

## Underwriting Instead of Underwater

*In today's underwriting environment, caution and collateral coverage are more important than ever. And, although economists say we're in recovery mode, underwriting in the near term will be affected by the expensive lessons learned in 2001 and 2002.*

By Dan Dooley and David Weinstein

### Return of Real Workouts

Over the last 24 months, workout lenders and turnaround professionals have experienced the return of "real workouts" — loans that are woefully "underwater" in terms of exit value vs. loan value. This is a very different environment than the go-go 90's, where financially shaky companies were regularly refinanced by moving up the risk/pricing categories of asset-based lenders who were typically employing what many of us called the "Greater Fool" theory.

The Greater Fool theory states that you can always find some take-out lender who will accept an early-stage turnaround story, or find enough comfort in liquidation values, to refinance at higher yields and increase his portfolio outstandings.

As a result of this mentality, when the economy overheated with dotcoms and telecoms, the ill-advised stretch deals of the 90's quickly unraveled.

From a turnaround professional's point of view, this happened for three basic reasons:

- 1. Over-Reliance on High Multiple Cash Flow/Structured Finance Loans**  
Senior debt multiples of trailing EBITDA reached 4.5 to 5 times on many roll-ups and 6 to 7 times in telecom. Equity sponsors and mezzanine debt typically contributed another 2 to 3 times EBITDA. Therefore, many buyout valuations were too expensive — and returns were based upon multiple successive years of further planned EBITDA growth. However, many of the financed companies were really worth no more than senior debt at the time of acquisition or recap when markets were at a high point. Because of this, senior lenders have seen many losses of greater than 50% of debt in the last two years as market values have plummeted.
- 2. Dropping Fixed Assets Values**  
In every basic industry sector, current capacity utilization is down dramatically — from a high of 85-90% to 60-70% today. In high fixed-cost business, such as heavy manufacturing, this is perhaps the single statistic that indicates economic recovery from this recession will be long and slow.

Returning to fixed asset values, the bottom line is that competitors don't need, and can't afford, to presently buy capacity. Traditional international dumping places for used machinery and equipment — Eastern Europe, Latin and South America and the Pacific Rim — are in recession as well.

And then there's China: the biggest factor in the worldwide reallocation of manufacturing is that deafeningly loud sucking sound of free trade with the giant. And because the Chinese typically buy only the newest, most technically advanced machinery, equipment and facility

values seem like they never liquidate near their appraisal value, no matter how current it is.

### 3. Business Plans with "Lots of Sizzle, but Little Steak"

Equity sponsors and many others funded deals based on strong financial modeling and not strong management plans. Our firm continually sees deals, which were struck in the late 90's, that are severely lacking in detail planning and management's ability to execute is questionable at best. From our perspective, a reasonable amount of "operational due diligence" on new deals by lenders and sponsors instead of by accounting consultants could have avoided some real blowouts in value.

### What's Ahead — Workouts 2003 vs. 2002

The year 2002 saw many big-time loan blowouts where fundamentally weak companies or worldwide commodity industries hit the wall with no near-term hope of any earnings turnaround. Many of these were liquidated or sold at an alarmingly low percentage of senior debt.

It's no wonder that many industries moved from darlings to dogs over the last 2 years — consider dotcoms, telecoms, retail and airlines. As lenders and equity sponsors contemplate investments in these out-of-favor industries, a popular technique to minimize risk is to have "operational due diligence" performed by workout consulting firms — firms that are witnessing the effects of many "management mistakes."

But 2003 seems to be the year of financial restructuring. Our current client base includes many companies that are EBITDA-positive and are fundamentally sound, but financial leverage is so high that the "earn-out period" is unacceptable to all stakeholders. Industry-wide, this is most apparent in our six telecom clients.

The interesting dilemma for lenders, especially traditional commercial banks, is whether they'll prefer to be bought out at deep discount or be willing to take significant debt-to-equity conversion and likely do much better over a longer term.

Telecom recaps will be huge in 2003, and the energy sector, which has very similar structural dynamics to telecom, is perhaps two years behind telecom in the workout cycle. Our prediction: there will be many more broken energy deals in 2003 with recaps following soon thereafter.

### Some Expensive Education

When the recession started, many lenders and equity sponsors were young — they had never worked through a recession. Without much "defensive" experience and the "blow and go" mentality of easy funding in the late 90's, it's easy to see how problem loans weren't identified quickly —

and appropriate workout actions were taken slowly. In hindsight, many investments should have been liquidated sooner and lenders should have become more aggressive.

As deals have unraveled over the last two years, too many examples of debtor fraud, accounting irregularities and borrowing base misrepresentation have surfaced. Unfortunately, human nature dictates that owners and managers of failing businesses will be tempted to manipulate reporting, under the theory of buying time to correct the problems. However, once you start down this unethical path, it's a very slippery slope with no end.

The result for lenders and equity sponsors? There's been some expensive education for employees who've lost jobs. However, the real questions are, "Will lessons really be learned? Will the lessons have staying power?"

