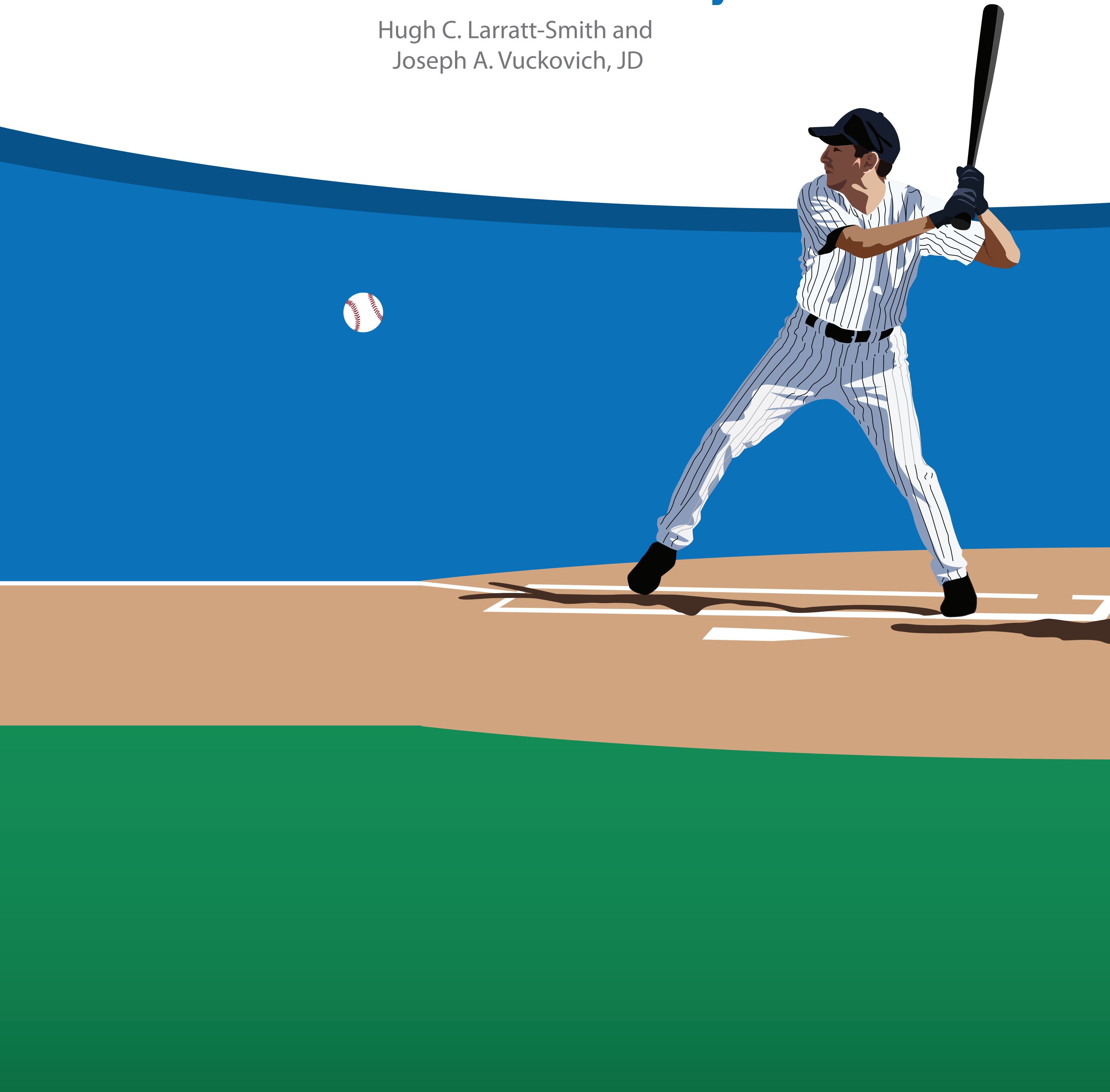
The Brush-Back Pitch

Lenders Dust off Their Playbooks

Hugh C. Larratt-Smith and
Joseph A. Vuckovich, JD



As lenders dust off their playbooks, 2010 could be a comeback year for commercial finance. With pricing and structures returning to normal, new players are entering the field, and the legacy ABL teams are adding to their benches. The brush-back pitch for some commercial finance players could be over-aggressiveness.

