<u>Three Bets At The Table: The Major Distressed Investing Strategies For Hedge Funds and Private Equity</u>

By Bobby Guy[1]

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A few months ago, I received a call from a friend asking for contacts at mezzanine funds to help capitalize his new venture. As I thought about his question, I realized that it has become very hard to name a pure "mezz" fund. The predominance of hedge funds and private equity groups in the last several years has resulted in a convergence of capital. While there are, of course, funds that tend to make significant investments at the mezzanine level, the abundance of liquidity in the capital markets leading up to 2007 has caused so many funds diversify their strategies that, in many cases, they have become indistinguishable. For example, ask yourself -- what is the difference between a private equity fund and a hedge fund? In many cases, the answer is now unclear.

A few weeks after that call, while engaged in helping a hedge fund update its distressed investing strategy, I realized that almost all acquisition strategies used by distressed investors fall into three major categories. This remains true regardless of the convergence of capital in recent years. These categories consist of the three primary ways to acquire a target company: *buying its assets, buying its equity, and buying its debt.*

When used as a model, the three categories can help identify new and intriguing investment opportunities, including the opportunity to develop niche investing strategies. Moveover, the fact that distressed investing can be collapsed into three simplified categories is not limiting. Instead, the fascinating complexity of distressed investing flows out of the numerous strategies available within each of the categories, and the unlimited capacity of investment funds to carry out the strategies in different ways.

One important exception to the three categories bears mention: some investment funds focus on strategies that involve merely playing the market, such as buying debt or public securities of distressed companies in the hope of selling the securities later at a higher price. These funds are using what we might refer to as pure "market strategies," because they look at the upside on the security and have little intention of acquiring or gaining control of the underlying company. The three categories outlined in this article are different, because they are acquisition strategies -- the "three bets at the table," as we shall call them, are ways to acquire distressed target companies or their assets. They are generally more activist, and the focus is on gaining control of the target company's future, and with it, the potential of future profits.

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[1] Bobby Guy is a member of the law firm of Frost Brown Todd, and is based in the firm's Nashville, Tennessee office. He focuses his practice on restructuring, reorganizations, and distressed acquisitions. He is board certified in Business Bankruptcy Law by the American Board of Certification, is named in Best Lawyers in America, and has been listed in Superlawyers since 2007.

Category 1: Buying The Assets

Distressed acquisitions are enticing because they provide the opportunity to pick up valuable assets at bargain-basement prices -- much less than the what it cost in services and materials to create the desired asset. And for distressed investors, the favored method for acquiring distressed assets has long been the asset purchase. The process is straightforward, and relative to the other equity and debt acquisitions, asset purchases are simple, more predictable, and generally involve less risk.

An asset purchase of a distressed company looks much like that of a healthy company -- it usually involves an asset purchase agreement, and the buyer is able to acquire assets while leaving behind the liabilities. There are several ways that a distressed investor can purchase the assets of its target:

- The short sale: This sale looks much like an asset purchase from a healthy seller. The differences lie in the fact that if the sale price is less than the secured debt, the bank holding the secured debt must consent to the sale. In addition, the buyer takes on certain risks, such as the inability to recover for misrepresentations by the seller (who won't have any money), and the potential that other creditors could try to attack the sale or pursue the buyer for successor liability. The risk of liability to unsecured creditors is usually small, but must be considered as part of the purchase.
- The foreclosure/receivership sale: Distressed investors can also acquire distressed assets by bidding for them at foreclosure or receivership sales conducted by a secured lender following a default. The sale process generally erases liens and claims of junior creditors, so the buyer is able to get clean title and avoid some creditor claims, a significant advantage of foreclosures compared to consensual sales. Disadvantages include the risks of limited due diligence and difficulties in getting contracts assigned without the consent of the third-parties to those contracts. Some of these issues can be pre-negotiated prior to the foreclosure; otherwise, the risks must be built into the buyer's pricing.
- The "363" sale: A third asset acquisition method is the bankruptcy auction, known as a "363" sale. The auction is conducted at the option of the debtor, not the lender, so it is essentially a voluntary sale.[2] Following the auction, the bankruptcy court enters an order approving the sale to the highest bidder, and this order provides protections that make the sale better in many ways for the buyer than the other types of distressed sale procedures. In addition, the buyer can take assignment of desirable contracts even if the other parties to the contracts object. Many times, the process also involves the early selection of a preferred buyer (known as the "stalking horse"), who sets the floor for the auction and is entitled to a break-up fee if outbid. As a strategy, some investment funds will bid only in auctions where they are given stalking horse protections; other funds prefer to bid openly at auctions instead of taking on stalking horse obligations.
- The REO Sale: Finally, the distressed investor not interested in purchasing at an auction will sometimes have the opportunity to buy an asset out of the lender's inventory

