abfjournal
Reprinted from the October 2005 Issue, Vol. 3, No. 9

The Next Wave:
Lenders Look Beyond the Horizon

Throughout the asset-based lending community, senior lenders are asking the same questions: Will there be another wave of loan credit issues and equity fund portfolio problems? If so, when will it occur and how severe will it be? In the following roundtable discussion, Howard Brod Brownstein and Roseanne Sweeney posed these questions to a broad spectrum of senior executives at leading institutions.

By Howard Brod Brownstein and Roseanne Sweeney

Throughout the asset-based lending community, senior lenders are asking the same questions: Will there be another wave of loan credit issues and equity fund portfolio problems? If so, when will it occur and how severe will it be? Which industries will be most affected? How prepared are lenders and funds given the general downsizing of lenders' workout departments, and funds' general lack of staffing in the workout area? Will the increased involvement of sub debt and mezzanine capital players complicate the workout process? If necessary, will lenders be able to sell loans easily enough, and at how steep a discount? The authors interviewed a broad spectrum of senior executives at leading asset-based lenders. Each interview focused on the above questions, although discussions ranged widely depending on the experience and viewpoint of each lender.

Prior to Hurricane Katrina, the U.S. economy seemed to be smoothly absorbing the steady rise in oil prices and interest rates over the past year or so. Strong gains in employment and the continued boom in the real estate market putting huge sums of extra cash in people's pockets effectively offset these forces. Notwithstanding a stubborn war in Iraq and mixed signals from the economy and world financial markets, economic growth as well as consumer confidence and business spending remained strong through the summer months. Private equity firms decried the inflated multiples commanded by acquisitions, and lenders across the board lamented the softening of loan underwriting standards.1 Many lenders continued to "make hay while the moon shines" and competed aggressively among themselves and with hedge funds for new business, even as they recalled how such periods of exuberance had preceded downturns in past economic cycles.

Beyond the cataclysmic regional impact of Katrina lies the national effect of the increased cost of fueling cars and factories, as well as the approaching home heating season. Petroleum prices directly affect the cost of many products such as plastics and synthetics, and it is unlikely that manufacturers will be able to pass along such cost increases to their customers quickly or completely. There has been a resulting quantum leap in the level of uncertainty as the nation waits to see how high interest rates and oil prices will rise, and how truly resilient the U.S. economy is to such shocks.

Given that the mixed economic signals are creating a very uncertain economic climate, many asset-based lenders have different opinions about whether there will be a wave of loan credit issues and equity portfolio problems, and if so, its expected timing and severity. The economic uncertainty coupled with the "hedge fund factor" in the marketplace has most asset-based lenders cultivating a wait-and-see attitude. Most lenders think that that the industries heavily dependent on consuming or producing oil — or products that use oil — will be the hardest hit in this environment. It's just a matter of how hard.

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Prior to Katrina, institutions ranging from a factoring division of a finance company to a global foreign bank had anticipated the slowdown to occur in mid- to late 2006, while two national banks that provide financing to smaller regional companies had not expected the downturn to start until 2007, with 2008-2009 expected to be the more challenging years, and others had had no specific forecast timeframe, but had been remaining vigilant.

However, now most lenders interviewed speculate that Katrina could well accelerate the downturn, and the common variable seemed to be how high fuel prices rise. Michael Stanley, executive vice president at Rosenthal & Rosenthal in New York, says, "It's hard to determine the economy's resilience to the simultaneous effects of the hurricane, rising energy prices and rising interest rates. The severity of the downturn will be affected mostly by energy prices and interest rates. Since both of these factors are uncertain at this time, it is hard to judge the true impact on the economy." Some lenders felt that if energy prices and interest rates keep rising at the current rates of increase, the downturn may start as early as 4th quarter of 2005!

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Michael Maiorino, executive vice president and managing director of specialty lending at Sovereign Bank, states that he is beginning to see some credit problems that he has not seen in a while, such as softening in top line revenue, and margin compression across the board. This leads him to believe that we may already be on the precipice of "The Next Wave," as oil prices and turbulent world markets are starting to take their toll. Additionally, he has found that increasing interest rates and oil prices have had a psychological impact on consumers that is probably worse than the actual impact on consumer product prices, and people are starting to re-evaluate how they spend their money. Such a decline in income deemed "disposable" could ultimately lead to a softening demand for goods and reduced production, he feels.

