

Dealing With the Chaos ... But 'The Future Will Be Better Tomorrow'

BY HOWARD BROD BROWNSTEIN

Lenders and turnaround professionals alike are listening for indications that we indeed have hit bottom in this free-falling economy. And questions abound like “what are we dealing with?” and “how do we deal with it?” In the following article—partially titled with a quote attributed to former Vice President Dan Quayle—Howard Brownstein reminds us in not so subtle terms, that “this too shall pass” and the time for hand wringing is over.



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The current economic situation poses difficult challenges for lenders and turnaround professionals alike. The drying up of the erstwhile flood of liquidity has made refinancing and restructuring solutions more difficult than even several months ago. Business bankruptcies have surged in 2008,¹ with credit quality steadily deteriorating.² Larger companies, formerly shored-up with easy credit and equity funds vying with each other for PIPE deals, are showing serious signs of stress.³ Even our federal government has leapt pell-mell into the restructuring business itself, summarily cramming down the equity of Fannie Mae and Freddie Mac.⁴

One gets the feeling that the economy is in free-fall. It's as though we've dropped a pebble into a well, and we're listening in vain for it to hit bottom. Politicians are no longer gamely denying we're in a recession, and the term “global credit crunch” is freely bandied about. The proponents of the much-ballyhooed Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) may have to take cover as commentators debate whether it has actually contributed to the roiling of financial markets, and has accelerated the economic downturn by making bankruptcy less accessible for homeowners and forcing lenders to write down assets too quickly.⁵ Everyone is asking, “How bad will it get?”⁶

What are we to make of our current situation? What tools are available to address it?

First, what are we dealing with? Is it stagflation—a return to the 1970s? We've clearly suffered another oil shock—but this time on steroids, without the long lines at gasoline stations, but accompanied by a dying dollar, an intransigent China, and an obstreperous and ungrateful Europe. We are in an election year characterized by antipodal candidates and a polarized electorate. Will the outcome of the election really resolve anything? Consumer confidence is at a near all-time low,⁷ the true impact of skyrocketing

gasoline prices hasn't even been felt yet, and the Supreme Court has helpfully proclaimed our right to each have a gun—perhaps several guns—in our homes. The war in Iraq plods on intractably, its original purpose a distant and apocryphal memory, while the war in Afghanistan we thought was over, apparently isn't.

For lenders, industry after industry is showing up on the “watch” list. What began as a realization that subprime credits were called that for a reason, has turned into a major decline in real estate values across the board, leaving even performing loans under water from a liquidation standpoint. First it was residential builders, then building supply companies, then do-it-yourself retailers, then the travel and hospitality industry. How will roadside motels and destination resorts fare if no one wants to drive, fly or spend?

Make no mistake, “this too shall pass,”⁸ but it's the mean-while that we're all worried about. How should asset-based lenders and turnaround professionals help borrowers (and themselves) weather the storm?

The story is told of a river that is overflowing, flooding the entire region. A man stands on his front porch with the water lapping over. His neighbor pulls up in a boat and says, “Jump in, Charlie, we're evacuating the town, I'll take you to the Red Cross shelter.” Charlie crosses his arms and says, “Nope, I put my trust in the Lord.” The neighbor shakes his head and steers his boat away, and meanwhile the water rises to the second floor. Another boat comes along, this time piloted by a sheriff's deputy, who says to Charlie, now sitting in his second story window, “Jump in, I'll save you.” Charlie again says, “Nope, I put my trust in the Lord.” Now the water is up to the roof. As Charlie is hanging onto the chimney of his house, surrounded by the rushing flood waters, a helicopter hovers above and drops a ladder. The pilot yells down, “Charlie, grab the ladder!” Charlie refuses, saying, “Nope, I put my trust in the Lord.” The helicopter moves on, and the water sweeps Charlie away, drowning him. He arrives at the gates of Heaven, God sees him and says, “What are you doing here?” Charlie says, “I put my trust in you, and you let me down.” God replies,

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"What do you mean, let you down? I sent you two boats and a helicopter!"

What tools are already at our disposal for the current chaos? Asset-based lending is closely related to factoring, one of the earliest forms of commercial lending. Lending on a borrower's accounts receivables is actually an indirect loan to the borrower's account debtors, even where the structures of traditional factoring aren't present. While, until recently, ABLs were reluctant to "rock the boat" with borrowers lest they go elsewhere, it's now a "lenders market," so ABLs can afford to toughen their practices without as much fear of losing market share. For starters, some of the standard practices in factoring should be considered for asset-based loans: lockboxes and blocked accounts, confirmation of shipment and receipt on A/R, credit insurance, etc.

Typically, ABLs center their attention on the borrower's aging of A/R, which is a historical document regardless of how often it is provided, and focus on "ineligibles" over 90 days old, excessive concentration among the borrower's customers, and dilution caused by sales returns and allowances.

