INDUSTRY ROUNDTABLE

Major Changes Seen for Next Round of Workouts

High Leverage, Complex Capital Structures, Nontraditional Players Cloud Outlook in the Middle Market

Editor's Note: *The capital markets environment is awash with liquidity in both traditional and alternative debt and equity. We assembled a panel of high-profile middle market dealmakers to look at prevailing trends in transaction activity in this space.*

The resulting discussion offers real-time insight into current middle market deal activity — types of transactions, the structure and cost of capital, and industries to focus on. These experts also address the near-term future — the potential impact of the changing U.S. Bankruptcy Code, the changing face of the restructuring/insolvency industry, and how macroeconomic trends are influencing middle market companies.

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Q **LEPAK:** Describe the current environment for middle market companies in terms of activity and capital requirements.

BOLDUC: The environment for mergers and acquisition is very robust. There is a lot of "product" in the marketplace — companies that are for sale and looking for capital, both equity and debt. We're seeing many players, some traditional and some not so traditional, who are interested in providing debt financing, as well as equity financing. Underpinning this level of activity is the fact that while the economy is not exceptionally strong, it's fairly stable — a low interest rate environment and no big changes anticipated. That provides investors with a general level of comfort.

LAGRANGE: We've seen some very aggressive activity among companies seeking mergers and acquisitions. We believe this is fueled by the availability of significant liquidity. The interesting questions are, in the near term, how long will the capital markets continue providing this level of liquidity, and how will the market participants act as the credit cycle ages? There are so many new players in the market compared to the last cycle, and many funds participating in the market have strategies that could bring some unforeseeable changes to the classic credit tightening.

DOBBS: Looking at debt financing, this year we've seen an increase in volume each month. But in the area of workouts and bankruptcies, the activity level has slowed considerably.

Banks have done a good job cleaning up their portfolios. Most of the traditional lenders have pretty clean portfolios. Default rates are way down. Banks that recently have gone through mergers have realized most of the expense savings projected from those mergers. Having squeezed out the bad loans, banks now are under tremendous pressure to grow volume, and they face intense competition on the debt side of the capital markets. We are awash in liquidity at every level of the corporate structure. As a result of that competition and pressure to grow, we're witnessing some extremely aggressive deal structures.

Banks are not only facing the traditional competition from other banks, but also competition from a growing number of hedge funds. With M&A activity increasing, financing opportunities have increased, but the multiples have been very high. Pricing has not always reflected the risk. Asset values have been rationalized to justify some of these credit extensions.

PACCIORETTI: We see the environment from two different perspectives: as crisis managers and as buyers of troubled companies through our affiliation with Jigsaw Partners. On the crisis management side, we are busy, but it's slower than last year. From the distressed seller and acquirer side, it's a very frothy environment. For deals where not too long ago we might have received four or five letters of intent on debt activity, today we'll have 10 or 15 parties interested in providing both debt and equity.

We are seeing asset-based lenders willing to allow additional layers in the capital structure — junior, mezzanine, and equity — to fill in the stretch piece and provide working capital. This is very attractive to stakeholders, as it gives them an opportunity to support a troubled company for another six to 12 months, to complete the

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The panel was moderated by **Kathleen Z. Lepak,** a senior vice president and the national sales manager for Citi Commercial Asset Based Finance, a business unit of Citigroup that extends secured commercial loans nationally to middle market companies in a broad segment of industries. She is also vice president of chapter relations for TMA.

The other panel members were:

John Bolduc, a managing director of HIG Capital, a middle market buyout fund, and Bayside Capital, HIG Capital's distressed investment vehicle that manages $500 million of committed capital.

C. Edward Dobbs, a partner and head of the commercial practice group of Parker Hudson Rainer & Dobbs LLP, an Atlanta-based law firm with an additional office in Tallahassee, Florida. The commercial practice group represents banks and other financial institutions in syndicated loans, workouts, and bankruptcy cases.

Ted Koenig, president & CEO of Monroe Capital, a specialty finance company devoted to providing innovative capital to middle-market businesses in the United States and Canada.

Patrick Lagrange, a managing director of Carl Marks Advisory Group. Based in New York, it provides investment banking services to middle market companies, specializing in mergers and acquisitions, divestitures, capital raising, debt and equity placement, and financial restructuring.

