Credit Risk Ready Podcast

Host Linda Keith CPA With Bill Conerly

A Business Path Through the Recession

Hi, this is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators and banking advisors to better understand and mitigate credit risk.

In this episode, Bill will walk through an example of how a company can and should evaluate current risks as we dip into this recession, and find possible paths through and out of it. Bill Conerly is a forbes.com writer. He has a PhD in economics and he is a business-focused economist. You can read more about Bill in the show notes.

Welcome back, Bill.

Bill Conerly:

Great to be with you.

Linda Keith:

So, here we are going down the recession path and the bankers that are listening want to be able to assess whether the steps that this business is taking are the right ones without the banker actually knowing the answer. Could you help us with what that might look like?

Bill Conerly:

Well, I was working with a company recently, and let me just walk you through that. The first step was to understand the business. And the company I'm thinking of was a manufacturing company, but the same process works in any case. And in this particular company, sales occur a long time after a deal is signed. So, they're making products for commercial and industrial construction.

And, if you think about that, by the time you see a crane up for a building, there were plans that were developed, there were permits, there was financing in place, so the sale of the actual stuff in the building may occur a year or two after a contract is signed. That can happen anywhere. If it's an ice cream shop, decisions are made one minute before the sale, or maybe 60 minutes, if it's a destination ice cream shop. But, keeping in mind those time lags is important. But then, when I sat down, the business owner was saying, "What the heck?" only heck was maybe not the word.

Linda Keith:

Still four letters, start with an H.

Bill Conerly:

Or other letters, but a little bit shell-shocked. And my first thought was, "Let's figure out what's a worst case."

Linda Keith:

Why was he feeling shell-shocked? What had just happened that pushed him into that? Was this a time when we were going into a recession or is this right now?

Bill Conerly:

This is right now.

Linda Keith:

Ah. Well, that would be shell-shocked, then. Absolutely.

Bill Conerly:

Pandemic lockdown. The company had been through recessions in the past. The leadership had been through recessions in the past, but this looked totally different.

We've got a shell-shocked leader and I want to see worst case. I like to look at historical data. And even though this recession is different from the others, I use this as a model and there are, in some cases, company data and the 2008, 2009 recession was pretty bad. So, knowing how sales dropped in that recession is valuable. I also looked at how the industry had done through past recessions. And you can get a list of past of business cycle dates, and if you've got industry data, look at that. But, it's not so important to get it precise as to get a magnitude. When this industry goes into recession, is it down 10% and sales are down 50%?

Then, what I suggested was that they sketch out three business plans, one for worst case, one for two-thirds of worst case, and one for one-third of worst case. They had in place a business plan that had basically the same economy, that was the pre-pandemic business plan. So, use that and you have three worse alternatives.

Then I said, "Are you profitable? And what will it take to be profitable?" Sales go down, raw materials costs go down. And that's true of a manufacturer, restaurant, but service businesses tend not to have much in the way of raw materials. So in many, many cases, it all comes down to staffing. I shouldn't say it all comes down to staffing, but staffing for most companies is the most important variable expense and also the most heart wrenching, emotional expense. If you're cutting back on your purchases of plywood, not a big deal. If you're laying somebody off who's been at your company for 20 years, that's a big deal.

When I was writing that book, Businomics, there was a section on how to get through a recession. So, I got on the phone to my friends in the banking industry who have a lot of experience. And I said, "Hey, what's the difference between businesses who get through a recession and businesses that do not get through a recession?" Their answer was very consistent: fast response. The businesses that delay cuts, delay change, were more likely to fail than those who took action promptly.

Linda Keith:

Well, let me ask a question about that because, during the recession, I know that I kept staff on longer than it turned out was a good idea, but it's so easy to see that afterwards when we realize how bad the recession got. One of the things that was happening was that, as I was making that decision month after month after month, I was having trouble with how soon will it come back. And I remember at one point, my husband actually said, "Linda, is there any stop button to this? Could you pick a dollar amount that you're not willing to go into debt more than that to keep this going?" And that actually was a helpful concept, was to say, "What is the stop button for you to not continue to keep staff?" or some of the other things that you're doing initially because you are counting on things turning around a little quicker.

Bill Conerly:

Certainly not easy to know, but I believe I have never met anybody who laid off workers too soon. Just like I've never met anybody who fired a poorly performing worker too soon. So, it just really doesn't happen very much.

One question that I asked in this project I was working on, was I said to the owner, "Your employees, are they all keepers?" That is, are they all people that you would want to have if the economy rebounds quickly. You know, there are a couple of problem cases in most companies. This is a good time to cut those.

Linda Keith:

Is that a good question if the banker is having that sort of conversation? I mean, I know you need to be careful as a banker not to lead them down a particular path, but that kind of question might get your borrowers thinking, but would it be too... I don't know, aggressive of a question?

