

Lender Exodus Allows Survivors to Be Selective

Diligence Required for Tapping Capital Markets

BY BAKER SMITH, CTP, MANAGING DIRECTOR, BDO CONSULTING CORPORATE ADVISORS, LLC

While the availability of new loan money has improved somewhat since last fall, potential borrowers are finding a much smaller funnel for middle-market loan requests, and surviving lenders are handling a volume of loan packages much larger than historical norms. As a result, business development officers are overwhelmed with new business loan requests.

For some lenders, the credit freeze was brought on by an increase in their cost of funds. In the spring of 2008, the London Interbank Offered Rate (LIBOR) shot up in response to the credit crisis and perceived risks, which caught many lenders off guard. Increases in LIBOR, the rate often used to calculate the cost to lenders for short-term funds, left some lenders upside-down with their borrowers. Even in cases in which a spread remained between a lender's cost of funds and a customer's interest rate, it sometimes was not enough to cover a lender's overhead and create residual profit.

While some contracts allowed lenders to pass along the increased LIBOR to their clients, there were occasional time lags in doing so. In other cases, contract terms limited rate adjustments to set intervals or to contract renewal.

Even if a lender could reset a borrower's rate, it wasn't always practical to do so. First, a lender would encounter inevitable protests and demands for negotiation from an affected borrower. Second, the rate is typically only part of a complex formula a lender uses to consider all of the fees charged, the borrower's ability to pay, and the risk that the borrower will refinance the loan elsewhere.

The likelihood of a borrower leaving for another lender, which is known as "runoff," was also a consideration. Given the high cost

of marketing and underwriting new loans, lenders loathe losing performing borrowers to runoff. And riskier loans remain with the lender after more attractive clients flee because underperforming loans are more difficult for a borrower to refinance with a new lender.

As a result, a particular loan portfolio's average interest rates easily may have been less than a lender's cost of funds. When that occurs, the more money a bank loans, the more money it loses. This cost of funds inversion was one reason that many lenders stopped lending altogether.

While there were more than 60 lenders participating in syndicated-loans in early 2000s, only about 10 are doing so now.

Reassessing Risk

Other factors came into play as well. As lenders struggled to find money at any cost to fund their client obligations, risk became a major consideration. Risk was the iceberg that jolted the financial system when it became apparent that basic considerations, such as the cyclical nature of the economy and alternative exit strategies, had not been factored into collateralized debt obligations (CDOs) and other new financial instruments.

As a result, risk considerations became a matter of priority for lenders. Given both the cost and scarcity of capital, the priority was to put money and underwriting time into the simplest and least risky financial vehicles. For many financial institutions, U.S. Treasury bills offered the least risk, the least complex underwriting, and the best guaranteed return. While putting money in Treasury bill safe havens diverts money from much-needed business loans, it helps lenders avoid management-

distracting criticism and second-guessing from the president and Congress.

But this risk prioritization has inhibited many lenders from taking any risk at all, regardless of their ability and experience in underwriting traditional business loans. As a result, lenders were simply not in the new loan market, at least temporarily.

However, rather than risk excessive portfolio runoff, many lenders have been willing to consider new loans and restructurings for existing customers, provided the borrowers were not in default. For those who were in default, continued lender support was possible, provided the borrower was not in a downward spiral. However, appraisals and repeat appraisals are now required more often not only for existing loan renewals, but also for new financings.

The disappearance of a large number of lenders from the business loan market — an entire tier of non-bank and foreign bank subsidiaries has evaporated — also has had a measurable impact on the ability of lenders to make new loans. While there were more than 60 lenders participating in syndicated loans in early 2008, only about 10 are doing so now.

Among the lenders remaining in the market, there is not enough critical mass to execute large syndications. Since asset-based syndications are not possible in the traditional sense, there are only club deals, which consist of a series of individually negotiated one-off contracts. Since these club deals are restricted by the total number of lenders and each lender's hold limits, maximum loan amounts have also been greatly reduced. While it was possible to syndicate a \$1 billion asset-based facility in early 2008, recent club loans have maxed out between \$250 million and \$500 million.

This evaporation of asset-based syndication lenders has characterized all commercial

continued on page 2

continued from page 1

and industrial (C&I) lending, including corporate, commercial, and lower-middle-market asset-based loans.

While all of the factors previously discussed led to loan market exits, LIBOR helped determine who survived. In large part, survivors were national banks and major regional banks. In this regard, deposits probably gave them an edge over most of the foreign bank subsidiaries and non-banks.

