

The definitive guide to

Distressed Debt and Turnaround Investing

second edition

A comprehensive resource for making, managing and exiting investments
in distressed companies and their securities

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THE QUEEN'S AWARDS
FOR ENTERPRISE
2009

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The new dynamics of distressed situations: is everything old 'new again'?

By Henry Miller and James Doak, Miller Buckfire & Co.

Introduction

In today's leverage-centric marketplace, a financially-distressed company typically has more debt and a more complex capital structure than a distressed company 10 to 20 years ago. The capital markets that assess and price the distressed company's securities are larger and more diverse with a wider variety of sophisticated financial intermediaries than in the past. While these tightly-wound credit markets once provided greater access to the then-healthier borrower at lower costs, the distressed company may find itself navigating extreme market volatility and negotiating with lenders who themselves are distressed. Regardless of their financial stability, securities-holders are more attuned to the market and the immediate value of their holdings, less patient, better informed and more familiar with the restructuring process and relevant legal codes than capital providers of the past. Whereas previously lenders in a distressed situation could be slow to take action and desirous of maintaining a relationship post-distress, these new players, which include hedge funds and distressed debt traders, quickly notice signs of distress and are willing to exploit situations for quick profits. Options for these new players include providing additional, high-priced capital, pressing an advantageous strategic plan or waiting for prospects to rebound. Due to this dynamic environment, it is critical that management teams, financial sponsors and investors construct meaningful action plans to ensure the company's liquidity, assess all options to preserve flexibility and to pursue value-maximising alternatives, and communicate proactively with all stakeholders.

A simple formula for distress

The two core ingredients of distress are operating volatility and financial leverage.

Operating volatility can come from many sources, including economic cycles, commodity prices, weather/natural disasters and political instability (previously thought to affect companies with operations in developing countries, not the slow-growing, indebted peripheral nations of Western Europe).

Other sources of volatility tend to vary by industry. For instance, the retail and restaurant industries are exposed to shifting consumer trends and tastes and factors such as weather and gas prices. Technology companies and print media purveyors face product obsolescence risk. Manufacturers face increasing pressure from low-cost foreign competitors. Consumer goods manufacturers are threatened by loss of pricing power resulting from the expansion of big-box retailers. Chemical and energy companies face rising energy and commodity costs. Casino operators face competition from gaming legalisation and expansion in neighbouring states. Healthcare companies face shifts in government

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reimbursement policy. These industry-specific causes of volatility are usually focused principally on one or two sectors, but their impact is often felt across the economy.

To a degree, operating volatility can feed on itself – as a sector’s value chains shift, weaker players drop out and suppliers and customers consolidate, prompting further evolution, pricing pressures and additional rounds of consolidation. However, in order to become a financially ‘distressed’ situation, an additional ingredient must be added to operating volatility – namely, significant indebtedness or other fixed obligations (for example, leases, pension and other retiree obligations, collective bargaining agreements and supply contracts). When a major portion of a company’s cash flow is needed to satisfy interest payments or other contractual obligations, there is less of a cushion to support weak operating performance. Warren Buffett likens taking on debt to driving with a spike sticking out of your steering wheel – no problem until you hit a bump in the road. Perhaps the metaphor should be reversed – hitting a bump in the road is much more of a problem if you are driving with a spike sticking out of your steering wheel. Because of today’s rebounding, creative and generous credit markets, that spike is larger and sharper than ever before.

In many cases, the stresses on a business from volatility and leverage are temporary and can be resolved successfully with some combination of time, new business strategies, revised operating tactics, new management and additional capital. But a business’ ability to implement a turnaround depends on market conditions. In the loose credit environment of 2004–07, a convergence of multiple negative events was required to generate enough distress to block access to capital markets. However, in a tighter credit environment, such as that of 2008 and early 2009, or 2001–02, a solitary factor could be sufficient to threaten the survival of a borrower.

Often, an initial trigger of financial distress is the tripping of financial covenants in debt instruments or bank credit agreements. That simple covenant default can initiate a vicious cycle of negative events that becomes increasingly difficult for management or a company’s financial sponsor to control. High leverage can shorten the period of time management has to respond in order to avoid the spike in Mr. Buffett’s steering wheel. Newsletters and websites devoted to stressed credits speculate on prospective non-compliance as critical dates approach, quickly report any default and frequently detail with startling accuracy what happened on ‘completely confidential’ syndicate and committee calls. The pricing on credit default swaps jumps, reflecting the perceived incremental additional risk of non-payment. Rating agencies’ comments and warnings of potential downgrades follow. Lenders, likely to feel that they have overextended credit, are alerted and become less forgiving. The temporary stumble quickly devolves into dire circumstances due to increased transparency and the potential for debt to trade away from the original par buyers into less friendly and more aggressive hands, such as vulture investors and hedge funds.

