CORPORATE and SME WORKOUTS
A Manual of Best Practice
The IFC “Corporate and SME workouts: A Manual of Best Practices” was prepared by a team led by Davorka Rzehak and Risserne Gadbibe with the support of Shundil Selim. The team would like to thank Panos Varangis for his guidance and contributions.

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The IFC Risk Management Advisory program would like to acknowledge the Ministry for Foreign Affairs of Finland for supporting the knowledge management and dissemination effort in risk management, including the production of the present publication.
The manual has been written to address several needs in connection with the non-performing loans (NPLs) within a lending institution. It covers four main sections: (I) Things to Do Before a Loan Becomes a Jeopardy Case; (II) Preparing for Workouts; (III) Taking Charge of the Workout; and (IV) Loan Resolution Implementation and Follow-up.

For senior managers of lending institutions, the manual provides guidance regarding: (a) key considerations in setting up an NPL unit within the lending institution (pages 26 to 28); (b) best practice organizational arrangements for handling a sizeable NPL portfolio (pages 28 to 29); (c) applying triage in managing an NPL portfolio (pages 30 to 31); as well as special topics in managing distressed loan portfolios resulting from money-laundering or other criminal activity and widespread financial crises (page 57). For those staff within the financial institution with responsibility for dealing with and resolving problems in connection with individual clients or loan accounts, the balance of the manual covers many topics likely to be of importance to them, as well as a series of practical tools that they may find of use.

We anticipate that with time and with feedback from users of the manual, specific material will be added in future to cover the regional laws, institutions and practices which are particular to the different regions. We have attempted to point out in a few sections where such variations can be expected to occur.

We have provided, in addition to the table of contents, summary check lists at the beginning of each section to inform the reader as to the kind of information to be found in the section. The reader can use these checklists also in preparing him/herself for the more challenging workouts.
Executive Summary

Introduction

Bank loans can become “non-performing” because of problems with the borrower's financial health, problems with the design or implementation of lender protection features, or both. In ascertaining how to deal with a problem loan, it is important to distinguish between a borrower’s “ability to pay” and “willingness to pay.” Making this distinction is not always easy and requires effort. This manual was written as a guide for lending institution staff dealing with non-performing loans (NPLs) extended to corporations and small and medium enterprises (SMEs). It deals with both ad hoc and systemic financial distress and delves into how borrower problems may have arisen in the first place. It provides guidance to lending institutions’ staff responsible for handling individual problem loans and to senior managers responsible for organizing portfolio-wide asset resolution.

PART ONE: Things to Do Before Loans Become Non-performing

Since asset quality is important to the overall financial health of a lending institution, the manual provides guidance on loan classification and systems and procedures for detecting and acting on warning signs based on the performance of borrower entities. Several categories of typical signs of distress are presented with the caveat that when taken in isolation the significance of each of these signs can be ambiguous. Emphasis is placed on familiarization with each borrower in order to identify groups of warning signs which then can be mutually validating as the basis for proposing remedial action.

At the portfolio level, considerations for determining reporting requirements and frequency both for individual loans and for the overall portfolio are discussed, and specific portfolio actions are presented. A distinction is made between cases of isolated or ad hoc financial distress of borrowers and the wider incidence experienced during periods of macroeconomic (or systemic) financial distress. Specific recommendations for worthwhile portfolio actions to take during a financial crisis and a bank-wide portfolio housekeeping checklist are provided.

At the level of the individual loan, the priorities and behavior of borrower and lender entities and their officers as they diverge in connection with cycles of varying length are discussed. Specific topics and related checklists are presented for: frequently-found documentation deficiencies and flaws; notice letters; guarantees, completion agreements, and comfort letters; the types of issues to watch out for and mitigating actions in connection with lender liability; priority of claims; cash
conservation; and additional actions in connection with the borrower – the latter with special emphasis on the importance of communications and identifying stakeholders, the potential for diverging stakeholder interests and the modalities through which stakeholders can exert influence.

**PART TWO: Preparing for Workouts – Organizing the Handling of Corporate and SME Non-Performing Loans (NPLs)**

In preparing for workouts, it is important to know why the borrower is failing in order to determine whether the lender can afford to work with the borrower to find a proper solution or whether the lender should take control of any security and let others do a better job. The workout officer must become familiar with the particulars of the relevant bankruptcy framework through the institution’s legal department or local counsel. It is prudent for the workout team to involve a lawyer as early as possible and to make sure the lawyer is informed of developments as they occur. Involving legal counsel before decisions become binding is highly advisable.

Senior managers of lending institutions who may be considering introducing or modifying arrangements for setting up an NPL organization within their institution are given guidance. Responses from many banks in a number of countries suggest that there is merit in keeping the NPL unit as a cost center instead of a profit center as is sometimes proposed when lending institutions have developed institutional skill in the area of asset resolution. The manual further treats information that is needed for effective asset resolution, what this means for bank records and information system design and for applying problem loan triage based on practical and effective analysis, diagnosis and asset classification.

**PART THREE: Taking Charge of the Workout – Workout Tools and Workouts**

In the third part, considerations and building blocks that support identifying loan resolution strategy options are laid out. Beginning with the importance of client emotions (which can also apply to other stakeholders), the discussion deals with the analysis of stakeholder agendas during times of distress and then delineates going-concern solutions and solutions involving divestment. It then covers the main issues involved when a distressed borrower enterprise seeks or obtains new money.

This is followed by a detailed discussion of a conceptual tool developed by IFC for selecting problem loan resolution strategies. Using a two-dimensional framework, the user is shown how to analyze the adequacy of loan security (collateral) and the borrower entity’s prospective viability as a basis for choosing from among six groups of workout strategies. This framework is presented for both good borrowers, in which case the lender and the borrower still enjoy mutual respect and trust, and problematic borrowers, where the term “problematic” refers to a borrower considered to be hostile to the lender, untrustworthy, or both.

Since debt-to-equity conversion is important for workouts when the borrowing entity is unable to generate cash flow commensurate with the initial terms and conditions of the loan, the manual addresses such equity investments, including the use of warrants and solutions where lenders may be compensated with participation in future upside potential.
Several practically important topics in preparing for the workout, determining when a debt moratorium may be warranted and the nature of standstill agreements are presented. The role of mediation and the principle of fair burden sharing are also examined.

The manual discusses arrangements and responsibilities for launching the workout, the importance of protecting loan security during the workout and the value of, and the adjustments required in, preparing a liquidation balance sheet. The role of a new business plan together with supporting financial projections is discussed in detail as the basis for the workout team to prepare for workout negotiations. Related to these tools are the steps involved in pricing the workout and maintaining fall-back strategies, given the highly fluid nature of workouts. This part finishes with a brief look at ways to protect against or deal with suspected money laundering or other criminal activity.

PART FOUR: Loan Resolution Implementation and Follow-up

The manual provides practical advice regarding the documentation that is essential for an effective workout. The main documents in the set include: the term sheet for the restructuring proposal, the loan agreements, the security agreements, and the ancillary agreements.

The main factors for how to account for problem loans are discussed, recognizing that the workout team must be cognizant of local accounting rules.

Finally, a few practical recommendations for important monitoring performance in accordance with the restructuring agreements once the new workout “regime” has been put in place. Although the monitoring function will need to address several aspects, the tracking of both how and when cash is generated is important.

This manual is a tool that users either preparing for a workout or in the midst of one can readily access information via the checklists provided for each section.
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Bank loans can become “non-performing” when the borrower’s financial health declines from what it was at the time the loan was extended. Non-performance can also occur if the normal lender protection written into loan documents was deficient at the time the loan was originated. And it can occur for both reasons simultaneously.

When the main causes of payment arrears are related to the financial health of a borrower considered to be a good client of the lender, we assume that the problem is mainly the borrower’s “ability to pay.” However, when the borrower’s character or attitude becomes suspect or hostile, the problem is then seen as the borrower’s “willingness to pay.”

However, the emotional and psychological aspects of borrower and creditor interactions during situations of financial distress tend to complicate matters to the extent that “ability” and “willingness” to pay cannot always be distinguished. If a borrower facing financial difficulty feels he has been unfairly treated by his lenders and shows anger or frustration, is he a devious character and therefore not creditworthy? Or is he someone who deserves redress of grievance? The answers are not always clear. We may need to dedicate significant time and effort to finding out whether the borrower truly lacks the financial means to keep his loan payments current (“ability”) or is simply hoarding cash (“willingness”).

Judgments as to whether a payment problem is the result of either “ability” or “willingness” to pay are inevitable in selecting a loan resolution strategy. Therefore, the quality of such judgments is important in determining the efficiency and effectiveness of our loan resolution efforts.

Behavioral and character attributes are also important. Because most of the information that lenders have about a company comes from the company itself and its principal owners, it is important to ascertain any possible sources of character-related bias in assessing the borrower’s financial health and profit-making potential. Even where the information appears to have been distorted, our ability to distinguish between deliberate efforts to deceive and borrower self-deception can make a big difference in finding the right approach to a resolution.

This manual was written to help lending institution staff who deal with non-performing loans (NPLs) extended to corporations and small and medium enterprises (SME), as well as loans showing any kind of distress, from early signs of payment problems to full-blown default. It deals with both ad hoc distress felt by individual companies and the systemic distress produced during macroeconomic financial crises.
In addition to addressing the “how to” aspect of dealing with NPLs, this manual helps portfolio and workout staff understand the important “why” of underperforming loans. To find solutions and apply the tools, it is important to realize how the problem arose in the first place. Therefore, the manual also provides some background information about how the problems may have arisen in the first place, how they may be identified, and how they should be seen against the background of the economic and legal realities.

For senior managers of lending institutions, the manual provides guidance regarding:

- Key considerations in setting up an NPL unit;
- Best practices for handling a sizeable NPL portfolio;
- Triage for an NPL portfolio; and,
- Special topics in managing distressed loan portfolios resulting from money-laundering or other criminal activity and widespread financial crises.

We recognize that the laws, courts, and legal systems, especially relating to bankruptcy, vary from one country to another. However, we believe that the guidance offered will be useful in most situations.
1.1 At the portfolio level

1.1.1 Loan classification systems

The health of a financial institution largely depends on the quality of its assets – including the loans it extends. Loans typically involve credit extended on the basis of a contract that is held by the originating institution until maturity. It is therefore good international practice and most countries require banks to classify their assets, especially loans, in one of five categories:

1. Acceptable – a loan with no detectable problems, in which the associated risks are unlikely to materialize over time.

2. Special Mention – a loan with material weakness that nonetheless does not warrant the expectation of a loss or a substandard classification.

3. Substandard – a loan for which neither the borrower’s financial condition nor the security or collateral package backing the loan would be adequate to protect the lender from loss.

4. Doubtful – a substandard loan with the added risk that any attempts to liquidate value and to collect on it are unlikely to generate enough to recover the lender’s capital.

5. Loss – a loan deemed uncollectible, because any assets backing the loan are gone or have lost their original value, and the borrower’s means to repay the loan are impaired. The loan may still have salvage value, but the effort required to realize that value is beyond that considered reasonable, which justifies the lender writing off the remaining outstanding balance.

Some financial institutions use additional categories, which should take into account the readiness of the organization to prescribe remedial or informative actions in connection with the extra categories. If the institution’s formal response to changes in loan classification is basically the same for each category across a wide range of loan classification categories, then the value of those extra categories may be questionable. In fact, they may consume too much of the staff’s time in trying to refine the classification with no real differentiation based on purposeful action or response.
1.1.2 Disseminating bank-wide guidance on warning signs and indicators

An important feature of any sound risk management system is consistent treatment of individual loans and borrowers across the entire portfolio. If the staff are free to pick and choose which factors they deem important with no guidance as to a common approach, loan assessments could then vary across the classification spectrum. Without guidance as to the significance of different warning signs and how to apply this information to assigning loan categories, even the most ambitious loan classification system can produce questionable information.

Best practice entails broad dissemination of the signs indicating potential borrower distress and delinquency. One way of categorizing warning signs is according to a company's:

1. Operations
2. Behavioral and management aspects
3. Reporting
4. Investing activities
5. Financing activities

The figure below shows some of the more common signs of borrower and loan distress. When taken alone, many of these signs may not indicate problems or they may be temporary. Often, only analysis allows us to observe combinations of signs that may validate the warning of ongoing or potential distress.

1.1.3 Signs of distress in the borrower and in the loan should be seen in combination

The process of accurately diagnosing a borrower’s financial condition involves identification of groups of warning signs that validate one another. Taken alone, most warning signs are too ambiguous to signal financial distress.

For example: Company ABC has experienced a recent acceleration of sales over the past several quarters and you question the company's CEO on this point. The CEO in turn questions why you are asking about such an obvious sign of success. Without additional information, you are not in a position to argue for an alternative interpretation. However, if any of the following warning signs were observed in conjunction with the rapid increase in sales, the story they would tell would be quite different:

1. Declines in profit margins – might signify that the higher sales were achieved from prices that are too low, overly generous discounts or rebates, higher selling costs, or some combination thereof.

2. Pronounced increases in product returns – might indicate that higher sales resulted from lapses in quality control, which would have a negative impact on profits, with a time lag as dissatisfied customers return their purchases. It could even involve government-enforced product safety recalls.

3. Pronounced increases in the aging of accounts receivable – might identify additional sales achieved by extending store or company credit without adequate credit scrutiny or safeguards. The additional costs of collection and losses on extended credit could have a negative impact on company profits with a time lag.
PART ONE: Things to Do Before Loans Become Non-performing

Warning Signs

Operations
1. Steady decline or rapid increase in sales
2. Frequent cash shortages
3. Significant changes in net working capital
4. Unexpected changes in strategy or business
5. Shrinking cash margins and unexpected losses
6. Unrealistic pricing/discount policy
7. Frequent revenue/earnings shortfalls
8. Increasing dependence on fewer customers
9. Negative operational cash flow with net profits
10. Deteriorating accounts receivable
11. Increased credit to affiliated companies
12. Lengthening terms of settlement for payables
13. Repeated changes in suppliers
14. Insufficient cash to take trade discounts
15. Inventory buildup with turnover slowing
16. Outmoded production or distribution system
17. Inadequate spending on critical activities
18. Failure to pay taxes
19. Non-renewal or cancellation of insurance
20. Billing practices are deficient

Management and Behavior
1. Poor or deteriorating sponsor reputation
2. A lack of management/sponsor vision
3. Increasingly authoritarian management/board style
4. Senior executives not providing financial information
5. Incompetent finance director or CFO
6. Management experience/skill deficiencies
7. Management and shareholder contentiousness
8. Frequent changes in ownership and key positions
9. Sponsors/managers’ unexplained new wealth
10. Quarrels between company and its auditors
11. Notable shabbiness/loss of pride in company
12. Personal issues constraining management team

Reporting
1. Worsening delays in financial reporting
2. Poor quality of, or inconsistencies in, reports
3. Qualified audit opinions and/or audit disclaimers
4. Unexpected and/or untimely changes in auditors
5. Many unusual items in financial statements
6. Revaluation of assets without convincing explanations
7. Padding of financial statements (mainly on the Balance Sheet)
8. Increasingly changing interim financials with surprises
9. Major unexplained planned vs. reported results gaps
10. A deterioration in ratings by external analysts
11. Regular breaches of financial covenants
12. Increasing incidence of waiver requests

Investing
1. Non-current assets increase faster than revenue/profit
2. Major procurement without proper rationale/financing
3. Working capital needs funded by asset sales
4. Inventory build-up without sound inventory controls
5. Seemingly speculative inventory purchases
6. Inadequate maintenance of plant and equipment

Financing
1. High or increasing levels of financial leverage
2. Increased short-term funding for long-term liabilities
3. Difficulties in accessing financing
4. Excessive lending to related individuals/affiliates
5. Obligations to creditors not fully met each cycle
6. Increasing customer/creditor complaints/legal action
7. Funding secured on less favorable terms
Many of these signs of distress can be objectively determined. But this is not always the case and the combination of signs of distress will require some knowledge of the industry and most certainly some, occasionally subjective, judgment. The experienced lender will also identify more subtle warning signs to reinforce objectively determined facts in arriving at a judgment. This is why personal contacts between the lender and the borrower are so critical: body language can be stronger than written language or numerical reports.

### 1.1.4 Loan and loan portfolio reporting requirements and frequency

Portfolio staff should be given clear instructions regarding the frequency and topical coverage of portfolio supervision or monitoring reports. Such supervision reports typically include:

1. **Loan terms, loan and interest payment history, borrower attributes, security profile** – Addresses who was intended to use the credit and why, relating the borrower’s main characteristics to the nature of the business or project.

2. **Credit risk review** – The review is an analysis of the risks affecting the borrower’s ability to repay. It includes industry risk, country risk, legal risk, operational risk, etc., along with factors that might influence willingness to repay the loan.

3. **Liquidity risk review** – For borrower company’s assets and liabilities, with particular attention focused on the actual liquidity of those shorter term assets on which the borrower will likely depend to meet his regular cash requirements.

4. **Market risk review** – Pertains to the risks inherent in the markets for the company’s obligations (debt) and other claims on its cash (equity).

5. **Security/collateral adequacy review** (discussed below)

6. **Adequacy of the information systems** – Provides regular information on the above points.

The different frequencies and levels of detail related to loan and loan portfolio reporting will vary in terms of costs and benefits. Best practices usually involve comprehensive portfolio reviews held semi-annually, with more focused reviews quarterly or monthly, depending on the extent to which the portfolio has loans in jeopardy and shows signs of other loans having potential for future problems. Well-focused reviews can help make sure that loan monitoring does not create a cost burden or demand excessive staff time. “Focus” is driven by the quality and effectiveness of the bank’s loan classification system and its guidance regarding warning signs. It should also cover all relevant areas of risk management. In fact, these systems and processes are best viewed by bank management and staff as incomplete work-in-progress, to be fine-tuned through continuous feedback. It is crucial to prioritize well before the first signs of distress actually crystallize.
1.1.5 Portfolio-level actions

The lender should ensure that its information systems have the right balance between entity-level (borrower, loan, property) information and portfolio-level information. Information such as the number of loans outstanding with a single obligor or company group – or the number of loans that involve co-lending or counterparty risk with another financial institution – may be just as important for risk management as being able to drill down to yet a further level of operational or financial detail for an individual borrower. This may become even more important during a financial crisis. Lenders should also be able to distinguish between those key currency-denominated loans that were extended to exporters or other borrowers in emerging-market countries who are more likely to have their own sources of foreign exchange, versus those borrowers taking advantage of the “carry trade” in the same countries but who will likely have to queue up at their country’s central banks for stronger currencies in order to service their overseas debt payment obligations. Reducing system blind spots before a financial crisis unfolds will make it easier for management to protect value during difficult times. When faced with a systemic financial crisis, staff are unlikely to have time for the broader information-gathering necessary to improve a portfolio.

Just as troublesome is information that is incorrect or inconsistent. This problem often results from rapid institutional growth, which can in turn result in fragmented information systems that lack data integrity controls. Barton, Newell, and Wilson have identified five actions that management should take while business conditions are relatively calm; these can be modified to apply to lending institutions:

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<td>Look for the warning signs</td>
<td>Develop both formal and informal information sources in connection with warning signs. Learn to spot sources of value destruction, build-up in short-term borrowing, likely formation of asset bubbles, and other sources of financial imbalances.</td>
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<td>Develop a crisis management mind-set</td>
<td>Develop a coordinated crisis response through training, especially workshops and simulations.</td>
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<td>Reduce financial mismatches and strengthen funding sources</td>
<td>To ensure a stronger cash flow position, identify ways to ensure sustainable levels of financial leverage and strengthen funding sources. Other actions include lengthening funding maturities, hedging major financial gaps, tracking financial health of creditors and borrowers, diversifying funding sources, and lining up additional credit.</td>
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<td>Ensure that borrowers safeguard the supply chain</td>
<td>Give special attention to supply chain discontinuities or problems. For key and particularly crucial inputs, arrangements for securing alternative sources or substitutes should be in place.</td>
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<td>Put alternative scenario and contingency planning processes in place</td>
<td>Preparing for crises by setting up a framework within which a variety of macro and micro alternative events and parameters are examined in light of their potential impact on the lending institution and potential mitigation strategies.</td>
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1.1.6 Establishing transfer criteria

There are multiple organizational possibilities for handling problem loans. Most lending institutions handle extreme cases of jeopardy in one of three ways:

1. The loans are sold;
2. The associated loan collateral is liquidated and the loan is paid from proceeds; or
3. Loans are worked out (usually involving some type of loan rescheduling or restructuring).

When the lending institution is a depositary institution such as a commercial bank, the earliest signs of difficulty are met with aggressive provisioning and write-offs because of stringent regulatory requirements. However, to the extent that NPLs remain on the lender’s books, the way in which the residual value is managed tends to vary.

In normal times, the pressure to book new loans amplifies the tendency to transfer problem loans out of the unit as quickly as they appear, usually to a specialized workout or recovery unit. This allows loan origination staff members to concentrate on meeting annual new business targets. In lending institutions that have loan origination and loan supervision handled by separate internal groups, and where there is also a separate workout/recovery group, these transfers from the portfolio group to the workout group are less automatic.

A well-thought-out and well-understood set of NPL transfer criteria and procedures can ensure that the right skills are brought to bear on problem loans before their condition deteriorates or problems become intractable. This is because:

1. Objective criteria for workout professional involvement is industry best practice.
2. Transfer of responsibility out of normal client relationship management ensures consistency and transparency in the corporate approach to workouts.

The table below offers examples of some of the considerations regarding criteria for NPL transfers. The lending institution may want to set a local or a convertible currency value threshold below which transfer of responsibility is not usually required on cost efficiency grounds. However, to the extent that any of the conditions described below pose serious risk to the lender, consideration should be given to relaxing the value threshold.

