CEIS REVIEW INC.

Commercial Portfolio Advisors
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THE CEIS QUARTERLY -Q1 -2020

Feburary 19th, 2020 - CEIS Review Inc. is a Commercial Loan Portfolio Consulting firm serving the needs of Commercial Lending Institutions. In this issue of CEIS' "The Quarterly" newsletter, we discuss the findings of the most recently completed Shared National Credit ("SNC") programs findings, with a focus on the effects of heightened leveraged lending and the inherit elevated risks with this lending segment, then we pivot to discuss the unique structures of hybrid asset based lending which are intended to meet specific borrowers credit needs when structured properly.

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SNC Review: Risk Remains Elevated in Leveraged Loans

This past fall's SNC program population showed elevated levels of loans rated Criticized and/or Classified (6.7 % to 6.9%), driven primarily by exposures within the Leveraged Lending segment. Being so, this issuance of the SNC report focus' on the Leveraged Lending, and the heightened risks therein.

Bank self-identified leveraged loan commitments account for as much as 49% of total SNC commitments in the market. Investors outside the banking industry held the greatest volume of special mention and classified commitments, followed by U.S. banks and foreign banking organizations.

The SNC program's review has identified many leveraged loan transactions that have weak structures which include layered risks outlined as a combination of the following elements; aggressive repayment assumptions, weakened covenants, or permissive borrowing terms that allow borrowers to draw on incremental facilities and further increase debt levels. Keep in mind, that many of these credit risk factors are in fact market driven and were not materially present in previous downturns.

With the identified increased market risk within leveraged lending, most Banks participating in leveraged debt have adopted credit risk management controls/practices specific to this portfolio segment, although please keep in mind that these controls have not yet to be tested by an economic downturn.

Financial institutions should ensure that portfolio management and stress testing processes, consider that recovery rates may differ from historical experience. Financial institutions also should consider how potential risks from a downturn in the leveraged lending market may affect other customers and borrowers within their respective portfolios.

Unique Structures Designed to Address Credit Needs Using Hybrid ABL

As an independent loan review provider to approximately 150 domestic and foreign lending institutions at any one time, ranging from small community banks to money center level banks, CEIS Review has the benefit of being able to gain insights towards emerging and prevalent developments within the banking arena regarding commercial lending activities. One such area is the evolution of and expanded interest of many banks, especially small community to regional banks, to engage in what I'll term hybrid asset based lending operations, with varying levels of success with clients and effectiveness. We are seeing more of our clients offering such transactions as a way to diversify their portfolios and best balance and address risks and resources with the needs of clients; and in conjunction with competitive pressures. A colleague of mine at CEIS, John McKenna, wrote a short article on this topic, and based on feedback received we thought it would be interesting to expand on it and share more of our observations and experiences. Other sources utilized included the OCC ABL handbook and some Sullivan & Cromwell legal material.

" Hybrid ABLs involve unique structures designed to address certain specific credit needs of customers by combining characteristics of cash flow and asset based lending into one credit facility."

Hybrid ABLs involve unique structures designed to address certain specific credit needs of customers by combining characteristics of cash flow and asset based lending into one credit facility. We have observed that Bank's generally offer hybrid ABL's to borrowers whose overall financial position and/or operating performance does not otherwise qualify for terms "typically" associated with a bank cash flow loan. The target client may be characterized by any one or a combination of issues such as rapid growth, seasonal fluctuations, slow paying customers, marginal cash flow generation, temporary operating losses, high leverage, undercapitalization, limited operating history, etc. Loans are made directly to operating companies and include manufacturers, wholesalers, distributors, retailers and service companies. The purpose of such financing is typically for working capital needs, but also includes purchases, acquisitions, and recapitalizations. A revolving line of credit is the most common type. While the types of borrowers and purposes seem similar to those seen in a traditional ABL, it is the credit analysis, structuring and monitoring that primarily differ. So, let's take a moment to look at the differences between asset based, cash flow and hybrid asset based lending.

