Chapter 19

Other Credit Factors: Distressed Credits, Bankruptcy, and Distressed Exchanges

What's in this chapter:

- distressed credits
- default and bankruptcy
- classes of claims
- subordination
- claims arising from bankruptcy and debtor-in-possession loans (DIPs)
- valuing the company
- sale or restructuring
- restructuring without bankruptcy
- a few pragmatic points on bankruptcy reorganizations and net present value (NPV)

COMPANIES SOMETIMES GET into financial trouble, and this can lead to default. This is more common for below-investment-grade companies than for investment-grade companies. The risk of default is part of the reason why yields are higher on leveraged debt instruments. Many studies show that over the long term, across a diverse portfolio, investors are more than compensated for the risk of default by investing in the leveraged finance

market. While good analytical work is often designed to avoid investing in a default, mistakes happen. It is important to understand how defaults happen and how debt instruments are treated in bankruptcies. This can impact how debt trades on a relative value basis, even in situations that are not likely to lead to default. There is a large portion of capital that is structured to specifically invest in distressed debt situations and bankruptcies.

Distressed Credits

There are numerous reasons why a company might become distressed, but generally, they fall into two broad categories. One is that the company has had operational declines that resulted in a drop in financial results, especially impacting cash flow. The second reason is that too much debt was put on the company in anticipation of growth or high-multiple asset sales that did not materialize.

Financial results can decline for numerous reasons, including:

- A dramatic shift in costs and expenses, such as a spike in energy prices.
- Changes in the competitive landscape, such as price cutting by a stronger competitor, new product development, or product obsolescence.
- Secular changes in an industry, such as the switch from analog to digital.
- Changes in government policies, such as health-care payment changes forced by the government.
- Weak management and poor strategic choices.

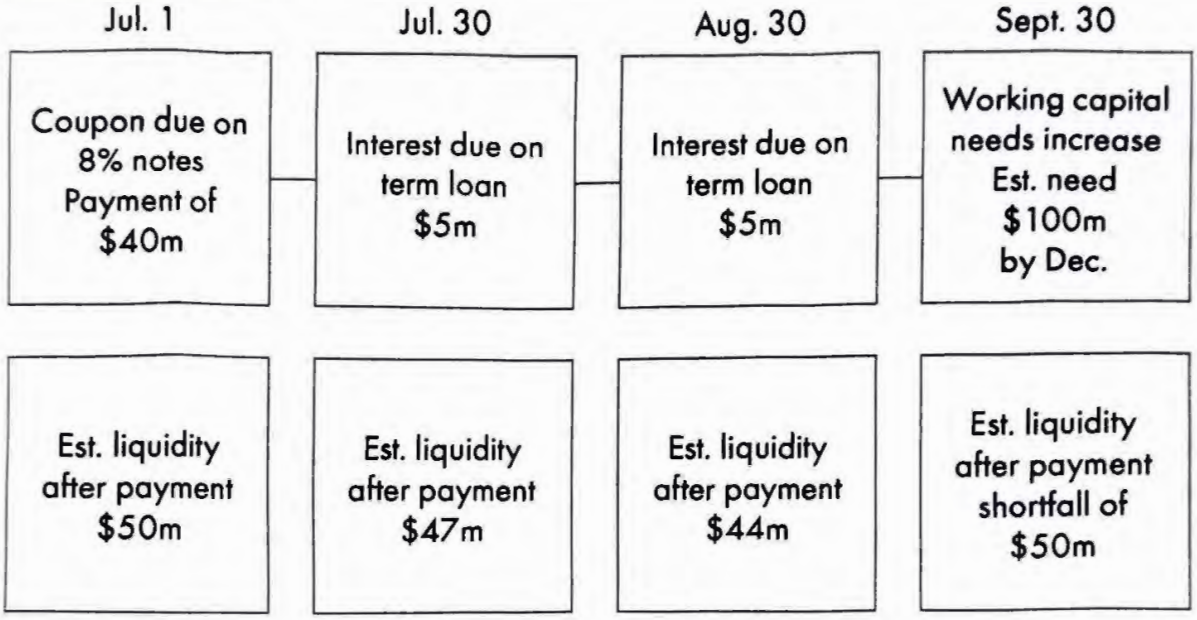
In situations where a company has done well financially but not well enough to deleverage and refinance its debt, it is often said to be a good company with a bad balance sheet. Sometimes these companies were overleveraged when the debt financing was originally put in place and valuations were too robust. Sometimes growth was anticipated, and expansion was funded with debt. Perhaps deferred pay coupon structures were put in place, and debt grew, but cash flow did not.

