

## World Bank Group, FinSAC

### Course on Nonperforming Loan Resolution

November 25-26, 2021

Instructor: Karlis Bauze

### Case Study #1: JSC Eastern Metallurgical Plant (EMP) - Loan Restructuring

#### Background

JSC Eastern Metallurgical Plant (“EMP” or the Company) is a big metal production company established in 1991. It operates a production facility constructed in 1961 and exports about half of its production, benefiting from being located close to a major national port. The production facility was substantially modernized in 1995, and then again in 2012 to increase capacity and expand the product range. The Company has been managed from the inception by its CEO Mr. M with a direct mandate from the controlling shareholder. In December 2012 Bank A (the Bank) loaned to EMP USD 360,000 to fund the modernization and working capital increase. The loan is repayable in USD 10,000 instalments over three years starting from January 2015. Monthly interest payments are based on 10 percent annual rate. The loan is secured by a mortgage of real estate, pledge of equipment, and furniture with a total estimated value of local currency 2,000,000 at loan origination. Additionally, the controlling shareholder provided personal guaranty for the loan.

Sales began to lag the targets in mid-2014 as the economy experienced major deterioration and sales to foreign markets became restricted. Mr. M initiated a savings plan to cut expenses with expectations for fast economic recovery. But sales and profits continued to be below forecasted targets throughout 2014-2016, additionally experiencing shortages in raw materials supply and steel prices decrease on international markets. In 2016 the Company reported EBITDA margin growth to 25 percent from 18 percent in 2014 and 2015. However, the generated EBITDA was insufficient to fund significantly increased debt service requirements. The major negative factor on the Company’s financial position was foreign currency loan revaluation due to local currency depreciation since 2013. In December 2014, the Bank postponed the start of principal repayment from January 2015 to January 2017 as part of a general bank-wide program of debt restructuring in response to macroeconomic deterioration. The balance of the loan as of December 1, 2016, was principal USD 360,000, plus regular monthly interest of USD 3,000 due on December 31, 2017.

Since the inception of the loan, Mr. M had regular meetings with the Bank on quarterly basis. On December 8, 2016, Mr. M called bank credit officer Mrs. S to schedule the next meeting. During the conversation, Mr. M said that the Company is not fulfilling the business plan in terms of sales and operating profits and, therefore, it would need a further waiver for debt to EBITDA covenant as well as some kind of “extra short-term payment relief”. The meeting was agreed for Monday, December 17.

Mr. M organized preparation of a revised business plan to be discussed with the Bank. Resulting projections gave him much cause for concern as local currency depreciation increased servicing of the debt and the company’s forecasted cash flows were insufficient to cover upcoming interest and principal payments. Mr. M was expecting a difficult discussion with the Bank.

## Transfer to Workout Unit

When Mr. M arrived for the meeting, he was surprised to see the credit officer Mrs. S accompanied by another officer. Mrs. S began the meeting by introducing Mr. K from the recently established workout unit of the Bank. She explained that the Early Warning System was designed to identify financial difficulties at an early stage when they are most correctable. EMP was added to the watch list in 2015 based on its weak financial position mainly due to foreign currency loan revaluation and EBITDA much below the business plan targets. The Company had an alarming increase in debt to EBITDA and interest coverage ratio. Though the loan had no past due payments, it was transferred to the new workout unit due to its continued weak financial position and anticipated insufficiency of generated cash flows to service the debt. Mrs. S thanked Mr. M for good cooperation, wished him well and left the meeting.

Mr. M was obviously disappointed about the loan's transfer to the workout unit and the change of credit officer. However, he began to review 2016 interim results and describe most recent developments in the financial position of his company. Mr. K appeared to be well informed about the company and asked appropriate questions. Also Mr. K provided very helpful comments about projections and underlying assumptions to improve company's performance. At the conclusion of the meeting, Mr. K promised to analyze the projections in more detail and try to find a solution for the Company to survive.

## Financial and Business Viability Analysis

Table 1. Selected financial indicators of EMP (in local currency)

|  | 2014       | 2015       | 2016 (E)  | mid-term targets |
|--|------------|------------|-----------|------------------|
| Sales                                  | 5,055,373  | 5,497,489  | 5,914,613 | 7,044,398        |
| EBITDA                                 | 919,756    | 966,316    | 1,617,809 | 1,767,436        |
| EBIT                                   | 832,755    | 885,695    | 1,540,368 | 1,631,084        |
| Net earnings                           | -2,295,960 | -2,467,443 | -588,442  | 939,501          |
| Key financial ratios                   |            |            |           |                  |
| Compound annual growth rate of revenue | -0.6       | 8.7        | 7.6       | 4.4              |
| Net debt/EBITDA                        | 5.7        | 8.9        | 6.1       | 1.9              |
| Debt service coverage ratio            | 2.1        | 1.3        | 1.7       | 5.2              |

Mr. K began his analysis by duly noting that the Company, like many other borrowers, had suffered from local currency depreciation having the loan in foreign currency. Additionally, the company had sales disruption on the international market, difficulties in raw materials supply, and decreased prices for steel production on international markets. These negative developments quickly resulted in high net loss and negative equity in the 2014 and 2015 financial statements. On the other hand, the company had remained at all times operationally profitable with positive EBIT and EBITDA. But the level of operating profit was insufficient to service the increased debt burden.

