WHEN FLAT IS THE NEW UP

Capital Structures Cause Sleepless Nights for Workout Bankers

BY HUGH C. LARRATT-SMITH, MANAGING DIRECTOR, TRIMINGHAM


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The Panic of 1873 started one of the longest recessions in U.S. history — 65 months of economic contraction. By 1874, 50 percent of America's iron mills would go bankrupt. By 1876, half of America's railroads were bankrupt.

That recession was far more severe because of the rapid rise of the U.S. economy preceding the panic. In the 1860s, Wall Street had cast its financial net across America, which meant that credit flowed to remote regions like never before. It also meant that financial panics spread across the country like never before. Real estate, machinery, and equipment asset values plummeted. Part and parcel of this was the railroad asset bubble in the mid-1880s, which burst with devastating swiftness and severity.

Similarly, the financial crisis of 2008/2009 has triggered a global reset in asset values. Every asset class has declined precipitously, whether it's natural gas, real estate, the stock market, automobile production, art, or industrial machinery.

The decline in values is keeping many lenders awake at night. Collateral that has supported many asset-based lending (ABL) deals has eroded, be it machining equipment, industrial buildings, or brand names. More worrisome to risk managers overseeing portfolios that include cash-flow loans is the deterioration in enterprise values and earnings before interest, taxes, depreciation, and amortization (EBITDA).

According to *The Financial Times*, $400 billion in bank loans owed by private-equity-owned companies will mature in the next five years — enough to buy twice the annual economic output of Ireland. Private-equity firms spent roughly $1.6 trillion on leveraged buyouts struck from 2005 to 2007, and these firms are now using a variety of measures, such as exchange offers and debt repurchases, to stave off default, according to *The Wall Street Journal*. Having leveraged up rapidly in the boom, they now need to deleverage in a hurry.

In light of the global reset in values, the interesting question that will be the topic of many future studies is this: Given that private-equity groups typically did deals with anywhere from 5 percent to 20 percent equity during the bubble, how many leveraged finance deals are out there with equity remaining, given the global reset in values?

Yesterday's Debt Is Today's Equity

A pressing question for workout bankers is, which private equity groups will stick around if they're out of the money on a deal?

Some workout bankers are finding that many equity groups insist on trying to stay in a deal, even when they're clearly out of the money. Battles are raging in media and other government-regulated industries, where ownership changes require regulatory consent. The pace of obtaining these consents can be glacial. Some private-equity groups are throwing this issue in the path of lenders who are trying to convert their debt to equity to gain control of a company. For example, in some radio and television broadcasting deals that are occurring against a backdrop of a dramatic drop in advertising revenues, lenders are being held hostage by private-equity groups that are using change of control as a delaying tactic, in hopes that EBITDA will rebound once the recession ends.

Another battleground is leveraged finance deals in which legacy owners are still in place. In many instances, a legacy owner who rolled some of his equity into the new company is now threatening to walk with the customer relationships if the lenders play hardball. Leveraged service companies can be tough cases for lenders to convert debt into equity.

Valuable customer relationships often stretch back years and can be very difficult to transition, particularly when legacy owners sense that their career with the company may be nearing an end.

On the other hand, instances also are surfacing in which private-equity groups are saying, “We’re done. It’s yours. Good luck.” This is not what many workout bankers want to hear, but the situation is partially mitigated if the private-equity group agrees to move out of the way quickly. When a private-equity group delays the inevitable or becomes obstructionist, then no one wins.

In the late 1990s, workout bankers who managed to get a private-equity group to consent to a capital call got high fives. Today, however, lenders have hit capital calls, only to be told by private-equity groups that some of the limited partners can’t fund. Some limited partners have been crushed by the equity and real estate markets, or have seen liquidity impaired by the auction rate preferred debacle in 2008.

Another problem with capital calls is that they appear to be a good solution when they’re inked, but heavy negotiations always seem to take place when they’re hit. Some private-equity groups view capital call notifications from lenders as simply another opportunity to open further negotiations.

What happens when a member of the lending group can’t fund an obligation under the credit agreement? The defaulting lender says, “Sorry, I have no new money. I’m battling redemptions and have zero liquidity!” If there’s a defaulting lender provision in the intercreditor agreement, the other lenders can force the defaulting lender to take a haircut. But some intercreditor agreements don’t have defaulting lender provisions, so a stalemate occurs. Lender defaults could accelerate in 2009 and 2010, despite some hedge funds raising the ramparts and blocking redemptions.