Increased transparency in the financial markets has also meant that operating issues translate more rapidly into declining financial performance for several other related reasons. Customers, vendors, employees and competitors have access to financial data and read internet chat boards and are increasingly aware of the financial health of their trading

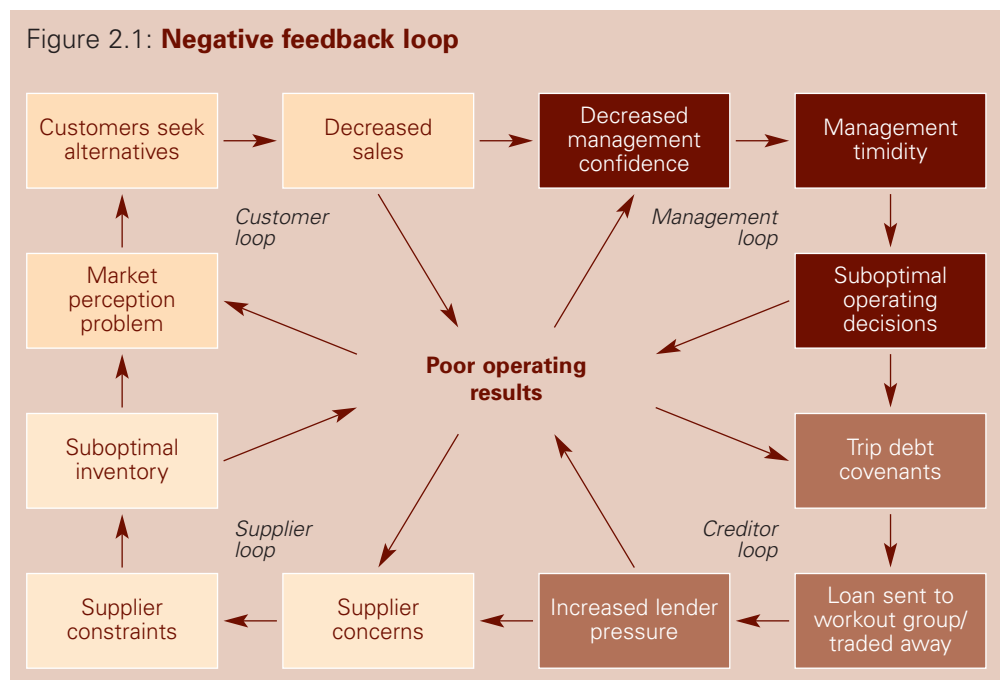
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partners, employers and/or competitors. As a result, poor operating results can set off a self-reinforcing chain of events that can damage a business franchise in a number of ways:

- Customers reject tarnished brands, poor service levels and unavailable inventory. They contact or are contacted by competitors who are quick to spin the 'bad' news to their advantage.
- Suppliers rapidly curtail trade credit to companies facing distress, creating further working capital stress. Credit-savvy vendors begin to demand deposits or cash on delivery; at the very least, they will shorten credit terms and reduce their maximum exposure.
- Creditors are more aggressive in monitoring performance and are less likely to agree to waivers or consents without concessions. They may seek to hire a financial adviser or retain special counsel. Some capital providers may believe the situation is prone to further deterioration and look to short the company's securities.
- As a result of these factors, a company's management may become hesitant to take the necessary bold moves to properly address the situation or, alternatively, becomes bogged down in the stakeholder drama. Key employees may begin to explore other opportunities.

As a result of this inter-connectedness, the distressed situation spirals out of control and eliminates the option of 'working things out quietly'. (See Figure 2.1)

Historically, bad credits in a commercial banking portfolio were shifted to internal work-out groups, which monitored loans more actively, enhancing the chances for a business' rehabilitation and/or loan recovery. Now, bonds and bank debt trade almost as readily as public equity. Taking advantage of market liquidity and pricing, original debt-holders may



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choose to sell their debt at a discount instead of trying to resuscitate or restructure the credit. Many banks and old-school institutional investors have downsized their workout and troubled asset groups, recognising that it is currently more cost effective to sell compromised positions than to ride them out. As a result, substantial holdings have flowed in recent years to distressed debt traders, whose strategies range from passive value investing to highly aggressive 'loan-to-own' tactics.

Despite these pressures, challenged borrowers need to increase operating flexibility, buy time to implement solutions and, in many cases, secure new capital. These actions can enable existing equity owners to retain and enhance value under otherwise disastrous circumstances. The guiding principle in today's market is that the earlier reality is recognised and action is taken, the greater the probability for superior recovery and returns.

This overview will address the following questions:

- How is today's market different from historical experience?
- What are some of the indicators of distress?
- What are the components of an action plan for a company in distress?
- What are some of the common mistakes made by companies facing difficulties?

Since the advent of the high yield or junk credit markets in the mid-1980s, technical and financial innovation and a growing supply of capital has led to a general increase in corporate leverage. Overarching credit loosening has been punctuated by periods of credit crisis, only to be followed by additional swells of optimism and euphoric lending practices.

The explosion in supply (and demand) for high yield debt and leveraged loans that had produced over \$2.7 trillion of outstanding leveraged debt by the end of 2009 has largely been the result of changes in global capital markets. (See Figures 2.2 and 2.3) Private equity firms, who took on high leverage to pay for their acquisitions, have become a much more significant factor in the credit markets; and given access to borrowings these firms made larger and larger acquisitions through 2007. In a mid-2000s investing surge, US-based private equity firms deployed almost \$1 trillion in leveraged buyout transactions, much of which was funded by leveraged loans and high yield bonds. Dollar-wise, buyout activity in 2007 represented 22 times the amount spent by buyout shops in 2001, the private equity industry's most recent low point before 2009 when activity dipped below 2001 levels. Of the approximately \$2.3 trillion of high yield debt and leveraged loans outstanding at the end of 2007, Standard & Poor's attributed some 40 per cent to leveraged buyout activity. Existing private equity portfolio companies also became sources of aggressive dividend recap transactions that fed the leverage markets and returned capital to owners soon after an acquisition. Fast forward to 2009, private equity-linked defaults accounted for nearly half of all US non-financial corporate defaults. While a major source of recent defaults, private equity-linked situations have continued to be a principal source of loan volume, though at slightly more modest leverage levels, when new deals are getting done. New mergers and acquisitions, leveraged

