FINANCIAL LENDING NOTES

A NEWSLETTER FOR COMMERCIAL LENDERS SPRING 2008

FUNDING GROWTH

When To Say Enough Is Enough

Growth is a primary goal for most business owners, because many tend to measure success by the top line. But business growth brings with it a whole new set of challenges.

The fact is that nothing challenges a small business more than growth. While it may lead to many new opportunities, it can also present dangers. It's not uncommon for small companies that have not prepared properly to grow themselves right out of business.

Given the tendency of many owners to overemphasize sales growth, even at the expense of profits, you (as their banker) play a key role in helping them know when enough growth is enough. The decision to slow growth is one of the toughest a small business owner might have to make, since many believe bigger is always better. You can provide the outside, objective voice of reason to encourage owners to slow down if unchecked growth is leading them down a dangerous path.

FINANCIAL CHALLENGES OF GROWTH

Growth requires a significant incremental investment in receivables and inventory to support the higher level of sales that comes with it. Generally, this cash can come from one of only two sources: owner's equity (capital, retained earnings, personal funds) or outside financing.

When owners turn to you for financing to support growth, there are several important steps you should take. The first is to distinguish between a temporary investment in current assets and a permanent one.

A common mistake made by bankers is to establish a line of credit with the expectation that the borrower will liquidate inventory and receivables in order to pay down the line.

However, inventory and receivables often represent a *permanent* investment in current assets. When inventory is depleted, the owner must buy more — in other words, available cash must be reinvested back into the business and, therefore, won't be available to pay down the line. In fact, a growing business will need to have the line renewed and perhaps even *increased*, not paid down.

Eventually, however, a line of credit will have to either be repaid or termed out. Therefore, you must create a structured process for determining when this stage is reached and communicating this fact to the borrower, ideally in the loan agreement or a commitment letter. Otherwise, you may have to spring an unpleasant surprise on the unsuspecting owner, who will be forced to slow growth, adjust his or her lifestyle or both.

At the same time, be sure to establish clear expectations with the owner about the bank's financial reporting and performance requirements. This includes what types of ongoing financial information owners are expected to provide and, as noted above, at what point the line will have to be repaid or termed out.

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How Might the Sub-prime Collapse Affect You?

The collapse of the sub-prime mortgage market has been the dominant financial story of the past year. The ripple effects have reached far beyond just the banks that made sub-prime loans and the customers who took them out — virtually every corner of the financial world has been affected in some way.

Large banks and mortgage companies have been hit especially hard, but most community banks did relatively little sub-prime lending. And most of the sub-prime loans they did make were sold into the secondary market, so few are holding any substantial volume of these loans in their portfolios.

But this doesn't mean community banks won't be affected. The ripples are reaching into several key areas — most notably, acquisition and development (A&D) and construction loan portfolios.

DISAPPEARING BUYERS

When the residential real estate market was booming, many community banks were aggressive in making A&D and construction loans to builders and developers. But today as many as half of all homebuyers can't get the kind of mortgages (e.g., sub-prime, Alt A, jumbo) that fueled the boom, which has removed a huge segment of potential buyers from the market.

As a result, many community banks are sitting on maturing construction loans. These builders either haven't finished or haven't sold these homes and don't have the liquidity to carry the loans until the homes sell. These portfolios used to turn every 9-12 months, but that time line may stretch to 18-20 months or longer, which will create funding issues and put earnings pressure on banks. In a worst-case scenario, banks may have to foreclose on the homes (many only partially finished) of builders who can't pay — a potentially expensive and unattractive proposition.

Here are a few more points to keep in mind with regard to your A&D and construction loan portfolio:

- Be sensitive not only to the loans in your own A&D/construction portfolio, but also to developers' other projects in the bank's market or other markets that may be financed by other banks. While your loans may be performing, a builder's projects and loans with another bank may be faltering, which could eventually impact yours.

- Smaller builders have been pushed out of the conforming market (loans under $437,000) in recent years by big-tract builders and into higher-priced markets (loans over $500,000). This is one of the weakest sectors of housing right now, with jumbo financing having dried up in many markets.

- Some developers are now approaching community banks about loans to start building homes not because they think there's a market for them, but because they need the cash flow. This is creating false demand for construction loans in some markets.

OTHER AREAS TO EXAMINE

In addition to your A&D/construction loan portfolio, look for potential impacts in these areas:

Collateral value — With the drastic slowdown in home sales, many builders and developers are cutting prices and offering concessions on new homes, which may adversely affect the value of residential real estate that you hold as collateral. You may have to test for impairment by getting a new appraisal and writing the property down to its net present value discounted for the cost to hold and sell.

Consumer portfolio — The impact of the sub-prime collapse, combined with the slowing economy, could easily spill over into your consumer loan portfolio — especially auto loans and HELOCs. Remember, if you don't hold the first mortgage, a second mortgage is basically an unsecured loan, and many of these are starting to go bad already.

