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Your Loan has Been Assigned to Special Assets...What Now?

By Mark R. Hahn, Managing Director of Brownstein Corporation October 20, 2011

You've been taken by surprise. Your banker, whom you have known and worked with for years, calls to inform you that your loan has been assigned to the Special Assets department. Your immediate questions are, "What is Special Assets?" and, more importantly, "What does this mean for my company?"

The Special Assets or "workout" department is where the bank manages credit risks that have been classified at or above a certain defined risk level that is deemed too high for the bank to handle in an ordinary fashion. The borrower may have missed payments or breached loan covenants, and/or appears likely to do so in the near future.

In short, your loan has been classified as distressed, and your lender has decided to bring in its specialists that know how to best exit a loan. Yes, that's right—your bank has decided to end its relationship with you, whether or not it immediately gives you a deadline for doing so.

The bank's workout specialists already understand all their options, including their rights in a bankruptcy proceeding under federal law, assignment for the benefit of creditors (ABC) under state law, and the rights and remedies they may have under the loan agreement. They know how to push the right buttons at the right time to maximize their recovery.

You can expect the tenor of your relationship with the bank to change completely. There will likely no longer be any interest in maintaining the customer relationship of the past; instead, the bank will have its eye on the exit door, and it's just a question of how long it will take to get there.

In some cases, your former relationship manager may remain involved, but he or she will no longer be driving the relationship. Be aware that loans go to die in the Special Assets department, and rarely will a client in workout be returned to the performing loan portfolio manager, with your banker friend back in the driver's seat.

Even if this were possible, it would likely behoove you to change banks anyway, since you'll forever be wearing a scarlet letter "W" (for Workout) in the mind of that bank's officers. So, make the mental cut:

your bank has decided that it no longer wants your company as a customer, and expect that once you are in Special Assets, you will have to replace your lender.

What to Expect Next

First, if you even suspect that you might be a candidate for assignment to Special Assets, get out in front of the issue with your banker. Ask about your bank's process when a borrower begins to experience distress. Does it transfer the loan to a Special Assets department? If you are borrowing from your bank's asset-based loan department, that group typically handles its own workouts, since its lenders presumably know the collateral well.

What are the triggers for your institution in transferring credits to workout? Are there any other borrowers in the printing industry also in distress at your bank? Does your lender simply want to exit the printing industry?

Take the bank's temperature—how aggressive is it with customers assigned to Special Assets?

• *Your lender will likely increase reporting requirements.*

If your loan is secured by the company's receivables and inventory, expect that your lender will notch up the reporting requirements that relate to the collateral. Monthly reports will be changed to weekly. As excess availability under the lending line gets tighter, your lender may request daily reports.

The bank will likely also increase the frequency of field exams, physical inventory counts, appraisals, and testing of receivables to estimate the probable percent of recovery in the worst-case scenario, should the company cease operations and have to liquidate. Even if the company has not been asked to provide these reports in good times, expect that the Special Assets credit officers will ask for them, all of which will be at the company's expense. Prepare your accounting staff for additional reporting to the lender.

• *Prepare yourself and top managers to hear terms that may be upsetting, such as GOB (Going-Out-of-Business) analysis, OLV (Orderly Liquidation Value) appraisal, bankruptcy and foreclosure.*

The lender may not have any intention of pulling the plug on your business (yet), but Special Assets will want an accurate picture of its position, including the worst-case scenario. Most professionals know that these terms can be misinterpreted, and they will be very circumspect in public or around your employees. But behind closed doors, you should expect and be ready for forthright and blunt language.

• *Cooperate with the bank's appraisers, examiners and financial advisors.*

Delay will only end up costing more in the long run, and further jeopardize the ability of the company to survive. Help the professionals to understand the true value of your equipment, inventory and cash position. If you don't cooperate, the appraiser, for example, will assume the worst and the result can be a lower valuation, which in turn will only make the lender more nervous about its position.

Accurate information will help the appraiser properly value your physical assets, and provide the best valuation. Since you will be paying for the appraisal, request from your lender that you be entitled to see all the reports and assumptions behind the numbers. You don't want to be blindsided by a reduction in your availability caused by a low appraisal, which was based on wrong assumptions. Respond positively to these professionals and their requests for information and access to your managers, since cooperation will increase the lender's trust in your ability to navigate the situation, and possibly lessen the pressure on the business.

• *Your borrowing costs are going to increase.*

The bank will likely impose fees for granting waivers or forbearance from immediate foreclosure. Expenses for the bank's attorney to prepare documents will be charged to the company. There may an automatic imposition of a default interest rate. The costs for appraisers, examiners and other professionals will also be charged to the company.

These unexpected costs are encountered exactly when the company can least afford the added expense, but from the lender's perspective, it is being compensated for its increased risk and costs of managing a loan to a company experiencing financial distress. In the event that the company is able to secure replacement funding from an alternative source, you should expect that lenders who are more risk-tolerant charge higher rates.

• *Focus on cash.*

Conserve cash. Put aside your GAAP thinking cap, and think CASH. For the time being, forget about accruals, depreciation and other non-cash factors. Establish a starting point and track cash from this point forward.

