The credit crunch:
a practical guide

Fall 2008

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Introduction

The credit crunch is rapidly making its way from Wall Street to Main Street and squeezing businesses across a wide swath of industries. Slowing growth, weakening demand and reduced lending by banks compound an already difficult environment in which key commodity prices are rising rapidly. While some geographies and industries are proving more resilient than others, our general advice to clients is to take proactive steps to prepare for potentially challenging days ahead.

The current upheaval in the credit markets is analogous to riding a roller coaster for the first time on its way down a steep hill. It has everyone holding on tight, hunkering down, with a sick feeling in their stomach and wondering when the worst will be behind them. No doubt, 2008 has been a rough ride for the economy and the financial sector. It seems that each week another major bank failure, economic crisis or government bailout is grabbing headlines. Keeping track of all of the events and understanding what impact they will have are daunting tasks. In this guide, we provide an explanation of some of the recent major financial events, a brief assessment of how they may affect the typical business, and a 10-point checklist of things to consider as you manage through this difficult time. With careful planning and foresight, you might even be able to turn conditions to your advantage. Businesses that are well capitalized, well positioned, and well managed should see opportunities.

Most of our suggestions are about good business practices. Management teams often ignore the fundamentals when the focus is on revenue growth, as it has been for several years now. That growth was fueled by easy credit and global demand, but the emphasis will need to change for now. The coming months should be about instilling rigor and discipline throughout your business.

In the appendices, we have included a snapshot of the financial crisis that provides a summary of what happened and how it might impact you in the days ahead. We've also included a diagnostic questionnaire to help you determine if your business or that of your suppliers or customers might be at risk of financial distress.

Cash is king

If you have cash on your balance sheet, you have a greater degree of flexibility in your decision-making.

What's the issue?

Cash is the lifeblood of any business, and it matters more than earnings. As the saying goes, "Profits are an opinion, but cash is a fact." More and more, bankers, investors and advisory professionals focus on the often-ignored cash flow statement. If earnings are growing faster than cash flows, red flags are raised.

In a slowing economy, understanding and managing cash flow are of paramount importance. Customers are likely to pay their bills more slowly, sales and profitability will likely diminish, and banks are less inclined to lend against insufficient or aging collateral. Liquidity can become constrained very rapidly. In recent history, many businesses didn't keep a close eye on their cash flows or near-term liquidity because it wasn't necessary. Banks were happy to step in and fill funding gaps.

What can you do?

"Stress-test your business plan and understand the resulting impact on liquidity," suggests Ben Gonzalez, a principal in the Grant Thornton LLP Advisory Services practice. "Focus on the components of working capital and the cash conversion cycle. Build and conserve cash. In a financially distressed business, build a war chest of cash, even at the expense of drawing down on interest-bearing credit facilities. Forecast near-term cash receipts and cash disbursements based on realistic financial projections and a sound starting point and include an analysis of the impact

of those assumptions on your borrowing base. Analyze variances and learn from them. If you can't produce this from information you have, bring in outside help. You need to look beyond sales and expenses and focus on actual cash, not EBITDA."

Negotiate aggressive credit terms with suppliers and customers. As soon as invoices are late, begin subtle but firm collection efforts. If customers believe they can use you to finance their own cash needs, they will. Reduce inventory levels and replenish on a just-in-time basis, to the extent practical. Sell aged inventory. In the short term, it may be wiser to sacrifice profitability in order to generate cash, but keep an eye on your borrowing base. Advance rates on inventory tend to be low, so focus on selling inventory to generate cash.

What can be avoided?

"Remember that big is not always better," comments Russ Wieman, national managing partner of Audit and Advisory Services at Grant Thornton LLP. "Growth consumes cash. A significant sales opportunity that appears profitable on its face may have dire consequences on a company's cash conversion cycle and its ability to finance it in this market. An increase in the duration of the cash conversion cycle is a negative signal. Thoroughly consider the implications to cash flow from increased sales requiring capital expenditures and ramp-up periods. Understand the worst-case scenario, and make decisions accordingly."

02 Be relentless on cost control

What's the issue?

In order to maintain your current or historic levels of profitability in an environment characterized by decreasing demand and increasing commodity prices, you will almost certainly need to cut costs and spending where possible. Escalating costs will cause margin compression and in turn put pressure on liquidity. Tough economic conditions require a razor-sharp focus on cost containment at a minimum, and cost cutting where possible.

What can you do?

Employ zero-based budgeting to review all costs very carefully in terms of their value to the business. What costs do you actually need to run the business? Conduct relative risk and benchmarking analyses against competitors in the industry, and look for ways to improve performance. Reduce spending as much as possible, and hold managers accountable for all expenditures and cash outflows. Institute cost justification and baseline investment returns on new projects.

