Risk Reward
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The Changing Face of Regulation

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ARE BANKS BUILDING UP A DEADLY PORTFOLIO OF UNDERPERFORMING LOANS? PART 2 – PREPARING FOR SIGNIFICANT LEVELS OF RESTRUCTURING

In the last paper in this series, banker Simon Ling-Locke, MBA, FCIB, DipFS Director of Credit Risk Services at Risk Reward Ltd, outlined a picture of expected increasing levels of distressed debt in the market over the coming years. Whilst many market participants had not positioned themselves to be protected against the liquidity and subsequent economic turmoil of 2008 and 2009, there does, Simon believes, still remain a narrow window of opportunity for players in the market to sit up and prepare themselves for the impending significant build up of distressed debt and subsequent restructurings.

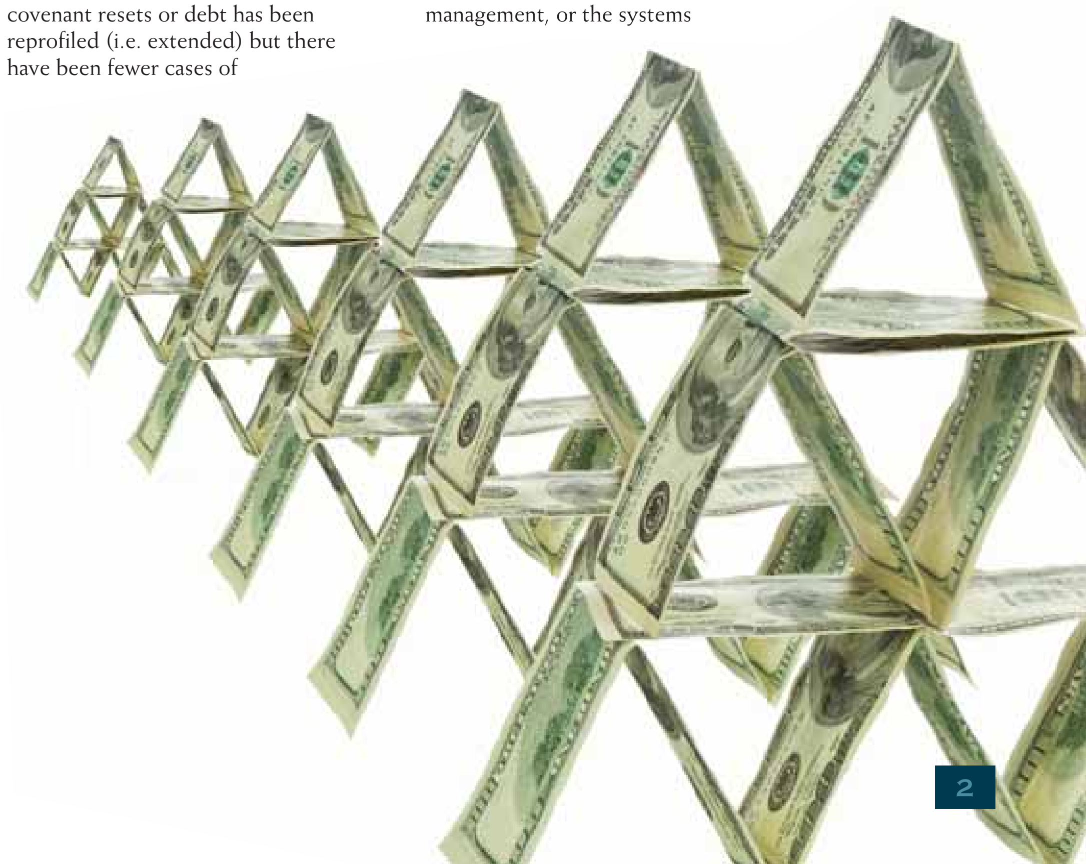
Some people may ask 'so what, we have dealt with major levels of restructurings during past recessions and will continue to deal with them now'. In a sense that is partly correct but there is also a whole range of new issues which will need to be faced and fewer lenders and restructurers have had to deal with those matters in the past. That is because of the nature of the more complex business and financial environment we operate in today than during previous cycles. This can most notably be seen in the leveraged loan market which had grown exponentially and had metamorphosised during the boom years.

This and the following paper in the series will seek to address the problems by considering some of the common themes seen in distressed credits as well as the key newer type issues restructurers will have to face (and which will be covered in the 3rd paper):

- impact from delaying a restructuring
- disconnect and lack of trust between management, owners and lenders (and indeed between different categories of lenders)
- the sheer volume of work and due diligence to be undertaken
- complexity of transactions with various different debt layers and differing agendas of the players
- cross-border nature of many transactions.

