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We are pleased to present the highlights of the 2007 Distressed Investing Conference, an inaugural event co-produced by the Turnaround Management Association and The Deal at the Wynn Las Vegas on January 17-19, 2007. This event linked more than 430 corporate renewal professionals and corporate dealmakers in an unrivalled opportunity to exchange ideas and hear the latest trends on distressed investing from leading experts in the field.

The educational content in this report will give you a glimpse of some of the most pressing concerns and opportunities facing the restructuring industry during a time of dramatic change in the rules of engagement in corporate lending. Get a behind-the-scenes look at the impact of hedge funds, private equity funding, international investing, collateralized loan obligations (CLOs), second liens and the distressed automotive industry.

Because of the extraordinary success of this inaugural event, TMA and The Deal are planning a repeat performance in Las Vegas during the week of January 21, 2008. Mark your calendar now to attend the 2nd Distressed Investing Conference for more news in the dynamic world of corporate restructuring and finance.

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MONEY CHANGES EVERYTHING:
DISTRESSED INVESTING IN AN ISSUER’S MARKET

With prices high and defaults low, making money in the current market isn’t easy. So refine your strategy and pick your spots.

BY ED BAKER

How strong is the distressed debt market? Let’s look at the numbers. Last year, according to Standard & Poor’s, the leveraged-loan and high-yield debt markets had their best years ever: Worldwide new issuance in the leveraged-loan market reached $681 billion, with $480 billion of that coming from the U.S. alone; new issues of high-yield debt reached $171 billion. The second-lien market continues to be hugely robust, with $28 billion in second-lien loan volume, up 74 percent from 2005, while spreads in the second-lien market have tightened significantly. Second liens now make up about 10 percent of the loan market. Increasingly, the activity in these markets can be attributed to non-banking entities—almost three-quarters of new issues now are to the non-bank loan market.

Given all the money in the markets these days, it’s no surprise that the market has become very friendly to borrowers. According to panel moderator James H.M. Sprayregan, covenant-lite deals were up tenfold last year, to $24 billion. Covenant cushions got friendlier to borrowers, while total leverage increased for the fifth consecutive year. At the same time, however, credit quality has decreased significantly, judging by credit ratings. Yet there simply isn’t much distressed debt or loan products in the market—the total amount of bonds trading below 80 percent fell in 2006, while the total amount of distressed loan product trading below 90 percent fell to just $15 billion; the default rate fell to just .048 percent by the end of 2006.

Those numbers paint a picture of an issuers’ market, with lots of liquidity, high prices, easy loan terms and low default rates, but what does it mean for the coming year? Is there too much money in the markets? Will default rates finally increase, as everyone has been predicting for several years now? What effect would that have on liquidity? Finally, given the strength of the market, can money still be made by investing in distressed debt?

In the view of Scott J. Davido, executive vice president, chief financial officer and chief restructuring officer of Calpine Corp., the market is experiencing ‘irrational exuberance,’ to use Alan Greenspan’s famous phrase. “And this is creating some very interesting dynamics—most good, but not all good. The fundamental point is that when you have too many dollars chasing too few deals, you get a lot of gravity-defying things.” He points to the ease of raising capital while in Chapter 11: “We’ve had almost a LendingTree.com experience—‘Where lenders compete for your business.’ ”

That may sound good, but in Davido’s view, it means that a new class of distressed investor has entered the market. “You see a lot of people playing in the distressed investing space just because they’re looking for places to put money to work. In situations that would have scared the living daylights out of more traditional investors a decade ago, people now embrace these investments even without a lot of distressed experience—or even without a lot of industry experience in some cases.”

That’s always bad, Davido insists. Restructurings, he notes, are no longer about par creditors and traditional debt holders who can’t wait to get out as soon as they make a little money. “Rather, you’re actually picking up some real partners who have a strong, vested interest in helping you structure new financings and giving you access to the capital markets in ways you may

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not have had. Nowadays, a lot of these distressed investors end up on the boards of companies. And that, by and large, is a good experience, because what you find is that they bring some interesting thinking to the room.”

