Yesterday's Debt Is Today's Equity

BY HUGH C. LARRATT-SMITH

Many senior lenders now represent the fulcrum security on a borrower's balance sheet. Optionality has become today's buzzword for all players in the capital structure. Second lien and mezzanine lenders — the proverbial "baloney in the middle of the sandwich" — want to keep kicking the can down the road with amendments to stay alive in the deal. In the fight for control of the steering wheel, the car may veer into the ditch.

On September 24, 1869, robber barons Jay Gould and James Fisk's scheme to corner the U.S. gold market unraveled. In the drama of that day, Black Friday, the price of gold collapsed in the worst panic since 1857. At the heart of the robber barons' scheme was an elaborate daisy chain designed to drive down the price of the U.S. dollar in order to increase American crop exports and the amount of gold the U.S. government earned in export taxes. (This gold scheme would also, incidentally, increase rail traffic on Gould's railroads).

The robber barons' secret goal was to enlist the U.S. government as an unwitting accomplice in their scheme to corner the gold market. Gould and Fisk hoped to convince President Ulysses S. Grant to hoard the gold that the U.S. government received from customs duties collected in New York. Gould and Fisk went so far as to open a gold account for the wife of President Grant without her knowledge, co-opt the President's brother-in-law, and bribe the federal sub-treasurer in New York City.

In the dramatic rise and plunge of gold prices that year, the American public became aware that the financial maneuvering of the brokers and bankers of New York could shake the nation. The mysterious money men of Wall Street, who seemingly produced nothing and instead merely juggled arcane financial securities, began to overshadow merchants, farmers and craftsmen in importance.

Fast-forward 140 Years

The American public is shocked at the power of Wall Street — hedge funds, arbitrageurs, securitizers and brokers of all stripes — to paralyze the global economy. The shock waves are still reverberating throughout banks and the financial community, resulting in a dramatic reordering of who's on top and who is roadkill. According to New York University professor Nouriel Roubini (who correctly predicted the global crisis), most of the shadow banking system has disappeared, and traditional banks are saddled with billions, if not trillions of dollars in expected losses on loans and securities, while still being seriously undercapitalized.

The result of the crisis of 2008–2009 has been a global reset in values. How so? The number of U.S. homeowners who are underwater recently hit a grim milestone: As of the end of June 2009, more than one-third of all mortgaged homes in the United States were underwater, according to *The New York Times*, almost certainly the highest it's been in decades. U.S. home prices have fallen by about one-third since the high-water mark in 2006 and are now back around 2003 levels, according to Standard & Poor's. Now, Federal Reserve and Treasury officials are scrambling to prevent the commercial-real-estate sector from delivering a left-hook punch to the U.S. economy just as it struggles to get up off the mat. U.S. banks and thrifts hold more than $1.2 trillion in commercial mortgages backed by office buildings, hotels, resorts, golf courses, shopping malls and apartments. Losses for commercial property lenders could total $150 billion, according to Deutsche Bank.

On the flip side, the good news from some commercial finance lenders is that lower-middle-market borrowers have fewer options these days, because the alternative-finance marketplace has dried up.

Though auto sales regularly hit 16 million annually before the recession, they've since taken a free fall, hitting a low in February 2009 of 9.1 million units. Once the clunkers program wears off, the U.S. auto industry will struggle to regain the 30% decline in annual sales in the past two years.

Private Equity's New Role

According to *The Financial Times*, $400 billion in bank loans owed by private equity-owned companies will mature in the next five years. That amount of mon-

INDUSTRY SNAPSHOT:
EQUIPMENT-RENTAL COMPANIES

Equipment-rental companies rode the U.S. housing and commercial real estate boom. Management teams worked overtime to keep up with demand for backhoes, hole borers, scissor lifts and every other conceivable construction and building-maintenance piece of equipment. Everyone wanted market share, and equipment-rental companies opened greenfield branches in cities like wildfire. Every manager wanted to "get points up on the scoreboard" by opening up new territories and beating the previous year's quotas. Original-equipment manufacturers offered everything from golf junkets to Hawaii to low-cost vendor financing to keep the sales of new equipment moving.

