eCredit news

Credit Professionals Alliance, Inc.

January 2025
Volume 272

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The eCredit News is produced in partnership with the NACS Credit Services, Inc.

LMEs: The New Trend for Financial Restructuring Outside of Court

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Abstract

A major trend in credit markets has emerged in the past few years: liability management exercises ("LMEs"). It's the latest action to avoid the expensive Chapter 11 bankruptcy process by extending debt maturities to allow more time for companies to execute an operational turnaround or conversely to kick the can further down the road to an eventual default.

While there have always been efforts to restructure liabilities outside of the court to stave off distress ahead of bankruptcies, the recent surge in LMEs is the result of opportunistic lending funds rapidly increasing over the last decade. The abundance of covenant-lite debt in sub-investment grade credit issued in the years leading up to 2022 has also made it easier to flex debt maturities.

What are the Components of an LME?
LMEs are used by the borrower to raise new debt that is either senior to the existing debt or backed by collateral that had previously been pledged to the existing debt.

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January Dates to Remember:

1st: New Year's Day

20th: Martin Luther King Jr. Day & Inauguration Day

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Typically, there are three types of LMEs, each with its own characteristics:

1. **Drop-down financing:** This debt management operation has been used most notably by PetSmart, Neiman Marcus and J Crew. In this scenario, the company transfers assets — often collateral — to a subsidiary outside of the credit group. Then new lenders or a subset of existing lenders provide structurally senior financing, or in some cases, exchange existing loans for structurally senior debt to capture the discount to the subsidiary secured by the transferred assets. These transactions often, but not always, utilize unrestricted subsidiaries, which are outside the covenants or restrictions of a loan agreement and are not necessary for the repayment of the loan.

2. **Uptier priming:** In this method, a company reaches an agreement with a group of majority lenders within one tranche of debt to subordinate liens or obligations to new debt. It then uses "open market purchases" provisions to incur new priming debt from consenting lenders to pay off the debt or rolls up the existing debt of consenting lenders. Most recently, this approach has been used by global business communications company Mitel as well as Serta.

3. **Double-dip:** Home decor retailer At Home and aftermarket auto parts company Wheel Pros utilized this restructuring strategy. Companies and lenders prefer double DIPs to asset drop downs as assets don't need to be transferred to different entities.

    a. First, a non-guarantor restricted subsidiary or an unrestricted subsidiary is created.

    b. Second, debt is issued at this new subsidiary.

    c. Third, the new debt at this subsidiary is guaranteed on a secured basis by entities where value resides (e.g., the same entities that guarantee the company's pre-existing secured debt) thereby creating one "dip" against collateral.

    d. The funds raised at the subsidiary are up streamed, usually via a secured intercompany loan, to the existing credit group (where the company's pre-existing secured debt has been issued) with the subsidiary then receiving an intercompany loan receivable that's then pledged to subsidiary's creditors as security for their debt – thus creating another "dip". Or simply put, the lender receives a "double dip" against collateral.

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What is the Overall Impact of LMEs on the Industry?

Even though LMEs are postponing bankruptcies, LMEs rarely solve the troubled borrower's fundamental problem: too much debt[1]. Thus far in 2024, nearly 35% of defaults and LMEs involved companies that had previously defaulted or executed an LME. For example, the average default rate historically is about 3 percent in high yield and leveraged loans. Today the default rate is only about 1.5 percent. Although the default rate appears lower compared to historic averages, the default rate could actually be as high as 4.25 percent if you include LMEs and distressed exchanges. For that reason, the real temperature of the distress market can be obfuscated.

A 4.25 percent default rate is above normal levels, which is what you might expect in today's high-interest-rate environment. Therefore, companies today utilize distressed exchanges much more frequently than in the past.

With outstanding high-yield bonds, leverage loans and private credit all rising precipitously, and BBB-rated debt quadrupling to more than $13 trillion between the end of the financial crisis and now, the situation indicates a correction of some form in the future.

If an economic downturn occurs, private credit will not be immune and could make the cycle more severe because debt that should have defaulted many years ago will finally default (i.e. zombie companies unable to service debt with existing profitability).

Unsecured Creditors are Most at Risk

LMEs can put lenders and unsecured creditors at risk. Existing lenders might be harmed as their collateral could be less secure than initially thought. Additionally, if the existing lenders have less collateral after the LME transaction those existing lenders will have a greater unsecured deficiency claim in a bankruptcy, which will dilute recoveries to trade vendors and other unsecured creditors. Unsecured creditors lose twice in a scenario where a company executes a double-dip transaction and later files for bankruptcy as the subsidiary debt issued will likely have two independent allowed claims. The first claim is a direct claim from the secured guarantee of the subsidiary debt and the second claim is the indirect claim intercompany claim against the debtors resulting from the intercompany loan.

