Zachary Scott
INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
WINTER 2003

The Journey Through Special Assets

If you encounter the bank's Special Assets Group (SAG), what should you expect and how should you respond?

by Michael T. Newsome

It's a depressing story—times are tough, demand remains soft. The business is making little progress against the strong head wind of an uncertain economy. A financial covenant or two in your credit agreement has been breached. The bankers are coming around with greater frequency and there is an unmistakable undertone of concern in their questions.Without an abrupt turn of fortune, one day soon you may field a call bringing news that the bank's workout group has assumed responsibility for the relationship. Banks apply a variety of labels to these folks—Special Asset Department (SAD), Managed Assets Division (MAD), Loan Adjustment Department (LAD), or as we refer to them, the Special Assets Group (SAG).

Over the past several years as the economic boom faded, the number of companies that have encountered SAG has grown. This trend may become more acute once economic recovery begins to take hold. As business begins to grow, companies often hit a brick wall of insufficient capital that can trigger problems with the bank. A transfer to SAG is typically not a huge surprise. Just the same, it tends to be traumatic, as it confirms a loss of confidence on the bank's part and breeds a heightened sense of uncertainty and anxiety in a critical relationship. A host of questions come up. With whom will we be dealing? How will the bank's attitude, objectives, and requirements change? Will they try to manage the business? Does this automatically mean bankruptcy or liquidation? How should management respond? What should the priorities be?

WHAT THEY SAY AND WHAT THEY MEAN

The standard speech that management is likely to hear from the workout people at the outset of the SAG ordeal (measured in months and, in some cases, years) may seem confusing because what is said and what is meant often are quite different, as shown in the following examples:

- *"We will take responsibility for the relationship."* This means all other relationships with the bank are immediately severed and all future communications must be directed to SAG. You are unlikely to get much help (other than a few words of encouragement) from your old friends at the bank, even if they are senior officers. It's fair to say that interference with the workings or dictates of SAG has never advanced a banker's career. While in SAG, consider Harry Truman's advice, "If you want a friend, get a dog."

> **Over the past several years as the economic boom faded, the number of companies that have encountered SAG has grown. This trend may become more acute once economic recovery begins to take hold.**

- *"We will be available to help you address issues and needs quickly."* Not true, particularly with a big bank and a relatively small credit exposure (< $10 million to $15 million). Special assets groups tend to be painfully slow and inflexible bureaucracies. The situation has worsened as banks have consolidated and as decision-making has been centralized. In reality, the typical SAG officer has almost no authority—decisions come from nameless, faceless executives in Minneapolis, Charlotte, or elsewhere. One would think that workout situations would demand direct, clear communication, but many banks erect barriers between the customer and the decision-makers that render direct communication difficult at best. And a double standard generally applies. If SAG wants something, it is unlikely to brook any delay. The flip side is that time is rarely a constraint when addressing a borrower's needs.

> **Special assets groups tend to be painfully slow and inflexible bureaucracies. The situation has worsened as banks have consolidated and as decision-making has been centralized. In reality, the typical SAG officer has almost no authority.**

- *"Our mission is to rehabilitate rather than liquidate."* True, in part, as liquidations are usually disasters for banks. But rehabilitation is not the goal either. Implicit in moving the credit to SAG is a determination that the bank is, at the least, ambivalent about retaining the relationship and would be happy to see the company take its business elsewhere. The priority is either to whittle down the credit exposure quickly or to exit the relationship. Large banks in particular have limited patience for protracted turnaround efforts and are willing to roll over small companies, without remorse.

WORKING WITH SAG

At best, you can expect a cordial relationship with SAG. But a pleasant demeanor or expressions of empathy should not be confused with support for management or the company. SAG's agenda is to reduce problem loan commitments as rapidly as possible and minimize loan losses. Several Northwest banks even set the compensation in their workout units to specifically reinforce these objectives. SAG will pursue its own interests with little regard to the implications for business operations, other creditors, management, or shareholders.

With this in mind, management must understand the following points to deal effectively with SAG:

- Credibility is a critical asset that is built by deeds, not words. In SAG, broken promises are routine, which accounts for the skepticism that characterizes experienced workout bankers. Tell the truth, but manage expectations carefully—under-promise, over-deliver.

(continued p.2)

Avoid surprises.

- Cash is king. You cannot operate without it. The majority of bankruptcies are the result of cash shortfalls, not earnings disruptions. Conserve or build liquidity by collecting slow accounts, cutting expenses, liquidating nonessential inventory and equipment, and eliminating unprofitable business units or product lines. Often this means booking losses as assets are written-down to market value. These losses are less important than the cash generated. Carefully track cash receipts and disbursements. Do not depend on the bank to make additional credit available during a cash shortfall.
- Develop and articulate a conservative business plan. The company's performance will be measured in relation to the plan. Make sure the bankers understand the factors that may positively or, more importantly, negatively impact results. Demonstrate to SAG that the business is doing all it can to improve its economic circumstances. Provide accurate and timely reporting.
- Proactively pursue alternative financing. It is important to understand the company's alternatives and the changes that are necessary to make a refinance feasible. SAG will expect to have refinancing options well-defined before agreeing to a long-term workout.
- Beware of partial or one-sided deals with the bank. Workout bankers are trained to turn up the pressure with demands for personal guarantees or added collateral as a precondition to discussing the account's future handling—"trust us, we'll take care of you." Collateral and guarantees should be granted only in concert with a restructuring of the loan terms that permits a reasonable chance of success. The suitable quid pro quo may be some combination of adequate credit line availability, default waivers, revised covenants, extended amortization, or lower interest rates. Resist SAG's inclination to keep the credit relationship on a short fuse (i.e., a series of rolling 30-day extensions). Hammer out a longer-term arrangement (six months to a year) that provides some certainty that the credit facilities will be available subject to reasonable performance hurdles.
- Expect to pay more for everything. The SAG experience is expensive. Banks have become keen on ratcheting-up interest rates and nicking the company with fees at every opportunity. This is done for two reasons: First, the risk has increased and the bank legitimately should be compensated, and second, higher costs provide the company an incentive to refinance elsewhere. SAG also tends to be liberal in the use of legal counsel and advisors at the company's expense. It is up to management to exert some control over the bank's spending.
- Get help. Dealing with SAG is time consuming, just when the business demands maximum management focus. The guidance of an experienced attorney is essential to navigating through a workout. And a competent financial advisor will lighten management's load and instill greater confidence at the bank.

The path out of SAG is predicated on making a plan and achieving it. But all agreements, no matter how ingenious, at some point will require performance that provides sufficient cash flow to fund debt service and reinvestment to sustain the business over time. The bank is an unavoidable distraction; nevertheless, management must remain focused on customers and operations. If the company's performance can turn the corner, doors will open to financing alternatives that will allow you and SAG to part company. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com