MainStream’s Top 10 Restructuring Trends

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As the U.S. economy approaches the end of the year with a combination of optimism over an improving market and concern over a possible jobless recovery, the restructuring industry faces equally challenging issues. In this report, MainStream Management identifies ten of the key issues facing the industry during these difficult economic times.

1) Over-leverage of existing companies

A reflection of the challenges facing corporate America is the fact that United States companies carry $1.4 trillion in high-yield bonds and loans on their books as of June 30, 2009. This level is triple the level held by U.S. industry in 2001, the result of eight years of low interest rates and increased availability of debt capital from both domestic and international lending sources. As a result of the increased debt burden on the balance sheet, the pressure on achieving stable and strong operating performance is significantly greater than at any point in recent corporate history. Looking ahead, more than half of the debt comes due over the next five years, a period during which economic recovery is likely – but not certain - to occur. The increased debt load combined with worldwide recessionary economic conditions has caused default rates to skyrocket to 11% in fiscal year 2009, up from 2.4%, according to Moody’s. Of even more concern is that Moody’s forecasts a default level of 12.8% by year-end 2009. “Be prepared for multi-year period of high defaults” says Louise Purtle of CreditSights. Only two industries – telecommunications and utilities – have default rates below their historical averages. In addition, many companies are taking advantage of “band aid” approaches to handling their debt load, including stretching out the length of loan amortization and not paying interest through the life of the loan. The increased pressure on operating performance will place a premium on restructuring teams with the history and experience of working in similar environments. The existing conditions will also place a premium on not simply operating performance but addressing critical capital needs in an environment of limited capital resources, especially on the debt side.

2) Financial institutions valuation challenges

One of the major challenges facing the financial services industry – and indirectly the financial restructuring sector – is that the fair value of loans by the nation’s largest banks continue to decline. Among the banks that were stress-tested in May 2009, the difference between carrying values and fair values grew 14.4% from December 31, 2008, to June 30, 2009. The gap of $164.4 billion as of June 30, 2009, represents the largest gap in U.S. financial
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institutions history. With over 70% of this gap coming from three of the largest financial institutions in the country – Bank of America, Wells Fargo, and Regions Bank – the implications to middle market lending in the near-term are significant. The principle reason for the increased gap is the lower cash flows generated by corporations, both private and public, as a result of the recessionary economic conditions. A secondary factor is that discount rates, a critical component of any valuation, are significantly higher due to higher perceived riskiness in loan portfolios. The combination of these factors and the dormant M&A marketplace has been the primary reasons for the relatively illiquid climate to exist for middle market lending. Looking forward, the proposed changes by FASB to the new mark-to-market valuation practices would increase the challenges facing lenders.

3) Lack of debt capacity for lending

According to the Federal Reserve Loan Officer Opinion Survey in July 2009, domestic banks indicated that they tightened standards and terms on corporate lending over the past three months. During that same period, demand for loans continued to weaken across all major sectors of the economy. According to lenders contributing to the Federal Reserve national survey, decreased loan demand and deteriorating credit quality were the most important reasons in the decline in C&I lending over the three-month period. On the international front, foreign lenders cited a less favorable economic climate and a more uncertain economic outlook as the principle reasons for decreased lending throughout 2009.

The implication to private equity firms has been nothing short of dramatic. Buyout firms, which represented over 22% of all M&A activity over the past five years, have shifted strategies to include all-equity deals, reduced ownership stakes, and seller financing. Each is a variation on the need to raise unconventional capital according to Dow Jones Review. Moving from a period where the average equity contribution was approximately 33% of total capitalization, the average equity contribution for LBO transactions in 2008 was over 45%. During that same period, LBO loan issuance decreased by 80% for 2008 as compared to 2007 levels. For the first quarter of 2009, LBO loan issuance occurred at a measly 2% of the first quarter 2008 levels, according to Thomson Reuters.