When a company is distressed, potential sources of liquidity and new cash flows become the more pressing aspects of credit analysis. Even relatively small events that impact cash flows need to be analyzed as these might cause the company to run out of money, such as the actual dates of interest and principal payments.[11]

11 On income statements, the interest payments are averaged straight-line over the year. But in reality, bond interest payments typically are made in a lumpy fashion, semi-annually. Bank interest payments are usually monthly.

Seasonal working capital needs can also cause strains. It is good to create a chart of potential dates when the company might fail to fulfil a financial obligation. It might look something like Exhibit 19.1. In this exhibit, the available liquidity does not go down by the exact amount of the cash payment due, because it is assumed that the company is generating some positive net FCF, about $2 million per month. In many cases, if the company realizes it will not be able to complete a financial obligation, it may look to file bankruptcy before that date to try to have better control of the case. In other circumstances, the company may go into a grace period or seek to negotiate a forbearance agreement if it believes it is close to rectifying the default.

Exhibit 19.1: Sample of a Chart of Potential-Failure-to-Pay Dates for a Distressed Credit



Looking at cash needs is part of the equation, but scenarios need to be analyzed as to what other sources of liquidity might be available:

- Are asset sales available, such as sale leasebacks of real estate?
- Frequently, covenants allow certain assets to be securitized, such as receivables or inventories. Is this a possibility?
- Can availability be drawn under a revolver? If covenants have not been violated, the revolver should be available.

- Although it's usually difficult to do when liquidity is an issue, consider whether an outside investor could be attracted to fund the company with new debt or equity. This might include the sale of the company.

After analyzing the potential payment violation dates and running scenarios of other potential funding sources, be sure to have a sense of when the credit may hit the wall. Keep in mind that the company management will also understand the liquidity risks and usually will not wait until the last minute to start a restructuring process.

Default and Bankruptcy

Bankruptcies are almost always driven by money issues rather than technical issues. Money issues are missed payments that are due. Technical issues include items such as violation of an affirmative covenant. There are times when legal obligations, such as a lost lawsuit, cannot be met, and that is what drives the default as well.

In most cases, the default occurs when a company cannot, or will not, make an interest or principal payment that is due on its debt obligations. The company usually has a thirty-day grace period in which to cure the default on an interest payment. After that time, the parties that have not been paid can begin forcing the company to file bankruptcy. There are often cross-default arrangements among the debt, in which if the company defaults on one debt instrument, it triggers a default in others.

Bankruptcy law varies from country to country. In some countries, a company that enters bankruptcy effectively gets liquidated, and proceeds are used to pay down debt obligations in strict order of priority. The USA and many other countries employ the concept of restructuring and reorganization. There are two varieties of business bankruptcies under the US Bankruptcy Code:[12] a Chapter 7 liquidation and a Chapter 11 reorganization. In a Chapter 7 liquidation, the debtor generally ceases business operations, and a trustee is appointed to administer the assets of the estate, liquidate those assets, and distribute the proceeds to creditors. In a Chapter 11 reorganization, the business debtor, referred to as a debtor-in-possession (DIP), generally continues to

12 The Bankruptcy Code is set forth in Title 11 of the United States Code, 11 U.S.C. §§ 101–1532.

operate as a going concern and ultimately seeks to reorganize its business and financial affairs through a confirmed Chapter 11 plan. In a Chapter 11 restructuring, the judge has great power in directing how this reorganization will take place. Generally, the judge tries to avoid liquidating the company because, ultimately, the bankruptcy court must confirm any proposed Chapter 11 plan of reorganization or a sale of the debtor's assets. In some countries, a third-party receiver or administrator is appointed to monitor the company during the process, and there is an extended period to see if creditors can be repaid. This chapter focuses on US bankruptcy laws.

