



# Show Me the Money

Non-investment grade companies needing to refinance maturing debt or seeking new money loans are still facing a tough lending environment despite the overall improvement in credit market conditions. This is especially true for middle market companies. FTI Consulting shares some practical insights on how best to find favor with lenders in these challenging times.

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**U**nderwriting scrutiny of middle market companies is, as it has always been, governed by the “5 Cs” – Character, Capacity, Capital, Collateral and Condition. But in the past year, the final “C” has overwhelmed the others, thanks to the tightening of the standards by which companies seeking financing are judged.

According to the 2009 Survey of Credit Underwriting Practices, the U.S. Comptroller of Currency's annual bank poll, 96% of the banks polled expected credit risk in their middle market loan portfolio to increase over the next year. The same poll had 67% of

## WHY BORROWERS SHOULD DO THEIR HOMEWORK



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When searching for asset-based financing, it is important for a company's finance team to understand the value of their assets and their cash flow. This involves understanding the appraised value of their fixed assets, examining their working capital assets, and ultimately understanding how those values will be viewed by their potential lender. In larger, widely syndicated transactions, another important consideration is the current market depth and capacity for other investors.

The appraisals and field examination are relatively straightforward, and the overall financing proposal process is more streamlined for a lender if that information is readily available and accurate. In some instances, the field examination and appraisals are prepared by third parties, but the lender may also choose to conduct their own valuations. As part of their own assessment of alternatives, companies should reach out to potential lenders for market updates. Companies should ask about the ABL and high-yield deals that are currently in the market, the current pricing and covenant terms, and the current valuation trends. In this economic environment, asset values have fluctuated dramatically, particularly in industries like specialty chemicals, building products, and manufacturing. By opening a dialogue with potential lenders, companies can better understand the value of their

collateral package and what assets would support a facility. Lenders like Wells Fargo Capital Finance are often willing to analyze a company's balance sheet and review collateral to provide meaningful feedback on the amount, terms, and structure of an asset-based or high-yield financing.

Companies should also try to understand the breadth of the options available to them and be willing to consider alternatives. This is especially important in a declining economy. With declining collateral values and less demand, companies are operating with less cash flow to support a refinancing. Unfortunately, this is often the time when companies are most in need of support from their lenders.

Finding the right solution may involve both a balance sheet and operational restructuring. It is apparent when a company has too much debt to support its business plan, but the need for operational assistance might not be easy to identify. Are there areas where the business model can be modified so operations are a little leaner? Should certain businesses be curtailed or discontinued? By looking for synergies between both the operational and financial restructuring, a company may be able to find a way to create additional liquidity.

It's also worth keeping in mind that some of the obvious short-term fixes can be counterproductive over the longer term. For example, we see a lot of companies reduce capital expenditures when times get tough. This is not always the best strategy, particularly if it substantially diminishes the value of your collateral at the exact time it needs to be maintained. This is where a firm like FTI Consulting can provide experienced industry guidance and management options to reduce overall costs and maintain a viable business plan.

Relationship banks like Wells Fargo want strong communications with their borrowers over a long period of time. It's easy to have a solid relationship when things are going well. The challenge is to continue to communicate and find mutually beneficial solutions when times are difficult. A key to success is developing strong relationships with your bankers well before a crisis arrives.

banks tightening their middle market underwriting standards this year, the most since the poll's inception.

Middle market lending picked up smartly in the last quarter of 2009 but remains far below the levels of the mid-2000s. With money center banks focused on larger clients and relationship banking, and many regional banks still capital-constrained by poor loan performance, it's unlikely that middle market lending will return to these volumes any time soon.

One thing is clear: middle market companies seeking bank loans need to be prepared for a limited appetite for leverage, tighter financial covenants, lower advance rates, shorter tenors, and higher spreads than in recent years. Above all, reluctant lenders are looking for another "C" from potential borrowers: Credibility.

While the balance of power between borrowers and lenders has shifted, borrowers should remember that they are far from helpless bystanders. Here are some of the key issues that bank underwriters are most focused on in evaluating a middle market financing:

■ **Collateral Is King** – Right now, collateral is crucial and most senior debt will be secured. Companies with tangible assets of determinate and material value are in a far more favorable position than those with fewer tangible assets. Valuing collateral is also a key issue, as real estate and some types of equipment have been severely depressed over the past year. Those seeking financing should go into bank negotiations with a clear understanding of the value of those assets to be pledged, preferably verified by a third-party source. Remember that assets are only useful as collateral if they can be controlled by a lender in the event of default and subsequently monetized in a timely and cost-effective manner.