Bill Conerly:

The way I would phrase it, I would play with something like this, are you thinking about staff reductions? Are you thinking about getting rid of the worst performers first? Or are you thinking about across the board? If you get to the point where you've gotten rid of the worst performers, are you now thinking of furloughs where people work four days instead of five? Or are you thinking of layoffs? Just ask a lot of questions without trying to lead down a particular path because the banker is not in the best position to know what the business should do.

Linda Keith:

Sure. Sure. And if the business owner thinks the banker is acting like they are, that wouldn't be good for the relationship.

Bill Conerly:

That's right, and I think there are some legal challenges as well if the bank is trying to dictate it. But, these three scenarios of worst case, two-thirds, and one-third worst case, or you could do other levels of magnitude, assessing profitability and cash flow, can the business cover its obligations? Many borrowers kind of forget about loan covenants.

When they signed the documents, page after page after page, and maybe they passed their financials on to the bank or maybe they forget and the banker hasn't asked, but there are loan covenants in most business loans. And the business really ought to know whether in these different scenarios it would be in compliance with the covenants. Let me tell you the question, Linda, that I recommend businesses ask their banker.

I do a lot of speeches to industry associations, business people, and I say, "Hey, talk to your banker and ask, 'How far are we away from the line of bankable versus not bankable?'"

I know it's not really a sharp line as much as a gray area, but suppose the economy goes down and the business is at one-third of worst case, would the bank be calling the loan or would the bank be saying, "Hey, we love you." And I also recommend that for businesses that do not have a bank line, talk to a banker and say, "Hey, what would it take for me to be bankable?" Even if you're not planning on borrowing money, it's a good conversation to have.

Linda Keith:

Well, and that means that the listeners that are bankers on this Credit Risk Ready podcast, perhaps they should be ready with some answers to those questions.

Bill Conerly:

Yeah. Be ready to think it through. And that's why I kind of like the old fashioned banks where there are people, human beings, who actually understand credit analysis, as opposed to credit analysis as something where numbers go into a computer and a computer makes the analysis.

Linda Keith:

Right. Well, as you know, I train loan originators. And one of the things I'm always telling them is it makes sense when you start out that you're at the level where you can only put numbers where they belong, but you have to move from that as quickly as possible to where you can actually understand the story behind the numbers. Ask questions, spot red flags, resolve them if necessary. So, we all start out with fill out a worksheet, but they need to know that is the bottom tier of their skillset, and not only do I want them there, but because the banks are sending them to me, their banks want them to move beyond the number-crunching as quickly as possible and be able to bring judgment, and bring good questions to the table.

Bill Conerly:

Right. Right. Absolutely. I recommend recession contingency planning, and at this point, we're in a recession and the ideal time to have done the contingency planning was before the recession. I hope that advice is useful to people.

Linda Keith:

But also, even if they did it before the recession, you need to look at that plan that you had and see if it even works for the recession we're actually in.

Bill Conerly:

Yeah, because this is a very different recession. But, what I did to develop the framework for a recession contingency plan was I kind of looked at generic business financials. You start going through line by line. And this is to address the question of, is this business going to be profitable or going to survive through various levels of recession? We've talked about staffing, but it's valuable to talk about the lease expense, rental expense, just go line by line through the expense statement. What's going to fall down automatically, like raw materials, purchases, what's going to have to be cut, and what just simply cannot be changed.

Linda Keith:

In budgeting we call that variable budgeting, right, where you're budgeting for these different levels, so it's the same concept. One of the things that some of the bankers have with their small to medium-sized customers is they don't have really wonderful CPA prepared and reviewed financial statements. So they have to do the same thing using the tax returns, and those tax returns don't necessarily identify variable versus fixed costs, and even optional versus non. So, the banker really does need to look there and say, "Well, they could cut back this training or charitable contributions, or even maybe some advertising right now", or maybe on the other hand, "Boy, this is a business that would really need to do advertising because of the geographic area they're in or the sector that they're in. Their customers need to know they are back." So it definitely would take a pretty sharp pencil to go through and try to assess, not only from the business standpoint, but now the business gives their banker something, and now the banker needs to bring an independent viewpoint to it and ask themselves, "Is this business making reasonable decisions?" Not to tell the business what to do, but just to assess whether what the business is now projecting still seems to be reasonable.

Bill Conerly:

That's exactly right. Linda. And in this environment, I think the businesses that survive will have a good understanding of their financials.

That doesn't necessarily mean a CPA on staff, but people who are watching the numbers. Some people love the sales. Some people love the production. Not a lot of people really love the numbers, but in this recession, the businesses that survive will be those that are looking at the numbers. If I'm a business loan officer and the owner doesn't seem to be in touch with his data, with what his costs are, what his revenues are, doesn't understand them very well, I would get nervous very fast.

Linda Keith:

Right. And nervous lenders don't usually extend the operating line of credit or do those other things that the borrower hopes they will do.

