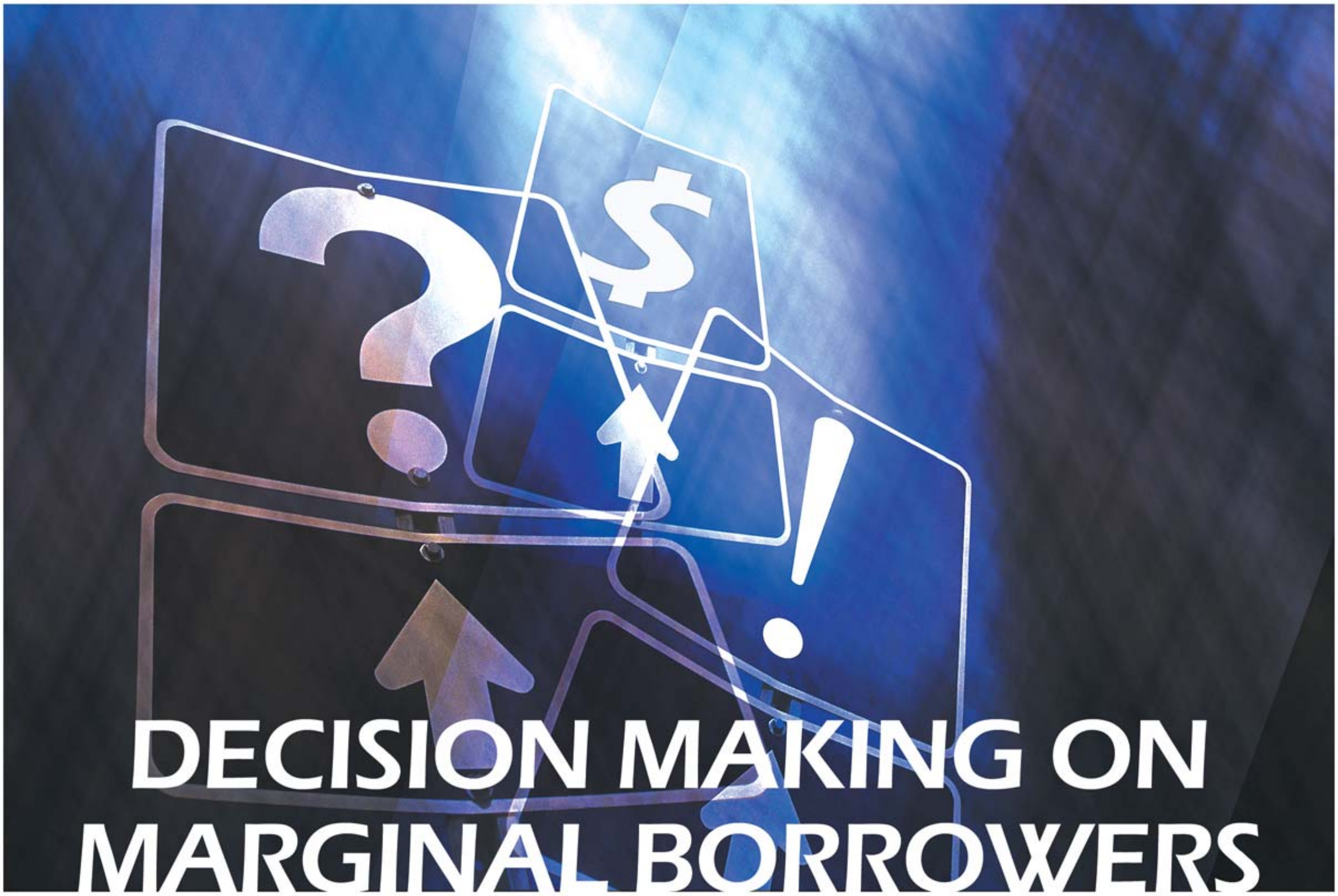


DECISION MAKING ON MARGINAL BORROWERS

A structured assessment of "management risk" can provide vital insight

by Gerald M. Sherman

In the early days of commercial finance, lenders were focused almost entirely on the quality and quantity of a borrower's collateral. Over the past several decades, however, the industry has matured significantly. Borrowers are often larger and more sophisticated and the demands of lending to these companies are often more complex. Concurrently, the competition for good loans has grown intense. Given this evolution, asset-based lenders today face tough decisions about marginal credits on a regular basis. Sometimes the key to making good decisions about these tougher deals lies in "softer" issues which go beyond the numbers. Regardless, both ABL training and day-to-day practice has remained largely focused on the traditional "harder" issues: collateral evaluation, loan structuring, fraud detection, legal considerations, etc.

