Surviving the Meltdown

by Alan Hughes Posted: January 1, 2012

B. Doyle Mitchell Jr., president and CEO, Industrial Bank and sister Patricia Mitchell, executive vice president, sales and operations, Industrial Bank (Photo by Kevin Allen)

"I was nervous. Our CFO was nervous," says B. Doyle Mitchell Jr., recalling the failure of several global financial institutions that marked the dark days of the Great Recession. "If there was a catastrophic domino effect through the financial markets, sooner or later it would trickle down to my community and affect the bank."

Mitchell, president and CEO of Washington, D.C.-based Industrial Bank (No. 8 on the BE Banks list with $382 million in assets), knew that while the bank hadn't been involved in the subprime market, there was no way it could remain unscathed. A lot was at stake. Industrial is a third-generation family business that was founded in 1934 by Mitchell's grandfather, in the midst of the Great Depression. The 49-year-old Mitchell wasn't about to let it fail now.

But the economic climate at the time of the Great Recession meant nothing was safe. More than 35% of Industrial's outstanding loans are tied to residential mortgages and home equity lines, 32% are linked to commercial real estate, 20% are with local churches, and 10% with small business loans. As the U.S. continued to hemorrhage jobs, tithing declined in churches, affecting their ability to make loan payments. "We've had quite a few problem loans—mostly in commercial real estate—that we're still working through," says Patricia Mitchell, executive vice president of sales/operations and sister to the CEO.

Despite these challenges, the bank managed to keep costs low in order to consistently remain profitable—even when the economy was the worst it's been in a generation. And now, Industrial faces the challenge of increased regulation while eyeing the possible need to consolidate to grow assets and resources.

From Great Depression to Great Recession

In the 1930s, Jesse H. Mitchell was a vice president at Industrial Savings Bank, a black-owned bank that closed during the Great Depression. "So, my grandfather and a few of the people who had been associated with Industrial Savings got together and formed Industrial Bank because there wasn't any other black-owned bank in D.C. at the time," says Patricia, a graduate of Drexel University. In the middle of the Great Depression, Industrial Bank opened with $250,000 in assets and 470 shareholders on the corner of 11th Street NW and U, an area in the Shaw neighborhood known as Black Broadway since it was one of the few places where African Americans could go to enjoy nightlife. Over the years, the bank expanded and now has eight locations and 28 ATMs in the Washington, D.C., metro area.

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But that growth hasn't been without its share of challenges, the most daunting of which came courtesy of a global financial crisis that left banks of all shapes and sizes scrambling to meet liquidity requirements and seeking government aid. "We didn't think it would affect us as much as it did, but obviously that happened after September 2008, as panic went through Wall Street and the large banks," says Mitchell. "We didn't have any exposure to [mortgage-backed derivatives], but as the economy got worse it started to affect areas of our portfolio."

As unemployment rose, the team began to identify potentially troubled loans as quickly as possible to ensure that the bank had the proper reserves. They began reappraising property—since values declined so sharply— and took write-downs on properties that were underwater. To ensure that borrowers could keep making payments, they contacted them and renegotiated terms.

"We're still attempting to do modifications for some of our borrowers and shore up where we can," Mitchell says, "but we've made provisions for loan losses." Funds that would have gone toward the bottom line were reallocated, and reserves for bad loans were increased to $2.5 million in 2009, $2.1 million in 2010, and are likely to reach $2 million for 2011. "That's a lot of money, but fortunately we did it before the examiners made us do it."

But other measures needed to be taken as well. For example, vacant positions at the bank weren't immediately filled. "We stopped officer bonuses, executive management bonuses.
We froze salaries for executive management," says Mitchell, a graduate of Rutgers University. "We did everything we could to get through this. It didn't feel good, but we have employees who understand that these are tough times."

Financial results took a hit, but Industrial stayed in the black. Profits for 2008 totaled $1.8 million. For 2009, a year when many banks posted losses, Industrial netted $77,000. By 2010, profits grew to $303,000, and 2011 is forecast to come in at around $1 million.

Regulation Blues
While Industrial Bank deals with the after effects of the crisis, it must also contend with stricter regulation. Community banks have to comply with much of the regulation that's aimed at curtailing the big banks that received bailout funds. But these smaller institutions, unlike the big banks, often struggle to secure the manpower and financial means they need to ensure compliance. As a result, Industrial is identifying new revenue lines.

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The traditional banking model is simple: Consumers deposit funds that a bank lends to businesses or other consumers while collecting fees for ATM use and other services. According to the Mitchells, Industrial is considering selling insurance and investment products, or offering such fee-based services as financial planning. Consolidation is also on the table. "We want to do an acquisition because the bank needs to be larger," says Patricia. "There's thousands of dollars in new compliance costs as a result of the new regulations, and the only way to absorb a lot of that is to grow. We are currently in a strategy to raise capital that will, in turn, lead to an acquisition."

How to Obtain Bank Financing for Your Business

While small business loans slid 4.1% from 2009 to 2010, there was still some $310 million that banks extended. So while credit may be tight, capital is out there. But what do banks look for these days before extending a small business loan? "I think a lot of people have the impression that banking is rocket science," says Douglas Dillon, senior vice president of commercial lending for Industrial Bank. "But even non-bankers can understand the basics." He says banks look for the following criteria:

• **Strong historical cash flows.** A banker will first examine your income statement and bottom line, and then add back a few things that are fairly essential to the cash flow analysis, such as depreciation, a noncash expense. They'll use the business' interest expense to come up with a rudimentary cash flow number. "That's important because bankers just want to have an idea of your capacity to repay their loan," says Dillon.

• **A good debt-service coverage ratio**. This is the ratio of cash available for debt servicing to interest, principal, and lease payments. The banker will calculate this by adding annual net income with amortization/depreciation, interest expense, and other items, and dividing that sum by the borrower's loan principal, interest payments, and lease payments. "This is the key ratio that most bankers are going to look at," Dillon says. He notes that most banks consider a debt-service coverage ratio of 1.20:1, or 1.25:1 to be very good.

• **Core financial strength versus just operational strength.** Dillon cites loan applications from two restaurants, both of which look good operationally. "One has a little bit stronger following—both serve good food. But one negotiated a lease with a rent that's below market and has low annual escalations. It's also in an excellent location with major tenant improvement allowances from the landlord. Plus, it's secured a contract, so some of its revenue is assured. The second did a good job establishing a financial foundation, but not as good as the first." As a result, while both have operational strength, the first one also has a more established financial foundation.

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• **A solid credit score.** There's no getting around the fact that banks will look at the majority shareholder's credit history. "It's important to know your credit score. If it's lower than 660 or 680, you need to start thinking about ways to improve it, if at all possible, before you walk into the bank," says Dillon. "Now, if you don't have a 660 credit score people may still take a look, but it makes it a bit harder. At some banks, your personal credit score for small business is one of the key determinants of whether the bank is willing to lend or not. That's not necessarily the case with us, but a credit score is an indicator of ability and willingness to repay personal debt."

• **Collateral.** The C-word isn't something many small business owners want to hear from a banker, but according to Dillon, collateral can come into play right behind cash flow in terms of importance. It is even more critical now as banks continue to try to mitigate risk. "We need to have a secondary source of repayment behind the operating cash flows of the business," Dillon says. "That can be hard to find these days, so we sometimes use Small Business Administration guaranties to make loans where collateral strength is minimal. We're utilizing the SBA's CAPLines line of credit product and actively seeking out clients that need lines of credit. The SBA has made the product more attractive to lenders, and it helps mitigate some of the collateral concern so that we don't necessarily need a 100% collateralized loan."

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