### Conditions for triggering a transfer could include a loan with an outstanding balance above the threshold and any of the following:

1. A loan classification of “substandard” (or worse);
2. A loan classification of “special mention” if syndication is involved and/or reputational/legal issues are at stake;
3. Actual payment default to the lender of above some “prudent” default threshold (set to avoid very small payment irregularities) that has been in effect for a minimum time (often 60 or 90 days). Financial institutions should have a much shorter period as assets can disappear much more rapidly;
4. Evidence or reliable knowledge of significant payment default to other creditors (with similar thresholds as above);
5. A request made by a client to the lender or to any of the client’s other creditors for a standstill agreement, a rescheduling, or a restructuring of the client’s debt;
6. A failure of a previous rescheduling or restructuring;
7. An indication of an imminent major default or materially adverse event, including government intervention or nationalization, notice of termination of operating license or concession, significant external rating downgrade of client or guarantor, sudden plant closure, etc.;
8. Transfer of the loan by co-lenders or other members of a lending syndicate to their loan resolution or recovery unit, or sale of exposure to a distressed asset fund;
9. Bankruptcy or liquidation proceedings begun against the borrower or guarantor;
10. Litigation, arbitration, mediation, or other dispute resolution mechanism involving or affecting the lender; or
11. Evidence or strong suspicion of corruption or illegal activity involving the borrower or the borrower’s other stakeholders.
1.1.7 Warning signs for systemic distress

Systemic distress occurs in an economy in which general financial payment obligations in the aggregate cannot be met as contracted from normal sources of liquidity, such as operational cash flows, orderly disposal of liquid assets, and conventional funding sources. When systemic distress reaches the equivalent of a financial flash point, it gives rise to a financial crisis, and the usual treatment of financial obligations as a collection of contracts subject to contract law breaks down. Government may try to resolve financial problems rather than leave them to the free market.

Some of the most common macroeconomic warning signs for a country include:
1. Chronic and growing public sector deficits;
2. Chronic and growing public sector indebtedness;
3. Weakening external debt-servicing capacity;
4. Rapid and sustained depletion of foreign exchange reserves;
5. Adverse changes in terms of trade; and
6. Signs of asset price bubbles.

Warning signs within a country’s financial sector can signal a future financial crisis:
1. Evidence of growing non-performing loans within the banking system;
2. Foreign exchange/maturity mismatches on bank balance sheets;
3. Significant deviations from Basel II guidelines evident within many of a country’s banks;
4. Relaxation of banking regulations; and
5. Increase in numbers of insolvent banks.

Box 1: Example of Faulty Documentation

After the filing for bankruptcy of a major industrial enterprise, the bank’s legal department, as it was preparing for further legal action, found that the principal document (i.e., the Loan Agreement) had only been signed by the then-CEO. The Articles of Incorporation of that company clearly indicated that all principal documents of the company needed to be signed by at least two members of the Management Board. The bank then had to prove that there had in fact been an agreement between the enterprise and the bank on the loan and its conditions. The bank was lucky that it was able to do so with other documents, correspondence, and statements by witnesses. The bank eventually prevailed but the incident caused unfortunate delays in the legal procedures.
1.1.8 Understanding how systemic distress differs from isolated (or ad hoc) distress

When the markets in which lenders’ clients normally operate are marked by financial crisis, lenders may consider modifying their responses in the following areas:

1. Loan collateral loses protective value as widespread illiquidity affects asset markets
2. Counterparty risk becomes more important, as even strong institutions can fail during a financial crisis
3. Widespread uncertainty and prospects of government debt forgiveness can cause good borrowers to stop servicing their debt obligations as they build up a cash war chest and avoid making payments that they believe might forestall some benefits of anticipated debt relief
4. Borrower companies should consider the financial health of key suppliers and customers during widespread financial crisis differently from borrower distress that occurs as an isolated event

Appendix 2 presents further explanation of how widespread distress during a financial crisis affects borrowers and lenders in ways not usually seen when problems are ad hoc or isolated occurrences.

1.1.9 Portfolio-level actions during a financial crisis

During widespread financial distress, several actions are recommended at the portfolio level:

1. The lender’s legal department should review all loan collateral for “enforceability”
2. Portfolio staff should update collateral valuation, taking into account changes in asset markets brought on by the crisis with particular regard to the current state of liquidity in those markets
3. The lender’s financial operations unit or accounting department should provide all portfolio staff with up-to-date breakdowns of all loan amounts outstanding and falling due, including accrued interest, penalty interest, loan amounts in arrears, arrears broken down by number of days outstanding, reimbursable expenses related to loan recovery, and any other amounts owing.

Box 2: Example of Deficient Security

After a loan to a local service provider in a Middle Eastern country had gone into non-performing status, a representative of the recovery unit of the financial institution visited the country and visited the local lawyer. When the lawyer saw whom he was dealing with, he went white as he suddenly realized that he had not perfected the security on that loan, consisting of a first-ranking mortgage on certain properties. As it transpired, the financial institution had purchased the loan from a local bank. The intention was to transfer registration of the security to the name of the new lender. In this country, there is by law a “suspect period” of not less than three years. A transfer of security within three years before a bankruptcy ran the risk of not being recognized by the bankruptcy court and the security becoming null and void. If that happened, the financial institution would become a mere unsecured lender among many. Fortunately, the financial institution could sell its loan to a second-ranking local bank that may have understood the situation but was anxious to perfect its own position. Needless to say, the financial institution was in a much weakened negotiating position.
1.10 **Bank-wide portfolio housekeeping checklist**

During a financial crisis, having up-to-date information on the full status of all loans in the bank's portfolio is indispensable. Quite often, when a country's financial or banking sector enters a period of turbulence, staff members of lending institutions consider any activities that divert their attention from dealing with their troubled loan accounts as a costly distraction. However, taking action on the basis of incomplete information or knowledge can be highly risky and may result in losses that could have been avoided if staff members had dedicated some time to “portfolio housekeeping activities.” The lending institution should assign priority during calm times to completing as many of the housekeeping tasks as possible, and they should be completed as quickly as possible at the first sign of impending financial crisis. Good information on problem accounts allows lenders the opportunity to take action earlier and offers the opportunity to choose from a better range of resolution strategies. Early detection of potential problems can improve the likelihood of better recovery outcomes.

Some of the more important housekeeping actions are listed in Appendix 3.
1.2 At the level of the individual loan

1.2.1 The project and loan cycles, personal behavior, and the dynamics of divergence

A major complication in a financial workout is the fact that relationships evolve. To start with, the business enterprise grows through the owner’s hard work into a small company and, eventually, a larger corporate entity. At the financial heart of the enterprise will be the financial decision maker – the owner, the bookkeeper, a professional financial director, or the Chief Financial Officer (CFO).

At some stage, the enterprise will need additional money to pursue a project, with financial aspects taken into consideration. In developing a financial plan, the financial decision maker may find that the project will require more funds than the enterprise has immediately available and therefore will seek a lender for loan funding. The relationship with the prospective lender has its own life cycle.

At the lending institution, the financial decision will first lie with the liaison with the client, usually a Loan Officer. The CFO and the Loan Officer will go through a series of negotiations, get to know each other, and learn to understand each other’s concerns. Their relationship does not end with the signing of a contract, because documents must be registered, waivers provided, etc., so that the CFO and the Loan Officer will remain in regular contact. Once the loan is disbursed and the enterprise starts implementing its project, however, they will have only sporadic contact when there is additional business. Over time, as people change jobs or retire, other individuals could fill their positions.
Should the enterprise eventually suffer a financial set-back, the CFO – who may be someone other than the original CFO – will have to revive the relationship with the bank, this time under far less pleasant circumstances. Initially, the bank is forgiving and prepared to accommodate. After the first payment default, an early attempt is made to reschedule the loan. However, there may be circumstances in which the situation deteriorates to where the bank has to call in its workout team. In this situation, contacts are more frequent, but the circumstances have changed dramatically, particularly when the Workout Officer, with no historical ties to the enterprise, takes over the relationship.
The above example shows how what could begin as a congenial personal relationship between a CFO and Loan Officer can develop into a touchy relationship between the CFO of a losing enterprise and the hardnosed workout officer of a lender. The institutional memory of what transpired at the time the loan agreements were signed will be reduced to what is written on paper, which is reason for making sure that there is always a paper trail. Very often in workouts, the representatives of both sides will remember verbal consents, waivers, or approvals that were, in reality, never granted and will have forgotten verbal promises that were not delivered upon.
1.2.2 Frequently-found documentation deficiencies and flaws

Following are some of the most common errors or deficiencies in connection with corporate loan documentation:

**Errors**

1. Failure to register security or registering the wrong security
2. Failure to notarize documents as required
3. Failure to perfect a security interest in the pledged collateral
4. Failure to detect prior encumbrances on assets offered as collateral for a loan transaction
5. Failure to include in the legal documentation adequate triggers that may be tripped as a result of deterioration in loan-servicing performance and in connection with the financial health of the borrower, as well as possible actions taken by the borrower
6. Failure to name the lender as a beneficiary on the borrower’s insurance policies
7. Failure to hold motor vehicle title where vehicles represent collateral
8. Failure to notify absolute guarantors of major documentation changes, dollar limits, or special notice provisions in connection with guarantees
9. Failure to include covenants requiring the obtaining and updating of key financial or net worth information on guarantors
10. Failure to have key documents signed by all of the proper authorized persons required by local company law or the borrower’s own articles of incorporation
11. Failure to obtain rent assignments or verification of borrower’s right to occupy real estate collateral
12. Failure to include covenants obligating the borrower to keep appraisal information up-to-date and to bear the costs of appraisal

Always try to deal from a position of strength. Specifically, once documentation deficiencies have been identified, bank staff should avoid bringing these to the attention of the borrower unless it is in conjunction with a request from the borrower for special consideration, usually in the form of a waiver request or a request for a payment stand-still, rescheduling, or financial restructuring. This presents the opportunity to deal with the deficiencies in a way that is less likely to give the borrower the idea that there would be advantage in exploiting what they may perceive to be a weak lender’s position.

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1 This section has been informed by and adapted from RMA, The Workout Manual, pages 5-7.
1.2.3 Notice letters

It is not enough for lenders to originate a loan to a corporate or SME borrower and then rely on the language in the loan agreement. Lenders must also exercise discipline, caution, and equanimity in their communications with borrowers, both oral and written.

Dunning letters – Normally associated with lenders’ demands for payment, these should also be applied to any of the following areas in which the lender considers the borrower’s action or performance to be unsatisfactory:

- Failure to pay principal and interest on a timely basis;
- Failure to pay as contractually agreed outstanding penalty fees and/or interest;
- Failure to provide contractually agreed information on a timely basis; and
- Failure to pay on a timely basis such obligations as property taxes, insurance premiums, etc.

It is important to keep such notifications current in order to protect the lenders’ legal position. Although courts can be reluctant to enforce loan foreclosure on borrowers for actions other than payment default, in many jurisdictions even technical defaults may be actionable if the lender can show that it provided reasonable and repeated notification that was disregarded by the borrower. The lender should have examples of dunning letters with varying degrees of stern language depending upon the number of
previous notifications sent and the borrower’s response. Although national laws and regulations vary, the lender should avoid unnecessary threats, as well as emotional, unfairly heavy-handed, or discriminatory language. In addition to being legally questionable, emotional and threatening language risks loss of credibility among borrowers and the business community. This is especially true when there is a lack of follow-up. Therefore, lenders should consult their legal counsel. In addition, the lending institution should have a uniform approach to such letters, though some degree of customization may be necessary.

**Acceleration letters** – It should always be clear that the lending institution is sending out the acceleration, rather than an individual employee. Acceleration is a formal action and should conform to the institution’s established procedures. The acceleration letter should reflect the specific requirements of the lender-borrower relationship and should be handled with care. It is important to record the sending and receipt of an acceleration letter, such as by certified mail or any form of mail delivery that requires the recipient’s signature.

**Set-off letters** – While set-off is normally addressed in the original loan documentation, a lender experiencing payment default should apply those assets of the borrower subject to set-off to outstanding debt in a way that conforms with local legal requirements. Once demand and acceleration notices have been sent, the lender should send a “set-off letter” that clearly establishes which resources have been used to set off outstanding debt and how these have been applied, as well as the resulting impact this has had on the remaining outstanding liabilities of the borrower. When current accounts or facilities with revolving lines of credit are applied during set-off, the lending institution should close those accounts and notify the borrower in the set-off letter. It may be appropriate for acceleration and set-off to be treated in the same letter. If a multi-lender workout is contemplated, set-off arrangements will be an important topic particularly as to whether assets normally available for bilateral set-off should be left on the table for distribution among the various creditors to a workout in ways that vary significantly from strictly bilateral situations. Early agreement will help avoid the risk that unilateral application of set-offs is not seen as a hostile or pre-emptive strike.

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2 It is important to know the local laws regarding set-off. In many jurisdictions, the essence of set-off is mutuality. The debts of two persons eligible for set-off must be owed to one another in order to be offset. The debts furthermore must be liquidated. Set-offs arise out of an exercisable prerogative and are not automatic rights. Certain setoffs may constitute voidable preferences if they occur within a number of days prior to the filing of a bankruptcy petition. In such a case, the voidable preference could entail the paying of certain obligations with available cash that may subsequently be deemed subject to proportionate sharing with all creditors in accordance with bankruptcy requirements. Furthermore, there is no burden of proof regarding intent or the occurrence of fraud.
Lending institutions should make every effort to have the appropriate templates and guidelines for such letters in place in advance of major workout activity.

1.2.4 Guarantees, completion agreements, and comfort letters

Guarantees – Guarantees are a type of loan enhancement in that they reduce the impact of non-payment of a particular loan, providing an alternative means for the lender to seek loan repayment.

Box 3: The Nature of Security

To make sure that the project that it was financing would indeed be completed, an international bank signed an agreement with the shareholders of an industrial enterprise stating that the bank would provide additional funds to the enterprise in the event of a shortfall in cash flow or if other planned financing would unexpectedly be unavailable. The bank demanded this so-called Project Financing Agreement in the belief that this would provide further coverage, and even inserted a statement that it could, on behalf of the enterprise, call on the shareholders to deliver on their commitments. The bank failed to recognize that (1) such agreement would be interpreted by the local courts as an agreement to benefit the enterprise, and the bank taking the money directly from the shareholders would hardly seem to be in the best interest of the enterprise; and (2) while there seemed an irrevocable commitment of the shareholders toward the bank, such commitment was not strong enough for the bank to pursue the shareholders and seize their assets.

Lenders managing guarantees should consider the following actions:

1. Require periodic updated financial statements from guarantors
2. Insist on either replacement collateral or compensating collateral in the event that guarantor assets appear to have been transferred beyond the reach of the beneficiary or that their value as loan enhancement has decreased
3. Avoid overreaching guarantees that may weaken the lender’s position due to the unrealistic nature of the liens or obligations that have been imposed
4. Be mindful of liens or pledges to others in connection with each guarantor’s assets; an unsecured guarantee favoring the lender will rank after the guarantor’s other secured lenders or counterparties
5. Be aware of the reputational risk or potential for embarrassment of certain types of guarantees in terms of amounts involved and the potential for adverse news
6. Avoid language in loan agreements that would absolve guarantors of responsibility or liability prematurely
7. Before releasing a guarantor from responsibility, identify any recourse the guarantor may have to “claw back” arrangements
8. Know the law of the jurisdiction in which the guarantee is being exercised as to whether you can pursue both the borrower and the guarantor simultaneously or if this must be done sequentially
9. Know each guarantor’s financial capacity to honor existing guarantees and to provide additional guarantees or security. This includes spelling out specific obligations of guarantors with respect to providing relevant information periodically or in response to specific events.
There are two main types of guarantee: **demand guarantees**, which do not require proof of default to be initially called; and **surety guarantees**, in which the beneficiary of the guarantee must prove that default has occurred before calling the guarantee.

**Completion agreements** – In a completion agreement, the borrower pledges to provide additional financial resources in the event of any project cost overruns. Generally, the beneficiary of a project completion agreement is the borrower company, which therefore must make the call. If a startup company is in dire financial distress, a court may find that a call on a project completion agreement may be inappropriate as it may be tantamount to “throwing good money after bad.” Even where the additional funding could arguably be applied to project completion, this may preclude having those funds go to paying down debt principal or interest in arrears.

**Comfort letters** – These letters are a way of recording intent but tend to “lack teeth” from a legal perspective.

### 1.2.5 Lender liability (LL) issues and ways to reduce LL risk

A lender can minimize its risks of liability by heeding the suggestions below:

- Keep to both the letter and the spirit of agreements.
- Make sure your conduct is consistent with the rights you intend to pursue and exercise. If you intend to change your legal posture and course of conduct, give reasonable notice to those parties materially affected.
- Ensure that your actions and conduct would be perceived as fair by a “reasonable person.” This is not to say that counterparties with vested interests will always perceive your conduct as fair and reasonable. However, if your actions could not convince a hypothetical arbiter, judge, or jury, you may be leaving your institution open to liability.
- Encourage the institution’s management to be clear and transparent about major policy changes to avoid undermining your negotiating position.
- Avoid insisting that borrowers meet unreasonable milestones or hurdles.
- Avoid taking an active part in the management selection process.
- Do not assume control or responsibility for the day-to-day operations of the borrower enterprise or any part thereof even if you are concerned about how it is currently being run. Written instructions may show excessive involvement in the day-to-day management of the borrower’s affairs and undermine your bank’s legal position and defenses against legal liability.
- Stay vigilant with respect to potential sources of priority claims, such as the need to dispose of hazardous waste, outstanding payroll obligations, etc.
- Treat all client information confidentially and ensure that any disclosure is within the scope of both the law and your institution’s privacy policies.
- Avoid making written or oral statements to outsiders and clients that could be construed as admission of fault on the part of your institution; avoid misleading statements and do not engage in “venting” against your lending institution. If the relationship with your borrower becomes strained in future, your own words can come back to haunt you.
• Make sure that all staff dealing with the institution’s clients behave appropriately. If necessary, reassign staff to remove the potential for liability.

• For outsourced services, review contractual arrangements, scope of work, and public perception of the relationship to limit the potential for liability arising from the actions of third parties.

• Never write or say anything that could be construed as relinquishing of your institution’s rights. Make prudent distinctions between what may be deemed a material breach of covenants and what may be considered a technical breach or default.

• If a borrower representative is making threats or is otherwise insinuating that the company might seek damages or take other such legal action against your institution, take good notes and make sure that you have witnesses present when feasible during important meetings.

• When executing formal actions against a debtor, make sure that you are aware of any conflicts of interest within your institution, then remove the conflicts or consult legal counsel.

• Make sure your institution complies with policies and procedures for dealing with criminal violations and suspicions of criminal or illegal activity. When evidence of criminal activity goes beyond unsubstantiated rumor or intuition, make sure the appropriate authorities are informed and that such notification is well documented.

• Avoid comingling borrower assets comprising your institution’s loan collateral with other assets.

• Do not apply covenants to demand loans. Instead, make sure that your surveillance and monitoring of the loan is adequate. If the borrower’s behavior is a matter of concern, remind them that your institution has the right to demand repayment of the loan at any time. If covenants are considered necessary, you should consider replacing the demand loan with a fully-covenanted term loan or facility.

### 1.2.6 Understanding priority of claims

Liquidation in most jurisdictions is guided by law regarding how the proceeds of borrower payments are to be applied in a particular sequence of priority.

A typical payment “waterfall” includes the elements in the accompanying box. Claims paid out of liquid resources may not readily reveal their payment priority as long as a borrower has sufficient liquid resources to meet all of those needs simultaneously. Illiquidity, however, reveals payment priority as an insufficiency of cash to meet all needs within the payment period and raises the issue of which claimants should absorb the payment shortfall. The loan documents should be specific regarding priority. To the extent they are not clear, prevailing law in the contract’s jurisdiction of choice should be the guide.

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1.2.7 Seeking cash conservation before new lending

If a company shows signs of financial distress and is also hemorrhaging cash because of an absence of financial controls and questionable spending patterns, its efforts to raise additional funding to alleviate the distress will be misdirected. Raising funds in the continuing presence of financial sloppiness or profligacy only reinforces such behavior and amounts to tacit approval. Therefore, before any decisions are made to secure additional funding, the lender will want to review the borrower company’s operations to help identify areas in which savings can be achieved and which would free up cash from its current uses. The lender could advise a borrower company to do several things before it turns to investors for additional debt financing:

1. Make a stronger effort in the collection of receivables
2. Delay those payments that can be delayed without adverse consequences
3. Look for innovative ways of reducing operating costs
4. Eliminate non-profitable product lines or units
5. Sell non-essential or non-core assets
6. Sale and lease-back of larger core assets
7. Reduce wages and salaries, the number of employees, bonuses, perks, etc. The key is to generate the most cash for the least adverse consequences –cut fat, not muscle
8. Raise equity or junior debt

Checklist:
- Know how to raise additional cash
- Utilize daily cash report and forecast of weekly cash requirements
- Avoid unanticipated cash shortfalls
The lender should recommend that the borrower company review its cash position through a daily cash report and a forecast of weekly cash requirements.

Annex 2 presents a possible format for the daily cash report.

The presentation in Annex 2 allows the borrower company’s management and the lenders to see the sources and uses of cash on a daily basis and detect any change in the number of orders booked and associated shipment backlog. A decrease would reduce the demand for daily cash while an increase would call for more working capital. The report also shows the extent to which operations and financing activities are sources of cash generation and of cash demand. Annex 2 allows operational priorities to be identified to meet best-estimate needs for the week ahead.

### 1.2.8 Additional actions in connection with the borrower

To the extent that the borrower lacks the means or ability to control its cash, lenders with the right to do so might consider taking control of the borrower company’s accounts receivable. This can be done through a “lock box” with a cash sweep that can be administered by the lender’s staff, a specialist consultant, or an outside trustee. Pay particular attention to invoicing and the process of collecting receivables through daily monitoring. The lender must both ensure that adequate controls are implemented and avoid being fully in control of the borrower’s business, due to the risk of lender liability.