Turning to the projections Mr. K believed that they were both conservative and realistic. The projections assumed modest increase in sales for the next 5 years driven mainly by volume increase. Forecast prices for steel products were in line with the bank's own internal forecasts. EBIT and EBITDA margins were expected to improve slightly with increased capacity utilization. Although the Company would have negative equity resulting from accumulated foreign currency losses, it would turn to positive net earnings as soon as local currency depreciation ceased. Mr. K concluded that generated cash flows with careful financial management should be enough to cover interest expenses, but the principal repayment schedule could not be fulfilled. Mr. M agreed with the conclusion.

During their meetings, Mr. K had been very impressed with Mr. M's knowledge of the company and recognition of the steps needed to turn it around. He was known in the business community as a conservative business man, was well liked by his employees, and tried to maintain close relationships with both his customers and suppliers. While a mid-sized player in a big market, the company had a good reputation and tried to diversify domestic and export sales. Industry projections assumed flat volumes for the next three years, followed by modest growth thereafter, whereas company sales volumes were slightly increasing in all periods.

Based on the above, Mr. K felt that the company's problems were temporary in nature caused by adverse economic conditions and that there was a basis to proceed with restructuring the loan. **Considering the high likelihood of the company being viable, Mr. K also contacted asset management companies interested in purchasing the current loan. In due time, competitive offers would be received.**

## **Restructuring the loan**

Mr. K began the restructuring process by reviewing the bank's restructuring guidelines for USD denominated loans. Loan conversion into local currency was not required because half of the sales were from exporting, generating foreign currency revenue. The guidelines recommended a tenor not to exceed five years, EBITDA of at least 110 percent of principal and interest repayments, a maximum interest rate of 8 percent. With average annual cash flow of almost USD 62,000 (assuming further 2 percent annual local currency depreciation), the most the company could afford to pay on an annual basis was USD 56,000. This amount was insufficient to meet debt service requirements that, according to the signed loan agreement, should amount on average to about USD 144,000 for the next 3 years.

Given these parameters, Mr. K began to calculate what level of debt the Company could repay over five years. It quickly became clear that EMP would not be able to repay its outstanding debt in full over a five-year period as the principal payments alone would amount to USD 72,000 per year on average. He then began to reduce the debt in USD 5,000 increments until he reached USD 225,000. Principal payments together with interest at 8 percent would total on average USD 55,277 below maximum target. Mr. K was unwilling to recommend that the Bank forgive the remaining USD 135,000 balance on the loan at this time. He therefore recommended that the existing debt to be split into two loans, both secured by a mortgage on the land and building, as well as pledges over furniture, fixtures, and equipment. The first loan, or the "A" loan, would be in the amount of USD 225,000 and would be payable in 60 instalments with a first instalment of USD 2,214 and each next instalment by USD 52 higher, plus 8 percent interest on outstanding debt. The remaining balance of USD 135,000, would be placed on the "B" note, at 0 percent interest and a bullet maturity of five years. To ensure Mr. M's continued cooperation, the Bank would agree in a new master restructuring agreement that the B note would be forgiven if the A note was repaid in accordance with its terms.

All loans would be governed by a master restructuring agreement which would contain covenants restricting dividends and other withdrawals by Mr. M, require a monthly cash budget together with quarterly financial statements, the maintenance of EBITDA debt service coverage at all times of at least 1.1, and provide that EBITDA above USD 55,000 be used to the "A" note until it is repaid. The master restructuring agreement covenants would also specify that the "B" note was not to be used in the calculation of the financial leverage covenants.

## **Evaluating workout options**

After deciding on the parameters of the restructuring, Mr. K began to calculate the NPV of the various workout options open to the Bank. Neither Mr. K nor the Legal Officer considered enforcement to be a

good alternative to pursue. Mr. M would likely be uncooperative, and the Bank could expect at least one appeal and several postponements. Also, it was likely that the Bank would not receive any proceeds for a three-year period. As the continued use of their collateral was essential for the Company to operate, it was likely that either the company or other creditors would put the Company into a bankruptcy proceeding before the Bank could file an enforcement proceeding. Nevertheless, he began by considering the value of the collateral in both a bankruptcy and enforcement scenario.