Workout groups have been disassembled at many lending institutions, with decades of institutional memory and learning walking out the door, often to equity funds.

Too little attention is paid to trends or other early warning signs, or a review of the borrower's own credit management procedures. Even if the overall amount of ineligible A/R isn't a problem, what's happening within the "eligibles?" Are the columnar totals all moving in a healthy direction, or the reverse?

Is the borrower regularly obtaining and analyzing its customers' financial statements and credit references? Insurance companies regularly offer reduced rates to home-owners who have home security systems; why shouldn't ABLs adopt the same philosophy for borrowers that have sound credit management? And why shouldn't a lender ask to see the borrower's credit files on its largest customers, even where there are no issues of excessive concentration in the A/R?

Inventory collateral can be analyzed beyond the routine "raw material/work-in-process/finished goods" categorization, and obsolete/aging classification. How does inventory mix line up with the current order book? How is customer turnover likely to affect future inventory utilization? Does the borrower have an ongoing system for keeping inventory levels under control, or is the borrower reactive, waiting for cash or lender pressure?

In general, the reporting required of borrowers by ABLs is mainly historical in nature, which can be like the proverbial driving a car by looking in the rearview mirror. The best-run borrowers do not manage their own businesses that way, but instead generate prospective reports that tell them what is likely to happen in the future. They look at their assets (the lender's collateral) in a future-oriented context, (e.g., financial and cash-flow projections, sales order books, and customer mix). ABLs should determine whether their borrowers have such reports, and if not, should look for opportunities such as waiver requests and extensions/renewals to require them. If necessary, suggesting or requiring that the borrower seek assistance from a turnaround professional to help develop such reports might be appropriate.

If the borrower's customers (and not just the borrower itself)

are in an industry that is likely to be affected by one or more of the economic forces described above, lenders should shift their perspective. That might indicate revising the loan structure, which may or may not be permitted under applicable loan documents in the absence of a default, but should be on the "to do" list at the next opportunity, (e.g., a waiver request, or loan extension or renewal).

All too frequently, lenders assume that the equity sponsor involved in a deal will "step up" with unlimited cash infusions as needed, based upon the sponsor's reputation or past dealings with the lender. The landscape is littered with disappointed lenders resulting from such mistaken faith. Lenders should beware making such assumptions, and should track how sponsors are in fact behaving in their other deals, for a harbinger of what is to come when trouble reaches the lender's own portfolio.

In terms of timing, some believe that we are in for a tax increase in 2009, regardless of the outcome of the election. The deficits have just gotten too large, along with the bail-outs of mortgage lenders and Wall Street firms. Therefore, it may be advantageous to take the likelihood of a tax increase into account when making decisions about forcing beleaguered borrowers to sell or liquidate, and about write-offs on loan portfolios (to the degree there is any flexibility).

Many ABLs have been lulled into complacency by the ease with which—until recently—borrowers could refinance elsewhere or a loan could be sold at par (or higher). Workout groups have been disassembled at many lending institutions, with decades of institutional memory and learning walking out the door, often to equity funds. Some lenders have begun restaffing these areas, and lenders will also have to reorient their thinking, putting up with a longer turnaround process in some cases rather than a quick exit.

Turnaround professionals should nonetheless anticipate that lenders will be far less flexible and expansive than in the past. They should seek simultaneous—not sequential—solutions, teeing up sale-of-business alternatives alongside turnaround and re-financing plans from day one. Few lenders will automatically have an appetite for a long turnaround, and ABLs will be loathe to lend further into their collateral in this economy.

Folks, it's all about risk, and the risk-return curve clearly has shifted upward and to the right. The time for hand wringing is over. Will the future really be better tomorrow, as our former vice president mused? Well, "we live in hope but die in despair." And if anyone hears the pebble hit the bottom of the well, please let me know.

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FOOTNOTES

- 1 Administrative Office of the U.S. Courts, News Release, August 27, 2008.
- 2 Kamakura Corporation Global Credit Index.
- 3 "Large Corporations Now Going Under, Three-Fold Increase in Biggest Chapter 11 Cases," *Turnarounds & Workouts*, July/August 2008.
- 4 U.S. Treasury Dept. Press Release. September 7, 2008, <http://www.ustreas.gov/press/releases/hp1129.htm>
- 5 "Bankruptcy Reform and Foreclosures," David P. Bernstein, July 2, 2008, <http://papers.ssm.com/sol3/papers.cfm?abstractId=1154635>
- 6 E.g., "How Bad Will It Get," Edward Teach (no relation to the pirate Blackbeard), *CFD*, June 2008.
- 7 Press Release, The Conference Board, June 24, 2008.
- 8 King Solomon is reported to have had a silver ring made with these words, to cheer him up when he felt depressed. (Quoted by then-Senator Abraham Lincoln in his "Address Before the Wisconsin State Agricultural Society," Milwaukee, WI, September 30, 1859.)