Another effect of that irrational exuberance is the tendency for the default cycle to stretch out. David Hilty, a managing director at Houlihan Lokey Howard & Zukin and head of its New York Financial Restructuring Group, attributes that to the easy loan terms companies can get nowadays. “With all the money chasing investments right now, in the leverage-loan market you’ve got term loans with no amortization, you’ve got covenant-lite, you’ve got few real maintenance tests. What has this done? This has caused there not to be triggers in debt securities where you used to see triggers. Has that caused defaults to stretch out? I think it clearly has.”

At the same time, Hilty notes, with so much money locked up in hedge funds for longer periods of time, hedge funds and other investors can afford to stick around longer—and that has influenced both how and why they invest. “People are looking at buying second-lien debt or term loans because doing so will allow them to consider owning the company’s equity so that they can influence the restructuring process, and really stick through operational turnarounds where maybe you need to replace management teams.”

There is, of course, an opposing view to the notion that the market has been distorted by all the excess liquidity. Nicholas W. Tell Jr., a managing director at TCW and head of its distressed investing group, posits that the financial markets may have become so efficient that they are simply less risky—and thus the high prices and low default rates. “What may be different this time is with technology and more advanced analytics we’re better able to manage our economy. That would result in longer periods of expansion and growth as well as shorter and less severe recessions when they do occur. If that’s the case, then it is completely rational for markets to value companies at higher multiples. Their earning
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power is now more consistent and arguably greater. With greater earning power companies can support more leverage. Overall, with less macro risk investors are entitled to less yield. And that is what’s happened when you have efficient capital markets.”

What does that mean for distressed investors today, Tell asks. “It means that defaults are not artificially low. Instead, defaults are low because the macroeconomic environment for companies has less risk in it. So what’s going to happen? The only time defaults resurge is when you have an economic downturn, and those economic downturns have been pushed out. And even if you believe that to be the case and you believe that recessions will be more mild when they do occur; there’s going to be less defaults than you would otherwise expect because the companies are going to be able to weather those recessions better.”

Sounds good—except of course if you’re a distressed investor. Still, Tell sees pockets of opportunity out there today. Among them is what he calls—somewhat counterintuitively, given the current high prices—discounted debt opportunities. “Discount in this environment is a relative term,” Tell concedes. “These are really relative value opportunities. My goal in looking for these is to try to take advantage of volatility in the market. When companies disappoint, it creates opportunities because they get rid of problems in their portfolio a lot quicker, and so you’re able to buy at a little bit of a discount relative to other comparable companies, for instance.”

More interesting, in his view, are what he calls control-type opportunities. “These aren’t good companies with bad balance sheets; these are actually good assets with bad management teams. Our job is to go in and ultimately take control of the situation—replace the management teams and turn around the company. And if you really believe there’s this great macroeconomic environment that’s going to continue, you’re now positioning the company to take full advantage. So not only do you get improved Ebitda or operating results, but you also get multiple expansion.”

The point is that there are opportunities out there today, but you’ve got to pick your spots, Tell concludes. “You may not be able to buy at the cheapest price, but you do have to buy with an understanding of your investment thesis. Is your plan to trade around your purchase? To own it? Or simply to wait out a bankruptcy and litigate till the cows come home and try to make money? Understand your thesis and you have real opportunities to make money in this environment.”

That’s pretty good advice in every investment environment.”

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A LAS VEGAS BOUT: PRIVATE EQUITY VS. HEDGE FUNDS

Flexibility of capital, convergence and collaboration define the current cycle for special situation investing.

BY MARTHA BROWN

Hedge fund and private equity investors, an intermediary and an adviser came together for a rare conversation about pressing issues and the shifts from traditional investing strategies. In this panel moderated by Frank Mack, managing director of Conway MacKenzie & Dunleavy, a lively discussion covered the differences, and increasing similarities, in how these groups approach financial structures, management issues, opportunities and risk.

While hedge funds and private equity players remain distinctive in their overall investment outlooks and management capabilities, more than one panelist echoed the trend of capital “convergence” in the special situations arena. In this cycle, the flexibility of capital is driving hedge funds and private equity firms to meet in the middle. The most successful have a very flexible approach to deploying capital Bhavin Shah, managing director of Oak Hill Advisors, explained. “Rather than private equity focusing on just controlled private equity, and hedge funds focusing on just trading situations because of the opportunities in the segment, it has evolved into more of a flexible pool of capital, doing everything from simply trading to buying debt, to effectively gaining control of companies, to pursuing straight-out controlled inter-private equity transactions.”

