

## THE LENDER'S EYE: WHAT LESSONS CAN WE AND OUR CUSTOMERS LEARN FROM BORDERS?

Don't let fear of lender liability gag you from giving timely warnings&mdash;when asked

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What was surprising about the Borders Group's Chapter 11 filing this week was the way the company's problems crept up under the radar until very recently. It was not an unsurprising development, in hindsight, but the speed at which it seemed to evolve surprised many observers.

What can this tell us about some of our own community banking customers and the quality and extent of their planning efforts?

As I understand the facts from the press reports, Borders Group made a number of strategic errors. Its owners and managers read the same tea leaves that all of us did and drew some conclusions from their observations that had a dramatic and unfortunate outcome on their business.

Even the failure of major strategies by such a large market participant can be instructive for community bankers. Here's a "big picture" sense of what they did and how these could have been errors and missteps by any of our community banking customers. The only differences here are the scale of the implementation and the scale of the misfortune.

Where did Borders go wrong?

Millions of books continue to be sold today, in spite of allegedly shrinking attention spans. And Borders was once held up as a brilliant model of book retailing.

So how did this bookseller wind up in such an unhappy chapter, Chapter 11?

First, the company sold its then-unprofitable internet sales capability to Amazon nearly ten years ago.

Perhaps management can be excused for not having then seen the importance of an internally owned and controlled web sales capability. But today it seems like a colossal failure at the time in anticipating the future in terms of evolving sales channels.

Second, the company deliberately "juiced" its return on common equity, the ultimate capitalistic ratio of Return on Equity.

Borders did so by incurring debt and using that debt to buy back common equity in the marketplace. While this reduced equity and increased financial leverage in the arithmetic sense, it also was, in effect, destroying the seed corn of the

business.

Equity capital is a scarce commodity in most businesses.

That this business chose to deliberately destroy it and borrowed money to do just that seems to me, at least, to be supremely short sighted. Sure, this strategy improved the nominal returns of the business (return on shareholders' equity and price earnings ratio of the common stock) for a while. But it left the company short of equity during extremely difficult market conditions that occurred over the last three years.

Did it never occur to anyone at the company that too sharp a pencil can rip the paper?

Third, Borders embarked on an aggressive physical expansion of store locations.

This expansion was characterized by a large increase in fixed costs-bricks and mortar and interest on a huge and growing mountain of debt.

Where were the company's bankers?

What about its financial advisors?

Were they blinded by the potential for fee income and the anticipation of generous yields on borrowed money?

The failure seems more prosaic when one thinks about the economic environment we all lived through during the last decade. Small businesses and large have to think through strategic challenges of distribution channels, product mix, size and scale, capitalization, stockholder benefit, and the legitimate concerns of various corporate constituencies.

Why didn't somebody speak up?

Do commercial bankers give business advice anymore?

Have we become so spooked with the threat of lender liability law suits that we are mum and mute when our customers speak to us of their plans and projects?

Do we know fantasy when we hear it?

And if we think we do, do we speak up and give a contrary or contradictory opinion? Or, is the customer always right?

I think we've all witnessed business failures due in varying measures to hubris, stupidity, short-term thinking, and perhaps old-fashioned greed.

Where this becomes a shared responsibility is when strategies are implemented largely with borrowed money that we or a group of banks have loaned to the borrower.

When the list of judgment lapses of Borders' owners and managers are catalogued and more completely understood and evaluated, what I think we're going to see is a web of complicit enablers. These will include lenders, investors, directors, consultants, and other participants and vendors who were focused on narrow and provincial interests and too little on the general welfare of the company.

Make no mistake. There's going to be a lot of wreckage and grief to go around out of this bankruptcy, particularly if, as some observers believe, the company's long-term liquidation will be inevitable.

Who spoke for the employees, a great many of whom will shortly be out of work?

What about the investors who saw their share price close at twenty-one cents a share on Monday?

Were none of these things foreseen by anybody in a position of influence or authority? Or with the ethical duty to speak up?

Did the banker-as-advisor model die?

This brings me back to an old-fashioned idea in banking: The best source of "business" advice available to a borrower is often from his or her banker.

The banker understands the marketplace and the attitudes and biases of creditors to business. You or I may not understand the physics or chemistry or electronic circuitry or the "science" of a borrower's product line. But we do know business and we know our communities.

If we have achieved a level of chronological maturity and generally kept our eyes and ears open along the way, we are repositories of experiences, observations, and anecdotes that can be enormously valuable to our customers.

They have to ask, of course, and some won't. But if they do ask and if you have an opinion, I hope you're forthcoming with it.

"But Ed, what about lender liability?"

Lawyers in recent years have frequently cautioned bankers to refrain from business advice.

That perspective (and I would call it largely misplaced caution) has deprived a generation of borrowers of useful

perspective.

We have to be careful, of course, that we are not dictating to a borrower any specific business practices or strategies. But we can venture a simple opinion relating to the wisdom of one strategy versus another.

That is hardly an effort by the lender to control the destiny of the borrower.

Being able to speak one's opinions confidently and authoritatively to borrowing customers requires a sense of self and self-confidence rooted in common sense and practical experience.

Every day affords each of us the opportunity to grow this way. There's no substitute for experience-ours that we can freely share with a customer or that which we acquire as we go about our work.

It's an integral and essential component of the value added process.

We need to use it well.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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