**Evolution:
how today's
market is
different
An uneven
march to new
leveraged heights**

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Figure 2.2: **High yield bond issuance through 2009**

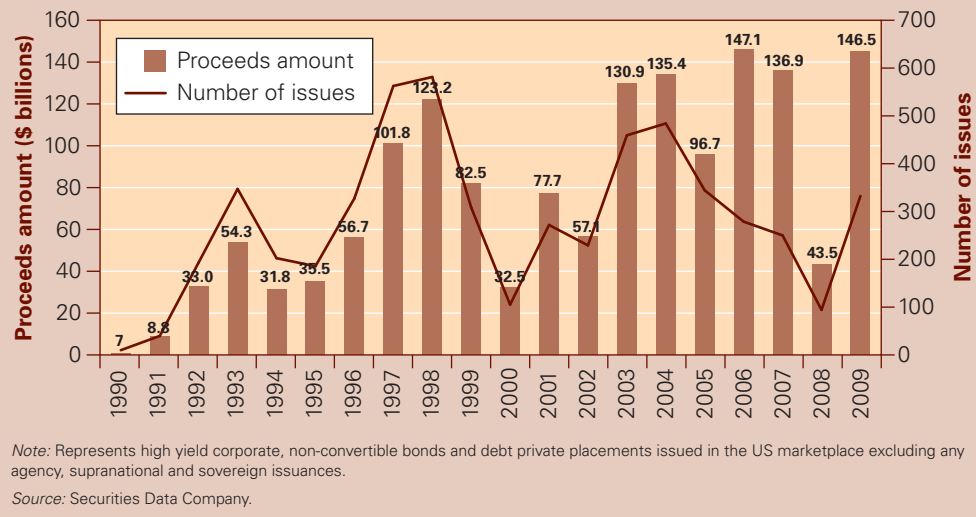
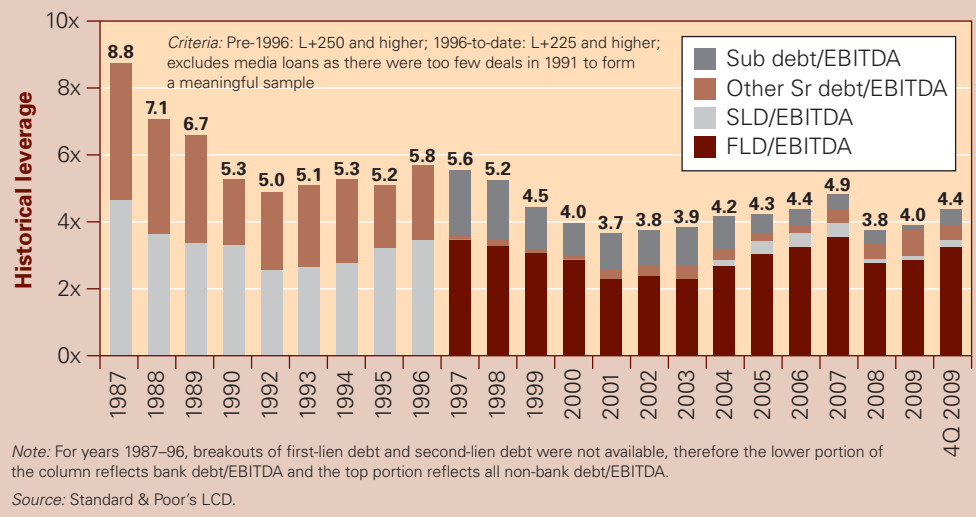


Figure 2.3: **Historical leverage in loan markets through 2009**



buyout and dividend recapitalisation loans, which were non-existent in 1Q 2009, represented 24 percent and 15 percent of institutional new-issue volume in 1Q 2010, respectively. At the same time, companies remaining public have increasingly turned to more aggressive borrowing for a number of reasons, including boosting shareholder returns and funding expansion with minimal dilution in order to remain competitive. The global equity markets have demanded that companies operate leaner, with more leverage and poorer credit statistics than in years past.

Even with the rapid growth in demand for leverage, the supply of capital has increased even faster. Over the last decade, the confluence of a low interest rate environment,

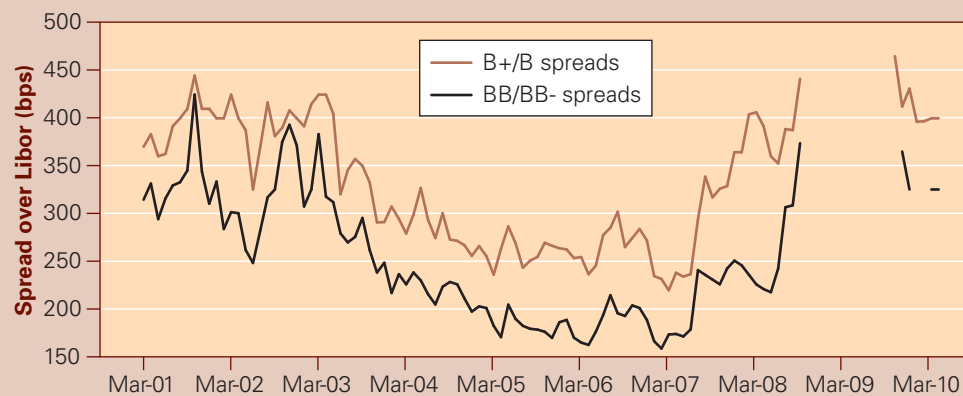
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increased institutional yield hunting and a flood of capital into hedge funds and structured loan vehicles has dramatically increased the size of the leverage universe.

