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Opportunities for quality business clients in Australian Banking……Strategies for the rest

Since the fall-out from the US-led credit crunch commenced late last year, Australian banks have commenced a full review of the quality of the clients they currently have loans out to. At the same time, we have seen banks taking the opportunity to reassess the price which they lend money to their clients. This process generally occurs during its "annual review" of the client.

In the main, these price rises are warranted because the price the banks pay to borrow money has also increased. In addition, we have seen banks employ a risk based pricing model more in their favour as the cut throat pricing offered by the banks for new business during 2006 and 2007 became non-existent as conservatism increased and credit availability eased.

Research firm East & Partners in its July, 2008 Research Note "Emerging from the Credit Crunch" noted that 54% of business with a turnover or $1 to $100m pa expected less access to credit due to the credit crunch. In the $1 to $5m pa turnover range, expectations of 84.3% of these businesses were for less access to credit. In all, business' views on future growth are positive, but their nervousness on how this growth will be funded is of concern.

Obviously, this provides a huge opportunity for the banks looking to lend to quality clients, but what is the opportunity for the client?

Quite simply, quality clients (and those that best represent the scope and value of their business) will be back on the front foot. Banks will seek out these clients to the detriment of some of their more riskier clients.

Since the end of 2007, we have seen an increased demand for our services to represent business clients going through "annual review" processes with their bank. In the experience of so called quality clients, banks are no longer offering increased loans at discounted pricing. On the contrary, in most cases they are demanding:

- Increases in pricing (margins) to offset higher funding costs and comply with their risk pricing models developed by "Head Office".
- Faster debt repayment as security values decline or at best stagnate.
- On the rare occasion, advising it would be in the best interest of the client to change banks.
- More and more terms and conditions imposed on the client particularly by way of financial undertakings (covenants).

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The first 3 points have obvious implications to cash flow. The final, whilst not immediately evident, lessens a business owner's control over their own business as they are forever reporting to the bank and ensuring they comply with the bank's covenants. This imposes enormously on the management time of the business owner and effectively keeps their eye off the strategic end of the business.

We have had substantial success being on the "same side of the desk" with the client during "annual review" negotiations in respect to on-going provision of lending facilities. I have always said, in tough times bankers travel in packs, supporting each other in delivering unpleasant options to clients. The power is no longer with the majority of customers and so it is a lonely side of the table they sit when discussing these options with their bank.

What to do?

<u>Quality Clients</u>

You know who you are. Your modus operandi is:

- always operate your banking facilities within limits;
- never "bother" the bank;
- generate strong cash in your business to support debt repayment and future growth of the business

note here the distinction between cash and profits – cash repays interest and principal and supports business growth – profits don't!

- in the main, the bank holds stacks of security not only in your business assets, but also personal bricks and mortar assets.

<u>The Rest</u>

Hopefully, these clients are now obvious.

I'm not saying "The Rest" are complete duds. They just need some guidance to:

1. Better represent themselves as striving for quality
2. More appropriately structure their cash management processes in their business
3. Properly structure the banking facilities available to them.

There is one more class of bank customer and they are the ones "teetering" on the edge of survival. Strategies for these businesses are significantly different and are not considered in this paper.

As the banks start acknowledging the Quality clients, the power will quickly revert back to those businesses. We have recently come out of a period which gave huge pricing advantage to the customer. These clients should utilise their position by:

- Properly negotiating a reasonable price increase – not be forced into the ambit claims raised by the bank.
- Trade off price rises for more security or greater covenants – the opposite applies here too!
- If the bank demands are unreasonable – look elsewhere. The power is with Quality and therefore these businesses will be courted by other banks.

For those considered to be "The Rest", your job is much more difficult than it has been over the past 5 years or so. Threatening to move banks is no longer possible (and may worsen your position in the near term as your current banker calls your bluff).

These businesses really need to look at the risk they represent to the bank in terms of financial position and utilisation of debt facilities. We would suggest the following strategies:

- Review existing debt structure. Are you always outside you arrangements (ie over your limits)?
- If so, is the cause lack of properly structured debt or poorly managed cash flow?
- If cash flow is the issue, manage your business to improve cash – or bring in someone that can do it for you.
- Request the reasons from the bank as to why your pricing is increasing. If your business risk has increased, ask the bank what can be done between now and next year to improve the risk and reduce the price.

Clients and banks alike need to remind themselves that the relationship is a partnership throughout all economic cycles. If over the past 5 years, you have moved from bank to bank to chase a percentage point or so, don't expect any loyalty from your current banker.

On the other hand, if you have demonstrated loyalty and have generated a sound relationship with your bank over a number of years, you have every right to expect commitment from their part.

The unfortunate thing about banking nowadays is there is little experience at the management ranks in dealing with "The Rest" in tough times. Our last tough period was over 15 years ago – a time when bankers understood their clients and were prepared to go into bat for them when the tide went against them.

We are in a period of significant management inexperience at the coal face in the Australian banking sector. Our role in conjunction with our clients is to "educate" the banker to more properly assess risk in a more commercial sense – not just as a margin grab because the power has shifted away from the client!

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