[2] The exception of course is where a trustee has been appointed or management has been changed; the sale of the voluntary choice of the new regime, but the old regime is likely hard set against it.

later, known as "real estate owned" (abbreviated as "REO"). If the secured lender puts the company up for foreclosure and is not able to obtain a satisfactory bid from a third-party, the bank will sometimes bid in its own debt (a process known as "credit bidding" that consists of setting off against the debt owed by the borrower), and the bank will become the new owner of the foreclosed assets. The bank will then find managers to operate the "new" company in the interim and will look for buyers to purchase the company at a favorable price. Because the assets have been through foreclosure, there is little concern about the claims of other creditors which have usually been erased, and the sales process looks much like the normal asset purchase sale between private parties (the bank and the distressed investor).

Category 2: Buying The Equity

Unlike asset acquisitions, buying equity is probably the least common method for acquiring distressed companies. This is because after the acquisition, the acquired company still owes all of its obligations; the equity buyer is essentially taking on the job of dealing with those obligations before it can realize any profit on its investment. This requires significant expertise (usually in the bankruptcy realm). As a result, equity purchases, including both stock purchases and mergers, are usually restricted to the realm of healthy companies.

There are several important opportunities for distressed investors that lie in equity plays, however, and these should not be overlooked. Potential equity strategies for distressed investors include:

- The LaSalle Auction: In a 1999 decision, the United States Supreme Court determined that existing equityholders, wishing to receive equity in the reorganized company as part of a Chapter 11 plan, are required to market-test the value of that stock in a public auction process unless they meet certain specific exceptions. The result is that in Chapter 11 reorganizations, the debtor company is virtually always in play. Creditors and other parties have the potential opportunity to bid for the equity in the reorganized company as part of the confirmation hearing. The winner at the auction would become the new equity owner of the company, which, thanks to the reorganization, would have just been relieved of many of its debts. This can be a profitable way to invest in the equity of distressed company.
- The Plan Investor: In Chapter 11 reorganizations, there is sometimes an opportunity for a distress fund to enter the process as the plan investor. In this role, the fund would put new money into the company at the time the company emerged from bankruptcy (presumably with most of its past creditor obligations discharged), and the investment would help the company fund its go-forward operations. In exchange, the plan investor would be issued equity (whether controlling or not, depending on the negotiation) in the new company.
- The Stock Pledge: In recent years, it has become popular with lenders to require that equityholders pledge their equity stake in the borrower as part of the security for the debt owed to the lender. When the debtor defaults, the lender then has more options: instead of simply foreclosing on the real estate and assets, the lender can foreclose on the stock of the company and take over operations, essentially effecting a change in control. The lender's foreclosure of the stock pledge is almost always a public foreclosure sale,

and distressed investors have the opportunity to bid for the stock at the sale. What is critical to understand is that the distressed investor, if it wins the bid, becomes the new owner of the debtor; the sale does not, however, erase the obligations owed by the debtor to its creditors. The distressed investor takes over management, and then drives the workout or bankruptcy process to resolve the obligations of the underlying company.