At the same time that new participants have pushed into the credit markets, commercial banks, the traditional source of debt capital for corporations, have worked to reduce their exposure to the market. Banks are breaking free from their relationship-lending roots and are now service providers in the global credit markets – concentrating on syndication, structuring and prime brokerage. Even as they retain a position in a credit facility, if they retain a position, they can monitor and adjust their exposure through the credit derivatives market. This has led even the more traditional banks to be more aggressive in their lending practices, since most of their income from a loan will come from upfront fees rather than a future stream of interest payments. While agent banks continue to take the lead in communications and negotiations, they are only one of the many syndicate member voices that will determine lenders' strategy. Investment banks that have stepped into this lucrative field of loan syndication will frequently employ a third-party agent to administrate the loan and adopt the tag line of a famous kitchen commercial – 'set it and forget it'. As a result, the discipline imposed by old-fashioned commercial banking credit officers reviewing transactions that would stay on their balance sheets has been diminished.

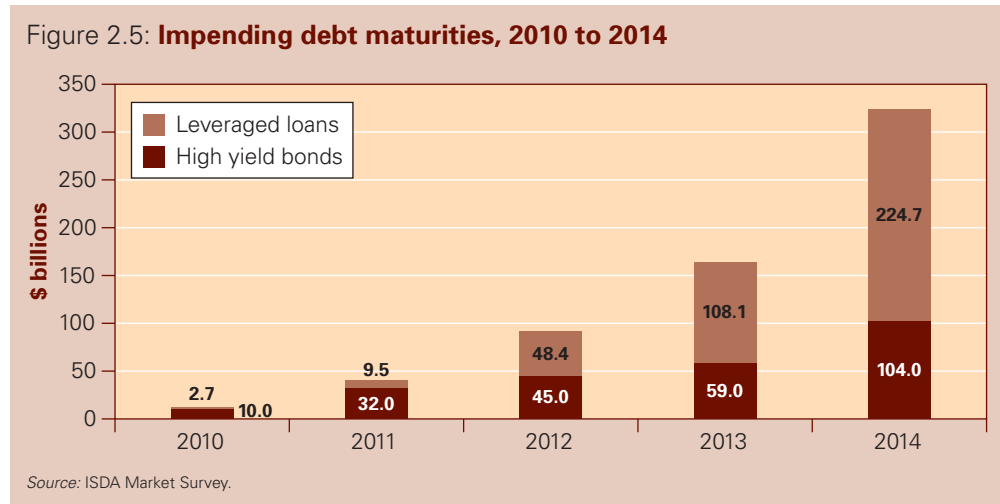
The imbalance in supply and demand has created opportunities for lower-grade credits, bolstering both primary and secondary markets. By the middle of the last decade, for the first time ever, over half of high yield issuers were rated single-B or under. By mid-year 2005, Fitch counted six industries that had over one-quarter of their constituents rated CCC+ and below, including cable, transportation, leisure and entertainment, textiles and furniture, supermarkets and drug stores and consumer products. As the bounds of acceptable risk have been stretched, underwriters and issuers, including those affiliated with private equity firms, have capitalised on the trend and launched riskier deals. Since 2005 year, over 90 percent of leveraged buyouts rated by the rating agencies have been single-B.

Figure 2.4: **Chart pricing spreads of BB and B loans**



Source: Standard & Poor's.

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Excess liquidity has also brought credit spreads (at moments in which the credit markets are open) to historic lows. For instance, the average LIBOR spread on B-rated institutional loans narrowed to under 275 bps before 2008, a range traditionally reserved for near-investment grade issuers. After gapping to 1,000 bps in early 2009, spreads have returned to a respectable 400 bps level. (See Figure 2.4)

As the markets have moved past the dislocation of late 2008 and early 2009, borrowers, lenders, investors and intermediaries have begun to focus on the almost \$600 billion of leveraged credit that is set to come due between 2012 and 2014. Over two-thirds of the bonds maturing in this wave have single-B ratings or lower. (See Figure 2.5)

New tools of the trade

While the march to higher leverage and greater risk has been fuelled by a mammoth but unsteady supply and demand growth, it has also been achieved in part by financial innovation and some clever, but occasionally deceptive, packaging. One recent trend that illustrates the lack of conservatism in the credit markets is the increasing issuance of 'covenant-lite' leveraged loans, which are free from customary lender-protecting restrictions and covenants. Additionally, the covenant packages of more standard leveraged loans have become weaker. In 2007, the average number of covenants in first-lien loans (excluding the 'covenant-lite' genre) dipped to a new low of 2.3, from 3.2 in 2005 and from 3.6 in 2004. Despite the market's pull back, this statistic has remained flat in 2008 and 2009. This general weakening or total lack of covenant protection has been a major reason why a number of the largest operationally-challenged leveraged buyouts have been able to stave off financial distress and continue accessing the capital markets. While one would imagine that feature has been pushed by demanding borrowers on begrudging lenders, the story is more complex. As the leading institutional buyers of leveraged credits have adopted specialised, 'human-capital-lite' management models, several discussed in the following pages, many senior fixed income investors have been complicit with regard to these structures, as fewer covenants create fewer defaults to monitor, more performing credits and fewer positions to sell from assets under management.