4) Limited M&A activity especially by financial buyers

Over the first five months of fiscal year 2009, approximately 2,500 deals worth $248.7 billion were closed in the United States. This represents a reduction of almost 30% as compared to the 3,750 transactions closed over the same time frame in fiscal year 2008 according to data supplied by Thomson Reuters. The level of activity in 2009 is lower than M&A activity in any period over the past five years according to industry experts. The largest decline has occurred in the private equity community. In fiscal year 2008, the private equity community generated 26% of all deal activity in the United States. That same figure for 2009 on a year-to-date basis was less than 5%, a dramatic decline in activity for a community that represented such a significant source of capital over the past ten years. While the private equity community continues to have close to $1 trillion of capital to invest, it is clear that concerns over portfolio company operating performance and unclear market valuations will keep the private equity community largely on the sideline for the foreseeable future. The exception to this will be traditional “bottom fishers” who accumulate capital to invest in the types of market conditions that exist today. Not surprisingly, there has been an uptick in distressed purchasing during the first half of 2009. For restructuring organizations, the challenge that is posed by the dramatic reduction in M&A activity is that lenders will need to hold onto portfolio companies for a longer period of time in order to realize legitimate long-term market value. Operational turnarounds that may have transitioned more rapidly into capital events will face a longer time horizon before a liquidation or recapitalization event can occur.

5) Increase in corporate bankruptcies

The dramatic downturn in the United States and international economies has, not surprisingly, resulted in significant increases in the number of bankruptcies filed in the country. What is surprising to many is the magnitude of the increase. According to the American Bankruptcy Institute, the number of U.S. businesses filing for bankruptcy totaled 14,310 for the first three months of 2009. This compares to 8,713 filings for the same period in 2008, an increase of over 64% on a year-to-year basis. These statistics are revealed on the heels of total filings for 2008 totaling 43,546, the highest level since 1997 and
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over 50% greater than in 2007. Many forecasts call for 2009 bankruptcies to reach levels never seen in the United States and around the globe as well. A successful emergence from a Chapter 11 typically requires the debtor to have three specific economic components.

1) A stockpile of cash;
2) Positive EBITDA
3) A debtor-in-possession loan facility to finance the bankruptcy

As the recent economic downturn and associated credit crunch has had a negative impact on each of these the implications for restructuring firms are a strong likelihood that there will be fewer companies successfully emerging from Chapter 11.

6) Impact of limited availability of DIP financing

Debtor-in-possession financing has been characterized as “the credit equivalent of a life raft during difficult times.” Companies typically use this form of financing to fund operating expenses and pay external advisors during a period of bankruptcy. Because DIP facilities are considered a “super priority” claim, lenders have traditionally found this form of financing to be attractive from a return standpoint. However, the downturn in the economy and the pressures facing financial institutions has limited the availability of debtor-in-possession financings for companies in Chapter 11 while also reducing the number of firms willing to provide lifelines to companies undergoing restructuring. According to bank industry experts, the rates charged on loans has also increased significantly over the past 18 months. Prior to the credit crunch, a bankruptcy loan could be issued at a rate of Libor plus 250 basis points, whereas these same loans are now priced at Libor plus 600 basis points. The covenants of DIP loans are also getting tighter while the length of loans has dropped from 12 – 18 months to a range of 2 – 6 months. The implications to restructuring experts of the last change in terms will be to shorten the time for a stand-alone reorganization. In addition, companies that are considering a bankruptcy filing may need to figure out how to raise capital to carry them through a reorganization given the declining number of DIP lenders.

