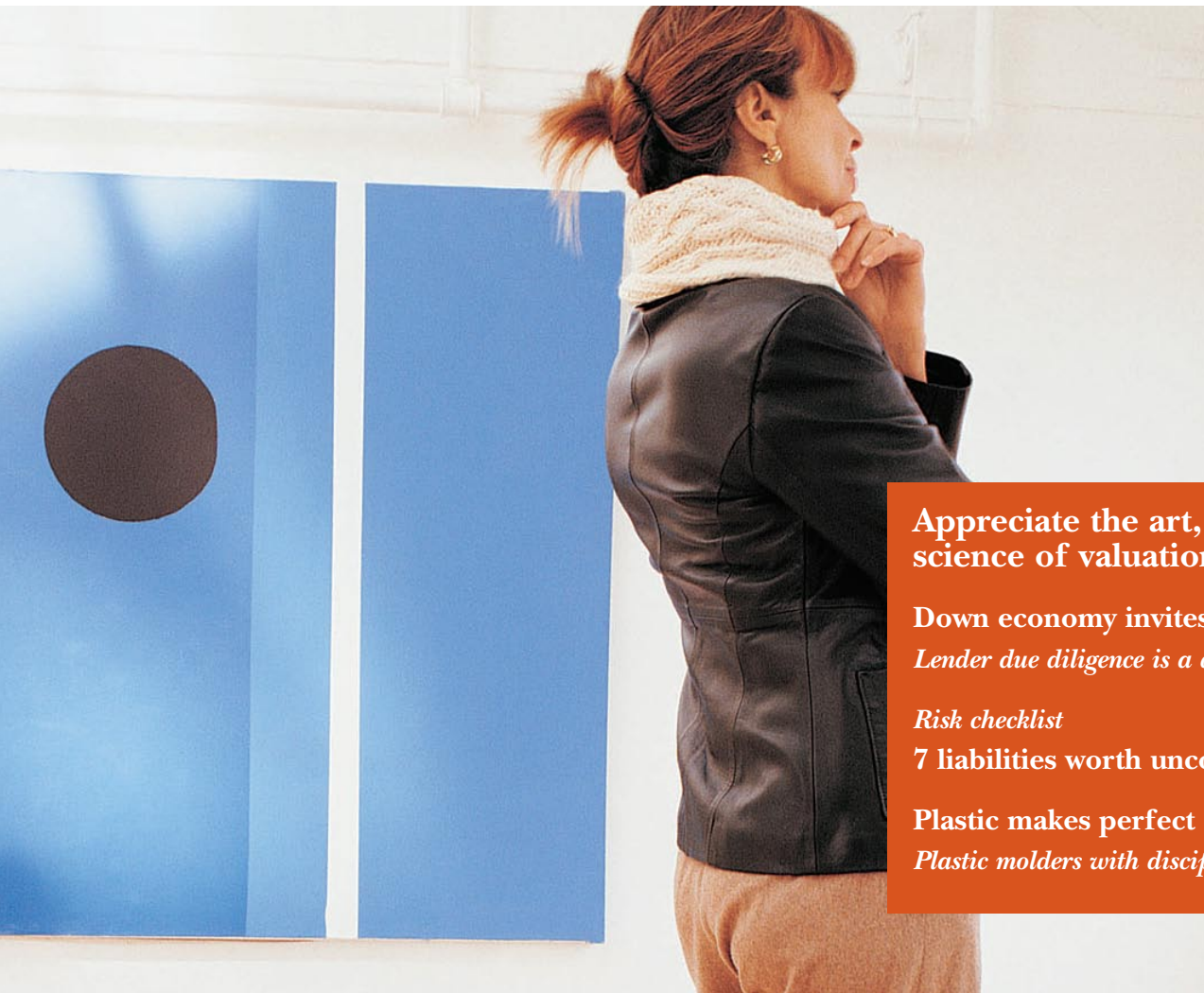


COMMERCIAL LENDING REPORT



JUNE/JULY 2010

**Appreciate the art,
science of valuation**

Down economy invites fraud
Lender due diligence is a deterrent

Risk checklist

7 liabilities worth uncovering

Plastic makes perfect

Plastic molders with discipline beat the odds

APPRECIATE THE ART, SCIENCE OF VALUATION

Value is in the eye of the beholder. As a lender you often have a stake in private company mergers and acquisitions. So it's important that you know whether the target's price is reasonable and that the buyer is emotionally detached. After all, a buyer that overpays is more likely to experience financial problems after the deal closes.

