

Asset-Based Lending at the End of the Era of Easy Credit

By Stan Scott

Best practices for a return to credit discipline.

Over the past decade, global economic expansion and money supply growth unleashed a seemingly endless flood of liquidity into the United States. Fueled by low interest rates and unregulated, easy credit, much of the incremental liquidity was channeled through hedge funds and private equity funds. Hedge funds have a thirst for leveraged investments, including subprime mortgage collateralized debt obligations (CDOs) and developmental stage companies bearing so-called high enterprise value. Private equity firms seek leveraged acquisitions in the commercial sector.

These newly important market players put pressure on commercial lenders of all types to streamline loan approvals and loosen covenants. Now it seems that credit expansion has peaked.

This article describes some of the changes that created an easy market for credit and suggests some ways in which lenders can reexamine credit quality and begin a return to fundamentals.

Financial Speculation Leads to Easy Credit

The evolution of financial markets over the last 30 years has spawned growing financial speculation, beginning in the 1970s. Resulting market bubbles since then have had little effect in slowing this financial market evolutionary process. Excess capital and growing global money supply has outstripped productive investment opportunities in the United States due to economic stagnation. The search for opportunities to employ these excess funds has led

to the rapid growth of financial markets and the creation of new financial instruments, giving birth to the derivative markets. The asset-backed securities market has seen spectacular growth over the last five years, during which we have witnessed the creation and widespread growth of subprime mortgage and leveraged credit-risk-transfer vehicles, such as CDOs, collateralized loan obligations (CLOs) and related derivatives known as credit default swaps (CDSs).

Pessimists suggest that these changes have created an out-of-control financial system driven by irresponsible investors and creditors. They believe that these players are capable of creating a high degree of systemic risk, resulting in potentially catastrophic financial or credit bubbles. Optimists believe that adequate diversification will prevent meltdowns. Robust liquidity coupled with easy credit led to speculation in housing, preceded by consumers' widespread tapping into home equity *via* home equity lines. Subprime mortgages in support of home purchases created a real estate bubble characterized by falling home values and rising default rates. Meanwhile, hedge funds heavily invested in subprime mortgage-related CDOs face cascading devaluation in these illiquid assets, as nervous investors force mass dumping of liquid assets to satisfy redemption requirements and nervous creditors restrict liquidity.

Just as substantial liquidity flowed into subprime mortgages in support of high-credit-risk consumers, the same has occurred—albeit to a lesser degree—in

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the commercial lending sector due to loose credit controlled by unregulated sources. A speculative commercial credit bubble is feared as market liquidity pulls back in the face of continued demand for liquidity by high-risk borrowers seeking to delay the inevitable: asset deflation on the revelation of anticipated rising default rates and recognition of underlying bad debt. While commercial loan and corporate bond default rates remain low, unregulated financial institutions and investors such as hedge funds and private equity firms hold much of the debt in the latest credit expansion. Consequently, historical commercial bank commercial and industrial (C&I) default rates and rating agency (Standard & Poor's [S&P], Moody's) default rate trends, currently near an all-time low, may not be reliable bellwethers of overall commercial credit quality. The unregulated sources are less likely to disclose troubled credits quickly or may lack traditional default triggers due to the recent tendency toward covenant-lite loans.

A speculative commercial credit bubble is feared.

Is Recent Economic Growth Real or Imaginary?

As evidenced in Exhibit 1, the world has experienced strong overall global economic growth during the last five years, led by China's industrial revolution and supported by unprecedented liquidity. Meanwhile, US domestic economic performance has recently slowed as measured by real gross domestic product (GDP). To put things in perspective, the United

States at number one represented 27.4 percent of total global GDP (or \$13.6 trillion), according to the World Bank. Japan is a distant second at \$4.3 trillion, while

China at \$2.7 trillion, and currently number four, is expected to replace Germany at number three by 2008. China represents the fastest-growing major economy as measured in real GDP at 11.9 percent

annually as compared to the United States at 3.4 percent, based on the latest quarterly results.

Much of the U.S. household and business asset expansion the last five years may consist primarily of artificial asset inflation (unsustainable holding gains). A major concern is that this growth has been propelled by record debt levels rather than by real equity appreciation, capital contributions, earnings retention or savings (Exhibit 2). The record asset expansion has far outstripped real GDP growth, consumer savings and corporate earnings retention (approximately 50 percent). Consequently, the reported record US "wealth" may be a somewhat illusory overstatement.

