The Bicycle Theory of Management

Things Sure Get Wobbly When the Bicycle Slows Down

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In the 1870s, when the British Empire was the epicenter of the financial universe, the editor of the *Economist*, Walter Bagehot, observed: "In England, after a great calamity, everyone is suspicious of everybody. As soon as that calamity is forgotten, everybody again confides in everybody."

Leading up to 2008, the lending marketplace was also a place where everybody confided in everybody. The liquidity in the ABL and cash flow loan markets was jaw-dropping. But fast-forward to 2009: everyone is suspicious of everybody.

Trust, or rather the lack of it, as Mr. Bagehot observed, is the problem. (Incidentally, the word *credit* comes from the Latin word for *believe*.) In 2008, the S&P 500 swooned 39.5%, exactly matching its decline in 1937 and marking its third-worst year in more than a century. According to the *New York Times*, bear markets usually take twice as long to fall this far as they do to rise by the same amount.

Likewise, in the credit markets the liquidity problems in 2008 have become corporate-default problems in 2009. The past year was "the worst year in the history of the high-yield market for price declines in junk bonds — by a huge margin — and quite possibly the worst year of all time in the capital markets history of this country," according to fixed-income analysts at Citigroup. The price declines were triggered by fears of escalating defaults, and 2009 promises to be a tough year as well for junk bond defaults and stalled maturities. The sheer amount of junk bond maturities in 2009 will stress-test many balance sheets — and the patience of lenders — in the next 12 – 24 months. Indeed, with the worst job losses in 45 years, corporate defaults will undoubtedly accelerate.

Like a bicycle going full-speed, things were very smooth when the economy was expanding at a rapid clip. Private equity groups were buying and selling companies at a dizzying pace, adding leverage at every opportunity. Now, like a bicycle that's slowing down, things are getting wobbly.

Rocket Ship to the Moon

Some lenders are now reining in borrowers that were positioned for rapid expansion but haven't throttled back growth plans. Many buyouts in the last two years were built on aggressive growth in order to justify big multiples. Lenders were invited to "step aboard the EBITDA rocket ship to the moon," and now the second and third stages of the rocket haven't fired; consequently, the rocket is losing altitude. Yet managers may be reluctant to admit that the growth will not materialize, or, in fact, that the tide has reversed.

In particular, we see numerous companies that haven't cut back on head office overheads, new product development or other "growth" elements of their cost structures. Some lenders find themselves confronted by tough choices — managers are telling lenders that aggressive marketing spending is needed to goose sales, yet lenders look at "soft" capital expenditures as a potential black hole for liquidity. We saw one clothing company, for example, spend a fortune on a 2008 Christmas catalogue that got delayed because the printer didn't get paid in advance. When the catalogue arrived a month late in the customers' mailboxes, many customers had gone elsewhere.

Many growth-company management teams have not lived through a deep

When the Wheels Come Off

Let's look at the bicycle industry. Strong summer sales in 2008 led many bicycle manufacturers and bicycle store owners to think they were largely insulated against the recessionary downdraft. Since 1999, sales of bicycles in the United States have held steady at around 18 million units, according to the *New York Times*. However, the number of specialty bicycle stores in the United States dropped from about 6,000 in 2000 to 4,300 in 2008. Chain stores, mass merchants and the Internet account for 83% of bicycle units sold but only 50% of dollar sales.

Double-digit increases in sales during the summer of 2008 prompted many retailers to make big commitments for 2009. Some store owners were reporting business up nearly 30%. But retailers misread the market signals that high gas prices would mean more bicycle commuters. Business skyrocketed in mid-2008 in tandem with gas prices, but so did the prices of bicycles and bicycle accessories.

Approximately 98% of bicycles are manufactured overseas with long lead times, so when retail bicycle sales started to drop, things got backed up like the runways at LaGuardia during a Friday-afternoon thunderstorm. Part of the problem facing retailers was that they made commitments for bicycles at the high-water mark for prices in mid-2008, and now the bicycles need to be sold in a rapidly softening marketplace. The higher prices for bicycles are turning some customers away, and sales have skidded into the ditch.

Surviving in this economic climate means bicycles retailers must choose products carefully to keep inventories lean and turning fast. With the credit crunch hurting retailers and distributors, "FISH" inventory (First-In, Stays-Here) can sap the debt capacity of a company dramatically.

recession before and are behind the curve when it comes time to cut costs. One common theme we see in underperforming companies is that management can't believe how fast a downward spiral can accelerate. A common refrain is "we can't make those cuts — they're too close to the bone." In some instances, the company's business model has changed dramatically and all spending needs to be completely reevaluated.

