How to Obtain Bridge Financing for Your Turnaround Client

Through a Distressed Loan Sale

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Borrower-initiated discounted loan sales are being used increasingly as a bridge-financing tool by companies in turnaround. In this form of financing, a distressed debt buyer acts as a third-party conduit to acquire the borrower’s loan from the bank’s workout department at less than par value. The debt buyer then steps into the shoes of the bank and, thereafter, enters into a restructure or forbearance agreement previously negotiated with the borrower. The borrower gets some measure of breathing room and flexibility, the bank exits the troubled loan and the debt buyer makes an investment consistent with its charter.

The sale of distressed bank loans was borne out of the need by the Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation (RTC) to liquidate a massive quantity of failed bank and thrift assets in the late 1980s and early 1990s. As the secondary market of distressed debt buyers developed, the private sector followed suit as healthy banks began divesting their portfolios of troubled commercial loans.

Today, many of the nation’s largest banking institutions regularly pool their sub-performing and non-performing loans and auction these assets to a fairly broad investor universe. The process is either managed in-house, through the bank’s loan sale group, or through distressed loan brokers. This is essentially the supply-side of the distressed bank loan market – transactions driven by a financial institution’s desire to dispose of distressed assets as a portfolio management tool.

Individual companies using debt buyers as a bridge drive the demand-side of the market. This form of specialty financing is growing in popularity. In fact, the sale of a single loan relationship by a bank to a debt buyer – a “one-off” transaction – is more likely to be initiated by a proactive borrower or its restructuring professionals than it is the bank or note holder.

How demand evolves

The scenario plays out over and over. A company’s performance deteriorates resulting in operating losses and increased leverage. The bank downgrades the credit and eventually transfers handling responsibility to its workout professionals – also known as the “special” or “managed” assets group. Invariably, the bank will demand better pricing for the increased risk as re-pricing opportunities arise.

Even with enhanced pricing the bank is not happy. That is because “criticized” or “classified” loans represent a major drag on bank earnings. Beyond “specific” reserves that may be required for individual credits, banks are also required to set aside general reserves equal to a certain percentage of the aggregate dollar amount of each risk rating category. The percentages increase dramatically at the lower end of the rating scale, such as with the regulatory classification of “substandard”.
Beyond the reserve impact of workout loans, banks carefully weigh other costs associated with holding adversely rated credits. These include staffing, legal and valuation expenses. Moreover, banks consider the potential negative impact that chasing bad loans can have upon a bank’s reputation in the local community.

Banks dealing with loans in workout typically assign one of two exposure strategies: (1) “maintain” or (2) “exit”. A “maintain” strategy signifies the bank hasn’t given up on the relationship – leaving the possibility of a turnaround and eventual return of the loan to the appropriate unit. Alternatively, the more urgent “exit” strategy signals that the credit presents an undue risk to the bank, and the borrower is asked to refinance. Not coincidentally, the point in time at which the bank gives the nudge may be the least opportune time for the borrower to refinance with another lender. Enter the distressed debt buyer to provide an effective form of bridge financing.

**How the sale works**

Directly, or through its financial advisors, a company seeking replacement financing approaches a distressed debt buyer about the opportunity. The debt buyer will first need to determine whether the company’s bank would be open to the concept of accepting a discounted payoff of its debt. If the answer is a steadfast “no”, there is little reason for the debt buyer to proceed. However, given enough weaknesses in the credit, the answer to this question will usually be “yes”.

The debt buyer will then sign a confidentiality agreement with the borrower and perform limited due diligence to mainly understand cash flow and collateral values. The primary objective is to reach an agreement on the terms of a debt restructure or forbearance – contingent upon the debt buyer acquiring the note from the bank. Once the debt buyer better understands the company and what type of restructure is feasible (or pre-agreed upon), a preliminary, non-binding offer (or “indicative bid”) is made to the bank. The bid amount is not disclosed to the company – and is maintained confidentially between the debt buyer and bank.

If the bank accepts the offer, the debt buyer will sign a confidentiality agreement with the bank and conduct its due diligence – primarily to establish a comfort level with the existing loan documentation. As noted above, an indicative bid is not truly binding on the debt buyer. Were the debt buyer to discover information in the bank’s files which materially differs from that reasonably relied upon by the debt buyer (e.g. the bank’s lien is a second, not a first), that could be sufficient reason to withdraw the bid. However, absent an egregious situation, most indicative bids are honored. Debt buyers are extremely protective of their reputations with banks.

