Financial restructuring: the company perspective

Lesson 5

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Introduction

The option available and the path to financial restructuring

- From the company perspective the options to solve a distress situation are limited to one or a combination of the following:
    - raise new capital
    - repurchase or restructure existing debt in or out of bankruptcy
- The decisions on the path will be based on the following factor:
    - time
    - liquidity
    - industry fundamentals, outlook
    - attractiveness of its assets and business units
    - existing contractual constraints
    - complexity of the capital structure
    - causes of financial distress

- From the investor point of view understanding the firm's potential moves allow to predict the likely path of restructuring and design an investment thesis

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Example 1: waiting

Example 1: basic scenarios

Tech Company

ASSET SIDE

- Intangible assets for 1000 at historical book value
- Cash on hand 225
- EBITDA -10
- CAPEX required for business plan150

LIABILITY SIDE

- 200 in 5% subordinated convertible notes with no covenants now trading at 25 c/$ and maturing in 2 years
- Shares trading below 1 (at peak they traded above 100)

- The noteholder who bought the notes at 25% (i.e. paid 50 for a 200 claim against the company assets) would love TechCo to file for Ch 7 (liquidation) and recover close to 200 with the company's cash
- Problem is that noteholder have no power to force a bankruptcy
- Management will have the opposite dream of continuing with the business plan
- A more probable and mutually beneficially scenario could be that the company uses part of the cash (225) to repurchase the notes which are trading at 25% (50 of value) and the leftover cash to fund the plan
- Amount to repurchase and price (which will be driven up in the market by the repurchase news) to pay will have to be carefully thought out

Example 1: new money options

Tech Company

ASSET SIDE

- Intangible assets for 1000 at historical book value
- Cash on hand 225
- EBITDA -10
- CAPEX required for business plan150

LIABILITY SIDE

- 200 in 5% subordinated convertible notes with no covenants now trading at 25 c/$ and maturing in 2 years
- Shares trading below 1 (at peak they traded above 100)

- Management would probably consider to raise more cash to put the company in a safe harbor and not having to worry about the note maturing in two years
- New equity would be impossible since the new money will go straight to the benefit of the noteholders
- Selling assets could be an option
- The company could also consider raising secured debt which would probably require to give a pledge on all the assets including cash on hand
- That would be bad for the noteholder (all assets pledged) and useless for the company (if the cash on hand gets pledged, the Company will not be able to use it to fund operations and Capex)
- The new money scenario is unlikely

