

The State of Bank Lending and the Impact on Your Business

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As we sit down to write this quarterly comment on economic trends and the markets, we are surprised at how many people can look at the same set of facts and have such divergent opinions about what is happening - in the economy in general, in the public markets for equity and debt, and in the market for bank loans for businesses of all sizes.

In a lead article in Barron's in recent weeks, an investment strategist from one of the large banks wrote that "the recession is over," and he foresees a strong economic recovery and a robust US stock market. Others in the same newspaper and elsewhere are talking about hoarding liquidity and buying gold in anticipation of potent inflation in a very difficult economy. The only statement that can capture the differences we see and hear is, "it depends on where one sits."

Napoleon is often credited with the phrase "an army moves on its stomach." Soldiers need food and other supplies in order to put up a fight. Keeping with this metaphor, our economy, as a collection of the individual businesses that comprise it, moves on its stomach too. Its food, however, is the credit our businesses need for working capital and long term investment capital.

Unfortunately, for the last 18 months or so, the supply lines of credit to all but the biggest businesses in our economy have been disrupted. Large businesses tend to have multiple supply lines in normal times, including all forms of banking products as well as access to global capital markets. In the most recent economic downturn dubbed "the great recession," very large businesses were given, in addition to all the other sources of credit available to them, the free gift of the credit rating of the United States. This guaranteed that they could continue to get all the working capital and long term capital they wanted. Imagine what would have happened to General Motors,

Wells Fargo, AIG, Citigroup and Bank America, among others, if the US Government had not guaranteed all of their borrowings. They would have failed.

In actuality, among the biggest financial institutions (with the notable exception of Lehman Brothers), "failure" actually meant being absorbed by an even bigger financial institution; Bank of America acquired Countrywide and Merrill Lynch, JP Morgan Chase acquired WAMU and Bear Stearns, and Wells Fargo acquired Wachovia. Even Lehman largely continues today within Barclays and Nomura, though the shareholders were wiped out as were most of the creditors.

The result of not allowing the biggest financial institutions to fail is a very highly concentrated banking industry. The top six bank holding companies now control \$9.1 trillion, almost 70% of all the banking assets in our country. As a result of this consolidation, total bank loans outstanding in the US have fallen from \$7.7 trillion in *(continued on next page)*

Market Intelligence

The economy is growing again, but it is difficult to ascertain the true drivers.

- GDP was up 5.7% in Q4, likely due to inventory replenishment and the effect of government spending.
- The majority of the S&P 500 beat earnings forecasts in Q4, due largely to cost cutting rather than sales growth

Financing continues to be very limited for small and mid-sized businesses.

- Loan volume was up in Q4 but still down year over year.
- Senior debt to EBITDA (free cash flow) in small to mid-sized businesses being sold was 2.5x in 2009, down significantly from 4.0x in 2007

Valuations of small to mid-sized businesses are stabilizing at fair values indicative of the long-term average as opposed to the highs of 2007.

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December 2008 to \$7.2 trillion in September 2009 – that's half a trillion dollars no longer available to good businesses.

While the very largest financial institutions have been consolidating, smaller banks have been failing. In 2008, there were 25 bank failures in the US; in 2009 there were 140, and in January 2010 alone, 15 banks failed. While most of the publicity has focused on these bank failures, small and medium size companies (those with less than 500 employees) have been left mostly to fill their supply lines for credit as best they can. As a result, bankruptcy claimed 63,000 of these companies in 2009.

This is devastating because these companies, companies like yours, account for 55% of the total workers employed in the US. The National Federation of Independent Business reported in February that small and medium size business optimism had been near historic lows for 16 consecutive months. NFIB also reported that capital expenditures expected to be made by small and medium size businesses in the next three months are near a 35 year low. To go back to our metaphor, it's difficult to keep the army moving when the banks aren't making any food available.

Larger industrial business, however, or those that are politically in favor seem to be doing just fine at keeping their supply lines filled with credit. Banks need to put loans on the books to meet their income expectations for 2010, so they are actively seeking to make loans to businesses with sales in excess of \$50 million. In addition, companies that are politically in favor seem to get all the money they want from the US government. The latest example is Southern Companies \$8 billion loan guaranty to build two nuclear power plants in Georgia. With a market capitalization of \$26 billion – we are absolutely sure Southern Companies did not need a US government guaranty.

Unfortunately, the current lending environment strongly favors larger companies, as illustrated above, and has largely left behind smaller businesses. Lending volumes to companies with less than \$50 million of EBITDA

slowed to a trickle in Q4 '08 (an estimated \$0.5 billion) and, although there was substantial improvement in Q4 '09 (an estimated \$2.5 billion), lending to small business is still greatly reduced from 2007 levels. Even the government sponsored Small Business Administration lending program has shown a decline from \$14.3 billion in 2007 to approximately \$9.3 billion in 2009 – a decrease of almost 35%.