With the number of funds increasing, a flexible capital approach is vital to compete. “Today it is tougher to get the real strategic advantage without the flexibility,” added Dennis Drebsky, partner at Nixon Peabody.

In tandem with this trend, collaboration is on the rise. With so many players chasing distressed opportunities, there’s a partner for everybody. Private equity firms are doing large deals, and hedge funds are providing the capital structure. Hedge funds already in the distressed game are partnering with firms that can bring operational skills to run companies. While styles, corporate

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culture and investing philosophies vary greatly between hedge funds and private equity firms, the general consensus is that a cordial but cautious environment remains.

Those philosophies are no better tested than when capital providers consider taking on distressed situations. Ray Whiteman, managing director and co-head of Carlyle Group’s Distressed Investment Fund, began the discussion with, “As we’re looking at a particular transaction, we’re working closely with the lead lenders to make sure that we have our friends in the syndicate, at least early on, to insure that if things do start to come unglued, we have relationships that we could kind of leverage, you know, put on waivers. And clearly, the second part, is we’re fighting like heck everyday on some of these deals to insure that we’re driving a return.”

Contrary to what’s been reported about hedge funds’ distressed takeovers in the general business press, Hyonwoo Shin, managing director at Marathon Asset Management, notes, “I think the whole loan to own concept out there is a bit overhyped and probably oversimplified. And remember, a lender generally doesn’t go into a loan to take over a company out of the box.”

When queried about the anticompetitive nature of club deals and how private equity firms get around nondisclosure agreements, Nixon Peabody’s Drebsky said, “If you’re under a strong confidentiality agreement and you seek out somebody, you can and say, ‘Look, I want to have a bid with you, but I can’t give you any information.’ There’s an awful lot of information that is public, especially if the company is in bankruptcy.”

How effective are the Chinese walls at hedge funds in preventing information flow? “Compliance is very important and is a best practice at the larger firms. Chinese walls do work and professionals take them seriously because if you get caught, you don’t have to worry about a black list; you’re gone,” commented Oak Hill’s Shah.

Increasing demands for returns, less tolerance for nonperforming management and more long-term relationships were among the reasons cited for why corporate renewal advisers are being brought into private equity-controlled situations as soon as companies show any grave signs. Even hedge funds that get involved on a lending basis will not hesitate to bring in experts. “If we are going to make that kind of bet, we want to have a third-party perspective—instead of just management’s perspective on the business,” said Shah.

Despite their differences, private equity and hedge fund investors agree that flexibility and relationships allow them to capitalize on the best distressed investment opportunities.
BUY HIGH, SELL HIGHER

The distressed debt business is awash in money and that’s made trading in this market a tricky proposition.

BY ED BAKER

The big story over the past few years in the market for distressed debt has been the spectacular increase in the amount of liquidity. For those who trade distressed debt, that’s meant much lower returns than they were used to three or four years ago—thanks to lack of product and the resulting high prices. What’s driving the current market, and how long will this scenario continue to play out?

Perhaps the most remarkable element of the current market is the very high prices distressed debt is getting today. Says David Tricano, a vice president in the America Special Situations Group at Goldman, Sachs & Co., “The past 18 to 24 months have been a very difficult market in the distressed trading world principally because you’ve had a significant contraction in spreads. You’ve had a significant increase in new issuance, coupled with a lot of aggressive leveraged money coming into the market. And there’s still excess liquidity in the market.

“One result of this is that the parameters of what defines a distressed asset have increased significantly. It’s not like the old days where you can buy distressed assets for 5 cents to 50 cents on the dollar in the subordinate parts of the capital structure, and secure bank loans somewhere around 70 cents on the dollar. But now roughly one percent of the leveraged loan market is trading at prices below 90.”

That, to most experienced traders in distressed debt, is unheard of. Still, there are players who believe that these prices reflect the market’s increased efficiency. Jeffrey Fitts, managing director on the distressed desk at GE Commercial Finance, is one of them. He points out that in the late 1990s, it was pretty easy to sit back and buy senior secured loans at 60 cents to 80 cents on the dollar. This time around, however, “it’s going to be tougher, because everybody’s been through it before and it’s harder and harder to pick up...