After it is determined that a credit will probably need to restructure, analyze the recovery potential for each tranche of the capitalization.

Realize that even if the company can avoid a bankruptcy and undertake a restructuring with the debt holders outside of the court system, the potential recoveries under bankruptcy form the basis of how the parties would negotiate such a transaction.

When a company files for bankruptcy, the debt obligations are considered claims, which are ranked by seniority and priority. The basic idea is that any value created from a restructuring is first used to repay the highest-ranking claims. If those claims are satisfied, the residual value can then be applied to the next most senior level of claims. This is often referred to as a waterfall. Claims from vendors, tax authorities, courts, and pensions also get ranked, as do the fees and costs related to the restructuring (which typically get administrative priority). Below is a simple ranking of claims:

1. senior secured claims
2. junior secured claims
3. unsecured administrative priority claims
4. general unsecured claims
5. equity interests

A debt obligation's claim typically includes the principal amount owed and any accrued but unpaid interest, up to the date of the bankruptcy filing.

For most claims, interest does not get paid or accrue during the bankruptcy process. Postpetition interest means getting paid, or accruing, interest payments during the bankruptcy. This typically occurs only in respect of secured claims, either as part of an adequate protection arrangement and/or where the case of the secured creditor is oversecured. If, for example, the value of the assets that secure the debt is large enough to cover the value of the principal of the debt obligations and the interest expense, and assuming there is enough liquidity, the judge may require that the interest payments on the secured debt continue to be paid, or accrue, throughout the bankruptcy. The judge focuses on the value of the collateral that secures those debt obligations, not the company's overall value. Before postpetition interest is granted, various parties—such as the company, secured debt holders, and subordinated debt holders—will likely get into a debate and make their cases to the court for and against granting postpetition interest.

Accreted value is an important concept in bankruptcy as it affects the size of the claim of a bond or loan. The claim size is based on accreted value, not the face value of debt. This can be significant if some of the debt was issued with deferred pay structures. The claim that zero coupon bonds, or those with an original issue discount, have in a bankruptcy is only the accreted value up to the date the bankruptcy is filed. Take, for example, a $100 million face amount of bonds originally issued at 61% of face value. On the day the issuer filed bankruptcy, the accreted value of the bonds would be 83.3% of the face value, or $83.3 million. That would be the bondholders' claim in bankruptcy. If these bonds were zero fixed, with a five-year zero period, and the bankruptcy took place after these bonds had fully accreted to face value in year five, the claim would be the full face amount, or 100%—in this case, a claim of $100 million, plus any unpaid interest.

As another example, assume a $500 million ten-year bond was issued with an 11% coupon, but it was issued with a discount of three points at 97 to yield 12%. That three-point discount will accrete in value over the life of the bond, and the claim of bondholders in a bankruptcy will, again, be only what the accreted value is, not the full $500 million. This discount is generally called an original issue discount (OID). The chapter on coupons has more details on accretion.

Classes of Claims

Claims in bankruptcy are divided into classes based on priority. Each claim within a class of security should be treated equally. For example, these classes may be divided into secured, senior unsecured, subordinated, and equity. The division of claims into classes can become complex.