Example 1: waiting

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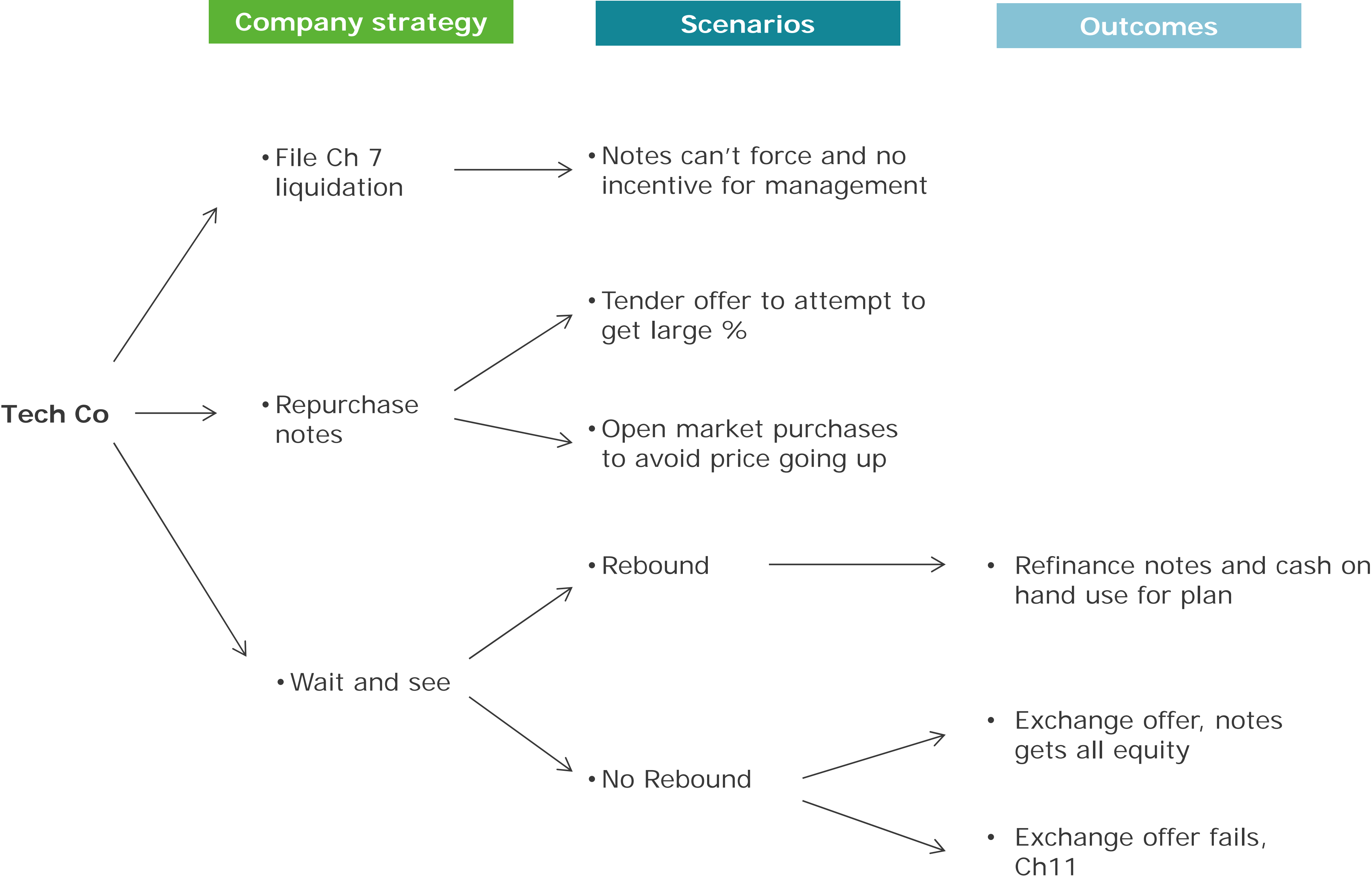
- Shares trading below 1 (at peak they traded above 100)

- Management can wait for a market rebound but it should be planning for the possibility that in two years it will not have the resources to repay the notes
- Assuming that bankruptcy will provide no real benefit (e.g. no significant contractual obligations to reject), probably the restructuring will be played out of court with the noteholders receiving the large part of equity
- From the investor point of view that would look like this:
  - ➢ Initial investment 50 for the notes
  - ➢ Probably 3 interests payments* received for 15
  - ➢ Receive the majority of the equity that considering historical asset values of 1000 + capex of 150 should be worth more than 35 (needed to breakeven for the investor)
  - ➢ The investor will therefor look at this as an equity investment and require overall return of 20%-30%

* Assuming semiannual installments and that only the one at maturity will not be paid

Example 1: Tech Co summary



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Example 2: no way out

Example 2: Steel Co

Steel Company

ASSET SIDE

- EBITDA 20 (6 years low down from 40)
- Tough sector in a weak economy
- Fixed assets rich
- Cash only 6

LIABILITY SIDE

- 50 secured bank line in technical default
- 150 in 12% unsecured notes (trading at 50%) with a coupon (9) due in two weeks and maturing in one year
- Private equity fund owner

- The private equity fund managers will make sure that the management is focused on maximizing the potential value
- The fact that there is a technical default (e.g. breach of covenant) means that banks have significant influence in the process
- Steel Co is an established business making money and with hard assets
- The challenge here is the one year maturity of the notes which the company will be unlikely able to refinance (they are trading at 50%) and has no cash for an internal deleverage
- The PE fund, if it believes in the business, may actually provide the support to repay the notes but it is unlikely to just write a check for the noteholders even at a discount
- PE fund can think of providing new money in the form of a secured loan, although probably only second liens are available (banks are already secured)
- But with the maturity and the risk of bankruptcy only one year ahead, the loan could risk to be considered equitably subordinated

Real life: Private Equity fund support

Bartec GmBH
Bartec Lenders Plan Oct. 28 Meeting to Discuss Charterhouse Proposal

Bartec's lenders will meet at the Allen & Overy offices this Friday Oct. 28 at 11 a.m. BST to discuss Charterhouse latest proposal, sources told Reorg. The creditors are reviewing a revised amend-and-extend plan from the private equity owner featuring a €60 million equity contribution. The German safety equipment maker's shareholder is offering to provide €40 million in equity.