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the type of returns that people in the distressed community were used to. I think the reality is the market has become more efficient, and that’s why you’re seeing 13 percent to 15 percent returns versus the 30 percent to 50 percent returns we used to see.”

At the same time, the market is producing more and more products to trade. It’s not just bank debt or senior subordinated debt. Now it’s also junior debt, trade claims, seller notes, private notes. According to James Trefrey, this means traders are “digging deeper and deeper into the capital structure for value, and we’re finding that we’re running into issues where it’s tough to quantify the risk.” Another effect of the increased liquidity in the distressed market is the increased risk brought about by the much greater power all that money gives issuers. It used to be that distressed loans, especially bank loans, came with a variety of financial tests that put a significant amount of pressure on companies to meet certain hurdles. In the current environment, however, those tests are being written into far fewer deals. Instead, covenants are being written that put far less stress on the issuer.

Finally, the distressed trading industry has been roiled recently by a critical decision in the Enron case involving equitable subordination claims. Enron had sued the defendants in the case, a group of funds that had bought claims held by Fleet Bank that had already been found to be equitably subordinated, maintaining that the equitable subordination found against Fleet Bank followed the claims when they were transferred to the defendants. The judge in the case, Arthur Gonzales, found against the defendants. “So you can be an innocent claimant who comes in and buys a claim, and be subject to equitable subordination based on the prior conduct of somebody earlier up in the title, in the chain of title,” says Tom Califano, partner and co-head of restructuring for DLA Piper Rudnick. “I think it’s caused a lot of concern for people.”

While the initial reaction was that the decision would be the end of the secondary trading market, and that no one’s going to buy debt ever again, that obviously hasn’t happened. Califano explains, “People have now changed the way they do business based on that decision.”

Still, the decision is out here, Califano observes. “Traders have to be prepared that if they’re buying a claim or if they’re buying debt, it comes with whatever infirmities that any seller in the chain of title might have possessed.”

Just another aspect of the risk involved when trading in the distressed debt market. ■

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WHERE VALUE HIDES
Perspectives on the effects restructurings take on the U.S. automotive industry.

BY MARIELENA SANTANA

The automotive industry is clearly the leading industry that is currently in a distressed state with bankruptcies of major Tier One suppliers, such as Delphi, Collins & Aikman, Tower Automotive and the recently filed Dura Automotive. Experts forecast a continued restructuring of the entire North American automotive industry over the next few years.

Who will be the winners and losers as the industry consolidates? What qualities does an automotive supplier need in order to maintain viability and growth? How should investors approach this market? What role will unions play in the restructuring?

Penny G. Friedman of CIT Business Capital and a panel made up of Kathleen Ligocki of Tower Automotive, Jeffrey Zappone of Conway, MacKenzie & Dunleavy Inc. and Durc A. Savini of Miller Buckfire & Co. LLC (as pictured, left to right) examined the opportunities and pitfalls awaiting investors in the automotive sector by looking at the financial, operating and strategic factors that are key drivers of value for automotive suppliers.

The state of the automotive business is dramatically different than it’s been in the past. So while the year has made a difference for automotive suppliers, they still face continued pressure from the Detroit Three (GM, Ford and DaimlerChrysler). According to Friedman, the outlook for U.S. auto demand is projected to be flat, possibly declining. “The slowdown in GDP growth and the instability of the housing market—all of these factors will cause pressure from the Detroit Three to continue.”

The second cause of automotive supplier distress is high costs, which include fixed labor costs, volatility in raw material costs and poor overhead absorption from the reduction of the market share decline. The third problem that is causing the distress among auto suppliers is intense competition. New suppliers are showing up globally, and there is competition coming from the domestic suppliers.

As Ligocki stated, Metaldyne Corp.’s merger with Japan’s Asahi Tech, backed by Ripplewood, was the first sign that globalization is changing the landscape. “Capital moving globally to back a foreign supplier merging with an American supplier is the beginning of a new wave. In the next two years we will see Indian, Chinese and Russian money moving more aggressively into the automotive supplier space.”