Relationship? What's That Word Mean Again?

We are now starting to see private equity groups "throw the keys on the table" on deals where they're out of the money. Although this is not what lenders want to hear, private equity groups partially mitigate the situation if they agree to move out of the way quickly. When they delay the inevitable or become obstructionists, then no one wins. There are some instances where lenders ask legacy owners (who usually rolled some of their original equity into the new entity) to step back into the game with some fresh equity and management expertise if the private equity group bails.

In the late 1990s, any commercial-finance portfolio manager who managed to get a private equity group to consent to a capital call would get high fives in the hallway. Fast-forward to today: some lenders have made the capital calls, only to be told by the private equity groups that some of their limited partners can't fund — they too have been crushed by the equity and real estate markets or had their liquidity impaired by the auction-rate-preferred debacle in 2008. Another problem with capital calls is that they appear to be a good solution when they're inked, but heavy negotiations always seem to take place when they're actually made.

What happens when a member of the lending group can't fund an obligation under the credit agreement? If there's a defaulting-lender provision in the intercreditor agreement, then the other lenders can force the defaulting lender to take a haircut. But some intercreditor agreements don't have defaulting-lender provisions, so there's a stalemate. This is one reason that the average hedge fund lost 23% last year and some lost more than 60%, according to Hedge Fund Research. Crumbling markets and a wave of client redemptions took their toll. Lender defaults could accelerate in 2009 and 2010, despite some hedge funds blocking redemptions.

You Bring Them a Chest of Gold and They Tell You It's Too Heavy

Banks are struggling to navigate the various cross-currents between Wall Street and Washington, D.C., Beltway politics. Some politicians are complaining that the banks are hoarding capital while the recession heads into its second year, but banks can be forgiven for shoring up their reserves during what is shaping up to be the worst downturn since WWII. Bank lending dropped 55% in 2008, according to the *New Yorker*. At every conference and industry lunch across America, you hear the same thing: no deals are getting done.

Some lenders are even showing long-time borrowers the door. This isn't necessarily the borrowers' fault. In many cases, the lenders' capital tightness prevents them from funding loans. Even some strong borrowers are saying that when they ask for new credit from some lenders, they feel like "you bring them a chest of gold and they tell you it's too heavy."

What's more, if competition among lenders forces a lender's cost of funds to a rate higher than the rate it agreed to charge the borrower back when funds were flowing freely, it has no choice but to exercise its discretionary rights to terminate or decline to extend the loan agreement, according to Roger Chari at Hahn & Hessen in New York.

"Similarly, if a lender has limited capital to lend, having a performing borrower may not be enough if the borrower's risk profile is higher than the profile of other borrowers or potential borrowers of such lender. The tighter credit standard might come voluntarily from the lender's credit committee, or involuntarily from the lender's funding source," says Chari. In each of these cases, a performing borrower that trusted its lender in good faith to be "commercially reasonable" in administering the loan can find itself scrambling to get other financing on short notice in order to prevent its lender's financial difficulties from ruining its own business.

Lenders are fearing a prolonged recession because of the steady drumbeat of bad headlines — plunging auto sales, record job losses, a dismal 2008 Christmas season for retailers, overleveraged companies sinking beneath the waves and the "F" word: fraud. Indeed, one hedge fund lender told us that in 2006 most of his 100 commercial and industrial borrowers were ahead of plan. Today, a company that is ahead of plan is the exception.

Borrowing Bases — A Moving Target

In Q1 and Q2 2009, some senior lenders are getting more nervous as collateral values weaken. Until now, they could be somewhat sanguine about weakening financial performance because collateral was holding up. However, collateral in the form of commodities such as steel, lumber or oil is showing some cracks. The related borrowers can be very worrisome to lenders that report on a monthly or even weekly basis.

Commodity markets in 2008 recorded their worst performance since modern records began, according to *The Financial Times*. The bull market for commodities, which lasted six years, collapsed into a disorderly retreat as the worldwide financial crisis dragged the global economy into the worst recession since WWII. The five commodity indexes tracking energy, metals and agriculture markets showed an average 40.5% dive in the fourth quarter of 2008, taking the full-year fall to 42.3%. Copper fell 54% during the year, and aluminum sank 36.1% in 2008.

Ugly surprises are starting to happen. Lenders with monthly borrowing bases may realize that borrowers now have major overadvances, for example. (Indeed, many scrap-metal operations have borrowing bases that are "white-knuckles" ever since metals prices began their collapse in 2008.) Other lenders are finding that the cash cushions from opening minimum availability of new loans have evaporated in just 60 days. Unless a lender ensures that a company has no held checks, opening availability can be short-lived.