Charterhouse will underwrite a new €20 million term loan facility paying Euribor+450bps. The C5 loan will be pari to the existing debt if Charterhouse provides it and senior to it if lenders provide it. The loan will carry warrants equal to 5% equity in the company if the debt isn't funded by Charterhouse.

Lenders are asked to extend all debt facilities to June 30, 2022, and will receive a PIK margin subject to the following leverage grid:

If leverage is 7x or higher, additional PIK margin will be 325 bps;
If leverage is between 6x and 7x, additional PIK margin will be 225 bps;
If leverage is less than 6x, additional PIK margin will be 175 bps.

The proposed PIK interests will be structured as preferred equity certificates, or PECs, due when the debt matures or at the sponsor exit. PECs are senior to the warrants attached to the TLC5.

Lenders have to approve the offer by Oct. 28 and will receive 75 bps for their support. Should the plan fail to reach unanimous approval, the sponsor will seek to implement the proposal using an English scheme of arrangement. During that time it will provide a €15 million bridge facility to boost liquidity.

PwC is providing an S6 restructuring opinion, which will underpin the proposal. Under the deal, Charterhouse will need to equitize shareholder loans if the opinion so requires.

Source: Reorg

Example 2: the restructuring option

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- Private equity fund owner

- The PE fund will probably plan for a restructuring. When?
- Bank can use the technical default to accelerate, but if they have decent collateral will probably do nothing
- Notes interest payment comes in two weeks so unless banks or PE fund finance the payment, the noteholder gets no coupon and restructuring starts in two week, otherwise in one year.
- In court or out of court?
  - A simple capital structure would allow out of court
  - Two weeks before an interest payment default are too short to prepare an exchange offer
  - If the PE fund believes that an exchange offer could ultimately be successful and avoid bankruptcy it could finance the payment to gain 6 months to prepare the offer
  - The nature of the steel business may suggest that the company may benefit from renegotiating contracts in Ch11, also considering that some of its competitors will likely to do so in a weak economy
- The competitive position of Steel Co will be considered by noteholders if and when they should consider an exchange offer

Example 2: the exchange offer

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- Private equity fund owner

- If the noteholders will think the risk is high they will request to see a premium versus the current trading value
- If noteholders get offered 60% in longer maturity notes plus 10% in stock it would seem to offer a premium of 20% versus the notes trading at 50%
  - if EBITDA recovers at 30, that would put leverage at a reasonable 4,7x
  - but if there is the risk of a future CH.11 anyway their claim against the estate will have nominal value of only 60% of 150 (instead of 150 now) with all the trade claims at the same level. Moreover the 10% in the equity will be subordinated
- Second lien could be offered to noteholders to improve their position. They could accept if they think that in a Ch.11 there is more recovery for 90 (60% price offered) of second lien debt versus 150 of unsecured which they paid at 50% (i.e. Recovery %> 75/90)
- For the PE fund giving second lien will be indifferent in a Ch.11 since the notes would be senior to the equity even if unsecured
- Moreover the PE fund will probably like to proceed with an offer anyway since in case of Ch.11 will reduce the nominal amount of claims ahead of them

