Cash Flow Lending – What A Difference A Year Makes! (Banking Lessons For 2001 And Beyond)

Ceil Pillsbury, (Email: ceil@uwm.edu), University of Wisconsin-Milwaukee
Roger Pillsbury, (Email: roger.pillsbury@abnamro.com), LaSalle National Bank, Milwaukee, WI

Abstract

This paper examines the cash flow lending practices that became prevalent in the marketplace during the late 1990s and early 2000. That time frame witnessed bankers significantly deviating from historical lending models which resulted in a marked increase in risk. The detrimental effects of those practices and the repercussions experienced by banks are examined in detail. The paper concludes with suggested modifications to cash flow lending practices and lessons for cash flow lenders.

Introduction

It doesn't take a very long memory (even for a banker) to remember 12 months ago when banks were lending up to four and one-quarter times multiple of Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). That is, if a company had \$10,000,000 in Adjusted EBITDA, banks would blindly finance \$42,500,000 in connection with a recapitalization, equity buyout, or merger/acquisition. For the sake of this paper, we will define the "cash flow" of a company as Adjusted EBITDAⁱ and cash flow lending as banks' attempts to predict and understand the cash flow of an enterprise. This paper examines the effects and repercussions of cash flow lending practices and provides guidance about, and lessons for, more realistic future lending practices.

To regress briefly, the traditional bank lending model would examine the balance sheet of a company, "margin" the company's assets, and then lend off those assets. A common example of such traditional lending follows in Table 1.

Under this traditional model, bankers would have made available \$13,868,000 to ABC Company in connection with a recapitalization, equity buyout, or merger/acquisition. A common misperception in the marketplace is that banks make significant profits on such loans. In fact, commercial lending has traditionally had relatively narrow margins and a large volume of good loans must be booked to cover even one bad loan.ⁱⁱ Traditionally, more risk, and commensurately more reward, has been the role of mezzanine and equity players.

Readers with comments or questions are encouraged to contact the authors via email.

Table 1
ABC Company

<u>Account</u>	<u>(000's omitted)</u>	<u>Collateral Value @ Margin</u>
Cash	\$ 300	
Accounts Receivable	7,027	x 80% = \$ 5,622
Inventory	8,991	x 50% = 4,496
Prepaid Expenses	606	
Other Current Assets	<u>261</u>	
Total Current Assets	\$17,185	
Property, Plant & Equipment:		
Equipment (OLV*)	\$ 2,344	x 80% = 1,875
Plant & Property (FMV**)	2,344	x 80% = 1,875
Other Assets—Goodwill	<u>2,318</u>	
Total Long Term Assets	\$ 7,006	
Total Assets	<u>\$24,191</u>	<u>\$13,868</u>

*Orderly Liquidation Value

**Fair Market Value

But the mid-to-late 1990's and early into 2000 saw a change in the nature of commercial lending. The Federal Reserve Board reported stiff competition for commercial loans in the mid 1990's with banks easing terms and accepting narrow yield spreads to gain market share [FRB 1997]. This left commercial lending divisions thirsty for profits and by 1998 a loosening of credit standards was reported to the Fed by Senior Loan Officers [FRB May 1998]. About this time an attitudinal change occurred among bankers and the time tested marginal assets approach to banking became too "mechanical" and was actually considered "old fashioned". The new, and quite frankly sexy, part of banking was cash flow lending. With the economy rolling along in a "Goldie Locks"ⁱⁱⁱ fashion, banks literally took their eyes off the valuation of assets and spent more time lending on what was thought to be an "understandable" and "predictable" cash flow.

Banks invested heavily in cash flow lending divisions by taking many of their youngest, brightest, best-educated, and most open-minded bankers (if there is such a thing) and asking them to lead cash flow lending divisions. Because these divisions were given "a license" to lend beyond the balance sheet it became "the" place to work within the bank. Promising bankers were anxious to get into cash flow lending. Cash flow bankers were interacting daily with investment bankers and venture capitalists who were truly the "money changers" of the 1990's. These individuals either had the money or they knew where to get it. Cash flow lenders quickly became entranced with the "go-go" lifestyles of investment bankers and venture capitalists and their world where deals were plentiful and large sums of money were flowing. Many bankers were secretly dreaming that their new networks would allow them to someday easily transition from the traditional world of commercial banking to the land of exciting lifestyles and mega bonuses. Both banks and bankers became more and more enthralled with the asset generation, pricing, fees and the billions of dollars that venture capitalists were able to raise [Fox 2001; Sullivan and Tally 2001].

With growing assets and increasing profits, banks were blinded to the reality of what cash flow lending really meant. Many bankers thought the venture capitalist money would be the first money lost if cash flow (EBITDA) became less predictable in the future. They believed that the venture capital monies were at risk, not bank funds if the economy were ever to soften. Other bankers thought that protection was afforded by associating with reputable equity players who would take actions (e.g. provide additional equity or halt dividend/interest payments) to protect shaky investments. Neither banks nor bankers

anticipated what would happen when the Goldie Locks economy inevitably cooled.

