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The Inflection Point: Financing a Successful Turnaround

BY HUGH C. LARRATT-SMITH AND JOSEPH A. VUCKOVICH

Asset-based lending and leveraged financing have reappeared in a way that was unimaginable a year ago. Suddenly in Q4/09, it was as though a switch was thrown. Trimingham directors Hugh Larratt-Smith and Joseph Vuckovich speak to several lenders on what makes for financing a successful turnaround.

HUGH C. LARRATT-SMITH
Managing Director, Trimingham's New York Office

JOSEPH A. VUCKOVICH
Director, Trimingham's Philadelphia Office

In 1871, 22-year-old Henry Clay Frick started his first coking operation to supply the nearby steel mills in western Pennsylvania, and thus began one of the great sagas in 19th century American business. He quickly secured a $10,000 loan from the Pittsburgh banker Thomas Mellon, a family friend. Frick's direct request for a second loan prompted the Mellon Bank to report favorably, "lands good, ovens well built; manager on job all day, keeps books evenings ... knows his business down to the ground." In the Panic of 1873, Frick borrowed regularly from the Mellon Bank to finance the acquisition of his floundering competitors.

Seven years later, on a Sunday afternoon walk, Andrew Carnegie had a sudden inspiration: "We must attach this young man Frick to our concern. He has great ability and great energy. Moreover, he has the coke — and we need it." Carnegie and Frick were both masters of the art of the turnaround.

ABL and leveraged financing have reappeared in a way that was unimaginable 12 months ago. Suddenly in Q4/09, it was as though a switch was thrown. The junk bond market came alive, leveraged loans were on their rapid march up to par and the private equity groups started bidding on companies. By Q1/10, dividend recaps were no longer a bad word.

The crisis in Europe and the yellow flashing GDP signals from the U.S. and China in Q2/10 prompted a sobering reassessment of risk. Spreads on large middle-market deals jumped by 100-150 basis points. Spreads on second lien and junior secured deals widened by 100 to 500 basis points.

By the summer of 2010, it seemed as though a new asset-based lender was being announced every week. The majority of these new ABL shops wanted opening borrowing of $7.5 million or greater, or were concentrating in the $2 million and under segment of the market. "The universe of ABL lenders in the $2 million to $7 million segment remains limited," says John Buck at Versa Capital Management.

The competition in the $10 million and over market has ratcheted up in intensity for those deals in the "wheelhouse" of the ABL groups. Pricing and structure for borrowers that have managed not to post a loss for the last two years is back at pre-crisis levels for revolvers. "For credits with a story — operating losses, management chaos or worse — there are plenty of options, but they are pricier. A well-secured revolver for a story credit could be priced at 1.5% to 3% premium these days," according to George Psomas, senior vice president at RBS Business Capital. If there's a big term piece, the borrower may have to bring in junior capital and second lien term lenders that are looking for yields in the upper teens on a turnaround.

For those non-bank ABL players in the $2 million to $10 million range, the yields on turnarounds can be very attractive — low teens or better. "The typical deal is a $4 million bank borrower that is in workout at a bank, is getting no new credit, is being hammered with reductions in advance rates and additional fees

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during a forbearance, and now needs additional working capital to fund growth in the early stages of the turnaround," according to Kate Lepak, executive vice president at MidCap Business Credit. "As long as the borrower has decent collateral and is not ethically challenged, a deal is possible."

In the $2 million and under segment, a number of new factoring firms are making their presence felt. Marty McKinley, president of Fordham Financial Services and former chairman of TMA notes, "For an attractive transaction, there's plenty of competition from factoring companies and from the regional banks. Still, pricing for notification factoring deals is holding steady in the low 20s."

Many players are shying away from term loans. Dedicated term lenders are re-emerging, with a focus on the split asset structure, which have separate collateral agreements instead of unitranche agreements — "split collateral deals," according to Mark Simshauser, vice president at term lending specialist Icon Capital Corp. "In today's complicated turnaround financings, the term lender must clearly be comfortable with and understand the fungibility of the machinery & equipment and/or the real estate. The debt capacity and closing liquidity of the borrower is increased when a capital-efficient debt structure is put in place."

An undisciplined turnaround is like putting makeup on a corpse.

"It's difficult to find lenders willing to provide a large term loan to a story credit if you're relying on single purpose M&E or real estate," says Colin Cross, senior managing director at Crystal Financial LLC in Chicago. "Traditional asset-based lenders will require several quarters of decent historical EBITDA to get comfortable. If EBITDA is choppy, that's problematic."

Says McKinley: "When the economy is in a growth mode, you can afford to make the occasional mistake in funding into a turnaround because you have the wind at your back. When the economy is in a slow-growth mode, a surprise on the downside is more likely than a surprise on the upside when it comes to liquidating assets."