The loan was secured by a mortgage on the land and building as well as pledges over furniture and equipment. A new appraisal prepared by an internal appraiser valued the land and building at local currency 2.5 million (USD 91,943), Mr. K applied a 60 percent discount to reflect the lack of transparency in the sale process during bankruptcy proceedings and 40 percent discount to reflect value deterioration during the enforcement process. The Bank had also received a new appraisal of the equipment and furniture. Mr. K believed that in a bankruptcy proceeding, the equipment, valued at local currency 100,000 (USD 3,677), would be sold at 35 percent of the appraised value and the furniture (valued at local currency 20,000 or USD 735) would be sold at 20 percent of its appraised value. For the enforcement process, he estimated equipment sale value of 45 percent of the appraised value and the furniture sale value at 30 percent. Lower sale value during a bankruptcy process is expected due to the less transparent sale process and restricted rights of creditors. The personal guaranty of the controlling shareholder was conservatively evaluated at zero recovery value because EMP was his sole property and guaranty enforcement has high legal risks. Total liquidation values of the bank's collateral expected from bankruptcy and enforcement procedures are shown in Table 2 below.

Table 2. Estimated value of collateral in bankruptcy and enforcement proceedings (in local currency)

| Items                   | Appraisal value at origination | Appraisal value (AV) updated | Sale value at bankruptcy |         | Sale value at enforcement |         |
|-------------------------|--------------------------------|------------------------------|--------------------------|---------|---------------------------|---------|
|                         |                                |                              | Local currency           | % of AV | Local currency            | % of AV |
| Land plot               | 300,000                        | 500,000                      | 200,000                  | 40%     | 300,000                   | 60%     |
| Building                | 1,500,000                      | 2,000,000                    | 800,000                  | 40%     | 1,200,000                 | 60%     |
| Equipment               | 150,000                        | 100,000                      | 35,000                   | 35%     | 45,000                    | 45%     |
| Furniture               | 50,000                         | 20,000                       | 4,000                    | 20%     | 6,000                     | 30%     |
| Total in local currency | 2,000,000                      | 2,620,000                    | 1,039,000                |         | 1,551,000                 |         |

Mr. K noted that the Bank would not receive the full value of its claim (USD 360,000) from the sale of the collateral in either a bankruptcy proceeding, or in collateral enforcement scenario. The shortfall would be considered as an unsecured claim.

He then proceeded to calculate the liquidation value of the remaining assets of the Company as shown below.

Table 3. Estimated Liquidation value of EMP's assets, excl. bank's collateral (in local currency)

| Balance sheet item        | Book value | Estimated recovery | Liquidation value |
|---------------------------|------------|--------------------|-------------------|
| Cash                      |            | 0                  | 0                 |
| Accounts receivable       |            |                    |                   |
| 0-30 days outstanding     | 2,873,178  | 60%                | 1,723,907         |
| 31-60 days outstanding    | 1,676,021  | 30%                | 502,806           |
| over 60 days outstanding  | 239,432    | 10%                | 23,943            |
| Total accounts receivable | 4,788,631  |                    | 2,250,656         |
| Inventory                 |            |                    |                   |

|  |                  |            |                  |
|--|------------------|------------|------------------|
| Finished goods                               | 222,050          | 70%        | 155,435          |
| Work in progress                             | 296,066          | 0%         | 0                |
| Raw materials                                | 222,050          | 50%        | 111,025          |
| <b>Total inventory</b>                       | <b>740,165</b>   |            | <b>266,460</b>   |
| Other current assets                         |                  |            |                  |
| Prepaid expenses                             | 0                | 50%        | 0                |
| Financial investments                        | 367,259          | 30%        | 110,178          |
| Promissory notes                             | 456,716          | 30%        | 137,015          |
| <b>Total other current assets</b>            | <b>823,975</b>   |            | <b>247,193</b>   |
| Non-current assets                           |                  |            |                  |
| Land plots                                   | 0                | 70%        | 0                |
| Buildings                                    | 0                | 70%        | 0                |
| Equipment                                    | 0                | 50%        | 0                |
| Other items                                  | 204,040          | 10%        | 20,404           |
| <b>Total non-current assets</b>              | <b>204,040</b>   |            | <b>20,404</b>    |
| <b>Total assets</b>                          | <b>5,528,796</b> |            | <b>2,537,520</b> |
| <b>Portion of the Bank in total recovery</b> |                  | <b>81%</b> | <b>2,055,397</b> |

Then, he calculated the costs of enforcement proceedings including: court fees for submission of claim and appeal, bailiff service, auction trading platform fee, and other selling expenses.