Procuring a professional appraisal upfront can mean the difference between a long-term lending relationship and default. Expert opinions also can assuage any concerns you may have, such as whether income projections are reasonable or comparables are truly similar to your borrower. And knowing business valuation jargon, methodology and potential pitfalls will help you make informed lending decisions.

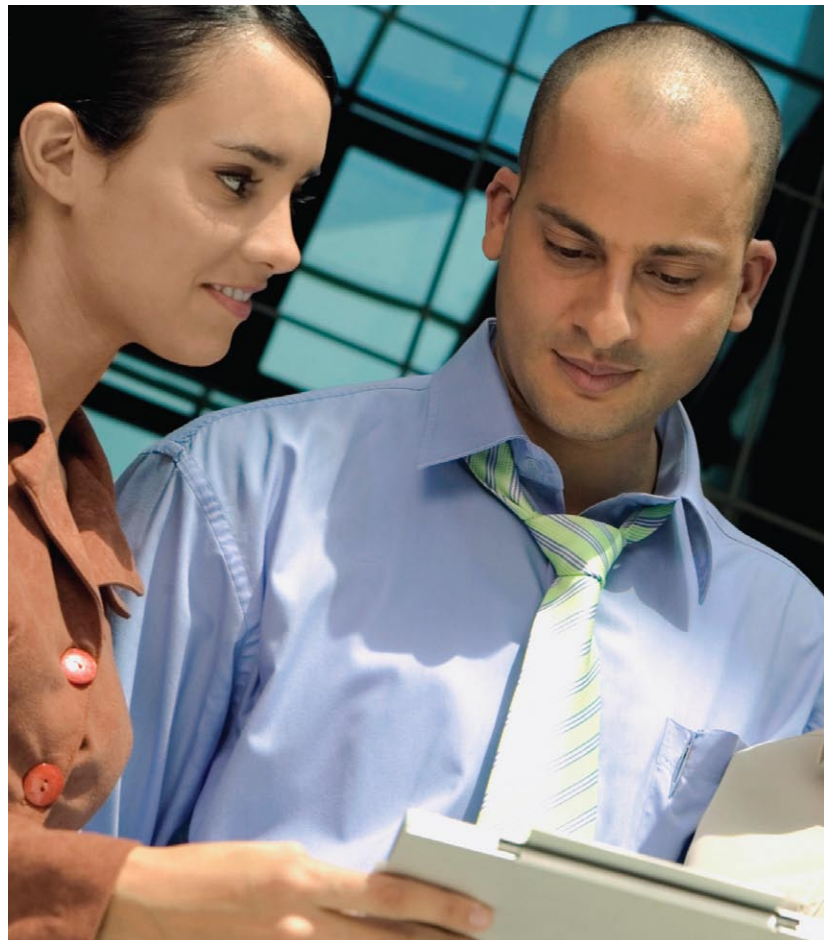
STANDARD OF VALUE

The term "value" can have many different meanings. *Strategic (or investment) value* refers to the perceived value to a specific investor. A business seeking to increase market share, for example, might pay a premium to acquire a competitor. Strategic value depends on an investor's individual requirements and expectations.

An important benchmark in negotiating deals is *fair market value*. Essentially, this is the price the "universe" of potential buyers and sellers would agree on for a business interest. Fair market value assumes no compulsion to buy or sell and reasonable knowledge of all relevant facts. Beware of deals where strategic value is significantly higher than fair market value. Many buyers overestimate the value of synergies.