One of the important concepts is that when a class is considered impaired, it gets to vote on any proposed Chapter 11 plan. If the court rules that a class is getting all that it is legally entitled to on its claims, it is considered unimpaired and does not vote on the plan, because it is deemed that this class will approve the plan. If a class is getting nothing, it is deemed to have rejected the plan, and it does not get to vote either. If a class is receiving some compensation but not 100% of its claim, it is impaired. It must approve the bankruptcy with both two-thirds of the class's dollar amount of claims and 50% of debt holders. In negotiations, if an investor controls 33.4% of the amount outstanding of debt in an impaired class, typically, it can block the class from approving the plan. This position size is usually called a blocking position. If an impaired class cannot get the requisite votes for a plan, it is within the court's power to force the plan to be accepted, or to cram down the impaired class. Bankruptcy courts generally do not like to force through plans on impaired classes. For this reason, very small classes that may have no true value on a strict priority basis are sometimes given a token stake in a reorganization.

The class of claims can matter. Assume there are two tranches of secured debt—in this case, a first and second lien. Generally, a second lien can be structured in two ways: It can be party to the security agreement of the first lien, or it can have its own security agreement. If it is part of the same agreement and a bankruptcy filing occurs, the holders of first and second liens are typically made part of the same class of claims. This causes a few things to happen. One is that the second liens may not have as much say in the restructuring, because their class will likely be dominated by holders of the first lien. A second consequence is that the collateral would need enough value to cover both issues (i.e., first and second liens) for the judge to consider postpetition payments. If the second-lien debt has a separate security agreement, holders would be in their own class. The first liens would only need enough value in the collateral to cover their loan to receive postpetition interest. Intercreditor agreements that outline the priorities and waterfalls between different pieces of debt can be a factor in how the debt instruments get treated.

A considerable amount of time in bankruptcy cases is often taken up by arguments over various claims ranking. Disagreements and maneuverings over ranking and classes may not just involve debt claims, but also claims from the trade, leases, and pensions, among others.

Subordination

Another area for debt holders to focus on when examining priority of claims is the idea of subordination. Usually, if not otherwise stated, debt is assumed to be senior. A common type of issuance in the leveraged debt bond market is a senior subordinated note. What makes this note subordinated is part of the indenture called the subordination agreement.

This subordination clause may state that "the notes are subordinated in right of payment to Senior debt." As covered in the chapter on covenants, because "Senior" is capitalized in this covenant document, it is a defined term and may be tightly or loosely defined. If no further clarification is given and the language simply refers to senior debt, it is loosely defined, and many claimants may argue that the bonds should be subordinated. In another case, assume the definition of *senior debt* in an indenture is "the existing bank loans at the time of this indenture and the 8% Senior Notes." This could be interpreted to mean that the subordination agreement is recognizing that the subordinated note is only subordinating its claim to these two items, and therefore any other senior claims should rank equally with these notes. This could include other senior debt that was issued after this indenture was written.

Exhibit 19.2 shows a simple capital structure laid out with only three claims and how each might be treated in a bankruptcy. It is assumed that the equity will get zero, so it is not included in the exhibit. The valuation of the assets of the demolition services company BlowUp Co. is $250 million, and this will be distributed among the claims. It is also assumed that the subordination clause in the subordinated notes only expressly subordinates the notes to the senior bonds.

The pro rata share for all the claims is established. Then some of the enterprise's value is taken from the subordinated notes to make the senior notes whole—in this case, $37.5 million. The other claims are not party to the subordination agreement, and their recovery remains unchanged.

The recovery is shown in the dollar amount and on a percentage basis. The dollar amount is the amount that would be modeled with regard to the balance sheet. The percentage amount equates to the value per bond a holder would receive. It equates to the price at which a trader would quote the bonds or loan, a percentage of the claim value.[13]

Exhibit 19.2: Simple Subordination Example for BlowUp Co. in $000,00s

				Adjusted for Subordination	
		Pro Rata Recovery in $	Pro Rata Recovery in % of Claim	Recovery in $	Recovery in % of Claim
Enterprise value	250.0				
Claims:					
Senior notes	100.0	62.5	62.5%	100.0	100.0%
Other senior debt	50.0	31.3	62.5%	31.3	62.5%
Sr. sub. notes	250.0	156.3	62.5%	118.8	47.5%
Total	400.0	250.0		250.0	

