

Exit Strategies for ABLs: Asset-Based Loans & the Secondary Market

The mainstream nature of current asset-based lending activity has served to increase the number of opportunities for varying exit strategies for asset-based lenders. The growth in the size of the secondary loan markets, and the increase in the realization by hedge funds and other investors of the potential returns associated with distressed situations have increased interest in the asset class and therefore liquidity of the market.

By Keith B. Stein

A sset-based loans have historically differed transactionally from typical bank loans. While banks will take collateral as security for their loans, a traditional asset-based lender will go much deeper and with much more diligence into the collateral. Frequently, asset-based lenders will track, as often as weekly or even daily, inventory and accounts receivable levels, in addition to monitoring through current appraisals the value of inventory and more traditional hard assets such as machinery and equipment. Asset-based lenders don't rely on credit rating agencies per se. Rather, for loss prevention and risk management they look, in part, to the appraiser and the corporate investigator doing background checks on corporate borrower principals.

Historically, an asset-based loan officer faced with a troubled situation has been confronted with difficult choices: supporting a risky turnaround effort, pursuing a long and uncertain workout or liquidation process, and the possibility that his collateral and capital would be tied up for long periods of time, perhaps in bankruptcy court. In some instances, the borrower might be persuaded to sell the business, but in distressed situations valuations are problematical. A lender looking for an exit strategy would usually have only one choice, the outcome of which was relatively certain or at least within the lender's control—to wait until it is possible to foreclose on and liquidate the underlying collateral.

Growth of Alternative Exit Strategies for ABLs

The acquisition and consolidation of many traditional asset-based lenders into larger lending institutions has brought asset-based lending under the umbrella of traditional lenders. With the current credit climate, asset-based products are being offered on a continuum along with other senior secured credit facilities. This integration, and the emergence of hedge funds and other debt investors, has spurred to the mainstream a secondary market in the sale and purchase of both performing and distressed asset-based loans.

Glenn Stewart, the head of loan syndication at Bank of America, one of the leading asset-based loan syndicators in the U.S., points out that asset-based financing has truly become part of the mainstream debt market, and is now seen as a critical product by many lending institutions. This growth and mainstreaming of the product has led to the emergence of many new players familiar with asset-based loan structures and able to analyze them effectively for investment purposes.

Stewart further points out that there are many cases of collateralized loan structures being designed with certain investors in mind. For example, in some cases a term loan is carved out of an asset-based revolver as part

of the same loan package and collateral, making the structure more attractive to certain institutional lenders who cannot purchase revolving debt by virtue of their charters or regulatory restrictions (recent restructurings of Goodyear, International Steel and Rite-Aid all contained structures that included this feature).

This flexibility and range of primary buyers, along with the spread of hedge funds and other secondary investors, has increased the range of options available to the holder of a troubled asset-based loan.

Tom Finke, who runs the loan group at the institutional asset management firm David L. Babson & Company, Inc., a member of the Mass Mutual Financial Group, with over \$75 billion under management, agrees, "The lending community has matured over the past decade since the 1990-1991 cyclical downturn, with many more participants who are willing to look at various types of troubled loan structures in the secondary markets."

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Why Sell?

Ultimately, a lender's credit policy team has to decide whether or not to handle its troubled loans internally, sell these loans immediately, or some combination of these two alternatives, depending on other portfolio management and risk factors. The desire to sell a troubled loan typically arises from several different thought processes of workout and credit officers:

- 1) "Take your first loss as your best loss." If a workout officer has the sense that the troubles he is witnessing are just the tip of the iceberg, it may be prudent to accept the impaired nature of the asset and allocate energies elsewhere.
- 2) Given the high cost of professionals in drawn-out workout scenarios, as well as the uncertainty surrounding the process, it may be better (in the workout officer's mind) to avoid the unknown and definitively quantify the

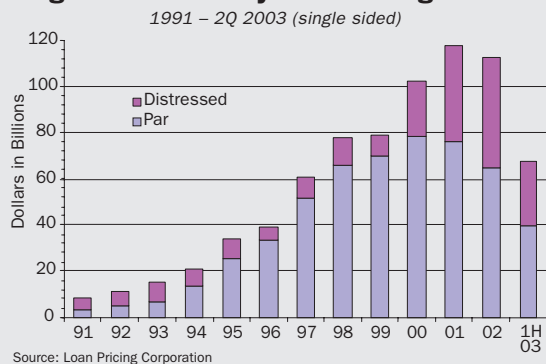
loss, in part to keep the regulators from imputing their own judgments as to the reserves and other net capital required for the situation.

- 3) In certain cases due to downsizing within workout departments, there may not be enough skilled “gray hairs” around that know how to manage through a workout. Less experienced staffers may play the game too conservatively and either be blind-sided and suffer losses or miss an upside opportunity.
- 4) At times, simple portfolio management will dictate that certain loans be sold when the lender is trying to maintain a certain risk and quality level in its portfolio, to meet internal strategic goals, regulatory concerns or meet market expectations.