Another common standard of value is *fair value*. In an accounting context, it's similar to fair market value, except that it's an exit (rather than an entry) price and, therefore, excludes transaction costs. Moreover, fair value only considers market participants active in the principal (or most advantageous) market.

Accountants use this term when, for financial reporting purposes, they value assets and liabilities — such as asset retirement obligations, long-lived assets and goodwill. Some distressed borrowers may have reported goodwill impairment during the recession, for example. This occurs when the fair value of acquired goodwill is lower than the amount shown



RULE OUT “RULES OF THUMB”

You’ve likely heard at least one valuation formula, such as one times revenues (for professional practices) or five times earnings (for manufacturers). But borrowers and lenders who bank on these “rules of thumb” may be in for a rude awakening after closing.

Oversimplified formulas overlook unique operating characteristics, such as nonoperating assets, exclusivity contracts or in-process research and development, which differentiate the subject company from its competition. Rules of thumb also may be outdated. For example, a valuation formula popularized during industry consolidation in the mid-1990s may not be relevant in today’s turbulent economy.

Another reason to shun rules of thumb is their ambiguity. To illustrate, does “earnings” refer to net income, pretax earnings, earnings before interest and tax (known as EBIT), or some other metric?

on the borrower’s balance sheet. These write-offs usually foreshadow financial problems.

METHODOLOGY

In much the same way they value real estate, appraisers apply three approaches to valuing a business:

Cost (or asset-based) approach. The value of a business is the difference between its assets and liabilities. For example, an appraiser might revalue the amounts shown on a company’s balance sheet. This approach is difficult to use on companies with significant intangible value. It’s typically reserved for holding companies and others that rely exclusively on hard assets.

Market approach. This approach generates pricing multiples from sales of comparable (or guideline) companies. Here, value is a function of selling price and a financial metric, such as annual revenues or last year’s earnings before interest, taxes, depreciation and amortization.

Public pricing data can be obtained from SEC documents (controlling interests) and daily stock market quotes (for minority prices). Alternatively, private deal terms may be obtained from proprietary databases.

Selection criteria for comparables might include transaction date, financial performance, industry

and size, for example. Finding a meaningful sample of comparables for some companies — especially niche specialists — can be difficult.

Income approach. Valuators project cash flows and then discount them back to their net present value. Discount (or capitalization) rates are based on the company’s risk. High-risk businesses are assigned a higher discount rate, which equates to a lower value (and vice versa).

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The income approach may be difficult for laypeople to understand. Sophisticated buyers and sellers are more likely to use this approach. It’s often the preferred method for startups and companies with significant intangible value.

PITFALLS

Methods and definitions explain some of the “science” underlying business valuations. But accurate appraisals also require finesse and qualitative assessment. Experienced valuators understand subtle valuation nuances and potential pitfalls.

For example, some sellers try to save money by reusing an appraisal prepared for, say, a previous gift tax return or shareholder buyout. Not only can these valuations be out of date, but they also may include inapplicable valuation discounts or use an inappropriate standard of value.

Valuations are only valid as of a specific date and for a specific purpose. Therefore, borrowers always should check with their appraisers before recycling an old report in a new context. Do-it-yourself valuations present another minefield of potential problems. The IRS and U.S. Small Business Administration recognize the importance of appraisal training and are establishing “qualified appraiser” criteria.

Before you finance a deal, ask whether the parties have consulted with valuation professionals. Ask for a copy of the written appraisal report, including the financial exhibits and appraiser’s curriculum vitae. Reliable appraisers have years of valuation experience and belong to professional appraisal organizations.

EDUCATED DECISIONS

Filtering through the data and arriving at an accurate value requires mastery of both the art and science of business appraisal. Lenders who understand valuation basics and expect borrowers to obtain outside valuation expertise will have a higher likelihood of making wise lending decisions. \$

DOWN ECONOMY INVITES FRAUD

Lender due diligence is a deterrent

Instances of fraud rise during down economies, making fraud awareness and detection critical — not only for business owners, but also for lenders. Your due diligence can raise a red flag that prompts you to meet with borrowers or seek additional assurance from a forensic accountant. Would-be fraudsters are typically less bold if they suspect the bank is looking over their shoulders.