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To accomplish many of the syndicated leveraged financings of the mid-2000s surge, syndicating lenders and their highly leveraged borrowers also turned to subordinated-lien structures to layer in additional financing, lower the weighted-average pricing of their debt or lower their overall interest burden. These securities usurped the position previously occupied by high yield bonds – providing holders the benefit of a floating rate and the nominal granting of a security interest in exchange for a decrease in yield. Though a subordinated-lien loan does have a secured interest in the assets of the business, the liquidation value of the assets is likely to provide only modest coverage for what is otherwise a ‘cash flow’ loan. The lending community affectionately refers to such secured but under collateralised loans as ‘air balls’.

The second-lien loan market expanded rapidly and was a major factor in increasing corporate leverage and postponing inevitable defaults through 2007, what the industry dubbed ‘restructurings in waiting’. From a modest \$1.2 billion of gross new issuance for the years 1999 to 2002 combined, lenders provided over \$60 billion in domestic second lien credits from 2003-07. At their peak subordinated-lien deals amounted to almost 10 percent of total institutional loan volume. These deals, characterised as ‘subordinated debt in drag’ by one Moody’s officer propped up the weakest and most levered portions of the credit market. While average leverage ratios (defined as debt to EBITDA) for all levered loan transactions crept up from a low of 3.7x to 4.4x, the average ratio for second-lien deals rose to 5.0x.

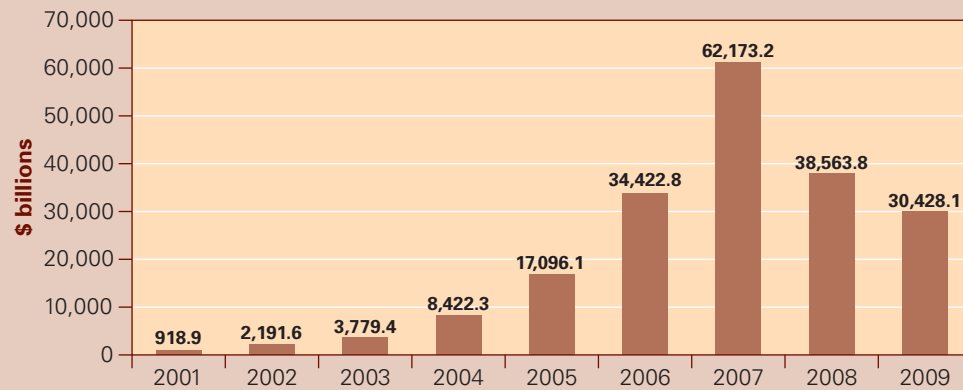
With their potent mix of a floating rate, higher spreads and the protection of an alleged ‘secured’ position, second liens drove a growing wedge between traditional secured loans and high yield subordinated debt. However, most holders of these loans and securities in the recent distress cycle found themselves acting as little more than speed bumps in restructuring processes dominated by senior secured lenders. Holders had not counted on valuations and financing markets moving so swiftly and suddenly that refinancing of the senior lenders would prove implausible, made more so by the arrival of ‘loan-to-own’ vultures acquiring the senior secured loans at their lowest valuations. The recoveries of subordinated lien lenders have more closely-tracked historical unsecured mezzanine results than traditional secured levels. This fad has now passed, falling from a peak of almost 200 syndicated second-lien deals in 2007 to less than 10 in 2009.

The tale of a capital structure innovation turning into a capital markets nightmare should not be a surprise. For instance, in the late-1990s, convertible securities with floating-price conversion features set at a discount from average past pricing became popular. However, in several circumstances, the borrower’s prospects declined and/or the investors sold the shares short, and the share price fell. As the convertible security acquired more and more shares, the share price fell further, creating a ‘death spiral’ that destroyed the company’s equity value and the investors’ investment thesis as well. The runaway popularity of second lien loans, in which borrowers figuratively, and literally mortgaged their company’s future, has had similar impact.

Credit derivatives are another innovation with ramifications that the market only now understands and appreciates. These instruments were largely provided by synthetic

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Figure 2.6: **Outstanding credit default swaps, 2001 to 2009**



Source: ISDA Market Survey.

CDOs (discussed below) – structured investment vehicles that hold derivatives contracts matching the bonds' cash flows rather than the actual securities. This market grew exponentially over the decade with minimal supervision, allowing participants to create or reduce credit exposure without owning or selling securities. (See Figure 2.6)

The existence of a deep and growing credit derivatives market allows credit speculators to bet on distress or to favour bankruptcy. Holders, even agents, can silently hedge out their exposure to a particular credit without exiting their position. More sinisterly, swap-holding bondholders can even become restructuring neutral or even pro-default, if their portfolio of credit protection is more extensive, shorter in duration or more profitable than their actual bond holdings. The out-of-court restructuring of trucking firm YRC was almost scuttled by bondholders who would have seen higher overall payoffs with a bankruptcy-triggered default.