The magnificent mansion and library of J. Pierpont Morgan stands at the corner of Madison and East 36th Street in New York City. Today, it is a serene setting for part of Morgan's priceless art and book collection, which includes three Gutenberg Bibles.

In October 1907, however, the scene was very different: a failed attempt to corner the stock of the United Copper Company triggered the Panic of 1907. When this stock manipulation ploy failed, the New York banks backing the ploy suffered severe runs, which led to the failure of the Knickerbocker Trust Company, New York City's third largest trust. The financial contagion spread across America, and it may have deepened if not for Julius Pierpont Morgan, who pledged large sums of his own money and convinced other New York bankers to do the same in order to shore up the banking system.

Before this, trust companies had enjoyed a period of high-flying growth: in the early 1900s, trust company assets had grown 244%, compared with national and state bank growth of approximately 90%. With no Federal Reserve Bank as we know it today, lending had run rampant.

As news spread of the panic, Morgan's library at Madison and 36th Street became a revolving door of New York City bank and trust company presidents seeking to survive the crisis. On Sunday, November 3, 1907 at 3 a.m., Morgan locked 120 bankers in his library and pocketed the door key to force a solution, a tactic he had been known to use in the past. He informed the trust company presidents and bankers that, unless a coordinated effort was made, the U.S. banking system would collapse the following Monday. At about 4:45 a.m., agreement was reached and he allowed the bankers to go home.

At one point during the crisis, Morgan was informed that the City of New York would go bankrupt by November 1, 1907, without $20 million of funding; in an effort to avoid the disastrous signal that a New York City bankruptcy would send, Morgan purchased $30 million of city bonds.

One hundred years later, history repeated itself. Instead of someone like J. Pierpont Morgan to quell the panic, the full weight of the U.S. government was brought to bear on the worst financial crisis since The Great Depression. An unprecedented amount of liquidity was injected into the financial system.

And the Great Recession, as pundits have named it, is finally showing signs of recovery. The financial markets are unfreezing, although some sectors are much more vibrant and robust than others. But the Great Recession has also caused The Great Consolidation in the commercial finance marketplace. Some of America's legacy marquee names in commercial finance are sitting on the sidelines or have disappeared altogether. And some new players have emerged.

Dusting Off Their Playbooks

Asset-based lenders of all sizes are dusting off their playbooks. The market for good credits is showing signs of life. The next two to three years should be a golden time for asset- based lenders.

The most robust part of the asset-based lending (ABL) market is the $50 million-to-$300 million segment, where the borrower has access to private equity, the high-yield market or the public equity markets. The liquidity engineered by the U.S. government is kick-starting this sector of the market. Asset-based deals of up to $300 million are happening on a club basis in today's marketplace. The oxygen starts to get very thin for anything above that level for deals that are not gold-plated. The club is typically tightly knit, and lenders dictate pricing and structure rather than the borrower or the borrower's investment bank. Gone are the days of a "hog-call" put out by the borrower's investment bank, except in those cases where the deal is gold-plated.

The Great Consolidation in the commercial finance sector has left few players in the $2 million-to-$7.5 million deal range, according to Michael Coiley, managing director at Ram Capital in New York City. "The ABL platforms of most banks want to have opening borrowings of $10 million and up," said Coiley, "which leaves much of the lower middle market up for grabs."

"For many middle-market technology companies, the U.S. technology sector has a huge comparative advantage over the rest of the world and is poised to grow dramatically," according to Minhas Mohamed, CEO of MMV Financial in Palo Alto, CA. "Technology companies, as a whole, operate with moderate debt and, as such, are positioned well to take advantage of the credit crisis."

In contrast, caution is the watchword these days in middle-market retail finance. Financing a "story" retailer with borrowing needs of $5 million is almost impossible. Only the larger retail deals are getting done quickly.

New players in the ABL world include TD Bank, Flagstar Bank in Jackson, MI, New Resource Bank in California, Cole Taylor Business Capital and The PrivateBank in Chicago. Other banks that are ramping up their ABL in the C&I sector include Regions Bank, Capital One, CapitalSource, M&T Bank and Tri-State Bank. RBS Citizens recently established a restructuring ABL group. According to Leonard Lee Podair at Hahn & Hessen LLP in New York City, "A fair number of new players, mostly midsized and regional banks, are entering the ABL fray. In my workouts, at least one out of three refinancing proposals I see is usually from one of these new names. As the secondary loan market has become less frothy, lenders are approaching new financing opportunities with more interest."