Small business portfolio — Any company that relies on the construction industry for significant revenue — roofers, electricians, framers, lumber yards, etc. — will likely experience a slowdown in the months to come, if they haven't already. ❖

Steps To Take

Here are a few proactive steps you can take to lessen the impact of the sub-prime collapse on your bank:

- Identify your total exposure to the residential A&D and construction industry.
- Keep a close watch on developments in markets where you have exposure.
- Intensify your portfolio monitoring.
- Look for creative ways to work with builders and developers to help facilitate the sale of their homes. And be aggressive in marketing and selling any foreclosed homes that you possess.
- Be sensitive to the funding implications of taking on new A&D and construction borrowers and prune your existing marginal borrowers to the extent that you still can.

When To Say Enough Is Enough *(Continued from Page 1)*

Finally, you must be careful not to loan too much money. Since the line will have to be termed out or repaid eventually, you shouldn't loan more money than the borrower can pay back over a reasonable period of time.

WHEN TO SLOW GROWTH

There are three benchmarks you can use to help determine when it's time to slow down growth:

1. **Can the borrower service the debt?** The debt service coverage ratio (see below) should not exceed 1:25.

$$\frac{\text{EBIDA – distributions in lieu of taxes (for S corps, partnerships and LLCs)}}{\text{Interest + current maturities of long-term debt + assumed amortization of the line of credit*}}$$

2. **How much debt will the collateral support?** Typically, banks will advance 70 percent of eligible receivables, 40 percent of eligible inventory, 50 percent of the net book value of equipment (or 75 percent of the appraised value) and 75 percent of owner-occupied real estate.

3. **Is there too much leverage?** Neither debt-to-equity nor debt-to-tangible net worth should exceed 3:1.

If a borrower exceeds any of these benchmarks, it's probably time to slow their growth and amortize the debt.

NON-FINANCIAL CHALLENGES

Owners of growing businesses face many challenges that go beyond the financials, primarily dealing with personal, management and system issues.

Personal considerations — What size does the business need to be to support the owner's compensation expectations and desired lifestyle? Is he or she willing to commit the time and resources necessary to grow the business to this level?

A common mistake made by many owners is growing just for the sake of growth, rather than growing because it is part of a structured plan that leads to a clearly defined goal. As a result, owners of fast-growing firms sometimes end up making *less* money and having *less* fun running their business.

System considerations — When a business is small, the owner may be able to keep up with things simply by using the business checkbook or a basic accounting program. However, the need for more sophisticated financial management and tracking systems grows right along with the size of the business.

You can provide valuable guidance here by sensitizing owners of growing businesses to the need for more sophisticated financial and reporting systems that will generate timely financial information and track inventory and receivables turns, profit margins and other key financial metrics.

Management considerations — The key question here is whether the owner can delegate larger portions of management responsibility to subordinates — or in other words, make the transition from "doing" to "managing" — and then manage these subordinates well.

If so, encourage him or her to undertake an honest assessment of personal strengths and weaknesses and then hire managers who complement the strengths and reinforce the weaknesses. If not, then the business should not be grown beyond the size at which the owner can manage things him or herself without undue stress and strain. ❖

We can help your borrowers analyze and upgrade their accounting and financial reporting systems to accommodate growth. For more details, please contact us.

**Unless the lender can demonstrate that the line is paid to zero periodically.*

What's the Sustainable Growth Rate?

To quickly calculate the percentage by which a company's sales can grow without changing financial leverage — or in other words, its sustainable growth rate, or SGR — utilize this formula:

$$SGR = \frac{ROA(1-D)}{E/A - ROA(1-D)}$$

Definitions:
E/A: Equity/Assets
ROA: Return on Assets
D: Percentage of earnings paid as dividends

So if a borrower's ROA is 7.5 percent, its dividend payout is 30 percent of earnings and it equity-to-assets ratio is 33 percent (or debt-equity ratio of 2:1), then its SGR would be:

$.0525 \div .2775 = 18.9\%$

What this means is that sales could grow annually at this percentage while keeping the debt-equity ratio at 2:1. If sales grow faster than this, though, financial leverage will increase.

Environmental Factors and Your ALLL

In the previous issue of *Financial Lending Notes*, we took an in-depth look at some of the challenges banks face when it comes to assessing the adequacy of their allowance for loan and lease losses (ALLL).

Given the uncertainty in many markets posed by the slowing economy and falling real estate prices, it's especially important that banks make sure the environmental factors they use when analyzing whether to increase or decrease their provision for ALLL are relevant and reasonably accurate.

Historical performance, in particular, may now be less relevant as a determinant in your assessment due to the current economic uncertainty. It may be difficult to justify the ALLL reserves you think you'll need over the next 18-24 months based on your experience over the past five years, during which time the economy, for the most part, was booming and real estate values were going up — drastically in some markets.

The environmental factors most commonly used to help analyze the adequacy of ALLL include:

- Unemployment figures
- Economic indicators
- Marketplace commentary
- Housing starts, sales and permits issued
- Absorption rates

Most of these statistics are available on a national, state, regional and local basis. The more local information you can get, the better, since conditions will vary widely among different regions of the country, and even within local market areas. For example, multi-family housing and commercial and industrial stats may be relevant to a bank that does business primarily in urban areas, but less relevant to one that is mostly rural.

Of course, environmental factors change frequently, so you should re-examine them periodically — at least quarterly, or maybe even as often as monthly. ❖

For help in determining the adequacy of your ALLL, please contact our office.