

## ***A Survival Guide for Middle Market Companies Caught in the Credit Crisis***

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With the economic crisis laying siege to virtually every corner of the National economy, the Treasury's \$700 billion (TARP) credit market bailout to selected commercial banks is thus far proving to be a holding action and not much more. The measures taken have bought time (how much is difficult to say), in addition to providing some potential insulation against further asset deterioration and loan portfolio problems that may emerge on the other side of an historically dismal holiday retail market. To date and by almost any measure, TARP has not engendered noticeable additional credit availability.

In the midst of this, business borrowers are coming under unprecedented scrutiny by lenders. Against a background of unremitting uncertainty once solid asset values are frequently being revised down for collateral purposes while historically predictable cash flows, once a firm basis for senior cash flow lending, are being granted less significance in a dizzyingly evolving credit calculus. Business borrowers and lenders alike are learning that the concept of creditworthiness is being redefined monthly, weekly and even daily.

So far the fallout has been significant across the Country. The impact in the central Midwest markets has been marked and unequivocal. More than a few middle market borrowers, who just 12 or even 6 months ago had reason to believe that they were in good standing, are now being asked to reduce their indebtedness by significant sums. And businesses considered highly leveraged, but nevertheless creditworthy, prior to the onset of the economic crisis are often being shown the door and moved into the bank's workout department in order to hasten their departure.

In our investment banking and corporate finance consulting practice we are now regularly engaged by middle market companies that require some sort of recapitalization (radical or partial); have been moved into the bank's workout department, or are considering a sale or merger of their company, or a Chapter 11 bankruptcy filing in order to outrun potential catastrophic outcomes.

Our experience has so far been that most of these companies have an incomplete view of their real options; often overestimate the efficacy of the solutions they have begun to embark upon; are often inexperienced with game-planning in this perplexing environment and are unfamiliar with, and may misread, the creditor's processes, strategies and intent.

Undeniably there are no simple solutions or wholly adequate rules of thumb to follow. Each situation is unique. Yet one thing can be universally stated on behalf of companies thrust into this situation, and that is, that time is of the essence.

Knowing what to do and acting decisively may be a matter of life and death for your company and its stakeholders. What can realistically be achieved in the capital markets; how creditors process problem loans; what steps might be taken once in workout; and what remedies are available under the law, including under bankruptcy law are critical data points.

What follows are some general guidelines:

### **Capital Market Options:**

**Other Commercial Banks:** There is every reason to find out whether another commercial bank might be interested in becoming your senior lender, since lending appetites differ from bank to bank. Clearly, lender fatigue and other subjective factors that may have come into play in your current banking relationship will not exist for another bank. It is also possible that the kind of exposure you represented for your current bank may be more acceptable for another lending institution. Each bank will view your credit from their unique perspective. Nevertheless as you might suspect, most commercial banks will be similarly challenged in this environment and will require comparable levels of collateral and cash flow that your current bank presumably has found wanting. Accordingly, making a decision to pursue another commercial bank should be based on an informed view of your company's bankability. If your balance sheet is decidedly upside down, the answer is right in front of you... it is unlikely that you are commercially bankable, at least in your current condition or without additional equity or subordinated debt to supplement your balance sheet.

**Equity:** There is no institutional market for equity aimed at recapitalizing middle market company balance sheets in urgent need of fixing. Private equity firms, in the main, seek control positions in profitable, growth oriented enterprises. And while the availability of minority investments from equity funds is more prevalent than generally reported, such investments are usually made in growth companies and typically employed to recapitalize owner's equity or drive additional growth, not as a financial life preserver.

Friends and family may be a more likely source of equity capital in these situations. In our experience the levels of capital usually required for middle market companies to offset working capital short falls resulting from bank credit roll backs can be significant and not easily assembled from individual investors even when risk adjusted equity-level investment returns are achievable.

**Sub-and Mezzanine Debt:** One potential alternative is sub-debt and mezzanine debt sources seeking opportunities in the credit crisis-driven recapitalization market. In fact, this market is growing. While companies in the situations described above will tend to look in relative geographic proximity for rescue capital, the market is national, and should be sourced nationally for best results. Debt capital from these funds is priced meaningfully above commercial bank rates, often in the middle teens to low to middle 20% range, all in. A typical menu of debt service and fees might include any or all of an early to mid teens current coupon rate, a payment-in-kind (accruing interest typically under 5%); puttable warrants calculated as either a percentage of the par value of the loan or percentage of the enterprise value, in addition to origination and monitoring fees. In reviewing this option, it is important to be aware that participants in this market will be exceptionally rigorous in making a decision to go forward and will price for risk and market demand for their capital, which at the moment, is higher than it has ever been.

Companies accustomed to interest rates at or around prime rate should be prepared for sticker shock. But remember sub debt and mezzanine financing are subordinated to the senior lender and therefore assume something akin to equity risk. In better times, your senior lender may have assumed some of this equity-like risk in the form of cash flow financing at far lower interest rates. Those days are

generally over—at least for a while. At the end of the day, higher priced sub or mezzanine debt may be preferable to a higher cost equity infusion, the outright sale of the company, or outcomes potentially more drastic.