This article will present a series of metrics that can be used to assess the primary "soft" issue ABL lenders typically address: management risk. An additional set of factors specific to the management risk of family businesses will also be discussed in view of their significant place in the market. In today's ABL environment, enhanced expertise assessing management risk should help lenders to be as aggressive as possible while still being prudent. In time, this should translate into higher outstandings, fewer problem assets and a competitive advantage for profitable growth.

Academic research

A significant body of academic research has demonstrated that business success — and failure – is, not surprisingly, driven by management. For example, Professor Robert Boyle of the University of Texas has published a number of articles focusing on the relationships between management and business performance. His article on turnaround strategies[1] detailed several key findings which point clearly to management's role in business difficulties as follows:

(Continued on page 22)

- Business failure correlated with the internal environment of a company more than its external environment.
- Solutions to internal problems are generally administrative, not strategic.

Augmenting Professor Boyle's work, Robert Lussier, an associate professor of management and research methods at Springfield College, published a highly informative article titled "A Nonfinancial Business Success Versus Failure Prediction Model" [2] . In that article, Professor Lussier reported the results of his study of 216 companies. Using logistic regression techniques, he tested the following 15 factors and their correlation to success or failure:

Planning	Professional advisors	Education
Staff	Parents owned a business	Capital
Financial control	Industry experience	Experience
Business timing	Economic conditions	Age of owner
Partners	Minority ownership	Marketing skills

The four factors Professor Lussier's research most strongly correlated with business failure were planning, professional advisors, education and staff—areas clearly driven by management. While this doesn't suggest that other factors tested have no importance, these findings suggest that management-driven factors have a particularly strong impact.

A number of popular business books have also examined these issues. Three particularly notable examples are Jim Collins's *Good to Great*[3], Tom Peter's *In Search of Excellence* [4] and Sydney Finklestein's *Why Smart Executives Fail* [5]. The findings presented in each share many themes and are largely consistent with the two articles presented above. While each of these books focused on larger public companies, it would appear reasonable to assume that their findings would generally apply to smaller companies as well. In fact, to the extent that smaller companies are often dominated by one or several owner/managers, the impact of senior management on the privately-held and family-owned companies asset-based lenders often see is far more significant than with large national and multinational organizations.

Seven "management metrics" to assess "management risk"

Basic credit analysis is focused primarily on a series of financial metrics: debt to worth, profit as a percent of sales, cash flow versus debt payment obligations, interest coverage, etc. For asset-based lenders, additional metrics including percentage advance-rate requirements against various types of collateral, overall availability, dilution and asset turnover hold particular importance. It would follow that a set of metrics could also provide lenders with a relatively simple, time-efficient and constructive framework for assessing management risk. The seven management metrics detailed below are based partially on research and partially on experience. Reflecting Professor Lussier's research, the first two metrics look at a company's management practices in the area of planning and the fourth looks at a company's emphasis on the staff training. The next three metrics help assess management's ability to perform against a series of clear criteria. The last metric addresses family business transition issues.

1. *If an annual financial plan has been prepared, does it include a monthly projection of the income statement, cash flow and balance sheet?*

This metric indicates the extent to which the company has invested the time and effort to truly understand its short-term outlook. Further, if each of these statements hasn't been projected on a monthly basis, it could suggest a less than full appreciation for them.

2. *Does the company have a written (or clearly articulated) strategic plan for the company going out 24 months or more?*

This metric provides the lender with an appreciation of the extent to which a borrower has a clear future direction for their company.

3. *Does the company have a training budget in its financial plan (assuming it has a financial plan)?*

This metric helps to define the extent to which a borrower is committed to preparing its management and staff to function effectively in the future.

4. *During the two prior years, has the company been able to perform within 15 percent, plus or minus, against the plan on key income statement and balance sheet measures?*

The key measures to look at would include: sales; gross margin; selling, general and administrative expense; interest expense; cash balances; borrowing requirements; account receivable turn; account payable turn; current ratio and debt to worth. If the company has consistently failed to perform within 15 percent of a number of these measures, a variety of issues could be suggested. These would include an inability to plan effectively and/or an inability to execute against plan.

