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Whereof What's Past Is Prologue...
Asset-Based Loan Underwriting Standards Begin to Slide

At recent meetings of asset-based lenders, a common theme was sounded: A scant 12 months into what many feel is a shaky economic recovery, asset-based loan underwriting standards are already sliding. Those who have been around secured lending for even a decade can easily remember similar cycles. Undoubtedly, Shakespeare said it best when he wrote, "Whereof what's past is prologue."

By Howard Brod Brownstein

The Irish dramatist George Bernard Shaw wrote, "If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience!" Or maybe it was philosopher George Santayana who nailed it: "Those who cannot remember the past are condemned to repeat it."

At recent meetings of asset-based lenders, a common theme was sounded: A scant 12 months into what many feel is a shaky economic recovery, asset-based loan underwriting standards are already sliding. Those who have been around secured lending for even a decade can easily remember similar cycles, like a tune from a familiar opera. In Act I, lenders set aggressive growth goals, and underwriters are under none-too-subtle pressure to get deals closed. Credit officers decry the easing of standards but are swept along by the tide of competitive forces. In Act II, lenders smile with pride on their large loan portfolios, lenders continue to consolidate and workout groups are downsized, even as storm clouds gather on the horizon. In Act III, the economy stumbles; credit officers tighten up on existing loans and effective interest rates rise, accelerating the spiral. Defaults increase, lenders pull in their horns on business development. To quote Yogi Berra, it's "Déjà vu, all over again!"

The apparent replay of this pattern led to several interviews with a diverse range of ABL leaders.1 One common observation emerged: Every lender is facing the same dilemma — how to meet growth goals while maintaining credit standards, in the face of competitors who are seeming to throw caution to the winds?

So what's different this time? Three possible factors:

- The powerful presence of hedge and debt funds that not only participate in or buy into, but even originate loans.
- The lessons learned from "Tranche B" lenders whom senior lenders have enviously seen earning handsome spreads, lending against value that senior lenders have historically overlooked.
- The "third way out" through the active market for distressed loans, to which lenders can turn when exits via a turnaround strategy or a sale of the borrower's business, or even foreclosure, are all relatively unattractive.

Each of these three factors undoubtedly has emboldened loan underwriters as they seek to meet growth goals. Several Wall Street firms have become senior lenders in their own right, graduating from buying participations to originating loans. Senior lenders are increasingly doing their own "B" strips of debt, providing a term loan or additional loan availability based upon enterprise value or intellectual property. And lender groups increasingly see new faces around the table, as some loan participants sell their positions early in the turnaround cycle to a growing community of distressed debt buyers.

More than one lender cited instances where they lost a deal after they had received a deposit to a competitor who waived a deposit and even significant parts of the due diligence.

But these developments notwithstanding, there has been an unmistakable leftward shift in loan underwriting. A senior officer of one of the country's leading lenders to retailers attributed the change to "the immense amount of liquidity, both in the system and on the sidelines ... and the willingness to put it to work which has created structural change and competition among debt providers." This lender wondered aloud, "Are we building another bubble?"

The mantra for credit officers seems to be, "Pricing, maybe; structure, never!" Lenders across the board complained about other lenders — never their own institutions — who are making seemingly irrational sacrifices in loan structure in order to book business. Some were willing to name names (sorry, this is not a kiss-and-tell article), and of course, they often named each other, although some names came up more than others.

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Not surprisingly, no lender that was interviewed would admit that his or her institution was among the most aggressive when it comes to loan structure. But clearly someone out there is booking loans that others view as excessively borrower-friendly.

Nearly all lenders interviewed indicated that ABL interest rate pricing had become "a race to the bottom." Bank-related asset-based lenders, who should have the lowest cost of capital, seem to feel that "pricing doesn't matter." One senior lender commented, "These low interest rates, while they last, should give borrowers time to use the lenders' money without putting much stress on operating capabilities." Several lenders accused competitors of loss-leader pricing-going as low as necessary to get the proposal signed and the deposit paid, and then "discovering" problems through the due diligence process that cause pricing to rise. Of course, such a practice is risky, both to a lender's reputation as well as to holding onto the deal.

More than one lender cited instances where they lost a deal after they had received a deposit to a competitor who waived a deposit and even significant parts of the due diligence. Other lenders said that they suspected competitors of closing low-priced deals which they expected to default, providing further profit opportunities through fees related to tripped covenants, and even default interest rates. Besides interest rates, lenders have historically looked to a host of fees for their profitability: closing fees, unused facility fees, monitoring or service fees, early repayment fees, etc. Key Bank's Lee Mosby and others cited examples where at least some of these fees had been reduced or sacrificed by a competitor in order to get the deal.