However, even after Katrina, some institutions continue to believe that 2006 will still be a good year for themselves and the economy, and that Katrina will just cause a short-term blip in the economy. These lenders point out that there is still a great deal of liquidity in the market, and they feel that the economy has not peaked yet. Additionally, the rebuilding of New Orleans and the Gulf Coast could be a mini-"New Deal," regenerating economic growth, albeit at lower profit margins if fuel prices continue to be high and increase costs. Such industries as lumber, metals (mostly steel) and concrete could benefit from the rebuilding efforts. On the other hand, the federal government does not seem inclined to raise taxes or cut other expenditures in order to pay for the rebuilding, so the increase in public debt could accelerate inflation and lead to further interest rate increases.

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Most lenders interviewed thought that the industries heavily dependent on energy will likely be most affected by Katrina, such as transportation, travel, industries reliant on trucking, steel and other metals, which in turn impact the automotive industry. Also mentioned were petrochemicals and petroleum-based products such as plastics. These lenders also anticipate that retailers will be affected, since people will be driving less in reaction to higher gasoline prices. Particularly hard hit will be industries and companies based in the Gulf Coast region, and in general those industries and companies with low margins that cannot absorb or pass along cost increases. Dan Landers, president of Citizens Capital, noted that each recession erodes the U.S. manufacturing base, because with each downturn more and more manufacturing gets moved overseas to take advantage of lower costs, but does not return even when the economy improves.

In terms of the possible severity of the downturn, opinions varied based on the different markets and industries in which each lender is involved. A senior executive from a global foreign bank expects the next downturn to be quite severe and possibly evoke the recession of the 1970s in which industries across the board were affected. He states, "The theory of business cycles has not been repealed, and the economy was due to turn anyway, despite the impact from Katrina and the increase in oil prices."

Others felt that, prior to Katrina, a downturn expected by late 2006 would not have been so severe because it would have been short-lived, well-managed and have a "soft landing." However, with Katrina increasing fuel prices, the severity of a downturn could be significantly affected. In contrast to this view, a senior lender at a national bank states that he expects the next downturn to be less severe than the last recession in 2001-2002, because companies are more efficient now. They survived the last downturn, he says, and have gained much better control over their accounts receivable and inventory.

Sovereign's Maiorino similarly expects the next downturn to be more manageable than the last one because consumers and companies are more sophisticated and even before Katrina had an expectation that oil prices would rise, and had become more sophisticated with interest rate management, laying off risk better with derivatives products such as caps and swaps.

John O'Kane, executive vice president of the Commercial Finance Group at CIT, says that it is hard to predict the severity of the next downturn. He believes that if it is at the same level as the 2001-2002 recession and is coupled with the current increasingly complex capital structures, it could be felt more by lenders. More conflicts among classes of lenders could occur with more complex capital structures, generating higher professional fees and slowing down the workout process. He has typically found the triggers for downturns are increases in interest rates and commodity prices, he says, however, anyone's projections of what will increase, when and how much, are usually wrong, and such increases usually occur in areas and at times that no one expected.

In terms of how prepared lenders and hedge funds are for any downturn in the market, each institution seems to handle their workout situations differently. Many of the national banks and finance companies manage problem credits within their asset-based groups, rather than transferring them to a separate workout group. Barry Kastner, managing director of Wachovia Capital Finance, states, "As diligently as they try to avoid them, asset-based lenders should be prepared for some losses and charge-offs in their portfolio, because they take risks by the very nature of the business. They are good at working credits out." Sovereign's Maiorino believes the "cradle to grave" mentality of asset-based lenders creates a sense of ownership of credits and their problems, and therefore they get worked out more passionately and consequently more successfully. These two leading lights of asset-based lending echo the teaching of William Sudhaus, an asset-based lending legend. When "Suds" managed asset-based lending at CoreStates Bank (now part of Wachovia Capital Finance), he preached to his lenders that they must be knowledgeable about the forces that could affect their borrowers, and be prepared to manage the risks taken with depositors' money through a downturn.

The bigger institutions with higher volumes typically still have separate workout groups; however, many of these groups have been downsized during the current long period of economic growth. While some larger institutions have policies of retaining and rotating workout talent in and out of line positions within the institution, others do not, and many such workout specialists have departed during downsizings. A senior lender at a global foreign bank said it is shortsighted of lenders to lose such intellectual capital.

Citizens Bank's Landers has found that banks have become efficient at handling the downturns because they are regulated and forced to deal with the issues. They also have more options now than ever. He finds that there is expertise around the organizations to work on workouts, and, if need be, nonperforming assets can be easily packaged and sold off.