Bill Conerly:

We talked about the banker not dictating to the business what to do, but the area where you might want to do a little bit of dictating is spend more time with your numbers, understand them better, and pay attention to them.

Linda Keith:

Well, and the way to do that, I would think, is as a banker, ask them questions they can only answer if they do that. So, even if you aren't telling them you have to spend more time on the numbers, but you might say something like, "I do know your operating line of credit will be coming up for review in about two months, so here are the things I'm going to want to know as we discuss that." Right?

Bill Conerly:

Right. Right. Right.

Linda Keith:

And now the business owner knows, actually. It gives them some confidence that the things they're looking at are the things you are going to want to know. I'm quite certain that the business borrowers are not looking forward to a phone call from their banker right now because they're worried about what their banker is about to do.

Bill Conerly:

That's right. And we tend not to make the phone calls that we worry about what is going to happen, just like we don't like doing performance reviews.

We're afraid of them, but people end up feeling better afterwards, maybe just because it's done. But, the important lesson here is we cannot delay conversations because they may turn unpleasant. We have to have the conversations. And 99% of the potentially unpleasant conversations turn out not to be unpleasant.

Linda Keith:

Right. Or at least, you know where you stand when the conversation's over.

Bill Conerly:

Right. And you're not doing a service to the business if you delay giving bad news and the business. I tell my clients, the business is not doing itself or the bank a favor by delaying delivery of bad news.

Linda Keith:

Exactly. Exactly. And hopefully, there's some good news in there. I know that when I... I've rarely had to deliver bad news. I'm a real estate investor, my husband was a contractor, so I was sort of the CFO for that company as well. So I interacted with bankers a lot and there were times when they would ask something and some of the answer was positive, and then some of it was something had gone wrong or there was a delay in getting some construction done. And I think they would have been suspicious if every time they asked me a question, it was always good news. Right? Because it's construction after all. Right? But I also wonder, going back to the work that you have been doing with this manufacturing client in helping to respond to that shell-shocked feeling with giving them some specific things that they can do, once you really have looked at how bad it can get, doesn't that often make you feel a little bit better because at least you're working with some knowledge, instead of just the fear of what could go wrong?

Bill Conerly:

Exactly. If a company has looked at a worst-case and says, "Yeah, it'd be pretty ugly, but we could survive that." Then, they can start thinking about the future, thinking about where do we have strengths relative to our competition? How can we come out of this ahead? And that'd be a great topic for another conversation.

Linda Keith:

Well, and I think that we will have that conversation because I do like to be optimistic. So, at this point, what it sounds like is, it's time to dust off the recession contingency plans if you did have them. If you didn't, it is high time for business borrowers to be looking at what's the worst that could happen and what would we do in several scenarios, so that by the time they speak with the banker, they have some specific ideas of what their plans are. Then, it's time for the banker to be thinking about what are those questions that we should ask that actually will help our business borrowers work through this process, and come up with a plan that works for them. If it turns out that we need to restructure a loan or consider an expansion of some of the lending that we'll get the questions we need then because the business borrowers are asking themselves upfront.

Bill Conerly:

Sounds good.

Linda Keith:

Sounds good. Bill, thank you so much for walking us through this case study. Your manufacturing company is certainly not the only one that's shell-shocked. We are all shell-shocked, and yet, we also can walk each other through this recession together.

Bill Conerly:

Together.

Linda Keith:

Thank you, Bill.

Bill Conerly:

Thanks, Linda.

Linda Keith:

Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound. Take care.

About Bill Conerly

Bill has a Ph.D. in economics and over 30 years applying economics to business challenges. He worked for First Interstate Bank rising to the level of Senior Vice President and has held positions in economics and corporate planning at two Fortune 500 corporations. And for the past 10 years he has consulted for companies large and small, helping them to make better decisions through a better understanding of the economy.

He writes for Forbes Magazine and is the author of two books.
The first is 'Businomics: From the Headlines to your Bottom Line -- How to Profit in Any Economic Cycle."

His most recent book is 'The Flexible Stance: Thriving in a Boom/Bust Economy." He is also a member of the Oregon Governor's Council of Economic Advisors.

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Links to books:
Businomics: From the Headlines to your Bottom Line -- How to Profit in Any Economic Cycle.
https://www.conerlyconsulting.com/writing/businomics/, also available on Amazon.

The Flexible Stance: Thriving in a Boom/Bust Economy.
https://www.conerlyconsulting.com/writing/the-flexible-stance/

Newsletter (free): latest issue, plus option to sign up:
https://www.conerlyconsulting.com/writing/newsletter/

About Linda Keith

Linda Keith CPA draws on her 30+ years of experience consulting with and training lending institutions, background in public accounting, 15+ years as CFO of the family residential construction company, experience as an Examiner with the Washington State Auditor's office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say “Yes” to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a move afoot to change the 'P' in CPA to stand for 'Playful'. The fact is people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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