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## The CEIS Quarterly – Q1 – 2019

New York, February 15, 2019 - CEIS Review Inc. is a Commercial Loan Portfolio Consulting firm serving the needs of Commercial Lending Institutions. In this issue of our newsletter, we discuss potential areas of concerns as observed throughout our Loan Review findings and how hybrid asset-based loans involve a unique credit structure designed to solve certain credit needs of customers by combining cash flow and asset-based lending in one credit facility.

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### ON MY MIND ...

CEIS' President and CEO, Joseph Hill, shares his thoughts



Indicators available to CEIS show that credit quality is generally sound, in planning for 2019 we see issues from our perspective that are potential concerns. Specific areas of concern based on our reviews are – a modest but gradual rise in criticized and classified assets, general loosening in underwriting standards for many loan types as evidenced in the increased level of policy waivers, the level of interest only transactions on stabilized properties, increased covenant compliance violation rates, and an observed complacency in managing portfolio risk and its potential direction. These observations and others may show an accumulated risk in portfolios that contain a notable level of borrowers that are not yet tested in adverse scenarios beyond the statistical models.

By fortifying your Institutions preparedness in each area of concern, you will be better suited to weathering any forthcoming storms. Only a foolish captain sets sail with only enough gas and supplies for the intended trip ahead, a responsible and experienced captain overstocks their gas & supplies, recruit the crew needed to operate the vessel, and plots alternative routes ahead of setting off out of the marina.

With the areas mentioned above, management may want to revisit these areas of potential risks and confirm that they have the appropriate controls in place to monitor these areas while reinforcing the risk tolerances set forth by your Institutions Sr. Management and the Board.

*Joseph J. Hill*  
President & CEO

### Mr. Robert R. Reuter: Managing Director and Executive Editor

CEIS Review is proud to introduce the newest member of our team, Mr. Robert R. Reuter, Managing Director - Executive Editor who is responsible for editing and analyzing the findings of the field reviewer teams and preparing the overall portfolio reports to CEIS' Clients base.



Robert brings with him over 35 years of commercial and investment banking experience. His background is comprised of senior-level positions in loan underwriting, credit, execution, risk management, portfolio monitoring, workouts, agency services, regulatory compliance, internal control processes, policy enhancements, and origination. He has developed and managed multi-billion-dollar portfolios in leveraged, C&I, project, asset-based, structured, and trade finance, including secured/unsecured accommodations to large-cap and middle-market firms, covering over 25 industries.

Prior to joining CEIS, Mr. Reuter was associated with UBS Investment Bank, most recently as Managing Director, America's Head of Loan Portfolio Management, National Bank of Canada and Algemene Bank Nederland/LaSalle National Bank. His executive responsibilities included serving as Chair and/or voting a member of loan approval, new business, loan review, and problem loan committees. He holds a BA in Finance as well as an MBA, both from DePaul University in Chicago.

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### Hybrid Asset Based Lending: Controls Are Necessary

As an independent loan review provider to approximately 150 foreign and domestic lending institutions, CEIS Review has the benefit of being able to gain insights towards the emerging and prevalent developments within the banking arena regarding commercial lending activities. One such activity that we have noted as of recently, is the entrance or expanded interest of some banks to engage in hybrid asset based lending operations with varying levels of success and effectiveness. While portfolio and income fee diversification are important, the increased activity should be fully vetted before additional risk is added to the portfolio.

Hybrid asset based loans involve a unique credit structure designed to solve certain specific credit needs of customers by combining cash flow and asset based lending in one credit facility. While the portion of the loan approved on a cash flow

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coverage basis is often managed with financial covenants, the asset based loan portion is supported by collateral coverage that is monitored with a monthly borrowing base. Therefore the lender must regularly ensure proper levels of both collateral and cash flow are acceptable prior to disbursement of loan advances. More importantly as this type of transaction is ever evolving, the lender should identify and be prepared to initiate at least two exit strategies.

