Principles to Consider When Choosing an Exit-Financing Lender

As the national economy shows signs of a recovery, an increasing number of bankrupt businesses are shifting their focus away from court-ordered protection and towards a restoration of profitable operations. Exit financing plays a key part in such recoveries, and as experts from Wharton and GE Commercial Finance, Corporate Financial Services observe, understanding a few key principles can help companies navigate a process that can be complex and dynamic.

During the first half of 2003, only 76 publicly held companies filed for Chapter 11 bankruptcy protection, according to a PriceWaterhouseCoopers study. The number represents the fewest bankruptcy filings during any six-month period since the first two quarters of 2000, and is a significant decline from the 114 recorded in the first half of 2002.

The results are even more encouraging when "large" bankruptcies—defined as those with assets of $3 billion or more at filing—are considered separately. Only three such filings were made during the first half of 2003, compared to eight "large" bankruptcies in the prior-year period. But despite the encouraging trend, GE Senior Vice President Penny Friedman notes that as more companies focus on exiting Chapter 11 they may encounter new challenges.

"During the past few years, many companies became familiar with Chapter 11 as ripple effects from the economic downturn and from negative trends in the travel, telecommunications and high-tech sectors spread to suppliers and other companies," says Friedman. "They soon realized that there are three primary ways of exiting bankruptcy: one involves a conversion to a liquidating Chapter 11 or Chapter 7; the second is to engage in a 363 sale (named after the applicable section of the bankruptcy code), which involves the sale of a debtor's selected assets or business units free and clear of virtually all liens, claims and interests; and the third is to reorganize and emerge as a viable concern."

The third alternative, emerging from Chapter 11 with a fresh start, can be a very positive step.

"But CFOs and other top executives should be aware that a number of challenges may arise during the exit process," says Friedman. "One significant concern involves securing exit financing during this critical time—and that means identifying a lender that understands the many issues involved in emerging from bankruptcy."

The Chapter 11 Process is Simplified, But It's Far From Simple

The Bankruptcy Reform Act of 1978 restructured the bankruptcy court system and overhauled the nation's bankruptcy laws in an attempt to conform to modern commercial transactions, observes Wharton Assistant Professor of Finance Hülya K. K. Eraslan.

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"The revised bankruptcy process, along with lower interest rates, has helped to slash the time it can take to emerge from bankruptcy," she says. "From about 1979 through the 1990s, it took an average of two to two-and-a-half years; now that time's down to about a year-and-a-half."

Eraslan adds, though, that a successful recovery involves regaining the market's confidence.

"It means acknowledging that there was a problem, and letting suppliers and others know that the problem has been solved," she says. "This may involve securing exit financing."

Focus Early and Use An Exit-Financing Lender That Delivers On Its Promises

"Structuring an exit financing package can be complicated, so it can be helpful to begin addressing the process as early as possible; perhaps even before the bankruptcy procedure formally begins," says GE's Friedman. "Remember that the debtor is not the only one making decisions—the bankruptcy court and all of the creditors must confirm the exit financing as part of the plan of reorganization (the "Plan"). With many voices and agendas represented at the table, each Plan is unique, and often complex."

She notes that the exit financing issue is given greater urgency because of the "exclusivity period" (for example, the length of time—typically determined by the presiding bankruptcy judge—during which the company may present its own Plan for consideration by creditors). If the creditors and debtors do not agree on the debtor's Plan during this time, the creditors may propose their own Plan.

Although a judge may grant an extension of the exclusivity period, Friedman says such a delay may send the wrong message to creditors, vendors and customers, resulting in a loss of confidence that can erode support for the Plan. And as Wharton's Eraslan reports, lining up the right source of exit financing can be a vital part of emerging from Chapter 11.

"In one case, a plan of reorganization was confirmed by the creditors and the court, but then the financing institution pulled the plug on the funds," Eraslan says. "The company required another six months to sort things out and finally emerge from bankruptcy."

Know Your Needs Before You Start to Negotiate

Expanding on Eraslan's comments, Friedman says that early on, a company seeking exit financing should determine the level of funding it will need.

"Often, businesses want enough funds to address liquidity concerns without overloading on debt," she says. "But creditors, who want to be paid, may want the debtor to maximize its debt load. The key is to forge an agreement that satisfies all the parties while using a lender with the experience, resources and flexibility to follow through."

Identify A Lender Who Can Meet The Timing Requirements Of The Process

Speed is critical given the requirements of working within the exclusivity period, and Friedman notes that there are a number of factors to consider in evaluating a lender's capability of meeting timing and other considerations.

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"One important criteria is the ability to offer a team of professionals dedicated to meeting tight timelines," she says. "GE's National Restructuring Group has a dedicated underwriting team working exclusively on bankruptcy related financings—including exit financing. This team is experienced with the bankruptcy process and is used to working around the clock to meet the timing requirements of its customers."

