Financial restructuring: the investor’s perspective

Lesson 6

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Introduction

The option available and the path to restructuring

- In the initial period of the restructuring phase the distressed investor is a relatively passive observer
- The basic “moves” of the distress investors are fairly straight forward: buy, hold, sell, sell short
- To that simple moves a set of important questions are associated: [buy/sell] what, when, how , how much, for what price?
- Moreover, whatever the investor strategy (sequence of move) is, it does have to be feasible in a world where other stakeholders pursue their own strategies
- The distress investor’s will develop the strategy base on its risk objectives, the possible exits from the investment, the form of recovery (cash, debt, equity) as well as the level of the involvement needed to manage the investment
- The investor will often utilize hedging strategies to reduce the risk

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Out of court situations

Example of target company situation (January 2016)

- TargetCo is a semiconductor and electronic boards manufacturer with highly cyclical operations
- In its peak year it generated EBITDA =350 but last year EBITDA was down to 150
- TargetCo is facing a liquidity event when it will have to refinance its 9% Senior Notes
- Cash on hand is limited to 100
- Assume today we are in January 2016

Target Co capital structure

Capital Structure 31-12-2015	Maturity	Book value	Trading price	Market value	YTM
Secured bank loan		150	100%	150	5,5%
9,0% Senior Notes	1/6/17	350	90%	315	17,4%
9,5% Senior Notes	1/3/22	500	82%	410	14,0%
6,0% Sub Notes	1/2/19	250	65%	163	22,5%
Total financial debt		**1.250**		**1.038**	
Equity		**200**		**200**	

Target Co leverage

Leverage at different EBITDA levels		At Face value	Net Market value
EBITDA = 150	Thru Senior	6,7x	5,2x
	Thru Sub	8,3x	6,3x
EBITDA = 250	Thru Senior	4,0x	3,1x
	Thru Sub	5,0x	3,8x
EBITDA = 350	Thru Senior	2,9x	2,2x
	Thru Sub	3,6x	2,7x

Note: Sub Notes have a lower interest rate because they were convertible but we are assuming that the conversion price if out of the money

Passive involvement

- In a passive investment strategy, the investor simply thinks that a security trades below fair value and over time will rise back to its fair value at which point the investor will sell for a gain or hold it till maturity
- The reason why the market is failing to recognize the fair value could be different. For example:
    - The company is cyclical and the market is failing to recognize this aspect when valuing the business
    - An unsecured bond is depressed by the layer of secured debt placed on top of it but the investor believes that the priority could ultimately be invalidated
    - The firm may consider a repurchase offer which will drive up prices
- In this strategy the investor will just try to identify the right moment to buy, will monitor the situation to validate its rationale and to decide the exit point
- When the target has a complex capital structure the investor will also evaluate the different risk regard profile of each security

Passive involvement: which security

- Suppose the investor thinks that 150 EBITDA for Target Co is the bottom of the cycle

Capital Structure 31-12-2015	Maturity	Book value	Trading price	Market value	YTM
Secured bank loan		150	100%	150	5,5%
9,0% Senior Notes	1/6/17	350	90%	315	17,4%
9,5% Senior Notes	1/3/22	500	82%	410	14,0%
6,0% Sub Notes	1/2/19	250	65%	163	22,5%
Total financial debt		**1.250**		**1.038**	
Equity		**200**		**200**	

- The more risk cautious investor would buy in the 9,5% Senior Notes 2022 trading at 82 thinking that soon the market will realize that there will be no refinancing risk and will align the value to the 9% Senior trading at 90 for a 10% return
- The investor will also note that the downside could be limited considering that at 150 EBITDA leverage through senior is 5,2, which considering the EV multiple of the sector could be covered by the value of Target Co

- The more aggressive investor may prefer the sub-notes thinking that they can rise to 75 although risk is higher (leverage at 6,3x)
- The sub-notes maturity is near term (ahead of the 2022 senior) and if paid off they provide a 22,5% YTM

