Intelligent Workouts:

Embracing a New Paradigm in Small Business Refinancing

By Jeffrey Sweeney

Let's Get Physical!

Banks currently lack an effective policy for optimally divesting large portfolios of bad loans. These loans, if refinanced, can provide asset-based lenders with substantial deal flow. Jeff Sweeney, a refinancing specialist and innovator in small business lending, sets out a strategy for getting banks to release this business and for engineering refinancing solutions that are optimal for the exiting banks, the borrowers and the incoming asset-based lenders.

Most commercial banks and a good number of asset-based lenders (ABLs) face an unprecedented avalanche of restructuring and loan workouts, together with the need to deleverage. This is occurring primarily in the world of small-cap finance, but it is also occurring in the mid-cap arena.

Fundamentally, the reason for this situation is that, in the present environment, businesses face reduced and declining asset values. And when banks put these businesses under great stress during workout, they usually leave them severely weakened — even fatally crippled. In many cases, it is the banks that push the small business over the edge into financial failure. Accordingly, small-business bankruptcies rose by 44% nationwide last year, according to the credit analysis firm Equifax, Inc. In California, filings were up by a staggering 81%. Recent figures indicate that the number of filings by small businesses is still rising.

It is about time we approached the problem of loan workouts differently, with an innovative and sensible plan that maximizes the return of principal to the exiting lender and the future viability of the borrowing business. Neither of these tends to occur right now. In this article, we will consider the workouts and financial-restructuring strategies necessary to repair some of the collateral damage from previous overlending and from continued bank failures.

Current Challenges

There is no doubt we stand at the dawn of a new age: the age of asset-based lending. Traditional uni-tranche lending from commercial banks is virtually at a standstill. The seemingly cleverer firms within the bank genre are now creating their own ABL divisions to handle the demand for ABL, which in the recent past had been served — in many cases misguidedly — by their commercial lending divisions. ABLs found those commercial banks stretching into their world several years ago, doing deals that were shockingly priced, severely undermonitored and overadvanced. Unfortunately, or fortunately for the traditional ABL, it is likely the execution by most banks in this “new” field will bear weaknesses similar to their past ABL attempts on the commercial side of the house.

Banks are forcing many workouts and restructurings of these misguided loans on borrowers because the recent financial crises has weakened either the lenders or the borrowers. In particular, a commercial bank may have granted the borrower what is essentially an ABL facility, but, without the important element of sufficient and timely collateral monitoring, it is now overleveraged on its borrowing certificate. Alternatively, the lender may have either been taken over or is no longer lending on certain asset classes and is therefore requiring the borrower to repay loans made against those asset classes.

Even in the ABL world, there has been a more conservative approach to qualified asset classes, most notably the reduction of inventory lending. As a result, the borrower is often caught with a surprising reduction in working capital, which slows the economic recovery in general and in many cases jeopardizes the viability of the enterprise itself. Typically, the borrower suddenly finds itself in a working-capital crisis.

Currently, the ability to borrow for working capital is shrinking, even though many of these smaller borrowers have weathered the crisis and are growing. According to a National Small Business Association survey released in July 2010, 41% of small business owners report they are unable to get adequate financing for their businesses, up from 39% in December 2009. This constriction of business working capital is slowing the economic recovery on both a micro and macro level.

It’s Time for a New Approach

Banks need to take a realistic look at loan portfolios and come to the obvious conclusion that many of these loans are not covered by assets as a secondary source of repayment. Indeed, they may even lack sufficient current cash flow as a primary source of repayment. They are noncompliant, and the bank must (and in many cases has) set them off against its loan loss reserves.

This is a relatively traditional

approach, has worked well in the past and generally follows regulatory guidelines. The problem is in the unprecedented volume of loans in this category. Moreover, the smaller regional banks are weak and traditional workout methods of selling off the distressed loans at a discount or squeezing the repayment out of the borrower are simply not working anymore. The realized rate of recovery is too low on the volume of distressed note sales, and banks generally lack the in-house skill set necessary to work out the loan. In addition, the slow rate of general economic recovery impedes the borrower from earning his way out of the crisis and does not afford the bank enough strength to absorb the current volume of losses.

Clearly, we need a new paradigm for workouts. The lenders desiring to exit are going to have to determine and acknowledge what portion of the loan is covered adequately by assets and then allow that portion to be refinanced at 100 cents on the dollar, usually through a number of different ABLs. The bank must carry the uncovered loan, or "air ball" balance, as an unsecured or second-lien loan. The borrower then repays all or part of this second-lien loan over some reasonable period as the borrower's cash flow or new working capital borrowings and advances permit. Under this proposed ABL refinancing program, the borrower can take out additional loans as the leveraged asset class grows. This is simply not possible under the current bank workout format, which hurts both the borrower and the lender.

ABLs have the necessary skills to assess and monitor the borrower's collateral going forward, something the banks usually lack, even in workout. ABLs are also familiar with, and many times utilize, cash management in the form of lock boxes and blocked accounts. Furthermore, through the use of intercreditor agreements, additional creditors, such as the exiting bank, can be repaid as agreed through these cash management accounts. Although banks are aware of these systems and occasionally attempt to impose them during workouts, they are not generally familiar with intercreditor agreements where borrowers' nondiscretionary cash flow pays third-party creditors. This vehicle, however, provides an excellent assurance that the proposed new second-lien loan payments will be paid as agreed. It is thus an essential ingredient of the program.

