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EARLY RISK DETECTION IN COMMERCIAL LENDING

IDENTIFYING WARNING SIGNS BEFORE CREDIT PERFORMANCE DETERIORATES



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Commercial lending risk rarely appears overnight.

In most cases, financial deterioration begins months before a loan becomes past due, a line of credit is maxed out or a borrower stops returning calls. By the time those events occur, the opportunity to proactively manage the relationship has often passed.

The challenge is not identifying problem loans after the fact. The challenge is recognizing early warning signs while there is still time to act.

This paper outlines how those warning signs appear, where to look and how to respond, grounded in a real-world example.

Where Risk Starts (*What Most Lenders Miss*)

Many institutions rely on obvious indicators of distress such as:

- ✓ Past due payments
- ✓ Overdrafts
- ✓ Breakdown in communication

These are not early warning signs.
They are late-stage indicators.

In most cases, risk begins **four to six months** earlier, showing up as subtle but measurable changes in:

- ✓ Sales performance
- ✓ Margins
- ✓ Working capital
- ✓ Management decisions

The key is knowing where to look and having the discipline to act when trends begin to shift.

The Core Cash Drivers Lenders Must Monitor

Every early warning sign ties back to how cash moves through a business.

There are seven core drivers that either absorb or generate cash:

- 1 Sales growth
- 2 Gross profit margin
- 3 Operating expense margin
- 4 Accounts receivable days
- 5 Inventory days
- 6 Accounts payable days
- 7 Appetite for fixed assets

When these drivers move in the wrong direction, cash begins to disappear long before a borrower misses a payment.

A Real-World Example: Golden Boy Industries

To understand how early warning signs develop, consider a real case.

Golden Boy Industries was a distributor of construction tools and supplies. The business served contractors and also had cash customers through a showroom operation.

At a glance, the relationship looked stable:

- ✓ Long-standing customer
- ✓ Payments current
- ✓ Continued borrowing activity

Nothing appeared broken. But over a two-year period, the business began to change.

*Those changes were visible.
They were measurable.
And they were missed.*



A Real-World Example: Golden Boy Industries

Indicator 1: Shifts in Sales Performance

The earliest sign of concern was a decline in sales.

- ✓ Revenue dropped 14 percent in the first year
- ✓ Followed by another 6 percent decline

At the same time, gross profit margin temporarily improved.

This created a false sense of stability.

At this stage, the credit still appeared to be a pass. ***But this is where early intervention should begin.***

What lenders should have asked:

- ✓ Is the sales decline temporary or structural?
- ✓ What is changing in the market?
- ✓ Can margin improvements be sustained?

Indicator 2: Margin and Expense Pressure

As performance continued to decline, the second layer of risk emerged.

- ✓ Gross profit margin dropped, costing the business approximately \$460,000
- ✓ Operating expenses increased, adding another \$500,000 in pressure

Nearly **\$1 million in cash was lost** through margin erosion and rising expenses alone.

At this point, the trend is no longer subtle.

What this means:

- ✓ The business is losing pricing power
- ✓ Costs are not being adjusted to match revenue
- ✓ Cash flow is beginning to tighten

A Real-World Example: Golden Boy Industries

Indicator 3: Working Capital Stress

The most critical warning signs appeared in working capital.

Accounts receivable: Collection periods extended beyond expectations, especially concerning given contractor risk.

Inventory: Inventory days increased from 108 to 135, tying up more than \$1.3 million in cash.

Accounts payable: Payment behavior began to shift, signaling liquidity pressure.

These are often the earliest and most reliable indicators of financial stress.

What this means:

- ✓ Cash is being trapped inside the business
- ✓ Liquidity is tightening rapidly
- ✓ The company is beginning to rely on external financing

Indicator 4: Management Decisions That Signal Risk

As performance weakened, management decisions compounded the problem.

- ✓ Over \$400,000 invested in fixed assets despite declining sales
- ✓ Over \$500,000 taken out through shareholder receivables
- ✓ A shareholder exit resulted in approximately \$3.5 million leaving the business

In total, more than **\$6 million in cash was absorbed or removed** from the company.

This is often the turning point where risk accelerates.

What this signals:

- ✓ Misalignment between business performance and financial decisions
- ✓ Weak financial discipline
- ✓ Increased reliance on borrowed funds

The Outcome When Warning Signs Are Missed

Despite these clear signals, the lender continued to extend credit.

- ✓ Debt increased significantly
- ✓ Sales declined by 20 percent
- ✓ Cash flow coverage dropped below sustainable levels

The relationship moved quickly from pass to substandard. At this stage, options were limited. The focus shifted from managing the relationship to minimizing loss.

Key Lessons for Commercial Lenders

This case highlights several critical takeaways.

- 1 Early warning signs are always present**
Risk does not appear suddenly. It develops through trends.
- 2 Income statement alone is not enough**
The most important signals often appear in working capital.
- 3 Small changes matter**
A shift in margin, a few extra days in receivables or inventory can represent significant cash impact.
- 4 Management behavior matters**
Financial statements show results. Decisions explain why those results are happening.
- 5 Timing determines outcome**
Early action creates options. Late action limits them.

What Lenders Should Do Differently

To improve early risk detection, institutions should:

- ✓ Establish clear expectations at origination
- ✓ Require and review meaningful financial reporting
- ✓ Monitor core cash drivers consistently
- ✓ Engage with borrowers regularly
- ✓ Adjust risk ratings as trends change
- ✓ Take action when performance deviates from expectations

This is not about being reactive. It is about being proactive and disciplined.

Key Lessons for Commercial Lenders

Consistent early detection requires consistent analysis.

Without structure, lenders may:

- ✓ Miss trends
- ✓ Interpret risk differently
- ✓ Delay action

Standardized systems help ensure:

- ✓ Financial performance is tracked consistently
- ✓ Risk ratings align with actual conditions
- ✓ Documentation supports decisions
- ✓ Action plans are clearly defined

This creates visibility, accountability and better outcomes across the portfolio.

Every problem loan begins as a performing loan.

The difference between a managed credit and a problem credit is not luck. **It is awareness, discipline and timing.**

The warning signs are always there. The question is whether they are recognized and acted on in time.

Turning Insight Into Action

Recognizing early warning signs is only part of the equation.

The bigger challenge for most institutions is consistency.

Even experienced lenders can miss trends when analysis is spread across individual spreadsheets, reporting is inconsistent or financials are not reviewed in a structured way across the portfolio.

This is where standardization becomes critical.

Instead of relying on individual interpretation, lenders can see trends clearly, identify issues earlier and document the steps taken to address them.

This creates a more proactive approach to credit management, where early indicators are consistently identified and acted on across the entire portfolio.

Commercial lending is not about avoiding risk.

It is about understanding risk early, responding with discipline and maintaining control throughout the life of the relationship.

With the right structure and visibility, institutions can move from reacting to problems to managing them before they occur.

Platforms like Square 1 Credit Suite powered by Suntell are designed to bring structure and visibility into the credit process by:

- ✓ Standardizing financial spreading across all borrowers
- ✓ Automatically calculating and trending the core cash drivers
- ✓ Highlighting shifts in performance that signal emerging risk
- ✓ Aligning financial performance with risk ratings
- ✓ Centralizing documentation to support internal reviews and examiner expectations

Meet with Kerry and learn more about the Square 1 Credit Suite.
[Schedule a meeting today.](#)