Asset Based Lending

ABL is a form of secured lending where borrowing capacity is based on the value of specific assets in which the lenders have a security interest.

The primary source of repayment for revolving ABL facilities is the conversion of the collateral assets to cash over the company's business cycle. Strong and frequent controls and monitoring are essential features.

" An example is a manufacturing company with the operating cycle starting with cash to purchase goods/services to holding/manufacturing to inventory to sale to receivables to collection and then back to cash."

Borrower Analysis

Assessing the borrower's financial position focusses on analyzing the business operating cycle and trends and the overall financial condition of the borrower. An example is a manufacturing company with the operating cycle starting with cash to purchase goods/services to holding/manufacturing to inventory to sale to receivables to collection and then back to cash. Banks need to understand a borrower's ability to convert working capital assets to cash over a meaningful period through analysis of the operating cycle in days or dollars, which can be compared to industry data and the borrower's historical performance and trends; typical metrics used include current ratio, working capital investment needs (A/R and inventory minus A/P and accrued expenses), inventory turnover, accounts receivable turnover, and accounts payable turnover; analysis can be over a monthly, quarterly or annual basis.

Establishing a Borrowing Base

Borrowing Base is a formula that determines the maximum amount a client can borrow at any given time and is based primarily on the value of "eligible assets", less reserves. The BB typically consists of working assets such as A/R and inventory; most of our clients observed typically use all or substantially all A/R; in certain cases, the BB may include less-liquid assets such as equipment or even intangibles (IP rights).

Common eligibility criteria for receivables:

• Receivables payable by a single customer may not exceed a specified % of the total borrowing base (addressing quality of customer and concentration limits)

• The receivable may not be past due by more than a specified number of days

• Amount of the receivable is not subject to an ongoing dispute with or offset by the customer

• Receivable must be subject to a first-priority lien in favor of the lenders at all times

• Frequent issues to address include dilution (i.e. returns and allowances, bad debts, and other offsets that create dilution) which varies by industry but is usually expected to be 5% or less of receivables; other concentration limits, restrictive receivables (i.e. certain government and healthcare) and ineligibles (i.e. affiliate receivables, re-aged receivables, foreign receivables. Contra-accounts, and unbilled receivables, etc.).

• Advance rates vary depending on the quality and nature of the receivables, each Bank's risk appetite and credit policy parameters. Common advance rates range from 70% to 85% with some banks allowing up to 90% of eligible A/R. We tend to see the higher end on these advance rates with out clients for both traditional and hybrid ABL's.

Common eligibility criteria for inventory:

- Should consist of goods of a type that the borrower sells in the ordinary course of its business

- Should be located on premises owned, leased or rented by the borrower with the lender having rights of access and waivers of claims from landlords, warehouse companies and mortgage lenders

- May not be delivered to a third party for sale on consignment

- Must be insured against casualty events

- Must be subject to a first priority lien in favor of the lender at all times

- Frequent issues include lender access rights and liquidation valuation

- Advance rates vary depending on the inventory type (i.e. raw materials, work-in-process, or finished goods). A bank typically advances up to 50%, although we see some advances upwards of 65% of the book value of eligible inventory or up to 80% of appraised Net Orderly Liquidation Value (NOLV)

Reserves

Most ABL agreements grant the lender the right to establish reserves against the BB to reflect risks expected to affect the value of BB assets. Reserves are deductions from the collateral value that consider the costs required to liquidate the collateral, the possible dilution of accounts, inventory obsolescence, or other factors that could affect the collectability of the underlying assets such as competing claims, and historical write-off rates. This permitted discretion is typically defined as the Bank's exercise of reasonable judgment in good faith in accordance with customary business practices.