Acquisitions and recapitalization deals have been largely funded by senior debt and hedge funds (\$1.4 trillion industry) or private equity (\$400 billion raised since 2002, including \$173 billion in 2006) invested in illiquid assets but subject to relatively short-term redemption requirements to investors. Impatient investors demanding redemptions may force hedge funds to sell at a discount, resulting in write-downs to hedge fund lenders and time-consuming, distracting renegotiations. Leveraged loan issuance over the last year topped

Exhibit 1. Strong Global Growth

Annual Figures	1997	2002	Change	2007 (1Q)	Change
U.S. real GDP	\$8.7 trillion	\$10.5 trillion	20.7%	\$13.6 trillion	29.5%
Personal consumption	\$5.8 trillion	\$7.4 trillion	27.6%	\$9.6 trillion	29.7%
World GDP	\$29.6 trillion	\$32.7 trillion	10.5%	\$48.2 trillion	47.4%
Corporate earnings	\$701.4 billion	\$610.4 billion	(13.0%)	\$1,536.7 billion	151.8%
Financial earnings	\$193.0 billion	\$276.4 billion	43.2%	\$498.9 billion	80.5%
Manufacturer earnings	\$209.0 billion	\$48.2 billion	(76.9%)	\$346.1 billion	618.0%
Wholesale earnings	\$47.6 billion	\$49.3 billion	3.6%	\$103.3 billion	109.5%
Retail earnings	\$64.2 billion	\$79.4 billion	23.7%	\$138.7 billion	74.7%

Note: Figures derived from U.S. Department of Commerce and World Bank statistics.

Exhibit 2. Has Growth Been Propelled by Debt, Not Economic Fundamentals?

Fiscal-Year-End Figures	2002	2007 (1Q)	Change
Credit market debt	\$31.8 trillion	\$45.9 trillion	44.3%
Commercial banking	\$5.6 trillion	\$8.0 trillion	42.9%
ABS issuers	\$1.9 trillion	\$4.1 trillion	115.8%
Finance companies	\$1.1 trillion	\$1.6 trillion	45.5%
Corporate bonds	\$6.2 trillion	\$10.1 trillion	62.9%
Mortgages	\$8.4 trillion	\$13.5 trillion	60.7%
Corporate equities	\$11.9 trillion	\$20.8 trillion	74.8%
Household assets	\$47.6 trillion	\$69.6 trillion	46.2%
Real estate	\$15.1 trillion	\$22.9 trillion	51.7%
Financial assets	\$29.1 trillion	\$42.5 trillion	46.0%
Household net worth	\$38.8 trillion	\$56.2 trillion	44.8%
Corporate assets	\$19.5 trillion	\$25.2 trillion	29.2%
Tangible assets	\$9.5 trillion	\$13.3 trillion	40.0%
Corporate net worth	\$9.6 trillion	\$14.3 trillion	49.0%

Note: Figures derived from Federal Reserve statistics.

\$700+ billion versus \$200+ billion in 2002. Private equity merger and acquisitions (M&A) transactions (buyouts of public companies) have thrived due to unprecedented financial market liquidity, thin spreads, lower closing costs, faster due diligence due to avoidance of Securities and Exchange Commission (SEC) scrutiny and the rigors and cost of the Sarbanes-Oxley Act of 2002.

We may see a backlash of industry regulation efforts in response to anticipated high default rates and rating downgrades on subprime and leveraged instruments such as CDOs (\$300+ billion), CLOs (\$150 billion) and CDSs (up 33 percent to \$34.5 trillion notional principal outstanding volume). Rating agencies face great challenges in rating accuracy as evidenced by the widespread downgrading recently announced by both Moody's and S&P on numerous subprime CDO issues. The inherent risks of these instruments may not be fully understood by issuers, investors and rating agencies. This sector does not have an active trading market; consequently, value remains a relative unknown with limited historical data to rely upon.

A Return to Credit Fundamentals and Discipline

The unprecedented global liquidity and accompanying environment of easy credit and thin rate spreads has

made it a borrowers' market the last few years. This pressures traditional secured lenders to assume greater risk and respond even more quickly. Automated accounting systems, the widespread use of the Internet and wireless technology have served to improve the information flow and communication between borrower and lender. In addition, these developments have put greater pressure on lenders to digest complicated borrower information more quickly in order to respond in real time. Lenders have been pressured to become like vending machines; tempted to commit errors in judgment; and make fast, rash, premature decisions. These decisions could come back to haunt them during a credit contraction and ensuing economic downturn.