Understand your fixed and variable costs and any outstanding liabilities not reflected on your balance sheet (e.g., operating leases, rents, performance contracts) and find opportunities for reducing costs. Pay close attention to variable costs, and completely reconsider any capital expenditure decisions. Institute policies that encourage and reward cost savings and cash conservation.

Talk directly to shop floor employees and back-office workers, not just your management team. Validate all significant assumptions you've made about your business, your competitors and the industry in which you compete.

Carefully consider a major area of cost: people. Make tough decisions now. Don't allow emotion to rule your decision-making. Use objective criteria to ensure that decisions are made in the best interest of the business and not based on personal relationships. Communicate well, retain integrity throughout the process, but move quickly. Instill confidence in your decisions and motivate those who are left.

What can be avoided?

Don't automatically cut marketing expenses. While this is traditionally seen as an easy target, doing so can have a significant impact on your competitive position, particularly when market conditions pick up. There's a lot of business out there, and in a slowing economy, it becomes a matter of having to try harder to grab share.

Think about your business and, more importantly, your strategy. Cost-cutting initiatives cannot be undertaken at the risk of diminishing value.

> Look hard at discretionary expenses and pick off the easy wins in areas such as travel, general expenses and entertainment — but don't compromise your business strategy.

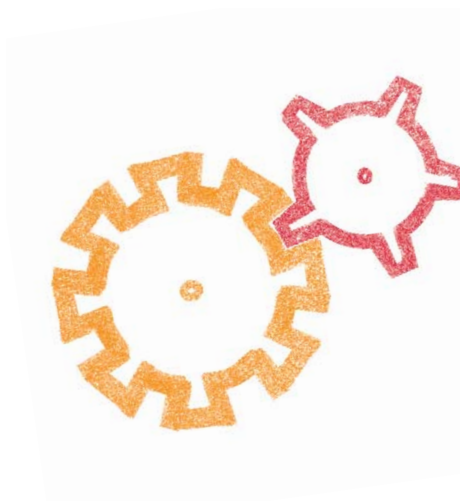
03 Evaluate customers and suppliers

What's the issue?

The recent challenges in credit markets, as well as a general economic downturn, have put increased pressure on the purchasing power and creditworthiness of customers resulting in a tightening of credit terms and product availability from suppliers.

What can you do?

Reevaluate credit terms with customers and negotiate the shortest reasonable terms. Carefully review (and continuously monitor) the creditworthiness of each new and existing customer before extending credit. This will better ensure full repayment in accordance with stated terms. Monitor the customer accounts receivable aging and quickly address any accounts that are past due. Request regular financial information from your largest customers to identify and evaluate risk. The buyers of your services may themselves not understand the financial position of their employer. Ask yourself a simple question: If your customer were to file for bankruptcy tomorrow, what would happen to your business? It's prudent to understand the credit profile of any customer that could severely impact your business if it runs into trouble. As an unsecured creditor in a bankruptcy, you will likely collect a fraction of your receivable, and only at the conclusion of a lengthy legal proceeding.



Understand how closely your business is linked to Main Street consumers. Your proximity to, or distance from, them will indicate how quickly your business will be affected as

consumers exercise greater caution in their spending patterns. The most vulnerable sectors will be those that rely on discretionary consumer spending and credit, such as housing, automotive, retail and other consumer durables and nondurables. All of these businesses will be affected by customers' tighter access to credit in the months ahead.

Take the opportunity to bargain with suppliers for the most favorable credit terms that are as long as possible. To the extent excess cash is available, negotiate for early payment discounts, because most suppliers will be hungry for cash. Critically evaluate whether you need more or fewer suppliers. Do you need to expand your supplier base because some of your suppliers are financially weak? Do you need to consolidate your suppliers, put more of your business with fewer providers and negotiate more favorable terms for your business? Either strategy could work, but only a robust analysis will provide the right answer for you.

What can be avoided?

Don't assume your customers or suppliers are financially healthy. Look for red flags of distress. Failing to promptly collect receivables may result in a cash flow shortfall that could affect all areas of your business. Accordingly, extending unreasonable credit terms in the hope of bolstering revenues may be equally detrimental. Immediately investigate any hiccups with your suppliers. Make sure delivery or quality mistakes are just that and not an indicator of more systemic problems.

Make sure you understand the financial well-being of your customers and suppliers. Look for signs of financial distress, and express your concerns. Ask for financial information on a regular basis, and analyze it carefully.

04 Get smarter on tax

What's the issue?

It is important to take appropriate advantage of the opportunities available to reduce your tax liabilities, such as fully utilizing available credits and deductions and making the least allowable estimated tax payment. If a company operates across multiple state and local jurisdictions, there are many opportunities to manage cash and reduce taxes in the sales and use tax and property tax arenas.

What can you do?