Table 4. Costs of collateral enforcement proceeding (in local currency)

| Type of costs           | Amount         |      |                                |
|-------------------------|----------------|------|--------------------------------|
| Court fees (two levels) | 82,530         | 3.2  | % of claim or limit of 504,000 |
| Bailiff initiation fee  | 32,000         | 2.0  | % of claim or limit of 32,000  |
| Bailiff service fee     | 155,100        | 10.0 | % of forced sale value         |
| Auction platform fee    | 77,550         | 5.0  | % of forced sale value         |
| Other selling costs     | 15,510         | 1.0  | % of forced sale value         |
| <b>Total</b>            | <b>362,690</b> |      |                                |

Similarly, he calculated the costs of a bankruptcy process including: court fees for submission of claim and appeal, bailiff initiation fee and bankruptcy case opening fee, salaries for arbitrage manager (for 6 months) and liquidator (for 3.5 years), and extra pay for value recovery to arbitrage manager and liquidator.

Table 5. Costs of bankruptcy proceeding (in local currency)

| Type of costs                     | Amount         |     |                                |
|-----------------------------------|----------------|-----|--------------------------------|
| Court fees (two levels)           | 308,344        | 3.2 | % of claim or limit of 504,000 |
| Insolvency case opening           | 16,000         |     | 10x minimal living expenses    |
| Statement of claims               | 6,400          |     | 4x minimal living expenses     |
| Bailiff initiation fee            | 32,000         | 2.0 | % of claim or limit of 32,000  |
| Arbitrage manager pay             | 30,924         |     | 2x minimal wage for 6 months   |
| Liquidator pay                    | 216,467        |     | 2x minimal wage for 42 months  |
| Sale organizer fee                | 154,125        | 5.0 | % of forced sale value         |
| Extra pay to liquidator / manager | 76,044         | 3.0 | % of net recovery value        |
| Other selling costs               | 30,825         | 1.0 | % of forced sale value         |
| <b>Total</b>                      | <b>871,129</b> |     |                                |

Thus, in a bankruptcy process the Bank would receive a total of local currency 2,222,361 (nominal value), which includes local currency 1,039,000 collateral liquidation value (Table 2), plus local currency 2,055,397 recovery from other assets (Table 3) and minus bankruptcy expenses of local currency 871,129 (Table 5). In a collateral enforcement process the Bank would receive only local currency 1,188,310 (nominal value), comprising local currency 1,551,000 collateral sale (Table 2) revenue minus local currency 362,690 enforcement expenses (Table 4).

In the meantime, two asset management companies have contacted Mr. K to express interest in acquiring the loan to be restructured. Proposal 1 involves a total nominal amount 4,850,000, of which 3,750,000 is payable by the end-2016. Proposal 2 involves a total nominal amount of 5,400,000, but a larger portion of the payment is scheduled for end-2017 and end-2018. Details of the offers are included in Table 6, parallel to the expected outcomes of other resolution options.

In order to take into account time value of money Mr. K calculated NPL for each option with standard 10 percent discount rate. Based on this analysis, restructuring was the best alternative.

Table 6. NPV Analysis of workout options (in local currency)

|  | NPV | 31.12.16<br>t=0 | 31.12.17<br>t+1 | 31.12.18<br>t+2 | 31.12.19<br>t+3 | 31.12.20<br>t+4 | 31.12.21<br>t+5 |
|--|-----|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Principal outstanding                      |     | 9,788,709       |                 |                 |                 |                 |                 |
| Interest outstanding                       |     | 0               |                 |                 |                 |                 |                 |
| Restructuring                              | 10% | 5,905,238       | 0               | 1,286,002       | 1,447,627       | 1,597,673       | 1,735,130       |
| Principal                                  |     |                 |                 | 824,142         | 1,051,254       | 1,286,794       | 1,530,762       |
| Interest                                   |     |                 | 0               | 461,860         | 396,373         | 310,879         | 204,368         |
| Sales to third party                       |     |                 |                 |                 |                 |                 |                 |
| Proposal 1                                 | 10% | 4,750,000       | 3,750,000       | 1,100,000       |                 |                 |                 |
| Proposal 2                                 | 10% | 4,845,868       | 1,350,000       | 1,800,000       | 2,250,000       |                 |                 |
| Bankruptcy                                 | 10% | 1,295,004       | -146,831        | -215,914        | -65,311         | -72,123         | 889,659         |
| Recovery                                   |     |                 | 0               | 0               | 0               | 0               | 1,039,000       |
| Expenses                                   |     |                 | -146,831        | -215,914        | -65,311         | -72,123         | -149,341        |
| Collateral enforcement                     | 10% | 872,593         | -39,300         | -48,400         | -37,170         | 1,313,180       | 0               |
| Recovery                                   |     |                 | 0               | 0               | 0               | 1,551,000       | 0               |
| Expenses                                   |     |                 | -39,300         | -48,400         | -37,170         | -237,820        |                 |
| <i>FX exchange rate assumptions:</i>       |     |                 |                 |                 |                 |                 |                 |
| <i>Local currency / USD, end-of-period</i> |     | <i>27.19</i>    | <i>27.75</i>    | <i>28.31</i>    | <i>28.88</i>    | <i>29.44</i>    | <i>30.00</i>    |

