



LJN'S Equipment Leasing *Newsletter*

Volume XXI, Number 2

February 2002

PRACTICE POINTERS

Getting Through Rough Economic Times With Lessons Learned From Lending

By Thomas F. Boland

The weakness in our economy over the past two years has resulted in increased defaults for lessors along with others involved in the credit risk business. As the write-offs are processed, senior management tends to question what went wrong and what is being done to prevent similar problems.

In my more than 30 years of corporate lending experience, I have approved thousands of loans, been through several economic cycles, managed many workouts (as well as a workout department) and made my fair share of mistakes along the way. Making mistakes in the credit business is not uncommon. However, the key to survival is learning from your mistakes.

Over the years, I have learned a couple of valuable lessons. Keeping these lessons in mind might help other lessors minimize their losses. Unfortunately, I won't be telling you anything you don't already know. The reason I'm now in the restructuring business is that although lenders may know these lessons, they tend to forget or ignore them, which helps create great opportunities for those involved in the mistake-fixing business.

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The first lesson from lending is that there is nothing wrong with taking a credit risk as long as you understand the risk and are compensated for it. This seems so obvious that it's hardly worth mentioning. However, this is the most common mistake that lenders make.

One only needs to look at Enron to see that there were significant risks in the company that the market didn't understand. This company was able to raise billions of dollars at attractive rates because its risk was perceived to be fairly low. The strength of the credit was confirmed by rating agencies that gave Enron a strong investment grade rating.

One proven method of understanding risk is to compare one company to another. Public ratings are invaluable in this process.

Until recently, investment grade credits behaved in a predictable manner. Public rating could be relied on to rate the risk. In the past few years, this has changed. Names such as Xerox, Lucent, Pacific Gas & Electric and Southern California Edison went rapidly from high investment grade to below investment grade ratings. Enron went from a Baa1 rating to bankruptcy in 34 days. Since 1999, over 120 companies have been downgraded from investment grade to non-investment grade. Relying on public ratings does not offer the comfort it once did.

Although many of these declines may not have been predicted easily, there were industry events that could have offered clues as to what was going to happen. The rapid deflation of energy prices, utility deregulation in California, asbestos litigation and the huge amount

of debt pouring into the telecom sector resulted in the eventual rating downgrades of many household names. Understanding risk means not only an analysis of a particular company, but also an understanding of the industry in which it operates. The leading indicator of a problem will be industry events in most cases. In many situations, the lagging indicator will be the rating agency action on a particular company.

Adequate Disclosure

An increased focus on an industry does not mean that less understanding of an individual credit is required. In fact, as the accountants work on the 2001 financial statements, the issue of adequate disclosure will be on the top of their list. It's possible that credit departments may have a lot more information to decipher, and analysts need to be prepared to understand what the footnotes are telling them. Unless this analysis is coupled with an in-depth industry analysis, only half the job is done.

Once you think you understand the risk, you need to be compensated on a risk-adjusted basis. There are many ways to do this, none of them perfect. Customers are insensitive to internal pricing models. They want the lowest price available in the market. However, if a customer isn't providing a fair return over time, one needs to question if this particular customer is worth keeping. What's important in pricing risk is to have a consistent approach and an understanding that as the risk increases, so should the return.

Now that we've gotten the hard lesson

out of the way, I'd like to share an easy one with you. One of the things I've learned over time is that there are no new mistakes. Lenders continue to make the same ones over and over but tend to call them something different.

For example, in the late 1980s lenders poured money into real estate construction loans for projects with no current cash flow based on valuations that predicted future occupancy and rents. Since there was lots of capital available, too many buildings got built and, coupled with an economic slowdown, lenders were faced with carrying assets with no cash flow. Over time, the assets were liquidated, and as the economy improved, the people who bought the properties out of bankruptcy at distressed prices tended to realize high returns on their investments. Having learned a valuable lesson, many lenders put numerous checks and balances on their real estate portfolio to ensure that lending against speculative construction projects was not repeated.

In the late 1990s, lenders poured money into the telecom sector to finance the build out (not to be confused with construction) of projects with no current cash flow based on valuations that predicted future capacity utilization. Many of these projects have run out of cash and are being liquidated at fire sale prices. At some point, as utilization of these networks grows, the new owners will make excellent returns, but for now it's a buyers market. In 2001, 30 publicly traded telecom companies filed for bankruptcy and more than 250,000 jobs were lost in that sector.

Although lenders were busy ignoring the balance sheet of borrowers because the future looked so rosy, many point to the U.S. Telecommunications Act of 1996 as the real culprit for the problems in this sector. It's clear that deregulation of the industry led to significant economic activity. It's also clear to most lenders that deregulation of an industry usually leads to problems.

For example, the airline industry hasn't been the same since deregulation, and Enron wouldn't be what it is today without deregulation of the utilities business. Luckily for most borrowers, deregulation is seen as a great new business opportunity for lenders. Lenders need to

review any changes they made to their credit process to accommodate these new opportunities—which were outside the box as far as leverage or cash flow coverage—and to think about how they will approach these types of situations in the future. When the next big trend hits, they'll get the chance to repeat these mistakes again.

Communication Is Key

My last lesson is to stress the importance of good two-way communication in a lending relationship. Many companies experience problems that can be addressed over time. Lenders view time as their enemy, since they know that a situation may continue to get worse and the carrying value of their loan will

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erode. When a lender is surprised, the time horizon to deal with a problem is truncated materially. There's nothing worse for a lender than to get a call from his boss regarding a newspaper article dealing with problems with one of the lender's clients. If the lender hasn't seen the article—or if he or she doesn't have any knowledge of the problem—things can start moving in the wrong direction rather quickly.

Valuable time can be lost and relationships can be strained as both the lender and the company attempt damage control. When problems develop, it's important that a borrower clearly articulate what the issues are and what management is doing to deal with the problem. Having a story that makes sense and a plan that seems attainable can buy valuable time and possibly added flexibility from lenders.

The communication process with lenders needs to be managed carefully. On one hand, you don't want them finding out about a problem from a third party; on the other hand, you don't want to precipitate a crisis and risk getting

cut off from new credit. Given the many problems lenders are dealing with today, they may tend to assume the worst and start showing up at customer meetings with associates whose business cards read "Special Assets" or "Corporate Restructuring." You're now in the work-out department and your solution time clock has been punched. This isn't the best time to get to know your lenders. Before you need their help, you need to have a good sense of who they are, what their strengths and weaknesses are, and how their internal decisionmaking process works.

This may be a good time to put in a plug for using the services of a restructuring firm. Knowing how to navigate through the problem remediation process can save valuable time.

Here's one more valuable tip: If you don't have a clear understanding of what you would like an adviser to do, then you may be wasting your money. An adviser can help identify problems, assist in constructing a business plan and work on the communications issues. He or she can only do this with access to the right members of management and with adequate information. Also, if you wait too long before seeking assistance, the opportunity to manage the timing issue may be lost.

Much of lending is common sense. When lenders tend to ignore conventional wisdom because of competitive pressures, problems will eventually show up. Bad loans are made in good times. As problems are being worked through in the present economic environment, valuable lessons are being learned. The challenge will be in a few years when the economy has recovered and there are new opportunities. Only then will you know what lessons you have truly learned.



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