Collateral values were strong. Good operators prided themselves on having their equipment "rental-ready,"and rental-fleet utilization rates hit a high-water mark in the fourth quarter of 2004 (North American dealers' rental-fleet utilization rates declined 4.7% in the second quarter of 2009, by comparison). Private equity groups liked the steady, "boring" cash flow.

Like the construction worker getting his hand caught in a descending scissor lift, rental-equipment companies now find themselves in a classic squeeze — margin compression and eroding equipment values. Some rental-equipment companies will do anything to keep fleet utilization rates high — special two-for-one deals, guaranteed up-time, lower minimum rental periods — you name it, it's getting done. Indeed, rental rates declined 13% in the second quarter of 2009 for North American dealers, according to an August 2009 survey by ISI Raso. As the rental-equipment companies close branches and furlough or lay employees off, morale suffers. Employees cut corners by sending equipment out when it's not rental-ready, resulting in customer complaints and collection problems.

Appraisals on equipment fleets keep getting uglier, too. Lenders are getting concerned about equipment-maintenance deferrals. Private equity groups are now getting weary of continuing capital calls.

This is translating into overadvances for many borrowers. Some lenders are now questioning how much exposure they want to a capital-intensive business that's experiencing margin compression and collateral erosion. All of a sudden, the equipment seems like more of a liability than an asset. Private equity groups are reevaluating what once looked like a stable, "boring" business with steady cash flow that now seems to demand constant capital expenditures.

ey will buy you twice the annual economic output of Ireland, says *The Times*. 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.

The interesting question that will be the topic of many studies in the next few years is this: Given that private equity groups typically did deals with anywhere from 5% to 40% of equity during the bubble, how many sponsors are in the money, given the global reset in values?

The global reset in values seems to hover around 33%, if the U.S. automobile market, the Dow, equipment values and real estate are any kind of proxy. (By way of a yardstick, the financial crisis of 2008–2009 hit the global economy harder than the OPEC crisis of the 1970s, according to *The Financial Times*.) This global reset in values means that many senior lenders now hold the fulcrum security in the deal. Many senior lenders are now the only people in the money — the people who own the company — so, in many cases, debt is now equity.

Gone are the hockey-stick EBITDA projections in the investment bankers' deal books. (Indeed, today's "flat" EBITDA projection is yesterday's "up" projection.) Gone are the "toggle" deals, which were like disco balls in the 1970s: You knew they were there but never understood why they were kept on the ceiling so long. Covenant-light deals were like leisure suits, long sideburns and platform shoes: In the cold, harsh light of morning, you wonder how people could get seduced. In the place of toggles, payment-in-kind deals (PIKS), and "cov-lites" are amendment requests, capital calls, cramdowns, agent mutinies, CROs, lift-stay motions and the other vernacular of the workout turnaround. The words of Billy Joel's hit song "We Didn't Start the Fire" could be re-rededicated to the lender community, substituting Billy Joel's headline-laden verses with restructuring jargon.

Leveraged-finance deals lie at the heart of the fulcrum-security debates like semisubmerged icebergs. In asset-based loans, it's relatively clear who is entitled to what. Not so with cash flow loans, which depend on hotly debated issues such as EBITDA addbacks and broken waterfalls. Some owners are asking their lenders for a free spin at the wheel (i.e., "give us some time," "energy prices are going back to 2008 levels," "it's just a matter of months," "the worst is behind us," "business is stabilizing," or "our sales pipeline is better now than it's been in two years.")

Maintaining Optionality

Optionality is a word we also hear a lot these days. Everyone wants it. No one wants to get pushed off the balance sheet. Ten years ago, it was usually pretty clear who had what optionality when a loan went sideways. Yet comparing today's capital structures to those in the 1990s is like comparing a simple water-driven turbine with the wiring of a nuclear power plant. They both generate power, but the processes are sure different.