Some senior lenders are locked into loan agreements that were not drafted by their attorneys, but by borrowers’ legal counsel under the careful watch of the investment bank putting the deal together. In certain cases, the investment bankers told senior lenders which law firms they were allowed to use. As a result, the senior lenders’ powers were subtly restricted in ways that are now coming back to haunt them.

Another headache for workout bankers in a troubled deal can be large bankruptcy professional fees. In some of the larger transactions with layers of senior, second lien, and mezzanine debt, some lenders are complaining about significant professional fees that seem completely out of proportion to the value of the company. Often, each constituency in the capital structure hires its own legal and financial advisors and pit them against other creditor classes. Unnecessary legal actions and other tactics delay the case and erode the value of the estate needlessly.

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Strange Bedfellows

Many syndicated loans have an agent who holds very little of the deal. In larger syndications, armies of CLOs may up the majority of participants in a deal, which can make restructuring very difficult. Adding to this problem is that most CLOs have no new capital to invest in a restructuring — all they can offer is a deferral of interest and principal, and waive defaults.

This lack of “dry powder” means that CLOs may not be in a position to hire professionals to assist with any restructuring. The CLO may compensate for this by simply being obstructionist. In addition, the compensation structure of many CLOs incentivizes management to avoid defaults/write-offs and keep the management fees coming.

There are signs in the marketplace that some hedge funds are trying to corral orphaned participations in a transaction with the intent of gaining control or at least a seat at the bargaining table. This is particularly vexing to second lien lenders, who may not relish the idea of bare-knuckles brawls with lenders who have a completely different set of objectives.

Other trouble spots occur when a lender group includes participants who bought into the deal at a price below par. What happens when one party thinks the loan is worth 98 cents, and others think it’s worth 68 cents, based on their valuations of the business? That’s when all of the parties may be exposed to some potential weaknesses in the intercreditor agreements. How about a senior bank group consisting of a traditional bank, a second lien shop, and a private-equity group that

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is a loan-to-own player? Or the senior lender who went into the original deal at par and gets a call from someone on his bank's distressed trading desk who just bought in at 80 cents and wants to vote down the latest amendment? These situations make for very strange bedfellows in some deals.

The lack of regulation allows hedge funds to advance funds into a troubled situation to avoid a default. One agent told the author that a hedge fund advanced funds to a troubled borrower through a side agreement — over the objections of the lender group — so that the borrower wouldn't trip a covenant. This allowed management to continue doing what it was doing, even though in essence the group was simply adjusting the angle of the aircraft as it plummeted into the ground.

In other situations a company hits an air pocket, and the private-equity group offers to buy the senior lenders out at 25 cents on the dollar. The resulting heartburn from this type of move slows the decision-making process in the senior lender group. An unsettling thought for some alternative finance lenders is private-equity groups buying up the senior debt of a portfolio company at a discount and then putting the squeeze on the second lien, subordinated debt, and mezzanine layers.

Some senior lenders now are specifying tight anti-assignment language in loan agreements so that a company's ability to swap out stringent lenders for more compliant lenders is blocked. However, this type of restriction was absent in most legacy deals inked from 2005 to 2007.

In the days of simpler capital structures, the entrance of distressed players into the fulcrum security historically accelerated a transaction, because the distressed investors often would buy in at a sufficiently low price that they were willing to trigger a crystallization at a 20 percent to 30 percent return of their purchase price. The advent of multiple layers to the capital structure blurs the clarity as to which security is truly the fulcrum security, and may make negotiation more difficult.

This is especially true if some investors bought in at prices above that which the distressed players are willing to accept. Compounding matters is the proliferation of second lien paper, which in some instances may restrict the ability of a company to secure debtor-In-possession (DIP) financing, or in others may set the stage for a priming fight.

The Lowering Tide Drops All Boats

Some lenders are now reining in borrowers who positioned themselves for rapid expansion and haven't throttled back growth plans. Many buyouts in the last two years were built on aggressive growth projections to justify big multiples. Lenders were invited to "step aboard the EBITDA rocket ship to the moon." Now the second and third stages of the rocket haven't fired, and the ship is losing altitude. Yet management may be reluctant to admit that its projected growth will not materialize or, in fact, that the tide has reversed.

