Cover Story

Workout Poker: Hold, Draw or Fold?

Experts in the Industry Discuss the Current Workout Environment

Edited by Hugh C. Larratt-Smith, principal, Trimingham Americas, Inc.

The following panel discussion was held on March 2, 2001, at the TMA Spring Conference in San Diego. In an effort to provide more current thinking on the workout scene, panelists offered recent remarks as well. Panelists included: Mark Fagnani, executive vice president and senior credit officer, Congress Financial Corporation; John O'Kane, senior vice president, Fleet Capital Corporation; Tom Donnelly, senior vice president, GE Capital Corporation and Vincent Harper, first vice president, HSBC Bank USA. The panel was coordinated and moderated by Brent Hazzard, senior vice president and team leader, GE Capital Corporation.

The tightening of the cash flow and asset-based lending marketplace has been dramatic over the last 12 months. The structure and pricing of new deals has gotten tougher for new borrowers. With profit warnings hitting the headlines daily, loans based on enterprise values are becoming more conservative. From toy telescopes to track suits to movie tickets, retailers are facing uncertain consumer sentiment and unstable inventory values. The current environment is forcing lenders to be less willing to stretch.

How has this sea of change in the marketplace affected workout officers' outlooks?

What factors influence workout lenders' decisions to work along with a troubled borrower, liquidate a deal or sell the loan to a distressed debt buyer?

The following panel summary highlights the thoughts of several workout experts on these critical issues in today's workout environment.

Brent Hazzard: As with many professions today, workout officers are in a very dynamic and fluid profession. What was a standard process a year ago is almost passé today. It reminds me of a quote that Jack Welch once said: "When the rate of change outside an organization exceeds the rate of change inside an organization, the end is near." For many of the borrowers we are working with today, this holds very true.

With economic slowdown upon us, it appears as though the wheels have fallen off the cart. What will the workout experts do with the cart? John, let's start with you — what factors do you consider when deciding to retain a troubled credit in your portfolio?

John O'Kane: The critical question for us is why is it troubled? Is it a company-specific issue, an industry-specific issue, a management issue? What is it that caused the trouble? Once we have identified that, we ask what is it going to take to fix it? And how fixable is it, within what time frame and what are the odds of fixing it? We also consider how we feel about management, ownership and the board. Are they people we want to work with? Are they on the same program or page as we are?

Vince Harper: Just to add to John's comments, we need to determine whether there is trust with the company and management. For HSBC, as a bank, we are typically involved in a relationship versus a transaction, which can impact the workout process. The idea of holding versus folding boils down to what your options are. If the workout group is involved early enough in the deal, an early decline as we call it, you may have more options to quickly exit the relationship without any pain on the bank's part. By the same token, in the context of a relationship wherein there are no "character issues" and to the extent we have some confidence in the viability of the underlying core business, we're willing to work through a turnaround phase with the goal of "rehabbing" the credit to return as a desired customer to the line business unit.

Over-riding this analysis are also industry-specific issues such as with the retail industry and the viability of the segment/channel that our customer is selling into. An example of the volatility and risk of this industry is a deal we had financing a national science category retailer wherein what had been a high growth segment collapsed in a matter of a year or so and was eventually liquidated — after we got out, I might add!

Brent Hazzard: We talked about how long you wait before credit turns around — what's the patience of the organization?

Mark Fagnani: For Congress Financial, there are two main ingredients in how long we will wait: first and foremost is our collateral position. It's getting harder and harder to assess these days, but certainly we look to the collateral first. If we think we're covered — that the assets are retaining their value — then we can continue to play. The other thing we look at is cash burn rate. No matter how good the collateral is, if the company is continuing to burn cash at a rate that will put us into liquidation two or three months down the road, there's no sense

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postponing the inevitable. If there is sufficient collateral and a reasonable cash burn, then to answer your next question, we will bring in a consultant and try to move forward. Otherwise, we will try to immediately move towards a work-down or soft landing of the loan.