#### Identifying conflicts of interest among stakeholders

Company stakeholders are often in situations in which they have a conflict of interest. As early as possible once a corporate or SME borrower has been identified as either a problem or a potential problem, it is useful to undertake an analysis of the following:

- All of the company’s stakeholders;
- Their representative bodies;
- A full description of the nature of each of their “stakes” and, with those who may have multiple stakes, which stake is likely to most affect their decision making;
- The payoff relationship inherent in each stakeholder’s interest in the company; and
- A description of the nature of any major conflicts of interest that the company might have.

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4 This section draws extensively on the valuable work presented by Tommy M. Onich of Turnaround Management Association (TMA) in his October 27, 2009 article: “Cash Management in Distressed Organizations.”
Stakeholders and corporate governance in situations of financial distress

Many company boards still have directors who address each matter for board consideration from the narrow perspective of their own institution’s interest instead of the well-being of the company or its shareholders. The workout specialist should consult the lender’s legal counsel to identify ways in which the legal environment and corporate governance may affect the activities being considered by the workout team.

1.2.9 The importance of good internal and external communications

Following are guidelines for making sure that the way in which your institution communicates is consistent with the risks it perceives.

1. Comments entered in loan supervision reports and credit reviews should be kept professional, as these files will be the first to be made available to litigants and the court.

2. When writing to clients or co-lenders, be brief and succinct. Pay special attention to the possibility of your words being taken out of context and used to the embarrassment or legal detriment of your institution. Avoid language that may weaken your institution’s ability to apply the rights and remedies to which the original loan agreements would otherwise entitle it. Avoid making any written commitment to additional future obligations unless this has passed your institution’s review and approval processes.

3. As technology expands the opportunities for recording physical and electronic conversations for unforeseen future uses, lending institutions should use caution in all communications, both written and verbal.

Ways for Stakeholders to Exert Influence

1. Supervisory board of directors and sub-committees
2. Syndicate
3. Steering committee of lenders
4. Trade unions and industrial organizations
5. Management committee
6. NGOs and lobbying groups
7. Courts
8. Political process
9. Consultants
10. Media
11. Regulatory authorities
12. Annual meetings
13. Rating agencies
14. Whistleblower activity

Checklist:

- Avoid potentially embarrassing comments in written documents
- Avoid making statements about commitments which have not been approved
- Be mindful of face-to-face and phone conversations as well
2.1 Taking stock

2.1.1 Determining the extent and main causes of distress

Many expressions in the workout business reflect the world of medicine: a company is sick or dying; a company is bleeding and its management is trying to staunch the bloodletting; a division may have to be amputated because the market is anemic; wholesale surgery will be required, etc. Similarly, prevention is superior to the cure, and a borrower should deal with problems before they become life-threatening. But bad judgment and bad luck may cause even the best-run corporation, let alone the small business borrower, to run into trouble. What is important is the cause of the problems.

Financial troubles can be self-inflicted: over-optimistic expectations, wrong spending decisions, misjudging the market, or mistakes with individual clients can all be laid at the feet of the enterprise’s decision makers. Or the lender may have been at fault: in the present crisis, many blame the financial institutions for having lowered their guard and lent funds to borrowers whose earning capacity was insufficient for the loans. In addition, the terms on which money was lent might have been unrealistic. In many countries, banks by law owe their borrowers due care and can legally be considered negligent. Even if the borrower’s ill financial health is due to external causes, such as a dwindling market for products or services, or rising prices for principal inputs, it is still important to determine if the borrower could have anticipated these developments or mitigated their impact.

It is important to know why the borrower is failing in order to determine whether the lender can afford to work with the borrower to find a proper solution or whether the lender should take control of any security and let others do a better job.

2.1.2 Understanding bankruptcy and the broader consequences of bankruptcy law

Bankruptcy is the condition of a legal entity that does not have the financial means to pay their incurred debts as they come due. In countries with bankruptcy laws, this status is usually established through legal procedures involving a petition by the bankrupt (voluntary bankruptcy) or by its creditors (involuntary bankruptcy). The workout officer must become familiar with the particulars of the relevant bankruptcy framework through the institution’s legal department or local counsel. It is prudent for the workout

Checklist:

- Ascertain causes of financial distress
- Identify causes in order to assess future fitness and avoid future mistakes rather than strictly to fix blame
- Be aware of or seek professional advice in understanding bankruptcy laws and rules which can greatly affect scope for solutions to problem loans
- Understand that bankruptcy laws and rules are ultimately local
team to involve a lawyer as early as possible and to make sure the lawyer is informed of developments as they occur. Involving legal counsel before decisions become binding is highly advisable.

2.2 Best Practice Organizational Arrangements for Handling a Sizeable NPL Portfolio

2.2.1 Structuring an NPL Organization

Most lending institutions generally and commercial banks in particular will have a unit dedicated to dealing with problem or non-performing loans (NPLs). The unit’s size and complexity will depend on several factors such as the size, nature, and diversity of the loan portfolio; the percentage of the loan portfolio that is problematic (however defined); the main sources of financial distress causing the non-performance of the loan portfolio (such as whether most of the problems can be considered ad hoc or are considered the result of a broader financial crisis) and the local laws as they affect and circumscribe what can be done in the area of asset resolution.

The head of the NPL unit should be selected on the basis of the extent to which their background corresponds with the most likely types of solutions required. For example, if because the main causes of financial distress and the attributes of the relevant business environment together suggest that most of the asset recovery will be litigious or court-determined in nature, then the NPL Unit Head might have a strong background in asset liquidation and legal recovery. Whether the preferred candidate is or is not a lawyer by training, he or she should be very comfortable with the main legal issues and procedures associated with asset recovery in connection with business lending in the relevant jurisdiction. In contrast, if the main prospects for NPL recoveries are likely to involve predominantly large and complex workouts, then the candidate for NPL Unit Head should have corporate workout and turnaround experience, and possibly merger and acquisition (M&A) experience. An NPL portfolio of problem loans to mid-market and SME borrowers in an investor-friendly business jurisdiction might benefit from an NPL Unit Head with a strong background in credit analysis and possibly general business consultancy or private equity (PE)/venture capital (VC). If the NPL portfolio is heavily weighted in favor of loans to SMEs, there may be useful aspects of micro-lending experience.

The NPL Portfolio Unit Head should function primarily as a facilitator and liaison manager. The Unit Head’s role includes:

- Approving or obtaining approvals for overall workout objectives;
- Setting budget parameters;
- Communicating to workout staff the expectations of the institution’s management regarding policy constraints or objectives, possibly with instructions on how to deal with certain high-priority non-commercial considerations; and
- Identifying with workout staff the specific targets, milestones, and sub-objectives against which performance review and performance pay will be applied.
Just as the attributes of the NPL portfolio will dictate the choice of NPL Unit Head, those attributes will also have a bearing on the **reporting relationship**. To the extent that your institution has an NPL portfolio involving corporate and business loans for which borrower relationships are at the CEO or sponsor level, it is important for the staff responsible for working out these loans to have fairly direct lines of reporting and communication with your top management. There are several reasons for this. First, resolution strategies for these loans will call for the flexibility, creativity, and quick decision making abilities of an experienced and fairly senior staff. Second, as many workout cases involve difficult relationships with borrower principal owners or senior managers, your institution’s responsible workout staff must command the respect of these individuals. If the staff are perceived by these borrowers as being less important within their own organization, these owners and borrower representatives may lose respect for them and try to go around them.

The **staff of an NPL Unit** need to be independent. The same staff who originated the loans will likely prove to be conflicted in one way or another on many of these assignments. Unless the institution wants to recruit all of its workout specialists externally, it needs to address the question of conflict of interest in a way that accommodates staff who spent time on the origination side and have subsequently decided on a career in asset recovery. It is generally best practice to ensure that even if some members of the workout team were responsible for originating the loan in question, the workout leader for that account will have had no significant prior involvement.

If the NPL portfolio contains a number of larger or complex jeopardy situations, the NPL Unit should be staffed with the idea that each workout officer would be responsible for no more than three or four accounts at a time. For middle market or SME loans, the typical case load per workout officer would increase to 10 to 15 loans. These numbers depend on the amount of activity that each case would generate. Supervision of most loans involves reminders to effect payment followed by waiting for client responses. Loan accounts in litigation can also experience long waiting periods if courts are heavily booked or loans are in countries where significant delays between steps in the legal process are the norm. Team size will be determined by the nature of distress, the suitability of the particular client to undertaking a workout, and the nature of the borrower company’s responses to its financial distress. For simpler workouts, the workout team might be staffed from across departments and include the team leader, a workout lawyer, and possibly a syndications specialist. Larger teams could also have analyst-level or more junior loan officers working under the guidance of the team leader.

In **staffing an NPL Unit**, the skills sought should address the main characteristics of the bulk of the problem loan portfolio without overloading the team with senior experts who may grow restive if tasked with telephone follow-ups on delinquent consumer loans and the like. NPL Unit staff should have a sound knowledge of finance and accounting principles, along with some additional traits:

- A penchant for problem-solving.
- A strong interest in the behavioral side of lending and asset recovery.
- A strong sense of self such that unpleasant treatment is not too readily taken personally.
- Courage and willingness to engage those who choose to take the fight to a higher level.
- An ability to accept that this is a profession where you cannot and should not try to win everyone over and make them a friend.
While not all workout staff will likely be considered expert in their field, the individuals who possess these qualities may be afforded a degree of latitude in dealing with problem clients. The reporting relationship between senior workout staff, the head of the NPL Portfolio Unit and the bank’s top management should take into account the following considerations:

- The size and complexity of the institution’s exposure to the client
- The likely incidence and severity of other-than-commercial issues involved
- The perceived skill set of the lead workout officer
- The relationship between the workout unit and the units responsible for originating the exposure in the first place

Large and complex workouts can stress a lender’s resources and resolve to the limit, so that management might want to ensure that all loan workout activities are conducted within a proper control framework. However, effective workout strategies are not always within the grasp of those outside the unit who lack the skills and experience of highly-respected workout specialists, who themselves have varied approaches. Micro-management must be avoided. In those institutions following best practices for NPL workouts, the most senior workout staff operate with a high degree of latitude, yet tend to apprise management of developments more frequently than do less experienced staff. They recognize that there is more at stake than can be simply captured in a net present value (NPV) calculation, and realize the risks to their institution of keeping one’s own counsel.

### 2.2.2 Making the NPL unit a cost center versus a profit center

During periods of rising NPLs, some lenders have considered establishing asset recovery as an organizational profit center. Indeed, there are several arguments in favor an NPL profit center. However, these arguments are predicated on a single, questionable assumption – the existence of an intra-company asset market that would accommodate a transfer of the NPLs in question, or, at least a proxy mechanism with all of the benefits of a functioning asset market in order to allocate resources efficiently. The problem is that it is extremely rare if not impossible to find a single organization – even a large bank – within which an efficient internal market exists. The efficiencies of a “market clearing mechanism” (predicated on an attempt to foster an internal market) are elusive for lack of the amount of competition needed to force buyers and sellers to actually agree on price. Consequently, an overwhelming majority of large lending institutions on several continents have reported that their banks decided against the profit-center model in favor of a more manageable cost-center model.
2.2.3 Bank records and systems support

Tracking the financial aspects of NPLs on a regular basis will test and stretch to the limit any lender’s back office support, particularly its information technology and data capture and processing systems. The importance of having accurate and timely information regarding the amounts owing on a client’s loan accounts applies to the entire NPL portfolio. Borrowers whose accounts have not yet been targeted for a workout may decide to legally contest a problem of chronic errors in billing, even if they have not immediately informed the institution of the errors, whether real or perceived.

A lender’s data processing system should be able to accomplish the following:

1. Make accurate interest calculations for a broad number of loan types and/or debt-instruments without having to resort to major software programming
2. Account for penalty charges and other assessed fees
3. Apply payments correctly in accordance with a payments waterfall that may include more components when a loan is in arrears or is being worked out than when it has always been in full compliance
4. Track equity interests resulting from payment in the form of shares, stock options, or debt-equity swaps
5. Track “new money” in any and all of its possible forms
6. Show the impact of proposed workout or restructuring terms and conditions for each creditor for purposes of assessing the extent to which such proposals adhere to agreed notions of “fair burden sharing”
7. Store several sets of target payment and loan balance schedules as well as actual performance in order to allow tracking of loan recovery as conditions evolve
8. Calculate, report, and invoice loan “payout amounts” on demand with minimal delay
9. Report loans by team and team member, by obligor, by currency, and possibly a few other key fields in order to track progress within the NPL Unit
10. Employ a sub-system or linkages to a separate information system for loan collateral and various forms of security, particularly with respect to periodic valuation updates, status of such key aspects as security registration and perfection, and including details regarding options with valuations and time to expiration. This component should also provide information regarding guarantees, stand-by letters of credit, surety bonds, etc., and their expiration dates and associated collateral maintenance information.

We can view the entire NPL portfolio as a pool of perpetual activity wherein the passage of time is always changing the amounts owed under a broad set of subheadings and in accordance with payment “waterfalls” determined by a combination of the individual loan agreements and the institution’s own policies. This should make it obvious that the NPL Unit and its workout teams require a system that is much more versatile and flexible than most standard loan-tracking systems.
Once it has been concluded that a workout would be in the best interests of all concerned, the workout leader must be selected. To the extent possible, this person’s skills should be matched to the requirements of the workout and the strengths of the staff. Yet workouts tend to be very fluid and the background and traits that seem initially desirable might not be what is needed in the long term.

### 2.3 Applying Triage in Managing an NPL Portfolio

Workout units within a lending institution practice triage, particularly in time of severe financial crisis. That is because, of course, every problem loan should be dealt with as early as possible but it will simply be impossible to deal with them all at the same time.

In a medical crisis, triage divides patients into three categories: those likely to survive regardless of the care they receive; those who are likely to die, regardless of the care they receive; and those for whom immediate care might make a positive difference in outcome. The first focus will be on the third category. Similarly, lending institutions divide incoming NPLs by priority so that the loans with the more serious problems but with a high recovery potential are handled first, while loans that will require even more work but with a relatively low recovery potential are placed last on the list, with the remaining loans handled in between.

#### 2.3.1 Analyze, diagnose, and separate NPLs into groups

Where the NPL portfolio of the lending institution consists of similar investments in terms of principal amount, interest rate, maturities and other conditions, it will do well to group these NPLs together and, at least initially, look for a group approach. This is true of both retail and commercial clients. Grouping these NPLs together allows for an improved diagnosis of why these are NPLs in the first place and may improve communications with the borrowers by allowing them to form an interest group. If a common approach can be found for these NPLs, this will greatly facilitate the work of the financial institution particularly where undertaken through a democratic approach or through majority voting in a class action taken to court. Even when a solution to the problems can only be found for a majority of borrowers with similar problems, this will help the financial institution as there will be fewer left over cases, and in finding a resolution, there will be legal or commercial precedent.

Once a group of similar NPLs has been identified, the lender can determine how best to proceed. There will be stakeholders who will try to complicate or even block workouts. For example, a financial institution trying to do a workout on a group of small entrepreneurs employing unskilled or semi-skilled workers at a time of growing unemployment will likely face protests from the government.

#### 2.3.2 Criteria utilized in performing triage

The criteria utilized in performing triage will be determined first by the capabilities of the department charged with the work-out, i.e., is the department specialized in work outs and does it have the staff and resources required to perform a proper work out, restoring the NPL back to financial health or alternatively recovering on the underlying security. This is more amply discussed in Section 1.1.6 (Establishing transfer criteria).
Assuming, however, that the NPL is in the hands of a well-staffed and well-equipped work out department, there will still be a number of criteria to follow in determining the order of priority of which work outs to undertake first. The first would of course be the quality of the NPL. Using the strategy selection process, further described in Section 3.2, would be a good start where projects in the third and fourth boxes of the selection matrix (where the borrowers are iffy) would typically rate a higher priority than those in the first and second boxes, where the borrower is otherwise in good shape, and those in the fifth box, where there is the assurance that the security – and hence the likelihood of a full recovery – is good.

However, certain qualitative aspects would also help determine the urgency with which the work out should be tackled, notably in terms of what the other stakeholders are planning to do or how they may be affected by the collapse of the borrower. One could think of a relatively small and well-secured non-performing loan to a large employer, whose collapse would cause massive unemployment in the region or even nationally. One could also imagine that the relatively small and well-secured non-performing loan is part of a very large syndicated loan where the lender has to collaborate with several prestigious banks and failure to do so would result in loss of future deals. Finally, the relative priority in scheduling the work out may be the result of reputational damage to the lender.

### 2.3.3 Managing bank loan portfolios during widespread financial crisis

While triage may be required even in relatively calmer times when the number of NPLs exceeds usual flow levels and the lending institution’s normal workout capacity, it is most needed during periods of widespread financial crisis. Its effectiveness will be strengthened to the extent that triage is performed as an integral part of the following activities which should be undertaken as a swift and focused response to a financial crisis.

- **Take stock from the outset** – this is the time for honesty in assessing the extent of the damage to the portfolio and applying conservatism to estimates throughout the diagnosis, keeping in mind that relying on hope is not a valid coping strategy
- **Devise broad strategies for loan portfolio recoveries**
- **Strengthen organizational arrangements for managing NPLs in order to staff, form teams, equip, and provide systems support to a best-practice NPL Recovery Unit. However, NPLs have a tendency to deteriorate quickly so do not waste time on perfecting the organizational structure.**
- **Make sure that the right people are assigned to loan recovery work throughout the lender’s hierarchy, even if it means reassigning senior and middle management**
- **Introduce performance-based incentives to attract and retain the best workout specialists.**
3.1 Strategy Options

3.1.1 Consideration 1: Understanding client emotions under distress

Financial analysis and detailed knowledge of the rights and obligations of the financial institution are important, but there is a critical third dimension that will greatly influence the success of the workout: the “human element,” which is the frame of mind of individuals and the relationship between the people representing the corporate debtor and the financial institution. Anecdotal evidence suggests that the outcome of any workout will depend to a great extent on the emotions and the characters of the borrower and the lender, and the way their relationship has developed. How the relationship between a borrower and a lender develops over time – and how the people representing both play a changing role – is a key dynamic.

First, the emotions do play an important, often critical, role in how the lender will approach his borrowing client. Picture the lender who shortly after having celebrated his first major loan transaction to an important client hears the first rumors about possible problems with the client. The lender may be inclined to call the client, but will prefer to believe the soothing denials offered in response. In fact, the lender may not believe the initial negative signals and, like the client, may be in a state of denial.

The banker will, however, become a bit more worried when another piece of bad news reaches him and, if only to seek confirmation that this is a misunderstanding, may give his client a call. This time, he, at best, reaches his client and detects a tendency to deflect the question or, at worst, finds his client delegating the matter to a junior associate who is not familiar with matters.

Should the lender manage a meeting with the client and learn that things are worse than anticipated, the client may prove to be hostile, blaming the lender, the bank or third parties for the problem. The interaction may devolve into a series of increasingly hostile monologues or even a blow-up. But at some point, both parties must realize that one cannot resolve the problem without the other and it is time for serious discussions, for the company to deal with its debt, and for the lender to realize that its loan has been impaired.
3.1.2 Consideration 2: Understanding stakeholder agendas especially during distress

It is of critical importance that the lender determines how its interests may be affected by the interests of the other stakeholders and what those other stakeholders can do to hinder the lender’s interests. This is important both when the interests are diametrically opposed and when there are commonalities, as among the providers of capital. In some cases, unusual forces may be at play: a government may try to influence the outcome in order to avoid a spike in unemployment or further drops in housing prices; anti-trust authorities may threaten to step in; safety agents may take measures, etc. Fears of reputational damage may cause a lender to step back from taking the necessary measures to protect its position and recover its loan.

3.1.3 Building Block 1: Going-concern solutions

So-called “going-concern” solutions are preferred to solutions involving the break-up of the enterprise in order to sell all or some of the parts. The whole idea of an enterprise is that it is worth more than the sum of the parts and the price that a used asset, or an asset that is sold under duress, can fetch is typically less than its book value, let alone its replacement value.

The going concern solutions may leave the borrower in charge of the business or enterprise as the lender recognizes that the borrowing entity is better placed to continue with the business. Nevertheless, the lender may insist upon some changes. There are three kinds of going-concern solutions: (1) Rescheduling; (2) Financial Restructuring; and (3) Operational Restructuring.

A rescheduling is the least invasive of the three and involves no more than the lender recognizing that the borrower will not be able to repay the loan within the demanded time, and agreeing to a more generous repayment schedule. This may be done in a formal fashion, with the signing of a formal document, or in a less formal manner, with the lender “looking the other way” or granting an informal moratorium.

A financial restructuring typically follows when the lender recognizes that the borrower’s cash flow will not allow for the repayments to continue on the original schedule and therefore the whole loan is restructured with changes in the principal, the interest rate, and/or the maturity of the loan.
The operational restructuring takes place if, as a condition for seeking the going-concern solution, the lender demands changes in the borrower’s operations that are expected to result in an improvement of the borrower’s cash flow from which the loan can be serviced.

### 3.1.4 Building block 2: Divestment

The lender can divest its position with the borrower via the legal route or the extra-legal route. The extra-legal route is always preferred, as it allows the lender to retain a measure of control. There are three ways in which the lender can extra-legally dispose of his position with the borrower:

- Settle with the borrower or a closely related party;
- Sell his position to a third party that has a greater appetite for the risk involved in the exposure to the borrower; and
- Persuade the borrower to liquidate the asset(s) and repay all or most of the loan from the proceeds.

In practically all cases under the extra-legal route, the lender will have to count on some losses, but the legal and processing costs are bound to be less. Particularly in the case of a settlement, it is important for the lender to recognize that it may be necessary to have the transaction approved by the court as not to do so, the lender runs the risk that he may have to return the proceeds to the bankruptcy estate, e.g., where the settlement is deemed to have treated the lender preferentially to other creditors.

The most common forms of legal divestment are foreclosure; bankruptcy; and court-ordered liquidation of the asset(s) or of the enterprise itself with the proceeds distributed to the lender and other creditors. Under a foreclosure, the holder of security in a particular asset may in some countries foreclose on the asset and become the direct owner of such asset, in which case the lender may dispose of such asset as he pleases. In other countries, while the holder of the security may foreclose on the asset, the asset will have to be auctioned off and will become the property of the highest bidder. Finally, there are countries where the holder of a security can only exercise his rights in a bankruptcy where the receiver takes charge of any auction.