As a result of the economic environment, banks have focused on improving their credit standards while also increasing their capital bases. The result is a significant contraction in 'traditional' leverage for companies. As an example, according to S&P companies with less than \$50 million of EBITDA averaged 4.0x Senior Debt when selling their business in 2007. In 2009, this same metric averaged 2.5x EBITDA – a reduction of 37.5%.

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Making Private Equity More Approachable

-- A Fast Fact About Private Equity --

- **Myth:** All private equity firms are simply financial engineers, loading companies with unwieldy debt burdens in order to make a quick buck.
- **Fact:** Many private equity firms, including ORG, use very conservative amounts of debt, preferring to use the cash flows of the business to drive growth rather than to pay interest and principle on heavy debt loads.

To learn more about how ORG's approach makes us unique, go to www.orgroup.com/approach.html

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A portion of this capital need has been filled with mezzanine financing, which has seen an increase in activity since 2007. However, the bulk of the increase has come from increased equity being put into businesses.

The good news is that Owner Resource Group has seen an improvement in the lending environment over the course of 2009 and expects modest, albeit constrained, improvement in 2010. In our recent discussions with lenders, we have witnessed a very conservative approach - most lenders are seeking a strong asset base to support their lending activities, and the cash flow loans (where little or no assets exist) that peaked in 2007 are very difficult to obtain. When cash flow-based loans are available, businesses generally need to be greater than \$5 million of EBITDA and have strong operating performance to qualify. Even then, the total leverage they can typically obtain from traditional bank financing is 2.0x to 2.5x EBITDA. As remarkable as this sounds, this is a profound improvement from early 2009 when the lending markets were mostly closed for business.

It is important to know, however, that loans are available to good companies and there are several actions you can take to generate a favorable outcome. Some strategies to increase your success include the following:

- Don't wait until you need a loan to start building relationships with potential lenders. Take the time to build a relationship - invite lenders to your facility, present them a short overview of your company and the success that you intend to have - take them to lunch (more often than not they will pay and should!) and get to know them. Ask them what they are looking for in today's market, what rates they are seeing, what kind of asset coverage they need. This will be educational for you and provide you an opportunity to educate them about the strength of your company.
- Present your business to potential lenders as if you're presenting to someone who would want to buy it. This means using best management practices, having structured

Did You Know?

ORG's Executive Ownership Plan™ is a proprietary financial structure that gives management teams the ability to take a significant ownership stake in our portfolio companies.

Under the plan, management can purchase ORG's shares following the achievement of a set of pre-established long-term metrics. This structure allows us to partner with strong management teams as we drive growth, together.

For more information go to
www.orgroup.com/executive.html

processes in place for delinquent accounts and credit approval, having a yearly budgeting process, maintaining a strong accounting department, and having a short-, medium- and long-term strategy. Show lenders how your business is strong even in spite of the current economy.

- Don't just search regionally. While you may have a good relationship with XYZ Regional Bank, XYZ probably did eight middle market loans last year while Bank of America did thousands. This is even more important in today's environment in which certain regions of the country have banks that are severely crippled. Make sure that you widen your search beyond your backyard.

- Run a competitive process. This sounds obvious but you would be surprised how many people don't run a process and/or simply roll-over a loan from term to term without making sure that they are actually getting a good deal. You

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are the client to the bank – make them earn your business much as you would make a vendor earn your business.

- Don't be afraid to use an advisor and or bring in a private equity investor. This sounds self serving but make no mistake that we and others deal with lenders on a daily basis. As a result, our outcome is usually more favorable. We don't (and don't have to) provide personal guarantees, we get good rates on our debt, and we negotiate flexible loan structures. Much like you are an expert in your business, private equity firms and advisors are experts in corporate finance.

In the meantime, if you're facing an issue or just have a question, feel free to call us. We are professional investors and a resource to owners of small to mid-sized businesses. ♦

Would you like to know what your fellow business owners are thinking?

The ORG Quarterly reaches over 7,000 owners and executives of small to mid-sized businesses. Every quarter we conduct a survey so that we can provide you an idea of how your colleagues are responding to the economic environment, and to the topics of this newsletter.

Your participation is anonymous, and respondents will receive the results immediately.

To participate in the 2 minute survey, please click this link. You will be able to view the results as soon as you complete the survey.

http://www.surveymonkey.com/s/ORG_Quarterly_2_Minute_Survey

Sources: WY Campbell, S&P, Barron's, The Wall Street Journal. The ORG quarterly is printed four times a year. All rights reserved. ©2010 Owner Resource Group.

Owner Resource Group was created to be a resource for business owners. We are a group of seasoned investors who support owners of good companies with capital and resources. We invest our capital and our partners' capital in companies to help them grow (organically and through acquisition) and/or to achieve a full or partial exit for existing ownership. Our core values inform everything we do in support of good companies.

We aim to:

- Be fair and transparent
- Be professional, yet friendly
- Be approachable and likeable
- Offer simple, yet thorough solutions
- Be smart stewards of our investors' assets
- And most importantly, listen...

...After all, it's your business, and no one knows it better than you

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