She adds that, depending on the size of the transaction, a company considering exit financing should also try to get a fully underwritten deal.

"At the very least, you want a lender that can carry a large hold, which can take out some syndication risk," Friedman explains. "You also want a lender that's experienced in exit financing, since a lot of surprises can come up at the last minute—including creditors who launch a last-minute appeal against the plan of reorganization."

The restructuring community is a tight one, she adds. "Finding a lender with a team of people well known by the debtors' advisors may offer some relief from the tough negotiations that are a part of any deal," she says. "As we've already noted, a lender with a reputation for flexibility, who also has a track record of delivering results can make the difference between emerging quickly or remaining in Chapter 11."

Of course, the process of selecting an exit-financing lender involves more than just weeding out unsuitable candidates. Among other efforts, it may mean gathering information about your particular circumstances and presenting it in a package for review by potential lenders. Such an information package typically includes the following:

1) At least three full years of historical financial statements
2) Year-to-date financial statements for the most recent year and the same period in the prior year
3) Business plan/projections (including projected cash requirements and detail on all assumptions in the model) covering the anticipated term of the exit financing
4) Draft plan of reorganization
5) Detailed information on collateral for asset-based loans

Take A Realistic Look At Your Circumstances

Friedman also advises emerging companies to realistically assess their current status and their business plan—and to then consider their position from a lender's point of view. Such an analysis could help to determine the type of financing that might be available.

"One area to examine is the level of restructuring activity that remains in your business plan," she explains. "For example, in May, when GE's National Restructuring Group became the administrative agent for $2 billion in exit financing provided to Kmart Corp., the retailer was still focusing on improving operations and financial performance. Consequently, we structured the exit financing as an asset-based loan (ABL) that linked borrowing availability to an inventory borrowing base. This structure created increased availability for Kmart over a cash flow loan structured as a multiple of historical EBITDA."

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In another exit-financing situation involving Thermadyne Corporation, the primary focus of the reorganization was the conversion of pre-petition debt to equity. In this case GE provided $50 million in exit financing where borrowing availability was structured as a multiple of EBITDA.

"The hold size was very important here," notes Friedman. "For a number of reasons, this would not have been a good candidate for a syndication, so GE held the entire loan. We were able to do this in part because of our extensive financial resources, and because our deal team understood the needs and risks associated with the company."

She adds that, "The key in all the cases is to look at the viability of the organization and then to design a financing structure that meets the debtor's needs based on a lender's understanding of the unique issues of each case."

Developing Trends in The Exit-Financing Arena

As businesses in general begin to recover, some trends appear to be developing in the exit-financing segment.

"Although banks, which provided pre-petition financing, continue to exhibit some hesitancy about providing exit financing, we're seeing other kinds of lending institutions — including GE — offering cash-flow-based exit financing that taps into the rating-driven market with large term B loans and a small revolver," she says. "Recent examples include Hayes Lemmerz International Inc., the leading global supplier of automotive components; and Laidlaw International Inc., which provides specialized transportation services."

In conjunction with its emergence from chapter 11, Hayes Lemmerz closed an $800 million exit-financing facility that includes: a $100 million senior secured revolving credit facility maturing in five years; a $450 million senior secured term loan facility maturing in six years; and $250 million of senior unsecured notes that mature in seven years. Separately, Laidlaw's exit-financing package was valued at $1.225 billion and includes a $625 million Term B loan.

Overall, says Friedman, the market for exit financing is expanding.

"It's a cyclical market that is now reemerging," she observes. "The opportunities for companies are definitely out there. But making the most of them means having a thorough understanding of your position and finding an experienced, flexible lender that's willing to go the extra distance for you."

In summary, exit financing can be a complex process. But the following principles may assist emerging companies that are looking for a lender:

Focus Early and Use an Exit-Financing Lender That Delivers on Its Promises.
As part of a plan of reorganization, exit financing can be very complicated. Addressing the issue at an early stage can help to relieve time and other pressures. But be sure your exit-financing lender has the track record and resources to follow through on its commitments.

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Know Your Needs Before Talking to a Lender.
While the debtor often wants enough funds to address liquidity concerns without being overloaded with debt, your creditors may want you to maximize debt load so they can be paid in full. The right lender will work with you to forge an agreement that reasonably satisfies the needs of all the parties.

Identify a Lender Who Can Meet the Timing Requirements of the Process.
It's critical for your lender to have an experienced and extensive team dedicated to keeping the debtor on a path to emergence from bankruptcy. Both you and a potential lender can save time if detailed information is available early in the process.

Take a Realistic Look at Your Circumstances.
Assessing your company's current status, revenue and expense projections, and business plans—and then considering them from a lender's point of view—could help to determine the type of financing that might be available.

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