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How Middle Market Companies Can Overcome the Credit Crunch

Facing fierce competition for funding, middle market borrowers need to plan ahead, communicate effectively and get connected.

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Here in Detroit the storm has passed, the auto bankruptcies are pretty much behind us, and we find ourselves back where we started -- the financial system is still a mess. In that respect, Michigan is not unlike the rest of the nation. While credit is starting to ease compared to the lock down of the past 12 months, only the best of middle market borrowers are able to attract funding. Despite the circumstances, the borrowing game doesn't have to be a crapshoot. Companies can increase their ability to secure the funding required to grow and survive by following a few best practices. However, to be effective, middle market borrowers must first understand the credit issues they're up against.

While much of the credit problem is due to economic uncertainty, internal problems within lending institutions also play a huge role in constraining new lending. With small to mid-size companies responsible for roughly 50% of all jobs in the U.S., the lack of credit for this market segment will continue to put a drag on the economy.

The credit boom over the past ten years was primarily driven by real estate lending, with the percent of real estate loans in the U.S. banking system portfolio increasing from 40% in 1998 to 55% in 2009. These amounts do not even take into account the hundreds of billions of dollars loaned and then sold off in the securitized market. Many regional and community banks are choking on bad real estate deals and it greatly restricts their ability to lend new money. Banks are forced to closely watch their capital ratios (in simplistic terms, capital/loans) and, with capital at risk due to unrecognized real estate losses, the amount of new lending possible is restricted due to pressure on the capital ratio.

When underwriting new loans, especially in the middle market, debt is often backed by a security interest in various company assets. Nationwide, and particularly in the Midwest, a severe downturn in collateral values for both real estate and equipment has led to values declining up to 50% from two years ago.

Underwriters are having a difficult time placing an appropriate loan to value against hard assets. Having been burned during the downturn, underwriters tend to err on the conservative side -- which translates into less liquidity available for borrowers hoping to lever up hard assets for access to cash.

Adding to the problem is the evaporation of alternative financing for both working capital and equipment leasing. Many financing companies lost warehouse lines from their banks or could no longer access

funding via the commercial paper market and had to close or greatly restrict lending. Equipment leasing especially has been hit hard as leasing companies have been swamped with equipment repossessions and do not have the capital available to fund new purchases - particularly for out of favor industries like automotive.

Underwriting standards have drastically tightened and the integrity of a company's accounting information has never been more important. Audited statements are a must for attracting new capital. In this market, reviewed or compiled statements may as well be written on a cocktail napkin. Timely reporting of monthly and quarterly information required by lenders is also very important as miscues in reporting now present giant red flags that something may be wrong.

With many banks having capital issues, especially regional banks that lend into the middle market, competition for funding has become fierce. While loans are underwritten on their own merit, a scarcity of capital means equally good loans or loan extensions are competing for a short supply of available funds within the bank. Many lenders have commented that obtaining new funding is as much about the political influence of the loan officer sponsoring the proposal as it is about the quality of the proposal itself.

Communication is crucial to managing a company's lending group. When things are good, most borrowers only interact with their lenders when it's time for a loan renewal. That means many borrowers are known only to their loan officer and not to the bank decision makers responsible for monitoring and approving credits. Making time to meet with bank executives, effectively laying out business plans and future capital needs, and getting to know all the lenders in your lending group sets the table for loan renewals or new funding.

Banks also pay attention to which borrowers utilize a full suite of services versus just "borrowing money." Treasury management, executive and employee deposits, credit cards, 401K administration and other services all provide direct benefit to a bank without the risk of lending. These are the areas where banks generate fees and make money. Borrowers using a bank's services have an advantage in today's market. When allocating scarce capital, weight is given to customers viewed as profitable due to service fee generation versus ones who only have a borrowing relationship.

Today, middle market companies not only need to worry about the competition in their marketplace, they also need to worry about competition within the financial markets for scarce capital. Effective communication, robust accounting systems, a well thought out analysis of where a company fits in the market, and a detailed strategy for moving forward all put a company ahead of the competition for funding.

To survive in the current environment, companies need to plan funding requirements well in advance, have the ability to communicate their plans, and establish the connections to find funding in a very competitive landscape. Third party advisors can be very helpful in assisting in these areas, both to provide a sophisticated level of analysis that may not be possible using in house resources and also to provide potentially crucial connections to funding sources outside the company's immediate lending group. While I believe the credit market issues should starting clearing up over the next 12-18 months, companies must understand these issues and be prepared in advance if they will need new capital or find themselves squeezed due to internal problems within their lending group.

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