

COMMERCIAL LENDING REPORT



MAY/JUNE 2009

Make your borrowers' concerns your own

Rethinking debt

A shake-up in the credit markets

How do your borrowers' inventory practices stack up?

Cover your assets with key person insurance

A roadmap for lending to trucking companies

MAKE YOUR BORROWERS' CONCERNS YOUR OWN

Chief financial officers are increasingly pessimistic about economic conditions, according to a recent *Duke University/CFO Magazine Global Business Outlook Survey*. For the first time in the survey's 13-year history, bears outnumbered bulls nine to one. In fact, many CFOs don't expect the recession to end until 2010 or later.

Lenders who understand their borrowers' financial expectations are better equipped to mitigate risk. Your borrowers' greatest concerns can tell you what to watch for in terms of high-risk behaviors and management quality. Good borrowers take charge of impending threats; weak borrowers take a "wait-and-see" approach.

WHAT'S WORRYING CFOs, EXACTLY?

"Throughout the history of our survey, CFOs have shown remarkable ability to predict future economic conditions," warns John R. Graham, director of the *Duke/CFO* survey, which was published last December. Senior financial executives are in the



trenches and know firsthand how internal and external factors affect their businesses.

Many of early 2008's top concerns — rising fuel and commodity prices, supply-chain risks, and attracting and retaining employees — were put on the back burner by year end. Now CFOs are most concerned about:

Consumer demand. U.S. consumers are worried about high energy and grocery prices, job security and declining property values and are, as a result, postponing major and unnecessary purchases or looking for deep discounts. Consumer spending habits trickle down through the economy. In 2008, retailers were especially hard hit by waning consumer demand. Now it's manufacturing's turn.

During a recession, keep your strong borrowers close, your weak ones closer. Communicate often and openly.

Credit markets and interest rates. Financial market turmoil is forcing many lenders to tighten their purse strings. In addition to inaccessible loans and credit lines, CFOs report higher interest costs — especially among small businesses and those with low credit ratings. As a result of the credit crunch, many CFOs have forgone profitable investment opportunities.

One business's accounts receivable is another's accounts payable. With bank financing harder to come by, some buyers are using payables as interest-free financing. In tough times, it's important that borrowers continually monitor aging receivables and rethink credit policies to prevent unexpected write-offs.

Forecasting. Predicting what will happen in the financial markets is more difficult than ever. This uncertainty confounds the management planning process because forecasts and budgets underlie many business decisions, including ordering inventory and supplies, hiring workers and leasing equipment. And forecasting risk can be a double-edged sword. Overzealous forecasts lead to excess capacity and unrecoverable fixed costs,

SURVEY SAYS

What's making CFOs pessimistic and causes them to stay up at night? According to a *Duke University/CFO Magazine Global Business Outlook Survey*, their top internal and external worries are as follows:

Top external concerns

1. Consumer demand
2. Credit markets/interest rates
3. (tie) Housing market fallout
New administration and Congress

Top internal concerns

1. Ability to forecast results
2. Maintaining morale and productivity
3. Balance sheet weaknesses

but overly pessimistic ones risk forgone sales. Lenders should review business plans and forecasts skeptically.

Employee morale and productivity. Employees face a tense work environment. Layoffs abound across all sectors, raises are the exception and pay cuts are becoming common. What's more, employee retirement and pension account values have plummeted.

The success of many types of businesses — including professional service firms, restaurants and clothiers — hinges on a skilled, established workforce. Business reputation and profits will suffer if employees seek greener pastures or let their own financial worries affect productivity.

WHAT ELSE CONCERNS THEM?

CFOs also are concerned and uncertain about the new presidential and congressional regimes, the housing market fallout and balance sheet weaknesses. Of these, the last should be particularly disconcerting for lenders who collateralize loans based on the book values of tangible assets.

In particular, CFOs in the transportation, media, technology and health care industries express mounting concern about whether their balance sheets accurately portray asset recoverability and market values. This year may bring record numbers of impairment losses for long-lived assets (such as property and equipment) and indefinite-lived intangible assets (such as acquired goodwill or brand names) in these sectors.

HOW ARE CFOs REACTING?