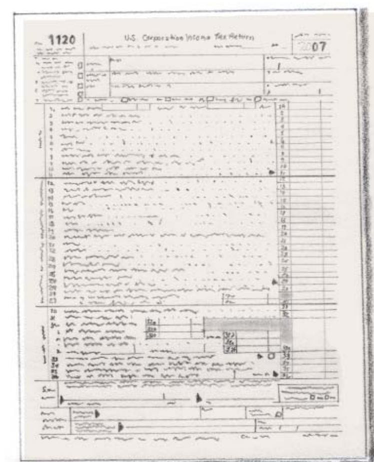
In terms of corporate income taxes, businesses should take appropriate advantage of the available tax credits. For example, the credit for increasing research and development activities may offer significant annual tax savings. For companies in the manufacturing sector, the fuel tax credit and a deduction for domestic production activities may also reduce your tax burden. Current-year credits may in some cases be carried back one year to possibly generate a refund of taxes paid.

Taxpayers should also take extra care when considering the calculation of quarterly estimated tax payments for both federal and state income tax purposes. There are several methodologies that can be used in the calculation of these payments, and frequently the taxpayer has the opportunity to choose the methodology that is most beneficial from a cash flow perspective.

If the profitability of the company has changed and you have overpaid estimated taxes, corporations may file a claim for a quick refund with the IRS immediately after your year-end instead of waiting to file the year's tax return. The IRS will act on this claim within 45 days.

In addition to federal income tax considerations, three state and local planning opportunities may result in immediate tax benefits. First, an analysis of sales and use tax responsibilities and liabilities frequently uncovers opportunities to reduce monthly cash tax payments and opportunities to apply for immediate refunds. Second, taxpayers should account for their existing real and tangible property to determine whether property taxes are being paid on overvalued, nonexistent assets and/or intangible assets. In some cases, discussion with state and local authorities can result in new or additional property tax exemptions. Third, it is worthwhile to examine the methodology that states use to determine a company's employment tax rate. At times, states commit errors when calculating these rates, and recomputation may result in reduced monthly payments of employment taxes.

Depreciation is another area that should be considered. For certain property purchased and placed in service in 2008, an immediate deduction of 50 percent of the cost of the asset is available.



Companies may also want to think about conducting a review of fixed and leasehold assets in order to ensure that each asset is depreciated over the correct life for tax purposes. Often these cost segregation studies result in a reclassification of a significant number of assets and can result in substantial immediate tax deductions.

These steps represent some basic ways to reduce tax costs and improve cash flows. However, there are a number of additional planning ideas that might be suitable, depending on your facts and circumstances, if you are considering major commercial transactions or restructuring.

What can be avoided?

Companies should avoid missing required payments and filings for all federal and state taxes. Trying to borrow from the government by putting off tax payments in the short term can result in significant interest and penalties. In cases where payment is not possible, taxpayers should file their tax returns, and work with the appropriate tax authorities to develop a payment plan.

In addition, given increased cash flow needs, a U.S. multinational may look to access cash accumulated at foreign subsidiaries. Companies should be cautious when repatriating funds from these subsidiaries.

While the temptation to repatriate the funds can be great, the tax cost of these transfers can reach a high combined U.S. and foreign effective rate, depending on the circumstances.

Loaning the amounts from foreign subsidiaries can have equally adverse tax consequences. Proper planning in advance of the repatriation can effectively manage the total global cash tax costs of these remittances.

Also, do not ignore the importance of accounting for income taxes, and the new pronouncement governing accounting for uncertain income tax positions (FIN 48). There may be a need to record additional liabilities that could negatively impact loan covenants.

Tax, in various forms, is usually one of the biggest overhead costs in a business, and it is important to look carefully at how to manage that cost and the related impact on a company's cash flow.

Reconsider capital investment plans

What's the issue?

Investing in new assets in a downturn can bleed you of cash when you need it most. Carefully consider your capital investment plans, and question the proposed value and timing.

What can you do?

Take into account the timing of investments. If it isn't mission-critical, consider delaying or deferring it. For a mission-critical asset, negotiate to acquire it under the most favorable terms, including, but not limited to, the use of debt financing to the extent available. It is essential to weigh the operating and tax benefits of the investment against the financing costs, especially in a lending environment that has become considerably more challenging. Cash flow budgeting should properly account for increased borrowing costs as well as constrained credit availability.

Attempt to fully understand changes to working capital that may result from a particular investment. The project may require increases, or decreases, in cash, accounts receivable, accounts payable or inventory. These changes in working capital should be included in the calculations we discussed earlier, as should economic value at the end of the life of the project.

Also be mindful of how recent changes in economic conditions and challenges in the lending climate are affecting your customers. Caught between the credit crunch that has made loans harder to get and more expensive on the one hand, and a weakening economy on the other, many Americans are expected to spend frugally in the coming quarters. Capital budgeting metrics (such as net present value and return on investment) should incorporate realistic assumptions based on current economic conditions. This will aid practical decision-making about whether to move forward with prospective investments.