“So while the pressure is expected to continue, that’s not necessarily a bad thing for investors,” said CIT’s Friedman. “There are still opportunities and a lot of volatility in both stock and bond trading. The lending market is starting to rationalize; there are first and second lien loan opportunities that are starting to be priced adequately in spite of the uncertainty in the supplier’s revenues in Ebitda and there are always opportunities to invest in the suppliers that are positioned well for long-term growth and stability. Those we would say are the winners.”

So how do you assess the winners in the automotive space? One should thoroughly examine five categories: the management team, the customer base, the product line, the cost structure and the capital structure.

And how do investors look at the capital structure and valuation of auto suppliers? In the view of Savini, “where you sit is where you stand. In this respect, investors, if you’re sitting there owning a security, your view on valuation is going to be very expansive, very liberal. If you’re a new money investor you’re looking to invest at the lowest valuation to own the largest portion of a class of securities or of an equity that you’re looking to invest in. And so a valuation is much more of an art than a science.”

Then the other way to look at valuation is by examining what you are investing in, and for an investor there are other perspectives to think about when examining investor valuation, such as return horizon. If you’re a longer term investor, like a private equity firm, then you’re more likely to take a slightly more expansive view of the valuation because you’re willing to allow the drivers of valuation—profitability, growth and risk to manifest themselves through a restructuring.

With the restructuring process itself, there are key groups auto suppliers need to be concerned about: customers, laborers and suppliers.

According to Zappone, customers want a company that has the financial flexibility to continue to operate, continue to supply, continue to be able to meet quality and delivery without fail. They want a company that has the flexibility to invest in new programs and do all the other kinds of things it needs to do so...
Customers have become far more sophisticated over the years: not only are they looking at the balance sheet, but as Tower Automotive's Ligocki states, “they want to know who’s behind it, are they funding it, do you have approval, do you have banker approval, who’s the provider of the money?” She states, “Balance sheet competition is going to be one of the new frontiers in automotive supply, particularly for Tier Ones.”

According to Zappone, “There isn’t a restructuring that’s going to be successful in the automotive sector without the participation or at least the acceptance of customers. So during the restructuring process it’s almost critical to arrive at the customer’s door, not telling them that you have a problem, but telling them you have a problem and here’s the solution and here’s the way we’re going to go down the path of doing it. It provides them a lot more comfort, which then will give them at least some comfort to consider you on awarding new business.”

As for unions, they know they face a crossroad—do they stand and defend their active workforce with as many benefits they can? Or do they become part of the competitive market-place and join the global workforce?

With the restructuring process, Section 1114 of the Bankruptcy Code is going to happen—benefits will be paid at pre-bankruptcy levels until a modification is agreed upon—and this usually means healthcare will be dramatically cut. Pensions will be canceled last, unless the company is in liquidation.

With Section 1113 of the Bankruptcy Code, one would expect auto suppliers to reject all contracts and hire new automotive workers to keep the supply chain running. However the automotive industry differs from other industries in that Ford, GM and Chrysler will not touch parts from non-union workers. “Their people won’t build with them, the trucks won’t get unloaded,” said Tower Automotive’s Ligocki. “So it forces the company back into a collective bargaining process, which is where unions believe they should be anyway.”

With suppliers, the restructuring process only makes things more difficult. Vendors are going quickly to COD and CIA terms. They have become much more hardened and will stop shipping despite pre-petitioned claims.

As one can see, in today’s automotive industry many factors have led to distress, but with a thorough understanding of potential issues, investors can be better positioned to find its hidden values.
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Europe’s distressed debt market has seen a huge run-up in liquidity and very few defaults—but how risky are these assets, really?

BY ED BAKER

Given the strength of the U.S. market for distressed debt, it’s no surprise that all that activity has had a huge effect on the distressed debt markets in Europe and Asia. Volume is up, defaults are down, and prices are high. That doesn’t mean, however, that international markets simply follow the U.S. Indeed, it’s partly the distinct differences that suggest continuing opportunities there. Still, in those differences lie dangers and pitfalls that must be kept in mind.

As in the U.S., the most notable feature of the European market is the huge amounts of money that’s been rushing in over the last few years. One result of all that money is the very high prices distressed debt is commanding. “Two or three years ago, a company was distressed if its debt was trading in the 70s or 80s,” says Lachlan Edwards, managing director and co-head of European restructuring at Goldman Sachs in London. “Now it’s obviously distressed if its debt is trading at 98.5. Similarly, a company used to be bankrupt when the debt was trading at five pence on the pound. Now, of course, it’s bankrupt when it’s trading at about 45 pence on the pound. People just seem to have got used to new pricing levels.”

