FEATURE STORY

Talk of Wave of Borrower Defaults Overblown

BY MYRA THOMAS

Will the long-predicted wave of defaults come to fruition? Key players in the industry provide their perspectives.

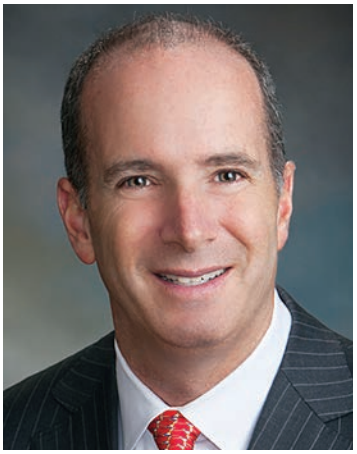
While the secured lending industry is often loath to discuss a wave of borrower defaults ahead, macroeconomic conditions would seem to point in that direction. Certainly, some industries, more than others, are feeling the heat. With inflation putting a dent in consumer wallets, retailers and distributors are most likely to see profits dwindle. And with inflation continuing to outpace wage gains, retailers are worried about sales for this upcoming holiday shopping season. It's a critical time for retailers—a time when stores traditionally make about 20% or even more of their sales. 2022 will be a true test, as retailers try to better predict and get in-demand items into the stores on-time yet move a backlog of less-desirable inventory built up over the pandemic.

According to Jennifer Cann, head of retail ABL portfolio for Bank of America, retailers are certainly most subject to the current economic turmoil. Besides the many macroeconomic factors coming to bear, increased shipping rates are also adding to retailers' woes, she notes. All told, the environment is likely to have a major impact on store margins and cash. She adds, "When these companies are experiencing double-digit negative decreases in sales, it's tough to make the financial metrics work. There isn't a bunch of fat that can be trimmed from the expense side of the business." It's a situation that Cann and other industry experts note will not be stabilizing for retailers anytime soon.

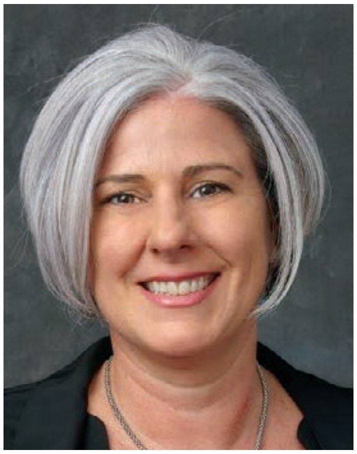
Ongoing supply chain disruptions are also adding to retailers' woes. Barry Bobrow, a respected industry veteran and host of SFNet's "In the Know" podcast, notes that retailers are also "at the whim of the current changes in consumer shopping habits." For instance, during the pandemic, consumers hunkered down and purchased more items for the home. Post-pandemic, home goods sales are expected to shrink. Bobrow notes that while retailers always need to make decisions about in-demand items for the holiday season, given the economic conditions, supply chain delays, and ever-changing consumer preferences, this year will be more difficult than most. Retailers will need to make smart choices to deal with the excess inventory positions built up over the pandemic, whether it's packing up some items for next year or offering steep discounts on others.

A Deeper Understanding of the Environment

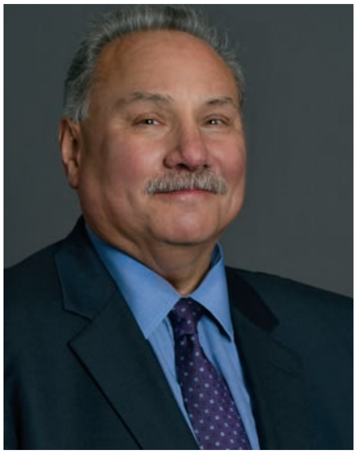
For now, secured lenders are aware of the challenges for borrowers in the retail space. But retail and distribution aren't the only industries feeling the heat. Continuing worker shortages and the lingering impact of this summer's drastic rise in fuel costs have also left other businesses, across a variety of sectors, dealing with the blow. It's a time, says Bobrow, asset-based lenders and factors should be especially mindful of any and all holes in credit documentation that can be exploited. It's also a time for lenders to remember to dot all the "I's" and cross all the "T's" when it comes to field exams and monitoring too. Fortunately,



BARRY BOBROW
SFNet's "In the Know"

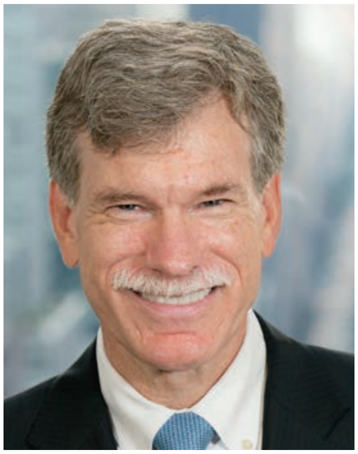


JENNIFER CANN
Bank of America



STUART KESSLER
PKF Clear Thinking

YVONNE KIZNER
Cambridge Savings Bank



DAVID MORSE
Otterbourg P.C.