Wells Fargo's ABL chief Martin McKinley has definitely seen pressure in the marketplace on underwriting terms. He cited examples such as a large bank-related ABL group that provided a loan to the underperforming subsidiary of a foreign parent corporation, i.e., with no guaranty from the parent. Deals are getting done with slim equity cushions, and rarely with requirements for additional equity injections where this would have been standard not so long ago.

Dan Landers, the head of asset-based lending at Citizens Bank, agrees that there has been a loosening of standards in the marketplace, and says that while his institution has to stay competitive on pricing, sound loan structure is sacrosanct.

He notes, "We normally see this phenomenon further into an economic cycle, but this time it's fairly early. There's just too much money chasing too few deals." He said that many prospective borrowers are getting six or more loan proposals, and then playing off the lenders. He notes that since everyone wants to meet their growth goals, "it's tempting for lenders to get invested in the process once they've issued a proposal."

Lenders do not seem to have budged from the usual range of advance rates on accounts receivable and inventory. But many senior lenders have augmented loan availability by providing a "B" or "C" tranche themselves, based upon enterprise value, intellectual property, or other noncurrent assets, rather than leaving this lending opportunity and the attendant profit to the traditional "B" lenders. Such senior lenders doing their own "B" strips may prefer maintaining overall control over the lending relationship, rather than having to deal with a "B" lender behind their flank. The specialized "B" lenders are still quite active, however, since many senior lenders prefer to leave to them the junior credit risk, as well as to have "someone else to pick up the pieces besides the senior lender's workout department."

In any event, many "B" tranches are really mezzanine capital notwithstanding their junior lien position, predicated on enterprise value and carrying equity kickers.

Citizens Bank's Landers notes that the somewhat improved economy may have given lenders too much courage. Senior lenders in some cases provide "B" tranches that are formula driven, effectively expanding the lending formula. Such instances can be complicated where not all participants in the senior lender group are participants in a last-out "B" strip, and this can cause conflicts. As for loan pricing, Landers says, "It's a battleground," and his team has to work hard to beat his bank's minimum rates of return while still meeting growth goals and upholding credit quality and is confident that they well. He shakes his head when he sees finance companies — whose cost of capital should be higher than a bank's — pricing asset-based loans so low. He suspects that the phenomena of loss-leader pricing and tight-covenant tripwires may be part of those nonbank lenders' pricing strategy. However, one large nonbank lender claimed that his capital costs are not significantly higher than a regulated bank's.

Even lenders claiming to be holding the line on loan structure, admitted to providing overadvances that are increasingly permanent rather than seasonal or temporary, and which effectively amount to an increase in the loan availability formula. All lenders claimed that they avoid the "A" word (air ball), but as Key Bank's Lee Mosby notes, an overadvance that is not tied to a legitimate and temporary need, or for which there is no demonstrable asset value, is in effect an air ball.

Barry Kastner, executive vice president of Congress Financial, noted that his perspective emanates from Congress and Wachovia's ABL businesses being managed pursuant to a unified strategy. He agrees that Congress has definitely seen a trend toward loosening credit standards in marketplace, and in order to remain competitive, Congress has had to be aggressive in pricing, structure and the entire borrower relationship. He has seen loan advance rates creep upward in the marketplace, but believes that while Congress is not exceeding liquidation values, other lenders appear to be going right up to the point of 100% of OLV and beyond.

Kastner confirms seeing a lot of overadvances being offered in the marketplace, but said that Congress is providing them only when they are really justified by the credit. Kastner feels that Congress' reputation for credit discipline is not inconsistent with seeing real value beyond the liquidation value of the borrower's collateral, and lending on it selectively, a lesson many have learned from the "B" lenders. However, he cautions, such additional value is less likely to be found in a turnaround situation.

Congress is reluctantly willing to lose a deal if other lenders are being too aggressive but hasn't had to sacrifice its goals for growth. If the borrower just says, "Loan me as much as you can as cheap as you can," then Congress might not win. But Kastner says that where Congress can introduce the value that being part of Wachovia brings, it has a competitive advantage, and he attributes Congress' successful growth in part to this advantage. Unlike some less scrupulous lenders in the marketplace, Kastner said that Congress works hard to maintain its reputation as a lender that will do its best to close on time and in accordance with the loan terms proposed.