Tom Donnelly: I agree. As long as I'm going to get paid at the end of the day, I have patience. If I'm assured that under the worst case scenario, I can get my collateral liquidated and get my institution paid, then I'll hang in there. If there's any certainty that the credit will deteriorate, this may prompt me into doing something about my collateral sooner. If I'm covered up in collateral, I frequently tell management, "Knock yourself out, try your restructuring, do what have you to, as long as I'm sure I can get repaid, I'm fine."

That's in an unregulated environment. In a regulated environment, like banking, if you have a criticized loan and it's seven or eight rated, your motivations are different. Repayment isn't the only factor in your decision. You have to consider how long that criticized asset will be on your books. Depending on your institution and your appetite for risk, you may decide to get rid of an asset as soon as possible. When I was at First Fidelity, we settled fully secured credits at a discount to improve our

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numbers and improve our ratios. The dynamic changes.

Brent Hazzard: The next question, which is near and dear to many of you, is under what circumstances would you request a turnaround consultant be involved in the process? Also, who should engage the consultant? Should it be the lender? Should it be the investor? The borrower?

John O'Kane: There are a lot of reasons to engage a turnaround consultant, which is welcome news to many in [TMA]. Among them, certainly our confidence in management and our assessment of their ability is the first reason. Additionally, one thing that is very frustrating for a lender and a reason to turn to a turnaround consultant is that we're getting unsatisfactory explanations about problems. Company performance isn't what it is supposed to be and we're either

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getting inconsistent explanations, unconvincing explanations or for some reason, we don't feel as though we understand it. If management can't make us understand and believe it, then we need to somehow validate what it is that's going on. A turnaround consultant is certainly a good way to do that.

There's also a very major role that the turnaround consultants can play in a bank group environment where the findings and opinions of the turnaround consultant carry a great deal of weight with the participant banks. For example, if we are agenting a credit. There's also a tremendous amount of credibility that is carried internally in any organization when you are trying to do something with a credit and you can say, "This is not only my opinion, but the opinion of an outside professional."

We are always concerned with preserving value and stopping deterioration in company performance or company prospects. Getting a turnaround consultant in quickly often times is a significant factor in what kind of deterioration continues or even accelerates. If we are in a fully secured position, this can be an issue, but it's particularly in some of these cash flow loans where the whole thing is based on enterprise value. When we're talking about enterprise value in a company that's declining in terms of performance, that's just putting us further and further at risk every single day. Getting a turnaround consultant in there as soon as possible can be the difference between a total disaster situation and something where we can preserve value. It's clear there's certainly a function for this role.

Brent Hazzard: Mark, would you like to add a few thoughts to that?

Mark Fagnani: When we've lost confidence in management, we want them to bring someone else in to implement the plan. One of the things I think consultants always need to do because the borrower can't, is deal with the trade or with other creditors. Our experience by and large is the debtor just can't do it — he's afraid, he doesn't believe he can get mileage out of the creditors and a good consultant for us is someone who can do this. It's free financing for us — it buys time and creates liquidity. We like to see consultants do that for us. That's a good reason to bring consultants in.

In answer to your other question, Congress Financial almost never engages the consultant. If we do, it's because we feel pretty threatened and need protection. We don't trust management, we have no confidence in the numbers and we may suspect or know we are being defrauded or that assets are disappearing. In addition to someone who can effectuate a plan, I need a watchdog that can represent my interests.

Vince Harper: As far as the lender engaging the consultant, that happens from time to time with our bank, but it's usually when it's a state of freefall. You don't have time to go through the dance of bringing in a short list of consultants, then have the company go through the process of evaluating the consultants. You may not have the 90-days plus that it could take to have the company retain the consultants.

What we do in those circumstances is say to the borrower, "Here's who you are going to work with just to help the bank understand the deal fully, and hopefully that consultant can transition down the line into working with you." There may be an instance where you are not so comfortable with the consultant retained by the borrower and you may want your own consultant to get in and vet what the borrower's consultant has to say. That adds a lot to the process and to the expense that the banks have to support through the financing.

