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Maybe Dilbert is Right: DIP Lenders React to Evolutionary Changes

APR 1, 2002 (TMA HQ CHICAGO) — Scott Adams, the creator of the cartoon Dilbert and author of The Dilbert Principle, says that he doesn't know why the economy works, but he is quite certain that it isn't because brilliant people are managing it.

First of all, Adams pointed out in his book, 90 percent of all new business ventures fail. "Apparently 10 percent of the time you get lucky," he observed, "and that's enough to support a modern economy."

Adams singles out management for many of his barbs in both his cartoons and his book. "First there were some amoebas. Deviant amoebas adapted better to the environment, thus becoming monkeys. Then came Total Quality Management," he quipped in the book.

"If you sum up all the absurd activities of management, the idiocies somehow cancel out, thus producing cool things people want to buy," Adams said. "Add the laws of supply and demand and you have pretty much described the whole theory of economics."

While his observations may not be statistically correct, Adams does illustrate that no discussion of the economy is complete without looking at trends in management.

In the past 20 years, the economy has gone through evolutionary changes. The highly leveraged transactions of the 1980s became the infamous bankruptcies of the 1990s. Industry after industry suffered, more as a result of leverage than of poor operations, the troubled economy, or even fraud.

Major casualties included conglomerates and mammoth companies such as Penn Square and Drysdale Securities; retail heavyweights Allied, Federated, and Revco; and virtually the entire steel, health care, and telecommunications industries. From the original Johns Manville case to the recent W.R. Grace & Co., USG Corporation, and Owens Corning asbestos-related bankruptcy filings, and all the way to today's "big dogs," Enron and KMart, case after case has caused the lending community to re-evaluate what it is doing, both before and after bankruptcy filings.

With the dust finally settled from the stampede of these highly leveraged transactions, turnaround professionals are now faced with companies that have increasing problems caused not by leverage but by poor operating performance. In part, or because of this, debtor-in-possession (DIP) financing remains a popular tool for helping companies rationalize their operations, improve their capital structures and, if necessary, restructure their debts with creditors. However, lessons of the past 20 years are evident in today's DIP financing structures.

Changing Needs

The U.S. Bankruptcy Code is designed to permit a debtor to reorganize its business rather than liquidate it. The 1978 revision of the code fostered a belief that bankruptcy is a "debtor friendly" process because it permits the same management team that may have caused some of the problems that precipitated the bankruptcy filing to remain in control during the bankruptcy process. This begs the question: if management caused or at least contributed to

the bankruptcy in the first place, why would any lender back them to get out of bankruptcy?

As in the jungle, only the strong survive. Companies have boards of directors that are responsible for weeding out incompetent chief executives. Also, DIP lenders in many instances require some form of outside operational or financial oversight by a crisis management or financial advisory firm as a prerequisite for providing financing. In today's environment, lenders routinely collateralize their DIP loans with both tangible and intangible assets of a debtor rather than relying on a court to grant "super-priority" claim status without even taking a filed lien, as was the case 10 years ago.

In a TMA Trend Watch survey published in the March 2001 issue of *The Journal of Corporate Renewal* , only 25 percent of the respondents said they noticed a tightening in DIP and confirmation financing terms. However, more than 80 percent responded that they had encountered stricter covenants.

Lenders point out that covenants have changed with DIP financing to keep pace with the different environment in which they now find themselves. While many potential borrowers 10 years ago never drew on these lines of credit, today's borrowers look to DIP financing as part of their Day One funding. Another difference, as one lender put it, is that today's "lender has little or no room to lend more aggressively against collateral, because debtors' assets are usually fully leveraged when they file."

Ten years ago, many large retail bankruptcies were characterized by over-leverage that featured substantial amounts of junk bond financing that these debtors had placed on their balance sheets to facilitate a buyout. Because of the automatic stay provision of the Bankruptcy Code, this class of unsecured creditors was not entitled to current interest payments on their debt, let alone scheduled principal payments.

By filing bankruptcy, a debtor effectively improved its cash flow by at least the amount of this debt service, plus any net pickup in trade payables, which were similarly subject to the automatic stay. Often, this improvement in "internally generated cash" was more than sufficient to provide adequate much-needed liquidity; therefore, little or no borrowing occurred against the DIP financing line, which became something of an insurance policy.

This was the underlying basis for decisions on whether to provide DIP financing at the time. The biggest issue a lender faced in the early 1990s was how to price the financing if a borrower never drew on that funding.

Marginal Performers

In the current lending environment, leverage remains an issue, but it is not the overwhelming albatross it once was. Now turnaround professionals encounter companies—in some cases, entire industries—that are failing as a result of global economic conditions, as is the case for the steel industry; overexpansion, as occurred in the telecommunications industry; or mismanagement, which has affected the health care sector.

Arguably, the low interest rates that characterize today's lending environment mask other over-leveraged businesses. As a result, many more companies would face the prospect of bankruptcy if interest rates were to jump even a fraction of a percentage point. Many

companies are barely covering their interest expenses, and any uptick in interest rates could cause these marginal performers to fall into default and potentially file for bankruptcy protection.

The test of management in such an environment is its ability to manage its operations, not just its balance sheets. Despite record-low interest rates, many companies are not generating sufficient cash flow to fund their interest expenses adequately, let alone their capital expenditure requirements, working capital needs, or in severe cases, even their payrolls.

Trade creditors, historically a source of post-filing cash, have become increasingly less willing to ship products based solely on the administrative priority granted to them by the Bankruptcy Code. They are now asking for—and in some cases requiring—cash on delivery or even cash before delivery.

Because of this decline in post-filing trade credit, DIP lenders have been asked to provide even more of the liquidity needed to run a troubled business. This was less of a problem 10 years ago, when many debtors' prepetition bank debt was unsecured. Today, many debtors enter bankruptcy with all of their assets already pledged to prepetition lenders, leaving a DIP lender no unencumbered assets to lend against and making it more difficult to prime the liquidity pump to jump-start the cash flow.

Management Missteps

So what now? Have the rules changed but the players stayed the same? Leverage, while still a burden, is not the cause celebre that it was 10 years ago, nor is it the sole cause of the current wave of bankruptcies. Certain industries are victims of general economic conditions and global events. Others, though, are failing because of bad management and poor operational performance.

Almost by definition, management should be synonymous with leadership. According to Adams, leadership is an intangible quality with no clear definition. The most important skill a leader must have is the ability to take credit for things that happen on their own, Adams said, at least partly in jest.

"A tribal chieftain would claim credit for the change of the seasons and the fact that wood floats," he explained. "They had the great advantage of the ignorance of the masses working for them. Television has largely filled this knowledge gap so the modern leader must take credit in more subtle ways."

In today's environment, Adams suggested that if a company's "accountants predict that profits are going up because of a change in international currency rates, then a good leader will create a company wide Quality Initiative, thus having a program in place to take credit for the profit increase."

It would be hard, and certainly unfair, to blame all of today's business problems on management or a lack of leadership. However, management missteps have caused many of the significant operational problems found today in small and large companies—the large ones simply make more headlines—and they cannot be ignored.

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