Collateral Appraisals

Collateral appraisals and field audits are important aspects of ABL underwriting, administration and problem loan management. A bank should obtain an appraisal during the underwriting process to help establish the BB and advance rates. Updated appraisals on working capital assets should be obtained throughout the life of the loan to monitor the collateral value, trends, and adequacy of the BB. These are typically limited to one examination in any 12-month period at the cost of the borrower and lenders usually have the right to request more frequent exams if the availability under the ABL falls below a certain threshold or there is an event of default.

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Field Audits

Field audits are integral to monitoring and controlling ABL's and helps detect fraud and financial weakness and is a customary way to confirm the quality of the borrower's financial data, receivables, inventory, and internal controls. A field audit should be conducted by a bank's dedicated field audit staff or qualified third party, during the underwriting process and before a new account is booked and regularly thereafter-often quarterly, semi-annually, or annually, but more frequently if risk dictates.

The loan agreement covers frequency and lenders usually have the right to request more recurrent exams under certain triggering events.

Financial Reporting Requirements

The type and frequency of financial reporting should depend on how much credit risk the borrower poses. An ABL lender often requires BB certificates and supporting documentation with reasonably detailed calculations (i.e. A/R aging's, inventory break-down) on a weekly or monthly. The type and frequency of financial reporting should depend on how much credit risk the borrower poses. An ABL lender often requires BB certificates and supporting documentation with reasonably detailed calculations (i.e. A/R aging's, inventory break-down) on a weekly or monthly basis. Annual and interim financial statements may also be required as these can help the bank determine whether uncollected receivables and obsolete inventory have been identified and appropriately reported on the balance sheet. Annual and interim financial statements may also be required as these can help the bank determine whether uncollected receivables and obsolete inventory have been identified and appropriately reported on the balance sheet.

" Sometimes the financial maintenance covenant is "springing" (i.e. is only in effect during periods when excess availability under the facility falls below a certain threshold of say for example 10-20% of total availability). "

Lockbox/ Cash Dominion Arrangements

In most ABL transactions, the bank either controls or reserves the right to control the borrower's cash receipts. Lockbox arrangements, wherein the borrower's customers are directed to send payments to a post office box where payments are collected and applied to a collateral deposit account controlled by the bank, are an integral part of an ABL. The bank may elect to exercise full dominion (more traditional) or springing dominion (more borrower friendly and only goes into effect upon a triggering event) over the cash receipts. In an event of default, lenders are not required to fund further draws and cash is swept to ABL lenders

Covenants

The use of covenants in an ABL differs from traditional cash flow lending as an ABL lender places less reliance on financial covenants and more reliance on collateral controls and monitoring. Covenants commonly focus on excess availability, reserves, and cash controls. Financial covenants, when present, typically take the form of a minimum fixed charge coverage ratio or minimum liquidity; limits on capital expenditures are also common. Sometimes the financial maintenance covenant is "springing" (i.e. is only in effect during periods when excess availability under the facility falls below a certain threshold of say for example 10-20% of total availability). Definitions of underlying financial covenants are closely negotiated. Each bank's loan policy should clearly establish financial covenant standards for ABL transactions.

Over-Advances

An over-advance can dilute the collateral coverage and may cause the lender to be under-collateralized. Over-advances should be approved in accordance with the bank's loan polices and be supported by an assessment of the adequacy of the company's cash flow to repay the over-advance.

Credit approval and loan documents should explicitly state when and under what conditions the lender permits an over-advance. Most banks do not allow an over-advance in excess of 10-15% of the BB and usually for short periods of time (i.e. seasonal needs).

Cash Flow Lending – Working Capital Line of Credit

This type of loan, for working capital purposes, is granted to a company based on the current and future level of cash flow that the underlying business may generate.

Borrower Analysis

The underwriting process generally considers historical, current, and expected operating results and cash flow generation (including quality and sustainability; margins, and coverages), liquidity (sources and uses; including future working capital needs), capitalization (including leverage and equity positions and ratios), competition, industry characteristics (including market share and niches), along with the quality and experience of owners and management.

