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On My Mind...

CEIS' President, Joe Hill, shares his thoughts

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Since our inception, CEIS Review has always followed the guiding principle to periodically reflect and evaluate our current processes and offerings in order to determine any appropriate refinements or modifications that will enrich our client's engagements.

With this philosophy in mind, we have recently explored ways in which to enhance our loan portfolio analytical capabilities and resulting reporting for our clients, and have since embarked on a few projects that will not only improve CEIS' internal process' but also benefit our clients in the way of enhanced reporting and portfolio analytics.

The first evidence of these improved analytical capabilities will be witnessed in our Quarterly Loan Portfolio Quality Trends report which many of you have read in the past. Going forward, we are planning on utilizing these newly implemented tools to further drill down on matters that may be of particular importance given the market for the quarterly report, as well as being able to include concise metrics regarding a particular portfolio quality indicator within our Loan Review reporting for clients.

While it is easy to get caught up in the status quo of the day, especially if that status quo is working well, I do feel that it is important to occasionally challenge yourself and your ways at times, at the minimum to determine if your practices are the best in place, or if in fact there are areas that can be improved to everyone's benefit.

Joseph J. Hill

President & CEO

Leveraged Lending

Transactional Considerations

Leveraged Lending has been receiving more press recently as transactions in this area continue to increase. As a result, the monitoring of these types of facilities has come under considerable scrutiny by the various Banking Regulatory Agencies. In this article we intend to highlight and discuss some of the primary characteristics and considerations of leveraged lending transactions, but not specifically the regulatory guidelines and requirements of the subject loans.

When discussing leveraged transactions, the types are: leveraged buyouts, (LBOs), management buyouts (MBOs), leveraged recapitalizations, and acquisition financing. While they all have separate and distinct purposes, their strategies are very similar. Namely, they use a significant amount of debt to complete the transaction.

Unlike other lending mechanisms, there is usually a sizeable balloon at the maturity of the facility. Senior secured lenders have a first priority lien on collateral. If there are second lien lenders in a transaction, their interest in the collateral is subordinated to the first lien loan's interest in the pledged assets of the company. However, the ranking of first lien and second lien loans are the same in the event the pledged assets are not sufficient to repay the outstanding borrowings. That is, that second-lien debt *is lien subordinated only*, not debt subordinated

When evaluating any transaction, it is important to understand the business plan of a company to determine the appropriate capital structure. Is there sufficient permanent funding that will support the company's growth – both internally and through acquisitions, as well as provide adequate working capital? Is there an optimal debt to equity ratio? In leveraged transactions, assessments of these issues are pivotal.

In this article, we will focus on the following topics as they pertain to leveraged lending:

- Risk Factors
- Financial Forecasting
- Covenants
- Exit strategies

RISK FACTORS

1. Credit risk can be defined as a borrower's failure to meet its contractual obligations to perform as agreed (e.g. interest payments, principal payments, covenants). Because leveraged borrowers have high debt levels relative to their equity and cash flow, it is more difficult for them to withstand adverse economic conditions or to make necessary capital expenditures. High debt levels increase the risk of default.

As with all loan transactions, the primary source of repayment in leveraged transactions is the ability of the borrower to generate sufficient cash flow to repay debt. Secondary sources of repayment may include refinancing, recapitalizing, or restructuring of debt through the sale or disposal of the company's assets or stock. Obviously, should a company be unable to generate sufficient cash flows or asset values, both sources of repayment will become significantly impaired. Consequently, it is particularly important that there is rigorous analysis and monitoring of these loans.

There are several factors that should to be considered:

- **Transaction Structure -** Because the overall debt requirements of a leveraged financing exceed the collateral value of the borrower, there is often a financing gap. And, as debt levels increase, this gap will widen. Risk is increased even more when the sources of repayment depend on realizing performance levels (revenue, cash flows, EBITDA) above those demonstrated in the past. Consequently, it is especially important to ensure and to subsequently monitor that the company is able to generate sufficient cash flow.

- **Repayment Schedule -** Because of the large debt obligations in leveraged transactions, the cash flows of the borrower are usually smaller in the first years after the close of the deal and principal repayments are often back-ended in order to match the timing of the expected repayment sources. Further, a longer repayment schedule may result in concealing credit weaknesses or providing permanent capital. As a result, each transaction should have carefully crafted covenants to provide ample warning.

- **Enterprise Value Dependence -** Enterprise values are taken into consideration by lenders when the committed facilities exceed the value of the tangible assets. They are often reliant upon management's ability to achieve revenue and expense projections, and can be adversely affected by a number of factors, including economic conditions and industry competition. In leveraged transactions, senior lenders in these under-collateralized positions, should have accelerated repayment schedules for that piece of the debt

- **Relying on Refinancing or Recapitalization -** A large percentage of leveraged transactions assume a refinancing or recapitalization will be the primary repayment source. Many times, there is no other realistic alternative source of repayment, and both lender and borrower assume that the refinance will occur when the company is able to de-lever its balance sheet. Obviously, this creates an additional risk, because any change in the economy or a problem with the credit itself will result in a lack of new capital available to finance the transaction.

