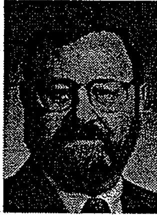
Companies, banks share challenge as area awaits economic recovery

Standard & Poor's announced in mid-January that it expects the U.S. economy to begin a gradual recovery in the second quarter of this year. However, due to the local challenges brought on by the merger of Compaq and Hewlett-Packard and the Enron bankruptcy, the Houston economy may take longer to spark an upturn.



POORLY PERFORMING LOANS

NELSON R. BLOCK

In the interim, companies with poor financial results should be aggressive about solving the problem and fully understand what lenders will require of them during the turnaround process. In dealing with lenders in the recovery process, business leaders should:

- **Prepare for new faces.** Lenders frequently bring in a new team to deal with poorly performing loans. The new officers have a fresh perspective on the company's business. Usually these officers are workout and troubled credit experts or sometimes just more seasoned bankers. Often, the younger staff dealing with daily operational tasks will stay in place, but a new senior officer will take responsibility for the loan.
- **Prepare for things to move quickly.** One of the long-term benefits left from the recession of the 1980s and 1990s is that Houston area banks and problem loan groups are managed by a generation of officers who learned workout skills early in their careers. These executives know that problems are best handled carefully but expeditiously.
- **Prepare for new requests.** Often, even well-secured loans lose their collateral value over time. The lender may request liens on new collateral, such as the assets of a recently acquired division.

For loans secured by accounts receivable, the lender may now want to obtain a lock box (post office box controlled by the lender) where customers send their payments.

The lender may feel that management needs day-to-day help in dealing with financial distress and suggest, or even require, the company hire an interim chief financial officer or turnaround specialist. Such engagements can be on a consulting basis or a short period of full-time work.

Lenders may request additional accounting information or due diligence reviews and may want financial reporting done more frequently. To manage a workout situation effectively and stay on top of the company's business, workout professionals for both the borrower and the bank will want to review financial reports often, measure performance and adjust goals for the company.

- **Prepare for the worst.** The past 12 months have proven again that anything can happen. Management should analyze those events that could cause the company to falter. Doing so will help clarify the company's position.

Guarantors should consider whether they might be called on for payment. In a liquidation, market forces discount the company's value several times. In an operating business, inventory and equipment are used to create accounts receivable, which should approximate the amount on the company's balance sheet. The lender will discount this value in the lending ratios (for example, 75 percent of accounts receivable, 60 percent of inventory and 50 percent of equipment).

This discounted amount, roughly equal to the company's outstanding loan balance, is the lender's target recovery from a rapid sale of company assets. However, if a forced liquidation reduces prices further, the lender will look to its guarantors to pay any deficiency.

- **Prepare for the best.** Lenders generally do not want to liquidate a business and will usually try to help a borrower that is aggressively trying to solve its problems.

The company should consider alternative lenders, especially those with credit criteria more appropriate to the company's diminished performance. Asset-based lenders, who typically accept more risk in their portfolios, have begun to see a long-expected upturn in activity.

Factoring companies, which purchase accounts receivable, and mezzanine lenders, which make loans on terms that look more like equity, will likely also be popular in this economy. Subordinated debt and factoring accounts receivable, which the company's principal lender finds not qualified also can shore up a distressed business situation.

In any problem loan, one of the borrower's greatest tools is taking the initiative. But, it can be lost quickly if management is not prepared to look at the company's financial situation, make realistic assessments and deal effectively with poor economic performance.

Management must develop an analysis of why the company is doing poorly and a plan for returning to profitability. Management must convince the lender it has the ability to implement the plan, win lender approval and then put it in effect. ■

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