Déjà Vu All Over Again?

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In our February 2006 edition of GFMI Educational ENews, we raised the subject of proper returns and structures for lenders and debt investors during a period of time when we were enjoying a mellow credit environment. We cautioned that one should avoid viewing the debt markets with rose-colored glasses, and appreciate that the cycle can swing -- and possibly swing wildly again -- as we had seen in the dark days of heavy defaults and weak recoveries in 2001-2002.

We don't mean to pat ourselves on the back, but the cycle surely did turn, and the blood-letting and red ink were worse during the past couple of years than in the earlier downturn. That's not to say that we are forever subject to a boom/bust scenario in the credit markets, but we need to be sanguine about the potential for changed conditions as we come out of the downturn and again dip our toes in the water. As we entertain term deals, what *specifically* should we be doing, to best manage these risks?

1. Trite as it may sound, *good credit skills don't go out of fashion*. Let's appreciate that the biggest failure in our analysis has always been an inability to realistically forecast the future. Do we believe those hockey sticks that issuers/sponsors present to us? It is not a game of simply playing with numbers (how much of a haircut is needed to be applied to those optimistic management projections?), but getting to understand our credits. KYC is not just an acronym that regulators throw around. KYC at its best is *in-depth due diligence*, and -- in fact -- often KYC turns into KYCC (Know Your Client's Clients)
2. Let's stick to our guns on *documentation*. Are we too quick to ease our standards on covenants, or not exercise the rights we enjoy by virtue of a tripped covenant? And, since when is change of control not a given?
3. Remember that *as the risk changes, so should return*. In earlier times, *pricing grids* were quite standard in bank deals; but we've seen examples that some of us may be moving away from that key feature. As we commented back in the '06 article, focusing on protecting our risk/reward trade-off should run a close second to our due diligence requirements.

The Office of the Comptroller of the Currency (OCC) has referred to an old adage of: "the worst of loans are made in the best of times"[1]. The corollary to that of course is that the best of deals are often made in the worst of times.

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Maybe it is time to go back to the 10 Basics of Credit Analysis:

1. Meet the highest level of management you can. What is their strategy? Does it make sense? If it's a small private company, meet with the owner as he/she will usually be the CEO, COO and, quite possibly, also the CFO (not a good sign). Entrepreneurs love to talk about their companies and, if given the chance, will chew your ear right off. A wealth of information can be gleaned in such a meeting. If you are analyzing a Fortune 500, chances are you won't have the opportunity to meet the key decision-makers. However, even if you meet with the assistant treasurer, you can still obtain a wealth of information -- if you ask the right questions.

2. Look at the board: Are they: *Competent*? What is their field of expertise? Do they have related business experience or are they there for window dressing? *Commitment*? What is their obligation to the company? Is this just one of 15 boards that this member is on? *Compensation*? How is the board paid? In cash, shares or both? If it's only equity, will their judgment be clouded?

3. Do your homework! Before meeting with the company, read the annual report including the Chairman's statement. Read *between* the lines. Also, read those very boring footnotes. This is where the detective work really pays off. There are jewels of information tucked away in the footnotes.

4. Be wary of lofty financial terms. "Proforma, core earnings, economic earnings, special one-time charges." Companies can have substantial latitude in the use of these terms. Are those one-time charges *really* one-time? If you are unsure, add back the charges to see what the real earnings would have been.

5. Analyze the cash flows! Profits do not pay a single creditor back. Cash does. EBITDA -- while one measure of earnings -- is *not the only one* to look at.

6. If looking at the long-term, **create a set of meaningful projections**. Management is always optimistic about the future of their business. Temper the key variables to show what *could* happen in a real worst-case scenario.

7. **Watch the company's share price**. While a high share price can give you some comfort, the stock market can be brutal and send the share price to depressing levels within a day. A low share price can be very indicative of bad news.

8. **Kick the tires**. Take a tour of the plant. Do the workers seem happy? Is the plant clean? What is the safety record? If you don't have the opportunity to visit

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the plant, then what is the office environment like? You can glean a lot from the office ambience. How does this reflect upon management?

9. **Review the industry and the company's competitive position**. How does your company stack up against the competition in terms of gross margins, turnover ratios, return on equity, etc.? If they are clearly ahead of the competition, then they are either doing a terrific job, or, they may be hiding something.

10. **Stay on top of your client**. Don't file away all your fabulous research and never look at it again. While sometimes a menial chore, the figures should be *updated at least quarterly* (if you have access). This is a good time to ask questions, especially when the ratios start to move in the wrong direction.

Remember the basics. Dig, dig, and dig. Ask a lot of questions.

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[1]2005 Survey of Credit Underwriting Practices National Credit Committee, June 2005