Banks generally offer hybrid asset based lending to borrowers as their overall financial position and/or operating performance does not otherwise qualify for terms “typically” associated with a bank loan. The prospective borrower may be characterized by any one or a combination of issues such as strong growth, high leverage, undercapitalization, “temporary” operating losses, seasonal requirements, etc. Most often the banker’s accommodation is an interim measure with the belief that the borrowing entity will at some point (1-3 years) qualify for terms associated with “typical” loan extensions.

As hybrid asset based loans are made to non-investment grade companies, a lender must employ a disciplined approach for monitoring compliance and managing exit strategies. Banks that are successful in this arena identify a clearly defined target market to participate in, and then set specific risk assessment criteria for that market before engaging in lending.

Each deal requires detailed analysis of borrower’s financial position, historical and projected operating performance. And as collateral quality and availability are essential to the transaction, analysis of receivable quality, turnover, dilution, terms, etc. is important. The sufficiency of the cash budget to support operations and to meet obligations as projected for each of the following 12-months should be also assessed.

Proper due diligence is necessary to justify the terms of the loan.

### **Monitoring**

- **Financial Statements and Borrowing Based Certificates**

The loan agreement should require timely submission of financial statements and monthly borrowing base certificates. Both should be carefully analyzed by the relationship manager for issues, changes, trends, etc. The borrowing base structure should not be considered an abundance of caution, but a critical component of relationship management as the risk of insufficient collateral coverage must be eliminated. Unlike real estate collateral loans, accounts receivable and inventory financing need frequent updated monitoring.

*“If the bank receives timely financial statements, timely monthly borrowing base and the loan is in full compliance - a field exam should only be needed once a year.”*

- Field Exams

A wide variety of issues can cause a borrower’s cash flow to deteriorate, not the least of which is re-stated financial statements. Therefore, a field exam conducted by a proven ABL examiner should be a condition prior to funding and at least annually thereafter. The field exam usually takes a week or more to perform, but provides the lender with important and detailed current information.

The bank must understand the full scope of its exposure to credit risk. Therefore there are numerous cash flow and collateral issues reviewed by the field examiner that can include: quality of earnings, financial trends, gross margins, terms of sale, class of debtors, cross age, concentrations, contras, turnover, dilution, bill & hold, progress billings, etc. If cash flows weaken for any reason, the loan should be converted to a fully monitored asset based loan while there may still be collateral coverage.

The Field Exam is a detailed and comprehensive report which should be thoroughly evaluated by a corporate finance professional with in-depth knowledge of leveraged finance and asset based lending. The relationship manager should watch for changes, weaknesses, trends, unexplained fluctuations, etc.

While the borrower generally pays for the Field Exams, the lender must ensure that the time and money are well spent. Field exams provide essential information about ineligible collateral, necessary reserves, and overall advance rates for the varied collateral mix in the borrowing base.

As long as the bank receives timely financial statements, timely monthly borrowing base and the loan is in full compliance - a field exam should only be needed once a year.

- Covenants and Triggers

Hybrid asset based loans need covenants and triggers that can be tracked to detect negative operating performance, too much rapid growth or negative borrowing base trends. A well-controlled loan provides early warning signs that can be tracked. At a minimum, review quality financial statements should be required a requirement; although more frequent field audits may offset accepting lesser quality financial statements. Monthly or quarterly financial statements must be spread in a timely manner and evaluated for adequate loan coverage and trends. Triggers for more frequent field exams should be established based on specific performance metrics.

- Fixed Charge Covenant

In addition to reporting and field examinations, the loan agreement should require a rolling four quarter fixed charge covenant of 1.25x. If it falls below the covenant, the loan should be considered for reclassification to a fully asset based loan which requires more frequent collateral reporting and at least two field exams per year. It may be also be advisable to have the inventory appraised.

- Liquidity Covenant

A minimum liquidity covenant of at least 10% of excess availability from the borrowing base should also be mandated. Violation of this covenant would also initiate a fully asset based loan process Stress Testing

The lender and the borrower should periodically stress test monthly projections to determine adequate cash flow and liquidity coverage. The relationship manager must have confidence in the borrower's ability to meet a changing environment.