With many intercreditor agreements that the courts haven't stress-tested, optionality among stakeholders can be quite murky and misleading. In some

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instances, some stakeholders throw legions of restructuring professionals into the battle, hoping to overcome opposition through sheer mass. Other stakeholders try kamikaze tactics such as putting a company into a Chapter 7, instead of a Chapter 11, with a stalking horse to create a soft landing. When TARP or TALF banks are in a distressed deal, some nonbank stakeholders are willing to play the political-embarrassment card against the banks to keep a company out of bankruptcy or liquidation.

Some people keep doing amendments and balance sheet restructurings in the hope that they can maintain their positions as the fulcrum security holders (or close to it) long enough that the company regains momentum or the economy or capital markets improve. This "kicking the can along the road" method is a common strategy. Alternative lenders that are essentially illiquid try to scrounge enough new money to keep in the game. This is the goal of many hedge funds and alternative lenders that can own companies with no OCC oversight.

The story is not so clear-cut for banks that have converted debt to equity. Owning equity in a company can carry a heavy regulatory burden for institutions that are under the eyes of bank regulators. After all, some banks have significantly beefed up their internal regulatory-compliance groups and these groups may have a high concentration of attorneys and Beltway-policy types who often don't see eye-to-eye with portfolio managers. As a result, many of these debt-to-equity swaps have limited shelf lives simply because of internal political pressures. Some banks may end up forgoing harvesting of their equity positions fully in the interest of quelling internal pressures.

Battlegrounds

Many traditional ABL players are getting heartburn over capital structures that force their hands too quickly. In the go-go days, a number of deals gave senior lenders only 45 days to act before second-lien players could foreclose. These compressed time frames don't give syndicates adequate time to respond to problems, particularly if the senior-debt syndicate has zombie lenders.
We're seeing zombie lenders that are mired in the seven stages of mourning, triggered by illiquid balance sheets. They're unable to act decisively or in an economically rational way because of their underlying liquidity problems. As a result, an agent may spend more time corralling the lender group into a common front than dealing with the borrower! Some alternative lenders are getting limited access to new money, but it's short term. Most of the fresh funding for alternative lenders doesn't allow them to commit to a loan tenor of 3–5 years.

Another battleground is leveraged finance deals with legacy owners still in place. There are many instances in which the legacy owner rolled some of his or her equity into the new company and is now threatening to walk with the customer relationships if the lenders play hardball. That's why leveraged service companies can be tough on lenders that want to convert debt into equity, because valuable customer relationships often stretch back years. These relationships can be very difficult to transition, particularly when legacy owners sense that their careers may be nearing an end.

A common factor in the fulcrum-security debate is that many "growth-company" management teams have not lived through a deep recession before and are behind the curve when it comes time to cut costs. For example, take the oil service sector. Many management teams were blindsided by declines in energy prices in the past 12 months. In summer 2008, it was inconceivable that natural gas prices would drop 75% in the next 12 months. A recurring theme in underperforming companies in sectors like these is that no one believed how fast a downward spiral could accelerate. And a typical statement by management is, "We can't do those cuts — they're too close to the bone."

We hear from workout managers in lending institutions that many companies have cut costs rapidly in response to decreases in sales over the past 12 months. In some industries, the decline in revenues has been breathtaking. Indeed, during the financial crisis, the world economy was contracting for the first time since WWII, with G7 economies contracting an unprecedented 8.4% in the first quarter of 2009. The big concern of lenders is that further revenue declines will leave management with no room to hide. The economists in some big banks are forecasting a second leg down in this recession, which could have significant strategic implications for many companies.

In certain instances, company business models have changed dramatically, and all spending needs to be completely reevaluated. For example, manufacturers of machines and equipment may have to scale back to parts-and-service businesses, with the occasional large order for machines. This strategy may allow companies to live another day, but management teams may have to fire their industrial engineers and let their intellectual property go stale. Other companies may have to replace their sales forces with sales reps who are oriented more toward parts and service rather than large machinery orders. Still other companies in the radio, magazine and newspaper sectors are experiencing changes so far-reaching that cost-cutting is simply delaying the inevitable. With overcapacity in many industries, many companies are facing severe challenges to holding prices. Competitors will cut prices to the bone just to create cash or accounts receivable and some lenders are allowing "zombie" companies to survive just so they can avoid writing down the loans. (For example, competitors in the equipment-rental industry have cut prices by as much as 40% just to book business.) Risk managers sometimes encounter stiff internal political pressure to bow to the "rolling loan gathers no loss" school of portfolio management.