" In cases where security is deemed needed, the lenders typically require a first priority lien on all business assets; with no collateral appraisals required. On average I'd say around 50% of our clients have annual clean-up requirements."

Security

The primary source of repayment is cash flow capacity. Depending on the overall credit quality, these facilities may be secured or unsecured. In cases where security is deemed needed, the lenders typically require a first priority lien on all business assets; with no collateral appraisals required. On average I'd say around 50% of our clients have annual clean-up requirements.

Guarantees

Generally, an unlimited personal guarantee of one or more of the principals is required for small to middle market, closely held borrowers; and depending on the credit profile. However, based on overall credit analysis, some banks will accept limited or no personal guarantees. Additionally, many bank credit policies require a global cash flow analysis on guarantors to assess their ability to support the credit.

Covenants

Cash flow credit facilities most often include one or more financial maintenance covenants to be tested on a quarterly, TTM quarterly, and/or annual basis. Based on our review of loan documents, definitions around the covenants vary greatly. Common covenants include: minimum DSCR, minimum EBIDA levels, fixed charge coverage ratio, and maximum debt to EBITDA ratio. We've generally observed that a significant amount of small to middle market sized companies are either not required to and/or are not submitting covenant compliance certificates as part of their reporting package; and banks are generally needing to prepare such calculations themselves and testing internally.

Financial Reporting

Financial reporting requirements typically include annual financial statements (audited, compiled, reviewed, or company prepared); interim financial statements (internal); business tax returns; personal guarantor financial statements, and personal guarantor tax returns; the latter two only if guarantors are required.

Hybrid ABL:

As mentioned earlier, hybrid ABL's involve unique structures by combining characteristics of cash flow and asset based lending into one working capital line of credit facility; the key drivers being the overall credit worthiness of the borrower, types of business, quality, value and liquidity of the collateral assets, and competitive landscape. Source of repayment is primarily cash flow from operations; along with liquidation of working capital assets. Banks that are successful in this arena identify a clearly defined target market to participate in, and then set specific risk assessment criteria. In our client base, we see these come in all shapes and colors but most are generally structured as follows, which is also consistent with other market comparables observed:

• Each deal requires detailed analysis of borrower's business and financial position, including historical, current and projected operating and cash flow performance and capacity; and liquidity and management. And as collateral performance and availability are essential to the transaction, analysis of receivable quality (i.e. turnover, dilution, terms of sale, payment history, class of debtors, concentrations) and/or inventory quality and characteristics. The sufficiency of the cash budget to support operations and to meet obligations as expected for each of the following 12-months should also be assessed, if provided by client. We are also seeing more of our clients performing sensitivity analysis on expected cash flows (i.e. on interest rates and potential loss of income) in new underwritings as well as for renewals and as part of annual reviews. We highly recommend banks to do this more consistently , especially with more heightened discussion around a potential economic downturn. We are also seeing more banks incorporating this requirement into their credit policies and procedures.

• Generally, these deals are governed by monthly borrowing base certificates (on occasion weekly) prepared by the borrower. The lenders have a first priority lien position on the BB assets and occasionally banks take a first priority lien on all business assets. Typically, these arrangements do not give the lenders 1) rights to establish reserves against the BB, and 2) rights to control borrower's cash receipts (i.e. lock-box/cash dominion); these are probably the two biggest weaknesses in the hybrid structure, in the event of deteriorating cash flow capacity. In many cases banks require borrowers to maintain deposit accounts with their institution (some with minimum balances) but generally not as a covenant requirement and most not with a collateral lien position.

• Each deal requires a collateral appraisal and in most cases a field audit during the underwriting process and before the deal closes. However, most loan agreements do not require annual appraisals and field audits on an on-going basis; although most allow lenders the right upon request or in certain triggering events.

• Most transactions require a minimum of one financial maintenance covenant which is usually a minimum DSCR or fixed charge covenant, and occasionally a liquidity covenant (i.e. at least 10% of excess availability); tested either quarterly or on annual basis. Typically, these deals do not have annual clean-up requirements.