Of course, this kind of workout arrangement may not rehabilitate the second-lien loan to the point that it can be recorded as a performing asset on the bank's books. Due to regulatory requirements, the lender may have to set off the loan balance against earnings. The payments of principal and interest, however, will go straight to the bank's bottom line as profits and will bolster the bank's earnings performance quarter after quarter.

The Role of the Refinancing Specialist

An optimal workout solution requires the exiting lender, the borrower and the incoming ABLs to work closely together. Optimization means the exiting lender recovers the maximum principal from its distressed loans, the new ABLs make appropriate loans given the borrower's financial situation and collateral, and the borrower receives sufficient working capital to operate and grow the business going forward, which in turn provides the best assurance to the bank that the business will repay the second-lien loan.

Clearly, this requires diligent coordination by the borrower's financial advisor. This advisor needs to be an experienced small-cap investment banker or refinancing specialist. It is helpful if this advisor has the ability to take some balance sheet risk in the deal. Generally, in order to bring in other lenders and negotiate effectively, this "lead arranger" should be a lender as well. No longer can the bank put in an advisor that is, at worst, really an agent for the bank and merely ministers over a self-liquidation of the distressed business at worst (and an ineffective arranger at best). That old-school tactic is not going to maximize the bank's recovery in these times and certainly does not optimize the outcome for the borrower.

The skilled small-cap investment banker or refinancing specialist executes a rational refinancing plan tailored to the condition of the business and the lending marketplace. The advisor must be able to assess the risk of the deal from a lender's perspective in order to choose the correct refinancing lenders efficiently. Shot-gunning a deal around to see who bites is a traditional but inefficient way to get this done. The advisor will work as an advocate for all parties: the exiting bank, the borrower and the new lenders. Taking out the existing loan often requires several ABLs, each with its own specialty and preferred collateral.

The proposed new process can be outlined as follows:

1. First, the advisor must conduct a skilled and independent assessment of the business with respect to its business model and viability as a going concern.
2. If the business is viable, then the advisor must obtain an accurate appraisal of both its cash flow as it relates to the ability to service debt and its asset values.
3. The advisor must skillfully survey the ABL and debt marketplace in order to provide reliable, accurate and executable term sheets for the portions of the debt that can be refinanced.
4. The advisor must assess any loan balances that cannot be refinanced to determine what repayment terms the borrower can meet, given the new debt structure and cash flows.
5. The advisor and the borrower must renegotiate intercreditor and subordination agreements, and they must facilitate those agreements among all lenders and the exit-

ing bank to ensure adequate liens and repayments exist within their respective underwriting criteria.

These activities can hardly be facilitated by a workout specialist at the bank or by the traditional advisors the bank usually recommends to work with the borrower. Most times, the level of mutual trust between the parties is very low to begin with due to legacy default issues. Additionally, the bank workout officers are not familiar enough with the ABL and debt market, with ABL appraisers or even with the customary practices among ABL lenders to recommend solutions, even if lender liability issues allowed them to do so.

The ABL and alternative-lending marketplace is extremely fragmented and consists of many small, medium and large lenders with a great diversity of product offerings, costs and favored assets. To optimize a workout, it is necessary to survey the lending market efficiently to locate maximum refinancing availability at the most favorable market pricing for any given situation. Without a wide range of refinancing solutions and lenders, this cannot happen. Usually, the bank workout officer or the advisors recommended by the bank approach only a small fixed group of lenders; if they do happen to look for suitable alternative lenders, they usually come back with mediocre results.

Furthermore, there is the problem of assessing the condition of the borrower. Here is where an accurate, independent assessment is most important. The norm is to rely on the business to provide the relevant data to the bank. The information obtained in this way is not reliable for several reasons, such trust issues, delays, perceived negotiating positions and the possibility that lenders may use information against the borrower later. Only an independent group with an implied fiduciary responsibility to obtain accurate information can actually secure and process the information from the borrower.

This information must not only be accurate, but also arranged in a way that other ABLs are receptive to it and can use it for their own due diligence. For instance, many well-meaning advisors prepare "pitch books" from the perspective of a middle-market equity hunt. However, these presentations have no bearing from an ABL perspective and are a distracting waste of time. Generally, borrowers will provide accurate information only when they understand that the information is directly relevant to the type of refinancing they seek and its release is clearly in their best interests.

Conclusion

Although ABL holds tremendous lending opportunities, banks need to assess carefully whether they have the collateral and borrower-management skills necessary to enter ABL themselves. Most will lack the required skill set. The new reality is that banks have to deleverage and work out of "problem" loans. They also need to raise additional capital and increase profits. This will not happen without a fresh, and more bespoke, approach to workouts.

Workouts have to start progressing more rapidly and to a higher, more professional and efficient standard. Optimal workouts for smaller companies require the parties to take the following actions:

- Bring in professional advisors that understand lending from a lender's perspective, preferably with the ability to take some balance-sheet risk on the deal.
- Realize that to optimize the maximum refinancing amount, several different ABLs will often have to participate.
- The bank must be willing to bifurcate its loan into an asset-based tranche "A" and an unsecured or junior secured tranche "B" to interest the maximum number of ABLs.
- Secure agreed payments on the bank's tranche "B" with cash management and intercreditor agreements administered by the ABL.

This new approach to workouts will accelerate their success rate and efficacy, and it will optimize the outcome for both the banks and the borrower. We are in difficult times economically and financially. The old strategies banks use to work out their clients are a failure in the current market. They place too much stress on businesses. It's time for banks to step back and really assess their policies with respect to workouts and restructurings. If ABLs can help them do this, they stand to gain an avalanche of business. TSL

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