What can be avoided?

The easiest thing to do is to just stop investing in capital during difficult times. Don't do it. Failure to make necessary investments or maintenance capital expenditures can put you on a slippery slope. If an investment is vital to keep your business operating properly, don't suspend or postpone the investment decision just because financing is more expensive and complicated.

Ask yourself if now is really the time to invest in new capital assets. Look for extended terms from vendors if it's absolutely necessary. Consider leasing to minimize the impact on cash flow.

06 Get closer to your banks

Take a hard look at your reporting and accounting systems. If these are weak and not quite what the bank would like to see, seriously consider improving them quickly.

What's the issue?

Given the current state of the credit markets, banks will be a lot more cautious and concerned about credit quality. As a result, they will need greater persuasion to lend you money when you need it. Borrowing will likely come at a higher price, both in terms of interest rates and fees, and will almost certainly include more restrictive covenants and require increased monitoring and transparency. In many industry sectors and geographic areas, new lending will be severely restricted, and you may struggle to refinance existing credit facilities. Banks are increasingly focused on the quality of their loan portfolios; their key concern is loan recoverability. You can expect a lot more scrutiny from your loan officer and a lot less latitude and flexibility.

What can you do?

Treat your bank as a partner in the business. Keep them informed and help them understand your business, your industry and competitive dynamics. Be sure to give them plenty of notice if you need help. The last thing a bank wants is to receive a week's notice that you need to double your line of credit. Proactively manage your relationship with your lender. Banks make money by lending money—they want you to prosper so they can continue to lend you money.

If you do need to go back to the bank for help or additional borrowing, discuss the best approach with your advisors. In many instances, getting your bank to work with you has a lot to do with how you ask for their help. Even if your business prospects are changing adversely, you will be better off being the one to tell the bank. But have a plan in hand when you arrive. Moreover, in today's credit environment, it's going to be critical to understand prevailing financing structures and terms.

What can be avoided?

Don't fall into the trap of thinking that it is up to the bank to guide you through any issues or problems. If you talk to your bank early enough, they may be a lot more open-minded in working through problems with you. However, be very clear that the ultimate responsibility for resolving any issues falls squarely on management's shoulders.

Do your best not to break any loan agreement covenants that might trigger a technical default. Also, do your best to stay current on your debt. In the end, you are trying to ensure that your company has the financing availability to operate the business effectively. You will clearly want to avoid having your lines of credit restricted, any demand loans called, finding your way into the bank's "special asset group" (aka the "work-out group"), or being forced to enter into a restrictive and expensive forbearance agreement.

07 Consider your financing options

What's the issue?

What happens if you are having issues with your bank (either due to your problems or their problems)? This can result in a severe restriction in your borrowing capacity, or worse, pulling your financing facilities altogether. With what's happened in the financing environment, it's not as easy as it used to be to simply secure an alternative source of capital.

What can you do?

Make sure you understand all your options for funding your business. Start with your incumbent lender, and consider alternative ways of structuring your current credit facility (e.g., term debt versus line of credit). Understand default provisions in your current borrowing agreements. Based on your size and location, understand who the alternative local, regional and national senior lenders might be for your business. Also consider other types of secured financing sources like leasing, asset-based lenders and factoring companies. In some locations, state and local government-supported financing programs might be available.

Other types of outside financing include subordinated debt, private equity and venture capital. These funding sources are generally longer in duration and often take more time to arrange. If you have enough time and flexibility, these sources can help improve your capital structure over a longer period of time.

Finally, don't forget about creative ways of accessing cash that might be tied up in the business. As discussed earlier, shortening your working capital cycle should be your first priority. Look at negotiating payments on long-overdue accounts receivable, or obtain financing through your trade vendors. Consider the sale of noncore assets or subsidiary businesses. Consider sale leasebacks on real estate to generate cash. In some industries, you might be able to ask for and receive advance or progress payments from your customers.

What can be avoided?

Do not automatically assume that your current lending relationships are going to stay in place. Avoid being in the position of not understanding your alternatives if you are forced to end your relationship with your bank, lender or other investors. Court other sources of capital, just in case. Don't be left without a contingency plan, and don't overstretch yourself.

Talk to us about helping you arrange financing. There are alternatives to traditional lenders, and we have an extensive network of contacts across the country.

Keep an eye out for bargains

What's the issue?

As lending markets contract, some companies will have or anticipate having liquidity problems. A number of these companies will consider a sale transaction as a viable option. It could be a need to preserve personal wealth, the real or perceived lack of alternatives, or a lack of confidence in a recovery. This feeling of uncertainty will drive many shareholders to seek an exit or a partnership with a strategic investor rather than hunkering down and trying to weather the storm independently, thus creating buying opportunities at depressed prices.