Financing: Drier than Texas in 2009

Lower-middle-market companies are finding it tough to refinance in this marketplace. Their choice of financing sources among banks and commercial finance companies has shrunk dramatically. Indeed, it's mind-boggling to think of the commercial finance landscapes in Boston, Atlanta or Los Angeles 10 years ago versus today, considering the number of marquee commercial finance names that have disappeared. And it's equally mind-boggling to consider how few commercial finance names will finance the eventual economic recovery in the years ahead.

Part of the challenge for many lower-middle-market companies is that lenders don't want to refinance an overadvance situation. Though some lenders have done a good job of creating surplus reserves in their borrowing bases in the past two years, many loan agreements still have legacy advance rates that are unbankable today. The problem may not be the quality of the collateral, it may be that the advance rates were way too aggressive in the first place. An adverse appraisal may trigger an overadvance, resulting in a "good P&L, bad balance sheet" situation.

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Some middle-market lenders did deals in the 2005–2008 period based on "boot collateral" such as commercial real estate (for example, a strip mall or a car wash that the business owner bought as a side investment). Strip malls were favorites with many business owners. They invariably had buddies who were putting land deals together, and everyone ponied up some cash as well as joint and several guarantees on the mortgages.

We know one manufacturing business owner who ended up guaranteeing the debt of a new 50-store mall in the tristate area. The leases allowed the retailers to walk away with no penalty if less than 66% of the mall was occupied. "Impossible, we have a great balance of national chains and strong regional retailers," he thought in 2005 when the mall was completed. He signed a joint and several guarantee. Today, the mall's occupancy is 55%, and from the street the mall looks like a boxer with four of his front teeth knocked out. Several of the remaining retailers have signaled that they want to renegotiate the rent or will walk with no penalty. With 100 of America's 1,000 largest malls in the zone of insolvency, this story is playing out with many middle-market business owners who diverted their attention from their core businesses.

On the flip side, the good news from some commercial finance lenders is that lower-middle-market borrowers have fewer options these days, because the alternative-finance marketplace has dried up. This is introducing greater rationality to pricing and especially structures. In the 2005–2008 period, whenever a borrower got offside with its lender, someone always seemed to step into the breach. The new lender would justify the stretch by saying, "We're just doing what the market is dictating." Today, lower-middle-market lending terms and pricing are as tight as a snare drum.

Some large, sponsor deals done during 2005–2008 are getting refinanced — but at pricing and terms that bear little resemblance to the good old days. The deals that are struggling to get refinanced are those with bond issues that mature in 2010–2012. Risk managers are very worried that borrowers will find it impossible to refinance the bond deals done in 2005–2007. Though the high-yield market is showing some signs of life, refinancing an overpriced bond deal will be challenging. As a result of this prolonged U.S. recession, the speculative-grade default rate in the U.S. has reached double digits, coming in at an estimated 10.2% in August 2009 compared with 2.5% in August 2008, according to S&P. It expects the speculative-grade default rate to escalate to a mean forecast of 13.9% by July 2010 but says it could reach as high as 18% if economic conditions get worse than expected.

Many leveraged loan players still prefer to buy loans in the secondary market, as opposed to doing new deals for borrowers. The yields can be more attractive, and the loans have had time to prove themselves. However, there are some signs that pricing in the secondary market has returned to a point where new deals are becoming attractive for borrowers a good track records, according to *The Wall Street Journal*. Leveraged loan prices have risen 21.7% this year to 83.7 cents on the dollar. So far this year, companies have sold $38 billion of leveraged loans, of which $8 billion are DIP loans.