"We see private equity shops becoming more active in doing synergistic acquisitions, such as substantial add-ons to their

THE ASIAN FINANCE DRAGON IS COMING TO AMERICA

In the 1970s and 1980s, it was Japan that was investing and lending to America. Now, it's the Chinese.

The investment arms of large Chinese and Taiwanese technology companies are pumping money into chip, software and technology-services companies in order to gain the latest technology. Some Asian manufacturers have proven they're more aggressive than the entrenched Silicon Valley venture capitalists to back some risky ventures.

In October 2009, Quanta, one of the largest contract manufacturers of laptops for brands such as Dell, invested $10 million in Tilera, a chip start-up in San Jose, CA, that is designing a radical computer processor. Quanta also invested $16 million in Canesta, another chip maker based in Silicon Valley, whose product changes television stations by simply waving a hand. ACER computers has invested in DeviceVM, whose software lets computers boot up in about five seconds, compared to the minutes many computers can take to start.

For entrepreneurs in America, the money flowing from China and Taiwan is a blessing. Not only do the entrepreneurs get much-needed capital, but they also get access to some world-class manufacturing and management best practices that can fast-forward them through their growth curves. However, this presents some risks for America's top technology companies, which could lose a vital window on top innovations. Asian manufacturers could wrestle away America's edge in technology research and design.

The bigger picture is this: China's GDP growth doubled in the space of 26 years compared to a fourfold increase in the British Empire's GDP in 70 years. The former has been China's achievement between 1978 and 2004; the latter was the British Empire's between 1830 and 1900, the height of the Industrial Revolution. Our GDP was more than eight times that of China at the beginning of this decade — now it is barely four times larger. Many pundits predict that China will overtake America as soon as 2027, less than two decades away.

Just why then, beginning around 1500, did the less populous and apparently backward Western Europe and America come to dominate the rest of the world, including the more populous and more sophisticated societies of the East? Much of the answer is in the corporate-financing innovations that started in the rough-and-tumble Amsterdam exchanges in the 1600s, then spread throughout Europe and the United States. Are we now seeing the end of Western Europe and America's 500-year ascendency propelled by the Scientific Revolution, the Industrial Revolution and now the Digital Revolution? How long can the globe's largest borrower remain the world's biggest power? Will financial innovation and risk-taking allow China to overtake the United States by this mid-century?

existing portfolio companies. This presents opportunities for lenders with available capital," said Podair. In the private equity market for $10 million-to-$50 million loans, the prevailing thinking is that any company that has made it thus far through the recession may well be worth supporting. Lenders are finding that it's a good time to push sponsors hard because threats by sponsors to throw the keys on the table ring hollow. In many cases, the support comes from the private equity group in the form of a one-year guarantee of principal and interest.

Back to Basics

In this tough job market, no one wants to risk proposing a difficult collateral package to a credit committee. Today, most banks are sticking to traditional borrowing bases — accounts receivable and inventory — when structuring a new credit. Loan agreements are filled with language allowing the bank to add reserves on short notice. On deals up to $20 million in the middle market, banks are asking for, and in some cases getting, personal guarantees, according to Paul Shur at Sills Cummis & Gross PC in New York City. In many cases, banks are asking for guarantees from affiliates and subsidiaries to shore up the collateral package.

But before lenders get overly enthusiastic about guarantees, Shur cites *In re Tousa, Inc.,* which raises the age-old fraudulent-conveyance issue with respect to upstream guarantees. This Florida case is generating a lot of discussion these days because it upends some assumptions about subsidiaries and affiliates guaranteeing debt at the holding-company level. "It's a brushback pitch for some lenders," says Shur.

"And cross-collateralization is back with a vengeance," he adds. "In the go-go days in 2004 to 2007, assets were not cross-collateralized, because lenders wanted loans that could be easily sold in discrete pieces. Cross-collateralization impedes the transferability of loans in the secondary market. Today, that's all changed."