While any creditor as well as the borrower may invoke the latter’s bankruptcy in a unilateral action, the result is always a multilateral operation with at least two parties (the borrower and the lender), but more often many parties (the borrower, the lender, other creditors, the tax authorities, etc.) facing each other to determine the rights of each party. The borrower can seek protection of the court and get the right to sort out his problems through the development of a plan that will then need to be approved by the court; or the court will from inception take charge, appointing an administrator, curator, or receiver to run the enterprise or the borrower’s assets on its behalf and develop the bankruptcy plan, which could involve the re-start of the enterprise or involve liquidation of the enterprise and the assets with the proceeds distributed among the creditors.

Finally, court ordered liquidation occurs when from inception it becomes clear that the borrower will never be able to meet his obligations and that full recovery of the borrower’s outstanding debt cannot be expected from extra-legal sale of the asset(s) or from the enterprise continuing to operate as a going-concern. Liquidation may be sought either by the borrower, the lender, or other creditors.
Box 4: Example Involving New Money

A manufacturing company processing a highly seasonal raw material ran out of money just before the harvest and the time of shipment. The local banks refused to extend further letters of credit, forcing the company to postpone shipments until it had ready cash available. At that desperate moment, the company approached its group of foreign bankers to ask for emergency assistance. These banks had a choice: deny the request in which case the company would almost certainly go bankrupt or together supply sufficient funds and get the company back to normal operations. In bankruptcy, the foreign banks realized that the fixed assets pledged to them would not be worth much in any alternative use. The current assets were all pledged to the local banks, and even they would be worth less in a bankruptcy. While the viability of the company was not assured, even a gradual winding down of the company and its activities would generate a lot more cash for the banks than an immediate bankruptcy. The foreign banks therefore agreed that it was in their interest to come up with some short-term cash.

3.1.5 Building block 3: The case for new money and recommended safeguards

There are cases where it may be much better to keep the enterprise going even when it has run out of cash. As in most “going-concern” cases, the assets of such a venture will be worth less on their own than they are in combination, than they are when their sale is hastened by the liquidation of the enterprise, or than they are when third parties are aware of the borrower’s difficulties.

Particularly in enterprises with seasonal operations or involved in large-scale construction or assembly work (where the alternative is to try and sell a half-finished product), last-minute financial assistance can spell the difference between enterprise life and death. Lenders will need to be familiar with the operations of the borrower in order to determine whether the case is real or whether this will become the classical case of throwing good money after bad. The lender will want to ensure that any additional burden is fairly shared with other parties that would benefit from the fact that the enterprise will remain a going concern. Thus, other lenders will need to be consulted and persuaded to chip in, but also management and the workforce may need to agree to forfeit part of their wages and salaries for a limited amount of time.

A critical issue is whether the lender, in agreeing to provide new money, can make sure that he can be treated more senior to the already existing creditors. This is an important reason for making sure that all of those with an exposure chip in and that there is some framework agreement among these parties. Likewise, the lender will probably seek some additional security but runs the risk that his security rights will not be recognized if the operation fails and the borrower or the enterprise still fails.
3.2 Strategy Selection

There comes the time in the life of any lender that he receives the dreaded call from an important borrower to inform him that the borrower will not be able to service his debt and will default shortly. The lender should remain calm, reflect on the situation and prepare for the inevitable workout. A good lender will have done the necessary analysis and have his various tools readily at hand. The selection of the right workout strategy can be a critical one and needs to be focused on as soon as practical.

The Special Operations Department of IFC has developed a simple matrix diagram that can provide some assistance in developing a workout strategy. It is based on the first two questions that the lender should ask when learning that a client of any type is about to default: (1) is the loan secured and does the value of the security cover the loan?; and (2) is the client or the business viable, potentially viable, or not at all viable?

3.2.1 Assessing the quality and adequacy of loan security, and assessing borrower viability and potential viability

The lender will have to consider whether, when the collateral is sold, the proceeds will be enough to cover the outstanding principle and any interest and penalties due. In doing so, the lender will have to consider a number of factors:

- How easy will it be to foreclose on the security?
- Can the lender, upon foreclosure, take ownership of the asset and sell it to a third party or will the asset have to be sold through an auction?
- If the asset has to be sold through an auction, can the lender bid himself and, better yet, use the loan to pay?
- Will any other parties share in the proceeds of the sale of the asset?
- How much will the procedure cost?
- How much time will be involved in the entire procedure?

In assessing both the available loan security and a client’s financial viability, the lender should be aware that the borrower may be transferring assets and funds out of the reach of the lender. Reality may therefore prove to be different from what is apparent to the lender. Transferring assets may be done for perfectly valid business reasons. This becomes easier if the borrower controls the previous links in the value chain (up-streaming) or the next links (down-streaming). An example of up-streaming is where the borrower, a shop owner, also owns the wholesaler or importer of certain goods and may wish to have more liquid assets in this activity for a while (window-dressing, payment of invoices, etc.). An example of down-streaming would be the small manufacturer owning his factory outlets.

“Tunneling” is a colloquial term for a specific kind of financial fraud. The borrower arranges for a sale of assets, pledged to the lender, to a second company, frequently at unreasonably low prices. The borrower or an associate will typically own the second company outright and thus profit from the otherwise disastrous sale, but more importantly, the cash or assets are removed from the control of the lender.
Of course, this can only be done where pledges of assets are not registered, such as in the case of accounts receivable or inventories.

### 3.2.2 A conceptual framework for loan resolution strategy selection

Questions as to whether the lender’s security (collateral) is sufficient and whether the borrower’s business is viable can be pictured in the two-dimensional graph, with relative security coverage (collateral over exposure) being measured along the horizontal axis, and the borrower’s viability along the vertical. It results in a matrix with six scenarios each having distinct features, e.g. section 1 indicates the client being viable and the bank holding more than adequate security, while section 6 indicates the complete opposite.
Each of the scenarios of the matrix represents a strategy that the bank may wish to pursue when commencing a workout. Thus:

<table>
<thead>
<tr>
<th>STRATEGY</th>
<th>IMPLICATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. False Alarm</td>
<td>Essentially, the default was an aberration due to a temporary problem with the enterprise, which is in good shape with good security. The client will be asked to pay as soon as possible and likely get off with a warning.</td>
</tr>
<tr>
<td>2. Negotiate Stronger Security</td>
<td>The client enterprise is, in principle, in good shape. However, to the extent that this may not be the case in the future, the lender may want to use this default as an opportunity to seek stronger security.</td>
</tr>
<tr>
<td>3. Reschedule/Restructure</td>
<td>The client enterprise is suffering some setbacks and its present cash flow is not sufficient to service its debt. To the extent that the client enterprise is potentially viable, this may change for the better in the future. Meanwhile, the security is sufficient should matters not improve. The lender could therefore reschedule its loan for maturities to better match anticipated cash flows. In the event that projected cash flows are not sufficient to pay all of the agreed debt service, the lender may consider to reduce the principal of the loan and convert the balance into some form of equity.</td>
</tr>
<tr>
<td>4. Restructure</td>
<td>The client enterprise is potentially viable. To the extent that security is not sufficient, the lender should not only reschedule the loan, but also recognize that security is not enough and therefore should reduce the principal of the loan and convert the remainder into some form of equity to assure that if the client enterprise does better, the lender will share in the upside potential.</td>
</tr>
<tr>
<td>5. Divestment without Discount</td>
<td>The client enterprise must be considered unlikely to ever generate enough cash for it to be able to repay the loan. In fact, continuing the enterprise may be a misuse of resources in an economic sense. The lender may want to liquidate its position through some form of divestment. Given that the security is supposedly worth more than the value of the loan, the lender should hold out for a full recovery.</td>
</tr>
<tr>
<td>6. Divestment with Discount</td>
<td>Here, too, the client enterprise is unlikely to ever generate enough cash for it to be able to repay the loan. Here, too, the lender should consider liquidating its position, but it should be realistic enough not to seek a full recovery of its loan as the value of the asset(s) securing the loan is below that of the outstanding balance of the loan.</td>
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</table>

### 3.2.3 Modifying the framework in light of stakeholder relations and other factors

While scenarios 5 and 6 are difficult for the client and are likely to meet with some opposition, outright hostility or lack of trustworthiness shown by the client will certainly affect the outcome of the workout and hence the selection of the strategy to be followed. It is possible that the client enterprise did not understand the rules and does not recognize that the holders of such loans effectively should gain control.
Hostility or untrustworthiness will call for a different approach:

<table>
<thead>
<tr>
<th>STRATEGY</th>
<th>IMPLICATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Negotiate prepayment or stronger security</td>
<td>While it can be anticipated that eventually the client will repay the loan, chances are that there will be a re-occurrence and that the lender will not be so lucky. A hostile client can seek to block, or at least delay, the execution of the security. This time, the bank will either use the pretext of the one-time default to seek a prepayment of the loan but at the least will want to strengthen its security.</td>
</tr>
<tr>
<td>2. Collect with view to divest</td>
<td>The client enterprise is doing well, has a clear positive enterprise value, and should be able to repay its loan. But the atmosphere is unpleasant and should the situation deteriorate, the lender will not enjoy the goodwill of the client enterprise in finding common ground while it will not have enough security to cover the loan. Maybe the client enterprise’s owner(s) can be persuaded to buy out the lender or there are parties around who are better able to deal with this situation. While there is no reason to sell out at a loss, the prudent lender will seek an exit.</td>
</tr>
<tr>
<td>3. Negotiate prepayment or stronger security. Consider divestment</td>
<td>The client enterprise is potentially viable and hostile. It will depend on the circumstances whether the lender will give the client enterprise the benefit of the doubt, while still negotiating a prepayment or stronger security. At the same time, the negotiations may become so difficult that the lender is better off selling the loan to a third party that is in a better position to recover the outstanding loan.</td>
</tr>
<tr>
<td>4. Collect with a view to divest</td>
<td>While in this scenario the client enterprise is potentially viable, suggesting that matters may improve, the hostility means that converting part of the loan into equity – assuming that the borrower is agreed – will make little sense. Future income is uncertain and the security is not sufficient so the lender will want to reduce its exposure no matter what, even at a discount.</td>
</tr>
<tr>
<td>5. Divestment but be prepared to accept a discount</td>
<td>The lender will want to liquidate its position for as long as it has some hope of recovery through the sale of assets. Although the security is supposedly worth more than the value of the loan, the client enterprise is hostile and may take action to prevent the lender from exercising its rights. While the lender should clearly hold out for a full recovery, it should for this reason be prepared to incur a small loss. To the extent that the underlying security apparently has value, the lender may take its time and not go for a fire sale.</td>
</tr>
<tr>
<td>6. Divestment at discount</td>
<td>This is much the same as in scenario 5, except that little is gained by further delay. A deep discount from the value of the loan is likely in realizing the sale of the underlying security.</td>
</tr>
</tbody>
</table>
3.2.4 Stakeholders and communication

A lender, particularly a large one, will want to know who the other stakeholders are, their priorities, and whether their interests are such as to result in support or opposition. This will affect the lender’s communications. The ways in which stakeholders communicate are also often the best way for a lender to communicate with them. For example, if other lenders are united in a consortium, the lender will want to communicate through the manager of the consortium. Small shareholders are best approached through the Supervisory Board, which can call a general meeting of the shareholders. Large shareholders, particularly those that can influence the outcome of the workout, should be approached individually.

Discretion will benefit both the borrower and the lender, due to the negative possibilities that occur when bad news is too widely disseminated. For example, if it becomes too widely known that the borrower is in financial difficulties, this will affect his business and thus his future viability. The large lender will thus try to be discreet in his approaches to other stakeholders to avoid the bad news reaching too many parties. By contrast, a small lender may wish to give his loan recovery efforts broader publicity in the hope that larger lenders (or large suppliers or customers) with more to lose will cause him to be bailed out. There are risks in such tactics. A small lender may therefore resort to discretely approach the borrower and the larger stakeholders with his threat to take legal action (“green mail”).

Box 5: Example involving Debt-to-Equity Conversion

The two lead banks in a banking consortium that had lent to a regionally important transportation company had successfully negotiated among the banks and with the company a completely new financial plan for the company after its collapse under the weight of too much debt. An integral part of the plan was for the banking consortium to get shares in return for a lowering of the loans. In fact, under certain scenarios the banking consortium could even become the largest shareholder. The government, through the local development bank, had indicated that it would support the restructuring both with financial support and by granting certain tax holidays. Against the proposal were the workforce, fearful of further cuts in the payroll, and local competitors, who were concerned that certain specialty equipment would be sold off by the company and might fall in the hands of a foreign competitor. Worse still, the banking consortium might at some stage decide to sell the company to a foreign strategic investor who would offer serious competition in an otherwise rather protected and closed market. In a curious maneuver, the workforce and the industry association got together and prevailed upon the government to withdraw its support at the eleventh hour, upsetting the restructuring and causing the bankruptcy of the company. Under protection of the local court, the administrator managed to generate sufficient cash to keep the workforce employed for a rather long period. The local competitors succeeded in their efforts to keep the market closed to outsider. The government, that had a good deal to begin with, ended up having to buy out the banking consortium to prevent it from selling off the assets. In preparing the financial restructuring, the banking consortium had, in retrospect, not paid sufficient attention to the interests of other stakeholders and/or had assumed that they would acquiesce.
3.3 Equity investments

Even institutions that do not make equity investments should take equity considerations into account when dealing with distressed corporate and SME loans. Quite often workout solutions may involve debt-to-equity conversions as a preference to outright debt forgiveness and in some cases there may be a strong case for accepting equity warrants in lieu of cash payments. Even if the bank, either because of its charter or its internal policies will not or cannot retain equity interests for long, its workout staff need to be mindful of important considerations arising out of equity interests affecting their institution’s role in the workout, including any possible conflicts of interest which will need to be addressed.

3.3.1 Considerations regarding debt-to-equity conversions

There are major differences between debt and equity in terms of risk, return, control, and commitment particularly where the borrower is an individual. These differences can be immensely useful in the course of the financial workout. The lender, in return for less control and a lower return and upside, should receive priority in return of the capital provided to the borrower. Conversely, this means that if the borrower’s capital is depleted, the lenders and other creditors should gain control, at least until they have recovered their outstanding positions with the borrower or in the enterprise.

When a borrower is in principle viable or even potentially viable, but servicing his debt in full has become difficult or impossible, the lender will probably opt for a going concern solution. To keep the borrower or the enterprise going will require adequate working capital and net cash flow, which may not be compatible with keeping the full loan in place. The lender could of course offer to forgive part of the loan, but this will not always be considered “fair and equitable,” as it is seen as rewarding the borrower. In such events, particularly when the borrower is an incorporated enterprise and has the means to do so, the lender may opt to receive an “equity kicker” as compensation for lowering the face amount of the loan to an amount that the borrower/enterprise will be able to service. The equity kicker gives the lender some upward potential in the event that the borrowing enterprise does better than anticipated.

The lender may take shares in the enterprise directly, effectively converting the debt into equity, or the new loan (with a reduced face value) may become convertible into shares. The lender can also receive warrants, which are the right to buy shares. Yet debt-to-equity conversion is usually a dramatic action with unforeseen consequences. In hostile circumstances, it is fraught with risk.

Converting debt into equity has some definite advantages for the borrower, as it will provide the borrower with an improved free cash flow. With the lender(s) now being among the shareholders, the borrower will eventually enjoy improved access to additional funding. Finally, the fact that the lender(s) have an equity stake demonstrates that they believe in the future of the borrower, which will give the latter improved credibility.

The lender must recognize that it will have limited in-house expertise in the borrower’s business and therefore cannot play an active role. The lender must also recognize that it may be exposed to hidden liabilities in the borrowing enterprise and may suffer unforeseen reputation problems. If there has only been a partial conversion of the loan into equity, the lender may find that, as a co-owner of the enterprise, the security rights have become impaired. If the conversion involves insignificant amounts, the lender may face problems in the future in trying to dispose of these. If significant amounts are
PART THREE: Taking Charge of the Workout: Workout Tools and Workouts

3.3 Equity investments

3.3.2 Equity warrants as possible “currency of repayment”

Lenders to corporate entities may resort to the use of equity warrants, i.e., a derivative security that gives the holder the right to purchase securities (usually equity) from the issuer at a specific price within a certain time frame. Warrants are often included in a new debt issue to entice investors, but they also lend themselves to workouts particularly where the warrants can be separated from the original debt and sold separately. While lenders will be able to use these shares as a bargaining chip, they may find themselves unable to take ownership or control, even on a temporary basis.

3.3.3 Relationship aspects and possible mitigating actions

When a workout involves a restructuring of debt and equity claims, including through the conversion of debt to equity, the injection of new equity financing, or the introduction of option-like or income participating features such as equity warrants and mezzanine finance instruments, the resulting capital structure can lead to a widening of the divergence among the economic interests of holders of claims against the company. One way of dampening the potential for stakeholder conflict is for the financial restructuring plan to require most if not all of the participating stakeholders to accept a vertical tranche of each of the types of the claims against the company (senior debt, subordinated debt, other mezzanine finance instruments, equity and equity options). An alternative way of mitigating the potential for conflicting interests is to restructure the voting regime. To the extent that these solutions are not appropriate, the restructuring agreements should elaborate the principles and modalities through which dispute resolution is to be achieved, such as mediation and arbitration arrangements.

Considerations affecting provisions for loan losses and write-offs of distressed loans

The lender must consider how to account for outstanding loans that are in apparent trouble. The first step is to recognize that there is a problem and to deal with it in the lender’s own books. For the amount to be provisioned (i.e., the expense set aside as an allowance for bad loans even before it is a fact that involved, the regulatory authorities may have issues, as some countries do not allow banks to carry equities on their books, and there may be a need to consolidate financially.
the loan will not be repaid in full, also known as a “valuation allowance” or “valuation reserve”) there are several important considerations. In some countries, a provision is tax deductible even before the loss is actually realized. In such case there will be a temptation to maximize the provision, resulting in an immediate tax credit, but this will clash with the desire to maximize profits as provisions typically are run through the income statement of the lending institution and will lower the lending institution’s equity. In addition, regulatory agencies will often dictate the amount of the provision and force the lending institution to put aside capital. This will leave the lending institution with a lower lending capacity.

A lending institution may decide to write off part or all of the outstanding loan, recognizing the reduction in the value of the loan asset or earnings by the amount of the incurred loss. The difference between a provision and a write-off is that the provision is still visible as a reduction of the gross loan amount (leaving a net loan amount) while the write-off leaves only the recognized remainder of the loan assets on the books.

3.4 Executing the Workout

3.4.1 Preparing for the workout

The following tasks represent common elements of just about any problem loan resolution effort. While the term workout usually applies to an effort to maintain the borrower entity as a going concern, the same tasks are required in order to undertake a workout or indeed to conclude that an alternative recovery strategy is appropriate (such as liquidation or divestiture).

1. Establish the workout team – applying guidance provided in pages 27 – 28 above, select the team
2. Assess the problems – try to identify the underlying causes of the borrower company’s problems, especially whether the main problems stem from external or internal factors
3. Analyze the business model – focus on the dynamics of the industry and sector to understand trends, the company’s performance relative to competitors and representative firms; understand how cash is generated, used, managed, and reported

How to Choose a Recovery Strategy

1. Identify all lawful recovery actions and their pros and cons
2. Estimates the cost and time involved in executing each of the main options
3. Choose primary and secondary recovery strategies based on an assessment of risk, return, and uncertainties; interim strategies may also be necessary
4. If syndication is involved or a coalition among lenders is deemed essential, make sure that other lenders are kept well informed

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5 IFC’s Department of Special Operations, Notes on Workout Cases. March 2007 pages 10-12
Steps to Take in Preparing for Negotiations

1. Review all legal documents to identify your institution’s rights and remedies
2. Check the status of your institution’s security in connection with all loans affected by the workout
3. List all covenants that have been breached as well as any events of default and/or potential events of default that have occurred and are still in effect
4. Determine stakeholders’ agendas, needs, and issues in order to identify both potential allies and coalitions with opposing interests
5. Assess principal owner commitment to the company or project and corresponding willingness to help find a solution
6. Determine your institution’s leverage and bargaining power
7. Prepare a balance sheet for the liquidation scenario
8. Pay special attention to any terms involving or affecting the release of security
9. Identify all other lending within your institution that could be affected by the loan that is the object of the workout
10. Understand the level of insurance coverage
11. Obtain all necessary internal authorities for conducting the workout

3.4.2 The case for or against a moratorium and standstill agreements

A moratorium may be declared unilaterally by the lender or the borrower, who is then in default. Or the lender and borrower may sign an agreement to delay or suspend any activities under the loan agreement. This is referred to as a “standstill agreement.” Such agreements often occur when there are multiple lenders or creditors who need to ensure that all agree to suspend enforcement of their legal rights for a specified period of time. This may be necessary to give the company time to collect information for a survival strategy or to allow creditors the opportunity to formulate a joint approach. From a legal viewpoint, a standstill agreement can effectively extend the time limitations allowed for certain things to happen as otherwise provided by either statutes or contracts.

A standstill will generally be proposed when it is expected that a restructuring of the lender’s debt is warranted. The standstill is an arrangement in which all lenders agree to refrain from certain actions to which they are legally entitled for a given period of time. It is predicated on the idea that financial stability is needed. This is because a restructuring usually takes time and is best designed when the borrower’s finances are reasonably stable.
Actions characterized as “not forbearance,” which the lenders might agree to undertake collectively in connection with a standstill or moratorium, include:

1. Extend new loan facilities;
2. Call for additional security;
3. Negotiate an increased pricing of the loans with the customer.

During a typical standstill, each participating lender or trade creditor will agree not to:

1. Declare an event of default (EOD), present a notice of demand, or accelerate;
2. Demand additional collateral or credit enhancements;
3. Materially alter the nature of outstanding credit facilities;
4. Charge penalty interest;
5. Pursue ongoing legal action or other enforcement or recovery activities against the borrower.