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In particular, many companies haven't cut back on head office overheads, new product development, or other "growth" elements of their cost structures. Some lenders find themselves confronted by tough choices — management is telling the lenders that aggressive marketing spending is needed to goose sales, yet lenders look at "soft" capacity expansion as potential black holes for liquidity. One software company spent a fortune on deposits and promotional material for six trade shows, for example, only to have the promoter of the trade show file bankruptcy.

Many "growth" company management teams have not lived through a deep recession before and are behind the curve when it comes to cutting costs. In the oil service sector, for example, many management teams were blindsided by a 60 percent decline in energy prices in the past 12 months. A common theme in underperforming companies in such sectors is that no one can believe how fast a downward spiral can accelerate. A typical reaction by management is, "We can't do those cuts — they're too close to the bone." In some instances, the company's business model has changed dramatically, and all spending needs to be completely re-evaluated.

Indeed, one hedge fund lender said that a review of his 100 C&I loans in 2006 showed most borrowers were ahead of plan. Today, a company that is ahead of plan is the exception.

Some borrowers may take advantage of this situation, with the result that a deal becomes a zombie. While participants in the capital structure battle it out, management may try to play one side against the other. In other instances, management gets so distracted trying to please each participant in the capital structure that it takes its eye off the ball in day-to-day management, or it becomes a deer in the headlights, afraid to make decisions with business risk for fear of displeasing the party that ultimately gains control.

In many underperforming companies, the incumbent management does not fully appreciate how quickly the downward spiral can accelerate. Consequently, it is less likely to take the drastic steps needed to salvage the company. Once management is behind the curve in cost cutting, it can be difficult to regain control of the situation. Yet, a complex capital structure can muddy the waters to the point that management becomes ineffective.

DIP Financing – Drier than Texas in 2009

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This is in stark contrast to the last recession in 2001 to 2002. According to industry players, only one traditional commercial finance firm, some Canadian banks, and a handful of hedge funds are actively soliciting new DIP business. Traditional ABL shops still want to do the triptych of bankruptcy financing — the pre-filing financing, the DIP, and the exit financing with existing borrowers — but they are not going out of their way looking for new DIP financing opportunities.

Those players willing to do a DIP are able to charge hefty fees and rates simply because demand far exceeds supply. Also, many hedge funds want call protection of two to three years in today's marketplace and consequently are shying away from DIPs because there is no real call protection. Some industry observers foresee more priming fights in the years ahead because of the aggressiveness of some hedge funds, and others think that the courts really don't want to see an incumbent get primed. Certainly, threats will be made about priming fights, but the bankruptcy courts will be unlikely to grant them.

Compounding this problem, once a company is in Chapter 11, a capital structure that looks like a wedding cake may make it tough to facilitate a Section 363 sale. How can proceeds from a sale between the revolver lenders and the term lenders who claim they are pari passu be allocated?

A growing number of struggling companies are liquidating in Chapter 7 rather than try to restructure in Bankruptcy Court. Many companies are caught between a slowing economy, a lack of bankruptcy financing options due to industry and the credit crunch, and the legacy covenant-lite lending agreements that allowed their financial situations to worsen before creditors could intervene.

This lack of covenants has raised the fear that companies will deteriorate to the point of no return while the lenders look on in horror. For example, the historically low interest rates have enabled many borrowers to have mediocre performance, but make their interest coverage covenant with ease.

More Pain Ahead

The United States recovered from the deep recession in the 1870s within five years. It took the more established, but slower-growing European countries, such as Germany, Austria, England and France, nearly twice as long to regain their economic momentum. Today, pundits are saying that the roles have been changed: China will recover from this global recession twice as fast as the United States.

The unprecedented amount of leverage on U.S.-style borrowers' balance sheets will make this recovery and the global reset in values very slow and quite painful. Workout bankers will need to sleep with one eye open, in light of the contentious battles ahead in the next 24 months.

One other painful aspect of this period will be the shrinking of the commercial finance marketplace. The financial services industry swelled to meet the financing needs of an overheated economy and ballooning asset values. It's now shrinking dramatically, with many seasoned lending professionals getting termination notices at the peak of their careers. This fact alone will cause many more sleepless nights. CR

Hugh C. Larratt-Smith is a managing director in Trimingham's New York office. He is Vice President-Programming and Director of TMA's New York City Chapter.