In the go-go days, as Shur calls them, some ABLs were using all kinds of non-core collateral — "boot collateral" — to shore up a deal. From brand names and trademarks to art collections to McMansions, some lenders were stretching to do deals by accepting all kinds of collateral. Desktop appraisals on machinery and equipment were acceptable for some credit committees, as long as the equipment wasn't in some place like Tijuana. Drive-by appraisals on real estate were acceptable for some approval pens, unless the real estate was next to a Superfund site. "Now, there's only very selective interest by lenders in owner-occupied properties, unless the company demonstrated reasonable cash flows: 1.2 times DSCR or better," according to Rory Phillips, president of New Venture Capital Corporation in New Jersey. "The LTV of the lenders are now 40%–60% of quick-sale value, using a three-to-six-months sales period," Phillips adds.

ABLs are more reluctant to lend against machinery and equipment or real estate, even when the factory or distribution center is next to Interstate 95 or the Pacific Coast Highway. Unless a blue-chip German manufacturer supports the equipment in the secondary market, it's tough to get credit committees excited about aggressive advance rates.

"And nobody wants properties in the hospitality industry unless the property is flagged, has strong continuing and current cash flows to service a DSCR of say 1.35 times or better," according to Phillips. Likewise, appraisers are not sticking their necks out on M&E appraisals these days either, to say nothing of putting a floor-price bid on M&E like the old days. In the last down cycle, appraisers and liquidators bought many broken-down factories and packed them up in containers bound for China or India. Strategies like that can always mitigate floor-price risk on machinery and equipment.

The precipitous decline in M&E values in the past three years still has many credit committees nervous. How many stories do you hear about companies whose sales have dropped to $45 million from $100 million and are saddled with 600,000 feet of factory space filled with idle M&E in the middle of a rural state? Or perhaps your credit officer just drove through Irvine, CA, or down Great American Drive in San Jose, CA, and eyeballed the For Rent signs on every building.

Filling the Financing Gap

So who's filling the term-loan gap on asset-based deals in the $5 million-to-$100 million category?

Term lenders are reemerging in the ABL marketplace, with a focus on the split-asset structure. These deals tend to have separate agreements instead of unitranche agreements — "split collateral deals," in the lingo of The Street. For example, the term lender may be very comfortable with the fixed assets, the brand name or overseas assets of the company, whereas the traditional ABL may only be interested in the current assets.

According to Dan Kramer, senior vice president of term lender ICON Capital Corporation, "Today's companies and their existing lenders are now realizing the importance of bifurcating the revolver and term-loan facilities. Revolver lenders understand accounts receivable and inventory financing, and a fixed-asset lender can maximize the borrowing power of machinery, equipment and real estate. The two credit facilities complement each other by increasing liquidity and potentially improving free cash flow for the borrower."

The advantage of bifurcation is that, if the traditional ABL and the term lender each get the collateral they want, then they may relax more when it comes to the intercreditor agreement. If the term lender only has second liens, then the intercreditor agreement may be much tighter.

Some of the players that have reloaded include LBC Credit Partners, which just raised $645 million, and Prudential Capital Partners III, L.P. ($965 million) which will make investments ranging from $10 million to $100 million to fund acquisitions, management-led and sponsored leveraged buyouts, recapitalizations and growth capital for middle-market companies in traditional industries. Special-situation fund Versa Capital recently established on-the-ground deal-origination teams in Chicago and Los Angeles. MMV Financial, which provides between $1.5 million and $10 million in venture debt financing to growth-technology and life-sciences companies, recently opened an office in Palo Alto.

Here are some others:

- Aladdin Credit Partners recently raised $570 million to provide DIP to POR credit facilities in the middle market and institutional market. It is looking at first- and second-lien enterprise value term loans and working-capital financings.
- Avante Mezzanine Partners in Los Angeles recently raised a fund that invests $5 million–$15 million in subordinated debt and minority equity.
- ICON Equipment and Corporate Infrastructure Fund is focusing on stand-alone term loans on M&E and real estate starting at $5 million. To date, ICON has invested more than $3 billion in equipment financing.

In the high-yield market, companies left for dead in 2006 have investors clamoring for their debt issues. In all, companies raised $11.7 billion in the second week of January 2010, the biggest in history, according to Thomson Reuters. For most issuers, the new debt isn't going to build new factories — instead, the new debt is pushing back maturities of other debt, buying the companies more time to improve operations and ride the economic recovery. In a reprise, some private-equity-backed businesses are paying dividends out of new bond issues. *Reader's Digest* even plans to finance its exit from Chapter 11 with junk bonds, the first company since 2005 to do so.

