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Stay in banker's good graces by coming clean when money's tight

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While the experts argue about whether we are in a recession, or whether the Houston area is immune to it, those of us in business need to prepare for the challenges of an economic downturn and what to do about it. An important aspect of that analysis is what to do about your loan.

BANK LOANS

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Sometimes during the life of a loan, the borrower's performance may be impaired or, just as importantly, may be viewed by the lender as impaired. Warning signs of a distressed loan include weakened cash flow, decreasing accounts receivable, rising costs, and build-up of inventory. In a revolving credit loan, where the amount of the loan varies as a function of the borrower's collateral, poor economic performance translates into a loan covenant default because the borrower is not in compliance with its borrowing base.

How can a default arise in a revolving line of credit, where the amount of money advanced only increases when the borrower's assets increase? The default often occurs because the loan anticipates cash flow. The borrower only sought a loan because its accounts receivable do not pay quickly enough to supply a reliable source of regular working capital. Its monthly cash needs were not being met by the payment of its accounts receivable.

When market conditions worsen, the business's deficiencies can outstrip the accumulation of assets that supports new loans. Assume that on January 1, the borrower's accounts receivable are $100,000, and the lender, using an advance ratio of 75%, lends $75,000. The borrower uses the $75,000 to pay employees, taxes, rent, utilities and purchase inventory. But adverse market conditions cause business to fall off, and on April 1 accounts receivable are only $80,000. During the intervening 90 days, unless the company's management was farsighted (and assuming it already adjusted for annual seasonal changes in business), it purchased the same amount of inventory and kept the same number of employees. Moreover, the borrower's non-payroll fixed costs – taxes, rent and utilities – have stayed the same. So, on April 1, the borrowing calculation is 75% of $80,000, or $60,000, but the borrower still requires $75,000 to operate.

The typical pressures of business loom larger in a downturn. The borrower, which needed daily working capital when it obtained the loan, is now strapped and using cash quickly. Management was already under stress from the many issues facing it when it took out the loan, and now confronts all those problems plus two more – a troubled business and a lender that wants to get paid sooner than expected. Time, which was short during any business day, is even more precious now, as the company's management spends more time analyzing its business problems, dealing with employees (one of the most difficult and worrisome activities in a workout), putting off creditors, and meeting with the lender. Certain strategies work well in such situations.

- **Be realistic.** Borrowers sometimes suffer from terminal euphoria, believing that current market conditions will change, the business climate will improve, a new investor can readily be found, or the company can be sold quickly. Jump these hurdles quickly. Be prepared for difficult times.

- **Avoid surprising the lender.** If there is going to be bad news, the borrower gets a jump ahead by being frank with the lender about adverse business results. This course builds credibility and trust, and creates an impression that management knows its business.

- **Plan ahead.** The lender probably receives disappointing news about business performance much better if it is accompanied by a plan identifying the problems and outlining solutions. Even an outline of issues may be helpful. If management is not certain what action to take, the lender may have ideas or suggest outside experts who can offer experience and expertise. Accurate, current financial information is vital.

- **Understand the options.** If the business cannot resolve its problems with changes to its business plan, assume that the lender will act to resolve them. The company's options include, in descending order of desirability: move to another lender, wind down sufficiently to regain profitability, wind down to generate enough cash to pay off the loan, liquidate, or have the lender liquidate.

- **Get the loan in line.** Often, asset-based lenders maintain the right to reduce advance ratios and strengthen eligibility requirements for collateral. If the business continues to require more money than its borrowing base justifies, the lender may use these tools to ratchet down the loan until the business's performance is again in line with the amount advanced on the loan.

- **Maintain the initiative.** Lenders know that everyone benefits when the borrower runs its business, even in a workout or liquidation. The company's management knows the business better than the lender, and is in a much better position to understand issues, see problems and implement necessary changes. Lenders will try to take a role of approval, rather than proposal, during the workout.

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