Example of Cash Flow Lending of the 1990's

Let us examine the typical scenario of a cash flow deal in the late 1990's and early in the year 2000. In those rosier days, sellers of companies were commanding multiples in excess of 8 times Adjusted EBITDA and banks were lending at multiples of up to 4.25 Adjusted EBITDA [Sikora 2001]. For the ABC Company introduced above, we will assume the following:

- Sales^{iv} \$55,700,000 with growth rate of 12.0% annually for the past 3 years.
- Adjusted EBITDA^v \$4,729,000 with growth rate of 16.5% annually for the past 3 years

Please note – EBITDA is growing faster than sales – Bankers like that!

1. Assume a value of the company of 8.5 times Adjusted EBITDA.
Thus, $8.5 \times \$4,729,000 = \$40,197,000$
\$40,197,000 is the purchase price of ABC Company.
2. In late 1998, 1999, and early 2000 banks would blindly lend 4 times Adjusted EBITDA.
 $\$4,729,000 \times 4 = \$18,916,000$.
3. Subordinated debt lenders would lend an additional amount up to 5.25 times EBITDA
(in this case another 1.25 of EBITDA)
 $\$4,729,000 \times 1.25 = \$5,911,000$
4. Therefore,

Purchase Price:	\$40,197,000	
Senior Lend:	(18,916,000)	
Subordinated Debt Lenders:	(5,911,000)	
	\$15,370,000	Purchase price that would have to be made up through seller notes and/or equity.

In addition to lending on high multiples of EBITDA, bankers were also accepting adjustments or "add-backs" to future EBITDA including A) "excessive" owner(s) compensation that was to be eliminated with the recap, buyout or merger/acquisition; B) cost savings that were expected to be realized with new management; C) synergies associated with mergers and acquisitions that would be gained by the combination of two enterprises D) "non-recurring" expenses that would not happen again under new management--such as receivables charge-offs, additional reserves for inventory obsolescence, additional "one-time" health and dental benefits where rates would decrease in future years, work stoppages that incurred in the past etc., etc., etc.

The difference of the \$18,916,000 that banks were willing to lend in the late 1990's and the \$13,868,000 that banks would have lent on the company under the traditional collateralized lending approach is the increase risk that banks exposed themselves to when they began lending on the "cash flow" of a company. Thus, banks would be putting approximately \$5,000,000 more at risk for a company that they wouldn't even think about doing that for a few years earlier. Sure, banks were growing in assets and generating more fee income by lending on the cash flows of companies, but banks were certainly not being compensated nearly enough through increased interest or fees for the commensurate amount of risk they were assuming. Nor were banks taking the additional steps necessary to monitor these riskier credits

in a prudent and profitable manner. This would become apparent to banks, but not until after the economic softening in Spring of 2000.

In fact, the problems with cash flow lending were apparent to the Office of the Comptroller of the Currency (OCC) and Federal Reserve Board long before banks acknowledged the problems [FRB 1998 and 1999; OCC 1999]. Despite warnings from regulators, banks were slow to tighten underwriting standards.

Banks began to recognize in the second quarter of 2000 what became clearly apparent in the third and fourth quarter: highly leveraged companies have diminished abilities to respond to negatively changing economic conditions and, consequently, are therefore a much greater credit risk than companies in a stronger financial position. By late 2000 the issues with highly leveraged cash flow lending became critically apparent to banks as these companies were no longer able to execute on projected efficiencies post recapitalization/buyout/acquisition. The more the economy softened, the greater the difficulty companies had in meeting projected EBITDA, much less Adjusted EBITDA numbers. Banks began to realize loan losses as the overly optimistic assumption about cash flows failed to materialize. It was painfully discovered that the once thought to be "understandable" and "predictable" cash flows were not so understandable and predictable after all. The predictability became less predictable as the "expected" add-backs were not realized and the "Goldie Locks" economy became "not so hot, but actually cold." By mid 2000 Senior Loan Officers reported to the Fed that they were becoming significantly more cautious in their lending practices but by then, of course, the damage had already occurred [FRB 2000].

As the problems materialized, aggregate commercial bank industry earnings fell during the year 2000 for the first time in ten years [Greenspan and Hawke, 2001].

Write-offs and loan loss provisions started increasing in response to the deteriorating asset quality. Below is a sampling of quarterly loan loss provisions (000's omitted):

	<u>03/31/00</u>	<u>06/30/00</u>	<u>09/30/00</u>	<u>12/31/00</u>	<u>03/31/01</u>
Bank of America	420,000	470,000	435,000	1,210,000	835,000
Finova Group Inc.	98,000	39,800	111,237	393,693	61,750
Bank One Corp.	362,000	1,013,000	516,000	1,507,000	585,000
Marshall & Ilsley	5,819	9,616	5,938	8,979	11,063

Sources: Edgar Online

Finova Group Inc.^{vi} filed bankruptcy in May 2001.

As noted by John D. Hawke Jr, Comptroller of the Currency, the ratio of loan loss reserves to loans had eroded to approximately 1.5 % by 2001 and he expected future bank earning to be impacted by the need to further bolster loan loss allowances [Greenspan and Hawke 2001].

