

Viewpoint

One of a series of opinion columns by bankruptcy professionals

Middle Market Enters The Realm Of The Recovery Professional

By Jeffrey R. Manning

Although I am not Nostradamus, write this down—2011 is going to be a tough and rough year for most of the U.S. middle market, defined as companies with less than \$1 billion in sales. Although the beginning of 2011 arguably ushered in the most optimistic business outlook since January 2007, because of credit market anomalies and fundamental structural economic challenges, the middle market will mostly be looking in from the outside in a year shaping up much better for larger corporate and multinational companies.

It is easy to be lulled into a dreamy outlook that happy days are here again, but middle-market business leaders, lenders, and investors need to peel back the onion and take a deeper look.

It is no secret that under the Troubled Asset Relief Program and during the Great Recession many U.S. lenders were guided by a principle of “amend, extend, and pretend” whenever U.S. borrowers experienced covenant defaults and loan maturities. Given the harsh market realities and dim prospects for refinancing much anything other than the highest quality credits, it was in the best interest of all parties, including government bank regulators, to take a liberal and cooperative approach on loan terms and accommodations.

For the most part, as banks relinquished regulatory capital, an increasing number of “permanent debt” situations have been asked to find another senior lender. For better quality credits, this task is substantially easier in the current market. Likewise, for credits with solid financial sponsors, new lenders have been increasingly interested in delivering competitive proposals. However, for the storied, hairy, or troubled situation, senior debt markets continue to be uninviting and daunting.

Expect a steady stream of hairy and troubled credits to get booted out of the “amend and extend” program over the next 12 months and into the realm of the recovery professional.

Five dominant issues support the view that the middle market will have a tough 2011, including:

- Political and tax battles
- Challenges to the Wal-Mart consumer
- Commercial real estate overhang
- Foreclosure hangover
- Unfunded public pension mess

Political and tax battles: Although the business community may have been encouraged by the midterm elections, it is difficult to fathom anything other than brutal partisan politics between now and the general election of 2012. Even in those situations where the Obama administration is “back-dooring” regulatory measures over legislative initiatives, the delays in implementing regulation often take six to 24 months, making it exceptionally challenging for businesses to manage or invest.

Wal-Mart consumer: The consumer with disposable income below \$25,000 faces such high unemployment, high foreclosure rates and high consumer debt levels that it is difficult, if not impossible, to spend in a manner like 2006. Given that 70% of U.S. economic growth is consumer-driven, challenges faced by this important consumer subset make it hard on many businesses, especially those in the middle market. And while the unemployment rate dipped to 8.9% last month, that reported rate sets aside the 14.5 million people who have exited the job market, plus millions forced to job share in order to preserve a less lucrative position.

Commercial real estate overhang: In April 2009, Deutsche Bank real estate analyst Richard Parkus reported that some \$1.8 trillion of commercial real-estate loans were maturing and it was clear that at least two-thirds of those loans could not be renewed under the previous underwriting methodologies. The situation has not improved or been resolved. As one of the remaining potential shockers to the underpinnings of the U.S. financial system, commercial real-estate debt problems remain a material challenge to all business, especially because these pressures may squeeze out funding available to the middle market.

Foreclosure hangover: Despite a Herculean effort and all the noble and good intentions by both the Bush and Obama administrations, residential foreclosures are winding inevitably through the financial system like a pig in a python. For the U.S. housing market to clear and return to anything even remotely normal, the rising pile of foreclosures has to work through the courts and into the resale market to the greedy and cruel hands of new investors. Until that hangover clears, it is hard to fathom how residential construction or other businesses serving the home consumer market will ever rebound. In some markets, it is hard to fathom how this market will ever improve since housing starts are a key leading economic indicator, and a key driver of middle-market business.

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Unfunded public pension mess: Finally, add a new mess to the challenges of managing the U.S. economy. In the coming year, municipalities will be forced to choose between raising taxes against a politically hostile voter, cutting critical government services, or honoring contractual commitments to the pension requirements of current and retired government workers. This conundrum adds to the morass of challenges facing the economy and this dynamic will play out in a particularly vitriolic manner as entertaining, if vicious, political theater.

Optimism is uniquely American. For more than 235 years, a core value of citizens has been meeting and overcoming challenges by industry, hard work and a little luck. In August 2007, beginning with the subprime contagion, the roots of what became the Great Recession started to undermine confidence in our financial system. Wall Street was vilified by politicians, the media and Main Street, and the U.S. government decided to dump enormous tax resources to prop up the economy and a number of rogue financial institutions and banks within the international economy.

Federal Reserve Chairman Ben Bernanke argues the economy indeed is statistically growing, the recession is over and unemployment will improve, although it may take five years to get back to employment levels seen back in

2007. However, the five business cycles I have witnessed in 30 years of professional experience lead me to differ: It certainly looks like the next 12 months are going to be tough and rough for the middle market company.

We have not seen the typical U-shaped recovery from this recession, although a few pundits have argued for the “bathtub shaped” recovery. The W-shaped double-dip feels like the most likely to this analyst. Or, we may be facing what New York University Finance Professor Edward Altman calls the “inverted square-root” shaped recovery, a.k.a. the Japanese economic cycle of the past two decades, before we witness material improvement in the U.S. business climate.

For the meantime, bet on it—2011 will be a rough and tough year.

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