Impact from Delaying a Restructuring

At the present time, we are hearing of many cases where facilities have had covenant resets or debt has been reprofiled (i.e. extended) but there have been fewer cases of comprehensive debt and operational restructuring. Does that mean we are in the nirvana of well run companies setting great strategies and pursuing objectives with vigour but just facing some short term financial issue? I expect not. The reality is often that management, or the systems



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management are using, are weak or deficient in some way. If that is true, then for a lender it is particularly important to understand how far a company has actually slipped down the performance ladder because if that is not understood how can one know whether just a financial restructuring will be sufficient? It would be like putting a sticking plaster on a patient who has just fallen down the stairs, grazed their forehead and broken their arm. I will therefore look at the periods a company goes through as it slips down into greater and greater distress. There are four periods which can be roughly identified as:

The first period is when the quality of income starts to decrease (perhaps seen in a deteriorating trend in customer orders, more sale discounts being given, a declining EBITDA[1] trend), perhaps 9-18 months out from crisis. At this stage good management would be able to identify the problem and start to implement new strategies to try to correct or ameliorate the declining trend. So why don't weaker management take corrective action at this stage? It can be because they are not aware of the problem as their internal management information systems do not break down data in a fashion which highlights the problem and this can be as much a problem for large companies as for SMEs[2]. It can also be because management are in rejection and believe the problem is temporary. At this stage it is very unlikely that any covenant triggers would have been breached (especially when we consider the covenant 'loose'[3] and covenant 'lite'[4] leveraged transactions in the last 2-3 years of the noughties bull run) and thus lenders would not be able to take any formal action (except to sell their exposure in the secondary market), even if they were aware of the build up of an impending problem.

The second stage is where the quantity of income starts to decrease, perhaps 6-9 months out from a crisis. By now the borrower is likely to be facing more frequent periods of cash outflows and deterioration in its profit and leverage matrices. Depending on how 'loose' loan covenants had been set at the outset of an agreement, lenders might or might not have documentation rights to take some formal action. At this stage there is still cash in the business and time to undertake due diligence to identify the key issues and to create strategies to deal with the problem. This could include disposals of part or all of the business. Also, the wider market might still be blissfully unaware of the problem, or at least the extent of the problem, so any disposals might be achieved on 'normal' rather than 'distressed' terms and hence likely to achieve higher prices. If lenders do not have any formal documentation trigger, they might possibly still be able, through private discussions and persuasion, to encourage the company's management to take action. At this point lenders though do not have anything other than carrots to persuade the borrower of the need for change since no covenant breach has occurred. The reality unfortunately is that banks are rarely this proactive (and indeed their own monitoring systems might not even pick up the significance of the growing problem at this stage) and thus miss an opportunity to try to stabilise a situation and protect the value of their loans.

The third stage is when there is a cash shortfall. During this phase the borrower will be exhausting unused commitments under its credit lines (if still available for drawings) and taking longer to pay its trade and other creditors, very probably including tax (VAT, PAYE, corporation tax etc). Lenders should by now be sitting down and negotiating with the borrower, but have loose covenants meant that there is still no breach of covenant yet? Or has the focus been on just amending covenants and possibly re-profiling debt maturities rather than addressing the wider fundamental issues leading to so-called 'zombie companies'? The reality is that rarely will a financial restructuring work unless accompanied by an operational restructuring as well.

The final stage is cash crunch. The problem can no longer be put off and is immediate. This is the most critical period since businesses generally do not cease trading for lack of profitability but through lack of cash. Cash is king and like a car without fuel, the business comes to a grinding halt without it. At this point trade creditors have stopped providing credit and are now demanding cash upon delivery, overdraft and credit lines have either been fully utilised or pulled, wages and salaries might be overdue, factoring or invoice discounting lines are being scaled back or terminated for new business, commercial insurance is being

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[1] *EBITDA – Earnings before Interest, Tax, Depreciation and Amortisation*

[2] *SME – Small and Medium Sized Enterprises*

[3] *During the period 2005-2007 in particular, the headroom of where financial covenants were set to base case operating assumptions became weaker and weaker, perhaps with a headroom of 40%, sponsors' might have been allowed a 'Mulligan' (where one covenant breach would be ignored so long as it fell back within covenant by the next test date) or permitted to inject new equity with that equity being treated as quasi income for covenant test purposes. Any of these documentation issues would tend to reduce the ability of lenders to act on a financial breach until a much later date.*