The discussion at the credit committee proved active as anticipated. Many members questioned why the Bank was willing to forgive the B note; others questioned why Mr. K did not just extend the maturity until the loan was fully paid. Some members felt that the Bank would be better served by allowing the Company to file for bankruptcy. Mr. K defended his decisions, pointing out that without the restructuring the Company was certain to fail resulting in the loss of jobs, and that the projections showed no ability to service the full amount of the loan on a fully performing basis. The proposed restructuring would allow the A loan to be returned to a performing status if the Company met the repayment terms for one year. The loan agreement also contained a cash flow recapture clause that would require all cash flow in excess of

USD 55,000 to be used as a prepayment to the A note. In addition, he was concerned that Mr. M would lose his incentive to work with the Bank as the loan now exceeded the value of the collateral and future growth was limited. Once everyone had a chance to speak, the head of Credit Risk Management spoke in favor of the loan restructuring. He reminded the committee of the Bank's commitment to work with cooperative borrowers and to restructure loans whenever possible. He pointed out that Mr. M was a long-term customer of the Bank; had a successful track record as a businessman; and had always fully cooperated with the Bank. Based on these facts, he believed that EMP had earned the chance to restructure.

## **Lessons learned**

Upon reflection, Mr. K felt that the EMP case contained several important lessons, including:

- *The importance of the EWS and prompt transfer to the workout unit.* The EWS had correctly identified potential problems as currency devaluation increased debt burden and operational performance deteriorated. Unfortunately, Mr. M was unable to cope with adverse external factors to manage foreign currency risk, as expected at loan origination, and avoid losses. The mandatory transfer of the loan to the new workout unit, right after the unit was established, allowed the Bank and the borrower to develop a solution before the Company was totally out of cash and had accumulated overdue payments.
- *The importance of working with a co-operative borrower.* Mr. M's history of working closely with the Bank, coupled with his pro-active approach to instituting corrective actions within the Company, gave the Bank confidence that he was able to manage the turn-around process within the Company. This proved to be a key factor in determining the bank's willingness to move forward with restructuring the debt of an admittedly marginally viable borrower.
- *The importance of recognizing when debt is unsustainable.* While it was true that the Bank could have just extended the maturity of the loan to accommodate full repayment, it would have done nothing to improve the company's fundamental problem of over indebtedness. The Company would have continued to struggle and there was a high likelihood that it would eventually collapse. It was also unclear if Mr. M's high level of cooperation would continue if he could not see some light at the end of the tunnel in the form of modest growth and an improved financial position. By the willingness to forgive a portion of the debt conditional upon the repayment of the A loan, the Bank has addressed both problems – the debt has been reduced to a sustainable level and Mr. M has been provided with a powerful incentive to ensure that the Company performs as projected. The restructuring also sent a strong signal to the community at large that the Bank was willing to work with cooperative borrowers and was committed to saving viable businesses.

## World Bank Group, FinSAC

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November 25-26, 2021

Instructor: Karlis Bauze

### Case Study #2: ABC Ltd. – Collateral enforcement and loan assignment

#### Background

ABC Ltd., established in 2006 by Mr. I, was an engineering company with a successful track record of realized projects in commercial and residential real estate. The company operated as a real estate developer and provided a wide spectrum of consulting services in real estate engineering. Known for its innovative solutions and outstanding expertise, the company expanded rapidly and quickly became profitable. In early 2012, having completed several very successful mid-sized projects, the company launched a substantially larger investment in an office and residential estate in the city center with total cost of USD 300 million. The company planned to fund this new project from accumulated savings, rent payments from a recently constructed shopping mall “GLORY”, and with a bank loan. Bank A financed USD 250 million (83 percent of the cost) on a 7-year investment loan at 12 per cent, with the remaining USD 50 million being paid in cash by ABC. The loan was secured by a mortgage on the land plot with construction in progress and the GLORY shopping mall. Mr. I also personally guaranteed the loan.

The company was hit by the economic crisis in the country. Occupancy rate at GLORY shopping mall remained much below the targeted level, rent rates in USD plummeted by about 50 percent due to local currency depreciation and remained at that lower level since then. The company was able to accomplish only 70 percent of the construction project, debt financing was exhausted and they faced a funding deficit to finish the construction. The total cost of the project increased by about 20 percent since its launch. The company was placed on the bank’s newly established watch list in March 2016 due to its net loss in 2015. Subsequently, the bank, believing that the problems were temporary in nature, tried to work with the company. The terms of the investment loan were revised to allow an additional one-year moratorium grace period on principal payments.