What can you do?

Well-funded companies looking to add market share, expand product/service offerings or recruit quality people might find it less expensive to acquire targets that fit this criteria than it would be to invest internally to try to achieve these goals organically.

The same limited access to capital that pushes some companies to sell will keep on the sidelines other companies that would have been suitable buyers in a normal lending environment. Additionally, traditional leveraged buyout funds will have more limited access to the "leverage" that allows them to consummate transactions at targeted returns. The result will be less competition for attractive acquisition targets and thus, potentially reduced pricing multiples on acquisitions. Seeking a professional advisor can increase exposure to such opportunities, while ensuring transactions are priced and executed in an effective, cost-efficient

manner. Whether you are playing the stock market, engaged in real estate or considering acquisitions, the best buys are made in a down market.

What can be avoided?

Do not make an acquisition just because you can. Good acquisitions are part of a well-thought-out growth strategy, combined with proper transaction execution and integration. Failure to approach acquisitions objectively can prove fatal.

More importantly, this is not the time to become distracted. Remain absolutely focused on the day-to-day running of the business. Be mindful of debt capacity, and don't overleverage the business.

Be alert to opportunities where business valuations are falling and where business owners are looking for quick exits rather than risking survival through a difficult economic period.

Protect your personal wealth

What's the issue?

The problems in the financial sector of the stock market clearly demonstrate the need for diversification. Diversification is equally important when considering additional business investments or personal guarantees in a business.

In our current economic environment, it is likely that businesses will have greater borrowing needs. In this environment, banks will want more security in the form of personal guarantees, additional collateral and more stringent debt covenants, even on existing loans. Solving business cash needs with personal assets will reduce the diversification of your overall personal net worth and further expose you to a long-term recessionary economy.

What can you do?

Before you agree to become more personally exposed for the sake of the business and less diversified personally, think hard about your options. While you may be emotionally (and financially) tied to the business, now is not the time for emotional decisions. Can the business survive a long-term recession? What will you do the next time the business needs cash?

Before you agree to become more personally exposed for the sake of the business and less diversified personally, think hard about your options.

Do not think just in terms of debt. Borrowing may be the quickest form of cash, but if it comes with additional security requirements or personal guarantees, think about the ramifications of having all of your eggs in one basket in a risky economy. While you may not like the idea of additional owners in your business, equity financing may be a safer alternative and provide you with additional resources if the economy does not improve as quickly as you expect.

If you decide debt financing is the best course, avoid, where possible, personal guarantees and pledges of personal assets to secure business debts. Employ experienced counsel to help with the transaction. The personal bankruptcy laws are less generous in terms of forgiving debt than they were several years ago. Understand the financial ratios of the business, and make sure there are no opportunities for technical default of the loan guarantees that will trigger the personal guarantee. Be sure the personal guarantee will not destroy your personal wealth outside the business. A smaller guarantee may mean less money available to the business, but it means less personal risk. Having to sell your business is a change in your life. Having to sell your house is life changing.

What can be avoided?
Throwing good money after bad.

Worst-case scenario

What's the issue?

You've taken a hard look at your business and stress-tested sales assumptions, but your fixed costs are such that even breakeven cash flows are based on certain levels of revenue. Your balance sheet is highly leveraged relative to your competitors. Your future is uncertain, and trade credit is contracting. You've produced short-term cash flow forecasts and your current outlook is negative, and you foresee a serious liquidity crisis looming in the near term. A payment is due on bank or bond debt, liquidity is waning, and a default is imminent. Bond debt is trading at a deep discount, so a capital infusion is unlikely.

What can you do?

Don't panic. The credit crisis and economic downturn are impacting businesses across almost every industry and the entire credit spectrum, so you're not alone. Carefully consider strategic alternatives. What are the advantages and disadvantages of restructuring a business through a bankruptcy? Does a sale of all or part of the business make sense? Is raising equity an option? What is the enterprise value of the business, and is that value greater than the face value of secured debt? How do you determine the value of all or part of the business? In a financial restructuring, the critical issue is indicative value.

Look at your business without its existing debt, and determine its debt capacity based on your most current financial projections. There are two fundamental approaches to determining debt capacity: leverage multiples and coverage ratios. Both are highly dependent on market conditions. Lenders and debt investors also look at alternative exit strategies, including the liquidation value of collateral and tertiary sources of recovery such as personal guarantees. Understand your bargaining position and your views on value. Consider your fiduciary responsibility. If you are operating in the "Zone of Insolvency," your responsibility is to creditors, not to shareholders.

What can be avoided?

Do not, under any circumstance, wait until you are almost out of cash. Build cash reserves and hire professionals who can help you assess your options. Don't assume the problem will go away over time. In most cases, doing nothing will cause value to erode rapidly. If possible, defer conversations with banks and bondholders until a full game plan is developed. Do not agree to provide additional collateral or a personal guarantee in exchange for covenant waivers, until you have fully assessed your options.