Active involvement

- In some situation the investor identify opportunities in which in order to realize a higher value of an otherwise undervalued security, there is the need for active investor participation
- Fairly typical situation is when the target firm is in financial distress but has good options such as debt repurchases or exchange offer to avoid bankruptcy
- The investor can for example acquire a reasonable block of distress bond and then approach, maybe after having organized other noteholders, the firm with a restructuring proposal
- The downside risks are linked to the possibility that the restructuring transaction cannot be executed and to the fact that the transaction may require time consuming the liquidity and the options available to the firm to stay out of bankruptcy
- Moreover, when the market becomes aware that a player is holding a large position will likely make it very painful to unload the position should the investor decide to exit

Real life: active involvement

Monte dei Paschi di Siena
Hedge Funds Holding c70% of Monte Dei Paschi di Siena's €1B FRESH Bonds Seek Buyback at 50c, Willing to Settle at 35-40c

Investors Attestor, Bybrook, Centerbridge, Eton Park and Eyck have asked Monte Dei Paschi di Siena (MPS) to buy back its €1 billion FRESH bonds at 50%. The funds, advised by Paul Hastings, represent around 70% of the notes and would settle at 35% to 40% with a minimum of 31%, sources told Reorg Research.

The bonds are not yet part of the Italian bank's liability management exercise and are trading in the high teens.The bank is expected to decide whether to buy the notes and at what price in the coming two weeks.

The same group of hedge funds approached the Italian bank a few months ago with a plan to convert their claims into equity at between 30% and 50% of their value, as reported by Reorg Research.

Source: Reorg

Active involvement in the case of TargetCo

Capital Structure 31-12-2015	Maturity	Book value	Trading price	Market value	YTM
Secured bank loan		150	100%	150	5,5%
9,0% Senior Notes	1/6/17	350	90%	315	17,4%
9,5% Senior Notes	1/3/22	500	82%	410	14,0%
6,0% Sub Notes	1/2/19	250	65%	163	22,5%
Total financial debt		**1.250**		**1.038**	
Equity		**200**		**200**	

- In the situation presented by TargetCo it is unlikely that the investor could add value through active involvement
- Although TargetCo has too much leverage it is unlikely it would be able to complete a voluntary deleverage transaction
- Cash on hand (100) is not enough to allow any relevant debt repurchase (2017 senior notes 315 at market value)
- The 2017 notes that are causing the liquidity issue are trading at 90 and are unlikely to accept a deeply discounted offer
- Nor they will accept an exchange with a pari passu longer maturity because at current market will imply a loss of value (2022 notes are trading at 82) and moreover it will put them at risk of the sub notes maturing before them
- An exchange into equity would significantly alter the risk profile: potentially high returns but high risk in case of Ch.11
- The presence of secured bank debt makes it unlikely to be able to structure a coercive exchange offers assuming banks already have liens on all assets

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Chapter 11 situations

Example of target company situation (December 2016)

- It is now almost the end of the year and latest forecast projects improved EBITDA at 175 for the year
- TargetCo is facing the challenge to have to refinance the 2017 notes in 5 months
- Because of the refinancing risk all of its bonds have decreased in price
- The 2017 notes declined modestly from 90 to 85 but considering the very near maturity that implies a YTM of 56% which means that the market requires significant returns
- If TargetCo is not able to refinance then it will likely be forced into Ch.11
- In that case the 2 senior notes should be trading at the same level which is likely to be 70 as the 2022 note which means 15% downside risk for the 2017 notes