Claims Arising from Bankruptcy and DIPs

Claims can arise during the bankruptcy process and the process can be very expensive. Claims related to the bankruptcy process (e.g., administrative expense claims) typically have a higher payment priority than pre-petition, general, unsecured claims. Analysts must factor these administrative priority claims into their liquidation or recovery analyses. Included among the administrative expense claims are the fees and expenses of estate professionals, such as the debtor's lawyers, accountants, and financial advisors. In some cases, additional debt needs to be issued to help the company remain a going concern. This super priority debt is called a debtor-in-possession loan (DIP), which in some bankruptcies has been huge and in others very marginal. An analyst will try to estimate how much of a DIP might be required. To estimate the size of the

13 If the subordinated notes' face amount and accreted value are the same, this would equal the price per bond. If the accreted value on the senior subordinated notes were less than 100% of face value, the price would be adjusted as such if the accreted value were 90% of par: (accreted value 90) × (recovery value 47.5%) = value per par (or face amount) 42.75%.

DIP, examine operational cash burn, working capital needs, and the estimated length of the bankruptcy. In most instances, a DIP or consensual cash collateral arrangement will be accompanied by a rolling thirteen-week cash flow budget, which provides a roadmap for the debtor's financing needs on an interim basis in the course of the bankruptcy case. The bankruptcy court must approve the terms of the DIP or any cash collateral arrangement. Counterbalancing the cost of the reorganization and any DIP may be the company's ability to build up cash during the restructuring process when it is likely to not be paying interest.

DIP financing can be an attractive investment for certain investors. It is given the highest priority and is often priced with an attractive coupon. It is also usually refinanced upon the company exiting bankruptcy or very soon afterward, so it is a very short-dated investment. In many situations, the holders of the senior-most debt tranche in the capital structure—usually the senior secured first-lien holders—offer to fund the DIP and will crowd out others from participating. This is done with the hope that the DIP will be attractively priced and retired soon after the completion of the restructuring. This can help increase their overall return on the bankrupt investment. The additional debt can also impact the recovery value for the more subordinated tranches of debt and effectively change the profile of the return for holders of the same class of debt (i.e., senior secured first-lien holders) who do not, or cannot, participate in the DIP funding.

Valuing the Company

Establishing enterprise value is very important in bankruptcy analysis. Even if the company has an offer from an entity to buy the company in bankruptcy, the various creditors, including the equity, will want to compare the price of the bid for the company to what they believe the company could be worth on a restructured basis.

Deciding on a company's value involves a high level of subjectivity and assumption. However, several valuation methodologies are widely used. One methodology uses valuations based on a cash flow multiple for a number of publicly traded comparable companies, and the average is applied to the bankrupt company's estimated cash flow. An analysis may also be run using a sample of acquisitions of comparable assets if the sample set is large enough. A third common type of analysis is to run a longer-term model of the company and calculate a discounted cash flow analysis. Once various asset valuations are

prepared, usually by advisory firms representing each class of claims, various parties involved in the bankruptcy are likely to debate the valuations for some time in front of the court.

These valuation methodologies capture only the value of cash-flow-producing assets. Other assets that are not producing cash flow need to be considered as well. There are some obvious assets to look for, including cash on the balance sheet and separable assets that are not producing cash. In the latter category, suppose the bankrupt entity is a lodging company with several hotels that are losing money, but another manager might find value in owning these assets, even though they currently produce negative cash flow. Digging deeper, there may be undeveloped real estate or real estate on which a sale leaseback could be done. These non-cash-flow-producing assets could also be intellectual property, from software code to trademarks, that are not currently being used or are in development. There may also be minority stakes in other companies that could be sold.

Another factor to consider in the company's valuation is how well the assets are being run. If all, or some, of the assets are operating at margins that are below industry averages, analysts might want to factor this into the valuation analysis. For example, suppose a manufacturing company is making its products at a 12% margin, and all its peers are operating at an 18% margin. A buyer hopeful of achieving 18% margins would probably pay a higher multiple than the industry average, because the buyer's projected adjusted EBITDA is higher than the historical average.