Beyond the new negative pecking order unsecured creditors now face, LME transactions that eventually end up in bankruptcy court are heavily litigated, which results in an increase in professional fees and less money available to pay post petition trade vendors[2]. In these cases, trade vendors have limited say in an LME settlement.

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[1] Oaktree Insights September 2024

[2] Envision Healthcare, Robertshaw and Westco Aircraft are three recent examples of highly litigated bankruptcies

In order to prevent expensive LME litigation in court, lenders are increasingly using pro-rata deals to allow all lenders to partake. Time will tell, but this strategy might result in less LME litigation in the future. Additionally, secured lenders are increasingly being more cautious with their credit documents in limiting language that could result in LMEs. One example is language termed, "J Crew Blockers". A J Crew Blocker is a provision or provisions in a credit document that prevents a company from transferring intellectual property or other valuable assets to unrestricted subsidiaries.

How to Mitigate Risks in an LME Transaction

Most methods of mitigating risks are similar or identical to those traditionally used with high-risk customers and suppliers:

1. Obtain financial statements from companies you do business with – especially when relying on for key supply or when issuing unsecured credit.
    a. Do this as a condition of issuing credit and as part of an ongoing risk monitoring process using a standard financial scoring template.
2. Once risk is determined, base your decision to extend credit on your company's risk tolerance.
    a. Balance the risk with reward (i.e. rate, margin) and communicate clearly within your company to determine/include those that should be involved in the decision.
    b. Mitigate risk through traditional means including contract language and contractual funding offset, shortened A/R terms, cash deposit, letters of credit, limiting advance funding payments to suppliers, etc.
    c. The goal should be to not leave money on the table.
3. Make sure to accurately reflect the risk of issuing unsecured credit in your company's financial statements (i.e. make sure reserved for properly based anticipated collectability).

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There are additional steps that can also be taken specific to LME transactions:

1. Unsecured creditors have options if a company files for bankruptcy after completing an LME; be preemptive before signing on to do work with a company or if they notice a customer or supplier indicating they are in distress.

2. As part of the credit review, vendors should search for terms such as LME, LMT, double-dip, uptier transactions, drop-down and out-of-court restructurings for their distressed customers and suppliers.

3. Unsecured creditors must also understand the customer and supplier, understanding that LMEs have been used by private equity funds behind the companies they own.

4. Additionally, understanding the nature of the LME can help provide insight. Did the company reduce leverage or extend the time before they eventually end up in court? Will the LME be contentious, leading to lender-on-lender violence or forcing the company into bankruptcy?

5. To maximize recoveries, unsecured creditors should be on the lookout for fraudulent conveyance. For any new loan or unencumbered collateral granted in an LME, unsecured creditors should investigate if transfers or transactions were for less than reasonably equivalent values.

6. In the event of bankruptcy, unsecured creditors can also do the hard work of determining where and in what legal entity any claims value resides. In this waterfall model, LMEs that involve complicated intercompany loans will necessitate that the unsecured creditors' committee undertake a legal entity recovery analysis for all the debtors' legal entities to determine where recoveries exist.

    a. Oftentimes, if a lender takes collateral at a previously unencumbered subsidiary the lender might be oversecured and trade creditors at that given subsidiary might be in the money.

7. Finally, unsecured creditors can leverage an LME if there is litigation or strife between two competing types of secured lender groups. Unsecured creditors can team with the lender group that offers unsecured creditors more value as a condition to support a particular lender group's plan of reorganization or sale process.

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Concluding Thoughts on LME Impacts to Unsecured Creditors

The recent trend towards LMEs is yet another dangerous trend in the marketplace that severely impacts recoveries to unsecured creditors and must be closely monitored by anyone issuing unsecured credit. Given the recent proliferation of LMEs coupled with private issuances of debt, it is more important now than ever to stay abreast of recent trends with those you issue credit to through regular reviews of qualitative and quantitative data (i.e. audited financial statements). Additionally, for many companies completing an LME, this represents just another way of ‘kicking the can down the road’ and bankruptcy is still likely to occur at some future point – though for the reasons above will more significantly negatively impact unsecured recoveries.

One of the most powerful things you can do to influence recoveries given recent trends around LMEs is to serve on an official committee of unsecured creditors when your LME customer files for bankruptcy. Serving on an official committee of unsecured creditors will get you a paid-for-seat at the table to help drive recoveries through the formal Court sponsored process by holding the debtor accountable for what is owed.

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As originally published in the Credit Research Foundation 4Q 2024 Credit & Financial Management Review

Remember to Take Advantage of Our Client Referral Program!

Earn Rewards for Bringing Industry Peers Together!