Tom Donnelly: Workout consultants help the workout officer — they make our job easier. I once had a case where I spent the better part of a day negotiating with an owner. He just wasn't getting it. He didn't know what I thought was important. He argued passionately that the trade should get paid before me because they were his friends and he intended to refinance me. So he would no longer have a relationship with me, but he would continue his relationship with his paper suppliers.

After a couple of hours of that I said, "We need a translator. I don't have the patience for this. Go get a consultant. In 15 minutes I can accomplish more with a consultant that's in the business, knows what's important to me and knows what I can and can't do than in two days with you!" Consultants add efficiency to the workout process, especially if you're swamped and you have a large portfolio. The consultant is going to

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come in with something that's workable, hopefully add some credibility and allow me to get on to the next deal.

Brent Hazzard: We promised to share some secrets of workout lending. Tom, can you share what qualities in a turnaround consultant you require when recommending them to a borrower. Second, once a consultant is engaged, what are the top three expectations you have of them?

Tom Donnelly: Right now, let's face it — there is a capacity problem in the industry. The top consultants and your usual go-to guys are constrained — there are so many workouts and liquidations happening now. We were comparing notes at GE, and this time last year we had maybe two liquidations in our portfolio; today we have over fifteen. So we are very busy. As far as qualities we look for, the first one is capacity — no matter how good someone was on your last deal, it's no good if he's swamped. Hiring him is not doing anybody a favor. Secondly, past experience counts a lot. If we've had a favorable experience in another deal, that's important. This is where participations are so valuable — you get to see new faces. We tend not to go, depending on how important the credit is, to people we don't know or people that don't come highly recommended. Finally, integrity of the consultant is critical. How have they acted in past situations? Are they truly representing the best interests of their clients?

Mark Fagnani: Speed — the consultant has got to get in, get his arms around a situation and be fast. Sometimes three or four days are all you really have before your first recommendation. Frankly, this is often because Congress Financial doesn't get consultants into situations until the situation is out of cash flow, out of availability and wondering, "How am I making payroll this Friday?" So I want speed, a known ability to deal with creditors and creativity. You have to always think outside the box, particularly if you are going to go to a full-blown liquidation. I want to know guys who can find ways to creatively market a company, its product lines or dispose of assets.

Once the consultant is engaged, my top expectation is for the consultant to get the business to cash-flow-neutral as quick as possible. Just get it stable, then we will develop a plan and figure out where to go next. I like workable, realistic plans. I expect the consultant, even if he's working on a turnaround plan, to start preparing for the worst in case the turnaround doesn't work out. Again, for Congress, always realizing on the assets is the bottom line. This last comment may rankle some people...I always want a principal in the firm. I don't want to engage a firm, even a [well] known firm, only to find out I'm getting third string, particularly in a really volatile situation. That doesn't work.

Vince Harper: Depth of operations experience. We usually want folks who can assess and evaluate operational issues. We're looking for a comprehensive approach, not just a generalist. Specific industry expertise is a must, particularly in such specialized fields as retail, high-tech and the like.

Going through the financials — we can do that. We don't need somebody to work through the numbers; we need someone who can get underneath the numbers. Having someone with industry experience is helpful in getting the borrower to accept the consultant as someone that they can eventually work with and perhaps get some benefit out of it.

We don't want a consultant that is touting the company line. We want a consultant to tell us everything that's going on, particularly to look at management and tell us who has the skill sets, if the person is misplaced and where there are holes that need to be filled.

John O'Kane: Tom touched on this point and I'll reinforce it — we all tend to go back to our favorites and we want an engagement partner who we've worked with and that's usually who we want working on the deal. Of course there'll be other people supplementing an engagement partner, but we want the partner to stay involved.

In some cases prior relevant industry experience can be a key consideration in determining whom to engage. Contract electronics manufacturing and automotive are two troubled industries that come immediately to mind in which prior experience is very valuable in today's environment. Also, since so many of our customers are suppliers to the retail industry in one form or another, specific retail industry experience is frequently valuable.

One last point: most of the time, the early stages of the case go reasonably as expected. There's a flurry of activity, an assessment of the situation and recommendations about what should be done. The real key, in my opinion, is execution over the long-term. The execution part of it is absolutely critical.

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