

Navigating Debt-for-Equity Swaps in the Middle Market

As interest rates rise and credit markets tighten, companies that find themselves unable to manage their debt burdens will face an altered landscape, one populated with new opportunities and new risks. As advisors to these companies, turnaround professionals must manage both financial and operational restructurings. In many cases, finding a partner to effect a debt-for-equity restructuring that provides additional capital for a business is critical to maximizing value for all constituencies.

In the last cyclical downturn, one of the surest forms of liquidity for middle market lenders was the blunt instrument of a bankruptcy filing, followed by a U.S. Bankruptcy Code Section 363 sale of a debtor's assets. This option, while offering a definitive outcome, was often difficult to implement and could lead to lower recovery rates because of the significant tangible and intangible costs associated with the process. Another viable option for a lender was to restructure the debt into a mix of reconfigured illiquid debt securities. This required more patience and a longer time horizon.

During the past 18 months, aggressive lending markets have allowed stressed companies to meet their liquidity challenges by expanding their borrowing rather than by implementing more difficult operational restructurings. As the credit markets tighten, these deferred operational restructurings inevitably will be required.

In addition to the myriad operational challenges turnaround professionals often encounter, they also must contend with complex balance sheets that feature multiple lenders in various tranches. Many of these



BY ANTHONY DISIMONE, MANAGING DIRECTOR, BAYSIDE CAPITAL

lenders are new market entrants who lack workout experience and may not have the appetite for the challenges ahead. As the classes of debt change hands, new constituencies can complicate a restructuring. While this liquidity has provided more options to borrowers, it also has made debt restructurings significantly more complex.

In the next cyclical downturn, the altered landscape is likely to lead to a significant growth in debt-for-equity conversions in the middle market.

Potential Pitfalls

Historically debt-for-equity conversions have produced mixed results for a number of reasons. Typical pitfalls included:

- *A lack of a long-term partner.* Traditional lenders and many new hedge fund lenders often are interested primarily in short-term recoveries rather than in long-term value creation. This focus on immediate monetization may be at odds with the long-term best interests of a business.
- *An inability to raise additional funds.* Impaired lenders are frequently uninterested in extending additional funds to troubled companies. As a result, a distressed company is unable to invest in its business and effect the changes necessary for an operational restructuring.
- *A lack of strategic direction and corporate governance issues.* Bank workout groups typically are not comfortable providing active corporate governance to their credits. This can leave a company rudderless at a time when it most needs decisive action. A syndicated senior debt

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structure involving several lenders assuming control makes effective governance even more difficult because of conflicting interests and a lack of clear leadership. This issue has grown in importance as syndicated debt structures have become more pervasive in the middle market since the last financial downturn.

- *Mismatched management incentives.* Compounding the problem, management incentives often are not aligned in a distressed situation as lenders seek to exercise their rights under the Bankruptcy Code's absolute priority rule. Without a specific plan, management has little incentive to make the extraordinary efforts required to achieve a successful turnaround, and morale suffers.
- *An inability to address operational issues.* Companies frequently are unable to address their operating restructurings effectively because of cash constraints or governance issues. Without the ability to make and implement bold and decisive plans, companies flounder.

Mainly for these reasons, many debt-for-equity conversions fail to provide lenders with the maximum recoveries.

Key Considerations

In many cases, conversion of all or a portion of a company's debt to equity will be the most effective

way to maximize value. There are several key factors to consider in executing a debt-for-equity conversion successfully.

Bolster the Team. Turnaround professionals should be brought in to augment management, stabilize the company, and begin the operating restructuring. They should be engaged early to help manage the process. A team of seasoned professionals adds credibility in the eyes of potential investors, increasing the chances of attracting outside capital for a company. Investors are more willing to rely on the expertise of a third party with whom they are familiar than they are to trust a management team that may have contributed to the current state of the company.

Turnaround professionals also provide management with additional capacity to deal with the extra workload that arises in a restructuring. Moreover, a turnaround professional provides an independent voice that can facilitate agreements among various constituencies, both within the lending group and with third parties.