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### **Underwriting "Lessons That Can Be Learned"**

The final and most important question is, "What lessons should we learn and put into the management of credit risk?" Here are five:

1. Management execution is the single most important factor in business success. A management team, much like a sports team, is building momentum positively or negatively, or merely treading water. The management factor needs to be continually evaluated.
2. When business valuations and the stock market keep going up, lenders will be pressured to follow suit to stay competitive in the growth market. This is the time to employ extra safeguards on new deals. Don't stop underwriting new deals, just be more selective and credit-savvy.
3. The impact of competitors in growth markets is always underestimated. Many entrepreneurs are looking at the same market opportunities. Typical 10% to 20% of sales volume contingency plan analyses underestimate the risk. Run a contingency analysis at 50% off to assess a melt-down scenario.
4. Develop an exit strategy on the front-end and update it annually if not more often. Understand whether a company is saleable, fixed assets/capacity is in demand, wind-down is feasible and management can be replaced. It's best not to go into a tough workout without a current view of the best exit strategy.
5. Force tighter controls and "help" on debtors faster. Rarely do workout officers and turnaround consultants see troubled companies getting oversight and help quickly enough. Conversely, only a small number of troubled companies that end up in workout or with turnaround consultants don't need help. The undeniable fact is that proper oversight and outside help are often delayed for subjective and emotional reasons — when objectivity and the facts are critical to drive decision making.

### **Underwriting Going Forward**

Caution and collateral coverage are certainly more important today for new underwritings. Assuming the economy doesn't take another body shot soon, the pressure on lenders to ease credit and resume portfolio growth will be increasing. So the critical issue will be how to take some extra safeguards to minimize underwriting risk.

## **Real Life, Real Losses**

When our engagement started, it looked like many other "industry roll-ups" we had seen. The equity sponsor, with help from its banking group, had acquired four metal fabrication and stamping companies over a two-year period. They had purchased "profitable" businesses from entrepreneurial owners and families in the \$15-\$30 million sales range at 4-5 times trailing EBITDA. Some owners were paid more heavily in cash than stock and other owners more heavily in stock. Most of the owners were given contracts to stay on to run "their" businesses.

The general concept was that creating a national manufacturing organization would lead to more volume with Fortune 500 customers and that a \$200 million revenue roll-up could go public or sell out at perhaps 7-8 times EBITDA. As you might guess, this deal never scored the touchdown anticipated. Our analysis highlighted problems in the original business plan as well as the plan's execution.

### **Business Plan Mistakes**

#### *Paid Too Much and Due-Diligenced Too Little*

All four businesses were purchased in peak earning years, and two of the businesses had significant inventory obsolescence issues that weren't cleaned up at time of purchase. And two of the businesses were totally dependent on one customer. All businesses seemed to be in the same business, but they served three very different industries, and had dissimilar equipment (type and age), different levels of business controls and different varieties of computerized information — ranging from excellent to almost none. Needless to say, all these differences made it very difficult for a central sales force to sell national capabilities to the planned customer base.

#### *Weak and Poorly Incentivized Management Teams*

Three of the four ex-owners stayed on to continue running "their" businesses. Only one ex-owner worked out as a keeper. One retired on the job and the other ex-owner wanted to run the business as he always had — and resisted all attempts at help or control by the parent. To make matters worse, the senior management teams in three of the four businesses were obviously very weak.

#### *Ex-Owners Leased Manufacturing Plants to the Company*

I'm sure this seemed like a good idea to conserve acquisition capital. However, this tactic added another leg to the leverage of the ex-owner when the roll-up results went south.

### **Business Plan Execution Mistakes**

#### *Acquired Companies Not Immediately Managed*

The President of the roll-up was the ex-owner of the platform business and a reasonably competent manager. However, he didn't have the experience or skills necessary to immediately take control of the acquired companies. So he wasn't very active in directing them. Also, he split his time between running his old business and managing the roll-up (90% and 10% by our estimates). As a result, only two things changed with the addition of acquired companies: corporate headcount increased and expenses grew.

#### *No Plan and No Accountability*

Three of the acquired businesses never had prepared a business plan and one had never even done a budget. Needless to say, the business plans that were accumulated were just a bunch of unexplained numbers without any action plans. And because there was minimal attention to managing the roll-up, accountability for the numbers was totally lacking.

### Financial Control was Non-Existent

The CFO was relegated to a historic reporter of financials — the ex-owners didn't allow the CFO to change anything. Not surprisingly, the roll-up was on its third CFO in two years.

### The Results

We were brought in to assess the financial plan, which projected a major turnaround. The company had serious volume drops in the two businesses that were sole-customer dependent. A third business' ex-owner departed painfully and took his head with him — unfortunately, his head contained all the key facts on how to run the business and yes, the recession was just starting and telecom was the major industry served.

This roll-up was too late to save and the company's pieces were sold and/or liquidated. Equity was blown out and the senior lenders recovered significantly less than loan value; thereby providing an excellent example of how not to manage investment risk.

The irony of underwriting is that the process is essentially structured as an offensive “let's do the deal” process for both lenders and equity sponsors. So while the business risk aspect of a deal is thoroughly reviewed by internal personnel, the all-important outside due diligence is restricted to accounting — only as it pertains to collateral — and legal due diligence.

Whatever the risk management process employed, it's critical to assess management and its ability to execute a plan. Third-party operational due diligence can minimize mistakes if the lender or equity sponsor truly wants to avoid future loan losses.

The current recession was 10 years in the making. The economists say we're already in recovery mode, but it's unclear today whether that's true. At any rate, underwriting over the near-term will be affected by the expensive lessons of 2001 and 2002. [abfj](#)

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