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Loans and Marriages: A Common Problem

As a lender making a loan to a company, have you noticed how the relationship resembles courtship and marriage? When all goes well, it can be a good marriage. However, should the company show signs of financial deterioration, the relationship could become rocky. Much like in a real marriage, sometimes recognizing early signs of difficulty is the most important step in solving the real underlying issues. Without pinpointing the real root cause early on, any action plan to correct it is likely to fail.

As a lender, you periodically receive financial reports from the company. You probably meet regularly with the company to discuss the "how are we doing" aspects of the business. What you want to look for are any early warning signs of potential trouble ahead. In that way, an action plan that addresses the real root cause of the problem can be developed to avert the future problems.

The concept of early warning signs has been applied to many aspects of life. There are warning signs that predict potential health problems, economic indicators that help forecast future fiscal well-being, and of course actions that can indicate worsening personal or family relationships.

How can you apply warning signs to evaluate and predict the future health of a business? One way is to answer 20 simple questions that will give an indication if there is trouble on the horizon for a company.

The first step is to review the company's most recent financial statement to answer the first eight questions. A simple yes or no answer will shed tremendous light on possible problems.

1. Has the company had a material sales forecast shortfall against budget for three or more months?
2. Have selling, general and administrative (operating) expenses increased as a percent of revenue or grown faster than revenue?
3. Have gross margin percentages declined for three consecutive months?
4. Have net profits been below budget for three consecutive months?
5. Have receivables over 60 days increased over the past three months?
6. Have payables over 90 days increased over the past three months?
7. Was the operations inventory shrinkage over the past year greater than the prior year?
8. Are phone calls and meetings requested by you, the lender, becoming more frequent?

The second step is to meet with company's top management and have them explain what actions they are taking to address any of the first eight questions that had a "yes" answer. The third step is to focus on the following 12 questions. These will require you to meet with top management from the company and elicit a "yes" or "no" answer about each of the questions.

9. Is the company writing checks to vendors and then holding the checks for future mailing (held checks)?
10. Has there been an increase in turnover in top or middle management?
11. Are suppliers calling more frequently, or demanding payment or tightening terms?
12. Have any large customers been lost lately?
13. Are the gross sales margins of the new customers lower than the margin received from customers you have lost?
14. Has there been an increase in workers compensation claims?
15. Has there been an increase in absenteeism?
16. Has the company seen an increase in product quality complaints?
17. Has top management (both the CEO and CFO) failed to visit all key locations at least once in the last year?
18. Is the company's sales forecast based on growth rates that are greater than the industry is expected to grow?
19. Has the company's actual cash flow been less than projections for three consecutive months?
20. Are the company's sales concentrated with customers who are experiencing financial or operational problems?

The fourth and final step is to add up the number of "yes"answers.

If you have less than eight "yes" answers in total, the company is probably in reasonably good health. If you have eight or more "yes" answers, the company may be on its way to declining economic health and you need to delve deeper to find the root causes. If you got more than fifteen "yes" answers, the company is probably in a state of denial regarding its health, and needs immediate outside assistance to bring it back on course.

Completing this four-step process will provide you with an early warning of potential problems in the relationship so that the marriage of lender and borrower can remain strong.

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