Viewpoint

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Oops! Tripped Covenants: Avoid Catastrophe After Loan Default

By Baker Smith

"All of a sudden my sales went down by 10%, and they haven't come back yet," an owner of a tool distribution company revealed. As the economy sputtered, his company's sales decreased. However, unlike previous downturns, there has been no bounce back, nor any sign that a return to pre-existing sales levels is imminent. Many businesses experienced a dramatic sales decline in the fourth quarter of 2008, and sales were no better in the first quarter of 2009.

Despite Federal Reserve Chairman Ben Bernanke's sighting of "green shoots" of an economic recovery, many companies still have no uptick in sales. Sales drops were not confined to any particular industry sector; consumers cut spending across the board, particularly in automotive, housing and retail. The consumer pullback was in reaction to numerous factors, including: forced sales of bedrock financial institutions, looming tax increases, increased regulations, commodities inflation and declines in value of the dollar, stocks and housing. As consumers processed these events, they cast aside many old spending mantras, such as "real estate always increases in value," "stay with stocks" and "the dollar is the world's currency."

While sales did not completely dry up, the new, lower level of sales reflected the consumer's reaction to numerous, significant economic events, an outcome unlikely to be influenced by official words and speeches. As a result, the optimistic consumer was replaced by the sober consumer. As the consumer spending decline rippled through the economy, business to business sales responded with cutbacks as well.

Although economists have attributed the drop to the recession, sales run rates for immediately preceding quarters have been characterized as unsustainable, excessive and driven by easy cash. Consequently, there is a widespread view among lenders, business leaders and turnaround consultants that the recent sales decline is, at least in part, permanent.

As companies reported fourth quarter 2008 and first quarter 2009 results, lenders noted with alarm that the sales drops and related ratios were historically unprecedented. Many of these key ratios affect loan covenants designed to protect a lender against financial loss. Such covenants are objective in nature, and simple to calculate once a borrower's financial results are plugged into the covenant formula.

Tripping loan covenants is typically an event of default, meaning that a company may be forced to immediately repay its loan in full or face foreclosure and sale, although refinancing the loan with a takeout lender is sometimes an option. However, refinancing has proven difficult in recent quarters because poor company ratios may classify the loan as "criticized" the instant it hits the takeout lender's books. Criticized loans are unattractive, even at handsome interest rates, because of their burden on lender capital reserves.

Given lender loathing of the political and public relations fallout from failed stress testing, lenders avoid the capital negative impact of criticized loans. What is more, takeout lenders are averse to credit risk and are uncomfortable with a company in default, particularly if the company is losing money. The prospective lender would prefer a company had several profitable or breakeven quarters before booking a new loan. Therefore, many companies in default are forced to stay with their existing lender.

Plummeting sales and tripped covenants do not have to mean the end of a company, however. How have borrowers in breach of covenants survived with their existing lenders?

Fortunately, such lenders were reluctant to demand full repayment or to begin foreclosure because lenders felt this was a poor point in time to liquidate and many borrowers were proactive in approaching their lenders with turnaround plans. Disappointing realization on companies and their assets in the last quarter of 2008 unnerved lenders who were considering liquidation.

Fewer buyers participated in such liquidations, due to valuation risks and lack of cash or credit, so recovery proceeds fell sharply and lenders had to book their losses. Consequently, lenders decided to avoid locking in almost certain losses by taking a "wait and see" approach, except when borrowers were bleeding so much cash that they would hit the wall soon anyway.

As a result, both borrowers and lenders have found turnaround plans very valuable in this economy. In one instance, after experiencing a 50% decline in sales, a recreational vehicle company approached its lender with a turnaround plan prepared by an experienced financial advisor. The plan assumed a steady state sales run rate while cutting overhead and operating costs to bring the company to break even. Rather than call the loan, the lender was pleased with the company, and continued to make cash advances even while the company was barely break even and still in technical default. Why? In comparison to the lender's other borrowers in the same industry, this company appeared proactive and poised for survival.

In contrast, when falling sales led to loan covenant defaults, a building products supplier avoided talking to

continued on next page

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Viewpoint

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continued from page 11

its lender. After the lender confronted the company and asked what management planned to do, the company downplayed the lender's concern. The company indicated it planned to take no action because it believed it was just a matter of time until sales returned. Management reasoned that any cuts would leave the company unprepared to take advantage of resurgence.

However, the company was unable to marshal any evidence of a rebound, such as increased customer purchase orders or positive building industry trends, and the company had no resources to fund cash losses pending the imagined sales revival, so the lender thought the company would run out of cash. In this case, the lender did not support the company's plan and insisted a turnaround consultant be retained as a condition of forbearance.

In today's economic climate, the key to company survival is to be proactive and to communicate with a lender in a credible way. A turnaround plan will not only validate revenues, but it will also cut costs to a level that will eventually return the company to breakeven. If company management feels that declining financial performance calls for a replenishment of credibility, a turnaround consultant may be of value. A believable business plan should contain more than a budget; it should spell out detailed operating assumptions, assign specific tasks to named managers, and establish a timetable for implementation. Because such a specific plan typically improves a company's likelihood of survival, a lender may overlook the company's covenant default and turn its attention to other portfolio companies with more pressing problems.

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