[4] *Covenant Lite transactions started to be used in a few transactions, firstly in the US and then Europe at the peak of the market in late 2006 and early 2007. Covenant lite referred to two different types of transactions, a) those with just one financial covenant incorporated into the loan agreement and b) those with no financial covenants but with just an incurrence covenant test, i.e. an event of default or loan acceleration could only be called if there had been non-payment by the borrower.*

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withdrawn, etc. The scope to rescue a business has now become very limited indeed without some degree of fresh cash being injected into the business to at least keep the patient alive whilst a diagnosis is being carried out. The life of the company will now become entirely dependent on:

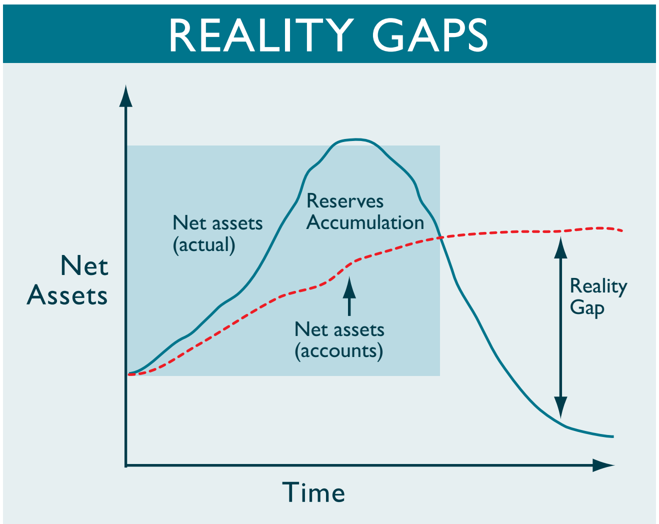
i) its immediate day to day cashflow (even the 13 week cashflow typically used by company restructurers will be too long by this phase); and
ii) the directors, who will be particularly concerned about potential personal liability of allowing a company to trade whilst insolvent (and it should be remembered that in some jurisdictions there is not just a cashflow test but also a balance sheet solvency test).

The simple truth is that the earlier proper action is taken, the better the chance for recovery or at least the preservation of value for lenders. If I am indeed correct in my analysis, then financial institutions which put problem credits on the 'back burner' through covenant resets whilst fire fighting and dealing with the more pressing companies heading for cash crunch, are actually missing a significant opportunity to prevent them from heading to cash crunch in the first place!

Disconnect between Management, Owners and Lenders

The other significant factor affecting the potential success or otherwise of a restructuring is the danger from differing groups not appreciating the severity of the problem until a fairly late stage leading to a blame game culture rather than one of trying to work together to find a solution. This is a very common theme, especially with players who have not previously experienced defaults and problem credits. There can also be the added complication that some creditors may have quite different agendas to the more traditional lenders (I will be discussing that in the next paper in this series).

As perhaps you might have realised from the earlier discussion, there can be quite a difference between reported historical performance and actual current trading and this is known as the reality gap.



During the good times, a company may well perform stronger than the audited accounts might suggest. This is because performance has been on an upward trajectory, time differences between current position and historical accounts, possible massaging of sales into the next period if budgets have already been achieved so enabling a stronger start towards attainment of targets during the following period. During bad times the opposite happens with hidden reserves being depleted. At first this will just show up as a flattening of the upward trend. Senior management may be unaware of the deterioration or be in denial of the crisis leading to delay in taking action and to the possible use of creative accounting. Eventually something will show through (a drop in sales or profit margins, breach of covenants, cash shortfalls) and it is at this point that the crisis is magnified due to the downside reality gap. Creditors face the shock of a sudden change in the paradigm and lose faith in the management's capabilities. At the same time, though, it is vital that the main stakeholders understand: i) the key issues being faced, ii) the steps which need to be taken, and iii) the probable time to remedy the situation. However, people often base decisions on perception and not necessarily reality so if the perception is one of lack of trust in the capability of management (and indeed in some cases management might need to be replaced or augmented) an adversarial approach quickly develops between owners, managers and lenders and precious time is lost as the borrower slips ever closer to cash crunch from cash shortfall.

This though is not the end of the story as organisational structures, positioning in the capital structure, documentation issues, asset values, location and quality of title, other stakeholder claims, negotiating leverage, are all factors which have to be understood and brought into the equation. I will be exploring these factors in the next issue.

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