According to John Brignola, executive member of LBC Credit Partners, many high-yield debt deals are refinancing the collateralized loan obligations (CLOs) from years gone by, which is breathing new life into some CLOs. "But loans for the middle market, story credits are still hard to find, and pricing has been holding in the mid-teens. For those larger companies with stable cash flows of $50 million or greater, capital is readily available from banks, and the institutional and high-yield markets," he adds. "From my understanding of the market, deals that were getting done in the L+ 10 to 12 range last year are, under similar risk criteria, getting done today in the L+5 or 6 range. Warrants are very hard to come by for companies of that size."

Many industry observers do not foresee a lot of new players on the second-lien scene for four to five years. One industry expert said that the cashflow and second-lien marketplaces won't return to normal until securitization returns — whether that's mortgage, car loan or credit card securitizations.

The refi market is still fairly quiet. Banks that are sitting on loans in forbearance are not moving them off the books; they want to keep the interest income and improve the likelihood of a full recovery. And there is always the concern for the new lender thinking, "Gee, what does the incumbent lender know about this credit that I don't?"

Commercial Lending — The Regional and Local Banks

In past economic recoveries, many regional and local banks played a prominent role in financing lower middle-market companies. Basing part of their credit decisions on their personal relationships with owners (and some boot collateral such as real estate), many regional and local banks provided "ABL-lite" credit facilities to recovering companies. This was especially true if the borrower had a breakeven year (from a P&L standpoint) as opposed to several years of persistently deep losses. Often, the regional and local banks would only require monthly borrowing bases with annual field exams and desktop or drive-by appraisals on fixed assets. The loan was a "relationship credit."

Continuing commercial real estate and credit card woes will constrain the role of regional and local banks in financing America's recovery in 2010–2011. Some industry observers have stated that commercial real estate and credit card losses have crested, but, by all accounts, this could be one river that's going to stay at flood levels for a long time to come. The role of many regional banks may be limited to buying participations in gold-plated syndications for the foreseeable future.

Still More Wood To Chop

Many lenders have large portfolios of commercial and industrial problem loans where the borrowers are largely treading water. We know one regional portfolio manager with 250 problem loans that has experienced only five bankruptcies in the past 12 months. Most of the loans are placemarked by forbearance agreements with the knowledge that liquidation is a far worse outcome. This is particularly true with lending relationships that are heavily weighted toward term loans, where the forced liquidation values are too ugly to think about.

"This has created a big spread between the bid-ask for C&I loans. Banks are selling real estate loans but hanging on to C&I loans," according to CJ Burger, managing director of Summit Investment Management in Denver. "With interest coverage tests so easy, many underperforming companies have been given breathing room," said Burger. "There's a lot more wood to be chopped in these companies from the standpoint of operating performance."

Banks can't kick the can down the road forever — the OCC has finite tolerance to amend and extend strategies.

One common theme in conversations with many industry veterans is that the "3 Cs of lending" (character, collateral and credit) got lost during the 2003–2008 credit bubble. Everyone managing an ABL group or portfolio ardently hopes that this discipline won't get lost in this upturn.

In 1912, John Pierpont Morgan testified before the House Bank and Currency Committee. He was questioned by Special Counsel Samuel Untermyer, and the following is their famous exchange on the fundamentally psychological nature of banking:

> *Untermeyer:* Is not commercial credit based primarily on money or property?
> *Morgan:* No, sir. The first thing is character.
> *Untermeyer:* Before money or property?
> *Morgan:* Before money or anything else. Money cannot buy it... a man I do not trust could not get money from me on all the bonds in Christendom.

Nine months later in 1913, the Federal Reserve replaced Morgan's "Money Trust" as a lender of last resort in the banking industry. TSL

Hugh C. Larratt-Smith is a managing director of Trimingham International, Inc. He is on the Advisory Board of CFA's Education Foundation.

Joseph A. Vuckovich, JD, is a director in Trimingham International, Inc.'s Philadelphia office. He earned an AB from Harvard University, and a JD from New York University School of Law.