Notwithstanding, issuers of new leveraged loans have a long way to go to get anywhere near the high-water mark of $535 billion in 2007, and there is still very little DIP financing available in the marketplace these days. Many lenders will do defensive DIPs merely as a bridge to a sale. This is in stark contrast to the last recession in 2001–2002. According to industry players, there is now only one traditional commercial finance firm, a new DIP specialty fund, some Canadian banks and a limited number of hedge funds that are actively targeting new DIP business. A handful of alternative lenders that were poised to dominate the DIP market in this cycle have either experienced significant investor redemption requests or can't get any leverage. Traditional ABL shops still want to do the triple crown of bankruptcy financing — the prefiling 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.

Players willing to do a DIP are able to charge hefty fees and rates simply because of the scarcity factor. Indeed, some DIPs are commanding stratospheric rates: Prime plus 700 to 1000 basis points, with 3% up front! Also, many hedge funds now want two-to-three years' call protection and consequently are shying away from DIPs because there is no real call protection. Some industry observers foresee more priming fights because of the aggressiveness of some hedge funds and others think that the courts really don't want to see an incumbent get primed. In two instances, hedge funds in senior debt syndicates that had already proposed DIPs to existing customers also decided to offer their own competing DIP proposals at reduced fees!

Compounding this problem is that once a company is in Chapter 11, having a capital structure that looks like a wedding cake, may make it tough to facilitate a 363 sale. Some hedge funds direct their legal teams to unearth every conceivable road block to others in the capital structure in hopes of preserving their optionality. We hear from some senior lenders that the legal fees on certain cases are stratospheric for that very reason.

Speed Bumps Ahead

The unprecedented amount of leverage on U.S. borrowers' balance sheets will make this recovery and the global reset in values very slow and quite painful. Some pundits are calling for a double-dip recession, the probability of which is increasing to 50% in 2010, according to PIMCO. The U.S. dollar reflects this outlook; it's down 13% since early March against a basket of major trading partners' currencies.

Many observers are saying that, once the effect of restocking of inventories and production levels from near-Depression levels fades, the global reset in values will continue to send shock waves through the economy. Even if we don't endure a double-dip recession, the recovery is likely to be anemic. Unemployment in the United States jumped to a 26-year high of 9.7% in August 2009, and that doesn't include underemployed workers. Some bank economists are forecasting a "bathtub" recovery: Steep down one side, then flat for a long time. Indeed, with government spending accounting for 26% of the nation's economy — the biggest since WWII, according to *The New York Times* — The road to recovery may be paved with bureaucratic obstacles.

One other painful aspect of this period will be the shrinking commercial finance marketplace. Though the financial services industry once swelled to meet the needs of an overheated economy and ballooning asset values, revenues in the finance and insurance industries, which accounted for 5.9% of GDP in 1990, rose to 8.1% in 2006 but are expected to slip to 7.2% this year, according to Moody's. In a recent study, New York University professor Tom Philippon and University of Virginia professor Ariell Reshef estimate that 30% to 50% of the extra pay finance industry workers received reflected this bubble. Indeed, pay and benefits at the nine largest banks declined by 11% from July 2007 to 2009, according to a July 2009 report by New York's Attorney General.

Plummeting stock prices are causing lenders more heartburn because many stock options are underwater, and repricing these options is probably not in the cards. Since the peak in 2007, the market capitalization of the country's 29 biggest financial services firm have been halved, according to *The New York Times*. Consider the mid-50s risk manager with kids in college and whose 401(k) is full of his own institution's stock, which has gone from $55 per share to $2 per share. Adding to the pain, many seasoned lending professionals are getting termination notices at the peak of their careers. These facts alone are causing many sleepless nights.

Jay Gould and James Fisk got crushed in their attempt to corner the gold market in 1869. But both robber barons lived to see another day. They became masters at vulture investing in railroad debt following the Panic of 1873, becoming very rich as they turned railroad bonds into control equity positions. (In fact, Jay Gould even outwitted the financial giant of his time, "The Commodore" Cornelius Vanderbilt, in December 1868). Both robber barons were emblematic of the economic reset in values that followed the bursting of the American railroad bubble in the 1870s. Indeed, if the global economy has reset downward by one-third in 2008–2009, then today's lenders are going to be in the driver's seat for years to come. **TSL**

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