5. *Was any key ratio in the prospect's income statement or balance sheet more than 20 percent below industry norms for two or more years?*

These key norms would include: gross margin, selling, general and administrative expense; interest expense; cash balances; borrowing requirements; accounts

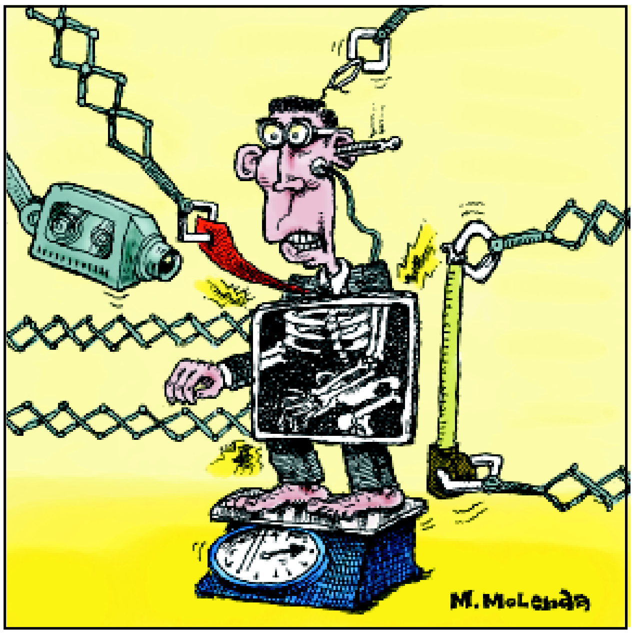
(Continued on page 24)

receivable turn; accounts payable turn; current ratio; and debt to worth. Sales per employee can also be a useful measure from time to time.

If the company has consistently failed to come within 20 percent of industry norm on one or several key measures, a variety of issues could be suggested. These would include an inability to recognize that the company is below industry norm and/or an inability to resolve the underlying problems.

6. Has the company experienced dilution which is more than 33 percent above industry norms for two or more years?

In many industries, dilution of five percent or less is considered acceptable. When looking at a specific borrower however, industry norms should be verified as they do vary. If the borrower has had high dilution, it could suggest a range of issues. If the problem is bad debts, it could be a weak credit and collection process. If the problem is in credits or allowances, it could suggest quality and/or delivery problems. If any of these problems have gone on for two or more years, it would suggest that management has not been able to identify and/or rectify the issue.



7. If the company is family-owned, has there been a management transition within the past five years or is one expected within the next two years?

By definition, a management transition within a family business suggests an increased level of management risk.

Using the seven management metrics

Unlike Professor Edward Altman's "Z-Score", these seven metrics don't provide a definitive measure or answer. Rather, themes, either positive or negative, will invariably appear. These themes will help lenders and lending managers form an assessment of the overall capabilities of a borrower or prospect's management.

When the responses are consistently positive, a lender and senior lending management should have an increased level of confidence in a prospect or current borrower's management. When mixed or generally negative, further investigation is called for with the level of effort and its exact nature to be determined by the circumstances. For example, if a company has experienced high dilution for several years, the lender needs to understand why dilution has been high and what's being done to improve the situation. Thus, the lender can learn more about the prospect from both the content and the nature of their response. If, for example, the prospect rapidly concedes that high credits have been an issue and outlines a program that's been put in place to reduce them, the lender might be able to upgrade its overall assessment somewhat. On the other hand, if the prospect doesn't fully appreciate the problem or doesn't have a plan of remediation, the overall assessment of management would likely be lowered even further.

One common situation with a marginal borrower, where the use of management metrics could be particularly helpful, is when the company has to accomplish clearly defined goals in order to improve its performance. For example, how many times has a lender heard comments like "the new product line introduction will get us over the hump" or "our revised pricing structure for next year will make all the difference in profitability." While experience has jaded most lenders about such comments, to the extent a clear assessment of a management team's likelihood for hitting such goals is available, lending decisions can be made with increased confidence.

It should also be noted that a rating system based on management metrics could be developed. For example, it could be as simple as evaluating a management team as a plus, neutral or negative. To go this step, there would be two preliminary requirements. First, to the extent the metrics discussed here are based more on experience than research, further work to refine them would be appropriate prior to implementing an operational system. Second, there would have to be strong senior-level support and lender buy-in with any organization adopting such a system.

The family-business borrower: Gaining critical insights

The vast majority of U.S. companies are family-owned and operated. And virtually every asset-based lending organization has family-owned borrowers. And most seasoned lenders have been confronted with at least some of the challenges these borrowers can present. In the extreme, lenders can even find themselves in the middle of family dysfunction where the underlying creditworthiness of the

(Continued on page 26)

borrower becomes compromised. In addition to using the seven management metrics discussed above, critical insights can be developed by focusing on these six fundamental concepts.

A lender can understand how effective a family management team is, but can never truly understand the family.

