Adventures in Unrated Debt Investing: *Acting Like An Owner*

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Liquidity is provided in greater amounts and variety each year in the form of junior debt for leveraging companies. This has resulted in a significant amount of junior debt now residing with a large number of unrated middle-market companies. Some investors in such debt are veterans of the subordination arrangements that go along with this style of investing. Other investors have arrived at this adventure in unrated debt investing relatively recently. These newcomers come from backgrounds where they are accustomed to readily available liquidity driven by large pools of equivalently informed and sophisticated investment managers. For those who are newer to this arena of investing—unrated junior debt of middle-market companies—this article offers a framework for protective action against downside risk in what is a relatively illiquid, covenant-light market. For traditional junior debtholders experienced with this market, it presents a viewpoint for choosing behavior in a changing world where uncertainty can cause harm with increasing speed.

CAPITAL STRUCTURE OF A BUYOUT

In a typical middle-market leveraged buyout, the capital structure of the acquired company is 20–30% equity (which is provided by a "sponsor") and 50–60% senior secured debt ("senior debt") provided by a bank or commercial lending institution, with the balance provided as "mezzanine" capital, sometimes as preferred equity but usually as subordinated debt. Recognizing that such non-senior debt comes in various forms, this article will refer to any such non-senior debt as "mezzanine debt" without trying to differentiate the characteristics.

The senior debt will be secured by a first security interest in substantially all of the company's assets. Sometimes the mezzanine debt is secured by a second position in those assets, sometimes not. The senior debt will be governed by a senior credit agreement and related documents. The mezzanine debt will be governed by a note purchase agreement and related documents. The note purchase agreement will usually be cloned from the senior debt credit agreement in large part and will contain financial covenants similar to those in the senior credit agreement, but set at looser levels. It will also contain events of default similar to those in the senior debt document.

There will also be a subordination agreement between the senior debt and the mezzanine debt that sets forth the terms upon which the mezzanine debt is subordinated to the senior debt. Subordination terms vary, but generally include payment blockage, turnover, and standstill rights in favor of the senior debt. Generally, if the mezzanine debt has a default, there is a cross-default to the senior debt. And when the senior debt has a default, it has the right to block the company from making payments to the mezzanine debt. Typically, that right is unlimited if the senior default is a payment default in respect of the senior debt. If the senior default is any other default, the blockage right is limited to a period of time, often 90 days. After that, the company can resume payments to the mezzanine debt unless a senior payment default has occurred in the interim. The effect is to force the senior debt to decide whether to accelerate its position, in which case the mezzanine debt won't get paid at all until the senior debt is fully repaid.

The subordination agreement often also includes provisions that limit changing the terms of either the senior debt or the mezzanine debt. There is also usually a maximum amount of debt that the senior lenders can extend to the company and have treated as "senior" under the subordination agreement.

The mezzanine debt will be term debt and will mature not less than 91 days after the senior debt's scheduled maturity date. If there is amortization of mezzanine principal, it will not begin until the term loan component of the senior debt is substantially paid down. Often, the mezzanine debt doesn't begin amortizing until after the senior debt is to be paid in full. Many times, the mezzanine debt will mature in a "bullet."

IN CASE OF AN EMERGENCY . . . WHO LEADS?

In many such middle-market transactions, the mezzanine debt is provided by a single source, such as a hedge fund or a small business investment company. Sometimes the source manages several funds and the mezzanine debt is shared among them. In our experience, such sources are seldom prepared to manage such investments actively or oversee the company's performance, although mezzanine debt sometimes has board observation rights, which can be helpful if the company's board meets fairly frequently (e.g., monthly). However, whereas the senior debt will have audit and collateral monitoring capabilities, the mezzanine debt usually doesn't and often relies on the sponsor to monitor the company's performance and to address any problems or "hiccups" that come along. If the company's financial performance deteriorates, the mezzanine debt seldom gets involved in trying to fix the situation, remaining passive and expecting (or hoping) that the sponsor will analyze the situation and take steps to correct whatever ails the company. Alternatively, mezzanine debt waits for the senior debt to demand that some crisis management action be implemented.