Example 2: the Ch.11

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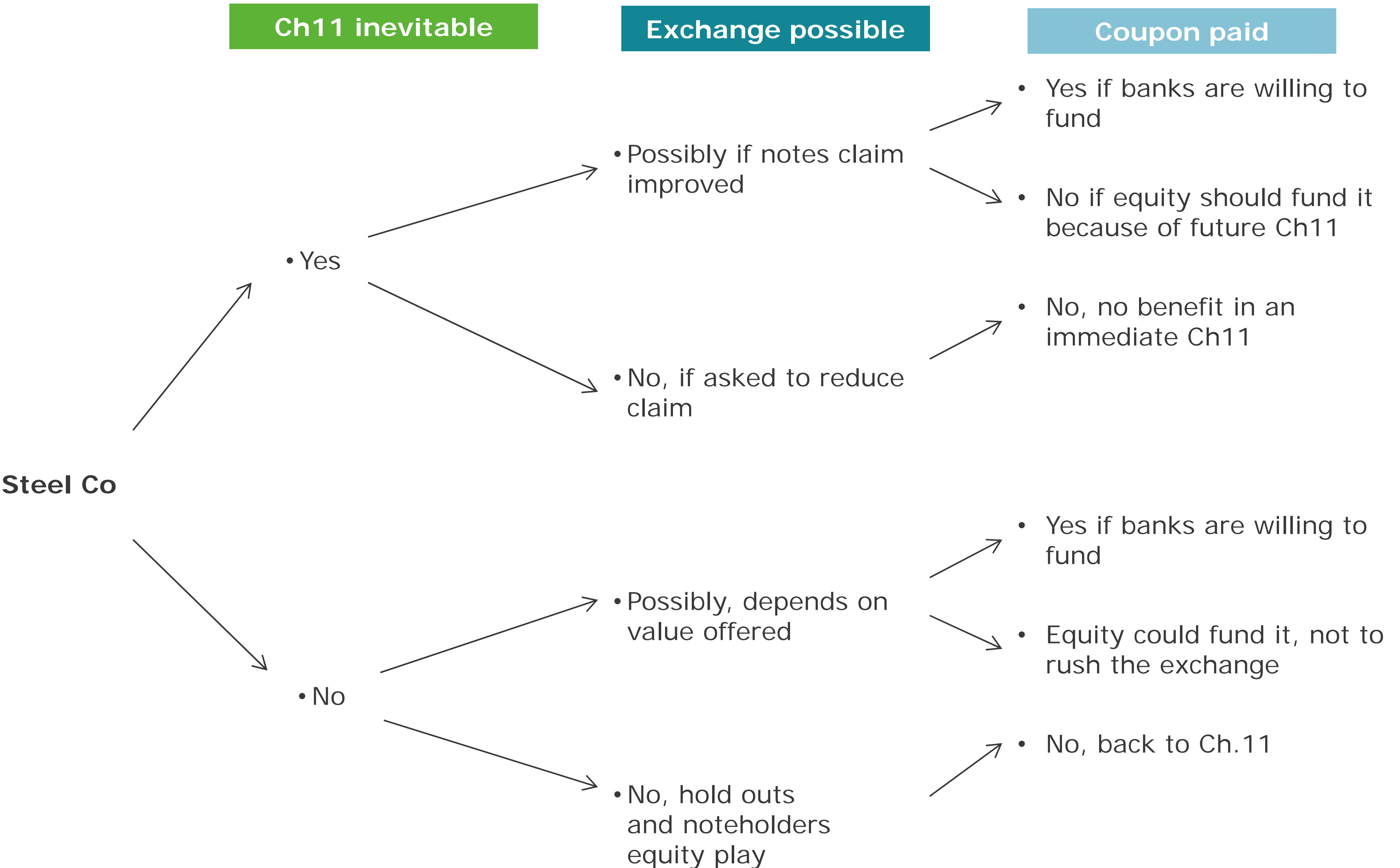
- Private equity fund owner

- If Ch.11 will ultimately be needed, it makes no sense for SteelCo to make the interests payment
- It is prudent therefor to assume that Steel Co will file Ch.11 immediately
- Since Steel Co produces significant cash flow (EBITDA) it is possible that part of the recovery for the noteholders would be in new debt
- In a Ch.11 recovery would be anyway significantly influenced by the amount of emerging non financial claims (e.g. pensions liabilities, environmental claims)

Return Analysis					
EBITDA	30	30	30	30	30
EV @7x	210	210	210	210	210
Secured Debt	(50)	(50)	(50)	(50)	(50)
Ch11 and Admin Claim	(15)	(15)	(15)	(15)	(15)
Value available to unsecured	**145**	**145**	**145**	**145**	**145**
Unsecured notes claim	150	150	150	150	150
Other unsecured	-	50	100	150	200
Total unsecured claims	**150**	**200**	**250**	**300**	**350**
% Recovery Unsecured	*97%*	*73%*	*58%*	*48%*	*41%*
1-year IRR					
for investment of 75 (50%)	*93%*	*45%*	*16%*	*-3%*	*-17%*

Example 2: Steel Co summary



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Options to resolve financial distress outside bankruptcy

Option 1: Raising additional capital

- Raising more cash may not solve the situation but it almost always buys more time
- For the Company more time may mean time to implement an operational turnaround or enjoy a market rebound
- For the investors may mean more time to waste resources but at the end it depends on whether the new capital improves or not the credit support available
- The erosion of credit support is one reason why bankruptcy laws often consider a criminal liability to incur in new debt when it is clear that the Company is insolvent
- A firm financial distressed will have limited roads to access capital:
    - ➢ Asset sales
    - ➢ Secured financing
    - ➢ Sale/leaseback financing
    - ➢ Equity sponsors