That of course is a way of saying that, as in the U.S., pricing has changed dramatically. Similarly, the default rate in Europe has declined to the point where it is essentially negligible. Says Richard Nevins, who recently returned to the U.S. after heading Jefferies & Co.’s international restructuring practice in London: “The default level in Europe, during the three years I was there, was essentially zero. It’s very low in Europe; it’s low around the world.”

That explains why, as Goldman Sachs’s Edwards puts it, “Refinancing is the new restructuring.” He notes that there is a much greater tendency towards doing private deals rather than public securities deals outside the U.S. “In 1999, less than 29 percent of leveraged loans were done in the private market. And now it’s probably 60 percent plus.” He attributes that to a fundamental change in how distressed investors are operating: “Whereas they might have bought into a deal to take the company through a restructuring in hopes of getting the equity, now they’re often just buying in in order to get a piece of the action when the refinancing is done.”

And that, says Jason Singer, the European mergers and acquisitions and private equity correspondent for The Wall Street Journal, has much to do with the very different nature of bankruptcy court proceedings in Europe. “People who get into this market tend to try to avoid going to court in Europe because it’s often more onerous and less predictable than it is in the U.S. In the U.S. the court system is fundamentally a part of the bankruptcy process. In Europe the process stops before it gets to court.”

Also, the European process gives a much wider group of stakeholders a say in how restructurings work out. “European law almost universally requires that equity shareholders have to vote to be diluted,” notes Jefferies’ Nevins. “That gives shareholders real standing in the negotiations.” In certain countries, France in particular, employees have a great deal of power to influence how a restructuring turns out. Thus, given the many very different jurisdictions in which restructurings can occur, simple nationalism can play a role in how a deal will get done.

Yet the influx into Europe of investors from the U.S. has had the effect of making the market operate more like the U.S. Observers point to changes in laws in both France and Germany that allow for a more open restructuring process. “These laws have been driven by practices U.S. investors have brought to Europe,” says Edwards. “That’s not saying they’ve adopted Chapter 11, but they have modified their laws in order to create a more dynamic environment, an environment in which people can do deals and in which, in fact, insolvency or formal proceedings are no longer so uncommon.”

Given this combination of factors in Europe—lots of inexperienced investors with lots and lots of money entering a market that plays by a variety of very different rules—it’s no wonder that pricing has gotten so high. Says The Wall Street Journal’s Singer: “Everybody wants to be in Europe, but there’s still some hesitation as to how we price the risk.” The big question, of course, is whether some event will occur, such as rising interest rates or stronger and stronger European currencies, that will make all those investors bail out of Europe, taking all that liquidity with them. Time will tell.
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AHED OF THE GAME

In distressed investing, alternative investment vehicles can be a successful path to control of your target—but it can get ugly.

BY ED BAKER

There are still plenty of buyers of distressed debt out there who are simply looking to hold onto their investment until they get repaid—or not. That’s by no means the only reason to make such investments, however. More and more often, such investors have other motives—perhaps to use their positions to get their hands on a particular asset of a company, or a particular division, or even to take control of the company entirely. They’re willing to take advantage of a variety of methods—acquiring senior and junior debt positions, providing strategic DIP loans, 363 sales and driving development of a plan of reorganization—to reach their goals. It can be an attractive proposition, with significant upside rewards, but the risks in such a complex game can be high. What kinds of companies look promising in such an environment, and what’s the best way to proceed?

The motives of the typical player in these kinds of control strategies are largely financial. In the view of Steven Strom, managing director in the restructuring practice at Jefferies & Co., a good target is made up of three critical ingredients: First, the company must have a certain known amount of hidden value, either financial or strategic. Second, it must typically be saddled with some kind of financial weakness—perhaps they’ve been starved of capital for a long time, thanks to a weak balance sheet. Third, there is usually some triggering event that sets the process in motion—bankruptcy, or a change in control.