- **Reliance on Equity Sponsors -**The success of closing a leveraged loan is often based on the strength and reputation of the equity sponsor. Lenders believe that most financial sponsors will stand behind their transactions because they need to protect their investments. However it should always be remembered that the sponsor's primary

obligation is to its investors. Its willingness to supply additional capital will be based upon the sponsor's perception of the borrower's ultimate enterprise value.

2. Collateral Risk - Senior secured lenders have a first priority lien on the assets of the borrower. Collateral provides a second source of repayment, protects assets from being sold by other creditors, and gives the senior lenders a preferred position in bankruptcy. Proper monitoring (field audits, borrowing base certificates, aging statements) is key, because in the event it becomes necessary to take possession of assets pledged as collateral, retention of their value in a liquidation scenario is vital.

3. Country Risk **-** For some credits, it is important to understand how cross-border transactions expose the borrower to country risk. Specifically, it is necessary to focus on potential business operating risks, resulting from such things as currency controls, regulatory changes, and political stability.

4. Strategic Risk - Strategic risk is a broad category that includes the potential impact on earnings due to incorrect business implementation or decisions, or an inability to respond to changes in the industry. The failure to execute a business plan or achieve objectives can have serious implications on the success of the company – and in turn, on the company's ability to generate cash flow to repay debt. Therefore, it is critical to focus on how well management understands the consequences of such issues as changes in technology, the competitive landscape, and regulatory matters vis-à-vis its industry.

5. Compliance Risk - Is the borrower following the appropriate rules and regulatory procedures, as well as abiding by the ethical standards? This can be ambiguous, especially if a company is dealing with regulatory issues of foreign countries, which may be vastly different from those of its native country. However, there is a real risk to earnings if a company is not in compliance. It can result in fines and invalidate contracts.

6. Reputation Risk - Damage to the integrity of the company can result in financial losses and even litigation. In many instances, it can harm a company's ability to conduct business due to a loss of existing clients and/or lack of obtaining new clients. A character issue can not only affect the borrower, but can involve the lender, as well. By financing a company with a negative reputation, the lender could also be exposed to reputation risk. Consequently, due diligence is extremely important, with a focus on internal policies and procedures.

FINANCIAL FORECASTING

It cannot be stressed enough that, because the debt levels are higher in leveraged transaction, banks must assess the cash flow of the business to understand whether it will be able to sustain the interest and principal payments of all the outstanding debt. Therefore, lenders need to focus not only on the financial strength of the company, but on the industry sector, and management as well. Has the company had a proven track record over time and various business cycles? Is there a significant amount of turnover in the company? Does management have a strategic vision? Is management continually revising projections?

- Identify the company's cash needs and how they are financed.

- Evaluate the appropriateness of the financing sources relative to the uses of cash.
- Establish the sources of repayment and the likelihood of generating sufficient cash to repay the proposed facility.
- Determine if the company's financial condition, given the trends, will be satisfactory.
- Can the company sustain or increase its operating cash flows in order to meet its debt obligations?

What is generating cash? For instance, if net income consists primarily of equity earnings, then very little cash flow may be available for expansion and loan repayment. Leverage may be understated if capitalization supports assets of questionable quality. It is harder for management to manipulate cash flow than net income because the latter can include a significant amount of extraordinary items not related to sustainable earnings.

Are the sources & uses legitimate?

Are sources sustainable?

  - Are uses recurring?

- Does the cash flow cover:
  - Interest
  - Taxes / dividends
  - Maintenance Cap Ex
  - Current Maturities of Long-term Debt
- Understanding and evaluating off balance sheet exposure
- Capital structure – Does the structure make sense?
- Detecting early warning signs of increased risk in the Balance Sheet
  - Decrease in A/P
  - Increases in inventory when sales aren't growing

Not only should banks be interested in projecting future income statements, balance sheets, cash flows, and financial ratios, but break-even analysis is highly recommended. Why? Because the fixed costs versus variable costs of your borrower are major determinants of cash flow. The greater the fixed costs, the less likely the company will be able to reduce expenses, and therefore, will be more reliant on generating increased revenues. On the other hand, the greater the variable costs, the higher the likelihood that the borrower will be able to reduce expenses, and therefore, will not be as dependent upon a larger revenue base. It is imperative to have a clear understanding of the key drivers of the company and how they will influence projections.

COVENANTS

Most leveraged transactions use *maintenance* financial covenants, that is, the borrower is required to adhere to certain financial performance tests on a monthly or quarterly basis. If the borrower is

out of compliance, the lenders have the right to accelerate the loan. In general, assuming the company is an on-going concern, the lenders and the borrower will negotiate a waiver and/or amendment for a fee.

