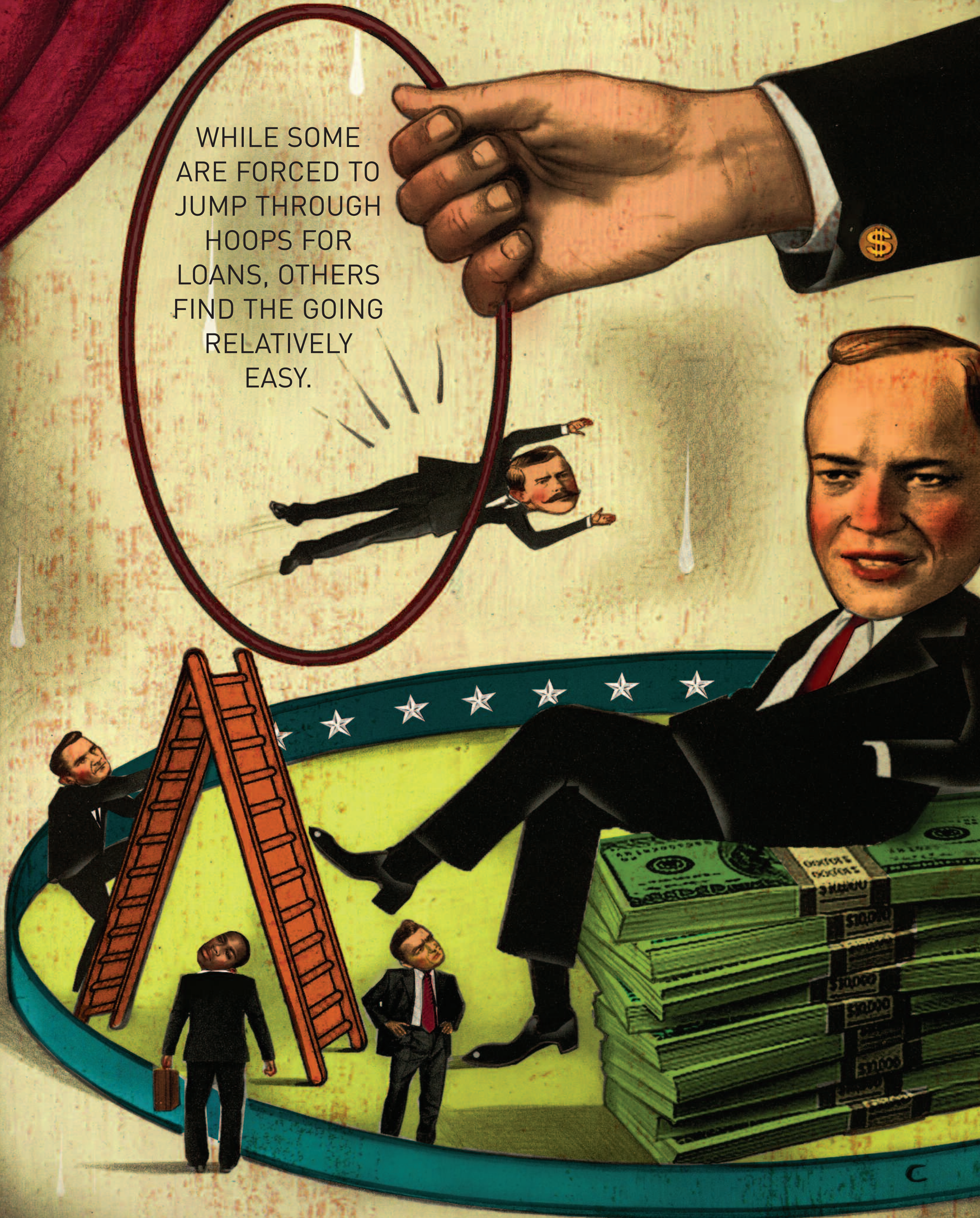
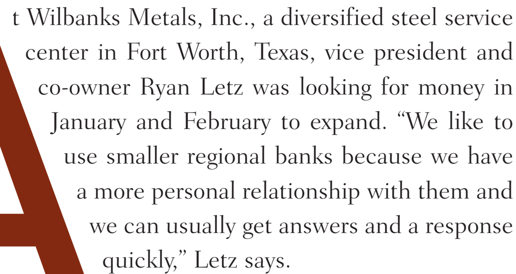
COMPLICATED CREDIT

BY STEVE LAWRENCE -$- ILLUSTRATION BY CRAIG LAROTONDA


WHILE SOME ARE FORCED TO JUMP THROUGH HOOPS FOR LOANS, OTHERS FIND THE GOING RELATIVELY EASY.



