

Protect Your Assets with Due Diligence

By Howard A. Rein and Harvey Nachman

The most successful deals are those that have a predetermined exit strategy in place before closing.

In this fast-paced world of new loan competition (formerly excess liquidity—currently wild volatility), sales, mergers and acquisitions, due diligence is often viewed as a stepchild to the anticipated increases in asset values and fees to be generated. In reality, due diligence is required to protect your assets. Without proper due diligence, potential gains can vanish as quickly as profit hype appears.

In most situations, two groups of outside professionals assist with due diligence: field examiners and turnaround professionals. In addition, an internal new loan/acquisition management team is normally created to define the profit opportunities and to delineate the risk factors.

Of the external providers, field examiners work primarily for lenders reviewing a borrower's books, records and collateral position. Their primary interest is in the value of the collateral itself, the performance of the collateral and how collateral reporting occurs. Included in this evaluation is understanding what the lending process entails and, most important, what the integrity of the collateral position is. From a field examiner's perspective, the focus of due diligence is on the accounts receivable and inventory as collateral to the loan facility.

Appropriate due diligence can be determined by the loan's position on the lending timeline. Every lending transaction can be placed somewhere along this line. For a new credit about to be booked, the due diligence is called a preloan survey. For an existing good credit, the normal due diligence is a rotational collateral exam. As the customer relationship matures and conditions change, lenders must determine if a borrower is showing early warning signs of trouble or, in the extreme, is about to file for bankruptcy protection. What examiners and audit

professionals will do with a given borrower depends on where the transaction is positioned along this lending timeline.

Under normal circumstances, financial due-diligence surveys and rotational field exams have three primary goals:

- To identify risks
- To provide solutions if underperformance or serious trouble is suspected
- To check for business disconnects and financial data mismatching

Identify Risk

Financial due diligence aims to identify the risks: the risks in the reporting structure; the risks in the financial statements, both balance sheet and income statement; and the risks inherent in the collateral. Trends assist in evaluating which way these risks may be heading. Analysts should determine whether conditions are improving or getting worse and should make meaningful recommendations as to how to deal with the changes.

Provide Solutions

The second goal of due diligence is to provide solutions if underperformance or serious trouble is suspected. In most cases, once a transaction starts to show signs of trouble, turnaround professionals are called in for assistance. Turnaround professionals

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perform due diligence (usually called an assessment) in order to analyze the viability of management and management's financial plans. The turnaround manager must determine whether or not a core business still exists, whether or not there are adequate funds available for a turnaround and whether or not internal management is up for the challenge. Management often has a plan that it would like to implement but that requires an additional infusion of lender funds. The lender or private equity group wants to know whether additional funding is worthwhile or an infusion is merely good money following bad.

Workout assistance can take many forms depending on whether the workout is hostile or friendly. This usually comes down to the character issue. The former chairman of the Commercial Finance Association (CFA) and CEO of Sunrock Capital, Walter Einhorn, once said, "In determining how a troubled loan plays out, follow this process: determine if the lender is a balance sheet lender or a character lender and then define whether the borrower has character or is one." In most instances, only the borrower who has character and the lender that understands this relationship will try to effectuate a turnaround. If this test does not convince you, prepare your Plan B liquidation scenario.

A loan that resulted in a call to a turnaround professional within 60 days of loan origination shows the importance of the character issue. The funds were loaned to enable the borrower to acquire two garment firms simultaneously. The accelerated lending process lacked adequate due diligence. Within a week of being engaged, the turnaround manager discovered that the fabric trade was already past due, that one plant was about to have its backlog canceled and that the borrower had previously been forced to file both a business Chapter 11 and a personal Chapter 7. Within 45 days, the trade filed an involuntary Chapter 11 against the firm. Had the due diligence been more thorough and the timeline less condensed, this loan would never have been originated or closed.

Spot Business Disconnects

The last test is to check for business disconnects and financial data mismatching. Any questions that the borrower cannot answer satisfactorily could require

a forensic accounting exercise. The most extreme forms of forensic accounting could involve litigation. A fraud investigation involves an actual or suspected larceny committed by a company upon a lender. The magnitude of the perpetrated act will dictate the scope of procedures. Often, there is confusion differentiating between forensic accounting and a fraud examination. The difference is simply the allegation of fraud. Forensic accounting is the search for answers to unanswered financial questions. Usually procedures involved with a forensic examination also apply to a fraud investigation, but there is no allegation of fraud.

Determine Exit Strategy at Loan Origination

Asset-based lenders and private equity firms (including hedge funds) want to know how they are going to exit the transaction and the financial impact of exiting under duress. Clearly, perfection of a security interest in the underlying collateral is an important consideration. In addition, an analysis of the ability to foreclose should be a part of the due-diligence effort. The ability to foreclose and the cost of foreclosure are important considerations and become determining factors in establishing advance rates for receivables and inventory.

Liquidation costs are usually built into advance rates. Reporting involves many things: borrowing base certificates, receivables aging, payables aging, perpetual inventory analysis, inventory reports, interim financial statements and year-end audited financial statements.

It is imperative that any lender understand the borrowers' collateral. Lenders should know the value of their borrowers' assets both as a going concern and under scenarios of orderly or forced liquidation, their risks and exposures. When they ask direct questions, they should expect to get direct answers. Vague or inaccurate answers are a clear signal to be on guard.

Red flags or early warning signs are often visible to the trained eye. The classic warning signs include deterioration of earnings, deterioration of margins (lower gross, higher SG&A, or selling, general and administrative expense, costs), aging payables and

continued on page 48

electricity or not. Gordon commends Edison for two great inventions: the electric power system (necessary to light his lightbulb) and “perhaps his greatest invention of all, the industrial research laboratory,” with Edison’s Menlo Park the first “invention factory where engineers, chemists, and mechanics turned new technological possibilities into practical—and, most important, commercially

viable—products.” It may be that this latter invention, the modern collaborative research facility that has replaced the individual tinkerer, is Edison’s most lasting legacy. Perhaps that number-9 ranking on the list of most influential Americans is an appropriate recognition for this contribution, not to mention the other by-products of Edison’s inventive genius.