Congress' Kastner says that in an appropriate situation it will permit the borrower to go in and out of its overadvance facility based upon legitimate need and covenant compliance, since the latter provide an additional safeguard. He has seen the number of applicable covenants increase in situations where advance rates have increased, particularly in loans to retailers.

Key Bank's Lee Mosby is unsurprised by current conditions, noting that in an economic upturn it's understandably harder to grow an ABL business. Key's approach is to stretch to meet competition only where credit standards can be upheld. "It's important to pick your spots," Mosby says.

Sovereign Bank's veteran ABL leader Mike Maiorino has seen credit standards loosening in the marketplace as well, and sees more flexibility on air ball financing. He notes that the level of M&A activity is only just heating up, so most of the underwriting activity has been for refinancing. It follows that, to create growth, lenders have to stretch their structures,

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he says. Sovereign has had to work hard to maintain credit standards and will not give in to "the insanity in the marketplace," but still expects to meet its goals for growth. Sovereign's market position is especially strong in New Jersey where there are relatively few competitors offering $5 million to $15 million ABL facilities. Maiorino echoes the observations of others regarding middle-market lenders, who are accepting more leverage in their portfolios as well as less monitoring: "I see lenders take risks but not get paid for it."

An important element of loan structure is the availability cushion required at loan closing, which lenders have historically required to be substantial to assure that the borrower will not run out of cash before the ink is dry on the loan documents. However, based upon lender interviews, the required size of this cushion has been diminishing. A senior credit officer for one of the country's largest asset-based lenders cited a more ominous sign: The willingness of lenders to allow junior lenders and even shareholders to take money out of the business at the refinancing. This is akin to a real estate owner taking money out of the property through refinancing, predicated upon the property value having increased. Such withdrawals in connection with ABL refinancing used to be unheard of, or at least required high thresholds of excess availability. Now, some lenders are having to allow such withdrawals in order to meet competition. So, while the total debt leverage in the deal might not change in the case of a withdrawal by a junior lender, more leverage is being borne by the senior lender. This is perhaps a clear sign that underwriting risks may be increasing.

North of the border, things are no different. Mark Sturrock, head of Royal Bank of Canada's asset-based lending group, has seen some loosening of standards by banks, especially in western Canada where there have been some new entrants. While advance rates are up a little on accounts receivable and inventory, RBC does not do air balls. Pricing for ABL's is apparently as difficult in Canada as in the U.S.

Of course, the ABL market does not exist in a vacuum and is related to other types of credit. Jacques Busquet, a senior officer of Calyon, a prominent European bank formed by the merger of Credit Lyonnais and Credit Agricole that is very active in large loans in the U.S., has a different vantage point. He sees others booking large syndicated loans that seem more and more like asset-based credits. He says, "CFO's are taking advantage of current market conditions, locking in loan terms for the next five years. There has been a loosening of covenants, especially at the bottom of the investment grade scale, with the leverage ratio of total debt to EBITDA going to six to seven times over the last 18 months. The definition of EBITDA has also gotten looser. For example, the calculation of 'bank EBITDA' might permit add-back of start-up costs. Capital market deals are less connected to traditional banking activities, due to swaps and other derivatives. Hedge funds that may have bought their debt position at a discount could well have a different outlook, possibly favoring shorter-term solutions that will create an up tick in the value of their investment, whereas the original lenders may feel more committed to the borrower's longer-term recovery."

The head of another prominent European lender's ABL business that is ramping up its activities also noted that leverage is up significantly from a year ago, and pricing is down. "There is more risk and less profit," he says. He noted the liquidity in the marketplace from the CLO market and other fund-driven sources, and predicts that many of these loans will be restructuring candidates in the future. He attributes banks' aggressiveness to their increased ability to sell off much of their risk, and estimates that 30% of ABL deals involve stretch pieces that amortize in three years, i.e., over the entire length of a typical ABL deal.

Another element of loan structure — covenants — has also been affected by changing underwriting standards. Asset-based lenders are traditionally trained to worry more about loss of principal than the risk of covenant default. The maintenance of availability under the loan formula was often the most important, if not the only, covenant. Notwithstanding, many asset-based lenders historically required one or two covenants, such as minimum levels of EBITDA, tangible net worth, or a fixed charge ratio.

Increasingly, loans instead require "springing" covenants that apply only if minimum availability is breached. Wells Fargo's McKinley also remarks on these "conditional non-covenant" deals, but expresses concern that without covenants in place, it may be difficult to sustain a purely demand loan. A senior credit officer of another large asset-based lender boasts that his institution "rarely loses a deal over covenants."