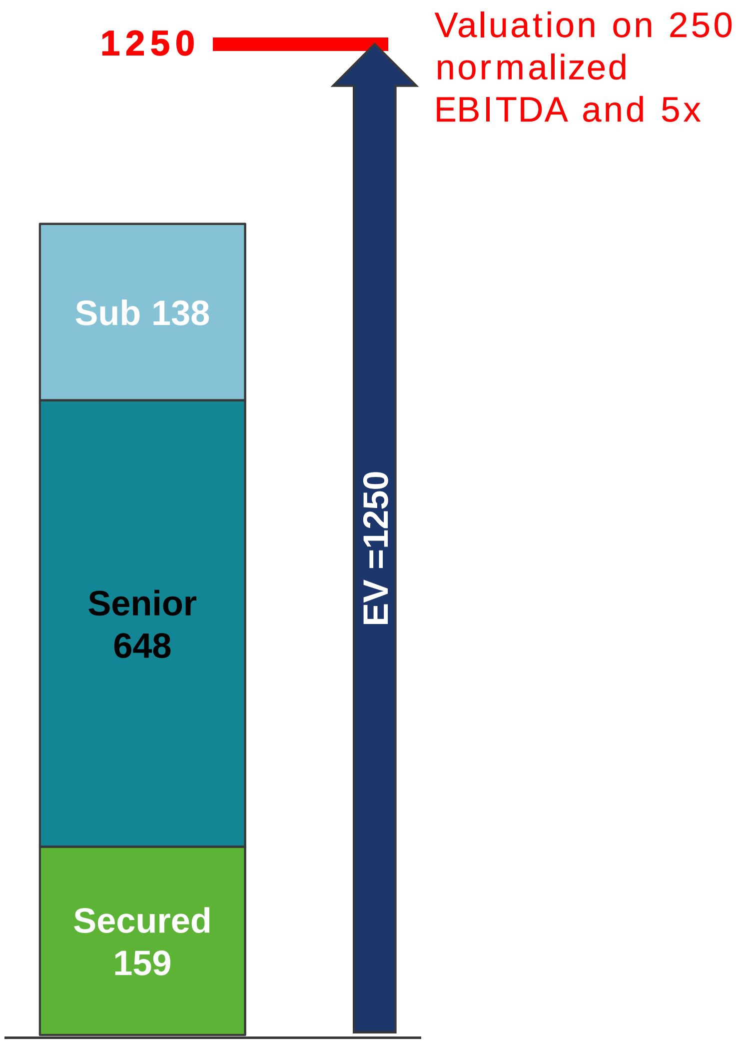
Target Co capital structure

Capital Structure 31-12-2015	Maturity	Face value	Trading price	Market value	YTM
Secured bank loan		150	100%	150	5,5%
9,0% Senior Notes	1/6/17	350	85%	298	56,6%
9,5% Senior Notes	1/3/22	500	70%	350	18,9%
6,0% Sub Notes	1/2/19	250	55%	138	40,4%
Total financial debt		**1.250**		**935**	
Equity		**200**		**200**	

Target Co leverage

Leverage at different EBITDA levels		At Face value	Net Market value
EBITDA = 175	Thru Senior	5,7x	4,0x
	Thru Sub	7,1x	4,8x
EBITDA = 250	Thru Senior	4,0x	2,8x
	Thru Sub	5,0x	3,3x
EBITDA = 350	Thru Senior	2,9x	2,0x
	Thru Sub	3,6x	2,4x

First issue: how much risk to take?



- Suppose the investor thinks that Ch.11 is highly likely but that the value of the debt is cheap compared to the recoveries that will be available (valuation will be done with a normalized EBITDA of 250 and at least 5x multiple)

SENIOR NOTES:

- The investor will likely avoid the 2017 notes that in Ch11 will likely be realigned to the 2022 notes price of 70 (with an immediate loss of value for 12)
- All senior at 70 will mean that senior is at 4,3x current EBITDA of 175 which seems reasonable in terms of recovery risks if there is not going significant value erosion in Ch.11

SUB NOTES:

- If the investor has strong believe about the EV at 1250 then the sub notes will be able to recover 100% with a current price of 55%
- However sub notes have 1000 of secured and senior debt* which means a pretty risky 5,7x current EBITDA
- The current spread between senior and sub is 21%** which could be considered low with high leverage thru senior
- Therefor it is likely that price of sub will decrease as the Ch11 gets closer and the investor could wait till adjustment in value

*Here you have to consider the face value which will determine the claim in the Ch.11
**Spread Senior-Sub = (70-55)/70 =21%

