

Macroeconomic Principles and Workout Decisions

By Stan Scott

What Econ 101 can tell you about underwriting decisions.

A year into a deepening recession, nervous asset-based lenders find themselves in uncharted waters. The credit freeze accompanied by the silent run on the financial system has pushed banks, finance companies and hedge funds to reduce asset-based commercial credit exposure to repair balance sheets or meet redemption requests.

Turnaround consultants and attorneys are working overtime and will likely remain busy for years to come. The acquisition-binge stage of the credit cycle is over, replaced by workouts and reorganizations.

These circumstances naturally create opportunities for asset-based lenders to rescue creditworthy borrowers recently ushered to the door by their existing lenders.

Lemons to Lemonade

Middle-market and small business asset-based lenders interested in turning lemons into lemonade should focus new loan origination efforts as follows:

- Assess demand/supply dynamics and develop a meaningful competitive profile of the prospective borrower.
- Focus on defensive industries, that is, those with inelastic (steep) product or service demand curves, such as nondurable consumer necessities.
- Consider the prospective borrower's life-cycle stage. For example, infancy and growth-stage companies often require hard-to-find capital to achieve critical mass and economies of scale.
- Seek customer and critical vendor diversification. Unhealthy dependencies during a credit crisis can bring down an otherwise healthy company.
- Avoid cyclical, capital-intensive manufacturers except those with superior market positions able

to increase market share at the expense of failing smaller competitors.

- Seek borrowers with sufficient liquidity at their disposal to survive an extended downturn.
- For a downsizing borrower, require that operating metrics reflect adequate elasticity or capacity to shrink the break-even point to the necessary level.
- Look for a comfortable collateral cushion supported by meaningful credit enhancements in the form of extra, or boot, collateral and strong personal guaranties.
- Insist that attempted debt restructurings or refinancings cure past-due accounts payable and taxes while reducing debt service (on a longer amortization) to a level that can be met timely on a recast, *pro forma*, most-likely-scenario basis.
- Impose relatively stringent and meaningful financial covenants (including debt service coverage and solvency), which serve to keep the borrower on a short leash that requires adequate progress as measured by frequent monitoring.
- Reject turnaround plans that hinge solely or predominately on top-line growth or, for a manufacturer, improved productivity.
- Closely scrutinize turnaround plans calling for a drastic change in the company's business model.

Industry Factors

It is not uncommon for lenders to take for granted macroeconomic and industry considerations during an economic boom period and, consequently, to fail to analyze the specifics of a prospective borrower's

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business. During a recession, however, lenders can't afford to neglect or gloss over characteristics such as the following:

- What does the borrower do?
- Where does the product or service fall on the spectrum of consumer or commercial needs to wants?
- Where does the borrower fit into the economy as well as into its respective industry?

Consumer spending represents two-thirds of domestic economic activity, and priority is generally a function of the consumer's individual needs/wants hierarchy in relation to income and wealth, which are typically budgeted first to basic needs with discretionary income allocated to "wants." Necessities include food, water, clothing, medicine, housing and transportation. Wants include luxury and leisure items such as boats and sunny vacations.

In evaluating a prospective borrower, lenders should consider the following demand- and supply-side factors.

Demand-Side Factors

- **Nature of product/service: necessity, discretionary or luxury.** A focus on defensive industries—for example, consumer necessities for which demand is fairly inelastic—is a common strategy in a recession. Irrespective of price movements, the demand for lifesaving prescription medications, for example, remains stable in a recession. Prices for prescription medications remain high despite deflationary pressure due to suppliers' patent-protected monopoly status.
- **Percentage of buyer's budget.** The greater the percentage of budget (all else equal), the more elastic the demand curve, meaning a price increase results in a disproportionately high drop in demand.
- **Durable or nondurable.** Durable products such as automobiles generally bear higher demand elasticity.
- **Product price point.** The higher the price, all else equal, the greater the demand elasticity.
- **Number of substitutes available.** A low number of available substitute products implies an inelastic demand curve, while a high number implies the opposite.
- **Current state of the economy.** When the economy is in the expansion mode of the business cycle, gross

domestic product (GDP) is rising, unemployment is declining, and corporate earnings and labor wages are up.

- **Future expectations of economy.** Human emotions such as fear or greed are contagious and may lead to irrational behavior, at times resulting in market bubbles and subsequent crashes.

