Lending to Contractors: Evaluate Performance Risk of All Contractors *Carefully*[1]

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Most commercial bankers understand why it is important to carefully evaluate performance risk when lending to building contractors. Yet, many lenders do not realize that performance risk also arises when lending to other types of contractors, such as school bus operators, job shops, high tech vendors and many types of service companies. Lenders must learn to identify a borrower whose business has performance risk and then act accordingly.

Borrowers with performance risk are those whose work must be completed before payment is received. Even specific goods have been shipped or actual services performed, the accounts receivable arising from activities governed by formal contract can be offset by the account debtors if the work remaining to be done is not completed. This risk is compounded when accounts receivable is the only significant asset owned by this type of borrower.

In most workout cases, lenders are reluctant to take over and complete the contracts because of such negatives as significant operating losses or lender liability. Therefore, account obligors may claim damages for business interruption caused by the contractor's failure to terms. The incremental costs of pre-bidding work may constitute an additional counter claim.

Performance risk arises whenever there are long-term contracts with specific enforceable

terms or, similarly, long-term purchase orders calling for serial deliveries of goods and services at fixed dates and prices. The longer the performance period, the greater the risk. Because of the typically long performance periods inherent in building trades activities, most lenders and smart borrowers know that heavy financing of the contractor's current assets is extremely risky for both parties.

Therefore, good building trades contractors simply do not borrow—at least not steadily—against their accounts receivable. Instead, they use progress payments from the project owner. They recognize that banks holding marginal collateral (performance-based receivables) have extremely limited options if problems arise. Marginal contractors often lack the stature to negotiate progress payments and seek financing from unsuspecting banks.

Unfortunately, both banks and their customers in other industries do not consider how payments will be made if problems

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arise. Borrowers are optimists who do not think about business failure. Similarly, even the most sophisticated banks not only fail to educate their officers about performance risk, but surprisingly, fail to even incorporate performance risk assessment in their basic field examination procedures.

Inevitably, this mutual blindness leads to numerous instances where a bank provides aggressive financing and the borrower develops operating and cash flow problems. The bank then turns on the credit spotlight and belatedly discovers that their collateral fallback position is inadequate due to performance risk. At this point, panic ensues and additional poor decision- making inevitably occurs to the detriment of all parties.

How to Reduce Performance Risk

1. Recognize that significant performance risk arises in at least 60% of your commercial portfolio. Borrowers who represent performance risk include those:
   - Whose products are tailor-made for specific customers.
   - Whose dominant customers require predictable fixed-price deliveries.
   - Who undertake complex projects.
   - Who offer long-term transportation arrangements.
   - Who are involved in installation phases and customization.
2. Understand that the financing of a contractor's property, plant and equipment poses no special risks for either party.
3. Educate your contractor borrower not to seek steady working capital financing of accounts or receivables with high performance risk. Steady company growth financed primarily by ongoing failures assessment and cash flow is the best recipe for a good night's sleep for all constituencies.
4. Recognize, however, that even some building trades contractors with extremely short-term contracts do warrant traditional accounts receivable financing. As a rule of thumb, contracts over 40 days become increasingly dangerous.
5. Avoid contractors who undertake jobs that are much too large in scope and size for the contractor s own resources. Also avoid contractors who fail to properly document change orders and who exhibit sloppy business practices. This business is tough and allows little margin for error. Another rule of thumb is to avoid contracts that are approximately 10 times greater than the lesser of your borrower's true net worth or working capital position.
6. Be aware that conventional corporate accounting doesn't provide you with the information to make many of the foregoing assessments. The accountant's report won't allow you to learn such information as: job length, job size, frequency of change orders, state of relative completion, actual costs vs. actual revenues to date. Lenders to contractors must understand percentage of completion and completed contract accounting standards as well as the significant taxation issues that may arise.
7. Understand that good contractors have job status reporting systems that permit the lender to provide limited current asset financing with knowledge of the foregoing information as well as an up-to-date picture, project by project, of duration, profitability, cash flow and billing practices.
8. Read all significant contracts to fully understand your customer's risks. For

example, look for price adjustment clauses in multiyear undertakings.

9. Consider split advance rates for those borrowers exhibiting significant performance risk in only a segment of their business activities.
10. Encourage your borrowers to insert specific termination provisions in their contracts limiting the offsets to be claimed.

Lending in the face of any degree of performance risk requires specialized awareness, training and competence. Bonding companies have great expertise in these areas and provide assurances to the project owner that the contractor has passed high approval standards and warrants a steady stream of progress payments in lieu of bank working capital loans.

Bonding company claims may often take precedence even over first security positions by banks in many cases. Therefore, it is doubly risky to lend on jobs already subject to bonding. Unfortunately, companies active in industries where bonding is available, but which fail to meet bonding company standards, have been getting loans from unsuspecting banks with disastrous results for all parties. Encourage your customers to use surety resources whenever possible and, in those cases where bonding is simply not available, approach the credit with the same standards and methodology employed by insurance companies.

To those bankers who say that the foregoing concerns are overblown and who point to one or two contractors that they have financed aggressively, this author will simply say, "You were lucky."