- The "Plague" or "Contagion" Sale: The owners of the distressed company sometimes will do almost anything to escape from their circumstances, and it is sometimes possible to buy their equity at very depressed prices (potentially by agreeing to absolve them from their guarantees). If the company is insolvent, then by definition there is no value in the equity, and the equity might sell very cheaply. The result following the sale is that the distressed investor, as the new equity owner, again has to drive the workout or bankruptcy process in order to bring the business back to viability.

Category 3: Buying The Debt

Buying or extending debt is the most indirect way to purchase a company, because owning the debt is not the same as owning the company. Remember the mantra from Caddyshack – "Be the ball"? For debt buyers, the mantra is "Be the bank." The debt buyer must convert the debt into ownership. There are several ways to do this:

- The Loan-to-Own Strategy: When a distressed investor buys secured debt from a bank, it has the same rights as the bank to foreclose on the assets of the defaulted borrower. So, one strategy for a distressed investor is to buy secured debt from the lender and proceed with foreclosure. At the auction, the distressed investor will credit bid (just like the bank could have done) without having to come out of pocket any cash -- it is allowed to bid up to the full amount of its debt simply by giving a credit against the existing loan. If the distressed investor bought the loan at a discount, it usually can still bid the full amount of the loan at the auction, getting essentially a free bump between what it paid the bank to buy the loan and the total amount owed on the loan. This gives the distressed investor a significant advantage in the bidding process. Even if the borrower files bankruptcy, either as a result of its financial struggles or in an attempt to stop the foreclosure, the distressed investor continues to have the right to credit bid its debt at any "363" sale in the bankruptcy. Bankruptcy creates other wrinkles, however, such as whether the borrower is able to reorganize instead of sell its assets; the unlucky distressed investor could end up as a long-term lender being paid a reduced interest rate on a reduced principal amount over many years instead of being able to take-over the company. This again is a risk that the distressed investor must examine and figure into its pricing.
- The Debt-to-Equity Conversion: Another strategy for distressed investors buying debt is to take control through a "debt-to-equity" conversion. Borrowers, especially in bankruptcy, are often forced by their inability to pay to propose converting all of their debt into equity in the reorganized company. The borrower does this by issuing new shares in the company to all of its creditors, who become the new owners of the company. If the distressed investor owns a majority of the debts owed by the borrower that are converted to equity, the distressed investor should then become the majority owner of the reorganized company. Distressed investors can also

sometimes buy enough debt that they acquire a blocking position in the bankruptcy, giving them the ability to force the debtor into a reorganization that gives the distressed investor control of the reorganized company.

- The “Friendly Lender with a Kicker”: A final strategy is for a distressed investor is to “save” a company from its existing lender by taking the existing lender out of the picture – either by refinancing the existing debt or by buying the existing debt (potentially at a discount). Prior to taking over for the existing lender, the distressed investor will cut a deal with the borrower to get an equity stake, or warrants and convertible debt, so that the distressed investor becomes a stakeholder in the borrower with significant upside potential as the company restructures.

Fund Specifics -- How Funds Differ In Playing Out The "Three Bets At The Table": So, there are essentially three comprehensive acquisition strategies, each of which presents multiple investment opportunities. Knowing this, how do hedge funds and private equity funds analyze these opportunities and then choose to act upon them? Funds have thousands of ways to differentiate themselves in the distressed opportunities they choose to pursue, and the way they choose to pursue them. Consider the following "fund specifics," as we shall call them, which each fund must consider in developing its own strategy:

