

WE CAN SEE THE NEXT WAVE COMING ...



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The recent run-up in interest rates, combined with the failures of Silicon Valley Bank, and Signature Bank, have resulted in most U.S. banks seeing a significant drop in their stock market value during the first half of 2023. This has led bank management to build up their **loan loss reserves** and change their focus to cleaning up their balance sheets by pushing out special situations borrowers (read **over-levered** and **under-performing** companies).

The Office of the Comptroller of the Currency (OCC), which is the primary regulator of national banks, defines a Leveraged Loan as a borrower with over 3.0X Senior Debt / EBITDA and/or 4.0x Total Debt / EBITDA. By this definition, any borrower under the **Main Street Lending Program** (4X to 6x bank leverage) is likely to be **over-levered** from a bank regulatory perspective. Furthermore with 15% amortization due at the end of year 3 (which is basically December 2023 to January 2024), liquidity may become squeezed for many of these borrowers. This liquidity issue may add to the **under-performing** designation by bank credit officers, and will likely result in additional defaults under the Fixed Charge Coverage covenants. This affects over \$12Bn of loans.

Since the last bank credit crisis 14 years ago, banks have done little to develop their loan workout capabilities. In fact, many middle market lenders are forgoing workout departments altogether while planning to sell distressed debt at a discount to "vulture funds" set up for that purpose.

All of this is why it is important for middle market businesses to proactively address pending default (within credit agreements) and liquidity issues versus waiting for the bank to respond. In a period of credit tightness, even a "technical" default can start a borrower down the slippery slope to permanent insolvency. SafeWater Capital provides a "30-day assessment" for middle market companies and their lenders to allow for sufficient time to proactively address strategic alternatives ahead of any unwanted bank mandates.

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Here are some basic facts about today's market:

1. Senior Secured Lenders have a right to hire an advisor (to help collect the loan) at the defaulted borrower's cost, but they do not necessarily have any right to impose a new officer (Chief Restructuring Officer. – "CRO") on the business.
2. CROs typically bill hourly and the average rate for a senior advisor is around \$700 per hour. CRO rates in the U.S. range from \$450 to \$1,500 per hour. At \$700/hr, a CRO bills \$5,600 per day and \$28,000 per week (before expenses). Most CROs include junior personnel on their deal teams at \$350 per hour or more.
3. Having an advisor spend eight hours a day at the company's headquarters rarely results in creating significant value or liquidity. In fact, at an incremental cost of more than \$30,000 per week for a CRO, cash-strapped borrowers are unlikely to be able to successfully restructure while maintaining existing equity control.
4. Most banks and middle market borrowers will do anything, and everything, possible to avoid a bankruptcy filing. Many legal and financial advisors (particularly those that are paid on an hourly basis) prefer working within a bankruptcy filing because their fee payments are approved by a judge's order.
5. Although CROs and financial advisors have an engagement contract with the borrower (which creates a duty of loyalty), they often act as agents for the bank, in hopes of getting future business from them and/or a permanent management position.
6. A CRO's primary duty is typically to manage the company's checkbook, in order to protect the bank's collateral. This is done with a 13-week cash flow model and any competent CFO is capable of doing this well.
7. Most over-levered, under-performing borrowers are going to need additional capital to resolve a default issue with the bank(s). This means hiring another advisor (ideally a registered investment banker) to look for debt and/or equity. Many borrowers resist hiring additional advisors after a CRO has been retained.
8. At SafeWater Capital, we structure our compensation to maximize the optionality for equity ownership. Our "30-day assessment" is only \$25,000, and our engagement work fees are typically fixed at \$30,000 per month and credited after three months, with a transaction fee tied to raising new debt and/or equity.
9. Our process is, first and foremost, focused on refinancing the bank debt within the liquidity window available to the borrower. This could involve mezzanine capital and/or minority equity.
10. We also work with the business' financial management (CFO or Controller) to help them develop and own the 13-week cash flow model. The nature of our work means we have no interest in replacing any C-suite executive at a client.

To find out more, contact us at SafeWater Capital.