Call professionals far in advance of a financial crisis, if at all possible. The more time you have to identify your options and craft a plan, the better your chances of success.

Appendix

The Credit Crisis: What happened and how it impacts you

2008: A tumultuous ride, thus far

Most people are generally aware of the major events of the past nine months, beginning with the sub-prime crisis and continuing through the failure and overnight sales of major Wall Street banks, and on to the more recent breakdown in the credit markets that has necessitated major government intervention. Years of easy credit, covenant-light loans, record consumer spending, housing speculation, and exotic mortgages set the stage for unprecedented home ownership levels and securitizations of assets by financial institutions feeding the voracious return objectives of hungry investors.

The system worked until the economy softened and fear started to creep in, as doubts were raised about the ability of borrowers to pay debts. Investors then started balking at paying higher prices for assets in the secondary market. With liquidity evaporating, a sudden flight to safety caused a rush to hoard cash, as buyers stopped buying, lenders stopped lending, and accounting rules governing certain balance sheet assets resulted in the recognition of mounting losses at banks and further reduction in the availability of credit.

The following is a brief overview of some of these significant events, including an explanation of what occurred and what it means to the economy.

Sub-prime crisis

As the economy continued its strong performance through 2007, mortgage lenders became more and more aggressive in lending on what's called the "margin." The term refers to those types of loans that edge ever closer to the line between aggressive and reckless. Sub-prime refers specifically to loans to individuals that have credit scores and credit profiles below a certain industry-set criteria. Loans of this

type typically carry higher interest rates, which created an incentive for mortgage lenders to extend credit to these individuals. As fuel and other commodity prices began to rise, marginal loans were the first to be affected as these borrowers had difficulty making monthly payments on time. Further, many of these loans were structured as adjustable rate mortgages (ARMs), meaning that after a set period of time, introductory interest rates reset. As lending tightened, interest rates — and therefore, monthly payments — increased. Compounding these problems, housing prices have been falling throughout 2008, resulting in situations where the value of the home might be less than the total debt (loan-to-value ratio in excess of 100 percent). Certain sub-prime (and now even prime) borrowers simply handed the keys over to the bank, defaulting on their mortgages. All of these issues converged to significantly increase mortgage defaults and give rise to the sub-prime mortgage crisis.

Bear Stearns

Wall Street conducts hundreds of thousands of trades per day, buying and selling securities to rebalance portfolios, lending to others doing the same thing, and making markets for securities to reduce counterparty risk to enable the efficient execution of trades. In order to do this, banks extend credit to one another, providing the liquidity and the necessary collateral to conduct trades without the need to sell other assets. In normal times, lending between banks is the engine oil of the financial world, allowing these firms to conduct their business and generate profits for investors. However, a series of complex events ultimately led to Bear Stearns's inability to borrow money from other banks, essentially cutting off the liquidity it needed to continue to conduct its business. The firm's exposure to sub-prime mortgage securities caused rumors about its liquidity, which caused other banks to stop renewing Bear Stearns's loans. Once that happened, a failure was imminent, and the Treasury Department, along with the Federal Reserve, acted. Their underlying purpose was to prevent the collapse of other banks because the global banking system is highly interconnected. The ultimate wisdom of the bailout and its effect on the economy will be debated for years to come.

American Insurance Group (AIG)

Among its many insurance products, AIG sold a product called a credit default swap (CDS). Essentially, a CDS is an insurance policy that an investor purchases to guarantee that it received a certain amount of value from a debt instrument if the borrower cannot continue paying its debts. Like any other insurance product, this policy is based on actuarial analysis of the security. AIG sold these policies to all sorts of investors, and it collected hefty fees. In fact, AIG sold policies to investors that had no exposure to the underlying security.

Think of it as your neighbor buying insurance on your car: He's confident your driving habits will result in an accident. This has resulted in the nominal value of CDSs far exceeding the face value of the debt they are supposed to be insuring.

The problem arose when certain securities — in particular securities tied to mortgages (including sub-prime) — began to significantly decline in value, with declines much greater than any reasonable risk analysis assumed. This forced AIG to pay out billions on insurance policies, numbers that were far in excess of what the company's forecasts had predicted. As AIG began to need more and more cash to make good on these insurance policies, the major credit rating agencies (functioning as they are supposed to function) reassessed the risk profile of AIG and signaled they would reduce their credit rating on AIG. A reduction in credit ratings results in a host of consequences, including increasing the cost of borrowing and limiting the type of credit that a company can obtain. It became obvious that AIG would be unable to raise enough capital to meet its commitments, and failure appeared imminent. The failure of an insurance company like AIG was considered too big a risk to the economy. Its widespread business activities reached every corner of the global financial system. As a result, the federal government stepped in and agreed to guarantee the obligations in a transaction that effectively transferred ownership of AIG to the government.