The willingness of all concerned parties to agree to a moratorium will depend on an appreciation of the moratorium as a means to an end and its purpose. Is it designed to prevent banks from taking action, allow accountants the opportunity to provide a complete financial review, give the company shelter while it disposes of assets, provide shelter for an orderly wind down of the company, or allow the company time to raise new financing?

### 3.4.3 Mediation

In response to numerous company failures following the systemic financial distress of the 1970s, the Bank of England developed a framework for how to approach individual workouts of corporate borrowers in distress during a systemic crisis. This framework, called “the London Approach,” is a system of mediation and incorporates:

1. A preference for out-of-court debt restructurings
2. Independent due diligence review
3. An agreed standstill period or debt moratorium
4. The formation of a lenders’ steering committee and chair
5. The provision of new money
6. The need for fair burden sharing and pari passu treatment of creditors

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*Chatterji and Hedges. Loan Workouts and Debt for Equity Swaps: A Framework for Successful Corporate Rescues. Page 162.*
### 3.4.4 The principle of fair burden sharing

In order to convince a diverse group of lenders to join in a stay and subsequent restructuring, there must be a clearly shared view of how gains and losses will be treated going forward, guided by the “principle of fair burden sharing,” which provides that:

1. Participants are to be treated equally (within a single class of claimant)
2. Participants are not to seek unilaterally to improve their relative positions going forward
3. Going forward, participants are to share additional risks and windfalls on a pro rata basis

Often, insufficient attention to the specifics of loss (and gain) sharing arrangements and the resulting impact on the participants has been the cause of breakdowns in moratorium and restructuring agreements. For this reason, the workout leader needs to ensure that the logic, rationale, and details of the mechanics of these arrangements are well understood by all concerned.

#### Practical issues in applying fair burden sharing and loss sharing arrangements

1. **Equalization** – the process of adjusting participant exposures to reflect their relative exposures to that of the day on which the parties agree the workout has started.
2. **Priorities** – in the case of new financing to a company the subject of a workout, the explicit treatment of priorities, particularly where such financing has not been provided by all of the original lenders on a pari passu basis
3. **Ringfencing** – arrangements to partition or treat risk differently where loans or credit have been extended to other companies in a group that are determined to deserve somewhat different treatment than the borrower company that is the subject of the workout
4. **Distributions** – arrangements for proceeds of any asset realizations to be distributed on a pro rata basis to the participants
5. **Indemnities** – arrangements to take care of essential contractors involved in the workout to receive payment from eventual liquidation proceeds on a pro rata basis in the event of shortfalls

**Checklist:**
- Be aware of need for Fair Burden Sharing
3.5 Launching the workout

3.5.1 Workout arrangements and responsibilities within the lending institution

In preparing for a workout, the workout leader will need to move quickly to ascertain such issues as:

1. Involvement of institution’s legal department
2. Extent of involvement of origination team and account managers
3. Involvement of credit function (department or committee)
4. Involvement of risk management function
5. Involvement of syndications department
6. Internal sign-offs and approvals

Principal Security Matters

1. Essential points to cover in the loan agreements regarding security
2. Monitoring compliance
3. Monitoring rights, remedies, and actions of other creditors
4. Monitoring factors affecting the value of collateral including changes in the nature and condition of pledged assets as well as in the market’s direction and liquidity for pledged assets
5. Managing waiver requests
6. Use of cash sweeps and lock-boxes

3.5.2 Protecting security interest throughout the workout

The quality or adequacy of a lender’s security interest involves a range of matters that should be addressed when the loan documentation is first being prepared and negotiated. Other aspects involve the lending institution’s own policies and procedures and how they are applied during subsequent loan supervision. Advice for workout staff includes the following:

1. Be careful in what you say
2. Watch what you put in writing
3. Be aware that inaction can be as damaging as wrong action
4. Gain a reputation for being “firm but forthright” rather than being “too clever”
5. Understand the company’s structure and where it stands within a group of related companies
6. Understand the company’s business model in terms of a SWOT analysis and update this knowledge periodically
7. Know all of your legal documents inside out

Checklist:

- Discuss possible organizational units and functions within the lender institution which will need to be consulted or involved in an impending workout.
- Protect security interest during a workout.
8. Try to at least meet all the main stakeholders prior to firming up the workout strategy
9. Avoid being seen to “take sides” or to make alliances too soon
10. Avoid attempts of others to undermine your credibility
11. Involve your bank's legal department regularly, even if you are a lawyer or know the law

3.5.3 Liquidation Balance Sheet

At some time, the loan officer in charge of a distressed loan will have to look at the absolute downside, the maximum loss that his bank will incur if the borrower goes bankrupt and the assets are liquidated. It is useful for the loan officer to compute for himself a liquidation balance sheet with a computation of the likely values that the various assets will bring in a liquidation scenario and a listing of the several claims on the borrower in terms of the strength of each claim. The first step would be to adjust the values of each of the asset categories for their likely recovery value.

Thus, within the main categories:

1. The item cash and banks will likely not have to be re-adjusted;
2. Accounts receivable will most probably have to be adjusted. In the example of Annex 3, the adjustment has been by 40 percent, as experience shows that trade debtors tend to delay payment of outstanding invoices as they suspect that the receiver or administrator will take his time in pursuing the claims. Also, trade debtors may apply some discount for anticipated counter-claims under warranties and, to the extent that they have to turn to other suppliers in the future, for “trade interruption”;
3. Inventories will have to be adjusted for the prices that they might reach in a liquidation sale. Raw materials will be worth more than semi-finished products. The value of finished products will depend on whether these are custom-designed or whether there is a ready market for them. Prepayments to suppliers will have a lower value and may be difficult to dispose of. As a rule of thumb, the authors have felt comfortable with an average discount of 50-60%;
4. A more difficult category of assets to value is fixed assets, particularly in the event of a rapid sale. The first question is how the assets may be disposed of, which is largely a legal question that varies by country. In some countries, the holder of the security can drive the process and even take ownership of the assets. Elsewhere, the receiver will be in charge of asset disposal and may subtract funds from any proceeds for other, preferential, creditors. Many countries demand that an auction be held for the sale of pledged assets. What prices the fixed assets will fetch in a liquidation sale will depend on the state of the market and features inherent to the asset in question. The authors have felt comfortable with a discount of 60% for land and buildings; 50% for production machinery and equipment; 80% for other equipment (mainly transportation equipment); and 90% for construction under progress, together for a weighted average in the case of the example of 50 to 60%.
5. An almost impossible category of assets is that of the so-called intangible assets. This category includes goodwill on assets acquired in the past as well as trademarks, intellectual property, and even certain e-mail addresses. The prudent lender will reduce their value to zero.

The next step is to determine whether the value of the pledged assets is sufficient to cover the outstanding secured debt. It is important to determine if there are priority creditors, such as tax authorities,
outstanding pension payments and, most importantly, severance pay to employees. In some countries, priority creditors may come ahead of secured lenders. Finally, it can be determined how much the secured lenders and the unsecured creditors will recover from the bankruptcy estate.

Doing this exercise up front will help in choosing the right strategy, as it will save the lender from assuming that he is best off with a liquidation. It may be that a going concern approach may generate more proceeds for the secured lenders and the unsecured creditors. This technique will help to negotiate with the other creditors, as it can help determine what each of them is likely to receive in a liquidation. In drawing up the liquidation balance, it is important to have at least a rudimentary understanding of how the law functions in a bankruptcy. As always, when in doubt, discuss with a bankruptcy lawyer. Likewise, use common sense: old machinery with outdated technology will likely only fetch scrap value in a liquidation sale.

3.5.4 Business plan

A business plan is one of the decision-making tools used by the management of a company and its financial partners, as it states the goals and implementation activities of a business. Every business entity will have some business plan, be it in the head of the owner-manager or in a written document. Every business entity needing outside finance will be expected to have a business plan, especially if it is in distress and must persuade business partners, including lenders, that it deserves a second chance.

A business plan is one of the decision-making tools used by the management of a company and its financial partners. While there is inevitably some overlap, these tools can be described as follows:

<table>
<thead>
<tr>
<th>Business model</th>
<th>The way the company runs its business, i.e., a broad range of informal and formal descriptions to represent core aspects of the business, including purpose, offerings, strategies, infrastructure, organizational structures, trading practices, and operational processes and policies.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business plan</td>
<td>Statement of the business goals and a description and quantification of the activities required to achieve these goals.</td>
</tr>
<tr>
<td>Marketing plan</td>
<td>Description of the market, statement of goals in the market and measures, both qualitative and quantitative, to be taken to achieve these goals.</td>
</tr>
<tr>
<td>Strategic plan</td>
<td>Process of defining a company’s longer-term strategy or direction and preparing for decisions on the allocation of its resources, including capital and people, to pursue this strategy.</td>
</tr>
<tr>
<td>Budget</td>
<td>Periodical summary of targeted sales revenues and expenditures and capital investments to be incurred to achieve these sales.</td>
</tr>
</tbody>
</table>

Business plans are internally or externally focused. Externally focused plans target goals that are important to external stakeholders and have detailed information about the organization attempting to reach the goals. Internally focused business plans target intermediate goals required to reach the external goals. They may cover the development of a new product, a new service, a new IT system, etc.
An internal business plan is often developed in conjunction with benchmarks of critical success factors, allowing non-financial measurements. Business plans that provide only general guidance on how goals will be met are called strategic plans.

A proper business plan represents all aspects of business planning process and draws from many different business disciplines: finance, human resource management, intellectual property management, supply chain management, operations management, and marketing, among others. A well prepared business plan will include some thoughts about the company’s selected business model and its strategic and market position. Various business analysis techniques may be used in strategic planning, including SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats). In a SWOT analysis, the company will have to present its views on where its business strengths lie; potential problem areas; business opportunities; and sources of threats to the business model.

### 3.5.5 Financial Projections

An important element of the business plan is the future financial outlook in the form of financial projections. These are compiled from a series of annual statements of income and expenses for a company, division, or department for future periods and years. Historical statements will also be included. Financial projections will typically follow the format of the financial reporting of the company, and will contain a projected income statement, a projected balance sheet, and a projected cash-flow statement for a series of years. A financial plan will provide an estimate of cash needs and show how the company plans to manage the cash.

Financial projections show how a business will achieve its business plan and, ultimately, its strategic goals and objectives. Financial projections reflect and quantify elements of the business plan and provide it with rigor by confirming that the objectives are achievable from a financial point of view and by allowing changes in the business plan and in the resource mix before important mistakes are made. Financial projections also help the owner or the CEO to set financial targets for the company and will form the basis for future annual budgets.

### Checklist:

- Determine likely business scenario (crisis, recession or boom time)
- Determine reasonable and preferably mutually acceptable business plan
- Use recent financial statements as model outline
- Decide on likely Revenue from Sales for review years
- Determine ratios between cost ratios and Sales Revenue
- Prepare financial projections

**Preparing financial projections involves the following tasks:**

1. Determine the basis of the sales and marketing plan how much can be sold
2. Identify the types of resources needed to achieve these sales
3. Quantify the amounts required of each resource
4. Calculate the total cost per unit of each type of resource
5. Summarize the costs to create a budget
6. Identify any risks and issues with the budget and, if possible, run a series of sensitivity tests for the more critical of these risks.
From a lender’s perspective, two elements are critical in the financial projections required from a borrowing client, particularly one in distress. One is the amount of “operational cash flow” the borrower will generate, which will determine how much debt the borrower can take on. The second is the amount of risk the borrower can afford to take on.

Annex 4 provides a typical full set of financial projections prepared by IFC. IFC prefers simple projections, as additional details are seldom worth the extra time and effort. Minor variations tend to balance out in the final bottom line. Another preference of IFC is to start with the projected income statement, which is relatively straightforward, then prepare a cash flow statement or statement of sources and uses of funds, and finish off with the projected balance sheets, which can then provide the preparer both with a numbers check and with the critical number of the available operational cash flow. To the extent that in a workout cash flow is probably the “bottom line” to be reviewed by the lender, you may want to compute projections so that revenues from sales will need to be corrected for increases in accounts receivable and cash collections. Similarly, cost of goods sold will be corrected for increases in accounts payable and cash payments to suppliers.

An important feature of IFC’s projection exercises is that they are also used to conduct so-called sensitivity tests that will show what happens (1) if sales volumes are down; (2) if sales prices are down; or (3) if one or more cost items go up in price. Using a simple spreadsheet makes this exercise much easier. As with all spreadsheet exercises, caution is necessary that there are no systemic errors in the model. For this reason, it is important for the lender – particularly in a restructuring or rescheduling – not to rely on the financial projections alone.

3.5.6 Sustainable Cash Flow and Debt

With the projections based on an acceptable and realistic business plan in hand, the lender can easily determine the sustainable cash flow. Technically this can be done by leaving the rows for debt servicing at zero in the worksheet projections and then determining how much excess cash is available with the borrower. This results in the free operational cash flow. Great care has to be taken that in determining the free operational cash flow, the borrower can use some of the operational cash flow to increase working capital and make investments in machinery and equipment, both to replace worn-out capital and to accommodate anticipated increases in sales. Conversely, of course, certain machinery and equipment may under the (revised) business plan no longer be necessary for the borrower to survive and could be sold with the proceeds added to the operational cash flow.

If the free operational cash flow has thus been determined based on a reasonable and realistic scenario and one that the lender(s) and borrower can agree on – referred to as the base case – this is commonly referred to as the sustainable cash flow, one that the future repayment schedule can be based on. A careful sensitivity test will show how the free operational cash flow will vary under different business scenarios. Lenders can then decide on whether they want to base their demands for future repayments on a more negative scenario – using the difference between the more negative and the more positive scenarios to seek additional accelerated repayments of principal – or whether they prefer to select the more optimistic scenario, risking that future developments will prove to be disappointing, in which case a further rescheduling or restructuring will be necessary. In this case, many lenders prefer to be more “optimistic” in the financial expectations, retaining more control over their borrowers by setting high targets for the future debt servicing.
In the example of the projections provided in the Annex, IFC already indicates what would be the “Excess Cash Flow” – in the example applied to a reduction in the short-term debt or an increase in excess cash – based on an agreed debt servicing schedule. To compute the “free operational cash flow”, IFC would have set the projected debt servicing at zero and then taken the “excess cash flow” as the sustainable cash flow in order to compute the appropriate debt service schedule.

The total sustainable debt can easily be derived from the sustainable (free operational) cash flow by computing its net present value (NPV). The lender will have to select the appropriate time horizon and the discount rate, which should be the appropriate cost of capital and should incorporate the risk-free market interest rates and some margin for the borrower’s risk profile.

One problem remains in setting the future debt repayment schedule: the free operational cash flow is likely going to be uneven. Lenders have a choice between establishing a debt repayment schedule, following closely the schedule of the free operational cash flow – and yielding irregular maturities – or agreeing a fixed maturity and demanding additional payments from any excess cash flow through additional “pre-payments” based on some contractual formula incorporated in the restructuring agreement or loan amendments. Both systems will generate acceptable results.

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**Box 7: Importance of Workout Leader**

A group of three banks had for years been negotiating with the owners of a small mining venture for the repayment of their loans. The situation did not lend itself to a foreclosure of the mine – which would have yielded very little – so most forms of legal action were suboptimal. The banks, through patient dialogue with the owners, tried to persuade them to put in more equity money that could be used both for further exploration and for a partial reduction of the debt. This worked for a while and indeed the debt was reduced significantly. At that stage, the individual loan officer who had been leading the discussions was replaced by a swashbuckler type who started threatening the owners with legal action. The owners, upset at the change of tone and now persuaded that they were throwing their good money after bad money, withdrew from the discussions, leaving the three banks to foreclose on what was, without the owners, a worthless shell.
3.5.7 Negotiations

Best practice in the recovery of distressed business loans is based on ensuring that ample effort goes into preparing for negotiations.

**To prepare for negotiations:**

1. Know your own loans and security position
2. Know the mindset or mental state of each negotiation counterparty.
3. Have a realistic assessment of counterparties' other personal or psychological attributes.
4. Know the main negotiating points critical to the success of the workout, and how each negotiating point is likely to be perceived by the counterparty.
5. Determine the overall posture best to adopt in conducting the negotiations.
6. Detail the relative merits of your chosen “posture” in terms of flexibility.
7. Separate the counterparties and their representatives from the problems caused by differences in positions.
8. Focus on each counterparty's needs and interests rather than their stated or presumed position.

3.5.8 Pricing the workout

After all the analysis, the lender will have to determine the terms on which it is prepared to continue the financial relationship with the borrower. Even where the one-time default proved to be exceptional, it is still likely that the risk profile of the borrower will have changed and will need to be reflected in new terms. When more drastic action is required, the risk profile will have changed even more and the lender will need to seek compensation for this.

Lenders have two ways to address a change in the risk profile: they can lower the risk, or they can seek monetary compensation for assuming the higher risk. The latter can be achieved by demanding a higher interest rate and/or by demanding a restructuring fee on top of the costs incurred by the lender. Thus, the three basic parameters that will need to be negotiated in a workout are repayment schedule, security, and interest rate.

If the net present value of the debt to be rescheduled or restructured and the expected future sustainable cash-flows before interest is positive, the lender will want to leave as much as possible of the security in place and instead reach for the customary internal rules for loan pricing, i.e., to compute the interest rate to be charged. These rules would include factors like cost of funds to the lender, cost of operations, credit risk requirements, and borrower options. Most large lenders will provide pricing sheets to their loan officers. The smaller lenders will want to use available market rates as their benchmarks. To the extent that the credit risk has increased, it would be appropriate for the lender to demand a slight increase in the interest rate, or capitalize the increase in interest to a lump sum to be negotiated as a
front-end fee and added to whatever cost-based fees the lender would charge upon consummating the restructuring.

The problem arises when the net present value of the debt to be rescheduled or restructured and the future sustainable cash-flow is negative. The package then becomes a matter of negotiations, complicated by the number of other parties with claims on the company. The outcome of these negotiations will depend very much on the negotiating position of the lender and the borrower. The negotiating position of the borrower will be stronger if it can show a relatively strong sustainable cash flow for the future. The negotiating position of the lender is largely determined by the strength of the security underlying the loans and by the lenders’ ability to foreclose on this security and effectively walk away from the negotiations.

If there is only one lender or the several lenders have roughly the same kind and coverage of security, it will be easy to determine the discount to be taken by the lender simply by dividing the total amount of debt outstanding into the amount of sustainable debt. For that part of the debt that cannot be sustained, other solutions will have to be found to compensate the lender, as discussed below. If there are several lenders, they will want to agree on the most likely business scenario in order to determine how much debt the borrower can continue to service, i.e., the sustainable debt. For this purpose the present value of the sustainable cash flow will be computed using the interest rate that is expected to be the outcome of further negotiations.

There is still work to be done if there are multiple lenders involved who have different security. Unless the unsecured lenders have some other legal or other grounds for seniority, they would probably be excluded from sharing. If the amount of the workout is large enough to accommodate the remaining secured lenders in full, their share will be the full amount of their loans. Otherwise, the remaining workout will probably be divided in proportion to the respective values of their shares.

Lenders may differ about the interest rate to be applied as a discount rate, but these differences will probably disappear as a result of negotiations. The differences in pricing may also be the result of different funding costs for each of the lenders, in which case the result will normally be a re-aligning of the interest rates to an average, leading to some lenders being better off than before. The argument that longer-term debt should carry a higher interest rate is not really valid here as, during the workout, all lenders will presumably have accelerated their loans and hence all debt will have become short-term. Interest rates will then only have to be differentiated to the extent that different lenders will accept longer repayment periods.

With possibly some lenders being allocated the full amount of principal outstanding and others receiving less or even nothing, the next problem is how to compensate the latter for their loss in principal. The size of the remaining sustainable debt is in effect equal to what remains of the enterprise value and is less than the amount of nominal debt. There is therefore negative equity and the issue is what is left to compensate those lenders who will be taking a cut. To the extent that the sustainable cash flows, and hence the amount of sustainable debt will have been conservatively determined, there is always the chance that actual results and cash flows will prove more positive. This is referred to as the “upside potential” and gives the negotiators some ability to compensate the lenders for their loss while giving the existing owners of shares an incentive to remain involved.
3.5.9 Maintaining fall-back strategies

Fall-back strategies are extremely important because of the potential fluidity of any workout. The following are worth keeping in mind as strategy is being developed:

Be prepared for your best strategy to become abruptly obsolete as new information comes to light – Workout strategies can be rendered ineffective suddenly, without warning and often as the result of revisions to what were previously believed to be immutable facts. This is because the workout environment is often unstable, highly dynamic, and charged with emotion on the part of most players. Best practice among banks that are leaders in loan recoveries involves sound procedures for selecting the primary workout strategy and at least one additional or fall-back strategy.

The importance of comparing options carefully during initial strategy selection – The scope for different views and approaches is ample. While occasionally some solutions will so clearly dominate all others as to not require deep discussion of alternatives, more often the best course of action is not so immediately obvious. In such cases, a thorough analysis and discussion of the strategy options will be an indispensable part of the asset recovery process. Best practice also involves formalizing the process, by holding the type of decision meeting appropriate for removing ambiguity as to what was decided and by recording the decision.

Comparisons of the various asset recovery options should involve quantification. As a minimum, each strategy option considered should be presented in terms of its internal rate of return (IRR) and/or its net present value (NPV). However, to the extent that certain aspects of risk and uncertainty play an important role yet are not always easily quantified, the framework for analysis and presentation should accommodate important qualitative considerations as well. The SWOT framework may be useful for comparing alternative workout strategies. Regardless of the framework used, it is important to ensure that all main assumptions are set in writing. Over time, assumptions that appear obvious early on are altered and rendered inapplicable. The workout specialist will appreciate having a record of the changing assumptions as the workout strategy evolves.