As long as the mezzanine debt isn't being blocked from receiving payments (and the company has the funds to actually make such payments), it is unlikely that the mezzanine debt will take any action at all in response to defaults under financial covenants by the company (although sometimes a "default rate" of interest will come into effect). Theoretically, upon such a default the mezzanine debt could accelerate its loan and demand repayment in full immediately. The same is true if payments to the mezzanine debt are blocked or stopped voluntarily by the company. As a practical matter, if this happened then the senior debt would also be accelerated and no payments could be made to the mezzanine debt until the senior debt was paid in full. The subordination agreement often contains a standstill that prevents the mezzanine debt from suing to collect its loan, but rarely is the standstill period infinite. When the standstill period ends, the mezzanine debt could file suit to enforce its note, obtain a judgment against the company, and then foreclose the judgment and have a sale of the company's assets. Proceeds would first go to pay the senior debt, but any excess proceeds could then be paid against the mezzanine debt.

In our experience, this almost never happens. It isn't hard to see why. Liquidation is time consuming and expensive and the mezzanine debt has little hope that it will be better off as a result. In fact, it's a disaster scenario, leading to a fire sale of the company's assets. If there has to be a liquidation, even an orderly liquidation (let alone a sheriff's sale), the mezzanine debt is not likely to get anything. So the mezzanine debt quietly (or sometimes not so quietly) endures when things go bad, waiting for the sponsor and the management of the company to find a cure. Given the terms of the subordination agreement, what else can it do?

MEZZANINE DEBT'S OPTIONS

If the sponsor fails to act or is too slow or ineffectual in responding, or if the deterioration is bad enough that the sponsor concludes that its investment is worthless, then the sponsor may abandon any effort to solve the problem, leaving the mess to the mezzanine debt. The senior debt, being first secured and having the right to get paid in full before the mezzanine debt gets anything, may defer acting for any of several reasons. It may not be worried enough to see the need, or it may be reluctant to take steps that might result in a lender liability claim. If senior debt is a group of lenders, they may simply not be able to reach agreement about what action to take. Thus, the situation may drift. The company may not be forced to address whatever is ailing it, and the mezzanine debt may wind up with a write-off of some or all of its investment.

Mezzanine debt has better options than remaining passive. Moreover, because the mezzanine debt investment is often "managed" money, the mezzanine lenders' managers may have a duty to do more than be passive. When the sponsor cannot or will not fix the company, the mezzanine debt is about to become the "equity" in the deal and should be thinking like an owner. When an owner sees his company sinking, he strives to understand the cause and determine what steps must be taken to right the ship. Then he sets about the process of implementing those steps.

The first step is to engage an experienced turnaround management professional to review the situation and come up with a plan for restoring the company's financial health. To maximize a turnaround management professional's usefulness, however, the professional should be called in sooner rather than later. This provides the time necessary to determine a performance improvement plan for the company's operations. So, when the company defaults under the mezzanine debt's financial covenants, the mezzanine debt should begin pushing for this. It may be early and the sponsor and the senior lenders and the company's management may all resist, but start setting the table. Blown financial covenants are a warning sign that a bad-tasting experience may be coming.

The greatest concern for mezzanine (and senior) debt is that the sponsor will misjudge the need for a restructuring to allow the company to recover. They remain passive, falling into the trap of allowing the company's management to continue a business plan that has failed. Anyone can get a plan wrong or not address something in a plan that others feel is important. On the basis of this human failing, the temptation is to give management another chance to update the plan. Although this well-meaning exercise may provide an "answer" everyone is looking for, only time will determine the potential outcome. And "we need more time" is not a good answer when things are going down the drain. Many mezzanine debtholders find the prospect of waiting several quarters for results unacceptable. At this point, debt and equity investors need to have more options. Management cannot provide the critical elements necessary for validation of a plan.