ABC defaulted on its October 30, 2016 interest payment. Based on this default, coupled with the fact that the borrower had been on the watch list for 6 months without substantive improvement and the owner, Mr. I, had not been responding to calls from his loan officer, the account was transferred to the workout unit in accordance with the bank’s internal procedures.

#### Initial steps upon transfer to workout unit

The company failed the initial viability assessment based on a debt-to-EBITDA ratio of 12.4 calculated on the basis of 2015 statements in the loan file, although it passed on the collateral coverage parameter with a loan to value ratio of 110 percent. Given the bank’s commitment to try to preserve going concern business whenever possible, it was decided that the bank should take a closer look at the account to determine if there was a possibility of restructuring the exposure.

The account was assigned to Ms. B, an experienced workout officer. He immediately conducted a thorough review of the loan file, noting that in addition to the missing fiscal statements ABC had failed to provide

its annual cash flow projections together with an aging of accounts receivable and inventory. He consulted with the legal team and together they determined that the collateral had been perfected properly and no legal documentation was missing. Ms. B also ordered an updated property appraisal. As required by the bank’s policy, within five days of the account being transferred to the workout unit, Ms. B notified the borrower, as well as Mr. I as guarantor, that (i) ABC was in payment default with respect to its October interest payment and requested that the past due amount together with late fees and penalty interest be brought current; (ii) ABC was also in default of the terms of the loan agreement with respect to the delivery of the year-end statements and ageing of accounts receivable and inventory; and, (iii) the loan had been transferred to the workout unit, introduced himself as the new relationship officer and requested the Mr. I contact him at his earliest convenience to discuss repayment options.

Fifteen days passed with no word from Mr. I. Ms. B sent a second letter requesting the information and notifying Mr. I that failure to respond within 15 days would result in ABC being classified as a “non-cooperative” borrower and transferred to the legal team for collection. Several days later, Mr. I called and apologized for his delay in responding, citing his preoccupation with operational matters of the company. He also claimed to have just “forgotten” to send the statements and committed to do so when he had a spare moment in the next few days. Ms. B responded that he would pick the statements up himself the next time he was in the area visiting another client. Mr. I reluctantly agreed.

During his visit, Ms. B observed that the company’s premises were well maintained, and the office furnishings were appropriately modest. Ms. B also noted that Mr. I seemed uncomfortable and evasive when pressed on the company’s financial performance and referred most questions to “his accountant”. He also seemed to be more focused on “new business opportunities” than on the current financial state of the company.

## Financial and business viability analysis

Once back in the office, Ms. B began his analysis of the company’s 2015 statements. He was not surprised to see that the company performance deteriorated sharply in 2015 but was concerned that the company was now past due on its taxes (see Table 1 for selected financial indicators). The combined effect of underperforming revenue given low occupancy and reduced rent rates together with increased operating costs primarily due to inflationary pressure resulted in lower operating profit which was insufficient to cover interest expenses. The company reported a huge net loss for 2015 of local currency 2,439 million (USD 127 million) mainly due to the revaluation of the liabilities denominated in foreign currencies. Expected financial results of 2016 were even worse in terms of interest coverage and liquidity indicators. He also noted the company’s declining quick ratio and noted that it was likely overstated due to the generally worsening quality of both the accounts receivable (based on the aging) and inventory. The company’s projections showed limited ability to service the debt. They were based on a substantial increase in revenue and profitability from yet to be identified sources.

Table 1: Selected Financial Indicators of ABC (in local currency ,000)

|  | 2014       | 2015       | 2016 (E)   |
|--|------------|------------|------------|
| Sales                                  | 309,299    | 459,179    | 520,213    |
| EBITDA                                 | 304,768    | 486,241    | 531,284    |
| EBIT                                   | 269,044    | 429,914    | 452,708    |
| Net earnings                           | -1,643,267 | -2,438,889 | -1,078,360 |
| Key financial ratios                   |            |            |            |
| Compound annual growth rate of revenue | -17.6      | 48.5       | 13.3       |
| Net debt/EBITDA                        | 9.3        | 12.4       | 12.9       |

|                             |     |     |     |
|-----------------------------|-----|-----|-----|
| Debt service coverage ratio | 1.0 | 0.8 | 0.6 |
|-----------------------------|-----|-----|-----|

Having concluded his financial analysis, Ms. B turned to assessing the viability of the business. He began with ABC's management. He noted Mr. I's lack of financial knowledge, his focus on construction process which prevented him from recognizing the seriousness of the company's problems, and his limited cooperation with the bank. This led Ms. B to conclude that Mr. I could not design and manage a turnaround of the company.