Proactive CFOs think of ways to counteract business threats. For example, sales and promotional campaigns might counter waning consumer demand and, therefore, increase revenues. Alternatively, performance-based compensation programs might enhance employee morale and productivity.

As the economy limps forward, many companies are in "survival mode." The CFO survey predicts that in 2009 U.S. companies will cut employment by 5%, outsourced labor by 2%, capital spending by 10%, technology spending by 4%, and marketing and advertising costs by 7%. Despite their corrective actions, CFOs expect average annual profits to decline by 9%.

WHAT CAN YOU DO?

During a recession, keep your strong borrowers close, your weak ones closer. Communicate often and openly — don't wait until year end to find out how your borrowers are faring — and ask what's keeping them awake at night. More important, how are they taking charge of adverse conditions?

Above all, remember that the market is cyclical and will eventually recover. Lenders who stand by borrowers in both good times and bad build profitable, enduring business relationships. \$



A SHAKE-UP IN THE CREDIT MARKETS

The corporate finance world is in a state of flux: Banks continue to retrench after a disastrous 2008, reining in debt and putting borrowers on shorter leashes. Borrowers also are rethinking their capital structures and lending decisions. For now, conservatism is the name of the game.

EXAMINING THE SUPPLY SIDE

Last year many financial institutions crashed and burned because they'd made poor lending decisions. The credit market was overheated, but now the pendulum has shifted and banks are re-evaluating risk and finding ways to prevent future losses. New policies include:

Higher interest rates. Banks have bumped up interest-rate spreads over their cost of funds. For example, interest rates for firms rated B or lower are at least two percentage points higher than in summer 2007.

Shorter durations. Shorter loan terms mean more frequent renewals. Borrowers must continually prove their creditworthiness and lenders have more opportunities to revise loan agreements or deny credit.



Stricter covenants. Banks are raising the bar for new applicants and renewals. Examples of borrower concessions include personal guarantees, higher collateral requirements, lower debt-to-equity ratios and more arduous independent review (for example, audits, midyear financial statements, and agreed-upon procedures engagements).

More due diligence. Bank executives expect loan officers to conduct more frequent, in-depth due diligence. If not, frontline employees may become scapegoats for poor lending decisions and customer defaults.

More than ever, you need to understand how to analyze financial statements, identify troubled borrowers and seek corrective action. An outside financial expert can help bridge the gap between loan officers' accounting know-how and their bank's expectations.

EYEING THE DEMAND SIDE

As banks retrench, debt seems increasingly less attractive, so many borrowers are adopting a more disciplined approach to leverage. Some are reducing debt loads or building reserves from operating cash flows to fund major purchases. Other borrowers worry that their lenders will freeze their revolving lines of credit and are drawing down revolvers to preserve liquidity. The trade-off is that customers must pay interest on the drawdowns, even if the money is just sitting in a bank account.

Additionally, the tables are turning on lenders: Now *borrowers* are evaluating the creditworthiness of their *lenders*. Skittish customers may choose more financially sound institutions to preserve access to loans and lines of credit and frugal ones may change banks for lower rates or preferential loan terms. Long-term customers should be reminded that they might lose their priority status if they switch, however.

PLAYING TUG-OF-WAR

Customer defections are costly: Your bank loses income, and you must invest time and effort to find replacement business. Until the credit markets reach equilibrium, banks must tend to customer relations. Periodic meetings serve not only to check up on your borrowers' financial performance but also to address their concerns — especially if your bank is the subject of negative publicity. \$

HOW DO YOUR BORROWERS' INVENTORY PRACTICES STACK UP?

Although borrowers often pledge inventory as loan collateral, the amount shown on their balance sheets isn't always accurate. In fact, inventory can be a breeding ground for mistakes because its accounting is complex and the volume of transactions that flow through the inventory ledger is high. If management is lax about inventory, problems can easily spiral out of control.

PANDORA'S BOX

Consider a borrower's aged inventory. It may include obsolete or damaged goods that should be auctioned, donated, destroyed or otherwise removed from the books. Alternatively, some owners treat inventory as a "slush fund" for out-of-balance accounts; when the books don't reconcile, they simply "plug" the difference to inventory (or cost of sales), rather than dig for the source of the discrepancy.