At Wilbanks Metals, Inc., a diversified steel service center in Fort Worth, Texas, vice president and co-owner Ryan Letz was looking for money in January and February to expand. "We like to use smaller regional banks because we have a more personal relationship with them and we can usually get answers and a response quickly," Letz says.

"This is a strong company and we were talking to a strong bank—one we had done business with for six years. But we wanted to finance new projects, and some new divisions we are starting, and increase our credit limit. They were not willing to do that."

Well they might have, if Letz and his partner would do what they had never done before. "They wanted personal guarantees on the loan, even if it was collateralized," he says. "We've never had that in the past, and the last thing we want to do is guarantee it personally. That is difficult for us to swallow."

At Lawrenceville, New Jersey-based Certified Steel Company, though, what's tough to swallow is the lack of business, not the lack of credit. "We have not had a great need for capital because our business is down, shipments are off maybe 25%," says Chief Financial Officer Dante Germano. "Which means we have converted our receivables into cash as we have shrunk our inventory. So we are a bit more liquid now than we usually are when we are running flat out.

"We do business with Wachovia and Wells Fargo and our letters of credit have been renewed and they are in place," says Germano. "We just have no need, unfortunately, to use them right now."

Tight Credit and Slow Business

Across the continent, the dreary picture for metals companies, and for too many of the manufacturers and builders who are their clients, is still tight credit and slow business. In meetings and surveys throughout the industrial heartland, businesses complain, often bitterly, that their banks have turned on them. The banks, often in exasperation, say that they wouldn't mind lending more, but the slow economy doesn't justify it. And besides, they say, these days there are simply not enough creditworthy applicants.

Enterprise Minnesota, the state's arm of the nationwide Manufacturing Extension Partnership, surveyed several dozen of its members and held 13 focus groups earlier this year to hear about the credit and business climate in the midst of recession. It found a "remarkable decrease" in the availability of credit compared with a year ago. "Even those with longstanding banking relationships said they were pretty frustrated," says Bob Kill, Enterprise Minnesota's president and chief executive officer. "In just a year, the percentage reporting significant concerns about credit availability jumped from 13% to 37%."

"The banks tell us one thing about why companies are not getting money, and of course we get a different story from the companies," says Michael Klonsinski, executive director of the Wisconsin Manufacturing Extension Partnership. These partnerships have trained a range of businesses in all 50 states to improve efficiencies, eliminate wasteful processes and become more profitable. That is hard to do though, when they can't borrow money to run their businesses. "There is no doubt that the banks have tightened capital requirements and the companies that need it are having a harder time getting working capital or the loans they may need to expand and purchase new equipment," says Klonsinki.

"This is the perfect time to invest in new equipment and processes and capacity. These things are 30 to 50 and sometimes even 75% lower priced than what they were. Anything that gets in the way of companies' ability to take advantage of these lower prices is going to hurt us badly in the long term," he says. "And I do see companies that are not loaded with debt that are able to make some of these important investments. But there are lots of others in slightly less better shape that would like to tap into a line of credit and can't."

Industry Changes Make it Tougher

Even worse, all this comes at a time of distinct structural change in America's manufacturers, seriously aggravating the problem. "We know the size of manufacturing on average is shrinking," says Michael Hicks, director of the Center for Business and Economic Research at Ball State University in Muncie, Indiana. "So instead of having the 2,500 worker mills, most new employment is occurring in shops with under 250 workers. And that suggests they are not as heavily capitalized, so they are going to be much more reliant on external financing." Which means, too, that their inability to get that external financing is hitting the manufacturing sector harder these days than it might have when mills and shops were much larger.

The banks have changed in important ways as well, Hicks says. Most significantly for manufacturers, they seem to have lost their ability to assess small business loans accurately. "Thirty or 25 years ago, if you lived in a small- or medium-sized town, the local banker knew

you and he or she was an expert at financing with traditional community banking funds," says Hicks. "But over the last decade or decade and a half, it is our impression that a huge amount of that expertise disappeared from these banks.

