Links Capital's Perspectives

Communicating with your Bank

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Almost every business at one time or another enters into a banking relationship where they have a line of credit or some kind of term financing with banks. From a cost of capital perspective, debt is the least expensive capital that one can attain and should use appropriate amounts of leverage in running their business. Banks are an important partner in the growth of any successful business and must be treated that way.

Most companies enter into a debt relationship with their bank in which the bank will advance capital based on the security they take on from the business. Operating earnings are very important but if you don't have security (accounts receivables, inventory, land, buildings, equipment other cash equivalents) the bank will be reluctant to enter into any banking relationship with the company.

The bank will generally take the first charge on all the assets in the business and will place some operating covenants along with required monthly reporting which may include an accounts receivable aging report, inventory listing, income statement, balance sheet, and covenant analysis. Current assets support the operating line of credit and are generally liquid assets; therefore, the bank will scrutinize these assets more closely as there is more risk that the value of these assets will change.

Dealing with Banks

Generally, a business's operations are not linear: the business moves up and down with the economy. Banks pay particular attention to trends in the business and so should the business owner. As a company evolves an astute management team will understand the changes that the business is experiencing well before the bank does.

I have encountered far too many business owners who are reluctant to share their knowledge with their bank. A statement I have heard many times from business owners is, "We are still going to be within our covenants, why should we tell the bank that?" Remember, the bank is your partner and not a necessary evil, so this is a relationship that you should be cultivating, not ignoring. As the business grows or declines you are likely going to have to rely, in one way or another, on the bank's support. Just because you are within your covenants with the banks doesn't mean that your bank doesn't see what is going on in the business. You are not the bank's only client and a luxury the bank has is the ability to see what their other customers in similar industries are experiencing, which can be positive or negative.

The advice on reporting is that the company should not only provide the bank with the required financial information, but also get into the routine of writing a quarterly management discussion and analysis (MD&A) on the business and providing that to the bank. MD&As are requirements of public companies that must disseminate information to their shareholders. Our suggestion for MD&As for your bank is not to go to the same detail that is required by regulatory bodies for public companies, but to develop a format where you can constructively look at what is relevant to your business so you can discuss what is going on and relay that information.

The narrative should be written through the eyes of the management team. When management takes time to sit down and make this kind of analysis, they will see many benefits. It also reinforces to the bank that you know your business and are constructively thinking about it.

Links Capital specializes in the divesting and financing of businesses in the Canadian middle market.

Links Capital's philosophy is to preserve value throughout the entire transaction process. Senior partners handle all aspects of the transaction from inception to close and beyond, maximizing proceeds.

Being experts in private equity markets and corporate finance enhances value to our clients through extensive buy and sell-side experience.

NORSEMAN

A manufacturer and distributor of industrial foam and fabric products along with their retail camping division, has completed a

Term & Subordinated Debt Financing & Private Equity Buyout

Links Capital acted as financial advisor to Norseman Group Ltd. in management's Private Equity Buyout Financing

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Communicating with your Bank

Links Capital are specialists working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses

When compiling information to be discussed on a MD&A the following are some of the items that could be considered:

- Revenue analysis
  - Product or service line performance
  - Gross margin analysis (product/division)
- Changes in accounts receivable/payables
- Inventory changes, slow moving inventory
  - Inventory turnover
- Changes in customer and supplier relationships
  - Pricing changes
  - Backlogs
  - Lead times
  - Volume requirements
  - Changes in contracts
  - Bad debts
- Liquidity position
  - Working capital requirements
  - Cash flow analysis for next 12 months
- Forecasts and budgets
  - How variances impact the business
- Sustaining and growth capital asset requirements
- Potential threats to the business, micro and macroeconomic
  - Regulatory changes
  - Compliance requirements
- Changes in competitor landscape
- Dealing with seasonal changes in the business
- Any key performance indicators
- Future projects or goals set by the company
- Warranty issues
- Labour requirements and key employee changes
- Environmental concerns
- Technology upgrades or requirements
- Risk strategy
- Risk of potential litigation
- Potential new shareholders/partners
- Intellectual property changes
- Any other risks to the business

Providing a report of such nature may be far beyond the scope of what the bank is looking for, but, realistically speaking, those businesses that look at this kind of information regularly and do the analysis have a better handle on their business than those that don't.

Sometimes it doesn't matter how good the management team is, a business may be subject to breaking their debt covenants with the bank. When a covenant breach occurs, the bank looks at both the management team and the business before deciding on the best way to handle the situation.

Consider the situation where management provides lead time to the bank that they are likely going to breach the debt covenant in a few months, compared to the management team that is informed by the bank that they are likely to breach covenant. Believe it or not, account managers at banks never like to be surprised – especially when it is a negative surprise – as it brings into question within their organization how well they know their clients.

Developing communication channels that show how well you know your business goes a long way in dealing with your bank when it comes to covenant breaches, debt renewals, bulges in operating lines, relaxing of covenants, improved margining, and permanent increases. Spend the time, develop a structure for reporting, and have a disciplined approach to provide valuable information to your financial partner quarterly. Taking this step forward will help position your company in the most favourable light with your financial partner.

Links Capital Partners is a professional firm focused exclusively on selling businesses, raising capital and assisting our clients acquire businesses. Links Capital are specialists in working with private equity firms, institutional investors and strategic purchasers in raising capital and divesting of businesses.

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