Find Suitable Financing. An investor should be sought who is willing both to provide liquidity for existing lenders and to support the company through its operating restructuring.

In many cases, turnaround professionals will find it helpful to look to distressed debt investors who can assess a situation promptly and focus on financial and professional support in both the short and long term. Investors who have experience with financially and operationally distressed companies can manage the complexity of the situation and focus on the key issues, freeing the management team and turnaround professionals to focus on improving operations.

Financial support should be flexible to allow for the most appropriate timing and structure to suit a company's complex needs. Ideal investors act quickly and provide fresh capital in many forms, including debtor-in-possession (DIP) loans, subordinated debt, or equity infusions. In addition, it can be beneficial to have an investor who will provide liquidity to existing lenders who are fatigued or who are not constructive in the restructuring process.

Turnaround professionals must be careful when navigating the changing and complex distressed debt market. They must differentiate between short-term investors chasing yield and long-term capital providers who will support a company through a successful turnaround. The ideal investor has significant experience with challenged companies, a long-term view on the success of a business, and a permanent capital base which, combined with an operational restructuring, creates long-term value.



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Dennis O'Dea*
Charlotte Office

*licensed in DC, MA, IL and NY not currently licensed in NC
phone: 704.343.2147 fax: 704.444.8741
dennis.odea@hmw.com



HELMS MULLISS WICKER

www.hmw.com

CHARLOTTE

201 North Tryon Street • Charlotte, NC 28202
704.343.2000

RALEIGH

2600 Two Hannover Square • Raleigh, NC 27601
919.755.6600

WILMINGTON

127 Grace Street • Wilmington, NC 28401
910.254.3800

Manage Ahead of the Crisis. A conversion should be implemented promptly to preserve the highest value. Often lenders recognize the need to restructure a company several months before the business hits the wall. Unfortunately, due to the increasing complexity of capital structures and multiple constituencies, reaching agreement among all interested parties on the best course of action is frequently difficult and time-consuming. It is during this period that the company loses direction, and value is often destroyed needlessly. The earlier a conversion can be implemented, the higher the likely recovery will be for all stakeholders.

Assess Directors and Management. The post-conversion board and management team should be composed of professionals and investors who have extensive turnaround experience and an economic interest at stake.

A post-conversion board should be limited in size so that key issues of strategy and direction can be agreed upon expeditiously and executed. The ability to act decisively is critical in a turnaround.

Board members should have several key attributes. They should have extensive experience working with companies implementing turnaround strategies. They also should have a significant economic interest in the company. It is critical that board members take a medium- to long-range view of a business to maximize value. Turnaround

professionals should be engaged to support management during the initial phases of the turnaround while management is assessed for augmentation and potential upgrade in areas of need.

Looking Forward

The skills required to complete debt-for-equity conversions successfully in the middle market will become more relevant over the next several years, when many companies that underwent balance sheet restructurings recently will need to reduce debt permanently. Turnaround professionals must remain sensitive to the issues surrounding debt-for-equity conversions and should develop relationships with investors who will work with them to effect operational restructurings that generate current and long-term value for their clients. ■

Anthony DiSimone is co-head of Bayside Capital, a \$500 million private equity fund that focuses on special situation opportunities in the middle market. The firm is an affiliate of H.I.G. Capital, a middle market private equity firm with more than \$2 billion of equity capital under management. DiSimone can be reached at (305) 379-8686.



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Managing Director
Peter Connolly • 203.956.4464 • peter.connolly@ge.com
www.gelending.com
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Brent Hazzard • 203.956.4034 • brent.hazzard@ge.com
Corporate Lending
Cyntra Trani • 212.370.8079 • cyntra.trani@ge.com

Global Media & Communications
Thomas Waters • 678.624.7930 • thomas.waters@ge.com
Global Sponsor Finance
Karen Austin • 203.956.4516 • karen.austin@ge.com

