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Elements of Corporate Risk (Third of a Series)

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Last week's column attracted the attention of one of our most loyal readers, and an astute observer of the credit scene. To go along with capex and cyclicality as prime corporate risks, he told us, "I would like to put in a plug for 'Where's the cash?'"

He continued, "Maybe in middle market companies it's not as significant, but we've been tripped up by intercompany cash management agreements. These (ironically) put all the cash at a holdco, when we were humming along thinking the opco lending was solid. Or the cash gets trapped in foreign subs." Excellent safety tip!

Let's now turn our attention to three of the most common worries of lenders when it comes to corporate risk.

Short borrower history – This relates to our discussion last week regarding cyclicality. How comfortable can you be with the creditworthiness of a company that's only been around since 2014? That's never been through a business cycle?

A related concern is hockey-stick growth. The market seems crowded at the moment with consumer businesses that have enjoyed a brisk run-up in revenues over the past couple years. Often assisted by social media tailwinds driving sales and marketing, these companies rocket from single-digit to $50 million in cash flows. But is this growth sustainable?

Apparel, health and beauty products, hatched from the fertile minds of ingenious entrepreneurs, may catch on quickly with the consumer, particularly millennials. But are they fads? Only time will tell. For every Burt's Bees or Bare Escentuals, there are dozens of Pet Rocks. It's one thing for equity investors to score big on a winner, but lenders don't have any upside. Boom or bust, they just get their money back.

Single product company – This is tricky. Do multiple SKUs count? How about brand extensions? It's not easy to know if a cool invention will have staying power. When Camelbak was first launched, it created a whole new category – portable hydration. In its early days, no one knew if it could compete against much larger, more mature brands. Yet a combination of strong sponsor support and excellent management made it one of the real success stories in consumer buyouts.

Customer/Vendor concentration – This is one of the toughest corporate risks for lenders to assess. For an aspiring founder, getting on the shelf at Walmart is a life-long ambition. But what if becomes a major share of the company's revenues? Big box chains can be ruthless about squeezing supplier margins.

Same is true of vendor concentration. Disruptions in either case can put a big dent in cash flows. Survivable for large corporates, but for leveraged middle market borrowers losing a 30% or more relationship can be lethal. How much concentration is too much? Each lender sets their own guard rails, but anything over 50% tends to be a non-starter for traditional senior debt providers.

We continue our series next week by looking at technology, regulatory, and legal risks.