■ **Evidence of Quality Management Is Crucial** – Often overlooked, this factor is of paramount importance in the underwriting process. Banks need to be comfortable with a management team's qualifications and character. Banks are also scrutinizing managerial performance, since in many cases this provides an extreme



data point. Management should have answers to the following questions when approaching lenders for financing: How have revenues held up in this downturn? How were costs kept in line with falling sales? How was working capital managed in the face of the recession?

■ **Ensure Your Financial Data Is of the Highest Quality –**

The integrity of the borrower's accounting information is critical. Financial statements must be audited, and controls must be strong. Demonstrating the internal control systems in place should be part of a presentation to lenders, as emphasizing the reliability of the company's financial reporting systems can go a long way in mitigating any skepticism.

■ **Understand the Role of Projections –**

Lenders generally expect a sluggish economy to impact the financial performance of middle market companies to a greater extent than large firms, negatively affecting cash flow and staying power. For this reason, upbeat projections are greeted skeptically and it is up to the borrower to convince lenders that realistic economic conditions are incorporated. Management should be prepared to provide detailed support for their projections and underlying assumptions. Even if banks accept these projections as reasonable, financing is unlikely to be provided at anything greater than a senior debt-to-EBITDA ratio above three times.

■ **Use Scenario Analysis –**

Borrowers should have a firm understanding of a worst-case scenario and a detailed plan to deal with it. Many private equity firms started undertaking scenario planning in early 2008. This planning enabled sponsors to reduce the amount of additional equity injected when refinancing. In 2009, one large European private equity firm was able to refinance more than \$1.5 billion of debt with additional equity of less than \$10 million. Management should follow suit and prepare a line-by-line plan of how costs will be cut and debt will be serviced if sales fail to meet expectations. In the same vein, management should evaluate

potential liquidation scenarios as banks will certainly need to understand them thoroughly.

■ **Understand Your Industry –**

Traditionally, attractive industries for underwriters are those with low cyclical and low technology/obsolescence risk because cash flows are more predictable. This downturn has spared few industries, but the risk of obsolescence and the intensity of competition continue to be heavily scrutinized in the underwriting process. Additionally, due to the renewed reluctance of banks to underwrite cash-flow loans for middle market borrowers, companies in asset-light industries such as software, technology, and services may find it more difficult to obtain financing, particularly if there is more than one lender. Those seeking financing should have a firm understanding of their industry, and be prepared to make a strong case to lenders on its attractive aspects, while explaining the company's plan to mitigate risk from its negative elements.

■ **Know Your Business –**

Attractive borrowers have compelling products and services, a strong brand name, little customer concentration, and highly credible management teams. Even in lean times, bank funding is usually available to high-performing companies with solid track records. Those seeking financing should know their business inside out, and be prepared to present a strong case on how the company stands apart from its competition. Unfortunately, most middle market companies currently in need of refinancing are doing so in the context of weak demand and stagnant revenues. These companies need to demonstrate how well they have been able to reduce costs and rescale their businesses to maintain margins and profitability. Management should also understand and be able to explain the company's positioning relative to competitors in the event of a normal recovery and a prolonged downturn.

■ **Reconfigure the Capital Structure –**

Banks are trying to cushion their exposure to the total leverage in a borrower's capital structure, often requiring principals

to have more "skin in the game."

Additionally, many middle market companies seeking refinancing are faced with weaker recent operating performance and more conservative covenant ratios, meaning less debt will be available to them than when the previous financing was put in place. As a result, companies may need a high equity or junior capital contribution to obtain bank debt. Personal guarantees may be required for smaller companies. In this case, the owners' finances and credit history will be on full display and can be prepared in advance. Make-whole or capital call agreements, particularly in companies with non-public fund-held equity, may be required.

■ **Be Prepared to Concede on Covenants –**

Banks are demanding tighter covenants. Borrowers should now expect tight covenants regardless of their credit history or relationship with the lender. More frequent reporting and valuation of collateral may also be required. Management should go to lenders with a willingness to accept these restrictions on any issue made in the near future, with the understanding that if the company does outperform these covenants, they can probably refinance their way out of this burden.

■ **Examine and Reconsider the Use of a Bank's Other Services –**

A history of using the bank's services such as treasury management or merchant services helps the company secure lending in two ways. First, it makes the company more attractive for the future fees these services will generate. Second, it frames the financing as relationship banking, based on a history of proprietary information gained through multifaceted business interactions.

■ **Self-Help Can Help –**

Companies can make the process of refinancing faster and easier by undertaking their own self-diligence prior to discussions with lenders. As well as knowing their own strengths and weaknesses, companies can also prepare a thorough analysis of their operating performance, financial metrics, and collateral. It may be worth asking an external advisor to assist with this – a good advisor can bring independent analysis, industry knowledge, greater credibility, and additional manpower. ■