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NEGOTIATION STRATEGIES IN COMPLEX DEBT RESTRUCTURING: ONE PART DUE DILIGENCE, ONE PART PSYCHOLOGY AND TWO PARTS COOPERATION



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GLOBAL RESTRUCTURING & INSOLVENCY

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Negotiation strategies in complex debt restructuring: one part due diligence, one part psychology and two parts cooperation

BY RICHARD GAUDET

The real estate industry has produced some of the best and most successful negotiators in the world. These are shrewd investors that make no concessions while negotiating in an industry where knowledge, information and audacity almost always make the difference between success and failure. These titans, who have earned their reputations and success through careful due diligence and preparation, often fail miserably in the negotiation of distressed debt with a bank, because most don't enter a workout negotiation with the same preparation, confidence and knowledge that they would have if the topic of negotiation was the acquisition or development of a new project.

In the words of Sun Tzu, "If you know the enemy and know yourself you need not fear the results of a hundred battles". As real estate investors, following this basic tenet prepares us to negotiate any deal by knowing the strengths and weaknesses of the project and the party that we are negotiating with. In spite of a clear understanding of this concept and significant experience in employing it in the normal operation of their business, these same investors will typically ignore this principal in the preparation and conduct of workout negotiations. Instead of taking time to understand the other side of a debt workout, most borrowers focus on their issues while ignoring the lender's strengths and weaknesses.

Preparation for workout negotiations requires focus on four basic areas: (i) what is the borrower's realistic objective; (ii) what is the bank's objective; (iii) who are you negotiating with; and finally (iv) can you satisfy the bank's objective and still achieve success?

Determine your objective. Many borrowers enter into negotiations with unrealistic expectations which prevent or delay successful resolution. To determine a realistic objective, the borrower must conduct an honest assessment of the available scenarios and define the pros and cons of each to establish those scenarios that would constitute success. In doing this, the borrower should solicit the feedback of available advisers. By engaging qualified sounding boards, emotion is taken out of the process and better ideas evolve. Not surprisingly, this self assessment often results in adoption of a workout strategy completely contrary to initial instincts.

Determine the bank's objective. Simply stated, the bank's objective will always be the same: Remove the basis of criticism in a timely manner with the minimum amount of loss. Unfortunately, in the current economic environment, there will always be a negative correlation between the time component and loss component of this simple objective. To successfully prepare for the workout negotiation, one must analyse all of the banks available alternatives and understand where each alternative lies on the time/loss spectrum and more importantly, where the bank's efforts are focused along that same spectrum.

Who am I negotiating with? Perhaps the most important component of preparation is to fully understand the institution and the individual that you are going to negotiate with.

We find wide variances in individual bank officer's demeanour based on individual account officers and even separate departments within the same institution. The ability of the account officer to comprehend and execute the bank's objectives can be influenced by the experience level of the account officer as well as the bank management's ability to successfully convey high level strategic objectives. Generally speaking, we find that workout officers at small community banks as well as national and super-regional banks can be relied upon to have a clear understanding of the bank's objectives and will generally act predictably and in accordance with management objectives. Strangely, the institutions that fail to demonstrate a consistent corporate objective are the mid-sized regional banks where control and communication tend to be less centralised. In these cases, an in-depth understanding of the individual can be more important than having a clear understanding of the corporate objectives.

From an institutional standpoint, one must understand and appreciate the pressures that dictate or impact the strategies available to the lender. A bank with a 2 percent capital ratio will never give serious consideration to a short sale that produces additional impairment of its limited capital; however, this bank would probably look favourably upon rate and repayment concessions as well as guaranty mitigation in exchange for assurance of continued performance for a specified period of time. On the other hand, a publically traded bank that is showing consistent reduction in

its non-performing asset levels will eagerly trade a reasonable loss for the benefit of demonstrating that the portfolio quality is on the mend. Bank financial analysis is different from conventional financial analysis, but can be quickly conducted through publically available information and an understanding of the regulatory and market sensitivities to financial performance.

In our practice, we review quarterly financial reports of over 100 lenders and combine this intelligence with anecdotal evidence derived from discussions with lenders, attorneys, and borrowers to define each lender's position, movement, and trend line along the time/loss spectrum. Based on this analysis, we strategically select the alternatives that carry the highest probability of success at any given time or elect to position a negotiation for a more favourable timeframe. As a result, we can consistently achieve either an interim restructure that allows for renegotiation at a more suitable time, or finalise a more permanent structure that meets the borrower's, as well as, the bank's objectives. In either case, the bank achieves terms that meet its immediate goals while preserving, advancing, or achieving the borrower's objectives.

To demonstrate a hypothetical scenario, a borrower who is hopelessly underwater on a loan payable to a failing institution would never successfully negotiate a discount to facilitate a sale or refinancing of the collateral because the lender could not afford the loss associated with the resolution. An interim solution could provide for a cash interest reserve in exchange for a release of personal guaranties. The bank has achieved its objective of avoiding a loss, and possibly argues that the credit quality is improved by virtue of the interest reserve and improving market trends. The guaranty was of minimal near term value to the bank because the act of enforcing the guaranty would potentially precipitate the very loss they are trying to avoid. In this scenario, the bank will either improve its financial health and be better prepared to consider a short sale in the future, or in the event of failure, the acquiring institution would be better positioned to negotiate a reasonable and timely settlement. By understanding the bank's position on the time/loss spectrum, the borrower was able to successfully position the asset for a successful resolution. ►►

Can a mutually beneficial resolution be achieved? With extremely few exceptions, the lender will always have the upper hand in a workout negotiation. Success is defined by finding the solution that addresses the lenders needs while preserving equity or limiting loss

on the part of the borrower and guarantors. To achieve this, one must identify the lender's sensitivities and cater to those sensitivities in exchange for acceptable concessions. A successful loan resolution is a process in which patience and preparation are the key virtues.

These virtues are often not a strong trait for the typical 'Type A' personalities that make successful entrepreneurs. In that regard, Sun Tzu again offers appropriate advice: "He who knows when he can fight and when he cannot, will be victorious." ■



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