New market participants

Looking beyond credit cycles and products, over the last two decades the capital markets have seen an explosion of new market participants, the most significant being collateralised loan obligations/collateralised debt obligations (CLOs/CDOs) and hedge funds. These two investor pools now dominate the market for highly leveraged loans, accounting for over 60 percent of demand in the primary market for leveraged loans (new issuance) in 2008 and 2009 and even higher amounts at the credit peak in the last decade.

CDOs and CLOs are structured debt, or specifically loan acquisition vehicles that are securitised and sold to pension funds, insurers and other large investors. The typical CDO, or 'cash' CDO, acquires fixed income securities, including bank loans, mortgages and bonds. A 'synthetic' CDO does not acquire assets, but rather provides credit protection to other investors, collecting periodic premiums in place of interest. CDOs are essentially warehouses of assets and do not have the overhead of a traditional lender. In particular, CDOs typically do not have workout groups, and, as a result, in a distressed situation, CDOs tend to exit rapidly from troubled situations. Whereas in the past a

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distressed company could hope for some support from its bank lenders, most CDOs are prone to jump ship, leaving the 'solution' to others. Those CDOs that remain in the credit through a restructuring pose additional challenges for an overlevered borrower. More so than 'loan-to-own' opportunists, or even commercial lenders, CDOs have emphasised cash and debt recovery, instruments of value that they can hold, over post-restructuring equity, which many are not allowed to hold and forced to sell. Inadequate delevering can be a classic recipe for a return trip to bankruptcy, a proverbial 'chapter 22'.¹

Enormous amounts of money have been invested in CDOs and their structures. CDOs have been at the heart of the recent manic nature of the credit markets. Created in stable times to offer diversified risk and steady yields to investors, CDOs can inflate an expanding credit bubble. Promoters must acquire and warehouse debt to raise capital and swiftly invest any additional capital they raise. In challenging markets, CDOs add to the selling pressure. Defaulted loans are frequently divested from assets. In some structures, rebalancing loan-to-value parameters to protect the most senior investors forces selling to create liquidity.

Critically, most of these structured vehicles will reach the end of their reinvestment periods over the next two years and begin liquidating their vast holdings. However, CDO origination is significantly off the 2005–07 pace and even the current ebullient high yield bond market is no replacement for the hundreds of billions of credit capacity the CDO wave has created. Without significant replacement demand, many borrowers will be returning to a much more hostile financing market.

A second and perhaps more dramatic addition to the distressed scene has been the plethora of hedge funds that have emerged. These funds have billions of dollars of capital to invest in both healthy and distressed situations. At their recent peak in 2007, over 10,000 hedge funds held \$1.9 trillion in assets. In early 2010, those assets had rebounded to \$1.7 trillion from a year-end 2008 trough of \$1.4 trillion. In and around that trough almost 1,500 funds liquidated. It is estimated that 4.6 percent of hedge fund assets under management are invested in distressed securities (a 2006 figure) and hedge funds account for 20 percent of the trading volume in the high yield market and 66 percent of distressed debt investing.

The rise of hedge funds searching for distressed opportunities has had a profound effect on the distressed situations and the credit markets. These funds can trade actively and aggressively, often not waiting for final resolution of a distressed situation before taking their profits. A vocal member of an ad hoc credit committee can be a force behind a particular restructuring path one day and gone tomorrow if the price is right. The activity of these players has elevated distressed pricing closer to par in stable markets, and at times increased volatility. Pressured by the potential for fund redemptions and desiring to post-competitive returns on their investments, many 'distressed-oriented' investors found themselves overextended in the last credit cycle and were forced to sell into the decline.

Many hedge funds have expanded the amounts that can be allocated to originating loans and holding illiquid securities (frequently referred to as 'side pockets'). Additionally, hedge

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fund managers have also capitalised on the capital markets' momentum by packaging CDO vehicles, which they continue to manage while divesting the various tranches. Other funds have raised dedicated 'distressed-oriented' private equity funds based on their investing track records and stepped into private equity and venture capital situations. In 2006 and 2007, the market watched a very well-known distressed situation hedge fund, Cerberus Capital, partner with a supermarket chain and a real estate fund to acquire part of the Albertsons grocery chain. Months later in a different sector, Cerberus led the consortia seeking to buy GMAC from General Motors and subsequently made its ill-fated purchase of Chrysler.

Approaching the distressed universe from the opposite direction, private equity funds have rewritten their playbook in response to this encroachment. Traditional private equity sponsors often cannot afford to wait for a restructured company to emerge from chapter 11 (in the US), because distressed investors now lend or purchase debt with the intention of converting their position to an ownership stake following a bankruptcy (that is, 'loan-to-own'). An example of this strategy was ESL Investment's 2003 acquisition of Kmart. ESL took control of the retailer by acquiring debt that was converted into equity upon the company's exit from bankruptcy. Those sponsors who tangle with existing creditors in competitive bidding situations have frequently found themselves in a self-defeating and expensive vicious cycle. As they bid higher cash values against creditors offering their securities, often acquired at a discount, they fed the creditors' belief that they have something of value not to be sold. In 2003, Burlington Industries had its sale to Berkshire Hathaway blocked by WL Ross & Co., which had acquired a substantial bond position in the bankrupt estate. The subsequent auction for the business was won by a Ross-led consortium. The Ross consortium bid knowing that a portion of their cash consideration would be returned to Ross based on its debt holdings. Berkshire chose not to bid.