7) Government role in bailout and impact on private sector

The recent bailouts provided to automakers, financial institutions, and to some degree homeowners by the United States government has been the source of considerable debate by economists throughout the country. An argument can be made that bailing out industries in this fashion “interrupts” the normal cycle of businesses, which allows the best to flourish while other less successful firms fail. The counter to this argument, of course, is that the dire straits that the United States economy faced in 2008 required dramatic, overwhelming reaction on the part of the federal government to avoid an economic catastrophe of even greater proportion. According to Dr. Michael Cosgrove, economics professor at the University of Dallas, the economy may actually become so stifled by government intervention that it could stop growing at a rate of 4% per year and instead grow at 2%. This would occur because the bailouts would unfairly affect companies that did not need capital to survive, putting them on the same level playing field of firms that did received government capital. Put differently, the “delicate balance of the free market” was interrupted. For firms undergoing restructuring, the notion of additional capital being made available for bailouts impacts the evaluation of different alternative options. For instance, a situation that heretofore would have been considered a likely liquidation candidate might now respond differently if the possibility of capital being made available occurred. A bailout in any form by the federal government is now best characterized as an additional lifeline or strategic alternative, something that changes the landscape of alternatives available to ailing companies.

8) Increased complexity of capital structures and competing interests

In today’s restructuring market, the diversity of stakeholders and agendas in restructuring negotiations are greater than ever, particularly for large corporations. Debt and equity structures are larger and more complex than at any time in corporate history and financial stakeholders may very often have competing agendas within the same organization. One financial institution, for instance, might own an equity interest in a company facing bankruptcy while also holding a senior or junior debt position. In that case, the interests of the limited partners in the equity ownership position, including the financial institution itself on a minority basis, may be in direct conflict with the debt holder solely representing the shareholders of the financial institution. This conundrum renders the work of restructuring experts more complex and
complicated than in most restructuring initiatives they have worked on. When the competing interests of management, organized labor, state government, suppliers, and other parties are taken into account, the number of moving parts with disparate interests is very high and difficult to manage. Only seasoned restructuring teams with a keen understanding of the multi-faceted interests of various constituents can thrive in this day and age of increased capital structure complexity.

9) Private equity portfolio operating performance

Many experts believe that the foremost challenge facing the private equity community is portfolio company operating performance. Servicing an overloaded debt service is secondary to ensuring stable, growing EBITDA or, in today’s economic climate, mitigating the reduction in EBITDA. Firms with ample stores of capital will have more options for continuing to support portfolio companies that require capital infusion to survive, either to cover operating losses or to continue making debt service payments. However, under any circumstances, it is clear that private equity firms will face longer holding periods and higher equity requirements, either up-front or in supporting portfolio company cash requirements.

For restructuring firms, the opportunity is to work with private equity firms not on workouts and turnarounds but on operational improvement. Private equity firm portfolio companies that are suffering from mis-management or from the general economic downturn will require intensive, out of the box management to survive and thrive in this recessionary climate. With the principle focus of private equity firms over the past five years being portfolio company acquisitions or platform acquisitions, a revised focus on improved operating performance will need to occur for the foreseeable future.

10) Recessionary climate

Advisors to then presidential candidate Bill Clinton were quoted in 1992 as advising the young governor from Arkansas that “it’s the economy, stupid.” Sound advice then, sound advice now. The plethora of factors impacting the restructuring community in 2009 and into 2010 all revolved around the continued questions regarding the economy in the United States and globally. The golfin equivalent of hitting a weak shot into a 40-miles per hour wind – one never knows whether the problem was the swing or the blustery winds – the existing economic conditions are the most challenging this country has seen since the Great Depression. Addressing over-leveraged companies; trying to raise capital to allow business enterprises to survive; or working with private equity portfolio companies to improve operating performance, all will either succeed or not based largely on the economic conditions in the United States stabilizing and improving over the next 12-18 months.

As MainStream Management examines the key factors impacting the restructuring community, there are a multitude of macro and micro level issues facing struggling companies and lenders to those companies. The breadth and depth of the economic recession caught most experts by surprise with the woes facing the financial services industry exacerbating the problems due to the lack of available debt capital. Restructuring firms will need to bring the full range of management services and techniques to the table in assisting owners and lenders stabilize and improve operations in order to create value during these extraordinary difficult economic times.

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