Beane Associates, Inc.

Beane Associates News July 2010

A bimonthly collection of news and advice for stakeholders of financially and operationally challenged businesses

Welcome…

Sometimes the professional writers say it a little better than I can.

Writing in the Wall Street Journal on June 21, reporter Emily Maltby asks "Where's the money?" Her article discusses the reasons behind the lingering credit crunch for small business, why borrowers can't latch on to the money that the bankers insist is available to lend.

Maltby's piece is worth reading, if it's still posted online. Here's a brief excerpt from her introduction.

Yet entrepreneurs are still struggling to land credit. Only half of small businesses that tried to borrow last year got all or most of what they needed, according to a survey by the National Federation of Independent Business. In the mid-2000s, 90% of businesses said they got the loans they needed.

What's going on here? Why is the credit crunch alive and well when it comes to small businesses?

Part of the problem is that most of the government programs created to address the problem have focused on Small Business Administration loans, which total less than 10% of overall lending to small companies. But there's a wider issue at work. Banks and the government are trying to avoid repeating the mistakes that led to the subprime meltdown. It's a perfectly understandable goal — but it's freezing up financing.

In this edition of our newsletter, we examine the issue Maltby discusses from a more practical angle. Chris Todd, one of our associates, offers suggestions to businesses on how to cope with the tightened lending environment.

Also, in a Q&A format, associate Jim Logue discusses what may become the new normal for many businesses — going into the secondary markets to secure financing.

As always, we hope you find these articles helpful, and we encourage you to forward them to others who are facing financing decisions.

For additional information on us, visit
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Sincerely,
Tom Beane, President CMC CIRA

Securing Credit in a Tight Market By Christopher Todd

Even as fresh signs of an economic rebound continue to appear, owners of struggling businesses (and "struggling" is an adjective that can apply to almost every business these days) fear that tightened access to credit will leave them poorly positioned to profit in the recovery.

As business continues to pick up, companies need more resources. Sales increase, so they need to purchase more materials, and payroll costs will go up as they fill those orders. But borrowers who have maxed out their lines of credit can't just call their banker, say "business is finally picking up, so I'd like to increase that credit line," and expect a routine approval.

With federal regulators giving increasing scrutiny to banks that have underperforming loan portfolios, lending officers at all banks are not only defending their existing portfolios but also looking more carefully at requests from prospective borrowers, even those whose accounts they've served for years.

While businesses may feel that the rules of the lending game have changed, bankers are more likely to say the rules are the same but they're being enforced more strictly. No matter what the opinion, the reality is the same: when it comes to financing, businesses can't take anything for granted anymore.

Loans are still available, but borrowers must work harder to receive them.

Banks are willing to loan to sound, secure borrowers who have sterling credit ratings and leave little doubt that they're capable of repaying their loans. Thanks to the broad economic downturn, however, the number of businesses who fit that description is significantly smaller than it was two or three years ago.

"Part of this is a natural cycle," says Jayne Armstrong, Delaware district director of the U.S. Small Business Administration. "Banks may have cut credit lines. Sales are down. If you don't have the sales to justify a loan, you're not going to qualify. That's the harsh reality."

How, then, does a borrower strengthen his chances of securing additional credit?

It starts with **additional documentation**. Be prepared to show your bank three years of financial records — tax returns, audits, financial statements. Prepare business

plan projections and aging statements on accounts receivable and payable. Depending on the size of your business, the bank may want to see personal financial statements as well as the documentation for your company.

As always, **"cash is king,"** so make sure you can demonstrate you have the resources and cash flow to pay back what you borrow.

Collateral is also important. It's not that the bank will be eager to foreclose on your vacant lot or a warehouse if you stop making payments, but putting up hard assets as collateral will give the bank a greater sense of security.

If your current line of credit is asset-based, take a close look at your inventory. Say you've got a large inventory of lumber, whose value has been increasing in the last few months. If your inventory turns out to be worth significantly more than what you paid for it, let your bank know. That may provide some of the justification needed to increase your credit line.

Your bank will also want to know what you've been doing to **tighten your belt**. Make sure the bank knows what you've done to reduce overtime, to renegotiate terms on health insurance and other benefit contracts, and to cut expenses in non-core areas of operations.

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Securing Credit… *(continued from front page)*

Take a look at how you're working with your unsecured creditors, a topic discussed in more detail in our December 2009 newsletter. You have more leverage than you might think. It's to your advantage to defer or restructure payments, so explore the possibility.