Once that target is picked, notes Frank Merola, a partner at boutique bankruptcy law firm of Stutman, Treister & Glatt PC, you’ve got to decide what debt you want to buy to start the control process rolling. “This is just a question of pricing,” he notes. “The more senior debt you buy, the more expensive; the more junior debt you buy, the cheaper. If you buy debt that’s too junior and it doesn’t work out, you bought the pig in the poke.” Merola notes that in the current multi-tranche capital structure employed by many companies, potential buyers are becoming less and less confident in their ability to arrive at accurate valuations. The result, he notes, is that they end up buying a variety of kinds of debt, especially non-reporting debt such as bank debt and trade claims.

Once the acquirer has bought a tranche of the debt that initiates the process, the next step involves helping the company through its financial straits to some sort of reasonable outcome. Says Thomas Vanderslice of Marathon Asset Management: “When we look for a target we are fundamentally focused on value. We come in and try to work directly with the companies in circumstances where we can. In our shop we have a very focused private financing effort that works from the top of the balance sheet down to the bottom of the balance sheet. We take positions and we try to work as cooperatively with the existing management as we can.”

Attorney Merola sees many people take a more aggressive approach. They look at the balance sheet and the capital structure, and go after what’s left—whether it be the intellectual property, or something else that other investors have left alone. “I have clients that go out and buy the structured finance piece that owns the elevators. Then they wait for the default, and then they go have a chat with the senior lender. And they say, ‘That’s a nice 65-story building you’ve got there, but when I take the damn elevators out, and the cables, and the motors, what’re you going to do?’ I was actually in a case, a very bad little casino case, where someone did a lease on the kitchen. And somebody said, ‘I dare you.’ And at 3 o’clock in the morning they arrived with cutting torches, and they cut everything out of the kitchen. Then they cut a hole in the roof and lifted the ovens out with a helicopter.”

Given that the ultimate strategy is control of some kind, or of some asset, is bankruptcy the best outcome? Jefferies’ Steven Strom doesn’t think so: “I think you want to try to negotiate a deal before you go into bankruptcy, and to have something pre-negotiated. Just going into a freefall involves a lot of risk for all the parties. It’s going to be a longer process, the business is probably likely to suffer deterioration in value, and the fees will probably be a lot higher.

“So before it gets to that point there’s usually a pretty aggressive discussion between the various parties about what should happen. But it doesn’t always work, and then you’ve got to take out the stick.”

A typical first step is to offer to do the debtor-in-possession financing. Many current arrangements involve structuring the DIP financing with all sorts of control covenants, such as default events involving the appointment of the trustee or an examiner, and the like. As “Machiavellian” as some of these covenants may be, they don’t all have to be disreputable, but it does give the DIP lender an inside track in case of a future sale of the company, since they control so much of the information involved in such a sale. Financing the DIP also makes sure you are in the lead position in the capital structure.

CONTINUED >
Once the DIP financing is in place, notes Merola, and you’ve most likely entered into bankruptcy, the next step is to plan for the exit. “If you’re the guy who’s doing this, you want to get out of bankruptcy as quickly as possible with the assets you want. So if you’re going to do an asset deal as part of the DIP—and that’s driven mostly by tax considerations—you’re going to have a timetable that gets you to a sale as quickly as possible. So you’re going to want to be the stalking-horse bidder.”

Now, if you’re the stalking horse bidder, says Edward Weisfelner, chairman of the bankruptcy and finance department at Brown Rudnick, you will need to ask for all sorts of bidding protections. “The smart guy makes a lot of noise about upset prices and minimum overbids in negotiating his role as stalking horse bidder, but what the smart guy really wants is to make sure there is no shopping, no talking. It’s the sort of bidding protection that suggests to anybody else in the marketplace that this deal is so well tied up in advance that it doesn’t make sense for anyone else to make a bid.”

Yet this business can get so tough that even when a lender looking for control has the DIP financing as well as the stalking horse position tied up, and even negotiated a breakup fee, someone can just walk in and say, “I will do that deal without a breakup fee or with a smaller breakup fee. Exactly as it’s written.” There are people out there willing to take advantage of the people already looking to take advantage of the system.

That is a result, in part of the current liquidity climate, for which all of these strategies are much more difficult to execute. Companies are not as desperate for pre-petition loans, or DIP financing, because they have a lot of sources. Yet there are still plenty of opportunities out there, Merola believes, “because someone can come in and put it all together in one package for management teams that don’t really understand all the moving parts. Such lenders can walk in and say, ‘This is the plan that’s going to get you out of here.’”