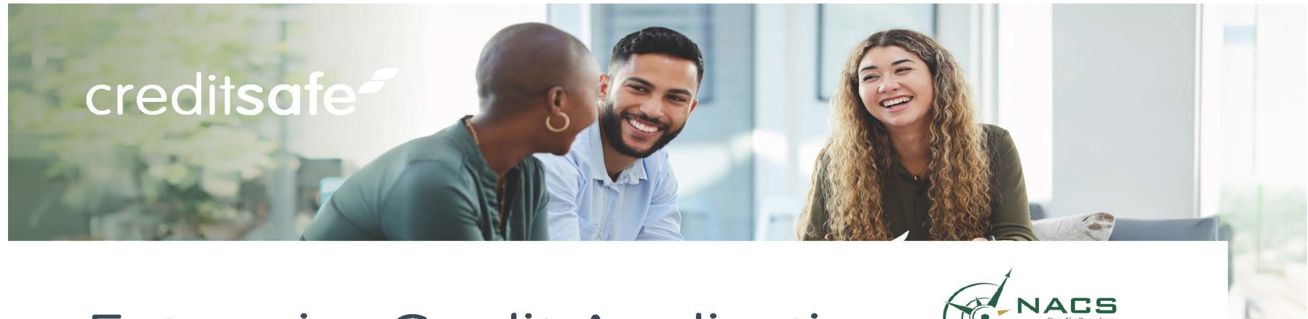
Here's how it works:

1. Refer a Company: Simply introduce us to other companies within your industry who could benefit from participating in our group meetings. These meetings provide an invaluable opportunity for industry professionals to share insights, collaborate, and stay ahead of the curve.

2. Earn Rewards: For every successful referral that leads to participation in our group meetings, you'll earn exclusive rewards as a token of our appreciation. For each referral that joins the group, you will receive a $100 gift card.

3. Enter Our $500 Gift Card Drawing: Each referral you make also earns you one ticket into a drawing for a $500 gift card, to be held at our December board meeting.

*Must meet group membership criteria. Please contact NACS for more details



Enterprise Credit Application

Automate your credit process and protect your business from risky customers in an instant

Processing large amounts of credit applications can suck valuable time out of your team's workday. Our research has found that 75% of finance managers take up to 8 hours to reach a credit decision on a single customer. When your business needs to quickly make decisions about hundreds, or even thousands, of credit applications, automation can help your sales team close deals and boost your cash flow much faster than traditional, manual applications.

How the Enterprise Credit Application Tool Will Help You

Use our integrated Check and Decide technology to vet prospects. Get answers about how much credit you can safely extend to a customer in seconds.

Your team's job just got easier: our credit application tool's intuitive, easy-to-use interface removes the headaches that come with manually reviewing applications.

Help sales and finance teams work in harmony with an easy, instant approval process. Sales can close deals faster and finance can rest assured the decisions are backed up by our accurate, up-to-date data.

Your credit application is completely customizable. Make changes to your policy as your business needs evolve and automate your credit decisions.

57% of businesses reported that their DSO increased in the last 12 months. Protecting your business from unreliable, late-paying customers will help you reduce your DSO and maintain your cash flow.

Our intuitive dashboard gives you a 360-degree view of your credit applications. Never let an application fall through the cracks again and easily manage all outstanding, pending and approved credit applications.

When to Use the Enterprise Credit Application Tool

Before signing new customer and supplier contracts: Vet your customers and suppliers before the contract stage to avoid late payers and protect your cash flow. Get a clear yes or no answer based on your existing credit policy instantly.

When determining credit limits for customers: Not sure whether a customer's credit limit should be increased? Your credit policy teams up with our Check and Decide technology, checking customers' financial profiles in the blink of an eye. Your team will have a recommended credit limit in just a few clicks.

For more information on how to get started please contact Rhonda Ross
rross@nacskc.com

Credit Professionals Alliance has been working hard to provide our clients with the most up-to-date webinars concerning today's challenges in the credit field. Watch your email for upcoming registration information on all of the following webinars.

January 8th & 15th: **Financial Analysis Boot Camp**

February 19th: **Construction Law & Bond Rights in Wisconsin**

Be sure to check out our website www.nacskc.com/education.html for additional educational opportunities as these are constantly being updated.

Are you looking for Certification and Certificate opportunities? Credit Professionals Alliance can lead you in the right direction, contact Rhonda Ross for additional information at rross@nacskc.com or (913) 383-9300.

Educational Update:
Credit Research Foundation Webinars

January 2025

CRF offers a variety of educational programs: Proctored Courses, On-Demand Courses as well as webinars.

March 17-19, 2025	March Forum—San Diego, CA
August 18-20, 2025	August Forum & Expo—Austin, TX
October 27-29, 2025	October Forum—Ft. Lauderdale, FL

It is very simple to participate: Go to http://www.crfonline.org and click on the Education.

Now offering a Certificate Program!

For additional information go to http://www.crfonline.org/events/current.asp

The following webinars are being offered by NCS Credit to register for these go to: https://www.ncscredit.com/education-center/events/

January 14th: The Basics of the UCC Filing Process

January 28th: The Basics of the Lien and Bond Claim Process

NCS

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