A major transition in the credit cycle calls for a return to credit discipline and time-tested fundamentals of creditworthiness. Financial performance and condition are the primary measuring sticks by which the success or failure of a business is judged. Business results are a function of both controllable, internal risk factors—comprising primarily management ability and decision making—and external factors generally outside the company's control, including the specific environment (economy, industry, etc.) in which the company operates. Financial performance and condition are also influenced by the company's specific life cycle stage, in turn a function of both management and environmental factors including the economy.

Management decision making directly influences the following key variables:

- Business plan/strategy and establishment of standard operating procedures
- Capitalization
- Organizational structure: marketing, operations, financial management
- Personnel recruitment and retention
- Physical plant including asset acquisition and maintenance
- Information technology (IT)/accounting systems (including financial reporting)
- Value chain and cost structure

Environment risk factors include the following:

- Economy: current state and trend (expansion, peak, contraction, trough)

- Industry: outlook, life cycle stage (infancy, growth, maturity, decline)
- Political: government regulation
- Natural disasters

The simultaneous interaction of these external and internal variables may be boiled down into the following major elements comprising the value chain, which collectively dictate financial performance and condition:

- Marketing ability/success
- Operating efficiency/effectiveness
- Asset/liability management (cash, accounts receivable, inventory, fixed assets, accounts payable, revolver, secured debt, capitalization/earnings retention)

These factors determine the degree of financial performance success or failure and resulting financial condition as measured by the following:

- Profitability, a function of sales success and expense management
- Cash flow, a function of profitability and asset/liability management
- Liquidity/solvency, a function of profitability, earnings retention and asset/liability management

Macroeconomic Factors Affecting Credit Quality

GDP growth rate. The recently reported second-quarter 2007 U.S. real GDP growth rate of 3.4 percent is on the surface encouraging. But consumer spending contributed only 1.3 percent to overall growth. This is a real concern since consumer spending represents two-thirds of overall GDP—meaning that business and government spending increases propped up the overall performance. The record corporate earnings are likely not sustainable but rather supported by the financial sector and derived from fees related to high-leverage deals and derivatives. Household consumption drives the economy. Business and government spending in response to a strong consumer sector is preferred to building inventories and expanding factories after a consumer slowdown.

Unregulated financial institutions and investors such as hedge funds and private equity firms hold much of the debt in the latest credit expansion.

What does slow growth mean? A slowdown to no growth equates to a decline of roughly \$400 billion in annual real GDP. Much of this revenue decline may be borne by highly leveraged small to midsize businesses, which represent the lion's share of domestic GDP. These small, higher-risk companies may lose support from nervous creditors, suppliers and large retail chains. Capital spending will slow, and many cyclical manufacturers will likely suffer an earnings reversal on revenue shrinkage. Declining revenue will have a more marked adverse impact on businesses with heavy operating leverage. Excessive corporate debt to high-risk borrowers renders debt-service capacity suspect, and the liquidation value of the underlying assets may be inadequate to satisfy the debt.

Vulnerability to commodity prices. Commodity prices (with the exception of lumber) are continuing their upward march in support of global economic growth driven by China and India's industrial buildup. Therefore, commodity inventories are likely to be at less risk for devaluation to creditors. But business borrowers will be subject to commodity price inflation pass-through risk.

Long-term strength. A critical macro issue in evaluating future borrower financial performance on the threshold of business and credit cycle contraction is the company's financial capacity to endure an extended economic downturn or period of financial distress beyond the time horizon of the proposed loan period. A business equipped to do so demonstrates high quality, strong earnings via efficient operations and asset and trade cycle management. Strong businesses are able to comfortably meet all obligations with available liquidity due to satisfactory historical earnings retention.

Borrower Factors Affecting Credit Quality

Balance-sheet strength and operating performance. Profitability, cash flow and financial condition are intertwined to such an extent that cash flow perfor-

mance, for example, is to a large degree a function of operating performance, financial condition and asset management. A well-capitalized, liquid business is more readily capable of effectively and efficiently employing the required labor, capital and trading assets, while adequately managing its trade and cash conversion cycles in order to produce satisfactory operating and cash flow results, thus further enhancing its financial position. Financially strong companies command better vendor terms and discounts, successfully recruit more talented labor and can afford to invest in efficient state-of-the-art technology more readily than their competitors.

Revenue growth and customer relationships. Borrowers subject to favorable economic and industry trends coupled with management success in cultivating customer relations are more likely to experience gross margin improvement on the strength of a growing, high-quality revenue stream. Increasing customers leads to economies of scale and accelerating profits. Savvy financial management yields incremental profits in the form of lower finance and working capital costs, while proficient asset/liability management helps maximize cash flow and debt-service capacity.