Raising additional capital: Asset sale

- Usually a company can sell BUs which can be carved out from the rest of the business, non operating assets (e.g. real estate, patents)
- The feasibility of this sale depends whether a buyer can be found willing to complete a transaction with a distress company which may later file for bankruptcy opening up arguments of fraudulent conveyance. Sometime bankruptcy is needed just to be able to sell certain assets (if the sale is done within a Ch11, the buyer is protected)
- Whether the asset sale is good or bad for the distress investors depend on what will be done with the cash.
- If the assets received fair value and the proceeds are used to pay down debt then whether the remaining debt will be better off depends on valuation considerations:

	Company Pre	BU Sale	Company Post	Company Post with repricing
EBITDA	50	20	30	30
Debt Face Value	500	120	380	380
Nominal Leverage	*10x*	*6x*	*12,7x*	*12,7x*
Debt Trading	40%		32%	47%
Trading implied Leverage	*4x*		*4x*	*6x*

Real life: Asset sale and risk of fraudulent conveyance

A third-party estimate on the value of Kodak's patents filed with the bankruptcy court pegs the entire portfolio at USD 3.4 to USD 4.3bn, including USD 2.2bn to USD 2.6bn for the specific patent pool that's earmarked for auction. Investors are concerned the company will not be able to attract fair market bids, said two hedge fund analysts and a trader.

A concern is that Kodak's auction process is going to be rushed since pre-petition attempts to engage potential bidders on 1,100 patents were halted by financial advisor Lazard in November on fears that investors could construct fraudulent conveyance arguments if bids came in cheap, added a private equity source, an advisory source and a flow desk analyst. As a consequence, the debtor did not have a running start on the sale process when it sought Chapter 11 protection in January.

Source: Debtwire

Raising additional capital: Secured financing

- If a firm has unencumbered assets, it could raise cash through a secured loan
- Usually it is rare that there are unencumbered assets in a distress company and allowing new pledges reduces credit support which is bad for existing creditors. Nonetheless three situations may arise that have potential for secured financing.
  - **Fallen Angels:** investment grade companies who had historically borrowed on unsecured terms. A limitation could be the fact that existing unsecured debt may contain negative pledge provisions
  - **Tech companies** which at the beginning borrowed issuing convertible notes based on a equity story of fantastic growth. Convertible notes are usually unsecured and have no protective covenants
  - **Second liens** when there is collateral value in excess of what is needed to cover first lien debtholder
- An hybrid solution of sale and secured financing is a sale and leaseback transaction. Advantages are that the company can still use the asset (in case it is needed for operations), the debt is in the form of a lease which may be off balance sheet, the valuation may be higher versus mortgage (liquidation vs going concern value)

- In general addition of secured debt in the capital structure does not enhance the position of unsecured creditors

Raising additional capital: equity sponsors

- The presence of a large institutional shareholder is usually seen as a positive factor in a distress situation because it usually has sufficient incentive to figure out how to solve the situation
- Although for an institutional investor like a PE fund a distress situation in their portfolio can be considered a regrettable mistake part of the risks involved in investing in risky assets, he will pay a lot of attention not to throw good money after bad money
- In fact if the incremental investment is lost, it is significantly more embarrassing considering that the investor had insider information and control of the firm. It will be no longer a regrettable mistake but a serious error in judgement
- Therefor an investor like a PE fund will inject new money only if it perceives it to be profitable and a way to recover part of the original investment

Option 2: Reducing leverage

- There are 4 ways to reduce leverage by purchasing or otherwise acquiring debt at a discount
  - Open market repurchases
  - Direct purchases from debtholders
  - Cash tender offers
  - Exchange offer

Reducing leverage: repurchases

Open market purchases

- They can only be done with bonds (which can be traded securities)
- The firm will act as any other investor and simply call the broker-dealers active on the market and make a purchase at the current price.
- The firm would usually use the underwriter as the broker-dealer because he may have the better knowledge of who holds the bonds
- To avoid price increase, the first goal is to keep the activity secret but such information will appear the next time to firm has to do some official disclosure (e.g. filing periodic statutory accounts)
- The firm will have to plan the repurchase activities between filing or disclosure obligations if it wants to minimize price increase

