

COMMERCIAL LENDING REPORT



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In the nick of time

Spotting distressed borrowers

Closing is just the beginning

*The real work starts
after the merger or acquisition*

Why pay attention to internal controls?

Making staffing firms work



IN THE NICK OF TIME

Spotting distressed borrowers

The list goes on and on: auto dealers, home-builders, manufacturers, restaurants, retailers and salons. The recession has impacted virtually every type of business. But how can you differentiate a temporary lag from irreparable mismanagement? Which borrowers are salvageable, and which should you pull the plug on?

NUMBERS DON'T LIE

Financial statements are a logical starting point. All lenders know the financial signals that a borrower is facing financial challenges. Problems with working capital, operating cash flow, credit lines and collateral values are all telltale signs. These problems can be severe — or not.

For example, a working capital problem could involve a single large bill that's 60 days outstanding due to an invoicing mistake (and probably collectible) or several invoices that are over 120 days (and probably uncollectible). The first scenario seems like something a customer likely could overcome, although it might cause the company to temporarily max out its line of credit. The second looks like an emergency situation that, if severe enough, could foretell a bankruptcy.

But what differentiates distressed borrowers is the severity of these signs. Minor problems materialize

as, say, a few late bills, occasional cash overdrawals or subtle changes in gross margin. Irreparable damages show up as payables over 90 days old, vendor demands for cash on delivery, unpaid payroll and recurring net losses. To avoid year end financial statement surprises, consider asking borrowers to submit monthly or quarterly reports. Strong borrowers likely will comply, but weaker ones may have something to hide and resist your request.

Other wake-up calls are borrowers that miss loan payments, fail to return phone calls or submit financial statements late. A qualified audit opinion — when the auditor disagrees with the treatment or disclosure of information in the financial statements — also is cause for alarm.

A sure sign of impending bankruptcy is insolvency — when a company's debts exceed its assets. Insolvent companies can't pay their debt when it comes due. Creditors eventually may force insolvent companies into Chapter 7 bankruptcy to receive some kind of payment on outstanding obligations.

COMMONSENSE RULES

Because most borrowers prepare only annual financial statements, the numbers often say too little, too late. Keep your eyes and ears open for



BE WARY OF LOOSE LOANS

Lenders can't rely on loan covenants — which might be too lenient — to catch problems. Some banks lured in customers with “covenant-lite” loans earlier this decade. Without loan covenants — such as minimum cash reserves or maximum debt-to-equity requirements — to foretell default, lenders seldom find out about financial distress until it's too late to remedy the situation. Lenient lending terms add insult to injury.

And without lenders to act as gatekeepers, inept or stubborn owners may continue to manage the business into the grave. So, it's more important than ever for lenders to keep a finger on the pulse of their borrowers.

the non-numeric indicators of distress. For example, when you visit a retailer, do its stores appear understocked or understaffed? Are leasehold improvements and signage up-to-date? Does the company advertise liquidation sales or steep discounts?

Other likely signs of impending bankruptcy include heavy layoffs and high turnover among employees, especially key managers and directors. These insiders often see the writing on the wall, and then make tracks for greener pastures. Major events — such as technological innovations by your customers' competitors, uninsured losses or the bankruptcy of a major customer — also can have devastating effects on future operations.

WHAT'S ON THE INSIDE COUNTS

Recession is an external factor that interrupts business operations. But irreparable financial distress often is rooted in internal problems. For example, management can be a leading indicator of financial success — or distress. Watch out for gridlock among owners, lack of management depth, frivolous spending habits and personal problems, such as contentious divorces or gambling addictions.

A business might spiral out of control if, for example, a retiring owner prematurely hands off business operations to inexperienced second-generation managers. Or an egotistical entrepreneur might be unwilling to admit defeat or to relinquish control to a team of turnaround specialists.

The key to recovery is conceding that there *is* a problem. Distressed business owners must ditch denial and implement stopgap measures, such as selling off underutilized equipment, liquidating inventory, asking employees to forgo raises and bonuses, renegotiating debt terms and converting fixed costs to variable.

MANAGEMENT STRENGTH: CRITICAL

An established track record is the best indicator of management strength. Investigate how a company performed during the 1992 and 2001 recessions. Then consider how market conditions have changed since the previous downturns. Of course, startups and new management teams require additional oversight to ensure continued viability.

Strong managers focus on core operations; veering off course, especially during a recession, can prove disastrous. Management also should know how to anticipate cash flow needs and to build a cash safety net in case of unforeseen events, such as a strike, a cost increase or a large warranty claim. Strong accounting systems identify which customers and products are most profitable — and which low-margin ones are disposable.