Playing your cards “close to the chest” regarding fall-back strategies – The extent to which information regarding fall-back strategies can or should be shared will depend on the particulars related to the loan and the borrower’s financial condition as well as the personalities and behaviors of the key stakeholders. The greatest challenge may be with the other lenders, who often have other loyalties or may be less than discreet.

Often the greatest strength of legal recourse is the threat of using it – Deterrence can be a highly effective control device, deriving strength from the knowledge that a particular course of action available to an adversary carries with it the possibility of adverse consequences. The value of perception of power and the ambiguity of its consequences can work to the advantage of the side able to take the potential action. In many cases, once legal action has been initiated, the entire process takes on a life of its own. Those against whom the legal action has been initiated often settle into a “bunker mentality” of defensiveness and unresponsiveness to any peaceful overtures. Some of the most successful recoveries have avoided the need for launching legal action as the mere specter of legal action was enough to guide the parties in the direction of a better solution.

Avoid making idle threats – The specter of a lending institution exercising certain rights and remedies has deterrent value. However, the line between fact and perception is blurred at best. To some degree,
the uncertainty of action and response in a multiparty situation contributes value to the dynamics of deterrence. Therefore, it should not be surprising that if the threat of a particular action is made too frequently and without follow through, the party threatening the action quickly loses credibility and the potential action loses deterrence value. The resulting change in perceptions can even enter the public domain.

**Avoid making things personal** – The workout staff must behave in a highly professional manner at all times. A distressed borrower may well start making accusations or trying to damage the dignity or character of the lender. The temptation to retaliate should be resisted. The deportment of workout staff most likely will be discussed at some point in a court setting, and a clean record in this connection becomes a decided benefit.

### 3.5.10 Where money-laundering or other criminal action is suspected or litigation is involved

While technology has been an enabling factor in encouraging financial depth in most countries, it has also made things easier for those wishing to transact financial business on a grand scale operating outside of the law. The standards to which lenders are being held in taking safeguards against illegal transactions and uses of funds have been tightened considerably. In many countries, measures aimed at curbing money laundering have been further reinforced since September 11, 2001, with legal and regulatory strictures against global terrorism. While each country will have its own regulations guiding financial institutions and financial transactions, U.S. rules are far-reaching both geographically and in terms of broadening the definitions of many activities that previously escaped the scrutiny. Any financial institution with transactions involving clients or other financial institutions in the United States should have its legal department apprise the institution’s management of the potential impact of the laws and regulations. Even a suspicion of illegal activity anywhere along the transaction chain should trigger certain steps.

**When you suspect illegal activity:**

1. Notify your institution’s legal department as soon as illegal activity is suspected or detected or when notice of litigation proceedings against your institution has been served
2. Make sure senior management is regularly and appropriately apprised of developments
3. Use caution in approaching other stakeholders with suspicions or evidence
4. Document all future dealing with the borrower
5. Minimize one-on-one encounters with those suspected of illegal activity or who have initiated litigation against your institution
6. Involve legal counsel more frequently than under normal circumstances and especially in connection with notifying the relevant authorities
7. Channel all external communications through a designated spokesperson or unit
8. Do not continue with “highest-NPV recovery” strategies if these will materially compromise the institution

**Checklist:**

- Be aware of international tightening of scrutiny of fraud and other criminal actions
- Prepare list of safeguards when first signs or suspicions of fraud or other criminal activity first arise
4.1 Documentation

4.1.1 Restructuring documentation

The most important documents in any workout will be the term sheet, the loan agreement, and the security documents.

Even before the lenders have determined that a going concern solution is feasible and indeed preferable and the transaction starts crystallizing, they will want to start preparing documents. This undertaking can be as simple as a single amendatory letter or as massive as entire boxes of document requiring multiple law firms and hundreds if not thousands of signatures. The full documentation may exist of one or several term-sheets, amendatory or completely new loan agreements, ancillary documents, and security documents. At the closing, all documents will have to be signed by all parties involved. The documentation will also determine the conditions of effectiveness of the restructuring. Before these have been met, the restructuring is not complete and it is theoretically possible to revert to the default and real bankruptcy.

The proposal should contain the following elements:

1. Full description of the borrower
2. Amount(s) of the loan(s) to be restructured
3. Restructuring fees and expenses, if any
4. Name(s) of the lender(s)
5. Anticipated date of closing
6. Representations and warranties
7. Repayment schedule(s)
8. Mandatory repayment(s), if any
9. Cash sweep mechanism, if any
10. Interest rate(s) and applicable margin(s) if floating rate
11. Default interest
12. Interest payment dates
13. (Revised) events of default
14. (Additional) security
15. List of documentation
16. Taxes
17. Governing law

Checklist:

- Establish parties to be part of the workout transaction
- Establish what minimum terms acceptable to parties other than the borrower
- Prepare draft term-sheet
- Negotiate draft term-sheet among parties other than borrower and reach tentative agreement
- Submit draft term-sheet to borrower
- Negotiate, agree, and initial term-sheet
- Have lawyers prepare draft legal documents for workout, including new or amendatory loan agreement and security documents, based on initialed term-sheet
- Negotiate, agree, and sign legal documents for workout
- Determine when conditions of effectiveness have been met and workout is complete
The Restructuring Proposal – Term Sheet

The term sheet is the most important piece of the workout documentation, as all further documentation will find their origin therein. A draft term sheet drawn up right at the beginning of the workout process provides lenders with a useful checklist of parties involved in the workout process and of the terms that will have to be agreed upon with the borrower, other lenders, and stakeholders. The draft term sheet is revised at every stage of the workout process, particularly during negotiations. In addition, before drafting the final and formal workout documents, including the new or amendatory loan agreement, lawyers will want to make sure that they can see the full picture of the proposed workout and can iron out any discrepancies and controversial points.

Term-sheets are a common feature in project lending or in the structuring of term loans. They facilitate the negotiations in that the various terms that have been discussed and agreed upon during the progress of the negotiations can be laid down until the final deal or transaction is agreed upon. Only when the term-sheet has been fully negotiated will it be initialed by the negotiating parties and given to the lawyers who will prepare the full documentation. Term-sheets focus on the main terms and conditions; they can be written in layman’s language and help save time and money.

Term-sheets are particularly useful in workouts, as they allow the borrower and lender to spell out what has been agreed upon and move on to the next item to be negotiated. In a workout, it may be necessary to include more than one creditor or stakeholder in the transaction, and the term-sheet allows the parties to agree on the main terms of the proposed restructuring transaction before the lawyers are asked to prepare the legal documents.

After determining that a workout will be feasible, lenders will want to put a proposal on the table. For smaller borrowers, this may take the form of a conversation between the lender and the borrower, to be confirmed in writing. For medium to large companies, where the terms are likely to be more complex and there is a need for the borrower to carefully study and absorb the, the proposal will more typically be in the form of a draft term sheet spelling out the conditions on which the lender is willing to restructure or reschedule the loan(s).

The Restructuring Documents – Loan Agreements

The complexity of the restructuring dictates which documents will be necessary. For a simple rescheduling of maturities, a letter may suffice and will have legal validity. However, if the face value of the loan and basic terms such as maturities and interest are changed, there may be a need for a new agreement. Lawyers will determine whether this will take the form of an amendatory agreement, where the body of the original loan agreement is left intact and the terms and conditions to be changed are covered in an additional agreement, amending the original. This has the advantage that the security and any other registrations remain in place and in full force. Sometimes the lender and borrower will agree that it is better to draft a new set of documents, starting with the Loan Agreement. There is the risk, however, that dissenting and unsecured creditors will try to gain in position, arguing that the restructured loan is in fact a new loan and that security is therefore junior to their claims. The contents of the new or amended loan agreements will follow the term sheet, though in more detail.
The Restructuring Documents – Security Agreements

In the event that new security has been negotiated, additional agreements will be required to have such security registered. Particular care will be necessary to ensure that the existing rights of the senior, secured lenders are honored and are not diluted or set aside in favor of those of the junior, unsecured lenders. Lawyers and notaries public are essential at this stage.

The Restructuring Documents – Ancillary Agreements

These will include additional overdraft agreements, guarantee agreements, share pledge agreements, security sharing agreements, and the like, all in line with what has been agreed among the borrower and lender. Again, lawyers are essential to ensure that all that has been agreed upon is properly reflected in all of the documents.

4.2 Accounting

4.2.1 Accounting for impaired assets

A lending institution's ability to identify risk and properly manage its overall loan portfolio depends on the quality of its accounting for problem assets. Although accounting standards will vary by country, the following provides a general treatment of accounting considerations for both problem and restructured loans.

A loan achieves the status of “nonaccrual” when any one or more of the following conditions are met:

1. The collection of any of the outstanding principal and all past and future interest accruals over the full term of the loan are deemed to be in jeopardy;

2. Except in the case of formally-restructured loans, any portion of the original loan has been written off; or

3. Any outstanding payment on the loan is more than 90 days past due and is both not adequately secured and is in the process of collection

If full recovery of both principal and interest owing on a loan is expected within a reasonable time, the loan should not be transferred to nonaccrual status. However, when a loan's full recovery becomes suspect for any reason, the loan should not be kept from nonaccrual status simply because the value of the loan security exceeds the value of the loan. If a loan qualifies for two performance categories, one of which is nonaccrual, then it should be classified nonaccrual. How strictly this is required and enforced will vary from country to country.

For loans to avoid being assigned nonaccrual status and determined to be in the process of collection, it is important to provide documented evidence that full collection of amounts due and unpaid is expected to occur within a reasonable time period, usually 80 days from the date that payment was due. Written commitments from the borrower should be obtained if such collection depends on actions on the part of the borrower.
For a problem loan to be classified as in the process of collection, evidence of repayment capacity should be based on operational cash flow generation or from convincingly reliable sources. It is important to be familiar with local laws in order to ascertain if bankruptcy procedures can ensure future payment that is sufficiently reliable to justify the loan in question as being in the process of collection.

Aggregation is also important. A loan in nonaccrual status prompts the need to assess if other loans to the defaulting borrower warrant being similarly classified as nonaccrual or is there sufficient evidence to suggest that other loans are sufficiently independent from the distressed loan in question as to eliminate any doubt of collectability. An important question that will arise in connection with many loans classified nonaccrual is when resumed payments can be counted as income. Once the loan's collectability has been re-established, cash payments may qualify for recognition of interest income if any of the following conditions are satisfied at the time when payment has been received:

1. Except in the case of formally-restructured loans, the loan does not have a remaining unrecovered prior charge or write-off
2. Payment has been made from an expected repayment source and this can be demonstrated through documentation; and
3. The loan, after having been adjusted for the payment, is not contractually past due by more than a certain number of days (such as 90 days in for countries following IFRS) and is not expected to become past due by more than the aforementioned number of days, or a repayment pattern has been set that reasonably demonstrates future payment capacity.

If the loan has an unrecovered prior write-off and has not been formally restructured, and a cash payment has been received, then use of the cash proceeds should be applied toward reversing the write-off before any amount of interest income can be recognized.

Under those accounting systems that follow fairly closely either U.S. GAAP or IFRS, for a loan classified nonaccrual to be reinstated to accrual status, all of the following conditions should be satisfied:

1. All principal and interest due on the loan has been paid and the loan is deemed current;
2. Except in the case of formally-restructured loans, any prior write-offs have been recovered;
3. The ability of the borrower to perform in accordance with the terms of the existing loan agreement carries no reasonable doubt; and
4. Evidence has been demonstrated of sustained performance in connection with the contractual terms of the loan agreement. Satisfactory performance is usually demonstrated by the timeliness of six consecutive monthly payments; four consecutive quarterly payments; three consecutive semiannual payments; or two consecutive annual payments.
4.3 Further Monitoring

4.3.1 Tracking financial obligations and managing cash flow during the workout

During a workout, managing cash becomes even more critical because the company as a debtor must concern itself not only with the overall manageability of its debt levels and timeliness of debt servicing payments, but also with questions of fairness and equitable treatment among its various creditors and other payees as cash becomes available and decisions are taken as to how it is to be applied. Sales of assets, which during good times would have happened without issue, now must be subjected to additional scrutiny to ensure that they do not trigger alarms of “fraudulent conveyance.”

Careful cash flow forecasting should be accompanied by sound cash controls within the borrower company. This can be achieved either within the borrower’s own systems or by introducing special organizational arrangements that effectively cordon off the cash management function. It can be handled by a lock-box with cash sweep, which can be managed either by the company’s own treasury, by an outside consultant, or by a special purpose vehicle that could take the form of a trust or a limited liability company.

When cash continues to be managed within the borrower company, make sure of the following:

1. Establish expenditure thresholds for different levels of review and control.
2. For expenditures over a certain threshold, ensure that double signatures are required to authorize payment.
3. Depending on the nature of the business, either centralize approvals and handling of expenditures, or set regular budgetary guidance and spending “envelopes” for unit or department managers with appropriate procedures for enforcing spending/budgeting reconciliation and accountability.
4. Rationalize approvals and payments system.
5. Use a third-party consultant or auditor to perform monthly operational audits as part of an ongoing monitoring process tailored to the key aspects of the workout and distinct from other audit and financial reporting functions.

Checklist:

- Ensure that borrower adopts proper action when he continues to manage cash during the workout.
5.1 Conclusion

This manual was developed to help the experienced lender deal with problem corporate and SME loan accounts. While it is fairly comprehensive, it cannot be encyclopedic. In future, we will attempt to customize the manual to the needs of key regions where practices warrant special topics or treatment. The manual also represents the first stage in a three-stage program designed to help portfolio and workout officers in IFC’s client financial institutions. The next two stages entail developing a series of online toolkits for workout officers, and developing regional workshops based on much of the material presented in this manual as well as additional material.

We welcome comments and suggestions from readers at any time.
ANNEX 1 Signs of Financial Distress

Operations

1. **Steady decline or rapid increase in sales** – When rapid increases in sales are attended by lower or even negative profit margins, an expansion and aging of receivables and inability of customers to pay, or an escalation in the number of products returned or services subsequently cancelled, these increases become a sign of distress. A sudden increase in sales may also be the result of a distressed company’s attempts to hide problems by recognizing revenues prematurely.

2. **Frequent cash shortages**

3. **Significant changes in net working capital** – Changes that are frequent and volatile could reflect a highly dynamic business environment, problems within the company, or a combination.

4. **Unexpected changes in strategy or business** – Changes that are too frequent and not obviously beneficial could reflect management problems or attempts to hide poor performance.

5. **Shrinking cash margins and unexpected losses**

6. **Unrealistic pricing/discount policy** – It is not uncommon for companies encountering financial problems to make the wrong call regarding price changes because they did not gauge correctly the price-elasticity of demand for their products.

7. **Frequent revenue/earnings shortfalls** – If the company’s competitors are not experiencing such shortfalls, this may indicate that company managers are optimistic with potentially grave implications for the company’s size and cost structure, including inappropriate use of financial leverage.

8. **Increasing dependence on fewer customers**

9. **Negative operational cash flow with net profits** – If the company’s operational cash flow is negative in more than one period when it is reporting net profits, this raises questions about the viability of the company’s business model, suggesting that the company is being sustained by new financing activities or by consuming capital while relying on minimizing non-cash deductions to show a profit.

10. **Deteriorating accounts receivable**
11. **Increased credit to affiliated companies** – It may be that this is justifiable economically but the process lacks safeguards. Or controls may be in place but the economic justification is wanting. In the extreme, this can be a way of tunneling cash flow away from the company’s rightful stakeholders.

12. **Lengthening terms of settlement for payables** – This may reflect unilateral actions taken by the company as coping measures because of insufficiency of cash to meet the payment of all obligations falling due in each cycle.

13. **Repeated changes in suppliers** – When a company changes suppliers frequently, it is important to ascertain the reasons. If quality or improved economy are not the apparent motivation, the problem may be one of suppliers tightening the terms of sale because of the company’s failure to settle the payment of invoices on a timely basis, possibly because of financial difficulties, and the company consequently trying on new suppliers with more generous initial terms.

14. **Insufficient cash to take trade discounts** – Failure to take trade discounts may reflect an inability to capture efficiencies because of deeper problems with the company’s business model.

15. **Inventory buildup with turnover slowing**

16. **Outmoded production or distribution system** – There are situations in which companies with a combination of natural advantage and good management can be very effective and competitive in deploying vintage equipment, facilities and distribution systems. Care is needed in making such an assessment in connection with the extent to which the company’s equipment, facilities, inventories and securities serve as collateral.

17. **Inadequate spending on critical activities** – Obvious examples of this are capital replacement as facilities and equipment wear out or become obsolete. In certain industries, research and development (R&D) is another critical area requiring cash outlays for a company to maintain competitiveness. Advertising and marketing costs represent another area where under-spending can go undetected.

18. **Failure to pay taxes**

19. **Non-renewal or cancellation of insurance**

20. **Deficient billing practices** – The best efforts of a company’s sales force can be significantly diminished if the company’s billing practices are sloppy. As a lender, you want to make sure that your corporate or SME client has a sound billing system that efficiently completes the business cash transformation cycle.

### Management and Behavior

1. **Poor or deteriorating sponsor reputation** – This can result from the owner’s conduct in running the borrower company’s business, his or her behavior on the company’s governance bodies, or behavior that is not business related, such as personal scandals or misconduct.

2. **A lack of management/sponsor vision** – To the extent that other signs of distress may be evident and market conditions call for more visionary leadership, this sign is an important one.

3. **Increasingly authoritarian management/board style** – Authoritarian behavior as an emerging style may reflect an effort on the part of managers to retain control in the face of mounting difficulties.
4. **Senior executives not providing financial information**

5. **Incompetent finance director or CFO**

6. **Management experience/skill deficiencies**

7. **Management and shareholder contentiousness**

8. **Frequent changes in ownership and key positions**

9. **Sponsors’/managers’ unexplained new wealth** – If managers known to depend on the company for their livelihoods suddenly begin displaying unexplained new-found wealth, this could signify misappropriation of company resources.

10. **Quarrels between company and its auditors**

11. **Notable shabbiness/loss of pride in company** – When a company is beleaguered with problems, one sign of malaise often is a loss of pride in the company.

12. **Personal issues constraining management team** – When top management are dealing with difficult personal issues, this can pose a serious threat to a company's financial health and general soundness.

**Reporting**

1. **Worsening delays in financial reporting**

2. **Poor quality of, or inconsistencies in, reports**

3. **Qualified audit opinions and/or audit disclaimers** – When auditors find it necessary to qualify their opinions in connection with the financial health of a company, this should serve as an immediate flag that bigger problems are to be found within the company.

4. **Unexpected and/or untimely changes in auditors** – Although audit firms can be changed with certain regularity (in fact, in some countries the regulatory authorities require changes every few years), an unexpected or untimely change may signal a dispute between the company and the audit firm regarding how the audit firm should portray the company's condition of financial health.

5. **Many unusual items in financial statements** – When financial statements have a number of unusual items, it may be an attempt to obscure poor performance, a misuse of company resources, or both.

6. **Revaluation of assets without convincing explanations** – Unjustified or unsubstantiated revaluation of assets is a common way to upwardly distort shareholder net worth for whatever purpose.

7. **Padding of financial statements (mainly on the Balance Sheet)** – This sign covers a broader range of potential distortion than mere revaluation of assets.

8. **Increasingly changing interim financials with surprises** – Frequent changes in the format, breakdown, and general presentation of the interim financial statements may signal an attempt to obscure rather than to inform.
9. **Major unexplained planned vs. reported results gaps** – If a company has shown that it can forecast within certain confidence intervals and then experiences major deviations from these bands, the cause may reflect any of a number of problems. These can range from shifts in market demand for the company’s products, sudden changes in the availability and/or prices of key inputs, and shifts in investor attitudes affecting the company’s ability to raise financing.

10. **A deterioration in ratings by external analysts**

11. **Regular breaches of financial covenants**

12. **Increasing incidence of waiver requests**

**Investing**

1. **Non-current assets increase faster than revenue/profit** – Real investment often requires large amounts of money be spent in a short time. Building a new factory or expanding an existing one can easily use resources significantly greater than a company’s annual increments to its total sales or its profits. But when non-current assets show a prolonged trend of increasing faster than either revenue or profit, this should be a signal to examine whether or not the company’s expansion is manageable taking all prospective sources of cash flow into account.

2. **Major procurement without proper rationale/financing** – If a company is adding land, plant, major equipment or other large purchases without having a clear rationale for the procured items, this can foreshadow financial distress.

3. **Working capital needs funded by asset sales**

4. **Inventory build-up without sound inventory controls**

5. **Seemingly speculative inventory purchases**

6. **Inadequate maintenance of plant and equipment**

**Financing**

1. **High or increasing levels of financial leverage** – The amount of debt a company can prudently take on depends on suitable measures of risk and assessments of company financial controls. Additionally, the size and apparent stability of profit margins also needs to be taken into account with larger and more stable margins permitting more indebtedness. In assessing the degree of financial leverage in a borrower company, a one-size-fits-all approach should be avoided even within a single sector.