- Geographic preferences for investments: is the geographic target area for acquisitions international, national, regional, or local?
- Industry preferences for investments: what are a fund's areas of expertise which it is most competent at handicapping? For example, some funds focus exclusively on healthcare (a personal favorite); others avoid healthcare entirely because of the high level of regulation in the industry. Popular areas for distressed investments in recent years in other industries have been transportation, energy, retail, manufacturing, telecom, hospitality, media, finance, and construction, to name a few.
- Capital structure preferences for investment: does the fund desire to invest at the senior secured debt level or at a different level, such as second lien debt, subordinated debt, unsecured debt, trade debt, preferred equity, or commonequity? Funds have the option of choosing between different types of debt at each level as well, such as, for example, bonds and debentures, vendor claims, tax claims, and participations in secured lending facilities (as opposed to single bank facilities).
- Control preferences for investment: does the fund always require a controlling position, or is it willing to take a minority position? If it takes a minority position, does it always require step-up rights in the event expectations are not met by the company?
- Range in size of investment: is the fund looking to make investments of $50-250mm, or $5-25mm? Every fund has a "sweet spot" which is their ideal investment target within a certain industry and investment structure. This may also mean that the fund has preferences regarding the size of the target company in which the investment is being made: if the fund's sweet spot is $15mm, and the

fund always requires a controlling position, then smaller companies and niche players will generally be the acquisition targets.

- Maturity stage of of target in which investment is being made: does the fund prefer companies that are struggling start-ups, or companies that have begun gaining market credibility but hit a bump at a major growth stage? Or, does the fund prefer struggling mature stage companies, that have grown into significant structure and culture? Other funds focus on post-mature companies at the end of their life-cycle, whose product market (and not just market share) has deteriorated, but which have high potential liquidation values in real estate or tax assets.
- Risk profile for investments: does the fund have a high tolerance for risk and swing for the fence every time, or a very low tolerance where investments must be (relatively) safe? Of course, there are funds that fall everywhere in between on this scale. A fund willing to buy equity in a distressed company in anticipation of directing the company through a successful Chapter 11 bankruptcy reorganization is taking on significant risk with a number of important assumptions, while a fund simply buying assets at a 363 sale out of a bankruptcy case with the insulation of court order is taking a much safer strategy.
- Source and cost of capital available for investments: does the fund have easy and immediate access to committed capital or lending at low rates close to LIBOR, or is the fund subject to significant investor restrictions that makes investing a more delicate process? The ability of a fund to access capital in order to leverage investments was one of the predominant issues that led to excess liquidity in the last cycle. The cost of capital to the fund also determines the baseline which the fund must make in return on its investments simply to break even.
- Yield requirements for investments: is the fund expected by its investors to return 25% per year, or is it allowed to make 12-15% per year? Does the fund have credibility to have several losing years in exchange for a year where the fund returns greater than 100%?
- Hold period for investment: does the fund expect to hold its investments for 3-6 months, or is it willing to stay in for 3-6 years? Funds differ widely in the time they anticipate expiring before they capitalize on their investment.
- Exit strategy/type of liquidity event: does the fund expect to take purchased assets to the market in a public offering, or sell its stake to another fund at a profit, or even sell the entire company? Or does the fund expect to get paid out because the company is required to use its profits to repurchase the fund's holdings as treasury stock at a certain point in time? Exit strategies vary widely by funds, and the scope in level of disruption caused by the strategy can be very significant.

These are the major criteria that funds must examine in defining their investment strategies. They are not exclusive, however; consider that every institution has a personality, and in this vein, that culture determines much about a fund. IT is sometimes said that "Culture eats strategy," a statement made to point out that no matter what sort of strategic initiatives a fund may hold out as its goals, if they are inconsistent with its culture, then the goals will rarely be met.

Conclusion

When developing distressed investing strategies, experiment with the "three bets at the table" and the possibilities this model presents. Even with the convergence of capital in the modern market, there are many ways for funds to differentiate themselves and develop niche opportunities. As a closing example, consider one fund whose manager gave a description that I will long remember: "We're the 'wierd deal' fund. If you've got something that just doesn't seem to work anywhere else, we want to know about it."