Thomas S. Paccioretti, founder and a principal of Broadway Advisors, LLC, a California-based consulting firm providing turnaround consulting, interim management, and restructuring services to financially troubled middle market companies. His engagements include CRO assignments for Southwest Recreational Industries, Inc. and Progressive Dairies, Inc., and President and CEO of Strouds the Linen Experts (NASDAQ). Broadway Advisors, LLC, is affiliated with Jigsaw Partners, LLC, an operations-focused acquisition firm.

turaround, and perhaps to get a better sale price. And we're finding financial buyers often outbidding strategic buyers, which is most unusual.

Q.

LEPAK: I think we all agree that there are significant levels of liquidity in the marketplace. I know from my perspective that competition has never been as tough as it is now. The challenge to grow, and especially to grow responsibly, is rather difficult. How do you think the current environment plays out in terms of pricing on middle market transactions?

BOLDUC: You can look at pricing in terms of purchase price multiples paid or expected returns. From a returns perspective, there is no doubt that there's been a significant lowering of expectations on both the equity and debt side. Some of that is driven by low interest rates and economic stability, but all markets are cyclical, and we clearly are at a cyclical peak. With many firms bidding to provide capital to companies, I believe middle market equity providers have moved toward diminishing returns. Some equity sponsors are accepting less than 20 percent internal rate of return (IRR).

Over the last 13 years, HIG Capital and Bayside Capital have kept a longer-term perspective and resisted the temptation to do deals at prices that don't make sense, just because that's what it takes to get it done in the marketplace. So on many deals, we haven't even made it to the second round. Still, we have found a number of deals in this environment that have unique characteristics, and we have competed successfully for them.

KOENIG: Prices tend to move down when there's more supply, and right now we have an imbalance in supply and demand for funding traditional middle market loans. There are many new entrants who are temporarily competing in the middle market direct investment space. Some are in the market because they haven't been earning an acceptable return in their core investment area — most notably large money managers or other investment managers, such as hedge funds. So, there's a lot of capital looking for a place to generate yield.

In the short term, this environment creates pricing pressure for lenders and opportunities for borrowers. But how reliable is this financing? Whether you are a long-term equity investor or a privately held middle market company, and whether your strategy is to grow, to buy and build, or to hold, you must be able to rely on your capital provider to be consistent in its approach.

But recently we've seen investment funds that are more interested in trading debt and equity posi-

tions through hedging transactions. These investment professionals can make a loan and short the equity of the company at the same time and earn a significantly higher yield than the traditional spread interest income from a loan transaction. This is very troublesome for borrowers, as the lender is now thinking like a short-term equity investor, betting that there will be a bigger payoff for them if things worsen and the borrower stumbles. The ultimate test is whether these short-term investment strategies, which may result in a temporary dislocation in pricing of 100 or 200 basis points, will support the needs of middle market companies in the long term.

Q. **LEPAK:** When the cycle changes and we face the next downturn in the economy, how do you see capital providers responding? Even in the middle market, there are a lot of complex capital structures with multiple debt and equity providers. How might a downturn unfold? Will the current capital structures come apart?

DOBBS: Not only is there uncertainty about how some of the new players, such as second-lien lenders, will operate in a troubled loan environment, but there also will be significant changes to the Bankruptcy Code beginning October 17. When we have an economic downturn, many companies filing for bankruptcy will be much more highly leveraged. But as a result of recent Bankruptcy Code amendments, companies will need even more liquidity in Chapter 11.

For example, there will be an increased number of priority and administrative claims, including administrative claims for ordinary course vendor sales in the 20 days prior to bankruptcy. Another liquidity issue is that companies will likely have to pay a much higher deposits for utilities. Putting an outside date for the exclusivity period for plans will require debtors to move with alacrity. All of those factors mean that Chapter 11, which already has become a forum for selling rather than for reorganizing distressed companies, may result in more Chapter 7 liquidations and even more quick Chapter 11 sales under Section 363 of the Bankruptcy Code, because time clearly will be of the essence.

It also will be interesting to see how the intercreditor agreements negotiated over the past several years between first-lien and second-lien lenders will play out in a bankruptcy environment. How much squabbling will there be in the early part of the bankruptcy case between the conventional first-lien lender and the newer-to-the-market second-lien lender, and how much time and resources will be consumed in such intercreditor fights? Many of these second-lien lenders are very sophisticated, but that level of sophistication may not extend to workouts or bankruptcies. It will be interesting to see how they will make decisions in this environment.