CONDITIONS SPARK FRAUD

Fire requires fuel, oxygen, and heat (or a spark). Similarly, occupational fraud requires three conditions: motive, opportunity and rationalization — what forensic accountants commonly call the “fraud triangle.” Economic downturns can ignite fraud by bolstering all three factors.

When meeting with borrowers or touring their facilities, look for circumstances ripe for theft or misstatement.

Employees with unemployed spouses or upside-down home mortgages, for example, may rationalize the need to steal property and resell it. And unethical managers may conceal deteriorating performance with creative journal entries to avoid loan defaults. Or they may attempt to inflate sales to preserve their bonuses (and their jobs).

OPPORTUNITY KNOCKS

The weak economy also adds opportunities to defraud. Layoffs typically spread the remaining employees thinner, making it harder to implement strong internal control procedures, such as supervisory review and segregation of duties.

Owners and top managers may be distracted from fraud prevention and detection efforts as they scramble to recover lost sales or focus on cost containment. And employees working





harder without more pay — and with personal financial problems — may be more likely to rationalize a fraudulent act.

BANKS CAN DETECT SCAMS

Lenders can make the proverbial difference when it comes to fraud control. Let's take a hypothetical case, in which a borrower's CFO used the recession to his advantage. In the first quarter of 2009, he secretly diverted about \$50,000 in customer payments to his personal bank account. He later wrote off these amounts as bad debts, knowing that shareholders and lenders would expect lackluster results because of the poor economy.

When his first scam went unnoticed, the CFO colluded with a supplier to overcharge for materials. The unscrupulous duo then split the difference between the amount invoiced and the true market value of the material. The owner accepted the explanation that materials prices had increased due to rising energy prices. Fraud wasn't unearthed until an observant loan officer noticed that the company's profits had suffered

disproportionately when compared to other borrowers in the same industry.

THE DEVIL IS IN THE DETAILS

But detection efforts shouldn't wait until fraud appears front and center. Proactively meet with your borrowers to explain the fraud triangle and how it applies to them. Discuss internal control procedures, especially as borrowers try to cut costs. Internal control shortcuts — such as eliminating training programs, fraud reporting hotlines or job rotation — often cost more over the long run as the costs of unchecked fraud accrue.

And your borrowers should watch for changes in employees' standards of living, lifestyles or personal behaviors (such as personal bankruptcy, drug abuse, divorce or gambling habits). These may be telltale signs that warrant a closer look at employee behavior.

OWNER FRAUD IS TRICKIER

C-level fraud, in which owners and managers have the authority to override internal controls, is trickier and more costly, according to the Association of Certified Fraud Examiners' 2008 *Report to the Nation on Occupational Fraud & Abuse*. Often these scams involve financial misstatement, which leaves less physical evidence than outright theft. (The ACFE hasn't yet released its 2010 report.)

To minimize fraud opportunity, lenders should keep a diligent eye on owners, managers and the company's internal controls. Audits can help, too, but they provide no guarantee against wrongdoing.

Regardless of the cause — mismanagement, fraud or macroeconomic misfortune — irregularities must be identified and *rectified*. Lenders can't assume that conditions will improve simply with an economic upturn.

TRUST YOUR INSTINCTS

Evaluate how economic conditions have altered your borrowers' motivations, opportunities and abilities to rationalize fraudulent behavior. If financial indicators or even hearsay causes you to suspect someone might be stealing assets or cooking the books, trust your instincts and look into it further. \$

Risk checklist

7 LIABILITIES WORTH UNCOVERING

When commercial lenders have advance knowledge of hidden risks and liabilities, they can advise customers on ways to minimize their potential exposure and possibly preempt loan defaults. Or they may decide to deny a loan altogether.