He then moved on to compare ABC with similar developers in the bank's loan portfolio. The comparison was not favorable. While all showed the impact of the major economic deterioration, most had managed their financial resources more effectively and exhibited a stronger financial position. Ms. B also noted that the real estate market had signs of oversupply with expected reductions in rent and occupancy rates. ABC's mid-sized GLORY shopping mall was located outside the city center, competing with two larger shopping malls nearby. The company had been struggling to increase occupancy rates above 40 percent for the last two years. Furthermore, the bank's own internally produced economic projections for the local real estate market did not support growth in the rental market, making it unlikely that the company could rent its substantial excess space in the near term.

### Deciding on workout strategy

Based on the above, Ms. B concluded that the company was not viable either from a financial or business perspective and referred ABC to the legal team. The legal officer working together with Ms. B proceeded to determine the likely value of the recoveries that would be received at the end of collateral enforcement and bankruptcy procedures.

The loan was secured by a mortgage of the GLORY shopping mall and the land plot with construction in progress. Per the most recent appraisal report, the two objects were valued at local currency 6,000 million. Then Ms. B applied 40 percent discount for the land plot and 30 percent discount for the shopping mall to include conservative price reduction in a collateral enforcement process. Similarly, Ms. B applied 60 percent discount for the land plot and 50 percent discount for the shopping mall to define a potential sale value of the assets in a bankruptcy process. Higher levels of discounts in the bankruptcy process were assumed due to the risks of a non-transparent sale process and restricted creditors' rights.

Table 2. Estimated value of collateral in bankruptcy and enforcement proceedings  
(in local currency ,000)

| Items                          | Appraisal value at origination | Appraisal value updated | Sale value at bankruptcy |         | Sale value at enforcement |         |
|--------------------------------|--------------------------------|-------------------------|--------------------------|---------|---------------------------|---------|
|                                |                                |                         | Value                    | % of AV | Value                     | % of AV |
| Land plot (incl. construction) | 200,000                        | 1,500,000               | 600,000                  | 40%     | 900,000                   | 60%     |
| Shopping mall GLORY            | 2,500,000                      | 4,500,000               | 2,250,000                | 50%     | 3,150,000                 | 70%     |
| Total in local currency        | 2,700,000                      | 6,000,000               | 2,850,000                |         | 4,050,000                 |         |
| Total in USD                   | 337,500                        | 220,662                 | 104,815                  |         | 148,947                   |         |

He then proceeded to calculate the liquidation value of the remaining assets of the Company as shown in the table below. Age analysis of the receivables during 2016 revealed that 50 percent of the accounts receivable were more than 60 days past due resulting in low recovery. Inventories analysis revealed that

about 40 percent of them were work in progress with zero recovery, finished goods accounted for about 20 percent, and raw materials accounted for 40 percent of the total inventory. Total receipts from the collection of current assets were calculated as follows in Table 3.

Table 3. Estimated Liquidation value of current assets (in local currency ,000)

| Balance sheet item                    | Book value | Estimated recovery | Liquidation value |
|---------------------------------------|------------|--------------------|-------------------|
| Cash                                  | 0          | 100%               | 0                 |
| Accounts receivable                   |            |                    |                   |
| 0-30 days outstanding                 | 178,922    | 60%                | 107,353           |
| 31-60 days outstanding                | 119,282    | 30%                | 35,784            |
| over 60 days outstanding              | 298,204    | 10%                | 29,820            |
| Total AR                              | 596,408    |                    | 172,958           |
| Inventory                             |            |                    |                   |
| Finished goods                        | 132,547    | 70%                | 92,783            |
| Work in progress                      | 265,094    | 0%                 | 0                 |
| Raw materials                         | 265,094    | 50%                | 132,547           |
| Total inventory                       | 662,734    |                    | 225,329           |
| Other current assets                  |            |                    |                   |
| Prepaid expenses                      | 5,199      | 50%                | 2,600             |
| Financial investments                 | 0          | 30%                | 0                 |
| Promissory notes                      | 0          | 30%                | 0                 |
| Total other current assets            | 5,199      |                    | 2,600             |
| Total assets                          | 1,264,341  |                    | 400,887           |
| Portion of the Bank in total recovery | 969,729    | 77%                | 308,683           |

Then he calculated the costs of enforcement proceedings including: court fees for submission of claim and appeal, bailiff service, auction trading platform fee, and other selling expenses.