2. **Increased short-term funding for long-term liabilities**

3. **Difficulties in accessing financing**

4. **Excessive lending to related individuals/affiliates**

5. **Obligations to creditors not fully met each cycle**

6. **Increasing customer/creditor complaints/legal action**

7. **Funding secured on less favorable terms**
ANNEX 2  Example of a Format for the Daily Cash Report

Figure 1: Format of Daily Cash Report

<table>
<thead>
<tr>
<th>(US$ millions)</th>
<th>Amount</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH AVAILABLE TODAY</td>
<td>0.40</td>
<td></td>
</tr>
<tr>
<td>OPERATING LOAN</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance Forward</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Advances</td>
<td>0.20</td>
<td></td>
</tr>
<tr>
<td>Payments</td>
<td>0.10</td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>1.10</td>
<td></td>
</tr>
<tr>
<td>Allowable by Formula</td>
<td>2.00</td>
<td></td>
</tr>
<tr>
<td>Loan Available</td>
<td>0.90</td>
<td></td>
</tr>
<tr>
<td>CASH AVAILABLE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash net of float all accounts</td>
<td>0.50</td>
<td></td>
</tr>
<tr>
<td>Loan Available</td>
<td>0.90</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1.40</td>
<td></td>
</tr>
<tr>
<td>TERM LOAN(S)</td>
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<td></td>
</tr>
<tr>
<td>Principal Loan</td>
<td>10.00</td>
<td></td>
</tr>
<tr>
<td>Arrears</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Payment Interest Due?</td>
<td>0.20</td>
<td></td>
</tr>
<tr>
<td>Payment Principal Due?</td>
<td>0.10</td>
<td></td>
</tr>
<tr>
<td>COMPLIANCE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating loan is 1M based</td>
<td></td>
<td></td>
</tr>
<tr>
<td>upon 75% of A/R less over</td>
<td></td>
<td></td>
</tr>
<tr>
<td>90 days plus 25% inventory to a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>max of 250K. This based</td>
<td></td>
<td></td>
</tr>
<tr>
<td>upon monthly report submitted</td>
<td></td>
<td></td>
</tr>
<tr>
<td>XXX</td>
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<td></td>
</tr>
<tr>
<td>SALES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales month to date</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales budget month to date</td>
<td></td>
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<td>NET BOOKING</td>
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<td>MTD</td>
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<td>A/R BEGIN MONTH</td>
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<td>TODAY</td>
<td>MTD</td>
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The weekly forecast of cash requirements could appear as follows:

**Figure 2: Format of Weekly Report of Cash Requirements**

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<th>LNS</th>
<th>BUDGET</th>
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<th>WK3</th>
<th>WK4</th>
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<tr>
<td>From sales</td>
<td>115</td>
<td>100</td>
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<td>100</td>
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<td>100</td>
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<td>From A/R</td>
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<td>From asset sale</td>
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<td>40</td>
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<td>40</td>
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<td>30</td>
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<tr>
<td>From other</td>
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<td>45</td>
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<td>Commissions/Royalties</td>
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<td>-1</td>
<td>2</td>
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<td>2</td>
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<td>10</td>
<td>0</td>
<td>10</td>
<td>10</td>
<td>10</td>
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<tr>
<td><strong>OTHER</strong></td>
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<td></td>
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<tr>
<td>Professional fees</td>
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<td>4</td>
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<td>4</td>
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<td>2</td>
<td>8</td>
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<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
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<td>TOTAL OTHER</td>
<td>27</td>
<td>22</td>
<td>5</td>
<td>22</td>
<td>22</td>
<td>22</td>
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<tr>
<td><strong>TOTAL CASH RECEIPTS</strong></td>
<td>200.00</td>
<td>195.00</td>
<td>5.00</td>
<td>195.00</td>
<td>195.00</td>
<td>195.00</td>
</tr>
<tr>
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<td>199.90</td>
<td>195.20</td>
<td>4.70</td>
<td>195.20</td>
<td>195.20</td>
<td>195.20</td>
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<td><strong>DIFFERENCE</strong></td>
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<td>0.30</td>
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<td>0.00</td>
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<td>1.10</td>
<td>0.90</td>
<td>0.70</td>
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<td><strong>CASH</strong></td>
<td>1.10</td>
<td>0.80</td>
<td>0.30</td>
<td>0.90</td>
<td>0.70</td>
<td>0.50</td>
</tr>
</tbody>
</table>
## ANNEX 3 Example of a Liquidation Balance Sheet

**TEXTILE COMPANY AS**  
LIQUIDATION BALANCE SHEET AND FUNDS AVAILABLE FOR DISTRIBUTION

<table>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Current assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Cash and bank</td>
<td>5,184,691</td>
<td>2,591,417</td>
<td>100.0%</td>
<td>2,591,417</td>
</tr>
<tr>
<td>2 Marketable securities</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Customer receivables</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.1 Accounts receivables</td>
<td>39,923,012</td>
<td>46,557,132</td>
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<tr>
<td>3.2 Allowance for uncollectible receivables</td>
<td>(2,156,300)</td>
<td>(2,156,300)</td>
<td></td>
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</tr>
<tr>
<td>3.3 Notes receivable</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total customer receivables</strong></td>
<td>37,766,712</td>
<td>44,400,832</td>
<td>60.0%</td>
<td>26,640,499</td>
</tr>
<tr>
<td>4 Other receivables</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.1 Receivables from affiliated comp.</td>
<td>48,952,970</td>
<td>68,800,766</td>
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<tr>
<td>4.2 Receivables from shareholders</td>
<td></td>
<td></td>
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<tr>
<td>4.3 Other short term receivables</td>
<td>101,727</td>
<td>113,342</td>
<td>0.0%</td>
<td>-</td>
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<tr>
<td><strong>Total other rec.</strong></td>
<td>49,054,697</td>
<td>68,914,108</td>
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<tr>
<td>5 Accrued income</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Prepaid expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.1 Prepaid/refundable taxes</td>
<td>9,424,156</td>
<td>7,697,973</td>
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<tr>
<td>6.2 Other prepaid expenses</td>
<td>920,377</td>
<td>796,665</td>
<td></td>
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</tr>
<tr>
<td><strong>Total prepaid expenses</strong></td>
<td>10,344,533</td>
<td>8,494,638</td>
<td>0.0%</td>
<td>-</td>
</tr>
<tr>
<td>7 Inventories</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.1 Raw materials and other materials</td>
<td>115,004,452</td>
<td>95,410,740</td>
<td>60.0%</td>
<td>57,246,444</td>
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<tr>
<td>7.2 Work in progress</td>
<td>118,639,085</td>
<td>138,021,190</td>
<td>30.0%</td>
<td>41,406,357</td>
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<tr>
<td>7.3 Finished goods</td>
<td>80,467,489</td>
<td>67,511,040</td>
<td>50.0%</td>
<td>33,755,520</td>
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<tr>
<td>7.4 Merchandise purchased for resale</td>
<td>8,507,189</td>
<td>5,922,240</td>
<td>60.0%</td>
<td>3,553,344</td>
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<tr>
<td>7.5 Prepayments to suppliers</td>
<td>5,479,234</td>
<td>8,909,108</td>
<td>30.0%</td>
<td>2,672,732</td>
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<td><strong>Total inventories</strong></td>
<td>328,097,449</td>
<td>315,774,318</td>
<td></td>
<td>138,634,397</td>
</tr>
</tbody>
</table>
# TEXTILE COMPANY AS

## II Noncurrent assets

### 8 Long-term financial assets

#### 8.1 Shares in affiliated comp.
- 15,259,258
- (3,256,323)

#### 8.2 Longterm rec. from affiliated comp.
- 800,000

#### 8.3 Other shares and securities

#### 8.4 Other long-term receivables
- 147,749

#### 8.5 Long-term accounts receivable

#### 8.6 Rendimaksu ettemaks

**Total longterm fin.assets**
- 12,950,684
- **12,940,647**

### 9 Noncurrent physical assets

#### 9.1 Land and buildings
- 309,524,206
- 309,485,359

#### 9.2 Machinery and equipment
- 522,762,522
- 521,924,918

#### 9.3 Other equipment & fixtures
- 8,229,676
- 8,912,558

#### 9.4 Accumulated depreciation
- (202,467,484)
- (211,823,494)

**Total tangible assets**
- 640,989,854
- 636,068,839

#### 10 Intangible assets

#### 10.1 Formation and organisation costs

#### 10.2 Development costs

#### 10.3 Purchased licences etc.
- 867,164
- 995,326

#### 10.4 Prepayment for intangible assets

**Total intangible assets**
- 867,164
- 995,326

**Total noncurrent assets**
- 654,807,702
- 650,004,812

**Total assets**
- 1,085,255,784
- 1,090,180,125

Less: **Pledged assets**
- 640,989,854
- 636,068,839

**“Free” Assets**
- 444,265,930
- 454,111,286

Less: **Preferential creditors**

#### Tax Liabilities
- 21,866,071
- 21,076,134

#### Pension related accruals
- 22,711,147
- 27,482,580

#### Severance pay to workforce (est. 3 months)
- 83,583,000
- 83,583,000

**Total**
- 128,160,218
- 132,141,714

**Available for unsecured creditors**
- 316,105,712
- 321,969,572

**Secured Debt and Interest**
- 607,756,162
- 599,108,739

**Pledged Assets**
- 640,989,854
- 636,068,839

**Surplus/Deficit in Security**

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<thead>
<tr>
<th>Surplus</th>
<th>Deficit</th>
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<tr>
<td>640,989,854</td>
<td>636,068,839</td>
</tr>
<tr>
<td>(317,825,952)</td>
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</table>

Initially Available for unsecured creditors
- 316,105,712
- 321,969,572

**Add: Surplus in Secuity**
- 640,989,854
- 636,068,839

Available for unsecured Creditors
- 957,095,566
- 958,038,411

**To be shared between:**

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<thead>
<tr>
<th>Unsecured Portion of Secured Debt</th>
<th>317,825,952</th>
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<td>% of Outstanding</td>
<td>33.3%</td>
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<tr>
<td>Unsecured Creditors</td>
<td>640,989,854</td>
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<tr>
<td>% of Outstanding</td>
<td>66.7%</td>
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**Total Proceeds**

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<table>
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<th>Unsecured Creditors</th>
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<table>
<thead>
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<th>% of Outstanding</th>
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<tr>
<td>48.9%</td>
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**ANNEX 3 Example of a Liquidation Balance Sheet**
## Textile Company AS projections (consolidated)
### Main Assumptions

### Scenario

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<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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<tbody>
<tr>
<td>Base year</td>
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<td>Proj.</td>
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</tr>
<tr>
<td>Sales (volume) - (all amounts in LC'000s)</td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Export Sales - West</td>
<td>982.752</td>
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<td>108%</td>
<td>110%</td>
<td>114%</td>
<td>117%</td>
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<tr>
<td>Domestic Sales</td>
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<td>108%</td>
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<td>Export Sales - CIS</td>
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<td>Less: Discounts and price reduction</td>
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<td>2.800</td>
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<td>Wages (EEK '000s)</td>
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<td>114%</td>
<td>120%</td>
<td>130%</td>
<td>140%</td>
<td>150%</td>
<td>160%</td>
<td>171%</td>
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<td>Social taxes (EEK '000s)</td>
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<td>Unemployment insurance (EEK '000s)</td>
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<td>Total</td>
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<tr>
<td>Administrative and General Expenses</td>
<td>70.349</td>
<td>95%</td>
<td>100%</td>
<td>105%</td>
<td>110%</td>
<td>115%</td>
<td>120%</td>
<td>125%</td>
<td>130%</td>
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<tr>
<td>General Sales and Administrative Expenses (% of sales)</td>
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<td>Commissions</td>
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<td>120%</td>
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<td>Financial Commissions</td>
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<td>Transport</td>
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<td>106%</td>
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<td>110%</td>
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<tr>
<td>Salaries, social taxes and unempl. Insurance</td>
<td>2,02%</td>
<td>101%</td>
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<td>104%</td>
<td>105%</td>
<td>106%</td>
<td>107%</td>
<td>108%</td>
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<tr>
<td>Other</td>
<td>0,63%</td>
<td>102%</td>
<td>103%</td>
<td>105%</td>
<td>106%</td>
<td>107%</td>
<td>108%</td>
<td>109%</td>
<td>110%</td>
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<td>Capital Expenditures (EURO’000s)</td>
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<td>2.000</td>
<td>2.500</td>
<td>2.500</td>
<td>6.000</td>
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<td>Borrowing for Excess Capital Expenditures (%)</td>
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<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
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<td>Borrowing for Capital Expenditures (EURO’000s)</td>
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<tr>
<td>Interest Rate (LIBOR) (%)</td>
<td>2,37%</td>
<td>2,40%</td>
<td>2,50%</td>
<td>3,50%</td>
<td>3,50%</td>
<td>3,50%</td>
<td>3,50%</td>
<td>3,50%</td>
<td>3,50%</td>
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</table>
## Textile Company AS projections (consolidated)

### Income Statement

(all amounts in LC'000s)

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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</thead>
<tbody>
<tr>
<td>Aud.</td>
<td>1,192,186</td>
<td>1,299,873</td>
<td>1,520,436</td>
<td>1,324,319</td>
<td>1,393,725</td>
<td>1,450,652</td>
<td>1,502,154</td>
<td>1,541,735</td>
<td>1,583,700</td>
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</tr>
</tbody>
</table>

### Cost of Production Sold

**Variable Costs:**

- **Raw Materials:**
  - 399,917
- **Packaging Materials:**
  - 29,401
- **Spare parts:**
  - 24,968
- **Chemicals:**
  - 25,043
- **Dyestuff:**
  - 30,175
- **Services:**
  - 14,518
- **Other materials:**
  - 50,880
- **Other:**
  - 30,800
- **Total Materials:**
  - 605,782
- **Energy:**
  - 46,724
- **Heat, steam, gas:**
  - 41,063
- **Water:**
  - 16,836

**Total Variable Costs:**

- 710,405

### Fixed Costs:

- **Wages:**
  - 186,720
- **Social taxes:**
  - 61,624
- **Unemployment insurance:**
  - 96
- **Total Fixed Costs:**
  - 248,344

### Total Production Expenses

- 958,749

### Less: Inventory Changes

- 4,276

### Net Production Expenses

- 954,473

### Gross Production Margin

- 284,925

### Marketing and Sales

- **Commissions:**
  - 37,283
- **Financial Commissions:**
  - 18,587
- **Transport:**
  - 25,699
- **Salaries, social taxes and unempl. Insurance:**
  - 7,565
- **Other:**
  - 9,329
- **Total Marketing and Sales:**
  - 98,463

### Administrative and General Expenses

- 67,758

### Other income less Other Expenses

- (4,765)

### Earnings before Interest, Taxes and Depreciation

- 109,959

### Financing Activities

- **Forex (Gain) /loss - net:**
  - 1.613
- **Interest on I.t. debt:**
  - 46,293
- **Interest on Shareholder Loans:**
  - 1,5%
- **Interest on s.t. debt:**
  - 2,5%
- **Interest earned:**
  - LIBOR
- **Other:**
  - -4,158
- **Net Financing Activities: expense net:**
  - 46,611

### Depreciation

- 40,238

### Earnings before Profit Tax and Extraordinary Items

- 23,110

### Extraordinary profit (loss)

- 0,00%

### Income Taxes

- 0,00%

### Net Income

- 23,110

### Ratios:

- **Gross Production Margin/Revenue from Sales:**
  - 23,0%
- **EBITDA/Revenue from Sales:**
  - 8,9%
- **Net Income/Revenue from Sales:**
  - 1,9%
## Textile Company AS projections (consolidated)
### Sources and Applications

<table>
<thead>
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<th>Source of Funds</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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</thead>
<tbody>
<tr>
<td><strong>Funds from Operations</strong></td>
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</tr>
<tr>
<td>Net Income</td>
<td>23.110</td>
<td>(47.354)</td>
<td>5.894</td>
<td>31.558</td>
<td>65.262</td>
<td>94.197</td>
<td>100.132</td>
<td>85.109</td>
<td>81.244</td>
<td>87.771</td>
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<td>Add: Depreciation</td>
<td>40.238</td>
<td>64.408</td>
<td>60.000</td>
<td>62.504</td>
<td>65.634</td>
<td>69.547</td>
<td>73.459</td>
<td>82.849</td>
<td>86.762</td>
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<td>Less: Deferred Taxes</td>
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<tr>
<td><strong>Total Funds from Operations</strong></td>
<td>63.348</td>
<td>17.054</td>
<td>65.894</td>
<td>94.062</td>
<td>130.896</td>
<td>163.743</td>
<td>173.591</td>
<td>167.958</td>
<td>168.005</td>
<td>178.445</td>
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<td><strong>From Other Sources</strong></td>
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<td><strong>Total Sources</strong></td>
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<td>387.689</td>
<td>94.062</td>
<td>130.896</td>
<td>163.743</td>
<td>173.591</td>
<td>167.958</td>
<td>168.005</td>
<td>178.445</td>
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<td><strong>Total Applications</strong></td>
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<td>387.689</td>
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<td>130.896</td>
<td>163.743</td>
<td>173.591</td>
<td>167.958</td>
<td>168.005</td>
<td>178.445</td>
</tr>
<tr>
<td><strong>Funds Flow/Revenues from Sales (%)</strong></td>
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<td>1,4%</td>
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<td>9,9%</td>
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## Changes in Working Capital

### (all amounts in EEK’000s)

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# Textile Company AS projections (consolidated)

## Balance Sheet

### Assets

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## Textile Company AS projections (consolidated)

### Long-term Loans

(all amounts in EUR'000s)

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### Disbursements/Capitalizations

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<th>Foreign Bank 3 - subordinated</th>
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### Repayments

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ANNEX 5 Sample Term Sheet

DRAFT

TEXTILE COMPANY AS

SUMMARY OF TERMS AND CONDITIONS

Draft dated July 25, 20..

This Summary of Terms and Conditions is indicative only. The summary is subject to approvals by the Combined Lenders’ management, credit committees and/or Boards, as the case may be, and is qualified in its entirety by the definitive Debt Restructuring Agreements and other documentation.

**Borrower**

: Textile Company AS (“the Company”), including for the sake of clarity, all of its wholly- and majority-owned subsidiaries, together referred to as “the Textile Holding”. The Company is wholly owned by Foreign Owner AB (“FOAB”)

**Amount of Restructured Facility**

: All Debt, referred to below as owing to the Combined Lenders, outstanding on the date of the effectiveness of the restructuring will be restructured.

The total amount of debt is subject to strict calculation and confirmation by the Combined Lenders.

For the purpose of the Cash Sweep Mechanism, indebtedness in currencies other than the EUR will be converted into EUR at the spot rate of exchange two days before the signing of each of the Debt Restructuring Agreements.

All of the unpaid and accrued interest (including penalty interest) up to the signing date of the Debt Restructuring Agreement shall be capitalized and added to the outstanding principal of each of the Combined Lenders’ exposure on the signing date of each of the Combined Lenders’ Debt Restructuring Agreements.

**Purpose**

: To refinance and restructure the Borrower’s existing long-term loans and working capital facilities.

**Restructuring Fees and Expenses**

: Reasonable out-of-pocket costs and expenses, including legal and consulting fees, incurred in connection with the preparation, negotiation and execution of the restructuring documentation, will be reimbursed by the Borrower upon the signing of each of the Combined Lenders’ Debt Restructuring Agreement.

**Lenders (together referred to as “the Combined Lenders”)**

: Local Commercial Bank, Capital, Country (LCBAS)
Local Trade Bank, Capital, Country (LTBAS)
Regional Development Bank, Capital, Second Country (RDB)
Regional Development Finance Corporation, Capital, Third Country (RDFCO)
Nature and Amount of
Current Principal Exposure (together referred to as “the Combined Lenders’ Debt”) (all amounts in EUR or their equivalent):  
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<tr>
<td>Senior Term Loan IFC – B Loan</td>
<td>10,260,000</td>
</tr>
<tr>
<td>Senior Term Loan RDB</td>
<td>4,500,000</td>
</tr>
<tr>
<td>RDFCO – Senior Senior Term Loan RDFCO – Subordinated</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Subordinated Term Loan IFC – C Loan</td>
<td>2,700,000</td>
</tr>
<tr>
<td>Subordinated Term Loan RDFCO – Subordinated</td>
<td>900,000</td>
</tr>
</tbody>
</table>

External Counsel: To be determined

Signing Date of the Debt Restructuring Agreements and other Documentation: Expected to occur no later than two months following agreed Term Sheet.

Conditions of Effectiveness: Standard for a transaction of this nature, including but not limited to:

- Satisfactory evidence that all approvals, licenses and permits have been obtained (including, without limitation, shareholder and (if necessary) regulatory approval with respect to the entry into of the restructuring agreement);
- Execution of FOAB Guarantee of the Combined Lenders’ Debt and the Emergency Working Capital Facility;
- Such other conditions precedent as may be considered appropriate (including, without limitation, delivery of satisfactory legal opinions);
- Provision by FOAB of financing (see below – “Shareholder Loan”) of EUR4 million under the terms of the Project Funds and Share Retention Agreement;
- Appointment of a Lenders’ Representative to follow developments at the Company and at FOAB on a periodic basis. Agreement that the Company will pay such Lenders’ Representative directly;
- Undertaking by FOAB to provide the Combined Lenders with quarterly information about its financial performance and status; and
- Undertaking by FOAB to appoint new permanent management at the Company.

Representations and Warranties: Customary for a debt restructuring of this nature, including but not limited to continuing legal and factual representations and warranties relating to financial statements, litigation, taxes, insurance, insolvency and compliance with laws, approvals, contracts, use of proceeds, corporate existence, enforceability and no material adverse change and such other representations and warranties as may be required by the Combined Lenders.

Repayment Schedule: For Senior Term Loans from IFC – A, IFC – B, RDB and RDFCO – Senior, principal payments in 16 equal semi-annual installments commencing on April 15, 20...
For the (existing) Working Capital Facilities and Term Loans from LCBAS and LTBAS, respectively, Limits reduced to zero in 16 equal semi-annual installments commencing on April 15, 20.. (but without prejudice to the Company’s freedom to negotiate higher lines with those banks or new lines with other banks from time to time)

For Subordinated Term Loans from IFC – C and RDFCO – Subordinated, principal payments in a single bullet installment due six months after the last payment of principal of the Senior Term Loans, i.e., not later than April 15, 20..

**Mandatory Prepayments**: Upon the occurrence of any asset sale exceeding in the aggregate LC10 million in any one year notify the Combined Lenders and the net proceeds in excess of LC10 million thereof shall be added to the Cash Sweep described below.

**Cash Sweep Mechanism**: From the year 20.., on or before April 15 of each year the Borrower shall pay to the Combined Lenders (except the holders of the Subordinated Debt) on a pari passu basis, as a partial debt prepayment, the higher of (1) any excess in the amount of cash and near-cash (defined as cash, bank accounts, time deposits, C/D’s, etc.) over the amount of 5 (five) percent of Total Revenues (from sales excluding intra-Textile Holding sales), as per the previous year’s audited financial statements, and (2) any excess in the amount of net working capital (defined as the sum of all current assets less the sum of all current liabilities other than the current maturities of long-term debt) over the amount of 26 (twenty six) percent of Total Revenues (from sales excluding intra-Textile Holding sales), as per the previous year’s audited financial statements. In the case of the (existing) Working Capital Facilities and Term Loans from LCBAS and LTBAS, respectively, the “repayment” will be used to lower the respective limits.

