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A New Lending Environment?

"History never repeats itself, but it does often rhyme."
Recently I was thinking about this quote, which is often credited to Mark Twain.

Sharp interest rate rises, the failure of Silicon Valley Bank (and others), stricter capital requirements put in place by the Federal Reserve Bank (the "Fed") and frequent predictions of an upcoming recession, all reminded me of the early 1990's just before our economy went into a period of very tight banking conditions. There are meaningful differences between now and then, but mid-2023 does seem to rhyme with the early 1990's in some important ways.

It also reminded me of my friend, John Romney (RF Investment Partners www.RF-Partners.com). We worked together in the early 1990's on a number of troubled credit situations. I often think about the things I learned from John, so I asked him for his thoughts about current lending conditions.

"The lending environment today mirrors, yet is slightly different from, other credit cycles I've witnessed since I started my lending and investing career in 1981," John said. He continued by noting, "The current lending environment exhibits less specific industry issues (other than the global response to Covid) but is more closely correlated to fiscal and monetary policy missteps and over-reach that have had a significant influence on the lending environment. The combination of factors has real consequences for bank borrowers."

"If we want to succeed as a team, we need to put aside our own selfish, individual interests and start doing things my way."

Possible Changes
The credit environment in the early 1990's had some unique characteristics that may be insightful to remember now, just in case some of them return. Here are a few:

1. Banks were aggressive about monitoring their industry exposure in the early 1990's. Bankers would look at their portfolio of loans, and if they felt they had too much exposure to a particular industry or economic sector, they would sharply restrict their lending and even invite some shakier borrowers to find a new bank (a polite way to put it). That's what kept John and I busy in the early 1990's. When you combine stricter capital requirements by the Fed with banks possibly attempting to "re-balance" their portfolio, it could lead to traditional commercial bank loans being harder to find for many more companies.
2. Non-bank financial institutions, which were new at the time, played a significant role as a financing source in the early 1990's to fill the gap left by banks. "Non-bank" means companies that lend money but are not regulated in the same way that banks are. Good examples would be Blackstone and RF Investment Partners. Interestingly, non-bank financial institutions have been much more active in recent months according to several articles and may stay busy if current banking conditions persist.
3. Non-bank financial institutions have more flexibility to make loans and can be more creative in how they structure loans. But they can be more expensive (interest and other fees) and can have fairly complex loan structures. While it can take more time and effort to identify non-bank lenders that have an interest in your

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industry and company, once they get on board they can often move quickly to provide financing that wouldn't be available otherwise.

4. Loan terms are often stricter in tight banking markets. Loan fees could increase (such as closing fees, documentation fees and collateral maintenance fees) and loan structures could be less forgiving (such as tighter and more loan covenants, prepayment penalties and excess cash flow sweeps – depending on the company).
5. Covenant violations are usually more difficult to resolve when banking conditions are tight and are often accompanied by serious meetings with the lender who demands to see a lot of information to get comfortable that the loan can be repaid. Additionally, lenders are more likely to enforce covenant waiver fees.
6. A focus on quality of collateral (accounts receivable, inventory and fixed assets), quality of earnings and overall due diligence are more common when banking conditions are tight. More frequent reporting (sometimes on a weekly basis) is more likely as well.

Hopefully none of this will come to pass but given current trends it makes sense to be prepared. In closing, John noted, "The big lessons to remember are: 1) Build realistic financial budgets and forecasts, 2) Increase communications with your current lenders, 3) Work with experienced professionals such as CPA's and attorneys when you need funding, and 4) Be proactive not reactive."

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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