LACK OF ACTION SOURS THE ADVENTURE

Procrastination in the face of bad performance encourages more bad performance. Deal fatigue results, particularly at the senior debt level. Things get worse when management's plan meets skeptical senior debt. There is an active market in senior secured debt. Senior lenders who want out can almost always sell their positions. Many would prefer to exit a position than go through the unpleasantness of telling the sponsor to force changes at the company. They have other deals with the sponsor and would prefer not to be difficult, particularly if the sponsor has no appetite for trying to save its investment and is willing to leave management largely alone. After all, the sponsor (and the management) can always offer to hand over ownership to the senior debt and walk away. Senior lenders are not prepared actually to operate companies and are accordingly reluctant to put on the kind of pressure that is needed.

When the senior debt doesn't feel motivated to seek restructuring changes, the company moves toward being "ownerless." If the creditors own the company but don't want to operate it, no one is acting as owner and the company becomes a rudderless entity headed for even deeper trouble. Economic incentives for each layer in the capital structure have changed. The sponsor has written off its investment and is loathe to invest any more effort in the situation. The senior debt is passive, relying on its collateral and the active secondary market in defaulted senior debt as probable exit choices. The mezzanine debt may be willing to sell at a discount, but the fact that the investment is unrated, middle market, and subordinated means market sentiment is unclear. An acceptable sale (or any sale) may not be available, even if the mezzanine debt is secured by a second lien. The mezzanine debt can take a haircut by selling at an unacceptably low price, or it can actively try to make things better.

GAINING LEVERAGE TO IMPROVE THE OUTCOME

In this situation, the mezzanine debt's best outcome requires operational changes that preserve and enhance the company's enterprise value, an amount almost always higher than the liquidation value of assets. But mezzanine debt's agreements with the company and the senior debt do not give mezzanine debt the tools to force that to happen, and jawboning the company's owner and management may not get it anywhere.

One route to getting power is for the mezzanine debt to purchase the equity from the sponsor. In some circumstances, the sponsor will agree, the senior debt (which usually has the equity pledged to it) will consent, and this can be done. Be aware that there are legal issues that sometimes make this alternative unattractive or impossible. (For example, if the mezzanine debtholder is also trustee of the company's retirement plans, or if such plans are insolvent, becoming a member of the "control group" must be avoided.) But, when this alternative is feasible, it should be considered. With control of the equity, the mezzanine debt can force the hiring of a chief restructuring officer to review the company and propose changes.

If obtaining control of the equity isn't viable, the mezzanine debt should consider pursuing enforcement of its loan documents. Although this is unlikely to result in a favorable outcome if left unchecked, it often brings the parties to the table to discuss the situation and look for a more promising direction.

A third possibility for obtaining some leverage is for the mezzanine debt to purchase some of the senior debt and begin pushing the senior lenders to take action. There usually isn't much financial risk in doing so, because the senior debt is in first secured position.

RATING THE UNRATED

In any event, the best outcome is to have the company engage a turnaround professional who can decide the best course of action to maximize value and then round up the support required from the lenders, the trade, and management to implement it. Such a plan, and especially one coming from a certified turnaround professional with experience and expertise in this area, will garner the confidence of the creditors and move the company from a certain future of asset liquidation to the maximization of its enterprise value. A turnaround professional offers a disinterested, neutral view of a company that can be communicated in a way that management, current investors and lenders, and any new investors can understand. Management lacks the neutrality and sometimes the skill to do this credibly. In the same way that a recognized debt rating agency will evaluate a company, a skilled turnaround professional will also conduct an evaluation. He or she will review myriad facts to come to conclusions about what can be done and then will organize the information and conclusions and present them in an unbiased way. This narrows the debate about value and allows investors and lenders to come to a financial picture—a "rating"—of the company.

This understanding permits the parties to achieve accelerated acceptance of a plan for the company that can improve the outcome for each class of interested parties. Moreover, while the company may need several quarters to realize the plan, with a viable and explainable plan in place, as implementation proceeds, the secondary market for the company's debt is likely to open up. As a result, the mezzanine debt will have improved alternative liquidity scenarios and the ability to exit the investment by selling it. Thus, by actively insisting that a turnaround professional be engaged and a feasible plan developed and put into action, the mezzanine debt can improve the value of its position even if it is aiming only for a quick exit.