Even after you've taken these steps, it's possible that the bank won't increase your credit line, or it will set a higher interest rate. In today's environment, that means it's time to **shop around**. The fact that you've been dealing with the same bank for many years doesn't matter now as much as it once did. While it's possible the bank doesn't consider you as low a risk as it did two or three years ago, it's also possible the bank has issues of its own; for example, its loan portfolio might now have more exposure than it desires in your industry.

The bottom line is this: Be realistic about your expectations for credit. The credit market is nothing like it was three years ago and there's no reason to think those days are coming back.

Helpful Hints

Here are some suggestions on how to better position your business when looking to have a request for financing approved.

- **Put together a complete package:** Have a business reason for financing; have three years of financial records — tax returns, audits, financial statements. Prepare business plan projections and aging statements on accounts receivable and payable.
- **Have reasonable expectations:** Allow appropriate time for the request to be considered, underwritten and approved; be prepared for requests for additional information
- **"Cash is king":** Ability to repay will weigh more heavily than collateral in the decision process.
- **Demonstrate that you're a good manager:** Show the steps you've taken to reduce or control costs, for example, reducing overtime, renegotiating insurance contracts, and/or limiting discretionary expenses.
- **Keep lines of communication open:** Communicate regularly with your banker; let him know how your business is doing; bankers don't like surprises.

Q&A with Jim Logue

The value of commercial real estate portfolios has dropped by 35 to 50 percent. Do you consider this the major cause of the credit crunch?

Yes, it's had an impact in several ways. Two or three years ago, advance rates were 75 to 80 percent of value. Now lenders are not looking to advance that much. In addition, real estate values are coming down, and there aren't many sales. As a result, bankers and real estate lenders can't trust the appraisals on properties being sold. Until there's a stronger market for buildings being sold or refinanced, that's going to hold things back. Finally, a lot of lenders are requiring that loans they made three or four years ago be reappraised because they feel their collateral values aren't there now.

There's been a lot of talk lately about "new credit criteria." Are the criteria new or is it just that banks are enforcing their rules more strictly?

We all talk about the three Cs of commercial lending — character, credit and capacity —and they're as important as ever. You have to have collateral, the borrower has to have good credit, be upstanding, and you have to have the cash flow. A few years ago, a lot of risky loans were being made. When things were good, they were able to do it.

Now, nobody wants to take the risk of a loan that has a story behind it — if a business is in recovery, or not meeting underwriting guidelines from the bank.

If there's a story behind a loan, the business will have to look for financing from secondary lenders.

What are the consequences when businesses must go into secondary markets to secure financing?

You're paying for it — lower advance levels, higher interest rates, more fees, but they're not going to be looking at your story. They're going to be saying, do you have the cash flow now? They're not worried that you took a big write-off in a previous period that wiped out your equity, or that your balance sheet didn't look great last year, as long as you've got the cash flow and your current business is viable.

So, businesses will pay more, but the lending criteria won't be as strict as when borrowing from commercial banks.

Correct. The loan-to-value ratio will be down, perhaps to as low as 65 percent of value, but they're not going to be homing in on your balance sheets. Remember, one of the key covenants for a commercial lender is debt-to-equity ratio. If you had business losses that wiped out your equity, then you're not a viable candidate for commercial bank.

Are you saying that lenders in the secondary markets are more willing to take a chance on a business?

I wouldn't call it taking a chance. They just have different underwriting standards. With a bank, you get the longest amortization with the best interest rates, because they're taking less risk — if you meet their standards. Secondary lenders are not looking at balance sheets; they're looking at asset values and cash flow.

Is it good then for a business to borrow in the secondary market, or should they look at this as a last resort?

Companies need working capital; it has to be part of the business model. They have to buy their materials and pay their employees. Until the business is on firm ground, the secondary market provides access to capital and should be considered a serious alternative by management.

In your crystal ball, how long do you see this lasting?

We're seeing some improvement already. The Small Business Administration has relaxed a little bit. For small loans, up to $2 million, the SBA is an excellent way to get a financing done.

Some sectors, those with strong receivables, will come back first. Residential housing, development, shopping malls, speculative real estate will be the last — and I don't think they'll come back for a number of years.

But bankers are realizing they've got to start making loans to make money again, so the smart loans will get done.

About Beane Associates, Inc.

Beane Associates, Inc.

Founded in 1984, Beane Associates, Inc. continues to build an impressive track record in helping private and publicly owned companies improve operational effectiveness and profitability during a time of financial challenge. The company has offices in Wilmington, DE, and Atlanta, GA.

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