To be where the action is, many private equity managers have amended their funds' charters to allow for the acquisition of distressed securities, including public and private non-control positions in equity and debt securities, as well as trade claims and other obligations. Just as securities seamlessly migrate from leveraged, to stressed, to distressed submarkets, what were once reasonably decipherable boundaries amongst classes of investors have now collapsed into a hazy continuum. Case in point, while simultaneously delevering Harrah's via a series of opportunistic discounted exchange offers and secured bond offerings, private equity owners Apollo and TPG provided the restructuring experience to dissect, acquire and restructure the capital structure of rival casino operator Planet Hollywood, sweeping the property into Harrah's Las Vegas asset base.

Warning signs: indicators of potential distress

What are these markets and players looking for? Although indicators of potential distress for a specific company can vary by industry and the state of the credit markets, the following are general indicators that a company is experiencing or headed towards financial distress:

- A degradation in operating results (due to loss of major customers, spiking supply prices and new competitors) coupled with near-term or medium-term debt maturities.

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- The company is repeatedly borrowing to pay interest, fund maintenance capital expenditure or fund working capital.
- Debt to EBITDA ratios are more than one to two turns higher than the ratios of competitors.
- Liquidity constraints are beginning to impact operating performance, for example, when cash on hand plus available lines of credit are less than five percent of annual revenues.
- The company's unsecured bonds are trading below 80 cents on the dollar or are yielding more than 14 percent.
- The company's secured bank debt is trading below 90 cents on the dollar.
- The pricing of credit insurance, via credit default swaps to the extent they are written, jumps demonstrably.
- The equity value of a company falls below 20 percent of the face value of its debt.
- Working capital levels are diverging from historical norms and/or industry standards (for example, accounts receivable collection lagging or accounts payable increasing).
- Credit ratings are downgraded to below B- for S&P or B3 for Moody's.
- Vendor terms are being shortened and/or trade credit is being reduced.

When finding these types of symptoms, distressed investors seek to evaluate the underlying causes of the distress and the ramifications of the distress. Is extrapolation to competitors, suppliers or customers appropriate? Is this a single sick animal or will the contagion infect the whole herd and food chain? Are stronger competitors the victors or the eventual victims of restructured operations under new ownership?

The stakes on such assessments are enormous. Many investors assumed the first telecommunications failures of 2000 were idiosyncratic in nature, the results of poor management, poor technological choices and poor funding decisions. To be clear, they were... at first. Many investors continued to fund into the leveraged markets, providing capital to the more stable emerging communications providers through early 2001, only to see many of those final bond issuances fail to pay a single coupon (known facetiously as NCAA issuances, meaning they paid 'no coupon at all'). Those who continued to invest failed to see the overcapacity being built into the emerging communications sector.

Inevitably, the ripple was felt in the market capitalisations of seemingly more solid names like Lucent Technologies, Nortel Networks, Alcatel and Corning. Large enough to survive the immediate industry contraction, these blue chips had to endure a multi-year stream of their grey goods in the market and the harsh reality that, at the height of the boom, they had turned into financing vehicles themselves and had contributed to the market's frothiness. By 2006 Alcatel and Lucent would combine, while Nortel would eventually liquidate in Canadian insolvency proceedings.

The opposite situation, overwhelming pessimism, is one that most seasoned distressed investors adore. Periodically, entire sectors are discarded en masse with the market failing to distinguish amongst good and bad business models. While less likely in today's markets, this still can happen, because many credit-oriented parties, such as banks and

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insurance companies, continue to manage their exposure by sector. In 2001–03, the veteran opportunists were picking through the wreckage to find gems in steel, energy and healthcare. Mid-decade, these experienced players and their growing cadre of imitators targeted the automotive and packaging sectors. In the first quarter of 2009, steely investors, fuelled by their experience, true sector knowledge and the courage of their convictions, bought into the strongest financials and retailers. Now, these investors are searching for value in housing, construction and gaming, amongst other industries.

Often, paradoxically, both of these sector strategies are appropriate because post-restructuring competitors emerge free of legacy capital costs and other liabilities that hound the healthier competitors who have avoided distress. They emerge more flexible, with lower fixed costs and less pricing pressure. Holding at par credit in a half-restructured industry can be the worst place to be, while holding the debt or equity of those early to emerge from chapter 11 can be the best. A clear example of this phenomenon has been the domestic air carriers. While the equity-holders of restructured United Airlines achieved significant recent returns, Delta Air Lines and Northwest Airlines continued to languish in bankruptcy and American Airlines eked out modest out-of-court savings. From its competitive positioning post-restructuring, United was able consider USAir and Continental Airlines as potential merger partners, choosing Continental. Only several years after their respective emergences from chapter 11, were Delta and Northwest able to come to merger terms. Sometimes the strongest company in an industry can simply be the last to fall.

Action plan

In the middle of every situation, there is a leadership team of senior management, directors and/or financial sponsors that must address the changed circumstances in their business model and in the capital markets. They must make decisions amid substantial uncertainty about whether they have the staying power to fight the tide, managing through the downdraft or need to capitalise on the uncertainty and monetising their optionality to recover what they can for stakeholders. The speed at which they adjust to the new reality and respond can have a dramatic influence on the outcomes.

Management teams in distressed situations should put into practice a detailed action plan to assess, expand and implement their financial alternatives. At their core, all action plans are driven by available liquidity. Liquidity determines the range of options that a company can explore and the time available to explore them.