LEAD THE ADVENTURE

The essential first step is for a disinterested but knowledgeable third party to assess the possibilities, develop a plan that maximizes value, convince the creditors and management that the plan will work, and build a consensus among the interested parties to support the plan. Such a plan may require downsizing, selling off non-core assets, shutting down a division, or other drastic action that management has not been willing to take. When a company gets sick, management seldom wants to make morale worse by firing people. The company's management isn't likely to invite in a chief restructuring officer, if only because the officer may find some of the management wanting. The sponsor, who had rosy projections when the deal started, has lost faith that management will solve the problem, but the sponsor doesn't know what to do either and is no longer interested. The senior debt may encourage the company to engage a turnaround professional, but if the sponsor and the management are unresponsive, senior debt won't make it happen by itself. Mezzanine debt can and must be the instigator.

We have been assuming that the company can be fixed. That isn't always the case—sometimes a liquidation is the right course of action to maximize value for the creditors. Since the company's management is almost never going to advocate winding up the business, the existence of this possibility is another compelling reason to get a fresh look at things and an outsider's view of what needs to be done.

MANAGING CONFLICTS

Reaching an understanding of what course of action to take is an important step in this process, but the next step is just as important. To implement the plan, a truce is needed among the lenders, other creditors, and management, so that action can be carried out in a climate of cooperation. A seasoned turnaround professional is helpful, sometimes essential, to facilitate obtaining a treaty among a dysfunctional group of creditors, managers, and investors. Even when the constituencies are acutely aware that something needs to happen fast, what that is in this maze of relationships and operational uncertainty is subject to differences of opinion. Without a turnaround professional to manage the process, as the constituencies divide along lines of legal remedies and relationships, rogue factions may emerge, which will delay implementation and drive restructuring costs higher, without improving the company's cash flow and debt service ability. Worse yet, litigation may result, distracting all parties from the real issue, which is fixing the company or liquidating it for the maximum value.

The keys to minimizing such unproductive conflicts are certainty and transparency. Transparency is a function of validating facts. Validation is best done by an outside disinterested party. An experienced turnaround professional will understand the gravity of the situation and the need for clarity. He will seek input from the constituencies and try to incorporate their respective concerns in the turnaround plan, so that all parties buy in. He will also be aware of the need for dispensing information to the interested parties in a timely, well-defined, and easy to understand format that fits with the scope and goals of the plan, allowing the parties to monitor how things are going and giving them the information needed to do so.

RATING THE OPTIONS

How the process should proceed will depend upon the details of each situation. Sometimes it will be appropriate to appraise assets or gather other information, and the parties will have to determine who pays for that. In some instances, a bankruptcy filing by the company may be necessary or desirable. In other cases, an out-of-court restructuring may be feasible. Some parties will want only to sell. Which agreements will be needed, and which alternatives will be pursued, must be assessed and supported by consensus. The goals and the roadmap for achieving them will depend on the specifics of the situation. However, whatever the possibilities, if nothing is done, the company's key management personnel will begin jumping ship, key vendors will ask for financial protection, key customers will begin seeking alternative suppliers, and the senior debt's deal fatigue will destroy any willingness to cooperate it might otherwise show. Quickly, the mezzanine debt will be under water and the senior debt will step in and force a liquidation. Why let this happen?

Even if an operating plan does not achieve total relief for the current lineup of creditors, it provides a powerful tool to facilitate obtaining infusions of liquidity and to assist an existing investor/creditor's exit, because it allows new investors to measure the plan's value, assess the likelihood and timing of recovery, and enter the investment as willing participants.

Holders of mezzanine debt of a company experiencing problems should recognize that their interests will not be protected by the other constituencies. Triage efforts should begin as quickly as possible. Seeking a validation of your options provides not only clarity but also transparency into the outcomes available. This creates options for new and existing interested parties, keeping your adventure in unrated debt from consuming you.

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