While some would argue that economies of scale and government support played a part, deposits appear to provide national and regional banks with a supply of money to lend at rates more favorable than LIBOR. In any event, except for some foreign bank subsidiaries that both accept deposits and make loans, most of the disappearing banks were dependent on sources other than deposits for their funds, many at LIBOR.

CDOs and other financing vehicles seemed to have been built on a model that assumed a continuously expanding economy with ever-increasing values of collateral. The years immediately preceding the financial crisis had witnessed precisely that kind of expansion, and the model seemingly ignored the cycles of expansion and recession which have characterized the economy over recent decades. Indeed, some economists had gone so far as to say that the era of boom and bust was over because the federal government had learned to moderate such cycles and encourage continuous economic expansion.

Even though the risk associated with CDOs and other new financial instruments was underestimated, why were traditional business loans affected? The risks for asset-based and commercial loans typically have been a matter of underwriting. Because of experience with negative events affecting businesses and alternate exit scenarios, loan underwriters have been able to structure business loans to minimize risks and ensure repayment if negative events did occur.

However, when problems developed with CDOs, it turned out that flipping the financial instrument to a new buyer was not as viable an exit strategy as many originally thought, and CDO valuations plummeted. At about the same time business asset buyers with cash became scarce. As a result, business collateral valuations also dropped.

Political Fallout

Amid the political fallout from the banking crisis and government bailouts, characterized in part by attempts to enact punitive taxes on bonuses, new business loan incentives for business development officers were significantly dampened. Incentives, bonuses, and marketing events are integral to the market economy, including the market for new business loans.

The political attacks also helped drive down the value of bank stocks, as some investors concluded that financial institutions would not be allowed to recover and succeed. They also led many business and financial leaders to conclude that Washington was not serious about economic recovery, but instead was pursuing a broader social makeover agenda.

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Indeed, Ben Bernanke, chairman of the Federal Reserve Board, seemed to indicate that a few cuts to the discount interest rate would counteract any negative impulses of the economic cycle and keep the expansion going. However, a majority of investors apparently were unimpressed with the Federal Reserve's rate-reducing tweaks because the economy plunged into recession and the stock market fell to less than 50 percent of its 2007 high.

The Federal Reserve discount rate cuts did little to help lenders' cost of funds. LIBOR apparently was regarded as a more accurate assessment of the value of money on a risk-adjusted basis but had little impact on collateral values. Not only did the rate cuts fail to halt the economy's slide, but also now that the discount rate is only 0.25 percent, there is little ammunition left with which to fight inflation. A Gallup poll conducted in February found that more than 70 percent of Americans are worried about inflation.

Competitive Environment

How does a turnaround consultant find a loan for a restructuring in this environment? The money may be available, but an advisor must be diligent to find it. First, though, the business plan must be comprehensive and logical. Lenders are so busy that loan requests that require substantial work to close any gaps in the story will be bypassed for simpler, more


clear-cut opportunities.

Although many middle-market asset-based lenders have exited the market, the entrepreneurial tier of smaller asset-based lenders is very active. Smaller entrepreneurial lenders typically borrow funds from larger asset-based lenders and charge their own customers even higher rates.

Nearly all new C&I loans feature both the interest rate and the structure appropriate to the risk. With fewer lenders at every level of the business loan market, it is not necessary to give away yield to win loans.

Structures are also more appropriate and include, for example, personal guarantees or provisions for more frequent appraisals. Frequent appraisals for inventory, equipment, and real estate help prevent surprises in collateral valuations like those that occurred when CDOs melted down. If a business trips its loan covenants, a lender has adequate tools and leverage in place to take remedial action, including introducing a turnaround consultant into the situation.

This is an opportunistic time for lenders to move upscale in both quality and size of loans. With only a few competitors looking at a large number of deals, a lender can be selective, funding only those applicants with believable business plans and adequate collateral coverage in case the turnaround plan fails.

Besides getting advantageous rates and structures, a lender will likely have the borrower relationship and associated business for a long time. In these difficult times, borrowers are likely to be so grateful for a lender's trust and understanding that they will be reluctant to ever leave. 

Baker Smith, CTP, is a managing director of BDO Consulting Corporate Advisors, LLC. Smith has led more than 200 crisis management and turnaround teams for distressed companies ranging from \$25 million to several billion in revenues, several as interim CEO and CRO. He is a member of the Beta Gamma Sigma business honor society and a recipient of TMA's Outstanding Individual Contribution Award. Smith is TMA's Vice President of Conferences. He can be reached at bsmith@bdocca.com or (404) 819-6304.



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