Further pressure can come from Wall Street, particularly if an equity analyst following the lender also tracks the quality of the lender’s underlying credits, driving lender share prices down on general fears of loan portfolio quality. Investment fund manager David Ray, of Woodside Capital, agrees, indicating that “many banks facing regulatory or Wall Street pressure to sell problem loans cannot wait on the outcome of a workout of a non-performing loan asset.”

As can be expected, valuation and pricing will always be an important part of the decision process. Although the distressed loan trading market has always been less efficient than the par market, the secondary markets for distressed loans have matured along with the par markets and the lending community in general, with market pricing information being increasingly available, and with multiple pricing sources generally available, at least on larger credits.

Figure 1: Secondary Loan Trading Volume



The Selling Process

If a loan has been designated by a credit or workout officer as something they wish to sell, generally the first step will be to get an indication of pricing. This will typically involve a few phone calls to one of the distressed trading desks that most of the major banks maintain (JPMorgan Chase, Citigroup, Deutsche Bank, CFSB, Goldman Sachs and many others maintain distressed trading desks). Although there is no official definition industry wide, a loan trading for less than 85¢ on the dollar is generally designated to be part of the distressed market. Greater than 85¢ and it will trade in the par markets.

The second step in this process is to find an actual buyer, come to agreement on price, and properly document the loan for transfer. It is most typical for a seller to utilize one of the trading desks to find a buyer, given the time that would be involved in finding a buyer on its own. In many cases, one of the main factors driving the sale is to reduce costs and hassles involved in a workout, so it would not make sense to spend these man-hours finding a buyer.

In certain cases, hedge funds with developed relationships will canvass workout officers directly. Ray of Woodside Capital finds that, typically for smaller loans (<\$200 million), there is not a developed trading market or pricing information available, and that working directly with workout officers can be helpful in finding appropriate opportunities.

In the case of an asset-based lender with a portfolio of loans that it wishes to sell, it is not uncommon to execute an auction process where buyers are contacted and invited in to look at all of the loans in the portfolio and asked to bid on a part of or the entire package of loans for sale. These portfolio sales may be held quarterly or semi-annually. A large segment of the secondary market involves single lender deals, but many times a primary syndicate bank has the right under its loan documents to execute a sale if the loan is in default. In other cases, agent and/or borrower approval may be required, even in default situations. There are even certain institutions that will assume the agent/administrative duties of a sold syndicated loan, even where that institution does not own any of the loan. There are also a group of service providers who provide loan sale advisory services for lenders, such as First Financial Network (www.firstfinancialnet.com) of Oklahoma City, creating and disseminating bid packages, establishing due diligence war rooms, advertising the sale and soliciting potential buyers to the auction.

The final step is executing the trade.

Who are the Participants in this Market?

The marketplace for par, near-par and distressed loan trading has exploded in the years since the early 1990’s. The initial secondary markets were formed out of an environment of high default rates, and indeed from 1991 to 1994, the volume of distressed trading was greater than par trading. As market activity has grown, the number of participants has also grown. (See Figure 1: Secondary Loan Trading Volume on page 14.)

Market participants include banks, hedge funds, pension funds, mutual funds for loans and bonds, and Collateralized Loan Obligation funds (“CLO’s”). Depending on the nature of the institution, they may participate on both the buy and sell side.

The advantages that many non-bank participants have in holding distressed debt for investment include the fact that they have fewer regulatory and accounting constraints. In certain cases they may have the ability to maintain a longer time horizon in dealing with problem loans than the originating lender. This greater degree of patience can boost value for parties on both sides of transactions.

How Efficient is the Marketplace?

The efficiency of the loan selling process has been greatly enhanced in recent years through the standardization of transfer and assignment documents, and through the efforts of the Loan Syndication and Trading Organization (the “LSTA” - www.lsta.org), a trade organization dedicated to increasing the efficiency of the loan trading marketplace. Founded in 1995, the LSTA has developed over 26 standard documents, including documents specifically dealing with distressed trades, that have helped speed the transfer process and eliminate marketplace disputes.

Before the LSTA, market participants would face many unknowns and an environment that led to disputes over items such as settlement timing, cash flow ownership during the settlement period, and the payment of various fees to third parties. All of these common concerns have generally been eliminated through the use of these standard documents.

As an indication of the success of the LSTA, it can be noted that even in loan sales that do not go through large trading desks, LSTA documents are still typically utilized. Certain sellers may choose in these cases to supplement the LSTA documents for specific situations, but for many participants they are a good starting point, if not an all-inclusive solution.

The differing objectives and capital sources of primary and secondary buyers of asset-backed loans do affect pricing of distressed loans. Indeed, many of the uncertainties regarding the workout process will transfer with the loan. As with other markets, imperfect information, and the perception that the originator of the loan will have the best information regarding the situation sometimes plays a part in pricing.

Conclusion

The mainstream nature of current asset-based lending activity has served to increase the number of opportunities for varying exit strategies for asset-based lenders. The growth in the size of the secondary loan markets, and the increase in the realization by hedge funds and other investors of the potential returns associated with distressed situations have increased interest in the asset class and therefore liquidity of the market. **abfj**

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