**Asset-Based Loans (ABL):** Asset based lenders are principally current asset lenders, looking for the lion's share of collateral support in accounts receivable, then secondarily in inventory and lastly in fixed assets. Although asset based lenders often will provide generous loan advance rates and close-to commercial interest rates (but with monitoring fees), it has been our experience that only a select number of companies in the situations described in this article will ultimately qualify for ABL. And despite deeper ABL advance rates, companies may still fail to meet their total recapitalization needs without additional equity or sub-debt support. This is not to say that ABL should not be considered for recapitalization, but rather that it may be one in a series of financing solutions.

Note that ABL audits are thorough; that some current assets may be excluded from the collateral where, for example, they are subject to customer completion agreements; that assets are newly appraised and usually for net orderly liquidation value, not fair market or even orderly liquidation value. The difference between net orderly and orderly liquidation value is typically about 15% relating to commissions and expenses related to the liquidation. It would be unwise to neglect this seemingly marginal detail when reviewing ABL as an option. It can prove a large difference and be a lot of money.

#### **A Note on Workout, Distressed Asset Values and Foreclosure:**

Being assigned to the bank's workout department is realistically almost always a one-way ticket out of the bank, not to a temporary rehabilitation zone. In workout, your affable relationship officer will have moved on and the remainder of your relationship with the bank will be with a workout banker. The workout banker's mission is to recover the cash loaned. Although a workout banker may apply pressure, for example, by rigorously enforcing loan covenants, applying default interest rates and reducing borrowing availability, among other measures, the last thing he or she really wants to do is to test the liquidation markets. They know that once the veneer of goodwill has been stripped from a company's assets in a forced liquidation, inventory and fixed asset values will drop dramatically and unpredictably and, in the case of accounts receivable, become far harder to collect. Even during more normal economic times, a competitive marketplace has little need of additional inventory, machinery or rolling stock, for example. *Whenever it has the chance, the market will discount overcapacity.*

On the other hand, the bank does not want the risks associated with assuming operating control of the company through a foreclosure. It just wants to recover its cash. As a result, there is usually time to act and affect some sort of transaction. However, as the bank accumulates reserves against the outstanding loan the financial risks that may have earlier attended a forced liquidation become less material and the situation as a result may favor foreclosure and liquidation.

Again, time is of the essence. Effective communication with the bank and realistically benchmarked plans and meaningful activity are essential. Your credibility is indispensable in these situations, almost as valuable as capital, so be sure to spend it carefully. The workout banker wants to see movement on your part, so keep things moving. The bank will often opt to postpone more onerous actions and/or lengthen

the runway with standstill agreements if it believes you are on, and diligently pursuing, a credible path. Note however, that each new agreement provides the bank the opportunity to extend its rights, tighten its requirements and increase its pricing.

**A Note on Chapter 11 Bankruptcy:**

Petitions filed under Chapter 11 provides the debtor with an automatic stay which, in turn, requires all creditors to cease collection attempts while also preventing debt collection efforts by pre-petition creditors against the post-petition company. Under some circumstances, creditors, or the bankruptcy trustee, may ask the court to convert the case to liquidation under Chapter 7, or to appoint a trustee to manage the company. Such would be typically granted if either of these actions is in the best interest of all creditors. A company may be able to liquidate under Chapter 11, in which case management is presumed to be able to obtain a better value by selling the operating company, or parts thereof, than may otherwise be achieved in Chapter 7 liquidation.

Our experience in working with clients contemplating filing for bankruptcy protection has been that to the degree Chapter 11 bankruptcy is broadly understood, there is far less clarity when it comes to how such an action might be applied to and may affect the individual company, owners and stakeholders.

Such questions as “is there a sufficiently compelling business valuation and going-concern argument to support a reorganization rather than a liquidation on behalf of the creditors; will debtor in-possession financing be available to provide liquidity during reorganization, among other questions?” require intense legal and financial vetting. Between ongoing legal fees and DIP financing interest and fees, bankruptcy is almost always an exceptionally expensive process. It is a last resort, and not applicable to every distressed situation. If you are considering Chapter 11, consult a qualified bankruptcy attorney.

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**Final Thoughts:**

Don't wait to act or to bring in legal, financial and accounting professionals to advise you. There is an inextricable and urgent relationship between time and capital in distressed situations. The importance of moving quickly to realistic solutions and alternatives cannot be understated.

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Ludlow, Ward & Greenberg Capital Partners, LLC is an investment banking and corporate finance consulting firm. The firm specializes in middle market mergers and acquisitions advisory and representation; capital sourcing and strategic corporate financial consulting. The firm is frequently engaged in capital restructuring, financial advisory and valuation support for both pre and post-petition bankruptcies.