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WHAT YOU CAN DO

No business has escaped the effects of this recession. But once it ends, on which side of the fence will your borrowers stand? Lenders who support borrowers through tough times build enduring customer relationships. But those who stay aboard too long are bound to go down with a sinking ship.

Evaluate the staying power of borrowers by looking at their supply chains. The more dependent suppliers and customers are on a particular borrower, the better positioned the company is for an eventual upturn. These are the borrowers you should stand behind.

For borrowers that play a less critical role in their supplier chains, watch for warning signs of irreparable financial damage. Salvage what you

can, and then consider taking more drastic actions, such as performing extra due diligence, seeking additional collateral or personal guarantees, charging higher interest rates and fees and calling the loan, if necessary. An outside financial expert can help lenders evaluate which borrowers are salvageable and which have reached the point of no return. \$

CLOSING IS JUST THE BEGINNING

The real work starts after the merger or acquisition

No matter how much you kick the tires, the only way to tell how well a used car performs is to drive it for a while. It's much the same with business mergers and acquisitions: Regardless of how many spreadsheets your borrower runs or due diligence procedures performed before the deal closes, you won't know if it will be successful until integration is completed.

So the real work begins after the closing. It's then that the new management team demonstrates its competence and ability to identify and remedy unforeseen problems. Here are some important issues to consider after your borrowers merge with, or acquire, another company.

KEEPING CUSTOMERS

Change makes customers wary. How a business communicates a merger or acquisition to customers can affect future revenues and profits. Large, profitable customers deserve to hear the news firsthand — either in person or on the phone. Merged companies should emphasize continuity and focus on what customers are gaining from the combination, such as improved service, more efficient distribution or better quality.

Concerns from your borrowers' customers about changes in staff, service level, price and location can be alleviated. If management expects to change any of these variables, the best bet is to win over

customers; then, once they've established loyalty to the new entity, slowly implement change. Otherwise, patrons will turn to competitors or substitute products.

Often acquisitions include employment agreements or consulting contracts for the exiting owner. These arrangements facilitate a smooth transition, because the seller can introduce the buyer to customers and advise the new management team about operating nuances. An ongoing financial stake in the business — such as an earn-out or installment payments — also can motivate the seller to help retain customers.

RETAINING EMPLOYEES

Employees also fear change. Their concerns include job security, relocation and compensation cutbacks, for example. If uncertainty and fear cause employees to jump ship, the buyer could lose



one of the business's most valued assets — its established workforce.

Even when unemployment rates are high, finding the right workers and training them takes time and money. Turnover also may cause customers to defect, especially in service industries where clients develop personal relationships with service providers.

Employees, like customers, need reassurance. Early, personal communication with senior managers and top performers can help bolster acquisition success. Companies might consider safeguarding future earnings by asking key employees to sign (or re-sign) employment contracts and noncompete agreements.

Companies also can ease employee stress by implementing changes slowly and providing cash adjustments to those who will see a reduction in benefits after the combination. It also helps to focus on the positive — such as postdeal career opportunities — and orient acquired personnel into the buyer's corporate culture as if they're new employees. For example, the acquirer can distribute updated policies and procedures manuals, provide training sessions, and hold a social event as an icebreaker for new and old employees alike.



USING A DEMERGER CLAUSE

Gauging postdeal success requires regular comparisons between forecasted and actual results. Weekly or monthly performance reviews enable management — and lenders — to cut their losses early. Common reasons deals fail include systems incompatibility, rapid change, underestimated cultural clash, and overestimated synergies and economies of scale.

Sometimes a financial professional is called in to take corrective action, similar to an informal workout or restructuring. Other deals are simply lemons. Demerger clauses provide a means of unraveling an unprofitable venture within a prescribed time frame (usually one or two years).

POSTDEAL DILIGENCE

Savvy lenders watch their borrowers closely after a major business transaction, because more than half of deals fail to boost shareholder value. Your diligence is increasingly important today. Although bargains abound in a buyer's market, businesses also face more risks and challenges in uncertain economic times. \$

WHY PAY ATTENTION TO INTERNAL CONTROLS?

Some risky customer characteristics, such as inadequate internal controls, are not easily detected: You're not going to see it mentioned in a financial footnote or hear it volunteered during a loan application interview.

Yet internal controls are an essential cornerstone of asset protection and it behooves you to ask customers for details of their internal control systems —

or make sure you get this information through a professional outside assessment.

IS ACCESS TO ASSETS RESTRICTED?