Supply-Side Factors

- **Cyclical or noncyclical.** Industry consolidation is a common occurrence during a severe recession, particularly given the collapse in the housing market—one of the country's most significant assets. Consequently, logic dictates the avoidance of cyclical, capital-intensive manufacturers except those with superior market positions able to increase market share at the expense of failing smaller competitors.
- **Industry life-cycle stage: infancy, growth, mature, decline.** It is important to pay close attention to the prospective borrower's life-cycle stage. Infancy- and growth-stage companies often require hard-to-find capital to achieve critical mass and economies of scale. Many are overleveraged, while experiencing inadequate cash flow to cover excessive debt service requirements.
- **Supply chain identity: manufacturer, wholesaler, retailer.** Manufacturers tend to experience the greatest earnings decline during a recession due to a capital-intensive cost structure. Fixed costs must be spread over shrinking sales volume.
- **Industry competitive profile: monopoly** (market controlled by a single supplier such as a utility); **oligopoly** (market controlled by three or four dominant suppliers such as the auto industry); **monopolistic** (a high number of competitors with similar but distinguishable products); **perfect** (includes agricultural products where there is little difference among products).
- **Value chain: capital intensive, labor intensive, working capital intensive.** Capital-intensive industries tend to suffer greater earnings reversals during recessions due to inherent high operating leverage. Lenders should be wary of working-capital-intensive industries with long trade cycles, for example, residential and commercial building. These require significant investment in accounts receivable and inventory and extended credit terms both from vendors

and customers alike. As the recession intensifies and unemployment rises, labor-intensive businesses may benefit from a labor supply/demand imbalance placing downward pressure on wages and broadening the supply of available workers. Meanwhile, labor-intensive businesses with a concentration in low-skilled workers under pressure to downsize possess a built-in lever to pull due to an inherently elastic cost structure.

- **Cost structure: fixed-/variable-cost mix.** Cost-structure variables such as plant and equipment and labor are variable in the long term; thus, capacity is variable in the long term but fixed in the short term.
- **High-tech or low-tech.** Advances in technology lead to long-term supply growth.

Borrower Factors

Both customer and critical vendor diversification is key, particularly during a recession and credit crisis. Unhealthy or heavy dependencies during a credit crisis can bring down an otherwise healthy company in the event of the failure of a major customer or supplier.

Credit is essentially the gasoline that runs the global economy and all are adversely affected during a credit crisis, including household name, blue-chip companies. Consequently, it is important to verify critical customer, vendor and creditor relations—don't just assume relationship continuity.

Since interim financial statements are not a reflection of real-time operating results or financial condition (but rather lagging in nature), recent adverse events may not be evident or readily disclosed. The loss of a key customer, credit insurance coverage, critical vendor support, lender credit tightening and rising credit costs in some combination in the current environment is a very plausible scenario, which could quickly lead to the demise of an otherwise healthy borrower.

Lenders should consider borrowers with sufficient liquidity at their disposal to survive an extended

downturn. As noted above, this means adequate credit availability from both lenders and critical vendors.

Lenders should hold borrowers to their projections and impose relatively stringent cash flow coverage, leverage and solvency financial covenants, which serve to keep the borrower on a short leash requiring adequate progress, and should also be monitored frequently. Accounts receivable collectibility becomes more suspect due to economic stress and credit constriction, while inventory and machinery and equipment valuations may become questionable since forced or orderly liquidation appraisals may not be based on recent actual liquidation comparisons due to the absence of such information or unique attributes of the underlying asset and, consequently, may be derived on a discounted basis from fair-market comparisons and subjective assumptions. Chances are even relatively recent forced liquidation value or orderly liquidation values may be too generous during a severe recession due to recent dramatic and/or unknown changes in supply/demand dynamics. Exit strategy limitations during a severe recession necessitate a hard look at collateral liquidation viability and sufficiency.

Return to Credit Fundamentals

Lenders should closely scrutinize turnaround plans calling for a drastic departure or change in the company's business model. Weak borrowers attempting to penetrate a new market, shift market focus or introduce new products likely face a low probability of success during a credit-strained recession.

A downsizing borrower's inherent operating cost and gross margin metrics should reflect adequate elasticity or capacity to shrink the break-even point to the necessary level. Also, attempted debt restructure/refinance exercises must cure past-due accounts payable (and federal taxes) in order to repair strained vendor relations while reducing debt service (on a longer amortization for example) to a level that can be met timely on a recast, pro forma, most-likely-case-scenario basis.

Condominium Construction

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subsequent claims of meddling or bad faith or gives the impression that the lender exercised control over

the borrower or the project. Moreover, if negotiations suddenly end without warning after good-faith discussions and lenders, without notice, commence the lien foreclosure, the borrower could claim that lenders did not act in good faith. In a lender-liability claim, the