Lenders should be aware that in some transactions, *incurrence* financial covenants are used. In this case, the covenant is only tested when the borrower is increasing debt or making an acquisition. For instance, a leverage test may state that a borrower cannot increase its debt if, on a pro forma basis, consolidated total debt to EBITDA would be in excess of 3.5x. However, the test is only performed when the borrower acquires more than $20 million of new debt. Consequently, the borrower could increase its debt level up to $20 million, even if leverage exceeded 3.5x.

In general, there are four types of financial covenants— coverage, leverage, EBITDA, and maximum capital expenditures:

1. **Coverage Covenants.** These covenants require the maintenance of a minimum level of EBITDA relative to specific expenses. The most commonly used coverage ratios are Fixed Charge Coverage and interest Coverage. These ratio should increase as the loan matures.

2. **Leverage Covenants.** These covenants set a maximum level of debt relative to EBITDA such as: Senior Debt to EBITDA and Total Debt to EBITDA. These ratio should decrease as the loan matures.

3. **EBITDA Covenants.** These covenants require a minimum EBITDA level at the commencement of the financing which must be increased by either a specific dollar amount or a percentage.

It is important to remember that EBITDA does not mean cash flow. It does not capture changes in working capital or capital expenditure needs. Further, a lender should consider the more conservative approach to EBITDA which does not allow management fees to be added back to EBITDA. Lenders should also be aware of “one-time" expenses being added back to EBITDA. If they truly are "one-time," they should not appear on an on-going basis as an add-back.

Finally, material changes to a facility (amount, rate, amortization, term, and collateral) generally require 100% of lenders and participants. However, there are some facilities where changes to collateral or amortization may be approved by a lower percentage of lenders, with a minimum of 67%. Understanding the documents and examining them diligently is imperative.

EXIT STRATEGY

Perhaps the most important aspect of leveraged lending is having a clear vision for repayment, as there is usually a balloon payment at maturity. There are several ways in which a leveraged transaction can be repaid:

- An Initial Public Offering (IPO) - although unlikely for most middle market companies
- Partial or Total Sale to:
  - Management (MBO) or buyback of shares
  - Private Equity (LBO)
  - Strategic Buyer
- Refinance

A borrower that is unable to refinance the debt may have a liquidity problem. In that case, the company's options are:

- Equity infusion (by owner or sponsor)
- Sale of assets
- Filing bankruptcy

Conclusion: Understanding all of the risks associated with leveraged lending is complex. As a leveraged lender, it is critical to remember that repayment can be adversely affected by numerous factors.

Therefore, it is vital to have a keen understanding of the borrower's cash flow and be satisfied that the risks associated with the borrower can be sufficiently mitigated to warrant the loan. Warning signs include: 1) continual modification of projections, 2) high management turnover, 3) underfunding of needed capital expenditures, and 4) net income consisting primarily of equity earnings rather than sustainable earnings. If the risks are too excessive, the potential for being repaid is severely diminished. As a senior credit colleague of mine used to say, "Time is the enemy of promise." Therefore, the shorter the tenor, the more likely the borrower will repay the debt.

CEIS Review has experienced senior banking professionals who can assist with the due diligence prior to funding these types of facilities, as well as review the loans on an ongoing basis, taking into consideration several leveraged loan performance indicators in accordance with Interagency Guidance on Leveraged Lending. To learn more on CEIS' approach on reviewing Leveraged Lending select here.

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About the Author:
Ms. Claudia Machaver is an Executive Consultant with CEIS involved with Leveraged Lending/Structured Finance reviews as well as complex commercial portfolio engagements.

To read her full bio

Industry News and Events

- RMA - The Canary in the Coal Mine, Author Mr. Michael Marcucci, CRC interviews CEIS' President & CEO Mr. Joseph J. Hill and several other Financial Executives on the current market conditions, and which non-traditional credit quality indicators that lenders and managers should be paying attention to while we are in "goodtimes".

- Shared National Credit review finds risk remains high, but underwriting and risk management improve

- FDIC - Prudent Risk Management of oil and Gas Exposures

About CEIS Review

CEIS Review is an independently owned consulting firm founded in 1989 by proven commercial lenders who specialize in commercial loan portfolios.

Services include Loan Review, loan portfolio Stress Testing, Loan Loss Reserve Methodology Validation or Advisement, portfolio acquisition review (Due Diligence), Credit Risk Management Process Review, Structured Finance Review (Leveraged Lending), and commercial loan policies.

CEIS Review has provided consulting services to more than 200 banks domestically and abroad, thus solidifying ourselves as a proven and trusted resource within the banking community

For information, email Justin J. Hill at justinjh@ceisreview.com

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