Lending Later in the Year 2000

By the late summer of 2000, senior bank lenders were no longer lending 4.25 on Adjusted EBITDA, but 3.50 times on Unadjusted EBITDA with higher pricing and more fees. By the end of the year 2000, banks that were still in the cash flow lending business were down to multiples of 2.75/3 times senior debt to EBITDA [Morse and Palmer 2001]. Pricing on these loans became "prime based" or Libor^{vii} plus 350 basis points (bpts) for the secured portion of the transaction and 400 bpts for the unsecured loan. Fees were a minimum of 1.50 - 2.0% of the total commitments. As the senior bank debt multiples decreased

Initial Draw is \$10,000,000 for the acquisition. No principal payments on the line are required, only interest at 8%.

- Principal required on the plant, property and equipment loan is paid over 10 years (straight line).

Cash Flow of ABC Company		\$ 4,729,000
• Interest on Line of Credit	\$10,000,000 @ 8% =	(800,000)
• Principal on P, P & E	\$ 7,500,000 ÷ 10 year	(750,000)
• Interest on Term Financing	\$ 7,125,000 @ 8.5%	(605,625)
On Average Outstanding For First Year		
• Maintenance Capital Expenditures		(400,000)
• Taxes at 40% Rate	\$ 3,323,375 @ 40% =	<u>(\$1,329,350)</u>
		(\$3,884,975)
Net Cash Flow of ABC Company		\$ 844,024 ^{ix}

A bank may be willing to lend beyond the \$13,867,000 in margined assets an additional \$844,000 because that is the "free cash flow" of the company. Therefore, assuming the same sales price multiple of 8.5 times, in the year 2001. A bank would lend \$13,867,000, plus one or two years of free cash flow. That is an additional \$844,000 or for two years \$1,688,000.

\$13,867,000
844,000 One year "free cash flow"
\$14,711,000 Banks willing to lend in Year 2001

\$13,867,000
1,688,000 Two years of "free cash flow"
\$15,555,000 Banks willing to lend in Year 2001

In summary:

• Banks traditionally lent on margined assets	\$13,867,000
• Banks were lending in late 1990's (4 times cash flow)	\$18,916,000
• Banks lending in the Year 2001 and beyond	\$14,711,000 - \$15,555,000

Lessons To Be Learned for 2001 and Beyond

1. Know your collateral. The historically prudent and profitable method of commercial lending involves understanding a company's assets. This method has been tried and true through all economic cycles and there is a reason WHY it has been the traditional model. While margining assets may not be very thrilling, it provides a reasonable return for the amount of risk assumed.
2. Be happy with what you are. Commercial bankers aren't investment bankers or venture capitalist and they shouldn't try to be. Commercial banking serves a critical function in the capital market by providing companies with access to funds at a reasonable cost and bankers need to value this role, not seek to fill the roles of others.
3. Don't make equity investments at loan spreads. Banks simply do not make enough spread over interest to accept the equity risks. Banks are in a low margin business and an industry simply cannot

afford to accept higher risks in low margin businesses.

4. Don't believe in "add-backs." Lend only on historical cash flow, not what might happen. Adopt a "show me the money" attitude on every loan and make a realistic assessment of each borrower's prospects.
5. Cash flow is inherently unpredictable. Thinking that bankers or anyone can understand the real cash flow of a business is a VERY difficult proposition.
6. The "Goldie Locks" economy was a fairy tale. We don't believe in fairy tales in real life, so we certainly should not when REAL dollars are involved! When good economic times are here they should be enjoyed, but not at the expense of sound underwriting practices. 📖

Endnotes

1. Adjusted EBITDA is EBITDA adjusted for "add-backs" which are discussed later in the paper.
2. Assume an interest margin of 3.5% on a \$5,000,000 loan resulting in net interest margin of \$175,000. To cover the charge-off associated with one bad loan of \$5,000,000 you must have approximately 29 good loans (\$5,000,000/\$175,000). Thus, profitable commercial lending divisions must typically produce large loan volumes and minimize loan charge-offs. Kovacevich[2001] notes that banks must make good loans 99.5% of the time to earn a reasonable profit.
3. "Goldie Locks economy" was a common nickname of the economy in the United States in the (late???) 1990's. The economy was "not too hot and not too cold", thus the reference to Goldie Locks and her adventure with the three bears.
4. Banks usually required sales greater than \$20,000,000 for cash flow candidates. Companies with less than \$20,000,000 in sales were not considered because of the belief that a sufficiently developed infrastructure would not exist for the company to have significant value absent the entrepreneur.
5. Again, a minimum EBITDA of \$2,000,000 was required because this inferred sustainability, and value of the enterprise.
6. On May 2, 2001, Finova Group Inc. and eight of its subsidiaries filed a Joint Plan of Reorganization with the United States Bankruptcy Court for the District of Delaware. © 2001 PR Newswire
7. Libor – London Interbank Offering Rate.
8. Undersecured means that the bank will still take a general business security interest in all of ABC Company assets, but be "out of margin" for a period of time.
9. This assumes no working capital changes.

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Notes