MISSING CUES FROM YOUR COMMERCIAL BANKER ...

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Commercial banking is a cyclical business. First, the regulators tend to over-react (every so-many years) forcing major changes in banks credit cultures and lending appetites. Second, many "relationship bankers" change employers like they are playing a game of musical chairs, which can often leave borrowers having to re-educate their new banker and/or credit officers. Finally, workout bankers go from "little to do" during the expansion phase of the credit cycle to "significantly overworked" during the contraction phase. This can often lead to critical decisions that are viewed to be "in the best interest of the bank," but not usually the borrower.

In our business, we hear these complaints as the primary reason for many companies' failure. Its true, that these factors can contribute to distress at a borrower, but its never the primary reason.

So what is a CEO/CFO supposed to do, in order to avoid stepping out onto that slippery slope?

First, understand that **company's have cycles too**. We call this the **Stress-Recovery Cycle** (see chart above). Growth and profitability is associated with doing most things right, but over time, unintended consequences tend to slow down the positive momentum and adjustments have to be made. Every company, from the corner grocery store to Apple, Inc., goes through these cycles. However, when the **stress phase at a company lines up with the contraction phase within the overall credit cycle**, we see real problems develop. This is even worse when a maturity date, or amortization start date, under the borrower's credit facility also lines up.

The best way to avoid a negative outcome with your lender is to **be prepared** and **be proactive**.

1) CFO's should always have a possible backup lending relationship identified with another bank and/or a non-regulated lender.

2) It is also important to understand the importance of financial covenants and financial reporting within the loan agreement and manage your credibility at the bank.

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Bank regulators typically focus on **two critical covenants** in reviewing bank loan portfolios (so naturally bank management is also critically focused):

1 – **Total Leverage** (Total Senior Secured and Unsecured Debt to EBITDA). This ratio is typically between 4.0x and 6.0x in credit facilities – depending on the size and stability of cash flows. Senior Leverage is usually 1.0x to 2.0x less than Total Leverage. A 6.0x Total Leverage ratio is considered "highly leveraged" by the Comptroller of the Currency (the bank regulator for national banks). Obviously, the lower this number the more comfortable the bank credit officers are.

2 – **Fixed Charge Coverage** ([EBIT + Lease Exp + Maintenance Capex] to [Principal + Interest + Lease Expense + Maintenance CAPEX]). This number should always be above 1.0 to 1, and most banks want to see it greater than 1.25x.

As banks review financial reporting, they pay particularly close attention to the trends in the two covenants. If these two ratios are strong, other covenant defaults are more easily dealt with in a waiver or amendment. But, as these ratios start to deteriorate, internal credit pressure is focused on the relationship banker. If he/she reports back something like "its just a one-time problem that will be fixed next quarter" and that turns out not to be the case, it destroys both his/her internal credibility <u>along with the management team's credibility</u>. This is usually the first irreparable step within the distress process. **Lost management credibility is the primary reason banks engage Chief Restructuring Officers or CROs.**

CROs are talented ex-accountants, bankers or executives that take an "<u>officer title</u>" with a defaulted borrower (<u>at the bank's insistence</u>) to manage cash and communications with creditors and vendors. Almost all CROs can also serve as **interm officers**, so they have a hard time gaining the trust of management teams. It is easy for a CEO or CFO to feel like there is a target on his/her back, after a CRO has been engaged. As an investment bank**, Safewater is prohibited from taking an officer title in a special situations client**. Unfortunately, the CRO industry has evolved to charging on average **$750 per hour** for the CRO and **$350 per hour** for a junior manager. This equates to over $30,000 per week and can often be self-fulfilling from a distressed perspective. Having that kind of cash drain on a struggling business makes it unlikely that it can recovery within the cycle, and it is more likely be liquidated. **SafeWater's standard engagement terms include monthly fees less than 25% of a typical CRO engagment.**

So the best strategy is to keep your options open prior to default and be **proactive** and **cooperative** after default. Have a general idea of "Plan B" if your performance starts to go sideways. Know that **you don't have to hire the CRO or financial advisors that the bank recommends**, but you likely do have to engage an acceptable party. Hire the advisor that gives you the best option for a positive outcome from your perspective. Protect your credibility within the bank, so if there is a case where you need the bank to stretch a bit in a pinch, they are more likely to help keep you away from that slippery slope. Finally, don't wait too long to shore up leverage or cash flow shortcomings. These are the areas that will affect management credibility the most. **SafeWater offers a 30-day assessment that can identify strategic alternatives to help you choose an optimal solution while avoiding the downside of a liquidation**. For more information, please contact your Safewater Capital representative.