Contrary to conventional wisdom, a financially distressed business may have many potential alternatives to a bankruptcy filing. Experienced turnaround professionals see filing for court protection as a restructuring tool, not a statement of failure. Frequently, filing comes at the end of an exhaustive process of considering other alternatives.

The best action plans are based on proactive communications with all stakeholders, flexibility in terms of rethinking past practices and seeing new opportunities and optionality (also known as contingency planning). They include an honest assessment of the prospects of the true operating business, independent of the capital structure, recognition

Section I: In-depth, incisive chapters

of timing, key dates and obstacles and a determination whether and how new money fits into the plan. While there may be preferred paths, to the extent that paths are dependent on willing third parties (M&A partners or new financiers), other alternatives, no matter how gruesome, must be mapped out and understood.

Boards of directors should demand such flexibility and honesty in thinking. In addition to evaluating the role for new capital, boards must also determine whether advisors, additional directors and/or new management would be additive toward resolving the problems at hand as a 'fresh set of eyes', a 'non-tarnished' and objective party, or both.

While every action plan must be tailored to the situation, the best should include the following steps:

- **Revise the business plan.** The management team needs to revise its existing plan, or at the least think through whether a revision is appropriate. Frequently, this can be done best with the help of a third-party adviser who can provide both an outside perspective and a validation of management's thought processes and/or conclusions. Additionally, advisers can also help management prepare for the range of pitfalls that tend to surface in these situations, including the tightening of supplier terms and the potential loss of significant customers.
- **Buy time.** Management should begin a dialogue with creditors in order to buy time. Engaging creditors in a dialogue early will allow the company to maintain control at least temporarily of the situation, while soothing lenders or creditors by acknowledging their concerns. A carefully prepared and accurate rolling 13-week cash/liquidity forecast is a critical tool of both management and creditors, showing all key protagonists where things stand and are headed.
- **Increase financial flexibility.** The company may need to obtain waivers, consents or other debt modifications from its sources of capital. This relief may be essential to assuring access to liquidity, such as cash on hand or revolving credit facilities. The company should also investigate selling noncore assets. Additionally, the company may need to renegotiate leases or other contracts.
- **Secure new capital.** Concurrent with the financial restructuring, management may need to look for new financial or strategic partners to invest in the company. Options for this may include refinancing existing debt, swapping debt for equity or sourcing new debt.

If a company does require additional capital, there are a number of alternatives, as described above, including additional subordinated secured debt and rights offerings, which allow the present capital providers to fund the business and avoid dilution by third parties. Hedge funds, in addition to holding debt, are sometimes eager to commit additional debt or equity capital in situations in which they are already invested. Processes like rights offerings have given existing stakeholders the ability to fund the business and defend their holdings from the dilution associated with expensive external capital. Additionally, rights offerings have also emerged as rational alternatives to resolve some valuation disputes. Parties who complain that a valuation is too low or that new money's stake in the business is too high are offered the ability to invest at that level ('put up or shut up'). Rights offering have anchored, or provided a competitive

The new dynamics of distressed situations: is everything old 'new again'?

Hazards: common mistakes in distressed situations

stalking horse alternative for, a number of recent in-court and out-of-court restructurings, including Sealy, Standard Pacific, Rio Tinto, Exide Technologies, JL French Automotive Castings and Foamex International.

- **Create M&A options.** Management needs M&A alternatives, which may include divesting or even buying assets. Another option could be finding a deleveraging merger partner or acquisition target. As a final option, management may consider selling the entire company.

As management teams and their incumbent investors approach distressed territory, there is a natural tendency to avoid the difficult decisions and actions that need to be taken. Management teams and investors in distressed situations often make several of the following mistakes:

- Denying that the company's fortunes have shifted sufficiently and failing to recognise the magnitude of the problem.
- Having unrealistic business performance or sale expectations as the solution.
- Investing additional capital without optimising givebacks from creditors.
- Waiting until equity is so underwater that it has no negotiating leverage.
- Believing that creditors/vendors do not want to see the company file for bankruptcy or will not take actions to force a filing.
- Believing that the 'market', including customers, suppliers and employees, does not know or does not care about a company's troubles.
- Believing that equity will retain its seat at the table after a bankruptcy filing.
- Not engaging in real contingency planning early enough.
- Pursuing a perceived optimal path and not developing contingency plans.
- Not communicating with and losing the trust of lenders and creditors.

Many companies answer the calls of potential advisors only with the wolves at the door. At that point, they may have lost control of the process, and it may be too late to create value or preserve optionality for all stakeholders.

Conclusions

The distressed universe continues to evolve rapidly as new parties and new capital flock to the mantra of special situations investing. The factors that have attracted these opportunists, such as increased transparency and liquid markets, have in turn grown from their participation. While these new market characteristics and participants have expanded the range of alternatives available to businesses as they begin to experience financial distress, they have also created new challenges. Management teams have less time to correct poor performance and poor capitalisation choices before they must answer to their new creditors, who, incidentally, are frequently prepared to become their new owners. To address these challenges, leadership teams need to be proactive and take actions early that preserve their flexibility and optionality. □

¹ Chapter 11 of the US bankruptcy code pertains to the restructuring and reorganisation of corporations. American restructuring professionals colloquially refer to return to bankruptcy as a 'chapter 22'.

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