Fannie Mae and Freddie Mac

Fannie and Freddie, as they have been known, were set up as government sponsored enterprises (GSEs) that made loans and provided loan guarantees. Both GSEs provided liquidity to the mortgage industry by purchasing loans from banks and other mortgage originators. Fannie and Freddie would then package these loans into larger pools and sell them off as mortgage-backed securities (discussed below). As mortgage lending became increasingly aggressive — targeting prospective homeowners with riskier credit profiles — Fannie and Freddie became laden with increasingly risky mortgages. As interest rates rose and adjustable rate mortgages reset, a large number of mortgages began to default. As the mortgage crisis continued and investors became increasingly concerned with the risk profiles of these securities, the GSEs' ability to support their own liquidity by using the mortgage-backed security market began to fail. Ultimately, the federal government stepped in and became the effective owner of both Fannie and Freddie, thereby guaranteeing that neither would fail. As of early 2008, Fannie and Freddie owned approximately half of the U.S. mortgage market.

Lehman Brothers, Washington Mutual, Wachovia, etc.

Though it might seem odd to include Lehman Brothers with the names of two major commercial banks, at a high level, the same thing happened to all three

institutions. Banks engage in a few basic transactions: taking deposits, lending money and investing in securities. In the case of these institutions, a somewhat circular series of events led to situations in which the banks were, or would quickly become, insolvent. The companies had to write down the value of their assets, thus depleting the capital supporting all their loans. Depositors, increasingly risk averse, started pulling cash out of these institutions. In order to protect the banks themselves as well as depositors and investors, these institutions were sold to other, larger entities that had sufficient capital to ensure solvency. As a result of these sales, the combined banks are now able to meet their obligations, execute trades, make loans, and most importantly, return deposits to individuals and corporations on demand. Lehman filed for bankruptcy court protection when it was unable to find a buyer or investor to shore up its capital. It is in the process of selling itself bit by bit.

Mortgage-backed securities and the credit crunch

Years ago, lenders would make loans to individuals and businesses and assume all of the risk associated with those loans. Further, once a specified amount of loans were made, the bank would need to raise additional capital to make additional loans to meet regulatory capital requirements. The securitization market provided a way to resolve both challenges. At the highest level, securitization involves transferring risk and profit from one entity to multiple investors. Essentially, a bank packages a pool of mortgages into one fund, and then sells the fund in pieces as securities. Each piece is entitled to interest and principal that are supported by the entire fund, thus reducing the exposure to any single mortgage and appeasing different appetites of various investors. The bank benefits by removing the loans from its own balance sheet, thus enabling the issuance of new loans. Origination fees are more profitable than the spread a bank earns between the cost of money (interest paid on deposits) and interest income (interest charged on loans it makes). Through the securitization market, banks also transfer default risk to third parties, the investors that purchase the securities backed by these pools of loans.

In a normal market, securitization works as intended. The percentage of nonperforming mortgages has been fairly constant for decades, and given the size of the U.S. mortgage market, a significant increase in defaults was considered unlikely at best. However, a host of factors combined to create an environment where mortgage defaults have increased, home prices declined, and the resulting risk of mortgage-backed securities skyrocketed, reducing the value of those securities and the desire of investors to own them.

Since mortgage-backed securities are widely held among banks and other investors and thus widely affected by the crisis, the market for buying and selling them has effectively disappeared. As a result, banks are now unable to sell off loans to make room for new lending. This issue is

further magnified by the requirement to mark the assets to market, an accounting requirement that mandates banks estimate the value of such assets based on what they can be currently sold for in the open market. The inability to sell the loans caused write-downs of the value of the assets, thus resulting in reduced capital accounts (banks are required to maintain minimum capital-to-loan ratios). The worst-case scenario is that all forms of lending could be affected, including auto loans, business loans, student loans, etc. If that sudden contraction were to become more permanent, the financial system would effectively freeze.

Borrowing is a primary way in which companies invest in the growth of their enterprises. Funding is necessary to finance day-to-day working capital, growth, capital expenditures and strategic acquisitions. The health of the economic system is reliant on the ability of banks to lend to consumers, businesses, investors and foreign governments. When fear and uncertainty take over the normal functioning of the system, people begin to ask what will happen to their money held by financial institutions. Widespread uncertainty causes financial institutions to conserve cash, and lenders require better and more collateral in order to make a loan or a trade. To restore confidence, the federal government passed a $700 billion bailout plan (known as the Troubled Asset Relief Program, or TARP). The intent of the plan is to accomplish two main goals: (1) enable banks to have the necessary capital to begin lending again by purchasing illiquid securities from their balance sheets, and (2) restore the confidence in the financial system for banks, individuals, businesses and government entities to conduct business in the ordinary course. All that being said, restoring order is a process, and takes time.