• The majority of hybrid deals observed do not allow for over-advances under the LOC.

• A sizable number of transactions observed do not require the personal guarantees of the principals, most based on the governing BB structure and underlying credit profile.

How many of your institutions are providing clients some form of hybrid ABL's? Any key structural differences in your hybrids other than what I've described in our observations?

Monitoring Controls – Hybrid Asset Based Lending

The complexity of administering Hybrid ABL loans results in higher transaction risk than for most other types of commercial loans and requires a disciplined approach to monitoring, controls, and managing exit strategies; which is ultimately integral to controlling credit and operational risk. Clear responsibilities should be established for credit approval, on-going credit analysis, collateral/cash proceeds control, field audits and portfolio management.

It is imperative to appropriately control the disbursements of loan proceeds to safeguard against over-advances and defaults. Borrowers draw against the borrowing base and the bank should ensure proper net availability prior to any funding to help prevent over-advances; any exceptions should require approvals in accordance with bank policy and be properly documented. We continue to note deficiencies in this area with a number of our clients. An unapproved over-advance may indicate a serious deficiency in the administration of the loan, inaccurate reporting by the borrower, and potential cash flow issues with the borrower. Whether approved or unapproved, the bank, in these situations, should discuss the current liquidity issues with the borrower to develop a strategic plan which could involve renegotiating terms of the loan. Additionally, the bank should keep track of borrowing levels and trends, against budget and expectations, so it can investigate any unusual activity, and manage as needed.

• The banks biggest challenge when lending against a monthly borrowing base is receiving timely and accurate information. The bank should have a tickler system to alert appropriate personnel if BB certificates and supporting information (i.e. receivable agings, inventory reports) are not received by the due dates as required, which is imperative to properly manage disbursements and potential resultant repayments to get back in line with availability. Bankers should also review information to identify any important trends or issues (i.e. in receivables quality, turnover rates, and concentration; and inventory for excessive levels, obsolescence, change in mix or write-downs) that may require further diligence and/or action. We've observed too many instances where banks rely on operations personnel to review the BB certificates for disbursements but where account/portfolio/credit managers have become somewhat complacent in reviewing the monthly materials to scrutinize and identify any key developments, trends or issues. The BB structure should not be considered an abundance of caution, but rather a critical component in assessing risk of liquidity and minimizing insufficient collateral coverage.

" An advisory comment is to not also fall into the trap of thinking the only ongoing diligence should be following the collateral through the BB."

•The banks reporting tickler system should also be tracking the timely submission and receipt of monthly, quarterly and annual financial statements, as required. These financials should be spread and evaluated by the bank in a timely manner, especially around borrower issues, changes, and trends regarding the business, liquidity and cash flow generation. An advisory comment is to not also fall into the trap of thinking the only ongoing diligence should be following the collateral through the BB. A broader perspective and analysis on the borrower's assets, liabilities, and cash flow are warranted. Bank should establish triggers for more frequent field exams based on specific performance metrics and trends. The scope of the field exam should address both cash flow and collateral issues (i.e. quality of earnings, financial trends, margins, coverages, terms of sale, class of debtors, cross-age, concentrations, contras, turnover, dilution, bill & hold, progress billings, overall advance rates, etc.). This also allows for more timely computations of covenant levels and compliance determination, if required; a critical tool in the event the borrower is not in compliance .

• CEIS continues to cite numerous exceptions in our reviews, for all deal structures, around proper tracking and timely calculations of covenant levels, and lenders not waiving or notifying borrowers of non-compliance/technical defaults; which potentially weakens the ability of lenders to seek remedy to the covenant violation due to lack of documented action

• Banks should ensure that collateral liens are properly perfected and maintained. The subject Hybrid ABL's are typically one year facilities renewed annually; with many on the books of a bank for many years; or expected to be renewed over a sustained period of time. It is therefore important for a bank to have a tickler system in place to alert the bank to file continuation statements for UCC filings, which generally expire after five years.