Bobrow notes that the macroeconomic dynamics impacting borrowers have made banks become much more conservative when it comes to structuring deals. Secured lenders are looking at borrowers closely and handling them on a case-by-case basis, as always.

Borrowers aren't being given the benefit of the doubt, as they might have during the pandemic. Cann notes, "During the pandemic, all lenders had no choice but to be flexible, as many businesses were forced to shut their doors overnight and shipments came to a near standstill." Lenders were there, at the ready, to provide support and capital to get through the unprecedented times. But that's simply not the case anymore, she says. Now, two years past the start of the pandemic, secured lenders are less patient, looking for their borrowers to have turned the proverbial corner and made consistent profits.

And while lender flexibility and forbearance will always be an option, David Morse, member of Otterbourg P.C. and co-chair of the firm's finance practice group, agrees that secured lenders are now much less lenient than they were during the pandemic. "A lender may choose to stretch those elements for a well-performing company or in the context of sponsor pressure, but where you see the focus in these transition times is, necessarily, on the collateral." Most asset-based lenders and factors are much less accommodating when they realize a borrower's financial problems are more structural than a momentary downturn. He predicts that secured lenders are likely to be more focused on a restructuring sooner than later and with less cushion in triggers, allowing the secured lender to take further actions more quickly to better protect their recovery. And, he says, advance rates and pricing are holding firm.

Lessons Learned

The focus, as always, says Yvonne Kizner, senior vice president of asset-based lending at Cambridge Saving Bank, is on borrower liquidity. With much of the government-supplied stimulus funds exhausted at this point, asset-based lenders and factors are honing in on portfolios, keeping an eye out for troubled assets. Cambridge Savings Bank moves quarterly-watch meetings to monthly when needed, and their ABL group closely monitors trends such as weekly sales, weekly cash receipts, and shifts in AR and AP aging buckets, looking to identify potential troubled assets as early as possible. Kizner also says that smart asset-based lenders and factors understand the value of a diversified portfolio of borrowers to head off the significant risk of a downturn in one sector or another.

More than anything, asset-based lenders and factors are well-aware of how to respond to economic uncertainty, none as great as the financial crisis of 2008 and 2009. "A properly structured deal should have the necessary guardrails in place," Kizner says. For instance, secured lenders are stepping up their due diligence and scrubbing data when it comes to retailers. "It takes a close monitoring of the value of our collateral to ensure an understanding of how things like labor challenges, shipping rates, and a slowdown in sales could impact appraisals and trying to get ahead of any deterioration," she adds.

Ultimately, for secured lenders, it remains essential that the lenders stick to time-tested monitoring practices, including trend analysis and consistent communication with borrowers to ensure the best results during a downturn, says Kizner. In the end, a very well-structured ABL deal and experienced and very attentive lenders and portfolio managers should protect the secured lender from risk of loss in any environment.

The Silver Lining

Stuart Kessler, CEO at PFK Clear Thinking, acknowledges that while the economy is in a rough patch, the U.S. isn't yet in a full-blown recession. While borrowing is edging up, most companies are weathering the storm and others are actually seeing growth, he says. GDP, while predicted to shrink some, and unemployment, expected to slightly worsen, are still relatively favorable.

An additional stumbling block might be additional rate hikes by the Fed. Despite that, the market is still seeing a substantial amount of liquidity for many industries. "There's investment—capital being spent on warehousing and upgrading distribution capabilities and capital being spent on R&D," notes Kessler. And, while retail is predicted to be the hardest hit by current economic trends, consumers are spending more on experiences post pandemic, he adds. The hospitality sector, as well as the airline and cruise industries, are seeing strong gains. However, one significant issue tempering their growth, notes Kessler, is the worker shortage.

Fortunately, for borrowers, there is an ever-growing number of secured lenders and private equity firms looking to lend and invest, and not all have the same risk tolerance. "Some secured lenders are certainly willing to take on a higher level of risk than others," Kessler notes. "But if a business should require a default waiver or some other type of accommodation related to their loan agreement, you'll see fees commensurate with it."

A Look Ahead

A very public bellwether for borrower troubles—bank write-offs—seem to show that distress has not yet had a significant impact on bank balance sheets. "We aren't seeing huge write-offs at this point," says Bobrow. "And banks simply aren't experiencing the level of stress typically associated with recession." The Stress Test results showed that while some banks need to build their capital buffers a bit, overall bank balance sheets are very strong and resilient. Problems appear to be limited to the companies that were overleveraged to begin with or those that have immediate problems with the maturity schedule on bonds and loans due in the short term.

The toughest place will be at the low end of the market, as is often the case, says Morse. The current liquidity in the market will most certainly soften the blow of economic upheaval and provide options for most businesses. "Meanwhile, many of the larger companies seem to have adapted, albeit not without difficulty, to issues around the supply chain, worker shortages and inflation, and have improved capital structures and leverage since the worst of the pandemic-generated downturn during the first half of 2020," he adds. All in all, it's putting borrowers, and subsequently secured lenders, in a much better position to deal with the potential challenges ahead.

Myra Thomas is an award-winning editor and journalist with 20 years' experience covering the banking and finance sector.