Sale or Restructuring

In some cases when a company enters bankruptcy, there may be interest in buying the company. An analysis has to be undertaken to estimate what the new reorganized enterprise could be worth, after all restructuring costs, in order to compare it to any bids that are being made to buy the company. An analyst cannot just assume a company can get sold. There has to be a buyer. If it is assumed that the company will be sold, part of the analysis should include a list of potential buyers. The more potential buyers with a realistic interest in the company, the more likely it is that the company could actually be sold at an attractive price.

The US Bankruptcy Code provides mechanisms for asset sales either under a Chapter 11 plan or outside a Chapter 11 plan pursuant to Bankruptcy Code § 363.[14] There are several benefits to utilizing the bankruptcy process to conduct an asset sale, such as 1) the ability to bind non-consenting creditors, lessors and other contractual counterparties; 2) the ability to transfer title to the assets to the purchaser free and clear of liens and claims; and 3) the oversight of the bankruptcy court, which substantially reduces the risk of a subsequent challenge to the sale.[15]

Most bankruptcy sales are conducted through a public auction process, which helps ensure that creditors and other stakeholders obtain the highest and best value for the debtor's assets. The auction procedures often include at least one bid for the company (a stalking horse bid), which ensures at least a minimal sale price for the assets, subject to higher and better bids at the auction. Sometimes this comes from a group of creditors. In most instances, secured creditors are entitled to participate in the auction and credit-bid the amount of their secured debt as part of the purchase price consideration.

More frequently in a bankruptcy, the company in bankruptcy is not sold, but reorganized. In the reorganization, the existing claims are given new securities in the reorganized company. The potential outcomes of this type of reorganization are endless. They usually evolve through various rounds of negotiation, sometimes while the arguments over valuation and priority of claims are ongoing. Bankruptcy investors and lawyers can be very creative, and different trends can be in vogue during various bankruptcy cycles.

As an example, assume a company was originally leveraged at 7× adjusted EBITDA, but over time, adjusted EBITDA declined, and now the company is in bankruptcy with a total debt of $1.170 billion, which equates to 9.0× adjusted EBITDA. After all types of experts have submitted their reports, and arguments have been made, the courts determine that a valuation should be no more than 5× adjusted EBITDA, or $650 million. After much wrangling between the claimants, the court determines that no more than 3× leverage

14 See 11 U.S.C. §§ 1123(b)(4) (stating that a plan may "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests") and 363(b) (stating that the debtor, "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.")

15 See, generally, 11 U.S.C. §§ 363(f) and (m).

should be on the company. This leverage may be determined by taking into consideration that it can pay a reasonable interest rate on its debt and meet its capital expenditures and still generate FCF while leaving, say, a 15% cushion for operational declines. Exhibit 19.3 is the capital structure of this company before the restructuring, including the DIP financing.

Exhibit 19.3: Capital Structure during Restructuring in $000,000s

DIP loan	40
Pre-petition claims:	
Senior secured bank debt	350
Senior subordinated debt	500
Subordinated debt	320
Total debt	1,210

In this hypothetical case, upon exiting bankruptcy, the company gets a new secured bank line for $40 million to pay off the DIP financing. The bank debt gets a new senior bond in the same amount outstanding as its claim. Together, this new debt totals $390 million to equal 3× EBITDA, which would cover the full claim value of the DIP and the secured debt. The bank creditors who are now the holders of the new senior bond will want to make sure that the new debt instrument they are receiving will be structured to trade at least at par so that the market value of its new security equals its prior claim. This may entail a high coupon or significant covenants. The more junior securities in the debt structure will receive equity. They realize that the higher the coupon and the more restrictive the new senior note will be, the more downward pressure it could put on the value of the stock it will receive. These more junior classes will argue in the courts for lower coupons and more lenient covenants versus what the former bank debt holders want.