Unearthing not-so-obvious risk and liabilities is multilayered: Lenders should perform industry risk analyses, interview management, request additional documentation and pay attention to business community word-of-mouth. The following questions are meant to help you uncover some of the potential risks and liabilities that can compromise debt service.

1. Is there an overreliance on certain customers?

Companies that rely on any one customer for more than 10% of their annual sales (or one supplier for more than 10% of their materials) risk sudden interruption of operations if the customer (or supplier) cuts its ties. Well-written, long-term contracts are one strategy to combat concentration risks.

2. Is there an overdependency on key people?

Lenders should evaluate the age and health of key people and the cost to replace them. Volatile employee or shareholder relations may increase the risk of losing a key person. Signed noncompete agreements and key-person life insurance policies may minimize the stress caused by a key employee's sudden departure.

3. Are there tax problems? When compounded with interest and penalty charges, tax liabilities can quickly take a toll on a business. Lenders should stay abreast of any customers being audited for income, sales and payroll tax deficiencies.

4. Are there any ongoing lawsuits? Pending legislation is expensive, and it can distract management's attention from the company's day-to-day operations. Bitter shareholder disputes may even result in court-mandated liquidations.



5. Is there a high risk for fraud? A strong internal control system is the best defense against fraud risks. While most companies worry about employees stealing assets, lenders should also watch out for managers using fraud schemes to misrepresent the financial health of the company. (See “Down economy invites fraud” on page 4.)

6. Are there foreign transactions? In addition to obvious geopolitical risks, foreign activity is susceptible to money laundering scams, repatriation and foreign-tax issues, exchange-rate risks, or the possibility that a foreign government might expropriate (or repossess) the company's foreign property.

7. Are there environmental risks? Environmental regulations may require a business to clean up its own property, even if a previous owner caused the contamination. Routine environmental assessments can help manufacturers and processors keep environmental clean-up costs to a minimum. \$



MARKET NICHE INSIDER

PLASTIC MAKES PERFECT

Plastic molders with discipline beat the odds

Hundreds of plastic manufacturers closed shop during the downturn — and many more likely won't survive 2010. The silver lining for lenders is that your fittest borrowers could excel by picking up inexpensive equipment at fire sales and taking over transfer work from bankrupt competitors. With the worst hopefully behind us, here's a regimen for healthy plastics manufacturing going forward.

DISCIPLINE

There's no margin for error in plastics production. Productivity is higher than ever, but volatile resin costs, soaring energy prices, sluggish consumer demand, tight credit and pricing pressures continue to threaten profits.

Strong manufacturers aggressively pare down shop costs and convert from fixed to variable expenses. This creates greater flexibility and lower breakeven points. For example, some plastic producers use part-time labor to reduce salary expense in slow times and eliminate costly benefits.

Top borrowers also take a disciplined approach to pricing. They don't underbid jobs just to cover overhead. They set a profitability threshold of, say, 10% gross margin. Jobs that fall below that threshold — or that require short runs — add complexity and should be reevaluated.

Job complexity is a function of the number of resins, presses and molds used. Small, low-margin

jobs (typically below 30%) usually aren't worth the incremental labor costs and scheduling hassles.

FOCUS

Every plastics borrower needs a formal long-term survival strategy. Many strive to be low-cost, high-volume producers. But competing on price and volume alone is difficult in mature markets.



Compute your borrower's value added (sales minus materials, purchased components and outsourced processing costs) as a percentage of total sales (or per employee). The lower the value added, the less valuable the borrower is along its supply chain — and the less bargaining power the manufacturer has with its customers.

Strategy makeovers maximize value added. For example, molders that target a niche — such as health care components requiring specialized engineering — earn higher margins. They likely also offer products and services that are irreplaceable to the supply chain, such as unique designs, tight tolerances (machining to exact measurements) or new processes.

PROFESSIONAL SUPPORT

Recognizing opportunities requires a keen sense of self awareness. But plastics borrowers often are unsure of how they rate against competitors in terms of financial performance, size and marketing strategy. You may need to steer borrowers who lack discipline and focus to an outside professional for a wake-up call. \$