"If all you are doing is packaging up your loans and selling them off, you don't need those people to assess that risk," Hicks says. "Loans became a commodity, and the buyers of those packages assessed the risk.

"Once upon a time, bank boards would have had experienced manufacturing people, but they were replaced by financial services executives who understood the new loan market," Hicks says. "So now most banks, even the heavily capitalized ones, do not have a convenient way to evaluate the quality of the manufacturing companies contracts or business plans. So they are reluctant."

For their part, the banks insist they are just looking for good credit and good business. "Lenders are far more eager to lend than six or 12 months ago," says Dr. Dana Johnson, chief economist at Comerica Bank in Dallas, Texas. "I do not want to make the case that credit is flowing in an entirely normal fashion. Lenders are being particularly careful and looking hard at creditworthiness.

"But we see that the big weakness in business lending is lack of demand," says Johnson. "Inventories are way down, capital spending rates are still weak. Most businesses are not needing credit and are not yet expanding their activity. We see a build up in business deposits at our institution. We see a distinct softness in demand."

The "Yawning Gap"

The truth, of course, is all of the above. There seems to be something of a recovery going on for the already rich, well-capitalized corporations. But the result, for smaller businesses, from metals service centers to windows manufacturers, is not cheery. You could see it reflected in a single day on the front page of *The Wall Street Journal*. The lead story heralded "Credit Market Springs to Life," but on page four, that story continued alongside a companion piece, which declared, "Gloom at Small Firms Clouds Outlook for Strong Recovery." Bond sales by the big guys, Bank of America and GMAC Financial Services were being gobbled up, the main story said. Caterpillar and John Deere were revving up again. "A yawning gap has opened in the early stages of the economic recovery between big companies and small businesses," the *Journal*'s companion piece pointed out. "With the former enjoying access to credit and growing global markets and the latter hurting badly on both fronts."

Just ask the National Federation of Independent Business, which found in February that 25% of the business owners it surveyed had to put up their homes as collateral for the credit they needed. Need we mention that in most areas of the country, those homes have fallen in value? Little wonder that the NFIB's Optimism Index, which measures its members' confidence in the economy, has been at historical lows for 17 consecutive months.

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At year's end, the National Association of Small Business had found 39% of its surveyed members complaining they could not get adequate financing.

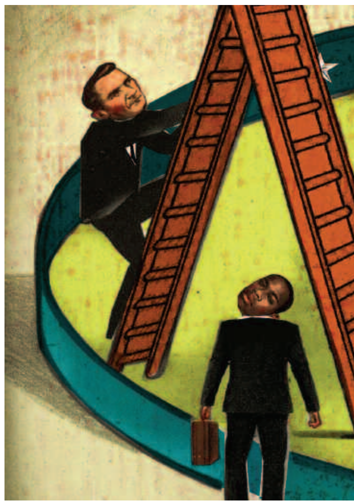
Of those who could get any kind of bank credit, more than a quarter reported higher interest rates and more stringent terms, no surprise really, up from 19% reporting the same problems in July of last year.

Still, Some Can Borrow

The bankers and investment bankers who focus on the metals industry particularly, see this as a layered problem. "There is more than adequate credit for the top tier of service centers," says Mark L. Parr, managing director and metals industry expert at KeyBanc Capital Markets Inc. in Cleveland, Ohio. "Then there is a medium tier of accounts that have seen their balance sheets liquefy dramatically because they have sold off inventory. And of course there is a lower tier of centers that have been more financially distressed, that took on a lot of

debt in '07 and '08 to fund major acquisitions. Or if their profitability metrics are below the norm for the industry, they will be having a harder time."

"You've had companies on the metals side, service centers, that have been able to survive with an inventory liquidation strategy. They may be losing money at the margin, but still have positive cash flow," says William G. Peluchiwski, managing director at Houlihan Lokey, an investment bank in Chicago, Illinois, that does metals deals among other things. "They had enough value in inventory that they could self-fund their businesses for awhile. But the market has now turned. The mills are anticipating price increases and the service centers are at critical levels of inventory. So they have to start rebuilding. And they have not been making much money, if at all, and they are looking to effectively borrow working capital to fund inventory purchases. But when you have skinny profit margins, or no profit margins, then you've got big issues. That is causing a squeeze on credit."