Special Assets will want to see a 13-week cash flow projection, in which you recognize cash receipts and disbursements during the week they will occur, giving you a clear picture of the sufficiency of your cash position for the entire upcoming quarter. You will also need to update this report weekly, and provide an explanation for any material variances of actual vs. budget.

Demonstrate to the bank that its position will not deteriorate further. Depending on the level of urgency, Special Assets will be much more focused on the cash flow model than your financial statements during the crisis period. Your lender will want to know that you can meet payroll and other critical cash needs without additional borrowing and that it will remain adequately protected by the collateral. Your 13-week model should include a section indicating the bank's collateral position at the end of each week and how this affects the company's availability of cash.

Use the cash flow projections as a tool for planning the changes you need to make to return the business to cash-flow positive. It's best not to perceive the 13-week projection as just another troublesome requirement from the bank. The reason the bank wants this report is the same reason you should take it very seriously—cash is the life blood of the business as it goes through the crisis period. Pay very close attention to this tool.

• *Develop a plan.*

Determine if the core business is viable, and if it is, what the company's position will be in three months, in six months, and in a year. If the business is salvageable, either on a standalone basis or through a sale or other restructuring, figure out what it will take to first stabilize the business, and then how to get to the goal. The bank will want to see a plan of action that is expressed in written narrative form and supported by financial statements and projections that show that the company has a clear path forward and will be able to meet its obligations.

• *Hire competent advisors.*

Bankruptcy is the backdrop against which you are playing, so hire experienced bankruptcy counsel. Do not rely on the attorney who served you and the company well for years, preparing family wills, handling the purchase of real estate and other transactional matters. If it becomes necessary to file for bankruptcy protection, or if the bank or other creditors force the company into involuntary bankruptcy, you will want to be prepared, understand your options, and know your responsibilities.

A bankruptcy specialist will often also be experienced with out-of-court restructuring and other options that are often less costly and more effective. The presence of bankruptcy counsel can be very helpful in your negotiations with the bank to obtain a waiver, forbearance or recast of the loan agreement.

Most lenders prefer that the company is prepared and properly represented, and they will respect your decision to engage knowledgeable advisors. In any case, don't "go to a gunfight with a knife"—get professional advice from an attorney who knows the field on which you will be playing.

If your issue is primarily manufacturing inefficiency, consider engaging a firm that is expert in the processes your firm uses. If you are losing customers or reprinting jobs due to quality issues, consider hiring a consultant who can guide your company to achieve the International Digital Enterprise Alliance G7 Master certification, or other programs such as Lean manufacturing, Six Sigma and ISO certification. All these programs will force your company to establish better standards and procedures, and then measure the company's results against these standards.

• *Engage a qualified turnaround professional.*

Special Assets may suggest or require that the company engage a turnaround professional, also known as a restructuring expert and/or financial advisor (FA). If the company does not react quickly to the bank's suggestion and engage an advisor, the bank may engage a turnaround firm that reports to the Special Assets officers, not to you. In most cases, it's best that the company engage the turnaround professional so he/she can advise you directly about the issues and processes you are likely to confront.

In any event, the lender will probably insist on unfettered access to the FA. This may work to your advantage, since the FA and Special Assets speak the same language, and consequently your FA will more quickly and accurately understand what the bank is looking for, and be able to translate this into actionable steps for your company.

You can find a turnaround professional through your bankruptcy counsel, the local chapter of the Turnaround Management Association (TMA) or ask the Special Assets department to recommend three or four qualified professionals it knows and trusts. The bank will probably give your company a bit more breathing room once it knows that qualified professionals are in place, especially if it is familiar with and trusts those professionals.

Next Steps

There is a whole discipline around the process of turning a company around, which is outside the scope of this article. Examples of changes needed to restore a business to profitability include staff cutbacks, reduction in physical plant, renegotiating your loans and trade debt, salary and benefit reductions, restructuring both inside and outside of bankruptcy, and a sale of the business to a stronger entity. Each one of these steps has a cost and a benefit that should be carefully considered and quantified before inclusion in the company's plan presented to the bank.

Remember that the bank has placed your company into Special Assets because it was concerned that the company will be unable to meet its obligations, especially its debt to the bank. The bank's primary goal at this point is to recover as much as possible from the company, recognize its losses if any, and move on.

It's likely that the bank has reached the point of "lender fatigue," and no matter how well your turnaround plan succeeds, the bank will not be eager to maintain your company as a customer. Do not wait for your bank to pull the plug on your loan and leave the company without sufficient working capital to operate.

Concurrent with everything else that the company needs to do when in crisis mode, management should begin a search for replacement financing immediately. The company may be able to move up the "risk ladder" to a lender that specializes in turnarounds or is more understanding of the ups and down of the printing industry. ***PI***

Mark R. Hahn is a managing director of Brownstein Corporation, a nationally recognized firm providing turnaround and advisory services to companies and their stakeholders, as well as investment banking services—including sale and refinancing of businesses, investigations and fiduciary, litigation and valuation services.

Hahn has more than 25 years of printing industry experience, having served as an executive, entrepreneur, company founder and owner, buyer and seller of printing firms, chief financial officer and independent advisor assisting owners of printing companies to maximize the value of their business. He can be reached at mark@brownsteincorp.com and 973-588-7399.