Over the past 25 years, a small group of family-business professionals have developed special techniques for working with families in business. Used properly, these techniques can help families address issues in their interpersonal relationships and the more typical business challenges they may have. The development of a comprehensive family history is often a crucial part of the process because the underlying issues are usually rooted in the personalities and events of years and generations ago. Using this information, together with a thorough investigation of the current situation, these trained professionals can begin to develop a true understanding of a family in business.

This comprehensive approach goes far beyond where a lender can or should go in developing an understanding of the borrower. Lenders are trained and experienced in finance, business, credit analysis and lending practices. While this may provide an appreciation of the challenges a family business presents, lenders simply don't have the tools or the training to develop a true understanding of the family.

A lender is far better served by letting go of the effort to "understand" the family and focusing on understanding the family management team's ability to deliver on its plans and build financial strength.

Performance speaks much more loudly than words.

Bill Parcells, the highly successful NFL football coach, has always been realistic when talking about his teams. To him, a loss was a loss, and it didn't matter if it was a close game or a trouncing. He was never interested in comments such as: "Just four points the other way and we'd have been in the playoffs." Similarly, a family business is what it is. If the family has built revenues, profits and a balance sheet over the years, that's what it is. On the other hand, if the business has struggled with cash, failed to deliver on plans or suffered dramatic ups and downs, no stories or excuses should detract from the fact the company *is sure to have had* fundamental management weaknesses. Many families in business tend to become ingrown and myopic. As a result, they often overvalue their successes and underappreciate their weaknesses. In working with a family management team, the lender must separate fact from family fiction. A weak history doesn't mean a family business isn't creditworthy and certainly doesn't suggest it can't improve its performance. Similarly, a strong history doesn't assure that a family business will always succeed. Looking at the past, however, does give the lender a good frame of reference. For the weak performers, the lender should learn about the steps the family management team is taking to help future development. For the strong performer, the lender needs to learn if the family is resting on its laurels, doing things the "way we always have" or working aggressively to adapt to future challenges.

A future orientation is crucial.

Change is a constant in every business: Product lines, markets, distribution channels, production practices and competitors. Changes in these and other factors present every family-owned business with the need to constantly adapt. Some family-management teams are very good at planning for the future, others virtually ignore it. How can a lender assess a family's perspective on the future? The presence of a clear succession plan is given considerable attention in the literature. A number of other factors should also be looked at. First, how are members of the next generation being trained to take over senior management positions? All too often, there seems to be an assumption that family members will somehow be ready when the day comes for them to take over. This demonstrates a fundamental lack of appreciation for the demands a family business can place on newly elevated family members. This type of shortsightedness tends to be passed down from generation to generation until its impact is fully felt. In many cases, the founder didn't fully appreciate his or her own contributions and similarly didn't realize what would be needed to train the next generation. A look at the nonfamily staff can also be very instructive. Just as the need to train the successor generation is overlooked, the need to have a strong supporting group is often ignored as well.

Another key consideration: The use of modern technologies as well as the need for efficient production, delivery and administration models. Today's economic environment forces companies of all industries, sizes and scopes to become more efficient. The failure to stay current for an extended period of time in any of these areas can put a company far behind competitively. Many lagging companies never recover from this disadvantage and eventually are sold or simply shut down.

A meritocracy matters.

Develop an understanding of how family members obtain their positions, the effort they put into their jobs and how they're compensated. The family's management of these areas sets a critical tone for the family and the entire company. Do family members have the requisite educational background and experience for their positions? Are their jobs truly earned or are they treated as a birthright? These answers are critical. The best way for employees to realize they have to perform well is by seeing the

(Continued on page 28)

family management team demand excellence within the family. While employees generally understand that ownership brings a certain degree of privilege, staff members don't like to see their company hindered by weak family performers. Special treatment for family members hurts morale. When there's a more capable nonfamily member for a particular position, the problem just becomes magnified. Employees also closely watch the work habits of family members. Being the first in and the last to leave demonstrates a family's commitment to the business.

Another critical area is family compensation. Are family members paid for the value of their contributions to the company or are they paid based on their last name? Overpaying for substandard contributions obviously hurts financially. More importantly, the company's long-term performance is hurt, sometimes profoundly. The acceptance of substandard family performance, let alone the overpayment for it, can rob a company of a strong commitment from employees and sometimes even its future.

Participatory management helps grow the family team.

While instincts and native ability play an important role, management is largely learned through training and experience. Likewise, the fine art of working as an effective team member or team leader is also largely learned. The experience of offering ideas, brainstorming, seeing thoughts being valued and helping to make good decisions can be a crucial part of a family member's professional growth.