Table 4. Costs of enforcement proceeding (in local currency ,000)

| Type of costs           | Amount  |      |                                |
|-------------------------|---------|------|--------------------------------|
| Court fees (two levels) | 189,000 | 3.2  | % of claim or limit of 504,000 |
| Bailiff initiation fee  | 32,000  | 2.0  | % of claim or limit of 32,000  |
| Bailiff service fee     | 405,000 | 10.0 | % of forced sale value         |
| Auction platform fee    | 81,000  | 2.0  | % of forced sale value         |
| Other selling costs     | 40,500  | 1.0  | % of forced sale value         |
| Total                   | 747,500 |      |                                |

Similarly, he calculated costs of bankruptcy process including: court fees for submission of claim and appeal, bailiff initiation fee and bankruptcy case opening fee, salaries for arbitrage manager (for 6 months) and liquidator (for 3.5 years) and extra pay for value recovery to arbitrage manager and liquidator.

Table 5. Costs of bankruptcy proceeding (in local currency ,000)

| Type of costs                     | Amount         |     |                                |
|-----------------------------------|----------------|-----|--------------------------------|
| Court fees (two levels)           | 308,344        | 3.2 | % of claim or limit of 504,000 |
| Insolvency case opening           | 16,000         |     | 10 minimal living expenses     |
| Statement of claims               | 6,400          |     | 4 minimal living expenses      |
| Bailiff initiation fee            | 32,000         | 2.0 | % of claim or limit of 32,000  |
| Arbitrage manager pay             | 29,452         |     | 2x minimal wage for 6 months   |
| Liquidator pay                    | 206,165        |     | 2x minimal wage for 42 months  |
| Sale organizer fee                | 94,664         | 3.0 | % of forced sale value         |
| Extra pay to liquidator / manager | 79,996         | 3.0 | % of net recovery value        |
| Other selling costs               | 31,555         | 1.0 | % of forced sale value         |
| <b>Total</b>                      | <b>804,576</b> |     |                                |

Additionally, Ms. B prepared a teaser about the loan and conducted negotiations with three asset resolution companies. As a result of these marketing efforts, the bank received two indicative offers for purchasing the loan. These offers valued the loan at local currency 2,350 million and local currency 2,100 million.

The legal officer then calculated the NPVs for all available options: loans assignment, collateral enforcement and bankruptcy proceeding (see Table 6), based on the estimates of relevant legal costs, and assuming, based on prior experience, that bankruptcy would take longer than enforcement and that creditors' rights are not well protected in bankruptcy proceedings. Based on the results, the legal officer recommended that the loan be assigned to the assets resolution company with the highest indicative offer (local currency 2,350 million). The next preferred option was collateral enforcement.

Table 6. NPV calculation for recovery from insolvency and enforcement proceedings  
(in local currency ,000)

|                        | NPV | 31.12.16<br>t=0 | 31.12.17<br>t+1 | 31.12.18<br>t+2 | 31.12.19<br>t+3 | 31.12.20<br>t+4 | 31.12.21<br>t+5 |
|------------------------|-----|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Principal outstanding  |     | 6,800,000       |                 |                 |                 |                 |                 |
| Interest outstanding   |     | 33,592          |                 |                 |                 |                 |                 |
| Loan assignment (sale) | 14% | 2,350,000       | 2,350,000       | 0               | 0               | 0               | 0               |
| Cash proceeds          |     | 2,350,000       | 0               | 0               | 0               | 0               | 0               |
| Bankruptcy             | 14% | 1,237,578       | -146,831        | -215,914        | -68,404         | -69,423         | 2,622,359       |
| Recovery               |     |                 | 0               | 0               | 0               | 0               | 2,850,000       |
| Expenses               |     |                 | -146,831        | -215,914        | -68,404         | -69,423         | -227,641        |
| Collateral enforcement | 14% | 2,170,789       | -90,000         | -119,250        | -52,250         | 3,564,000       | 0               |
| Recovery               |     |                 | 0               | 0               | 0               | 4,050,000       |                 |
| Expenses               |     |                 | -90,000         | -119,250        | -52,250         | -486,000        |                 |

Recoveries net of costs discounted to present at bank's standard discount rate of 14 percent.

## Lessons learned

Several months later, in response to a question asked by his manager, Ms. B lists the following lessons learned from this case:

- The loan was poorly underwritten at inception. The real estate market was already showing signs of distress and the bank failed to adequately assess the likely effect on ABC's business as well as its ability to rent the excess space which was considered to be an important source of repayment.
- The loan agreement did not require quarterly financial statements together with the aging of accounts receivable and inventory or a monthly cash budget, which would have allowed the bank to monitor performance more closely and take corrective actions earlier.
- The EWS system correctly identified the borrower's declining financial performance but the loan officer's inexperience coupled with an overriding desire to accommodate the borrower and avoid NPL recognition prevented him from adequately responding to the elevated risks.
- The restructuring of the loan represented an improper use of the moratorium tool. This option was designed to be used for short periods only to allow time to assess the borrower's financial condition. When the initial grace period expired, the bank should have conducted a full financial analysis and either restructured the loan based on the projected sustainable cash flows or referred the loan to the workout unit.