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CIT's O'Kane notes, "Workout talent at many lenders had been reduced by the 2001-2002 recession and even more is gone now." He feels that the limited remaining workout talent at many institutions (other than CIT), coupled with the complex deal structures created by the second lien lending explosion, could create an especially difficult downturn period for lenders, even though second lien lending ironically allowed many otherwise difficult deals to get done. O'Kane says, "With 'The Next Wave,' intercreditor negotiations will take as much time and energy as debtor-creditor negotiations. In fact, the borrowers may get lost in the shuffle while the creditors battle it out. This will be a good environment for turnaround consultants, since all the stakeholders will need assistance."

Since buyers of distressed debt have done well historically, many institutions are currently ramping up their own distressed debt buying groups in anticipation of the next economic downturn.

Kastner of Wachovia says his institution maintained credit standards in a highly competitive loan market that has seen aggressive pricing and structure. "You have to play the game to meet the growth goals of the business and keep your momentum," he says. But he adds that Wachovia also continues to measure and quantify the degree of "stretch" in its portfolio, and to require discipline in the use of stretch, such as by requiring amortization, triggers with covenants, blocks in availability, etc. He believes that this vigilance is how his institution manages its exposure.

CIT's O'Kane and Bob Arth, executive vice president of Bank of America Business Capital, are both concerned about the availability of DIP financing if there is another wave of loan defaults. In the current environment of abundant capital and easy credit, many companies have no assets left to pledge to secure DIP loans. O'Kane sees this as a recipe for earlier resort to §363 sales after bankruptcy filings, especially in light of recent bankruptcy law changes. He recalls that DIP financings for middle-market companies were constrained in the 2001–2002 recession for this same reason, and this time looks like it could be worse. Arth states, "Under these highly leveraged bankruptcy scenarios, senior secured lenders will have to be in the primary position before they will give additional liquidity in a bankruptcy. Many debtors will only be able to pay DIP interest, maintenance capex and professional fees during bankruptcy, and will not be able to pay principal, subordinated debt or any new capex."

In addition to more complex capital structures and higher debt leverage, many lenders are concerned about the ability of hedge funds to handle a downturn. As relatively new entrants to the asset-based lending market, these funds often have little experience with business failures or workout talent within their organizations. Additionally, the hedge funds have relatively high exposure to their second lien and "airball" positions, which will get hit hardest in a downturn. Some observers say that the degree of credit acumen varies widely among such funds, although the larger funds typically have some expertise to handle workouts. One senior lender suggested that hedge funds might be planning to rely on the senior lenders to manage the workout, and just slipstream behind them. These funds also may be overestimating the borrower's ability to fix its own problems. Some speculate that, given the huge amounts of money at the hedge funds' disposal, and no regulatory requirements, they can afford to take bigger and longer-term risks on structure and should be able to weather the high and lows. However, others believe hedge funds to be particularly vulnerable to the problems of asset-based lending, being without any daily monitoring of collateral.

With so many products available to funds such as trading of debt and investing in equity, they may be able to find new and creative ways out of difficult situations. For instance, funds may take the asset-based lenders' traditional role in offering DIP financing in "The Next Wave." Or funds may be more willing than banks to "loan to own," and use DIP financing as a way to obtain the equity more cheaply. In any event, how hedge funds handle the next downturn could impact the economy significantly. Will they be efficient in solving problems? Will they be as efficient as the banks? Will they work their way out, or will they sell their way out of the problems?

Which brings us to the question of monetizing risk and the liquidity of debt markets: Will lenders be able to sell loans easily in the next downturn and at what discount? Since buyers of distressed debt have done well historically, many institutions are currently ramping up their own distressed debt buying groups in anticipation of the next economic downturn. This has temporarily created a seller's market, since there currently is limited product to buy. In the past, selling off debt made sense both for regulatory reasons as well as to clean up the lender's balance sheet, yet often did not make sense for economic reasons. CIT's O'Kane notes, "In the next downturn it may make economic sense to sell debt early, because overly eager buyers will ratchet up prices and overpay, at least in the first round of selling." He predicts that the second round of debt buying could reflect a more normal market. Sovereign's Maiorino hopes the secondary market for distressed paper remains strong, because it offers lenders a great advantage by giving them another alternative for handling problem loans.

For any market, it always comes down to the relationship between supply and demand, or in this case, the relationship between liquidity and price. The fewer buyers or less liquidity, the steeper the discount and the lower the price, "The Next Wave" is coming; the only question is when. abfj

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ENDNOTE

See, e.g., "Whereof What's Past is Prologue... Asset-Based Loan Underwriting Standards Begin to Slide," *ABF Journal* March 2005.

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