Direct purchases

- Usually a debtholder anticipating that the firm may be a purchaser will call the firm and offer to sell the securities
- The firm would be interested in the offer if the amount of bond offered is significant
- In fact a debtholder would be interested in a direct transaction to realize this “large block” premium

Reducing leverage: offers

Cash tender offers

- A firm can propose to purchase outstanding bonds according the relevant security law
- The proposal (solicitation) will contain a set of very specific conditions like: deadline to tender, maximum amount that will be purchased, proration criteria if maximum is exceeded, price (or auction mechanism).
- Cash tender offers are usually used when the target is to repurchase a large amount of bonds while with lower amount probably and open market approach is preferable
- In order to be successful a tender offer holdouts should have a relatively low probability to receive a cash recovery on the principal in the future
- The firm could include in the terms of the offer explicit language prohibiting future repurchases

Exchange offers

- Usually firms in distress have no cash for tender offers and, in those cases, deleverage can be achieved exchanging old securities for new securities
- Exchange offers can be coercive if designed to leave nonparticipants at risk of being significantly worse off (e.g. exchanging subordinated for senior secured with pending a significant risk of bankruptcy)
- Non coercive exchange offers present a comparative attractive opportunity (e.g. debt for equity swap which if not successful would lead to a Ch11 in which debtholder would still get equity but probably of lesser value due to bankruptcy costs)

Constraints in the range of options

- The range of options discussed is theoretically available but impractical in certain situations
- The common sources of constraints in that regard usually are:

- **Liquidity**: hard to make purchases with no money
- **Time to liquidity event**: a liquidity event can be the payment for which the firm is projecting not to have enough cash
- **Complexity of the capital structure:** in general the more layers exist in a capital structure the more difficult will be the restructuring. In particular secured bank debt usually limits what can be done because of covenants, already existing liens, restricted payments etc etc
- **Causes of financial distress:** the causes and their reversibility usually significantly constraints the range of options available

Real life: starting (or restarting) the process

Jack Wolfskin Retail GmbH
Jack Wolfskin Lenders Start Organizing as Company Faces Covenant, Liquidity Squeeze

Jack Wolfskin lenders are starting to organize after the German clothing retailer warned them this week that earnings were under pressure from a stronger dollar, increasing costs and slow acquisition execution in China. The company risks struggling to comply with its 6.4x leverage covenant at the end of the year and for the life of the deal, according to sources familiar with the situation.
The company told creditors to organize and hired PJT, Freshfields and Gleiss Lutz, as reported by Reorg.
Lenders including GSO, Sankaty, Unicredit, Bayside, Tikehau, IKB and Commerzbank, will hold a call to discuss next steps and will consider holding a beauty parade. Legal and financial advisers have been preparing pitches. The agent is Bank of America Merrill Lynch.
Jack Wolfskin has approximately €430 million debt and faces a €16 million payment in August 2017, part of its €80 million revolver, the remainder of which is due in 2018.
Management told lenders that EBITDA for the financial year 2016/2017 could drop substantially below the initial €61.4 million forecast, which would further affect both covenant compliance and liquidity, sources said. September 2016 numbers are not out yet.
Under a business plan presented to investors last year the outdoor clothing retailer expects EBITDA of €60.9 million in the year ended in September 2016, when leverage is expected to peak at around 6x and anticipated €61.4 million EBITDA in 2017, €66 million in 2018 and €74 million in 2019.
Deloitte, who worked on an IBR during last year amend and extend will produce a new one while Talbot Hughes McKillop will provide the group with a Chief Restructuring Officer (CRO).
In July last year, the company told lenders that to return to growth, it would focus on integrating its Chinese acquisition, improving its online presence, fixing performance in Germany and selling inventory overhang, as reported.
At the time, private-equity owner Blackstone provided the business with €75 million to repay 25% of the term loan B as part of a covenant reset agreement. Lenders to an €80 million facility agreed to extend it to May 2018 from August 2017, increasing margins to Euribor+500bps. The TLB was reduced to €240 million after repayment.
Lenders agreed to reset covenants to 6.4x for the life of the deal, giving Jack Wolfskin 30% headroom on its new business plan.
Blackstone acquired Jack Wolfskin in a buyout in 2011, according to the group's website. The retailer's debt comprises €314 million of term loan B paying 500 bps, a €45 million second lien paying interest of 9.5% and an €80 million RCF paying 450 bps.

Source: Reorg