Employees' Annuity Corporation: Making a Loan Whole

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Abstract

This case requires the student to analyze what happens when a borrower is in violation of one of the covenants of its private placement agreement. C&B Foods (C&B), the borrower, has been purchased by a hedge fund and C&Bs indenture requires it to offer to "make whole" its loan if there is a change in ownership. The student is asked to not only determine the present value of the "make whole" offer but must weight several other considerations prior to making a recommendation as to whether or not to accept C&B Foods' offer to make the loan whole.

Making a Loan Whole

Employees' Annuity Corporation (EAC) is one of the premier 401k pension fund managers in the United States. EAC receives funds daily that have been withheld from employee paychecks from client corporations in each of the fifty states. They also receive matching contributions from the corporations themselves. Upon retirement, employees have the option of receiving a lump sum payout, an annuity, or some combination of the two. Given the tax implications of a lump sum payout, almost all of the employees opt for some kind of monthly payout.

EAC's corporate structure has groups that invest in publicly traded stocks, publicly traded bonds, real estate, high risk securities, natural resources, and private placements. The natural resources group invests in agriculture, mining, timber, and fishing.

Prior to retirement an employee can direct how his or her funds are to be invested. When the stock market is rising, more funds are typically invested in publicly held equities. When the market is in decline, bonds and private placements gain favor. Upon retirement, many employees opt for an annuity and by doing so have left EAC free to invest these funds where the firm thinks they can earn the highest return. For several years the portfolio of the natural resources group has outperformed the market.

This case involves a situation that has arisen in the private placement group (PPG). PPG has the responsibility of investing approximately $50,000,000 of new money each week. This is in addition to reinvesting the proceeds of any loan in the portfolio that reaches maturity. It is EAC's policy that the group's portfolio must maintain an average BB credit rating. In addition to conducting research and making recommendations on potential private placement opportunities, analysts are charged with monitoring their portfolios on an ongoing basis to check for any change in the borrower's credit rating as well as for any violations of the private placement covenants.

In addition to the credit rating restriction, PPG must maintain an expense ratio of less than .75%. This group's expense ratio is currently well below this limit. This has enabled PPG to take advantage of accepting qualified internal transfers of personnel and to hire from the outside when the need arises. Since clients are guaranteed a minimum return of 3%, placements cannot be made that will not cover this return as well as associated expenses. EAC has also set limits on how much PPG can lend to a single borrower.

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Given the volume of lending that is required, PPG considers only loans that are of a substantial size. Investment banking firms such as Goldman Sachs and Morgan Stanley frequently contact PPG and other potential lenders on behalf of corporations that are seeking considerable funding. Once a potential private placement has been identified, analyzed, and deemed acceptable, it is sent to in-house attorneys to determine any covenants to include in a potential loan agreement. EAC then makes an offer that consists of both the maximum amount that it is willing to lend and the interest rate it is seeking on the loan. There is no guarantee that EAC's offer will be accepted. If EAC's offer is accepted, it is not unusual for the investment banker to make a deal for less than the maximum that EAC is willing to extend. The investment bankers and thus PPG usually know the length of time that the borrower seeks the funds. The size of the loan request is a bit more uncertain. The amount requested may go up or down as a result of the various potential lenders' interest rate requests. Once all of the potential lenders make their commitments, it is up to the investment banker to determine the percentage of the deal each lender will get. The big players (lenders) in this arena usually get treated more favorably than the smaller firms which can only supply a small piece of the action. Investment bankers frequently will specify a range into which they expect the lenders' pricing of the loan to fall. If PPG's interest rate exceeds this range, they might get a second chance to reprice the loan. While it is not common, a potential lender may offer to lend at a rate below the range given by the investment banker.

In addition to getting potential deals from the investment banking firms, EAC has established relationships with a number of large banks. These institutions may have borrowers that seek considerable funding for an extended period of time. Frequently banks prefer to finance the short-term needs of their clients and bring in lenders such as EAC for the long-term financing.

It should be noted that PPG does not make an offer on all deals that are brought to it by investment bankers or large banks. The potential borrower's credit rating is the first hurdle that must be cleared. If the borrower does not have a credit rating, PPG uses an outside agency to determine if the borrower could be considered "investment grade." While the credit rating of the potential borrower prohibits PPG from getting involved in a considerable number of deals, there are also other considerations to be taken into account. PPG has banned deals to firms located in several countries due to economic and geopolitical uncertainty. While the potential borrower may have a good credit rating that does not mean that a particular deal is without considerable risk. EAC is not only concerned with the risk of a deal going bad, it must also consider the impact which foreclosing on a loan could have on its image. EAC does not want a headline to read, "EAC forecloses on city's only hospital." The in-house attorneys and risk assessment team have stopped several deals in their tracks.

The covenants written into a loan agreement often put a variety of restrictions on the borrower. These restrictions may include such things as a limit on additional funding the borrower may seek from other sources. There may be restrictions on the borrower's paying dividends. The failure of the borrower to maintain certain financial ratios such as the current ratio may have implications on whether or not the loan is called. A common clause in a placement's indenture requires a borrower to offer to make whole on a loan if there is a change in ownership of the borrower. Indeed, this stipulation appears in the C&B loan agreement. Given the recent purchase of C&B by the hedge fund, it is up to PPG to decide if it should accept this offer to make whole or keep the original loan intact.