Under this scenario, the company is worth $650 million, and $390 million of that value has been allocated to the debt for the DIP and the bank claims. The remaining $260 million would go to the senior subordinated debt. However, its claim was $500 million, so this class and the subordinated debt would be considered impaired classes. The most senior class of debt that is impaired and not paid in full is sometimes called the fulcrum security. This impaired class needs to vote on approving the plan and also frequently controls the equity, postbankruptcy.

Theoretically, no value should be allocated to classes more junior than the senior subordinated debt. In reality, some token value is often given to expedite the process. In this case, 3% of the equity value is given to the subordinated debt, and warrants that had a strike price equal to a valuation of 7× current EBITDA were given to the equity. The allocations and recoveries are outlined in Exhibit 19.4. Except for the DIP facility, the securities are getting their value not in cash, but in a package of securities. The true value of the consideration they are getting will depend on how these securities issued during the reorganization will trade in the market post bankruptcy.

Exhibit 19.4: Capital Structure and Recoveries (in $000,000s unless Noted)

	Claim	Received in Bankruptcy	Valuation	% Recovery
DIP loan	40	Cash	40	100.0%
Pre-petition claims:				
Senior bank debt	350	New senior debt	350	100.0%
Senior subordinated debt	500	97% of equity*	252	50.4%
Subordinated debt	320	3% of equity*	8	2.4%
Total debt	1,210		650	

*Based on equity value of $260 million

The equity ownership of a company typically changes during a bankruptcy. Some class of debt holders often ends up controlling the equity. This can make for strange combinations of equity holders controlling the company. Major shareholders may have varied views on what they want to do with the equity and may have varied time horizons for their investments. Often post reorg equities are not that liquid so the positions may not be easily exited. Some investment structures that are designed to invest in debt may not be allowed to own equity or have a limit on how much equity they can own, and this can be problematic.

Non-US Jurisdictions

Bankruptcy laws vary by country. Where the company issuing the bonds is domiciled will often dictate which bankruptcy laws will be involved. This location may be different from where the company is operating. A company may form a separate subsidiary to issue the debt. Luxembourg is a popular country for bond-issuing entities. There have also been cases of shifting venues as creditors and the company may vie for different jurisdictions to oversee the bankruptcy. Some codes favor liquidations; some use the concept of restructuring under what is known as controlled management, using the courts and commissioners. With many legal structures leaning more toward liquidations, frequently corporations and creditors spend an extensive amount of time trying to negotiate an out-of-court restructuring plan in European cases; and in some countries, there are structures to protect the company while it tries to address these issues. These nuances in bankruptcy codes appear to be part of the reason for companies and bondholders in Europe to be more reluctant to pursue bankruptcies as a strategic alternative for a struggling credit.

Restructuring without Bankruptcy

A company typically exhausts many other avenues to finance or fix its liquidity situation before filing for bankruptcy. These alternatives often include looking to undertake asset sales, bring in new investors, and negotiate with existing lenders to try to arrange some type of debt exchange out of bankruptcy.

One of the many reasons companies want to avoid bankruptcy are the costs associated with the process. These include not just the legal and transactional costs, but also less direct costs to the business that can hurt the company's long-term value. They could include the loss of customers and the ability of customers and/or suppliers to potentially break contracts. There can also be ramifications for the company's ability to win new business, especially if it's dealing with government entities. These factors need to be added to any analysis of a stressed company.

There is also the concern that as soon as the legal filings have begun, the management and equity owners tend to lose control of the process, and sometimes lose their jobs and their equity stakes. For these reasons, management, equity holders, and many debt holders usually prefer to avoid bankruptcy.

Frequently, management and the debt and equity owners try to work out a reorganization that may look like a bankruptcy, but in reality is an out-of-court restructuring in the form of an exchange offer. This can help preserve more equity for the owners. The more senior creditors tend to get a package of securities relatively comparable to what they might get in a bankruptcy, but without the time, risks, and impact associated with a bankruptcy. There are endless possibilities for how these exchanges could take place. However, it is not always easy to get the various parties to agree to terms without going through the courts. Holdouts can be an issue for completing these out-of-court restructurings. This occurs when a small group of holders of a security choose to not go ahead with an exchange. In many cases, by holding out, they can improve their position and get a better return on their holdings, which is also referred to as a free-rider problem. If holdouts become too large, they tend to jeopardize the entire exchange.