"You also had the banks under great scrutiny themselves," says Bob Wujtowicz, managing director at InterOcean Advisers, LLC, in Chicago, Illinois, another investment bank that does metals deals. "Their lending limits dropped and they had the Fed looking over their shoulders. So they began looking more at industries they were comfortable with and metals has never been one of those. It's just never been a hot area for the banks."

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>
> *—Michael Hicks*

Michael Hicks at Ball State also sees the animosity and uncertainty in Washington as an increasingly important contributor to economic gridlock. He points particularly to doubt about the impact of health care legislation, whether a cap-and-trade or greenhouse gas regulation scheme will become law and the so-called "freedom of choice" bills that would make it easier for unions to organize.

"Now just the fact that all this potentially high impact legislation is wrapped in uncertainty means that you are reluctant to borrow," says Hicks. "The legislative turmoil feeds into the caution and uncertainty. Businesses do say they are having a hard time borrowing and many are. But they are also understandably reluctant to leap into borrowing or expanding. You've got a noxious stew."

Looking at Alternatives

To try to keep this stew off their table, service centers, manufacturers, the credit hungry are looking at some options they have traditionally used, but that are now more expensive, and some they have never considered before.

The more familiar include working with vendors and getting the banks and others to at least finance new inventory with the company's assets as collateral. The asset-based lending may include borrowing against receivables, or against a specific purchase order for each job.

"With the mills, if you can demonstrate a strong balance sheet, we can still deal with them," says Germano at Certified Steel. "We have always been able to discount our financing with the mills and get a 5% break when we pay in 10 days. It is just that now we need a little more from the marketplace."

"Existing lines of credit and the asset-based loans; a lot of that could be pushed out from 2009 to a 2012 time frame," says KeyBanc's Parr. "Again it depends on the customer. But there is a financing pool in the market that is probably capable of funding the current pricing and demand environment."

And the more expensive loans against receivables and purchase orders? These usually come with a 2% to 3% monthly premium over regular lending rates, plus a fee. "It's not unusual, the personal guarantees, factoring and purchase order financing," says Parr. "You have banking as an industry trying to claw its way back. And interest rates are very low. So that makes it more difficult to have a return on capital."

It also makes higher interest plus fee loans more attractive. "Banks in general are looking to a secured environment," says Parr, "They want every piece of tangible property they can get their hands on."

The Banks Have Their Own Problems

Besides, it is abundantly clear that serious trouble throughout the banking industry is far from over. The FDIC's fourth-quarter 2009 industry profile, for example, showed loan losses rising for the twelfth consecutive quarter. Net charge-offs stood at $53 billion, the highest quarterly rate in 26 years. No wonder the agency reported that loans and loan balances had declined for the sixth straight quarter.

"Two to 300 banks have been closed," says Jim Haughey, chief economist for Reed Construction Data in Waltham, Massachusetts, which tracks the developers and the construction industry. "About 700 banks are now on the FDIC 'Watch List,' which means that their bank examiners are telling them to reduce their

exposure to real estate [and everything else risky]. Discouraging applications and denying loans is the easiest way to do this."

Hard Money for a Price

For those who can't get their banks to tumble, there are lots of independent asset-based lenders ready to pick up the slack. Always for a price of course, and often with some pretty strict ground rules of their own. "We demand our clients have at least 30% gross profit margins," says Richard Eitelberg, president and founder of Hartsko Financial Services, LLC, which does mainly purchase order financing and letters of credit from its offices in Bayside, New York. "And our deals usually run 90 days."

The fees for his loans, in that 90 days, can usually shave at least 7.5% off a 30% gross profit. "We don't charge interest," Eitelberg explains. "This is all fee-based, because two, three, four percent a month over prime can be seen as usury in some states. So the client's got to say to himself, 'I can't get financing and is 23% better than nothing?'"

"We don't want to replace a bank lender if he can get it," Eitelberg says. "This is when you can't find money, but you've got deals to do and do not have the capital structure to do it."

In the past, when money was cheap and plentiful, it seemed that in addition to ready credit, there was always somebody looking to buy into companies with solid cash flows and good prospects. This, of course, meant that the existing owners had to give up a piece of their enterprise. But with the growth horizon seemingly unlimited, that often seemed a small price. These days, not so much.