If bankruptcy is inevitable, it will certainly be prudent to file sooner rather than later. And pre-bankruptcy planning may result in more prepackaged plans, which are a bit easier under the Bankruptcy Code amendments. We can expect a lot more pre-Chapter 11 marketing efforts to sell the company and to establish stalking horse bidders and more bankruptcy filings with a view toward a very quick 363 sale.

> "Asking people who have worked 20 years in a particular industry to retrain for a new service job that is more useful but may pay much less takes some time and threatens their ability to maintain their standard of living."

KOENIG: I think Ed's comments are right on target, although there will be a significant change in the workout process versus past down cycles. Many companies are so highly leveraged today that covenants are being set at or near business plan. When borrowers breach covenants, the kinds of lenders that have traditionally managed workouts are motivated to restructure the covenants and work through the issues with the goal to rehabilitate the company and retain the customer.

But we've already seen that some of the new capital providers have a different motivation and agenda. They may fail to give consents or provide amendments to documentation over routine issues, creating a more hostile environment earlier in the workout process. This will cause bankruptcy filings to take place sooner, and they will be more costly. Given the level of complexity as a result of multiparty intercreditor agreements and the varying goals of the capital providers, there will be some hostility between traditional lenders and those investment managers seeking yield-only at all costs. There will be a lot of finger pointing and "shooting first and working out second" as this next cycle evolves. This is a significant risk for middle market companies and their private investors.

Q. **LEPAK:** Given these changes, how are you planning to prepare for the next down cycle?

PACCIORETTI: We find the biggest change is speed. Middle market transactions are turning very quickly. Two of our most recent CRO engagements come to mind. We had a $750 million manufacturing roll-up that we sold through a Section 363 sale 76 days after filing. And we sold a $165 million manufacturing and construction company 29 days after we came on board—same approach, a Section 363 sale. The lenders in both cases would provide debtor-in-possession (DIP) financing only with very onerous terms; and in both cases, company leadership decided not to take the financing. Without a DIP, you have a very short runway.

Both of these cases worked out well, and we got top dollar. Some of that was due to the competitive marketplace, but we had to work very quickly. In the next cycle I see the same need — to work hard and fast — so we aren't planning to change our processes or procedures. However, working quickly may be more difficult because of the complexity of the capital structures resulting from today's deal environment. As Ted pointed out, how the yield-only players work through a trouble loan with their fellow creditors will be a new, interesting, and critical dynamic.

BOLDUC: We're already getting calls from senior bank groups who have a non-traditional capital provider that isn't playing nice in the sandbox. It's typically somebody who is yield-focused and doesn't want to be around long term. When the bank group needs to get consents or waivers, these guys are just digging their heels in and basically saying, "Give me fees, and I want out." So, we've been getting an increasing number of calls from companies asking us to come in and take those providers out so they can try to move their business forward. In my mind, this is the biggest issue complicating the next downturn.

Q. **LEPAK:** When do you think the next recession or the next round of restructurings will begin, and will there be an event that will trigger it?

KOENIG: My guess is that the economy will begin to slow toward the end of the first quarter of 2006. There will be more pressure on operating earnings, and given the amount of leverage companies are maintaining and the low gross-margin manufacturing environment we have today, there is no doubt that a number of covenants will be breached. In my opinion, that will be the start of a more intense downturn. However, I think it will be a more shallow downturn than we have seen in past cycles because there is so much liquidity in the capital markets at this time.

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LAGRANGE: I don't think we will see a broad economic downturn before the second or third quarter of 2006. I think a major risk is the continued willingness of the consumer to spend. Consumers have borrowed so much money—they've tapped their home equity lines, their credit cards are extended — that this is a tremendous risk to the economy. When consumers finally stop spending, businesses that are dependent on consumers and that are already leveraged will be the first to start running into issues.

BOLDUC: The market will turn—it always does. However, there are a couple of ways to measure where we are in the cycle. One measure is default rates, which have been at 2 percent or less. The historical average has been much closer to 4 percent. If defaults rise back to that average, volume in the turnaround business will essentially double. I don't know when or how the next big bust will come, but we are unlikely to remain at this cyclically low level for any extended period of time. I think there will be a nice pickup here in the next nine to 12 months.

PACCIORETTI: I think a downturn will occur in the first or second quarter of 2006. Before then, I think there's enough capital to prop up companies through the holidays. I would focus on the post-Christmas season. At that point, a reduction in inventory valuations could trigger defaults and force workouts or liquidation. So if the retail sector fares poorly over the holiday season, it could be a busy first quarter.

Q. LEPAK: What industries are currently active in your practice? Which industries will be particularly hard hit in the next cycle?