To evaluate the strength of borrowers' internal controls, you (or an external auditor) could start with examining their restrictions on access. Their employees should have access only to those assets necessary to perform their jobs.



To help define who has access to what, a company needs to put job descriptions in writing. In addition to outlining the scope of employees' responsibilities, job descriptions should address the separation and duplication of sensitive duties. If job descriptions aren't available, the company might have a summary checklist of internal controls that they review periodically.

ARE ACCOUNTS ANALYZED?

One sign of good internal controls is regular reconciliation and analysis of key accounts. Companies should never wait until year end to confirm account balances. Depending on the business, monthly or quarterly bank reconciliations may be appropriate. Companies also need to analyze account balances — using variance analysis, common-sizing and breakdowns of sales by territory or product line — to identify unusual trends that warrant further attention.

Regular audits can help catch problems early. They might be performed by an internal audit committee consisting of senior managers — though in many cases management is too busy with other responsibilities to perform this function. For this reason, external audits by accounting professionals are recommended. Keep in mind that external audits can unearth material irregularities and deter corruption, but they won't necessarily detect

immaterial defalcations. In fact, no type of audit provides an absolute guarantee against dishonest employee behavior.

ARE CONTROLS PRIORITIZED?

For internal controls to be effective, companies need to publicize them. A company might offer training classes or publish articles in the employee newsletter to let everyone know that internal controls are a priority and that serious consequences await perpetrators. In addition, companies should communicate fraud reporting mechanisms, such as anonymous hotlines, and explain warning signs, such as unusual journal entries, management override of internal controls and employees living beyond their means.

Companies also should recognize that the process of implementing strong internal control systems is ongoing. Even after putting a policy in place and communicating it to employees, management must continually monitor controls to ensure they remain adequate and effective.

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GETTING INFORMATION YOU NEED

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First, if your borrower is getting an audit, the independent auditor must submit a management letter to the client informing them of notable weaknesses in the internal control system — and you should ask for a copy of it. (If the infractions are minor, the auditor may elect to render a verbal report to the client.)

Second, if there is no audit, your only recourse is to send in accountants to perform a field audit on the internal controls. Either way should sufficiently fill you in on this important customer characteristic. \$

MAKING STAFFING FIRMS WORK

Staffing is a cyclical industry that fluctuates with the economy; revenue dwindles during downturns. For example, staffing revenue plunged in the fourth quarter of 2008 — down 19.5% from the fourth quarter of 2007, the largest year-to-year quarterly decline on record, according to the American Staffing Association (ASA).

But as the economy gradually regains momentum, the ASA expects a surge in the demand for temporary and permanent staffing services. The Bureau of Labor Statistics (BLS) concurs: The employment services industry — which includes temporary agencies, employment firms and recruiters — is expected to be a hot growth sector through 2016, second only to management, scientific and technical consulting services.

A NEW PARADIGM

Some staffing firms may need to rethink the way they do business, however. In addition to temporary and contract staffing, firms can increase profits by offering value-added services, such as training and human resource consulting.

The type of work being outsourced also is changing. Companies are turning to staffing firms less for industrial and clerical help and more for high-skill positions, such as accountants, engineers, IT specialists and even CEOs. The BLS expects most industry growth to come from the service sector, especially professional and business services.

Another way for staffing firms to boost profits is to focus on a market niche — health care or information technology, for example — that has advanced training requirements and a limited supply of qualified professionals.

FLEXIBLE ALTERNATIVES

“Temp-to-hire” arrangements are another emerging trend. Human resources personnel can cherry-pick their favorite candidates from a staffing firm’s pool of prescreened labor. Before committing to a full-time offer, the employer can field-test whether a candidate is the right fit in terms of talent and personality.

Not all employees working with staffing firms want a permanent position, however. Some temporary workers are drawn to the flexibility of working for a staffing firm, even when they work 35 hours or more each week. Examples include baby boomers easing into retirement, single parents and stay-at-home moms. These full-time temporary workers typically choose staffing firms that offer training, retirement and health care benefits.



“GOLDEN” RECEIVABLES

Another advantage with staffing firms is the quality of their accounts receivable. Having their receivables as collateral is excellent because they are supported by a time card signed off by their customer. Thus, the customer can’t refute the receivable being genuine. This is especially important to asset-based lenders that rely on the collateral more than the cash flows.

A SHINY FUTURE

Like many sectors, employment services has been limping along. But those firms that survive this recession will be poised to bounce back with the economy. To make the most of the next upswing, your employment-firm borrowers should revise their business models to keep up with the latest staffing industry trends. \$