In a discounted loan sale, the cornerstone document is the loan sale agreement. Typically, the only warranties given by the bank involve the bank being the rightful owner of the note and the outstanding balance of such note. The bank will also be required to disclose any pending or threatened litigation with the borrower. The promissory note is endorsed to the debt buyer like any other negotiable instrument. Mortgages and other collateral documents are assigned to the debt buyer.
Why the concept works for borrowers

It is useful to understand that the core competence of a debt buyer is dealing with poorly-performing companies and under-collateralized loans. This is the fundamental premise upon which a debt buyer will acquire a troubled loan. The fact that a borrower’s current cash flow is insufficient to cover reasonable debt service, or LTV is over 100%, are not critical. These factors simply affect bid price. The loan may even be in payment default.

Ideally, the debt buyer and borrower will execute a term sheet – subject to successful acquisition of the debt at a price acceptable to the debt buyer in its sole discretion. The economic terms of the deal the debt buyer reaches with the borrower naturally play a large role in what is offered to the bank for its debt. However, the debt buyer will also factor-in the possibility that the borrower could backtrack on the terms of a restructure, or otherwise default on the deal soon after the debt is acquired. Were this to happen, the debt buyer would be faced with a set of circumstances similar to that which the bank had faced. Herein lay the reasons why this concept works.

First is the debt buyer’s lower cost basis than the bank. The difference between the amount the borrower will pay the debt buyer on a restructured note (the “legal debt”) and the amount paid by the debt buyer for the loan (the “basis”) is referred to as “built in” yield. Second is the debt buyer’s much greater flexibility regarding arrangements that can be made with the company. This could also include some level of debt forgiveness. Almost anything that makes economic sense is possible, which is not always the case in a regulated banking environment.

Why the concept works for banks

The major advantages to the bank in selling a distressed relationship to a debt buyer are that it is fast, certain and final. To a workout officer, it’s not uncommon to hear a borrower say “if I could raise X amount through a refinancing, would the bank accept a discounted payoff?” The problem with this picture is that the borrower’s offer is so conditional such that it doesn’t justify a truly thoughtful response. Consider the analogy of someone that walks on a car lot and says to the salesperson “I’m not ready to buy a car today, but if I were, what’s your best price?” Few workout officers care to squander precious time and effort – and risk their credibility with senior management – to seek approval for a “maybe” scenario. This is particularly true when the request involves debt forgiveness. In contrast, the alternative scenario involves the bank being contacted by a reputable debt buyer that has performed enough due diligence with the company to tender the bank an indicative bid.

In a loan sale, a third party with whom the bank is dealing with directly is funding the bank’s exit. This affords the bank a measure of control– which is not the case in a scenario where the debtor attempts to refinance with an entirely new loan transaction. The discounted loan sale approach also eliminates the significant time and cost associated with documenting a new loan documentation. Rather, the debt buyer simply leverages the existing loan documentation, so long as it is not materially deficient. After the note is acquired, amendments to the existing documentation will likely be needed, but this is a world away from having to re-document the entire loan transaction.

For a company already cash strapped, avoiding the costs associated with a new loan transaction is important to preserving value. Since a debt buyer will likely only want to be an 18
to 36 month bridge, the company will eventually need to find a home with a permanent lender, but these costs are deferred at a critical time for the company.

Banks – and particularly those operating in smaller communities – don’t like to set precedent when it comes to discounting debt in bilateral transactions with their borrowers. However, banks typically will be more agreeable to selling the discounted note to a third party. The money is all the same color, but there’s a certain psychology that works against discounting the note directly with the borrower. To this point, a common provision in the loan sale agreement between a bank and debt buyer will prohibit both parties from disclosing the price at which the note was sold, thereby protecting the mutual interests of the bank and debt buyer.

**Discounted Loan Sales…a Win! Win! Win!**

The discounted loan sale concept creates value for all parties. It provides the borrower much-needed time and flexibility until a permanent financing source can be procured. The bank exits a troubled loan quickly and quietly. Moreover, since the borrower brought the debt buyer into the transaction, there’s no element of surprise when the loan is sold. The discounted loan sale provides the debt buyer with the opportunity for an attractive return on its investment.

For all the foregoing reasons, borrower-initiated discounted loan sales are growing in popularity. They can be an important and useful tool for turnaround professionals where a client needs bridge financing and it must be obtained quickly.

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**About the Author**

Stephen G. Bernardo is Chief Operating Officer of Hilco Financial, LLC. Based in Canton, MA, Hilco Financial purchases distressed bank debt from $1 to $10 million. Mr. Bernardo is a seasoned financial services professional with more than 19 years of experience in loan workout, asset-based lending and distressed loan acquisition and management.