WISE BORROWING

Apple Inc., which was reported to have $245 billion in cash on hand at the end of the first quarter of 2019, also showed about $122 billion in debt. If Apple has—or chooses—to borrow, it's certainly no shame if your company borrows as well, if done wisely.

Borrowing needs depend on factors including capital needs for facilities and working capital to manage seasonality of production and sales. If a company makes products that require buildings and equipment, it will likely need long-term debt. Likewise if business is seasonal in terms of either production or sales, it's not unusual to require a line of credit or similar short-term credit facilities.

Awhile back we met with a prospective client who needed assistance with cash flow forecasting, a common request. They had recently completed a debt restructuring and now had a number of bank covenants they needed to hit by the end of the year. Frankly, the forecasting should have been done before the loan agreements were signed.

As they spoke we must have been nodding our head a bit too much while taking notes because at one point the prospective client said "I take it you've seen this before, right?"

We proceeded to chat about how easy it can be when times are good to use both profits and short-term financing to launch into the next long-term project or asset acquisition. Then when profits slow down and the operating line is maxed out, there are really only three options: sell something off, have ownership inject capital, or restructure long-term debt to pay-down the short-term debt.

The match between the need and the loan is critical. An operating line of credit for normal working capital and seasonal needs is fine. Cash is an input as much as labor or parts and it has a cost (interest) like any other input. But if you're using your operating line to acquire long-term assets, you've mismatched short-term debt with a long-term asset and you might be headed towards a debt restructuring or capital call.

Use long-term debt when acquiring long-term assets. This may seem pretty basic but is often overlooked in the zeal to proceed with a new project. Short-term interest rates can be attractive, but they are also variable. In a time of rising rates you could get caught with high debt service costs. Instead, look at fixing your long-term rates and get loans with a low (or no) pre-payment penalty to give yourself options later if you need them.

If you find yourself in a tight spot with a maxed out operating line, but you have good equity in your long-term assets, you can probably restructure your debt, pull capital out of your long-term assets and pay down your operating line. This is fairly common "get-out-of-jail" maneuver, but it's not "free"; expect to receive a good kicking when it comes to loan fees on the new debt.

We have worked with many companies that have found themselves in challenging lending situations, ranging from relatively small and new businesses to well-established companies approaching a billion dollars in sales. The situations range from those who've encountered unforeseen (though not necessarily unforeseeable) difficulties to those planning out debt needs and covenant compliance before finalizing agreements and starting projects.

Planning certainly comes with challenges and costs but it will spare you a lot of pain in the end.

A FEW TIPS:

- Before entering loan agreements, plan your needs and repayment scenarios under a number of assumptions, optimistic and pessimistic. Match your needs with the right loan facility and length of term.
- There are different functions within a lending institution including sales, relationship management, and analysts. You might meet all of these, but there are others you may not meet directly including legal counsel and people higher up the loan approval chain. That's where a lot of the hang-ups can occur and it's important to anticipate and explore those needs as early as possible.
- When the negotiation of new landing arrangements gets serious, a lending institution may require you to sign a mandate requiring that you negotiate solely with them during a set timeframe. This is understandable given the work that can be involved but you should be reasonably certain they are the right match before doing so.
- Larger deals may require syndication, the joint participation of two or more lending institutions. This can be due to regulatory or internal lending limits and is perfectly acceptable but does add another layer of complexity.

Morrison's Brent Morrison and Geoff Chinnock provide services to Morrison clients primarily in the areas of business planning (including budgeting, cash flow forecasting, and financial modeling), feasibility studies, interim controller/CEO/CFO services, and special projects. You can contact Brent at bmorrison@morrisonco.net, and Geoff at gchinnock@morrisonco.net.