Second issue: what type of post reorganization security

- The investor shall consider if it has preference in which kind of post reorganization security he or she will be paid
- That will be a function of:
  - The valuation used for the plan of reorganization, different from the investor's view (EV=1250) because it will be the outcome of a negotiation between claim holders
  - The appropriate amount of leverage in the postreorganization entity
- The EV assumed for the plan will determine the overall recovery for each claim while the amount of leverage will determine the type of interest the claimant will get in the Company
- We will consider the case with or without leverage in a low and in a high valuation case

Low valuation case

Low Valuation Case			
Valuation EBITDA		250	
EV x		4,5x	
Plan EV		**1125**	

Low leverage post reorganization capital structure

		Value	Leverage
Secured bank debt		150	0,6x
New senior debt			
Equity		975	
Distribution of equity	**Claim**	**Recovery**	**% of equity**
Senior debt	850	850	87%
Sub note	250	125	13%

High leverage post reorganization capital structure

		Value	Leverage
Secured bank debt		150	0,6x
New senior debt		600	3,0x
Equity		375	
Distribution of equity	**Claim**	**Recovery**	**% of equity**
Senior debt	250	250	67%
Sub note	250	125	33%

- Considering that secured bank debt is below 1x it is reasonable to assume that the old debt will be repaid post confirmation with the proceed of a similar facility
- With a low valuation senior creditor will receive a higher piece of the equity and if the true value is higher than the plan they will benefit
- Senior creditors will argue that Ch.11 is always detrimental to a business, that the true value of the firm is not known and therefor a low valuation should be adopted to avoid the downside risk
- In the case of high leverage we are assuming that the new debt will be given to pay senior claim but there is no requirement to assign debt based on the priority of the claimant
- Sometimes senior debtholder may prefer to hold the 100% of equity and use a new debt facility to raise cash to pay the sub their recovery in cash

High valuation case

Higher Valuation Case	
Valuation EBITDA	250
EV x	5,5x
Plan EV	**1375**

Low leverage post reorganization capital structure

	Claim	Value	Leverage
Secured bank debt		150	0,6x
New senior debt			
Equity		1225	
Distribution of equity	**Claim**	**Recovery**	**% of equity**
Senior debt	850	850	69%
Sub note	250	250	20%
Old Equity holders		125	10%

High leverage post reorganization capital structure

	Claim	Value	Leverage
Secured bank debt		150	0,6x
New senior debt		600	3,0x
Equity		625	
Distribution of equity	**Claim**	**Recovery**	**% of equity**
Senior debt	250	250	40%
Sub note	250	250	40%
Old Equity holders		125	20%

- If recoveries are such that old equity holders will get nothing then the management will tend to favor low leverage to allow better financial flexibility post reorg
- If old equity is going to receive a piece of the new equity they will tend to prefer higher leverage to increase the share of equity allocated to them
- On the creditor side the presence and allocation of debt in the post reorg capital structure can be influenced by the type of creditors sitting in the unsecured creditors committee (for example hedge funds vs mutual funds)

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Feasibility Consideration

Considerations regarding the capital structure

- The first factor an investor should consider is the existing capital structure and what that structure allows to do
- The first consideration will be about the secured bank debt: the higher it is relative the firm value, the less likely it is for a distress investor to be involved meaningfully other than buying a large block of the bank facility which usually does not trade at a discount
- Banks tend to have a strong covenant package with which they can drive and control most of the pre-bankruptcy period
- In a bankruptcy secured creditors will be protected by the concept of adequate protection (e.g. limit what the company can do with pledged assets, demand post petition interests)
- The possibilities for the investors to buy a piece of bank debt increase with the level of distress, sometimes driven by the need of banks to manage their non performing loan portfolios

Valuation and liquidity of securities

- For an investment opportunity to exist, it is not enough to find a distress situation but a case of misvaluation is needed
- Usually opportunities for misvaluation exist right after a negative information event, in proximity of a liquidity event or in highly cyclical sectors when the market fails to fully recognize the impact of the cycle
- The investor will also need to investigate the feasibility to build the desired position which can be difficult and expensive if the market is illiquid
- It is important to know if other distress investors are already involved and knowing their track record can put light on the directions they will try to drive the situation