2006: Maybe a Good Year For Some Wine Vintages, but Not For Loan Agreements

It was a year that many lenders wish never happened. Why? Because in the market froth of 2006, loan agreements became so weak that, when the house started to burn, the firefighters were powerless to do anything about it. Some lenders are now watching the house burn to the foundation.

Some senior lenders are locked in loan agreements that were drafted not by their own attorneys, but by their borrowers' attorneys under the careful watch of the investment banks putting the deals together. I've heard stories of investment bankers telling senior lenders which law firms the senior lenders were allowed to use in certain cases. As a result, the senior lenders' powers were subtly restricted in ways that are now coming back to haunt

The 1862 Financial Failure and Confederate Defeat

In May 1863, two years into the American Civil War, Major General Ulysses S. Grant confronted the Confederate army under Lieutenant General John C. Pemberton in Vicksburg, Mississippi. Surrounded, with Union gunboats bombarding their positions from behind, Pemberton's army repulsed two Union assaults, but they were finally starved into submission by a grinding siege. On July 4, Independence Day, Pemberton and the Confederates surrendered.

The fall of Vicksburg was as one of the great turning points in the war. And yet, from a financial point of view, it was not really the decisive one. The key event had happened more than a year before in New Orleans, more than 200 miles downstream from Vicksburg. On April 29, 1862, Flag Officer David Farragut had run the guns of Fort Jackson and Fort St. Philip to seize control of New Orleans, thus strangling the South's cotton exports.

The finances of the Confederacy are one of the great might-have-beens of American history, according to Douglas Ball, author of *Financial Failure* and *Confederate Defeat*. A lack of hard cash as well as a lack of industrial might undercut what was, in military terms, an impressive effort by the Confederate states, according to Harvard history professor Niall Ferguson in his new book, *The Ascent of Money.*

According to Ferguson, the South desperately needed capital from Europe, but European investors mistrusted the Confederacy (Confederate President Jefferson Davis had openly advocated the repudiation of state debts when he was a U.S. Senator). To raise capital in Europe, the Confederacy had to sell bonds that were collateralized with cotton. To make these bonds attractive, the Confederacy manipulated the price of cotton, driving it up from 6.5 cents per pound in 1860 to 27.25 cents in 1862.

If the South had managed to hang onto New Orleans until the 1862 cotton harvest had been exported to the cotton mills of England, then it might have managed to sell £3 million of cotton bonds in London. However, collateral is only good if a creditor can get his hands on it. Any investor who wanted to monetize the collateral had to run the Union blockade in and out of New Orleans, which was not an enticing prospect. Breaking lenders' trust by manipulating the value of the collateral and then not being able to deliver the collateral was devastating to the Confederacy.

them. Let's look at an example.

In 2006, an investment bank issued a "hog-call" on a leveraged buyout for a food products company on the West Coast. The revolver was $35 million, and there was another $85 million in a subordinated unitranche term loan agreement. The lenders took comfort in the fact that the investment bank doing the hog-call was a participant in the term loan and was the unitranche agent. The revolver lender thought its position as the senior lender would protect it; however, the loan documents incorporated a nasty thing called a steering committee in which 51% of all lenders could block many key terms of the loan agreements.

At the closing dinner in Santa Monica, all seven of the unitranche lenders, the revolver lender and the borrower made many a toast, evocative of Robin Hood's men: "one for all and all for one."

Then the investment bank sold its position in the unitranche loan.

Then the investment bank resigned as the unitranche agent.

Then the cash burn started.

Deciding that the revolver lender didn't have enough skin in the game (to quote one of the unitranche lenders), the steering committee told the revolver lender that it couldn't have access to the borrower's cash. The revolver lender tried to establish cash dominion anyway, and the borrower refused, cheered on by the steering committee. (The revolver lender was not a bank, so the borrower's bank accounts were not readily accessible.) The revolver lender requested daily borrowing bases for accounts receivable and weekly instead of monthly inventory reporting, but the borrower refused. By this point, the unitranche lenders had hired separate legal counsel. The legal counsel for the revolver lender opined that the language regarding its rights as the senior lender was very weak, and the attorneys gingerly suggested that signing loan agreements drafted by investment banks maybe wasn't such a good idea.

The revolver lender is now convinced that the unitranche lenders are preparing for a fight.