What can be expected in the credit markets going forward?

Despite the government intervention, credit markets are anticipated to remain tight in the intermediate term. Banks continue to hoard cash while trying to eliminate or write down from their balance sheets risky mortgage-related loans that are clogging up lendable capital and deteriorating capital adequacy. Meanwhile, interbank lending has dramatically declined, resulting in lower liquidity for banks.

What does this mean for the typical business owner?

Securing new debt or refinancing/extending current credit facilities has become increasingly difficult. Today, debt is still available, but banks and investors are looking for higher-credit-quality issuers with greater protection against loan defaults. In addition, debt providers are looking for increasingly larger premiums to compensate them for the risks related to extending credit. Accordingly, borrowers can expect increased borrowing costs. Additional fuel for higher borrowing costs results from wider credit spreads coupled with a

dramatic rise in short-term variable rates such as LIBOR. Consolidation within the U.S. banking industry, as institutions continue to merge or fail, will decrease competition, thereby supporting the increased borrowing costs as well as higher anticipated bank fees.

Additionally, lenders are increasingly requiring added credit enhancements such as personal guarantees from business owners, LIBOR floors (for variable-priced loans), and most importantly, stronger covenant packages with greater restrictions on total leverage levels and increased cash flow coverage of interest, fixed charges and debt service. Meanwhile, uses of borrowed funds are also being closely monitored, with substantial restrictions on dividend distributions and owner salaries.

Lenders have also tightened advance rates on collateral to provide additional cushion in case pledged assets decline in value in today's volatile market environment. Along with these reduced advance rates, borrowers are experiencing increased financial reporting requirements in the form of more frequent submission of borrowing bases or financial statements to lenders.

Many business owners are being forced to consider nontraditional financing sources such as sale leaseback arrangements, greater reliance on leased equipment, just-in-time inventory management, and sales of assets such as factoring of accounts receivable to supplement their liquidity or financing needs.

From a personal wealth perspective, business owners and managers are increasingly working with their bankers, accountants and consultants to figure out a rational and appropriate investment strategy. As the questionable viability of many banking institutions continues to make headline news, many owners are concerned about the deposits in their operating accounts to the extent these deposits exceed the FDIC insurance limit. Because of this, there continues to be a "silent run" on many banking institutions — further restricting lendable capital and tightening available credit — as depositors have continued a flight to quality. Many business owners are considering "safe" short-term investment vehicles such as U.S. Treasury notes or T-bills. The significant rise in demand for these types of investments has, however, significantly depressed yields, resulting in lower earnings for investors.

Appendix

Questionnaire

Consider the following questions. An affirmative response to a number of questions could be indicative of a company experiencing financial and/or operational distress.

Financial

	Question		
1.	Is a “going-concern” opinion at issue?	Y	N
2.	Has revenue decreased by more than five percent during the last 12 months?	Y	N
3.	Has gross margin decreased during the last 12 months?	Y	N
4.	Has the company’s operating cash flow (EBITDA less capital expenditures) decreased in the last 12 months?	Y	N
5.	Has the company’s cash collection cycle increased in the past 12 months?	Y	N
6.	Has the quotient of average inventory divided by annual sales increased by more than 10 percent during the last 12 months?	Y	N
7.	In the last 12 months, have vendors increasingly demanded cash on delivery or reduced credit terms?	Y	N
8.	Did utilization on revolving credit exceed 85 percent of availability in the last 12 months?	Y	N
9.	Has the company violated the terms of its borrowing agreements or breached debt covenants in the last 12 months?	Y	N
10.	Is the company highly leveraged relative to industry competitors?	Y	N
11.	Has the company’s debt credit rating been downgraded, or has its debt traded at a discount over the last 12 months?	Y	N
12.	Does the company expect to have difficulty meeting scheduled principal or interest payments?	Y	N

Management/Organizational

13. Has there been significant turnover among the senior management team?	Y	N
14. Is management reactive rather than proactive in solving problems?	Y	N
15. Has the company not produced a monthly financial plan (including projected income statement, balance sheet and cash flow statement) in the last 12 months?	Y	N
16. Has the company not prepared a strategic business plan in the last 12 months?	Y	N

Sales/Marketing

17. Did the company lose market share in the last 12 months?	Y	N
18. Have any new entrants captured significant market share during the last 12 months?	Y	N
19. Have there been major delays in launching new products?	Y	N
20. Are the company's sales highly concentrated among few customers?	Y	N
21. Is it fair to say the company is not deeply familiar with the credit profiles of its major customers?	Y	N

Operations/Production

22. Is there over-capacity in the company or its industry?	Y	N
23. Is the company's technology lagging?	Y	N
24. Have customers cited an increasing rise in quality problems in the last 12 months?	Y	N

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