The due diligence process, an important part of loan underwriting, has also been affected by market conditions. Some lenders are requiring fewer appraisals or narrowing the appraisal's scope, and also requiring less frequent collateral audits. Lenders' audit and legal fees, long a sore point but nonetheless an automatic pass-through cost to borrowers, are back on the bargaining table in many instances. With lenders having to "eat" more of these costs in the context of loans with narrower profit spread, it's at least plausible that corners may be cut as lenders seek to economize.

Interestingly, the most troublesome competitors that many asset-based lenders cited were not other ABL's or the hedge funds, but, as Key Bank's Lee Mosby points out, the bank-based middle-market lenders who are underwriting what used to be asset-based loans, as leveraged cash flow deals. Many middle-market lenders lack the monitoring capabilities of true asset-based lenders, and in any event do not require the level of collateral reporting that is typical for an asset-based loan. Ironically, several bank-affiliated asset-based lenders pointed the finger at these middle-market lending poachers within their own lending institutions! In addition to this "front-end" competition from middle-market lenders, there is also competition on the "back-end," as degraded credits that used to be transferred from the middle-market lender to its ABL group, are instead being retained by the middle-market lender, since they are competitively difficult to replace. The level of competition also varies regionally; for example, a senior officer with one of the country's largest ABL's noted that New England has seen a number of new asset-based lenders, as well as the return of others that had previously curtailed their ABL activities.

The question on everyone's mind, as we rise this roller coaster one more time, is when the next downturn will begin and what will happen in the ABL market. The senior lender to the retail industry quoted earlier predicts, "By the second quarter of 2005 we may see changes in the economy, but the effect of those changes may not be as dramatic as in past cycles." That is, due to the factors described above, lenders will have more ability to create liquidity in order deal with credit changes. Jacques Busquet of Calyon expects that 2005 will continue the credit expansion, but that 2006 could be the year of change. Citizens Bank's Dan Landers wonders whether loan pricing will come all the way back when the economic cycle reverts.

Congress' Barry Kastner expects the economy to remain relatively strong through 2005 and into 2006, but can't predict beyond. He noted that economic cycles seem to be shorter and more dramatic, with the pendulum swinging further each time, so while the current recovery may seem pretty solid, the next downturn could be more severe. A senior officer of another large nonbank ABL said that as early as mid-2005 we may see some changes in the economy, given all the variables: the war in Iraq, the weakness in the dollar, the rate of inflation in commodities, and the likelihood of increasing interest rates. Royal Bank's Sturrock sees the robust market in Canada continuing through 2005, but won't predict beyond that. The ABL head of a prominent European lender predicts that

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the next downturn — in about 18 months — will be more severe, and will be marked by loans owned by funds that are prepared to take ownership of the borrower or else trade off their loans, since they typically lack workout departments.

"We're in the most aggressive point in the cycle, enjoying the benefits of a good economy," Wells Fargo's McKinley says, but he notes factors could build in the opposite direction, such as inflationary pressures and increases in interest rates. He suspects that many businesses will not be able to stand the strain of even modest tightening, much less a catastrophic event.

Perhaps the most worrisome comment about current loan underwriting standards came from a loan marketing officer over more than a few cocktails at one of this past fall's well-attended conventions. He was describing a deal he had just closed, which he admitted involved significant risk. When I asked him whether he was concerned about the traditional attachment of his reputation — and job advancement — to the future of this loan, he laughed and said, "By the time this loan gets into trouble, and it will, either I will no longer be at this bank, or this bank will no longer be at this bank." So lenders' former front-line credit management tool, the business development officer, may have become more of an incentives-driven salesperson and less of a gatekeeper.

In closing, one of the local legends of asset-based lending, Bill Sudhaus (of Philadelphia National Bank, now Wachovia), used to tell his lenders how important it is that the borrower's management have a plan for a downturn, and that the lender needed a plan, too. He used to say that lending in an economic upturn was easy, since stress on borrowers was low. The real challenge for asset-based lenders is to be able to manage through your borrower's problems, and to deal proactively to deal with them. It remains to be seen whether the ABL industry will heed Bill Sudhaus's words, and prepare now for the next phase in the economic cycle. abfj

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ENDNOTE:

1 Interviews were conducted on a non-scientific, anecdotal basis, but included senior officers of several large asset-based lenders. Some lenders who were interviewed asked not to be identified by name or institution, but were nonetheless forthcoming with their opinions.

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