LAGRANGE: We have no single industry that seems to be more active than others. The list is diverse, ranging from auto-industry-related companies to makers of a wide range of consumer products, as well as healthcare service companies.

PACCIORETTI: We are currently active in the manufacturing and service industries and some retail, but I think the U.S. manufacturing industry will take another serious hit in the next cycle. Asian countries, in particular China, can manufacture a product, put it on a boat, and ship it back here at a landed cost that is 30 percent less than if it were made in the United States or other countries. That's tough to beat.

The other area to watch is the automotive industry and related suppliers. When you look at their costs associated with retirement and healthcare, there are obvious signals of a serious problem. And of course the retail sector is always a candidate for trouble. If you're not Wal-Mart, it's a difficult business to be in.

DOBBS: It is not clear whether the adverse effects of a down cycle will be visited upon any particular industry. In the last 10 years or so in the United States, we have developed an incredible sophistication and talent pool in "peddling money." We have bankers, investments bankers, and money managers who are extraordinarily imaginative and resourceful. But we have an undersupply of talented chief executive officers who know how to run a company, execute a business plan, and make provision for a company's long-term future. I think that's one reason why some middle market companies are having difficulties.

But one industry we are looking at closely is healthcare. It continues to face extensive state and federal regulation, stiff competition, ever-changing laws, an aging society, and a relative dearth of capital and governmental funding. All of those changing dynamics will create challenges for both community hospitals and urban hospitals, and many will be in need of restructuring services.

Q. LEPAK: With the manufacturing base that was so strong in this country for so many years moving offshore, how do you think the shifting macroeconomics affect middle market companies? What kinds of opportunities will it create for our industry?

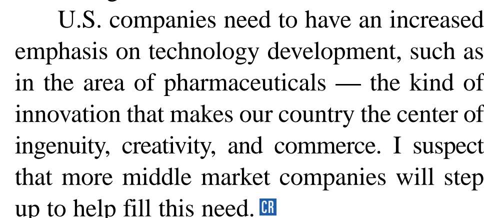
LAGRANGE: The fact that products can be made less expensively, perhaps with equivalent quality, in other parts of the world poses significant challenges for the state of manufacturing in the United States. If you look at the impact of trade flows on factors such as interest rates, you realize there are tremendous challenges facing domestic manufacturers.

KOENIG: The American finance industry has become very good at inventing new ways to provide capital to middle market businesses. Today, the largest single holders of debt are collateralized loan obligation (CLO) and collateralized debt obligation (CDO) funds. The largest single concentration in all of these funds today is not the automotive sector, the manufacturing sector, or even the retail sector. It's the business services sector. As manufacturing jobs in the United States have been lost, there has been a shift to a more distribution- and service-based economy. My guess is that those of us in the business of providing capital will continue to be creative in finding new ways to put that capital to good use.

LAGRANGE: I agree that the capital markets are very efficient at chasing investment opportunities globally. The problem is that efficient allocation of capital doesn't address what can be significant social costs and inefficiencies. For example, asking people who have worked 20 years in a particular industry to retrain for a new service job that is more useful but may pay much less takes some time and threatens their ability to maintain their standard of living. This creates challenges for the politicians as they try to sort out economic and trade policies.

PACCIORETTI: Many business managers don't have experience working through market reversals and increased competition, particularly from low-cost producers. They delay their response to signs of trouble, reducing the turnaround options available, and end up accelerating the company's downward slide. We also see companies with great products, strong margins, and a dominant position in a small market try to grow through acquisitions. Management is often ill equipped to handle aggressive growth plans and to integrate acquisitions. They lose focus on their core business, sales and profits decline, their growth plans begin to sputter, and they find themselves fighting desperately to regain the earnings before interest, taxes, depreciation, and amortization (EBITDA) they previously had. They need to restructure the enterprise. This creates opportunities for us to assist these firms through this painful but necessary process to regroup, restructure, and revitalize.

DOBBS: The successful middle market players will be those that can pick a niche and fill it. Companies with a predominantly U.S. strategy will need to ferret out what products or services are needed here and can't be provided by a lower cost overseas provider. Or, they need to identify what is needed in an overseas market and develop a strategy to provide it there, whether it's technology, oil drilling, or something else.



U.S. companies need to have an increased emphasis on technology development, such as in the area of pharmaceuticals — the kind of innovation that makes our country the center of ingenuity, creativity, and commerce. I suspect that more middle market companies will step up to help fill this need. CR

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