The final step in the strategy, observes Brown Rudnick’s Weisfelner, is to deal with any of the other debt or equity holders who might want to block your efforts at control, perhaps because they see a huge upside potential in the company’s equity. The best way to deal with them, he says, is to buy them out outright. “I’ve got to pay them. But I’m happy to pay them. With all the liquidity out there today, I’ll be able to raise the money. If you can move with speed, you’re likely to prevail.”

The lesson: Speed and staying in front of the crowd are the winning strategies in the control game of distressed investing.
THE UPS AND DOWNS OF THE CLO MARKET

Collateralized loan obligations are looking pretty good at present, with unprecedented new issuance and solid returns—but what would a down cycle bring?

BY ED BAKER

Consider how rapidly the market for collateralized debt obligations has grown. According to the Securities Industry and Financial Markets Association, 2006 was the best year ever for the asset class, which includes collateralized loan obligations: worldwide new issuance almost doubled from the year before, to $489 billion, and the association expects 2007 to experience double-digit growth yet again.

That, says William May, managing director in the derivatives group at Moody’s Investors Service, is a tribute to the solidity of collateralized debt obligations (CLOs). “What investors get out of CLOs is instant diversification in a rock-solid asset, as well as the benefit of the resources and the expertise of the CLO manager. CLO managers get to increase their assets under management, they earn management fees and they often participate in the upside of the deals through performance premiums, while typically retaining some portion of the equity at the bottom of the deal. Many investors want to make sure that the managers have skin in the game.”

Yet the popularity of CLOs has had another effect. Spreads in the various tranches of CLOs have tightened significantly, with the result that overall returns have come down. “Today you’re seeing a market with so much liquidity, where banks are literally taking principal positions and trading CLOs actively, and with many more participants in the market,” says William Brown, a partner at Sandelman Partners LP, and head of its structured finance department. “As a consequence, the expected yields have come down over time. When the market first launched, in a base case scenario you might’ve expected an 18 percent to 20 percent return, while today, in many cases it’s 8, 9, 10 percent.”

Does that mean there’s less risk in this market now? That of course depends on how risky the tranche you invest in is. Brown raises-
es the specter of what would happen if the overall default rate were to increase. Naturally, he notes, managers will try to get assets that are likely to default out of their portfolios, since “it’s a blemish on their record if they’re sitting on a defaulted asset, and that’s one of their key marketing considerations when they’re trying to do their next deal.”

That’s why Brown points to three critical factors for the CLO market: diversity, ratings and liquidity. “It will be interesting to see how these vehicles will respond if we do come upon a rising default environment. If so, you should expect to see many managers forced to dump defaulted assets into the market.” Thus, he suggests, “If you’re going to be an investor playing in any tranche in this market, you have to have comfort with respect to how it is going to look down the road.”

Lynn Tilton, chief executive officer of Patriarch Partners, certainly agrees with Brown’s analysis. “CLOs, like leverage, are great during good times but are very dangerous during bad times,” she says. “These are 10-, 12-, 15-year deals. You’re never going to not have to withstand one down cycle. So you need to have a structure that allows you to breathe during the darkest moments. And it’s very, very difficult to show your investors they’re protected, and at the same time truly protect them when things do go wrong.”

That’s why her firm likes to take controlling positions in the distressed companies it invests in—it allows her to work proactively to get her investments through those down cycles, while profiting from their success in the good times.

So, words to the wise: The current up cycle may continue for a long time, but when the music stops, there won’t be enough chairs for all the players. Don’t be left out in the cold.

The panel of experts reflects on CLO’s increasing influence in the senior leveraged loan market.
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The Deal’s Bankruptcy Insider “hottest” league tables

Ranked by new assignments gained on bankruptcy cases filed in 2006

### Hottest lawyers

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Hugh Ray of Andrews Kurth; Linda M. Delgadillo, CAE, Executive Director of TMA; James Baker, keynote speaker and former U.S. Secretary of State; Colin Cross Chairman of TMA and Kevin Worth CEO of The Deal LLC meet and greet.

Conference attendees enjoy a networking break in between panels.

A conference attendee shares his thoughts with the “State of the Market” panel.

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