Even worse, a desperate borrower might bury fictitious year end journal entries in the inventory account as a way to mask poor performance. This strategy artificially inflates inventory and profits, enabling under-performers to temporarily stave off unwary lenders and buy time to turn things around.

LEAN AND MEAN

Strong inventory management is a defining characteristic of top retailers, manufacturers, distributors and contractors. Lean inventories free up cash for other business opportunities, such as launching a new product line or purchasing equipment. Plus, the lower a company's inventory, the lower its carrying costs, including storage, security, insurance and loan interest expenses.

The trick is finding the balance between minimizing inventory costs and maintaining customer service. Often, CFOs are at odds with salespeople and plant managers over inventory levels. Inventory management software programs can help borrowers balance these conflicting objectives by tracking inventory trends, forecasting demand and identifying reorder points.

CAREFUL COUNTING

A borrower's inventory management program is only as reliable as its underlying data, however. Although required annually by generally accepted accounting principles (GAAP), physical inventory counts are more than a compliance issue. They verify that the amounts shown in the accounting system match the number of units on-hand.

Companies should begin preparing before the physical inventory date by assigning and training personnel, cleaning up the warehouse, labeling inventory, and precounting slow-moving items. It also helps to minimize inventory on hand by, for example, completing customer shipments, postponing supplier shipments and discounting or disposing of overstocks and obsolete items.



Strong borrowers also implement controls over their inventory. Companies should limit access to inventory and monitor those responsible for reordering. Security measures such as locks, cameras and alarms are essential. Owners should periodically review their inventory ledgers for unusual transactions, such as those with round numbers or ambiguous journal entry descriptions — especially if they appear at the end of the accounting period or are later reversed.

WARNING SIGNS

One of the most significant signs that inventory is out of whack is unusual financial statement trends. For example, lenders might notice that inventory has grown as a percentage of total assets, or gross margins have changed significantly. Such trends may forewarn of problems such as overstocks, write-offs, errors or fraud.

Also tour your borrowers' facilities, letting common sense guide you in answering these questions:

- * Are shelves organized and units clearly labeled?
- * Can workers find inventory items quickly?

- * Are items logically organized (for example, similar items grouped together, heavy items located on low shelves and fast-moving items located near receiving/shipping)?
- * Does the company use a computerized inventory system?
- * Are any inventory items dusty or expired (if perishable)?

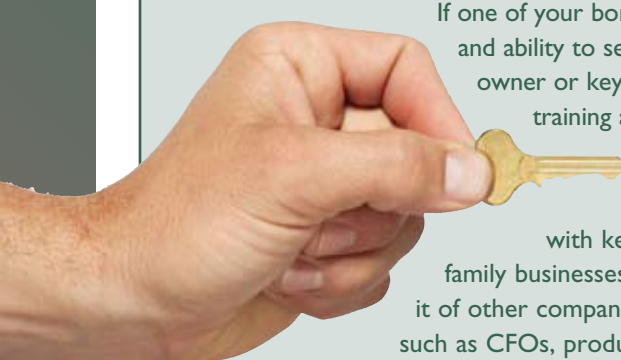
Trust your instincts during site visits. Lenders offer fresh outside perspectives and may point out inefficiencies that company personnel have overlooked for years.

OUTSIDE ASSISTANCE

Inventory accounting is outside the comfort zones of most lenders. But independent financial experts can help when financial statements or plant tours raise red flags about inventory management.

CPAs can help borrowers select and implement inventory management software, review overhead allocation rates, coordinate and audit physical inventory counts, conduct price testing, evaluate or modify internal controls, identify write-offs, and investigate for fraud. Peace of mind is just a phone call away. \$

COVER YOUR ASSETS WITH KEY PERSON INSURANCE



If one of your borrowers suddenly lost a key person, how would it affect their productivity, profits and ability to service debt? For many small businesses, the death or long-term disability of an owner or key employee spells disaster. Some businesses eventually recover after finding and training a replacement, but others are so reliant on key people that they're forced to close shop.

When the unexpected occurs, businesses and lenders can offset their losses with key person life and disability insurance proceeds. Many loan covenants require family businesses and startups to purchase key person insurance, but you may want to require it of other companies as well. Even though most key persons are owners, other employees — such as CFOs, production managers or IT specialists — may warrant coverage.