One method to avoid the holdout problem and a long bankruptcy process is to prepare a prepackaged bankruptcy. In this case, the company reaches a prenegotiated agreement with two-thirds of each class of creditors to go ahead with the proposed plan. It then files the bankruptcy plan. By doing this through a bankruptcy process, with the majority votes already in place, the courts can force holdouts to go along with the plan. This process also looks to be in and out of the courts in approximately ninety days. This time frame is accelerated for a typical bankruptcy. Such a filing may have challenges, but the courts are usually anxious to move the process along.

Another method to avoid the complexity and difficulty of addressing the entire capital structure is to simply try to address the most urgent issues in the capital structure. This can be done through exchange offers, which can be structured to be coercive to holders who do not, initially, want to go along. Assume a company has a debt maturity in eighteen months that is in the form of a $200 million 4% subordinated bond. If the company covenants allow for the issuance of senior secured second-lien debt, the company could offer the subordinated bondholders $150 million of a 7% second-lien bond with a six-year maturity. If

the company chooses, it could structure the exchange with a consent that could strip all the covenants from the old 4% bond. This addresses a large portion of the near-term maturity issue. But if the company still faces a default and enters reorganization, the 4% bondholders who do not accept the exchange are materially disadvantaged in the bankruptcy—a risk that could coerce them to accept the exchange offer.

A Few Pragmatic Points on Bankruptcy Reorganizations and NPV

The examples in this chapter involve simple structures. Companies that have more complex structures can take a very long time to wind through the legal system. This can occur when multiple entities have issued debt within the corporation; when there are various cross-guarantees between subsidiaries; and when significant transfers have occurred between restricted and unrestricted groups. Additionally, if a company has a large number of foreign subsidiaries, foreign laws can add to the complexity of a restructuring.

It is also important to note that bankruptcy courts are rather unique in the legal system. Bankruptcy judges have considerable power and sway over the outcome in these cases. The bankruptcy judge has been referred to as the most powerful person in the room.

When looking at recovery values, one has to consider the securities that are being received in the restructuring. Frequently, postbankruptcy securities are fairly illiquid, especially equities. Because of the negotiated nature of the bankruptcy process, some of the more unusual features seen in a debt instrument often appear in the structure of a new bond or loan issued out of a restructuring. This can add to the illiquidity of the consideration that bondholders and loan holders receive.

The amount of time that a reorganization can take has to be considered when trying to reach an investment conclusion about a stressed credit. As an example, for the company described in Exhibits 19.3 and 19.4, if an investment team's analysis reaches the same conclusion as shown in the exhibits, the senior subordinated notes are worth a price of 50, postreorganization. Bankruptcy can take a very long time. If a decision is being made at the beginning of the bankruptcy process whether to invest in these notes or not, a view has to be established as to how

long the process will take and then what the present value is for that recovery, especially as no interest income will be getting paid on the investment. If the expectation is for a two-year bankruptcy and the return that is being sought is a 20% internal rate of return, the day the company files bankruptcy, an investor should be willing to pay 34.7% of face value for a bond, using the net present value[16] (NPV) formula as follows: $(50/(1.2)^2)$. The more complex the structure is, the longer the bankruptcy can take, which may increase the risk for the recovery, so a higher rate of return might be sought as well.

Closing Comment

Many investors look to avoid stressed credits and restructurings; others look to specifically invest in these situations. Whether or not an investor expects to be involved in reorganizations, understanding how securities get treated in a bankruptcy is key to having a clearer understanding of the relative value of debt that has different rankings, such as what the yield spread should be between a senior secured debt instrument and a senior subordinated instrument.

16 The desired internal rate of return is used as the discount rate in the NPV analysis. The internal rate of return that is chosen should factor in the potential return on other investments as well as the level of risk of achieving that return.