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The Time is Now

Economic Downturn Brings Opportunities

BY: MICHAEL PSAROS, MANAGING PARTNER, KPS CAPITAL PARTNERS, LP

For the past three years, the most frequently asked question among turnaround professionals has been, "When is the next downturn going to occur?" Based on the recent collapse of the subprime mortgage market and the resultant disappearance of liquidity in the corporate credit markets for all but superior credits, it appears the time is now. Distressed investors should see a significant increase in investment opportunities over the next two to three years.

This view is based on well-known structural changes that have occurred in the market during the current cycle, the impacts of which will only be amplified when the economy enters a recession. Valuations of companies in buyout transactions have been irrational—even pedestrian companies are being purchased at prices that are at historically high levels relative to substantially all valuation metrics. These transactions have been fueled by the excessive financial leverage as measured by all traditional metrics, sometimes set against a company's future but unrealized cash flows, and often against a company's peak earnings.

In general, it appears that many financial buyers valued acquisitions based not on the intrinsic value of the companies, but rather on the availability of financing. Significantly for turnaround investors, the ready availability of financing reached all the way down to companies with operational and financial problems that in more rational times would have been shunned in the credit markets.

The disappearance of seemingly limitless amounts of liquidity in the corporate credit markets changes everything and will have a material impact on the environment for turnarounds and restructurings. The demand for redemptions at hedge funds, coupled with the need to sell positions to raise capital to fund those redemptions, and the disappearance of investor demand for collateralized loan obligations (CLOs) probably will result in the material contraction of "bail-out" or "band-aid" financings.

Over the past three years, hedge funds and other non-traditional lenders have been actively providing bail-out financings to companies that otherwise would have been forced into a more formal restructuring process. While these financings provided companies with a temporary fix for their capital structure, they generally have not addressed the fundamental structural, operating, and management problems that hindered these companies in the first place.

While there always will be firms that provide this type of capital, they are likely to become more discriminating. As a result, this financing option will only be available to companies that have demonstrated their ability to repay the incremental borrowings.

Therefore, it is reasonable to expect default rates to increase in the near term, with a resulting increase in the number of corporate restructurings. The "daisy chain" of bailout/band-aid financings will not be available, which will push many troubled companies into default. In addition, because many of the band-aids already have failed and others will fail, companies no longer will be able to put off dealing with their core problems outside of a formal restructuring process.

Furthermore, the high yield market (public and private/Rule 144A) has experienced three consecutive record years of issuance. Historically, a correlated "echo boom" in restructurings has occurred three years after a record year of issuances.

Over the past three years, a new segment of the capital markets, generally known as the "second lien" market, also has emerged. The second lien (and in some cases, third lien)

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market is generally opaque, inefficient, and not "traded." It is focused on the middle-market and generally has very little judicial precedent in Bankruptcy Courts.

In general, the providers of this capital are hedge funds, whose principal activity is trading securities — not extending credit or working through complex operational issues. A contraction of capital available in this market is likely, coupled with a lack of an active trading market and requisite experience in restructuring these companies. This dynamic is likely to create significant opportunities for control-oriented private equity investors.

Day of Reckoning

While each cycle shares certain characteristics with previous cycles, there are always significant differences. Certainly this cycle will be very different for many reasons. First, because of the multi-constituency nature of most capital structures, the previously simple act of determining who has the right to what collateral or which creditor has priority will become difficult — and often litigated. Second, because most creditors in second lien or "B/C-tranche" debt are institutional/non-bank providers of capital, the traditional workout option will diminish, resulting in more pressure to sell.

Third, recent changes to the U.S. Bankruptcy Code are expected to result in more sales of companies and/or assets of companies operating in bankruptcy, and on a far more expedited basis than in the past. The institutional nature of today's creditor base, coupled with changes in the bankruptcy law, will probably result in a corresponding diminution in the number of companies reorganizing on a stand-alone basis in bankruptcy. This is a positive trend for control investors, because more companies and assets may be available for sale instead of remaining captive to protracted, creditor-driven reorganizations (that often result in Chapter 22s).

Finally, over the past five years, buyout transactions completed have been significantly larger than in the previous five years; therefore, the resulting bankruptcy and restructuring transactions will probably be significantly larger and more complex and require larger amounts of capital to successfully implement a restructuring and turnaround investment.

The absence of a temporary capital market option will require companies to focus on their core operating problems. Even companies financed with "covenant-light" loans eventually will face a day of reckoning.

Turnaround professionals should welcome a return to the norm. The absence of a temporary capital market option will require companies to focus on their core operating problems. Even companies financed with "covenant-light" loans eventually will face a day of reckoning.

Central to the investment strategy of the author's firm is a belief that superior investment returns are achieved primarily by catalyzing the turnaround of the business and operations of underperforming or distressed companies, often, but not necessarily, accompanied by a financial restructuring of the company's debt and other liabilities. There is an inexhaustible supply of poorly managed companies. Companies often fail for no other reason than poor management and execution, and both under-managed and mismanaged companies and assets can be found throughout all points of the economic cycle.

Once financing alternatives are generally no longer available, a large universe of companies will be exposed that are experiencing operational problems, including companies that are cash-flow negative, have histories of recurring losses, and require the installation of new management. This will create a competitive advantage for hands-on, control-oriented investors who focus on fixing the operations of underperforming, distressed, or bankrupt businesses.

Maximizing Recoveries

In this new cycle, investors who have a demonstrated ability to create and execute a turnaround plan that results in the creation of a viable going concern from a failed asset or company will be in demand. In such cases, the control-oriented firm will find it advantageous to partner with various creditor constituencies to effectively catalyze the restructuring transaction. These partnerships should prove symbiotic because most creditor groups are not interested in gaining control, have no desire to restrict their ability to trade, and will welcome an investor capable of turning around a business to maximize their recoveries.

The cycle has started to turn, and it will be more complex, different, and exciting for turnaround-oriented professionals than any before.

Michael Psaros is a co-founder and managing partner of KPS Capital Partners, LP, and a member of its Investment Committee. KPS Capital Partners, LP, is the manager of KPS Special Situations Funds, a family of private equity funds with more than $1.8 billion of committed capital focused on constructive investing in restructurings, turnarounds, bankruptcies, and other special situations. Psaros serves on the boards of directors of a number of the firm's portfolio companies. He holds a bachelor's degree from Georgetown University, attended Sofia University in Tokyo, and serves on the Board of Advisors of the Robert McDonough School of Business at Georgetown University.