In summary, prudent administration of a Hybrid ABL is integral to controlling credit and operational risks. Diligent monitoring of cash flow and collateral coverage is necessary to detect early deterioration and for proper on-going management. Timely identification of risks allows the bank to take swift action to try and control risks and protect assets. Pro-active involvement, identified roles, strong management information systems, and appropriate responsibilities are key to responding to borrowers performance. As a result, banks may need to consider strengthening the structure of the Hybrid ABL at certain times to include one of more of the following: rights to establish reserves against the BB; cash dominion or springing cash dominion arrangement; more frequent collateral appraisals and/or field audits; additional financial covenants; additional collateral; personal guarantee(s) of key principals; capital infusion; etc.

" As part of our typical loan review process at CEIS, we provide financial institutions feedback on loan grade variances, grade outlook, financial trend, credit policy exceptions, technical reporting exceptions, underwriting risk and covenant compliance, just to name a few."

As we all know, this topic of prudent loan administration is important for monitoring not only hybrid ABL's, but for all loan products in each banks commercial loan portfolio. As part of our typical loan review process at CEIS, we provide financial institutions feedback on loan grade variances, grade outlook, financial trend, credit policy exceptions, technical reporting exceptions, underwriting risk and covenant compliance, just to name a few. Over time, CEIS has developed a client data base tracking many of these metrics as well as others, on a quarterly and annual basis. The overall data base has shown increasing negative financial trends for client loans quarter over quarter in 2018. Additionally, the overall level of technical reporting exceptions averaged approximately 25% in 2018, with the most common missing or dated annual and interim financial statements, missing or dated personal guarantor financial statements and personal tax returns, and dated annual reviews; additionally, for CRE specific, missing or dated rent rolls were also common. These are in addition to my earlier comments regarding insufficient covenant monitoring and follow-up in many cases. As mention these to further illustrate the importance of solid and timely monitoring, controls and analysis as part of a pro-active and effective portfolio management process, particularly in view of continued discussions around the timing and severity of the next economic downturn.

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Related Links

Related links used in the Newsletter is in Orange.

Shared National Credit Review Finds Risk Remains Elevated in Leveraged Loans

FDIC Updates Money Smart for Small Business Credit and Banking Modules

Agencies propose changes to modify Volcker rule "covered funds" restrictions

2020 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule

OCC Highlights Key Risks for Federal Banking System

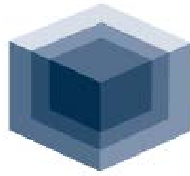
The CEIS Quarterly Newsletter – Volume 5, Issue 4

The Fed Wants to Loosen Rules Around Big Banks and Venture Capital

Q1 2020 Events

Events in Orange CEIS Review will be sponsosring and attending.
Hope to see you there!

Event	Location
ABA Conference for Community Bankers	Orlando, FL - Febuary
Tennesse Bankers Association Credit Conference	Nashville, TN - Febuary
Florida Bankers Association Bank Risk Management 2020	Tampa, FL - Febuary
Western Bankers Association 2020 Annual Conference	Scottsdale, AZ - Febuary
IBANY's Complaince Conferece	Rochester, NY - March
IBANY's Compliance Conference	Poughkeepsie, NY - March
Tennesse Bankers Association Compliance Conference	Nashville, TN - March
IIB Annual Washington Conference 2020	Washington, DC - March
CEIS Review, Inc Stress Test: A Roundtable Discussion	New York, NY - March
Western Bankers Association CRE Concerntration Management	New York, NY - March
ABA Risk Management Conference	New Orleans, LA - March



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CEIS Review, Inc. is an independently owned financial consulting firm established in 1989 to serve the needs of lending institutions with commercial portfolio related services. 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 justinjh@ceisreview.com.