



Vulture Investors: Swooping Down Soon

Their mission is to prey on the financially distressed.

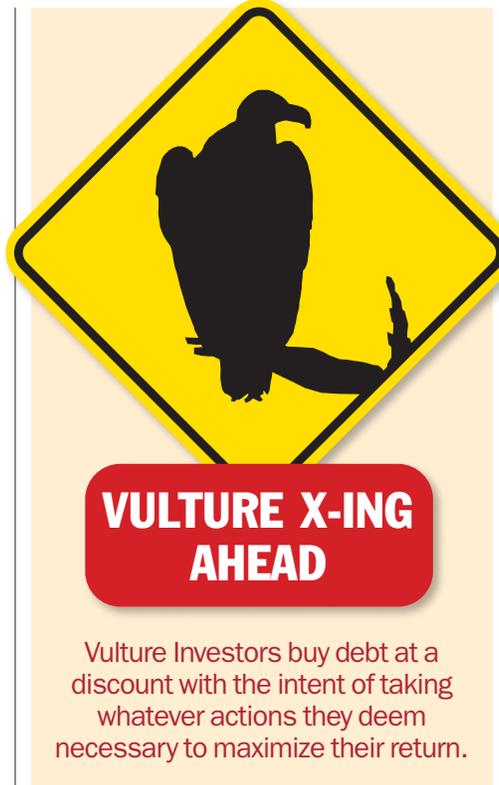
by Mark D. Working

The current economic downturn has negatively impacted the financial results of many businesses. With reduced cash flow to service debt designed for a more robust economic scenario, and with banks having a lower tolerance for leverage, borrowers can find themselves between a rock and a hard place. As we discuss elsewhere in this issue, dealing with your bank can be challenging in this environment. But, when your loan is sold to a Vulture Investor, the discussions can take on a considerably sharper edge. Vulture Investors buy debt at a discount with the intent of taking whatever actions they deem necessary to maximize their return. As they swing their sharp elbows in a forced reorganization, borrowers can come away bloodied and, sometimes, empty handed.

SETTING THE STAGE

At the time a lender makes a loan, there is an assumption of a specific level of repayment risk in accordance with terms. As fear of default increases, the perception of risk grows, and the value of the loan declines from face value as scheduled payments are discounted by a higher rate (to reflect the greater risk of repayment).

In previous business cycles, lenders would bring pressure to bear on borrowers by ratcheting up pricing and screwing down credit availability. The intent would not be to strangle the business, but to make life sufficiently unpleasant to motivate a refinancing with another lender. If a takeout by a new lender were not feasible, then a more bruising restructure, or possibly an outright liquidation, would be in store. These days, refinancing alternatives for distressed firms are very limited as many of the specialty finance companies that concentrate on this segment are grappling with an abundance of problems and are having difficulty attracting funding themselves. At the same time, many banks are under pressure to bolster their capital positions and address growing non-performing asset exposures. The implication is severe constraints on the ability to fund new loans. As a result, most banks would prefer to remove distressed loans from their balance sheets and move on.



Selling distressed loans to third-party investors is one way to accomplish that.

Back when times were good, you may not have focused on your lender's unfettered right, following an event of default, to sell your loan to a third party based on a loan-agreement clause that typically reads as follows:

The Bank may sell participations in or assign this loan, provided, that so long as no event of default has occurred and is occurring, the Bank may not sell participations in or assign this loan to a person or entity that is a direct competitor of the Borrower without the consent of the Borrower, which shall not be unreasonably withheld.

Accordingly, it would not be surprising for a business owner, following any unresolved credit agreement violation, to field a call from a Vulture Investor to discuss the business, its newly purchased note and, possibly, your personal guarantee and financial situation. A scary thought, indeed!

THE MARKET FOR DISTRESSED DEBT

A general rule of thumb in the distressed-debt market is that a loan devalued to 80% or less of face, or par, value is considered "distressed." The imbedded assumption is that it is sufficiently likely that the company will not be able to repay its debt in accordance with terms and that some form of restructuring of the balance sheet will be necessary. Purchasers of distressed debt are familiar with the tools to accomplish a restructuring. They operate on the presumption that a steep economic downturn will create a plethora of opportunities from which attractive returns can be earned for their efforts.

In a free capital market, money flows toward the highest value opportunities and, in today's environment, distressed debt is capturing the attention of investors. Already, a considerable amount of capital has been amassed to pursue defaulted real estate loans. The federal government is creating a program to entice private investors into the market for distressed, asset-backed securities. And, of course, trading activity has been robust in distressed public bonds and broadly syndicated leveraged loans.

Attracted by the deep discounts of high-yield corporate bonds, the "junk" bond market experienced a net inflow of \$4.4 billion between November 2008 and February 2009, at the same time as most other fixed-income categories declined. Since last October, \$26 billion has been raised to invest in distressed debt, almost all of it in hedge funds. Some very large investment firms have recently entered the market in a major way:

- Carlyle Group raised \$1.35 billion to buy bank loans, publicly traded bonds, and ailing companies;
- Goldman Sachs announced its commitment to invest \$4.5 billion in distressed debt;
- Apollo Capital announced its intent to focus on credit investments over the next 18 months.

Surprisingly, there has been very little distressed commercial and industrial ("C&I") loan sale activity in the middle-market, to date. In part, this may be due to lagging

recognition of accelerating distress in middle-market C&I portfolios, as well as difficulty in reaching pricing conclusions. However, we believe that this will soon change.

We're just beginning to see the formation of funds focused on investing in middle-market C&I loans. Ares Capital, for example, just announced the \$250 million Ivy Hill Middle-Market Credit Fund, designed to buy first- and second-lien bank debt and mezzanine loans.

Most of the middle-market, equity-fund managers with whom we've spoken have expressed hesitance to acquire debt with the intent of forcing restructures and flexing creditor remedies to obtain significant equity positions. Nevertheless, most indicated that they would be anxious to participate in reorganizations and provide the capital to replace existing participants, as well as to carry out the business plan. As they watch others take a more aggressive approach in pursuit of attractive returns, we expect that some of these funds will revise their rules of engagement.

IMPLICATIONS FOR BORROWERS

Borrowers meeting their new Vulture Investor partners may look back fondly on even the most unpleasant meetings with workout bankers. Vulture Investors approach the situation from an entirely different perspective; they seek to parlay their position into out-sized returns via one of two methods:

- Use arbitrage to force a sale in situations where the business could be worth more to someone else than it is on a stand-alone basis.
- Recapitalize to reset the capital structure where it is either misaligned or overcapitalized, often as the consequence of over-paying in a buyout and/or the excessive use of leverage.

In an arbitrage situation, the investor extracts his return by collecting as much as possible of the face value of debt that was acquired at a deep discount. In some cases, this includes charging significant interest and fees. In a recapitalization, the path to a return generally requires conversion of all or part of the debt to equity at a realistic current

valuation, thereby severely diluting or eliminating the interests of existing shareholders. The bet is that the business will recover and return both the original face value of the loan, plus equity created in the process.

The difference between banks and Vulture Investors is that the latter are unafraid to aggressively use their legal remedies to exert control over the business and its strategy. If necessary, these investors are often quite willing to replace management and direct the operations themselves.

Our advice to business owners is that if there is doubt about being able to meet the company's future liquidity needs or lenders' requirements, it could well make sense to develop a relationship with a "friendly" capital source in advance, rather than wait for the crisis. It is preferable to be sitting alongside an investor partner who values your contribution when a new capital structure and ownership strategy are being assembled. ♦



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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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