Collateral value. A credit contraction and resulting economic slowdown may adversely affect asset-based lenders' collateral values via escalating accounts receivable bad debt, declining inventory values due to excessive inventories, depreciating machinery and equipment values due to an equipment glut (same for big-ticket luxury items) and shrinking real estate values associated with artificial asset inflation. Accounts receivable subject to suspect overall creditworthiness, excessive concentrations and inordinate performance risk (that is, progress or milestone billings governed by project-driven contracts) may be at greater collections risk. Meanwhile, recognition of slow-moving inventory levels may impair secured debt while hammering borrowers' balance sheets and revealing overstated prior-period earnings for product already paid for but now worth less than original cost.

Quality of earnings. The quality of reported earnings and stated asset values becomes of paramount

importance in the face of a credit cycle downturn. Quality of earnings is a function of both the accuracy of the financial statements and the reporting system and the quality of the underlying assets. One must

filter out nonrecurring income/expense events and unrecorded items such as unrecognized bad debt and inventory adjustments. In addition, it is critical to consider intangibles that may be the source of the company's

value: intellectual property, customer list, product/service delivery proficiency, etc.

Lenders should undertake the following to assess not only the quantity of reported earnings but also the quality:

- Examine sales mix changes (volume and respective margins) by product line/business segment.
- Identify and distinguish between internal and external cash flow drivers.
- Identify/isolate underlying triggers to gross profit margin changes and note respective contribution margins by product line.
- Evaluate and investigate the validity of quantitative benefits stemming from implementation of revenue/margin enhancement strategies and or corrective action plans, such as lower supply costs via new sources or renegotiated contracts, product sales price increases, introduction of new higher-margin products, cost-cutting measures, synergies acquired, efficiencies gained *via* new systems and processes acquired and implemented.
- Investigate unexplained improvements in gross profit margin in the face of declining sales. These may be attributable to a nonrecurring event such as a LIFO (last in, first out) liquidation (computation of COGS [cost of goods sold] includes older, lower-cost inventory as LIFO layer is breached), which results in an artificial inflation in reported earnings and may be signaled by a decline in inventory levels.
- Remember that period-ending inventory write-ups increase gross margins and resulting profits. Conversely, period-ending inventory write-downs decrease gross margins and corresponding earnings.

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- Note the effect of any change in interest rate and amortization period when considering a debt restructure/refinancing exercise.

Working capital effects of worldwide sourcing. As China and India continue to expand as sources of outsourced manufacturing and service labor to the United States, the U.S. wholesale network will require ever-increasing working capital in support of in-transit inventory. Working capital requirements are a function of the inherent operating cycle as determined by the specific industry and competitive environment, and comparisons should be made accordingly. Generally, the tighter a company's gross and operating profit margins, the more efficient the company must be in managing its trading assets and underlying turnover activity to generate sufficient operating cash flow.

Sources of liquidity. Lenders must consider additional liquid resources in the form of cash balances, pending asset sales, unused reserve line of credit availability, untapped spontaneous trade debt and owner contributions to supplement cash flow from operations. Also, note any impending contingent liabilities or commitments, which may require near-term future cash outlays. Note evidence of any hidden equity in assets, which could conceivably be realized in cash via sale or leveraged *via* debt instruments to smooth out unforeseen cash flow timing differ-

ences or other financial challenges. For most small businesses, tangible equity is centered in net trading assets, including accounts receivable and inventory, and, to a lesser degree, machinery and equipment. Consequently, the quality of asset valuation is critical. Limited use of secured debt and conservative earnings retention leads to a solid capital structure.

Time for Credit Discipline

The high-risk attitude permeating financial markets coupled with a herd mentality of investor euphoria has created a commercial credit bubble. Too much money chasing a finite set of deals creates both excessive leverage and artificial asset inflation. Unregulated intermediaries such as hedge funds may be slower to disclose bad loans, thus artificially veiling a rising trend in loan defaults that may eventually trigger a knee-jerk credit contraction, leading to record bad-debt levels and business failures.

Asset-based lenders must closely monitor highly leveraged transactions for signs of deterioration, prudently assessing collateral values in relation to loans in the event of worst-case scenario liquidation. This means maintaining credit discipline, bearing in mind that credit enhancements coupled with meaningful financial covenants on high-leverage and turnaround transactions represent important credit safeguards.

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