In 2008, mezzanine and subordinated-debt lenders were starting to get nervous about tightening cash flow. In some cases, it was debatable whether they would be in the money once the 2008 financial results rolled in.

This case illustrates several important points. First of all, ten years ago no ABL or cash flow lender would sign a loan agreement with such weak language. Second, leveraged buyout lenders typically knew and trusted each other when they were doing deals together in the late 1990s. In deals governed by steering committees, the participants were your friends. Not anymore.

Things could get uglier in 2009 and 2010. Revolver lenders will be saying, "I won't do anything more, and I'm cutting back on the revolver by increasing reserves. Forget any talk of overadvances."

The slowdown in the economy is translating into lower EBITDA, tighter profit margins and lower debt and equity multiples. In 2008, mezzanine and subordinated-debt lenders were starting to get nervous about tightening cash flow. In some cases, it was debatable whether they would be in the money once the 2008 financial results rolled in. Then, it was the second-lien lenders that started to feel some pressure. Now, ABL lenders are starting to see cracks in their portfolios. Again, as the bicycle loses speed, it starts to wobble.

The scarcity of new loans in the marketplace has been partially caused by the secondary market for bank loans crowding out the new-loan marketplace. When a lender can buy a LIBOR +4% loan with four years' average life and a 15% yield, why make a new loan? Many lenders feel better about buying the secondary loan of a proven company versus making a new loan to a company whose performance may be unproven.

Another reason for the scarcity of new financing is that few loans amortize, so there's minimal run-off or churn in the portfolio. With 1% in annual amortization, for example, many lenders' capital structures are frozen.

In September 2008, loan pricing went through a dramatic (and many lenders will say a welcome and long-awaited) uplift. Loan structures tightened. Today, the job of being an agent can be tough. A modest request by a borrower, such as incorporating a new subsidiary, might receive a disproportionate response from the lender group. At any opportunity, lenders want to reprice or recovenant a loan, but some borrowers will go to extraordinary lengths not to refinance or change the terms of an existing deal.

DIP Financing — Don't Bank on It

There is very little debtor-in-possession (DIP) financing available these days. This is in stark contrast to the last recession in 2001–2002. According to industry players, there is only one traditional commercial-finance firm, some Canadian banks and a handful of hedge funds that are actively soliciting new DIP business. Traditional ABL shops still want to do the triptych of bankruptcy financing — the prefiling financing, the DIP and the exit financing with existing borrowers — but they are not going out of their way.

Despite a jump in bankruptcy filings

Commercial finance professionals continue to face the double-edged sword of industry consolidation. On one hand, industry consolidation has meant better pricing and better structures on new loans. On the other hand, the ranks of commercial finance professionals are getting thinned with the industry consolidation.

last year, new DIP loans were sharply lower in 2008 than in the two most recent bankruptcy waves, according to data from Thomson Reuters. In 2008, the number of new DIP loans was about 35% below the number issued during the economic downturn in 2002 and about 46% below the number issued in 2005 ahead of changes to the bankruptcy code. The data showed lenders are still doing "defensive DIPs," or "DIPs of necessity," but they're often very short-term and contain restrictions or demands for a quick auction process. The lender's incentive isn't to rehabilitate companies, but rather to keep the company afloat long enough to find a buyer.

Interest rates for DIPs have spiked in recent months, more than doubling from a year ago. The average DIP loan in 2006 and 2007 was LIBOR plus about 4% to 4.5%. Last year, it jumped to LIBOR plus 6.1% but rose throughout the year. In January 2009, chemicals maker LyondellBasell, which filed for Chapter 11 protection, paid Libor plus 10% for its term loan.

Players willing to do a DIP are able to charge hefty fees and rates simply because of the scarcity factor. Also, many hedge funds want 2–3 years of call protection and, consequently, are shying away from DIPs because there is no real call protection. Some industry observers foresee more fights in the years ahead because of the aggressiveness of some hedge funds, but others think the courts won't cooperate.

Compounding this problem is the difficulty of facilitating a 363 sale once a company is in Chapter 11 and has a capital structure that looks like a wedding cake. How do you allocate the proceeds among the revolver lenders and the term lenders that claim they are pari passu?

The Year Ahead

Indeed, with lenders fearful of surging defaults in commercial loans in 2009, workout departments are building bench strength in a hurry. Defaults are predicted to double in 2009. Until 2008, underperforming loans could be sold or refinanced with comparative ease. Today, lenders have to work out problem loans.

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Like a bicycle going full speed, things were very smooth when the commercial finance marketplace was moving at a rapid clip. Now that it's slowing down, things are getting wobbly for many riders. **TSL**

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