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How Deteriorating Bank Balance Sheets Are Impacting Privately-Held Companies

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After returning from lunch you notice the voicemail light is blinking - your commercial lender has left you a message. His message is not to invite you to an upcoming sporting event, but instead to discuss the upcoming maturity dates of your company's revolving line of credit and term loans. Your company has had a long and solid relationship with your bank, but your loans are not scheduled for renewal for another five months. You surmise that your lender must want to keep the competition away, and his proactive call must be to discuss what else his institution can be doing. THINK AGAIN.

BACKGROUND. From 2003 through much of 2007, senior bank debt for privately-held businesses was readily accessible and relatively inexpensive. Armed with low interest rates and challenged by high growth demands from Wall Street, many banks quickly transformed from conservative lenders into aggressive business partners to their borrowers. In addition, new loan requests from non-traditional sectors long avoided by banks since the S&L crisis of the 1980's & 1990's began cycling into lending institutions. Opportunities involving high-leveraged lending, commercial, office, and multi-family real estate financing, and commercial land development, became a solid source for banks to grow their loan portfolios and expand their balance sheets. Statistics from the FDIC report total asset growth amongst commercial banks rising from a level of $7.6 trillion at the end of 2003 to a level of $11.2 trillion at the end of 2007 representing over a 10% compound annual growth rate.

By late 2006, underwriting standards across many banks had clearly changed. A number of banks began to extend substantial senior debt not based on traditional guidelines such as a company's historical performance or collateral, but instead extended credit based on multiples of historical cash flow, and in some case, multiples of projected future cash flow. After record levels of loan growth, the rally finally came to a halt when the subprime mortgage market began to collapse in 2007. Coupled with deteriorating commercial, real estate development, and construction lending markets, many banks found themselves quickly in trouble. These events were the impetus to a tremendous amount of change to the U.S. banking market, including the departure of some storied names such as Wachovia Bank (now part of Wells Fargo), Washington Mutual (now part of JPMorgan Chase), National City Bank (now part of PNC Financial Services), and the failure of many other smaller banking institutions.

YOUR BANK'S BALANCE SHEET. Fast forward to present day, many banks have now realized that the value of assets reported on their balance sheets are in many cases, significantly overstated. Traditionally, banks have been allowed to operate within regulatory guidelines that limit their leverage based on ratios of their capital and assets. In basic terms, a bank's leverage ratio is simply a measurement of a bank's capital base to its total adjusted assets. However, with banks being required by regulators to both increase loan loss reserves and write-down non-performing bank assets, the result has been a significant drop in asset values negatively impacting bank capital levels and leverage ratios.

These past events have changed how banks today do business with their customers. Regulators are requiring banks to reduce their exposure to non-performing borrowers and increase their capital base – requirements easier said than done. Due to their own deteriorating balance sheets, banks have had to deleverage which results in their borrowers having to also deleverage. What is a shock to most privately-held business, whether seeking a new loan or renewing an existing loan, is the current market perception of "leverage". Loan structure terminology used by banks in 2007 such as "overadvance", "amortizing air ball", and "no personal guarantees" have been replaced in 2009 by such terms as "required principal amortization", "additional collateral requirements", and "full personal guarantees".

WHAT TO DO. The consolidation among banks, coupled with tighter credit standards driven by increased bank regulation and deteriorating bank asset quality, has decreased the credit appetite for many senior lenders. Virtually no company that uses bank financing has been immune from these changes. If your business is dependent on bank financing, you should know by now, the senior debt market has significantly contracted. Companies need to plan well in advance of scheduled maturity dates to allow adequate time to explore options. Simply calling other competing banks to replace an existing bank debt structure will usually be an exercise in futility. Changes in the credit appetite of banks and far stricter underwriting standards are forcing leveraged companies to pursue a variety of financing and strategic alternatives, including:

1. Replacing all or a portion of traditional bank debt financing with non-bank sources of capital. It is not unusual in today's market for a company's senior debt to be refinanced at maturity and replaced with a mix of senior debt and sources of "junior capital". Junior capital includes financing such as subordinated debt or equity capital typically provided by institutional sources.

2. Shrinking the size of the business to decrease costs and improve cash flow. For companies under $100 million in sales, we recommend a full analysis of monthly expenses of $1,000 or greater. A careful examination of fixed expenses, variable costs, and working capital can immediately help address cash flow problems.

3. Selling specific company assets or a portion of the business to raise cash. Unproductive assets sold are an immediate source of cash. Further, for any owned real estate, companies should evaluate the benefits of a sale-leaseback transaction. An equity recapitalization is also an option for some companies worthy of consideration.

4. Exploring legal reorganization or bankruptcy protection. What should always be a last resort, consult with your legal counsel as to what legal remedies might be explored to give your company time to execute a turnaround, refinancing, restructuring, or other strategic alternative.

While banks deleverage and in turn force their customers to deleverage, stress and conflict become unavoidable between bank and borrower. Regular communication with your lender is a must and will hopefully foster constructive dialog and possible solutions. Don't wait for your commercial lender to leave you a voicemail - be proactive and give your bank a call about the future of your relationship. Gaining your lender's current perspective relative to your company and your industry will be important in planning for 2010 and beyond.