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Offering to make whole a loan means that the purchaser of one of PPG's borrowers has to offer to give the lender (EAC) the present value of the remaining stream of interest payments in addition to the par value of the principal. The selection of the discount rate used to compute the present value of the interest payments has a major impact on the amount required to make whole the loan. It is specified in most indentures that this rate is be the US Treasury note rate today for the remaining time to maturity plus some number of basis points. A basis point is one hundredth of one percent.

Given the size of the loans that PPG makes, much time is spent in researching both the potential borrower as well as the purpose for which the extended funds will be used. Frequently there is a "road show" in which the investment banking firm goes over the general aspects of the loan request. If it appears that PPG is seriously interested in being part of the deal, a due diligence trip to the potential borrower is fairly common. Both of these two events take time and cost money.

One reason why "make whole" is a common feature in a loan indenture is to reduce the risk exposure of the lender. In arriving at the decision to make the loan, the borrower is researched and the lender has a good idea of the level of risk involved. If a different firm becomes ultimately responsible for the interest and principal payments of the loan, this flow of funds may be perceived as riskier. Requiring the borrower to remit the present value of all interest payments rather than just the outstanding principal is a way for the lender to recover some of the considerable cost involved in analyzing the loan request.

Marie is an analyst at in the PPG group at EAC. C&B has just been purchased in its entirety by a hedge fund. Marie must notify the client and "remind" it of its responsibility to offer to make whole the loan. It is also Marie's job to make a recommendation to the managing directors as to whether or not EAC should accept the offer to make whole.

C&B borrowed $50,000,000 with an original maturity of ten years. The interest rate on this loan is 4.8%. Interest payments are to be made monthly and the principal is to be paid back in a balloon payment at maturity. This loan was made eighteen months ago. At the time of the loan, C&B was rated BBB. After checking online, Marie has determined that the discount rate mentioned above to compute the present value of the interest payments would be 2.4% on an annual basis. This is the Treasury note rate plus 50 basis points. While checking for the Treasury rate Marie noticed that the Chair of the Board of Governors of the Federal Reserve has recently made statements that have caused the investment community to suspect that the era of low interest rates is about to end. One implication of this, if it is true, is that a replacement for the C&B loan may be at a higher rate. If PPG believes that rates are going to increase, and if they are inclined to accept the offer to make whole, should PPG act quickly or drag its feet on informing C&B of their decision? If the US and the world economies are expected to heat up, how would this affect PPG's decision?

Marie is concerned that at some future point C&B's loan may appear on the hedge fund's balance sheet and be counted against the lending limit that EAC has established on the hedge fund. Marie has determined that EAC can lend the hedge fund an additional $150,000,000 at the present time so that a possible transfer of the $50,000,000 private placement should not cause a

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problem. However, by accepting the offer to make whole, there is the possibility of creating ill will with the hedge fund and it might go elsewhere in the future for financing. There is also concern that the hedge fund's credit rating will suffer due to its acquisition of C&B.

Before Marie can make a recommendation to the managing directors, she must consider a number of other circumstances surrounding this decision. Marie's group has experienced pressure to get money out the door. Funds waiting to be invested often only earn the Federal Fund's interest rate. This is currently substantially less than the 3% investors have been guaranteed as a minimum return on their investment. If PPG cannot invest its approximate $50,000,000 of new pension contributions in addition to any money that has to be reinvested due to loans reaching maturity each week, this group will see funds diverted to another group within EAC that can move money out the door. Managing directors spend considerable time lobbying for more funds to invest. They do not want to have these funds taken away from them. We are dealing with people with substantial egos at this firm.

Interest rates are near an all time low and finding companies with a high credit rating that need substantial funds and are willing to pay an interest rate significantly above 3% are few and far between. To make Marie's task more difficult, the hedge fund got a subsidiary of C&B to take out a loan which will be used by the hedge fund for the purchase of C&B. Since this loan will show up on C&B's balance sheet, EAC has been informed by an outside credit rating agency that C&B will get a rating downgrade from BBB to BB+. (It should be noted that C&B remains a strong company and its credit rating would not be changed if this takeover did not occur.) While this new rating is above the required average portfolio rating of BB, any downgrade of a company in PPG's portfolio has repercussions. PPG may have to sell off a different loan that has a lower credit rating or make a new loan to a firm with a higher rating in order to maintain an overall BB rating on EAC's portfolio. This latter course of action would be very difficult to do in the current economy.

Like many senior analysts in Marie's position, a substantial amount of her compensation comes in the form of an annual bonus. Among other things, Marie is evaluated on the performance of her portfolio, how much money she gets out the door, how many new contacts she can establish, and the quality of the advice she provides to the managing directors. When Marie presents a recommendation to senior management, she wants to be sure that she has left no stone unturned. It is the kiss of death for Marie to say too often, "Gee, I never thought of that."

Marie has asked you, a junior analyst, to determine how much C&B has to offer to make whole the loan. In addition, she knows that the managing directors will ask how many dollars in interest will be lost if the decision is to accept the offer to make whole. This amount is simply the difference between the present value of the future interest payments and the sum of the future payments. She wants you to look at all the implications of both accepting the offer to make whole, as well as the potential consequences of rejecting the offer. While it is up to Marie to come up with the recommendation to present to the managing directors, she would like you to express your opinion on this situation. It is 9:00 am Thursday morning and Marie wants your report before you leave for the weekend. The managing directors have told Marie that they want her recommendation at 10:30 AM Monday. She wants to spend the weekend looking over your findings.

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