By contrast, many family businesses are run in an authoritarian, dictatorial style. Compounding this, some family business leaders actively exclude children from certain issues and maintain a level of secretiveness. In these circumstances, working in the family business is far less likely to help prepare family members for increased responsibility and authority. Further, having observed an authoritarian style, young family members are much more likely to adopt that approach as well

Clear core values help the family business endure.

Successor generation senior managers who take on leadership roles need to be able to articulate what they and their business stand for. A shared understanding of how the family wants to do business and why can help family members maintain and enhance their ability to work together.

In his landmark books, *Built To Last*[6] and *Good To Great* [3] , Jim Collins details the extensive research he conducted that correlates the presence of enduring "core values" with a company's long-term growth and profitability. Core values act as a company's internal compass, providing a clear sense of direction. They permeate an organization and are a key consideration in major decisions and policies. Thomas Watson, IBM's CEO during its early years of explosive growth and profitability, stated his belief about core values as follows: "If an organization is to meet the challenges of a changing world, it must be prepared to change everything about itself except its basic beliefs as it moves through corporate life. The only sacred cow in an organization should be its basic philosophy of doing business."

Collins's research methodology included an analysis of a significant number of the most successful companies in the United States over the past 100 years, including many that started out as or continued to be family-owned. The research demonstrated a clear relationship between the extent to which a company truly embraces its core values and its long-term success. Significantly, the research also found that the specifics of a company's core values were not themselves necessarily crucial. What does matter is that a company "lives, breathes and expresses it [their core values] in all that it does."

What about family conflict?

In the fall of 2005, a well-known Massachusetts company filed for Chapter 11 bankruptcy protection simply because the two brothers that owned the company had irreconcilable differences. The third generation to run the company, they effectively owned 50 percent interests in both an operating company and the real estate affiliate housing it. One brother was negotiating to buy out the other as a way to resolve the dispute, but they couldn't come to terms. Subsequently, the brother who had planned to exit, and who was also CEO of the real estate affiliate, instituted eviction proceedings when the operating company didn't pay what he considered to be appropriate rent. Amazing as it may sound, the brother instituted eviction proceedings on a company in which he owned a 50 percent interest.

(Continued on page 42)

Decisions making on marginal borrowers

(Continued from page 28)

In the case of the brothers, their poor relationship was no secret. Often, however, conflicts, even very serious ones, can be well hidden. Given the obvious sensitivities, this is usually a much more difficult area for lenders to get their arms around. Stay alert for subtleties that might suggest a problem. For example, a raised eyebrow when talking about a sister's work habits or a shrug when talking about how decisions get made can be an indication that something is amiss.

Does family conflict mean a company is no longer creditworthy? No but it does indicate a need for precautions. A line increase including a seasonal overloan provision may no longer be prudent. A request to finance a major facilities expansion including the need to fund substantial soft costs may no longer be viable. Regardless, an effort to keep in regular contact with the borrower should be made. While conflict generally doesn't change a company's creditworthiness overnight, it's typical for a lender to pick up on the issue later than would have been preferable.

Final comments

The ABL industry is continuing to evolve and evolution creates opportunity. The ability to effectively and efficiently assess the management risk of every borrower, particularly the marginal ones, can be a significant building block in the effort towards developing a competitive advantage in the crowded, highly competitive ABL industry. ▲

Endnotes

[1] Robert Boyle, *Turnaround Strategies for Small Firms*, 29 J. Small Business Mgmt. 3 (July 1995), at 33.

[2] Robert Lussier, *A Nonfinancial Business Success Versus Failure Prediction Model*, 33 J. Small Business Mgmt. 1 (January 1995), at 8.

[3] Jim Collins, *Good To Great: Why Some Companies Make The Leap And Others Don't* (New York, NY: HarperBusiness, 2001).

4 Thomas J. Peters and Robert J. Waterman, Jr.., *In Search Of Excellence: Lesson From America's Best Run Companies* (New York: Harper & Row, 1982)

5 Sydney Finkelstein, *Why Smart Executives Fail And What You Can Learn From Their Mistakes* (New York: Portfolio, 2003)

[6] Jim Collins, *Built To Last: Successful Habits Of Visionary Companies* (New York, NY: HarperBusiness, 1994).

Gerald M. Sherman is the managing partner of CCR Corporate Revitalization, LLC, Westborough, MA. A former officer in the asset-based lending group of a major regional bank, he is also vice chairman of Diamond Business Credit, LLC. He can be reached at gsherman@ccrcr.com