Those Skittish Equity Investors

"Some could turn to equity deals," says Wujtowicz at InterOcean Advisers. "But some private investors who have shown some interest in metals in the past are very skittish these days. They still don't know where things are going."

"People are looking to do private placement lending, but it is expensive, says Peluchiwski at Houlihan Lokey. "It may cost 10-plus percent plus an equity position in the business. But you as an owner have to make a decision whether to take that high cost debt because it saves your overall value."

But the high cost options, especially for those on the edge, work less and less these days, and when time runs out it propels owners into more drastic solutions. "So another option is a sale," says Wujtowicz. "Or the total liquidity of business. After all, they've got to try to

sell the business to someone who can do something with it, and in a couple of liquidations, it was very unfortunate, but we could not find a buyer."

Even so, the bankers say, not a few hard-pressed owners are considering moves they never had looked at before. "Adversity tends to drive change and we are seeing more interest in consolidations than we ever saw before," says Wujtowicz. "Even more typically we are finding one owner calling up another and saying 'maybe we should get together.' These tend to be in similar categories, flat rolls, or wide gauge or heavy gauge as opposed to a lot of product diversification. And geography is important too, if they can consolidate in one facility."

Some companies are also finding funds by selling their own offices and warehouses, and, as part of the deal, leasing them back at market rental rates. These days a sale-leaseback can be affordable and can free up needed cash. But it also means facing the uncertainty of being a renter instead of an owner. "They sell the building and stay in it," says Jane Robins, vice president at Arthur J. Rogers & Co., a Chicago, Illinois, real estate firm. "There is no interruption in their operations. They have the cash to continue operating and they don't have the capital tied up in the building."

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"We are seeing a lot of it. But it is a fine balancing act to see whether it makes sense," Robins says. "Obviously how bad you need the money is one consideration. But it may not make sense if they don't have enough equity or if they can't get enough money out of the building. In this market, investors may want to pay less. But we have seen it be a real lifesaver for some companies."

The Obama administration is trying to open the energy technology market even more with $2.3 billion in stimulus money announced in January to promote green technology and industry. It remains to be seen how that money will be spent and how fast. But with so many states in dire financial situations themselves, that money seems likely only to keep many local governments just above water, if that. "Over the next year, collapsing public budgets are likely to have a more negative impact on construction than credit availability problems for private developers," says Haughey at Reed Construction Data.

Some States Try to Step Up

There are modest state programs in Michigan and Wisconsin, among others, that create loan programs for creditworthy manufacturers looking to expand, become more efficient and go green. Most, however have been around for years and do not offer the level of support that would represent any kind of light in the tunnel.

There is a piece of federal legislation introduced by Michigan Representative John D. Dingell and a powerful handful of co-sponsors that in any other Congress would be promising. The Dingell measure would pull $20 billion from the Troubled Asset Relief Program, the one originally designed for bailing out big banks, and offer it to manufacturers as loan participations and collateral guarantees.

"We had a series of large meetings with businesspeople and Michigan corporations and they continuously complained about the unavailability of credit," said Dingell. "But there are mechanisms that would work if we are smart and this is one of them. It is patterned after a Michigan state program that has never had a loan go bad."

House Ways and Means Committee Chairman Sandy Levin, another powerful Michigan Democrat, is a co-sponsor, as is Financial Services Committee Chairman Barney Frank (D-Massachusetts). In years past, that would signal a speedy passage, at least through the House. In these times, as one seasoned congressman put it, the success of it is simply impossible to predict.

The same goes for a series of Obama proposed initiatives to boost the impact and effectiveness of the Small Business Administration. He has proposed as much as $30 billion in new loan guarantees, increased lending levels and other measures. But all of it requires Congressional action. And the only thing reasonably certain on fractious Capitol Hill in an election year is that none of this is going anywhere. "It would be like turning water to wine," said one highly placed congressman trying to push all of this legislation forward.

If the economy would recover strongly, a lot of these problems would resolve themselves. But it is pretty hard to find academic, economic or business folks who believe that will happen. "I think it is going to be a very slow movement back to full employment," says Hicks at Ball State.

And for the metals service industry? "I think it is going to get even smaller and that we could see a pretty dramatic wave of consolidation even with recovery in the economy," says Wujtowicz. "It is not a robust recovery."