THE MECHANICS

Typically, borrowers pay non-tax deductible key person insurance premiums. But payouts to beneficiaries — which may include the company or the financial institution, but rarely the key person or that individual's estate — are made tax-free.

The key person must be notified that the company is taking out a policy and be able to prove insurability. Before issuing a key person life policy, most insurers also require companies to implement a formal succession plan, which minimizes their reliance on key people and maps out a contingency plan.

THE PRICE TAG

Monthly insurance premiums are a function of the key person's age, health and medical history, as well as the type of insurance product. Term coverage, which typically expires in 10 to 20 years, generally is less expensive than permanent insurance.

When a company has more than one key individual, a "first-to-die" policy can save money. After one key person dies, the "first-to-die" policy expires. Most insurers will permit the company to purchase a new policy on the surviving key people without proving insurability again.

ADEQUATE COVERAGE

The amount of desired coverage also affects the cost of key person insurance. Financial professionals can help borrowers estimate coverage needs. Factors to consider include the value of the business, the individual's contribution to the bottom line and replacement compensation.

In addition to covering outstanding debt principal, insurance proceeds may need to cover short-term operating cash flow deficits, replacement costs, liquidation costs, and/or shareholder buyouts in accordance with the company's buy-sell agreement, if applicable.

A ROADMAP FOR LENDING TO TRUCKING COMPANIES

Virtually every U.S. consumer good is put on a truck at some point. In fact, more than 80% of communities rely exclusively on commercial trucks for their delivery of goods, according to the American Trucking Association (ATA).

A cornerstone of our economy, the trucking industry provides opportunities to lease and finance equipment purchases. Additionally, some lenders participate in accounts receivable factoring, which typically offers advance rates of between 85% to 90%.

POTENTIAL ROADBLOCKS AROUND

Like the sectors that it relies on, trucking has been slammed by the recession. Last summer, for the first time ever, fuel outpaced labor as the top operating cost for truckers. Some carriers passed along fuel surcharges to their customers, while others tackled mounting diesel costs by lowering consumption by, for example, installing auxiliary power units, which power parked trucks more efficiently than idling engines.



Trucking companies also face a shortage of qualified drivers. ATA predicts that the shortage of long-haul drivers will reach 111,000 over the next five years. Many drivers over 55 will soon retire, and quality of life issues — such as extended periods away from home and unpredictable schedules — are dissuading younger workers from a truck-driving career.

INVESTING IN TECHNOLOGY

To attract and retain drivers, many companies are raising hourly rates and installing onboard computers, which enable drivers to communicate with friends and family while on the road.

Technology also offers trucking companies a competitive advantage. For example, global positioning systems (GPS) enable a trucking company to monitor its fleet and dispatch shipments more efficiently. In turn, customers — especially just-in-time manufacturers — can track the real-time status of their orders.

A BLESSING AND A CURSE

State and federal agencies regulate trucking to improve highway safety and lower carbon emissions. But regulations take a toll on trucking profits. Since its inception in 1999, the Federal Motor Carrier Safety Administration (FMCSA) has mandated more frequent, stringent driver inspections and carrier compliance reviews; more arduous CDL testing; and increased sanctions for violations.

FMCSA hours-of-service amendments reduce driver productivity by limiting on-duty time and lengthening breaks. More stringent hazardous material (Hazmat) licensing requirements, which include fingerprinting and background checks, deter some drivers from renewing their certification, adding to the labor crisis. And the 2010 EPA-mandated clean diesel technology is expected to hike new truck costs and lower fuel efficiency.

A Department of Transportation (DOT) Web site at <http://ai.volpe.dot.gov> tracks records of existing or prospective trucking borrowers. Lenders can review this site for useful information, including accident reports, insurance coverage and limits, number of trucks and drivers, previous DOT violations and penalties, and DOT safety inspection results.

DO YOUR TRUCKERS MEASURE UP?

Today every trucking company faces obstacles. It's how they respond to these challenges that separates the strong from the weak. Lenders who understand what differentiates trucking firms stand to profit over the long haul. \$