**Interest Rates**: The interest rate on the Loans and Facilities of each of the Combined Lenders shall be three-month EURIBOR plus the Applicable Margin, which shall include all fees and other banking expenses other than those explicitly referred to elsewhere in this term sheet. All interest and fees shall accrue on the basis of actual days elapsed and a 360-day year.

**Applicable Margin – Base**: 1. Senior Term Loans 2.5% 2. Subordinated Term Loans 3.5% 3. Existing Revolving Working Capital and New Factoring and Stock Financing Facilities 5.0%

**Default Interest**: 2% above the Applicable Margin

**Interest Periods**: Interest Periods shall have a duration of three months for the Senior Term Loans and for the Subordinated Term Loans, one month for the Working Capital Facilities and Term Loans from LCBAS and LTBAS, respectively, and one month for the Emergency Working Capital Facility.

**Shareholder Loan**: FOAB will honor its commitment under the Project Funds and Share Retention Agreement (PFSRA) and provide deficiency financing as provided under Section 2.02 of the PFSRA in the form of a subordinated loan of EUR4 million (approximately LC60 million equivalent). This loan shall be made on the terms as specified in Section 2.05 of the PFSRA and made available in full on or before the date that the Emergency Working Capital Facility becomes available to be drawn down by the Company.
Emergency Working Capital Facility: The Combined Lenders will make available a self-liquidating Emergency Working Capital Facility of EUR4 million to be opened on the closing of the Debt Restructuring. Most likely, this will consist of (i) additional factoring and/or stock financing facilities to be made available by LCBAS and by LTBAS for their own account; pro rata to their exposures and (ii) by LTBAS in the form of an overdraft limit made available by LTBAS and guaranteed by each of the Combined Lenders, other than LTBAS and LCBAS pro rata to its exposure.

The terms of the Emergency Working Capital Facility will be normal commercial terms and include an interest rate of EURIBOR plus the Applicable Margin.

The Emergency Working Capital Facility and the guarantees provided by the Combined Lenders other than LTBAS and LCBAS will expire on December 15, 20...

Deferral of Principal Payment: The Company may elect to defer payment of principal on the Senior Term Loans and, in the case of the Working Capital Facilities and Term Loans from LCBAS and LTBAS, respectively, defer the lowering of the limits (i.e., thereby extending the overall maturity by one or more payment periods) without this resulting in a formal payment default by the Company for an aggregate amount equal to the amounts paid by the Cash Sweep Mechanism in the preceding two calendar years at such time that the Net Working Capital falls below 85/365 of Total Revenues over the preceding 12 calendar months to be certified by the Company’s auditors at year-end. Interest shall, however, be kept current at all times.

Undertakings: In addition to those already incorporated in the present Loan Documentation, the Borrower shall be subject to the following undertakings:

Not to incur capital expenditure above EUR3 million or its equivalent in the aggregate within any one calendar year unless this is approved by the Combined Lenders;

Not to make any payments of principal under the Shareholder Loans until the Combined Lenders’ Debt has been repaid in full; and

c) Not to pay or declare dividends until the total of the remaining debt under the Combined Lenders’ Debt is less than EUR19.5 million equivalent and then only if there is no existing default or an event which with the passing of time may become a default.

Events of Default: Substantially those that are currently included in the existing Loan Documentation, but including any insolvency affecting FOAB.

Security: Existing security will remain in place but will be extended to also cover the new Emergency Working Capital Facility;

The existing Security Sharing Agreement and Security Agreements will be amended to remove the current disparity between the positions of the Local Banks and the other Combined Lenders;

A full and unconditional guarantee by FOAB of the outstanding loans and of the Emergency Working Capital Facility provided by the Combined Lenders, supported by a pledge of FOAB’s Shares in the Borrower; and subordination of existing and future indebtedness (1) to subsidiaries of the Company; and (2) to – or guaranteed by – FOAB, any of its subsidiaries and its shareholders.
Documentation: The Debt Restructuring shall be governed by acceptable documentation, standard and customary for a restructuring of this nature including, inter alia, the usual representations, warranties, material adverse change, conditions precedent, increased costs, indemnities, and events of default.

Documentation shall include, but will not be limited to, the following:

- IFC Amendatory and Restated Agreement
- RDB Amendatory and Restated Agreement
- RDFCO Amendatory and Restated Agreement
- LTBAS Agreement extending rollover period
- LCBAS Agreement extending rollover period
- LTBAS Factoring and Stock Financing Agreement (for Emergency Working Capital Facility)
- LTBAS Overdraft Agreement (for Emergency Working Capital Facility)
- LCBAS Overdraft, Letters of Credit, Factoring and Stock Financing Agreement (for Emergency Working Capital Facility)
- Agreements between other Combined Lenders, other than LTBAS and LCBAS, and LTBAS guaranteeing LTBAS Overdraft Agreement (for Emergency Working Capital Facility) on a pari passu basis
- FOAB Guarantee Agreement
- Amendment to Share Pledge Agreement to include LTBAS and LCBAS.

Taxes, Withholdings, Deductions: All payments will be made free and clear of any present or future taxes, withholdings or other deductions whatsoever (other than income taxes in the jurisdiction of the Lender’s applicable lending office). The Borrower will indemnify and gross-up the Lenders for such taxes paid by the Lenders.

Break funding costs will also be included.

Governing Law: English law and the non-exclusive jurisdiction of the English Courts, except that (a) Local Law to govern Agreements between other Combined Lenders and LTBAS guaranteeing Factoring and Stock Financing Agreement and the (amended) security documentation where applicable; and (b) FOAB Guarantee Agreement to be governed by Foreign Country Law.

Signed for Agreement

Textile Company AS
By:

12. LCBAS
By:

Foreign Owner AB
By:

LTBAS
By:

International Finance Corporation
By:

Regional Development Bank
By:

Regional Development Finance Corporation
By:
Appendix 1: Glossary

**Ability to pay** – an operating premise that when a loan goes into payment default and possibly further into arrears, the main reason for this default can be found in some kind of problem with the borrower’s “ability to pay” and not with his “willingness to pay.”

**Accounts payable** – owed to vendors for products and services that those vendors allowed to be purchased on credit. It appears on the company’s balance sheet as a current liability.

**Accounts receivable** – money owed to the company for products and services sold on credit. This shows up as a current asset on the balance sheet.

**Ad hoc financial distress** – a situation in which a company is showing signs of undergoing financial stress but where the causes of the distress appear to be internal to the company.

**Anti-Money-Laundering (AML) laws and regulations** – most financial institutions and many non-financial institutions are required to identify and report transactions of a suspicious nature to the financial intelligence unit in the respective country.

**Bankruptcy** – the condition of a legal entity that does not have the financial means to pay incurred debts as they come due. In countries with bankruptcy laws, this status is usually established through legal procedures involving a petition by the bankrupt (voluntary bankruptcy) or by its creditors (involuntary bankruptcy).

**Budget** – summary of targeted sales revenues, expenditures, and capital investments to be incurred to achieve these sales.

**Business model** – the way the company runs its business, including purpose, offerings, strategies, infrastructure, organizational structures, trading practices, and operational processes and policies.

Business plan – the statement of the business goals and a description and quantification of the activities required to achieve these goals.
**Carry trade** – borrowing of money at a low interest rate in one currency in order to invest in a security or investment that provides a higher interest rate in another currency.

**Cash flow** – a measure of cash availability after taking into account all relevant sources and uses of cash. Cash flow has three main components: operational, investing, and financing.

**Cash sweep** – an automated process whereby all, or a portion, of the available cash is moved from the borrower’s account(s) into an account controlled by the lender(s) or by a neutral party, trusted by both sides, removing it from the borrower’s control.

**Fraudulent conveyance** – occurs when a debtor transfers property or other assets with the intent and purpose of moving it beyond the reach of creditors’ ongoing or impending claims. Such conveyances are generally annulled by the courts.

**GAAP** – Generally Accepted Accounting Principles

**IFRS** – International Financial Reporting Standards

**Internal rate of return (IRR)** – The discount rate that makes the net present value equal to zero.

**Jeopardy case** – an investment that has certain characteristics (including the strong likelihood that in the absence of intervention the institution will not recuperate all of its capital from the investment.

**Loan classification system** – a standard classification system that bank regulators in most countries require their commercial banks and other depository institutions to follow in classifying the loans carried on the books of those institutions. The five main categories among which a loan must be assigned a designation are: acceptable, special mention, substandard, doubtful, and loss.

**Lockbox** – A service provided by commercial banks to companies in which the company receives payments by mail to a post office box and the bank picks up the payments several times a day, deposits them into the company’s account, and notifies the company of the deposit. This enables the company to put the money to work once it is received, but the amounts must be large in order for the value derived to exceed the cost of the service.

**Marketing plan** – description of the market, statement of goals in the market, and measures, both qualitative and quantitative, to be taken to achieve these goals.

**Money laundering** – in U.S. law, the practice of engaging in financial transactions to conceal the identity, source, or destination of illegally gained money. In UK law, the act is defined as “taking any action with property of any form which is either wholly or in part the proceeds of a crime that will disguise the fact that that property is the proceeds of a crime or obscure the beneficial ownership of said property.”

**Signs of distress** – any of a number of things that can be observed either within a borrower company or in connection with the behavior or condition of its main stakeholders which may provide an indication of financial problems or potential financial problems in the not-too-distant future.
**Strategic plan** – process of defining a company’s longer-term strategy, or direction, and preparing for decisions on the allocation of its resources, including its capital and people, to pursue this strategy.

**Structural subordination** – occurs when a bank or other institution lends to a holding company that uses the loan proceeds to infuse capital, in the form of equity or deeply subordinated shareholder loans, into one or more newly purchased operating companies. The holding company lender is structurally subordinated in right of payment relative to third-party lenders that may be extending credit directly to the operating subsidiaries.

**SWOT Analysis** – a framework for analyzing a business or a strategic initiative in terms of its strengths, weaknesses, opportunities, and threats.

**Systemic financial distress** – financial distress observed in numerous companies, which occurs as the consequence of broader macroeconomic or structural problems in the country’s economic and payments “systems.”

**Terms of trade** – a dynamic price variable representing the ratio of the trade-weighted average of the international prices of a country’s exports of goods and services to the rest of the world over a trade-weighted average of the international prices at which it imports goods and services from the rest of the world.

**Triage** – system for allocating scarce resources; it provides the maximum resources to individuals of highest priority, and few or no resources to individuals of lowest priority.

**Venture Capital (VC)** – growth equity capital or loan capital provided by private investors (or specialized financial institutions). Also called risk capital.

**Voidable preference** – in bankruptcy law, the notion that a transfer of property within a certain time period before filing for bankruptcy may be set aside, because it takes property out of the bankruptcy estate and may diminish the money available for unsecured creditors. There does not have to be any showing of fraudulent or dishonest intent.

**Willingness to pay** – an operating premise that when a loan goes into payment default and possibly further into accrued arrears, the primary reason for this default has been a change in the borrower’s “willingness to pay” and can include changes in either the way or the extent to which the borrower continues to acknowledge the original loan obligation either in terms of the outstanding amount of the loan, the agreed method of payment, or the actual timing of payments to be made on the loan.

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HBS Project Finance Portal
Appendix 2: Understanding How Systemic Distress Differs From AD Hoc Distress

When the impact of systemic distress is first felt, it is common for many creditors to resort to the same collection strategies and tactics that they used when the only NPLs they were experiencing were clear examples of ad hoc company distress. This often results in frustration as important changes in the overall business environment thwart the efficiency and effectiveness of this approach. The main difference between a normal business environment and an environment marked by financial crisis is the disappearance of market liquidity affecting virtually all asset markets – securities markets, financial derivatives markets, real estate markets and even the markets for capital goods. This is often because credit dries up as lending institutions address the need to shed risk and to strengthen their capital base. A major consequence of general market illiquidity is that loan collateral becomes highly illiquid and as a result loses realizable value. Lenders who decide to foreclose on pledged assets need to consider the full costs of maintaining those assets until such time as they can be liquidated. For example, during the financial crisis in the US which began in 2008, many banks delayed foreclosing on homes with delinquent mortgages precisely because of the high costs of maintaining and physically protecting these properties from vandalism and even natural disaster, pending resale. Prospects for resale were not good over the protracted period precisely because home prices were expected to continue their decline with both prospective buyers and their mortgage providers reluctant to commit to a transaction that could soon be financially “under water.”

An additional risk is that of counterparty risk, which is usually best mitigated through selectivity in entering into relationships. When one is confident in the bank with which one deals, as well the securities broker, the insurance company, etc., and the business environment in which each operates is benign or better, then the idea of counterparty risk can almost be overlooked. A financial crisis can suddenly threaten the viability of any one of those counterparties. As a financial crisis worsens, governments may introduce measures and programs aimed at alleviating the adverse impact on certain key segments of the population. These actions can engender expectations regarding subsequent rounds of relief, which can have a perverse effect on credit discipline. Many borrowers now guard cash carefully both as insurance against uncertainties and so as not to forego their eligibility to receive what they anticipate to be forthcoming government debt relief. If some debt forgiveness is anticipated, then debtors, including those with the capacity to maintain their contractual levels of debt servicing, will want to maximize prospective benefits from the anticipated debt relief. This results in a swell in loan defaults as delinquencies caused by inability to pay suddenly are accompanied by new delinquencies caused by a lack of willingness to pay. Sorting these out becomes a major challenge to lenders.

Another distinguishing feature of financial crises is the disposition of judges, courts, and those responsible for enforcing the law with respect to secured transactions. In these situations, many in the judicial system are more sympathetic to the borrower’s plight. Lenders also face longer lead times before loan resolution or recovery as the legal claims mount and the court system becomes overloaded.

While forbearance is an option and certainly something that borrowers will try to obtain, how it is done must be weighed carefully in terms of its longer-term legal consequences. It is important that the lending institution go on record that despite any forbearance with respect to the time allowed for debt servicing, it is not in any way relinquishing or abandoning its claims. Any forgiveness in terms of discounted amounts or penalties or interest waived should be carefully documented and communicated.
to the concerned parties. A well-conceived lender policy with specific guidance to portfolio officers regarding how to handle delinquent accounts during a broader financial crisis is strongly advised.

The appropriate coping responses of a borrower company in financial distress precipitated by a broader national or regional financial crisis will vary from what needs to be done during a case of ad hoc distress. In an ad hoc situation it is not unreasonable to assume that the borrower company is the weak entity while its suppliers and customers are doing business as usual. In a systemic financial crisis, however, the best path to improved financial health for the borrower company needs to take into account the financial condition of members of its supplier network as well as members of its customer network.

Regarding suppliers, the typical coping response for a company experiencing ad hoc distress would be to try to extend the payment cycle in order to bolster its liquidity. However, during a systemic crisis, the financial condition of suppliers of critical goods and services can threaten the supplier’s performance or even survival, so it may benefit the borrower company to offer them preferential treatment. Not all suppliers will warrant such treatment, and this may offer the borrower company the opportunity to make adjustments in its supplier network. Similarly, it will be important for the borrower company to have a good understanding of which customers should be the focus of efforts to strengthen the relationship and which may be reduced or even discouraged. During ad hoc distress, the borrower company may reduce prices to increase sales. However, in a systemic financial crisis, not all sales are of equal quality. The borrower company will want to protect and consider ways to support its good customers while possibly letting go of problem customers. Knowledge of the general financial state of each of these groups will help make the determination. If the borrower company also extends credit, then this knowledge becomes even more critical.

To cope effectively with a systemic financial crisis, the borrower company will need to delve deeply into the current situation and problems facing its key suppliers and customers. While there will no doubt be other needs and requirements for our borrower company to survive, being in a position to undertake an appropriate set of responses in this area will undoubtedly be fundamental.
Appendix 3: Checklists for Housekeeping Tasks

These can be organized in a spreadsheet that staff can use to set priorities for their work on the problem loan portfolio.

**Checklist for DOCUMENTATION:**

1. Are all of the major legal documents available?
2. Are all legal documents complete and properly signed?
3. Have all borrowers and legal counterparties been identified?
4. Are all appraisal documents readily available?
5. Are all recent financial projections available?
6. Are all loan supervision reports available and complete?
7. Are all insurance policies available and current?
8. Are all environmental reports available?

**Checklist for SECURITY (COLLATERAL):**

1. Is each item of security or collateral properly identified?
2. Are pledged assets accessible?
3. Are they separable?
4. Are they registered?
5. Has security interest been properly perfected?
6. Has all security been valued?
7. Security adequate relative to exposure?
8. Foreclosure permitted outside of the legal system?
9. Average foreclosure resolution times in relevant jurisdiction?
10. Have there been recent cases of asset disposals or transactions involving “fraudulent conveyance”?

**Checklist for OTHER LIABILITIES (both on and off balance sheet):**

1. Identify all of the relevant creditors and counterparties to obligations of the borrower. Identify each creditor or counterparty.
2. For each corporate and SME borrower, identify the following with respect to each of the credit/debt facilities at its disposal:
   - Gross and net exposure
   - Pending and uncleared transactions in the pipeline
   - Currencies of each facility and funding source
   - Contingent liabilities
• Derivative products
• Facilities extended to multiple counterparties
• Composite facilities

3. Prepare or seek specific information on:
• Term loans
• Revolving loans
• Acceptances
• Overdrafts
• Receivables financing facilities
• Guarantees
• Swaps
• Forward foreign exchange contracts
• Documentary credits
• Forfeiting
• Settlement and other transmission of funds

**Checklist for INSURANCE POLICIES:**

Are all of the borrower’s life, property, and casualty insurance policies current?

1. Is there a well-known schedule of when insurance policies are falling due?
2. For each insurance policy, is it clear who is (are) the beneficiary(ies)? Is your institution included?
3. Is there knowledge as to whether the company is able/willing to pay for policy renewal? Is your institution prepared to fund the renewal of insurance policies in order to protect its exposure?
4. Is the contemplated amount of renewed insurance policy coverage adequate to the value requiring insurance protection?

**Checklist for LEGAL:**

1. Have all legal opinions in connection with the loan and borrower been identified and are they readily available?
2. For each loan, has the relevant legal jurisdiction been identified?
3. Have all relevant counterparties been identified in respect of rights, obligations, and undertakings?
4. Are you aware of any particular legal course of action that is prohibited, restricted, or simply not practical within the legal jurisdiction of the relevant loan agreements?
Checklist for WAIVERS:

1. Does the institution have readily available a written history of all waivers requested and granted? If not, are data available to compile such a history?
2. For each waiver requested and granted what did the lender specifically ask for and receive in return?
3. What has been the cumulative net effect of waivers on the bank’s risk/reward position?

Checklist for ARRANGEMENTS WITH SPECIALISTS:

Have contact addresses at hand of the following types of specialists whom you may need on fairly short notice:

1. Bankruptcy/workout lawyers
2. Private investigators
3. Receivers
4. Dunning, liquidation, and auction specialists
5. Turnaround management specialists
6. Appraisers
7. Distressed securities traders

Checklist for COVENANTS:

1. Is information readily available regarding important historical and current covenant breaches?
2. What was the nature of the breaches? Were they minor and brief or chronic and involving significant additional risk to the borrower and the borrower’s capacity to service the loan?
3. What is the “cure period” for covenant breaches provided in the contractual documentation?
4. Has the borrower organization and the relevant counterparties been adequately notified of any and all breaches?
5. What is the lending institution’s recourse?

Checklist for CONTACTS:

Ensure that lists of the following are available, with current contact information, at the first signs of impending economic and financial distress:

1. Relevant client company contacts
2. Key service providers (auditors, accountants, lawyers, etc.)
3. Creditor (co-financier) contacts
4. Relevant government, union, NGO contacts

**Checklist for KEY CONSULTATIONS:**

Ensure that those lender units responsible for the following functions are involved in the process at an early stage and on a continuing basis as appropriate:

1. Syndication desk or syndication management
2. Workout and/or asset recovery
3. Financial operations (specifically, the unit responsible for tracking and doing the accounting for interest payment and loan repayment performance)

**Checklist for LOAN DOCUMENT ISSUES AND TOPICS:**

When preparing a new corporate or SME loan – or confronted with the need to refinance a troubled borrower – eliminate as many deficiencies in the loan documentation as possible. The new loan
documentation should provide for the following:

1. Full analysis of demand or at minimum monthly or quarterly performance tests
2. Cash flow coverage
3. Financial ratio tests
4. Loan-to-value test (based on either discounted cash flow or appraisal)
5. Collateral formulas
6. Full financial reporting from all obligors to include signed balance sheet, profit and loss, and cash flow statements; lease abstracts and hard copy lease agreements; and quarterly signed rent rolls
7. Right to inspect books and records
8. Right to order periodic appraisals
9. Full reimbursement of all expenses, legal and others
10. Name lender loss payee and secure full physical asset insurance coverage
11. Pledge of significant intangibles
12. Cross-collateral and cross-default provisions
13. Full recourse to affiliated companies
14. Environmental compliance indemnity
15. Notice of legal actions under other loan agreements
16. Reaffirmation of personal guarantees
17. Waiver of prior claims and causes of action

**Checklist for Assessing Borrower Viability:**

1. Analyze the borrower’s business model on the basis of current and projected information
2. Adjust the balance sheets of all relevant components of the borrower’s corporate group structure
3. Adjust the income statement of all relevant components of the borrower’s corporate group structure to establish sustainable cash flow from continuing operations
4. Re-calculate the borrower’s enterprise value within the context of a up-to-date view of the overall company or group structure decisions
5. Calculate sustainable debt on the basis of the adjustments above
6. Ascertain on the basis of discussions with other creditors and principles of fair burdening sharing, a workable debt restructuring package, including net benefits to each party in comparison with the most likely liquidation scenario