I Need to Understand the Deal in One or Two Sentences

What are some of the key drivers in the decision to lend into a turnaround? One of the common themes of turnaround financing is simplifying and focusing the business. Lenders and investors want a company where the path to profitability is understandable, such as eliminating unprofitable lines of business, facilities, customers or products. In some cases, the company's revenue may drop 20% to 40%, but if unprofitable business is culled, then the decrease in revenues is welcomed. Lower revenues also mean lower working capital requirements.

"When we see one quarter of steady operating profit under its belt, there's a possibility that the company has turned the corner," says Cross. "We look at other leading indicators to gauge the turnaround point of the business, including trends in operating costs and backlog," he adds.

According to John Brignola, executive member of LBC Credit Partners, "We need to see that ample availability is built into the revolver to fund any potential cash burn during the turnaround. We want to be comfortable that the management team won't repeat the same mistakes that got them into trouble in the first place. We need to see that the issues that caused the problems — material input costs, union issues, product quality — have been dealt with realistically in the turnaround plan."

"For starters, we need to understand the deal in one or two sentences. Secondly, we need to know that all unprofitable activity can be eliminated from the company over some reasonable period of time. We

think a company has turned the corner when there's stability in monthly EBITDA," says Lawrence Berger at Blackstone Capital.

Many bank ABL shops won't fund into a turnaround, but want to see six months of positive EBITDA. They also want healthy opening availability and a proforma that shows fixed-charge coverage of a minimum 1:1.

Dying From a Thousand Cuts

Lenders and investors try to avoid companies with significant operating losses that are "dying from 1,000 cuts." When sizing up a turnaround, "you need to figure out if the cash flows are achievable. You need to know that if the company has a broken wing, it can heal over time. It's no good going into a turnaround where the capital structure gets re-jigged, but the operating metrics of the company are unchanged. The ideal turnarounds are bad balance sheet, decent P&L companies," says Bruce Ferguson, managing partner at Apex Fundamental Partners LLC. "We look hard at the collateral to gauge our downside in case we have to liquidate, but good collateral is no substitute for a solid turnaround plan."

"We have seen an increased focus by lenders on fraudulent conveyance issues in acquisition financing in light of the *In re Tousa, Inc.* decision," says Daniel Ford at Hahn & Hessen in New York. "The benefit of a 363 sale is that the lender financing the acquisition has the comfort that an auction occurred under the supervision, and with the blessing of, the bankruptcy court."

According to Ford, "Article 9 sales can be more problematic because there are often significant liabilities that are left behind and the quality of the sales process can vary widely. However, secured party sales can be consummated much more quickly and with lower transaction expenses than sales under the Bankruptcy Code, and we most frequently see these transactions where the 'selling' secured lender is taking a significant haircut and therefore there is no 'reasonable' price that would have resulted in a recovery for other creditors. In addition, obligations to critical trade creditors are often assumed by the buyer in secured party sales."

He continues, "Another way is where the private equity firm funds the entire purchase price themselves, and an ABL lender is just asked to provide a new working capital revolver. These transactions can be attractive to ABL lenders because any fraudulent conveyance risk is eliminated (as the lender did not finance the acquisition). This technique provides a cleaned-up balance sheet through the bankruptcy process or secured party sale process, while still allowing the ABL lender to demand higher fees and pricing because of the distressed history of the acquired business/assets."

"Lending to a company that does not have a written and detailed turnaround plan that includes hurdle dates, deliverables and assigns responsibility for implementation is like driving across country without a map," says Walter Schuppe, managing director at CapitalSource Bank. "It's not enough to simply review the plan. The lender has to aggressively track the implementation."

As many in this article have noted, the downside risks need to be carefully underwritten in today's uncertain economy, and a disciplined approach will separate the winners from the losers. An undisciplined turnaround is like putting makeup on a corpse.

Henry Clay Frick had the reputation of mastering every conceivable operating detail of his operations. On many occasions, his grasp of the granular metrics of his vast empire astonished his lieutenants and his Carnegie partners. For nearly two decades, until their falling out in 1900, Frick and Carnegie together would build the largest industrial empire in America, a record of success that was largely based on sound principles of turnaround financing that endure today. abfj

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HUGH C. LARRATT-SMITH is a managing director of Trimingham's New York office. He is on the board of directors of the Commercial Finance Association's Education Foundation and the New York City chapter of the Turnaround Management Association.

JOSEPH A. VUCKOVICH is a director in Trimingham's Philadelphia office. He earned an A.B. from Harvard University, and a J.D. from NYU School of Law.

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