

Balmoral Bulletin December 2022

Financing Markets Update

We recently attended SFNet Middle Market Symposium, focused on the asset-based lending community. The speakers were as engaging as were the debates attendees had between sessions. We captured a cross section of views during the symposium that we'd like to briefly share with you.

Closing out 2022, we are evaluating the weighty changes occurring in the economy, and in turn, the lending market. Right now, companies are forced to address more variables than at any other time in the recent past: inflation, labor shortages, supply chain issues, skyrocketing fuel prices, ongoing employment-related issues and unpredictable demand, to name a few.

Interesting was the fact that across industries, current inventory levels have increased because companies went long in response to prior supply shortages and lengthening delivery times. Sales are not down, but inventory levels are through the roof, as lenders are seeing borrowers with up to 70 weeks of supply, which is putting pressure on recovery values. This unique situation will most likely see even more instances of borrowers being over-advanced on inventory, creating pressure with lenders. Some borrowers will be able to manage through this unique time. Others will not as they work to navigate what this new normal means.

Overall, the situation we're facing today will be challenging. The economists who spoke cited the current labor participation rate at 62%, compared to being historically closer to 66%. When combined with an unemployment rate at 3.5%, which is too low, they made it clear that the economy is essentially overemployed. The same economists predict that the labor market will balance in the next 6 months as savings are depleted due in part to wages not keeping up with inflation.

Combine this with the murky direction the Fed is taking. On the one hand, they're doing too much. On the other, they waited too long to make their move, and we could see further Fed action. As predicted, after the symposium the Fed did implement a 75bps increase at the November meeting. The economists predicted that the Fed could do at least another 50-75bps increase next year. It was clear that actions this year have been "unprecedented," and the Fed's goal of a "soft landing" could very well mean mild negative growth, not low growth.

Taking all of this into account as we move into 2023, we will most likely see many lenders and borrowers who might otherwise have looked for cash flow lending solutions, turn to an ABL facility. We can count on traditional lenders tightening their grip and being less tolerant of delayed payments, delinquencies or violations of loan agreements now that we are in a much more differentiated lending environment. Though conditions are shifting, it's interesting to note that most believe that M&A activity will actually *increase* next year.

The bottom line would indicate that borrowers need to be much more careful and diligent when it comes to financial management and dealing with lenders. Many became accustomed to the good times during COVID. Banks were far more lenient and forgiving with deadlines and minor technical defaults owing to a more supportive approach from the Fed. Management teams are now being tested with harder and more complicated issues, and the return to the Fed's pre-COVID posture means banks no longer have tolerance for slip-ups. Borrowers now need to be more on top of their numbers and focused on strict compliance with lending agreements.

We will all need to tread carefully in a market that continues to be described as “slow” and “uncertain,” believing that those trends are likely to continue well into the new year.

With a significant focus on financial projection analysis and a recognition that this current environment is a stress test of focused forecasting and planning, we hope these insights will give you a baseline to organize your thinking as we move into the new year. Thank you for your continued trust and confidence.

As always, we welcome your feedback,

The Balmoral Advisors Team

About Balmoral Advisors

Balmoral Advisors is an independent investment bank dedicated to providing mergers & acquisitions, corporate finance, and financial restructuring advisory services involving mid-sized transactions. We specialize in helping clients sell their businesses, find and complete acquisitions, and raise or refinance capital. We work with business owners, corporations and financial investors worldwide involving early stage growth companies, successful mature businesses, corporate divestitures, special situations, and distressed transactions. For more information visit us at www.balmoraladvisors.com.

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