### **On-Going Management**

The relationship manager and supervisor should be pro-active and accept accountability for responding to the borrower's performance. Being so, a monthly sign off should be required regarding compliance and approved exceptions. Additionally, any trends should be noted.

Diligent monitoring of cash flow and collateral coverage is necessary to detect early deterioration and is required for proper on-going management. Cash flow loans are fine when they cash flow, but when debt / EBITDA multiple exceeds 4x one needs confidence that the collateral has been monitored and will be sufficient to provide an adequate fallback position. Although other potential exit strategies exist: guarantees, refinance, asset sales and capital infusion – one frequently returns to collateral protection as the primary exit strategy. The lender must remain vigilant lest he/she find themselves struggling to meet the liquidity needs of a desperate client.

### **Transition**

Once a loan is determined to require full monitoring, the transition should be smooth for the customer. Providing future adequate financing is a must. The ABL process usually requires electronic reporting on receivables, payables, inventory, etc. These reports are already prepared by the customer and can be transferred easily. The ABL department can efficiently manage this information for accurate controls and borrowing. ABL teams analyze, appraise, monitor, and verify the collateral. Defaults will occur, but ABL losses should be minimal. If the borrower is in compliance, he has the comfort of knowing that there is a binding contract that generally remains available for three years. The Stucky Electronic Operating System is used by virtually all ABL shops and greatly streamlines reporting for both the customer and the bank. The system provides complete clarity regarding sub-limits, dilution, ineligibles, borrowing availability, etc.

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*“Banks should only book asset-based hybrid loans if they have lenders experienced in this area and organizationally, the structural know-how.”*

## Conclusion

There is no need to lose a valued customer as long as the bank can provide adequate financing. Historic losses using ABL are low and many banks will improve the risk rating if the loan is properly monitored with full collateral protection.

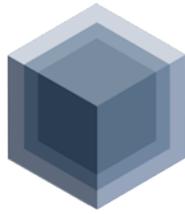
A bank should only book asset based hybrid loans if they have lenders experienced in this area and organizationally, the structural knowhow. Otherwise, the bank should consider developing a strategic alliance to out-source this service. An advisory comment is to not fall into the trap of thinking the only asset(s) you need to follow is the collateral in the Borrowing Base. A broader perspective on the borrower’s assets, liabilities, and cash flow is warranted.

It is important to keep your customer happy, but naturally, hybrid asset based lending is potentially an area for notable losses if the bank’s internal skills and internal structure does not follow good practices.

*John Mckenna  
Senior Reviewer*

## Related Links

- [OCC Releases Revised Data Released for Stress Tests](#)
- [OCC Releases Dodd-Frank Act Stress Test Scenarios for 2019](#)
- [FDIC Issues List of Banks Examined for CRA Compliance](#)
- [Federal Reserve Board releases scenarios for 2019 Comprehensive Capital Analysis and Review \(CCAR\) and Dodd-Frank Act stress test exercises](#)
- [There’s Nothing Wrong with Stronger Banks](#)
- [U.S. Trade Deficit Narrowed in November](#)
- [Elusive Inflation, U.S. China Trade, and Another Shutdown](#)
- [S&P 500 Climbs in Strength in Industrial Sector](#)



# CEIS REVIEW INC.

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## **About CEIS Review**

[CEIS Review, Inc.](#) is an independently owned financial consulting firm founded in 1989 to serve the needs of lending institutions with commercial portfolio related services.

### **Services include:**

- Loan Review Programs
- Portfolio Acquisition review (Due Diligence)
- Structured Finance Review (Leveraged Lending)
- Commercial Portfolio Stress Testing
- ALLL Methodology Validation or Advisement
- Credit Risk Management Process Review

CEIS' mission is to assist institutions to better manage their commercial portfolios, thus avoiding regulatory hardships and enabling profitability. If you'd like to learn more, please contact Justin Hill at 212-967-7380 or [justinh@ceisreview.com](mailto:justinh@ceisreview.com).

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