

## Despite a Bleak Climate — There Are Opportunities in a Distressed Economy

BY WARREN H. FEDER

**As fewer options become available** for borrowers and lenders as credit tightens, there are still many opportunities for distressed investors. Carl Marks' Warren Feder describes the climate and the advantages that exist in this market.



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**A**s those in the “deal business” are so painfully aware, credit is tighter than at almost any time in recent memory. For the larger transactions, liquidity has pretty much left the market and banking balance sheets are bloated with loans that cannot be sold. The secondary market has largely disappeared. Increasingly more banks are closing their doors to new loans.

The bottom line is simple: The remaining banks and lending funds are lending less and charging more under tighter operating and financial covenants. As a result, it's now more difficult to get waivers for technical defaults on loans or to get a loan at all.

Despite the bleak economic climate, opportunities do exist for distressed investors. Investors with dry powder (cash reserves) will be able to scoop up assets at exceptionally discounted prices. There also will be opportunities to jump in earlier out of court (prior to a bankruptcy filing) and higher into the capital structure. New structures, such as equity invested as secured convertible debt, also will emerge.

Liquidation will be the likely alternative for many companies. Consequently, liquidation prices will be more commonplace and will effectively set the floor on pricing. As bankruptcies get shorter, however, investors will need ready cash and the ability and willingness to act quickly and decisively to capture these opportunities.

It's an interesting time for the mergers and acquisitions segment — for both buyers and sellers — as a number of key factors have begun to shape M&A opportunities in the current distressed economy, offering surprisingly attractive prospects.

### **Fewer, More Selective Senior Lenders**

The lending landscape has become tighter over the past few years. Some well-established, middle-market

lenders are effectively out of the market. Some have disbanded lending groups, while others have cut back on making new loans. A number of newer lending funds have closed entirely or are severely constrained. Credit standards are tougher all around.

Advance rates on asset-based loans have become more conservative; lenders now are less willing to advance against nontraditional assets. Stretch pieces and air balls are a distant memory. Lenders also are offering lower multiples on cash-flow loans to sponsors for middle-market buyouts. And, while it was always more challenging to get pure cash-flow loans for non-sponsored middle-market companies, now it's almost impossible.

Other considerations related to the decrease in lenders include failing syndications and fewer parties for club deals. While some business development corporations' (BDC) specialty lending funds and new funds are still in the market, they too have become more conservative than in the past.

### **Junior Lenders Demand Better Quality Deals**

Traditional “B” loans (junior lien loans), as they had come to be up until last year, have largely disappeared. In fact, some senior lenders are not permitting second lien loans at all. Instead, junior lenders are stepping in to cover areas where senior lenders have traditionally lent in the past. In some instances, these junior lenders are the sole providers of debt financing.

In one buyout, a well-known private equity shop negotiated a \$400 million acquisition and turned to its traditional lending partners to provide \$200 million of acquisition debt. The lender was unable to syndicate the loan. Needing to close quickly, the private equity firm turned to a specialty lending firm to provide \$150 million of debt to fund the acquisition. In this case, the traditional junior lender was able to get a rate in the mid-teens for a far safer credit by jumping into the breach left by the senior lender.

When junior lenders do lend on collateral, they shy away from getting deeper in collateral for second positions and more often demand an unencumbered first on separate and distinct collateral for their loans. Enterprise value loans, when done, are only for better-quality companies

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with more sustainable and proven cash flow or a bevy of well-known brands.

This has resulted in the rise of mezzanine financing — unsecured debt capital that fills the gap between equity and senior debt and gives the lender an ownership or equity interest in the company as part of the price for the loan.

### **Good Companies Are Still Getting Deals Done**

While overall merger and acquisition activity is down by more than 50%, middle-market M&A deals are getting done. Numerous private equity funds have raised enormous amounts of capital over the past few years. This capital is committed and needs to be deployed. Additionally, strategic investors have large amounts of dry powder and are interested in buying at more realistic prices in this market.

The net result is that good companies are still closing deals at good valuations. While overall multiples have slipped a bit, deal structure has migrated to make up for lower liquidity in the debt market. Buyers are investing more equity, while structures such as seller paper, roll-over equity and earn-outs make up the difference.

### **Strong Companies With Clear Strategy Can Find Financing**

If your company maintains a strong bottom line and smart business practices, opportunities exist, although not as openly as in the past. You might have to do some sleuthing to uncover available financing options.

Private equity firms are taking a more favorable view towards minority investments. They do, however, expect negative covenants, which give them substantial rights if the business plan is not realized.

Mezzanine funds are enjoying a definite resurgence. They will provide capital to strong cash-flow companies in return for a coupon and warrants. Hedge funds remain opportunistic and will provide financing in the right circumstances.

A note to borrowers — realism plays a crucial role in seeking financing opportunities. Refine your business plan. Have a realistic view of what capital providers seek, and most importantly, tell your story in the most advantageous way. After all, competition is fierce.

### **Full Wave of Defaults and Bankruptcies Yet to Come**

Just like the old saying notes, things are going to get worse before they get better. Many companies that should have fallen early in the credit crunch — particularly those in retail — have remained on life support. Some private equity and hedge funds have continued funding because they have been unwilling to

take write-offs. Covenant-lite loans do not allow lenders to call defaults. And, furthermore, Fed-induced cuts have created an unstable low interest rate environment.

Putting off the day of reckoning has left struggling companies in far worse shape because many have put necessary operating improvements on the back burner while they still had ample liquidity. Detrimental inefficiencies have remained in place and, in many cases, bad management continues to thrive unchecked.

In the past, some of these organizations had the hope of a possible bailout. Not this time around. The distressed economy has taken its toll on operating performance, and rescue financing, so prevalent only a year ago, has become all but extinct. Compounding this will be the fate of regional banks. Largely untouched so far, these entities will follow money center banks with liquidity issues.

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### **Bankruptcies Will Be Shorter With More Liquidations and/or Hyper-Accelerated Asset Sales**

New amendments to the bankruptcy code have significantly impacted the fate of struggling companies. These changes leave less time, and require higher costs, to restructure. In addition, the diminished value of companies pushes lenders toward demanding a speedy end.

As a result, liquidators are more readily stepping in early as stalking horses, interested buyers selected by the bankrupt company to make the first bid on its assets. Stalking-horse bids permit the distressed company to go into auction with the assurance of having some bidder. After the stalking-horse places a bid, other potential buyers may submit competing bids. Simply put, the stalking-horse bid sets the floor so that other bidders can't low-ball the purchase price even further. As experts in valuing assets quickly, liquidators can submit a bid in a matter of days. In the current distressed economy, stalking-horse liquidators have, in effect, shortened the time frames for competing bidders to enter the arena. This means that competing bidders will need to be able to evaluate the acquisition opportunity quickly and, if they decide to bid, have the cash to pay for it.

Another factor playing into shortened restructuring periods centers on debtor-in-possession (DIP) financing. DIP financing

is arranged by a company while under the Chapter 11 bankruptcy process and generally has priority over existing debt, equity and other claims. In the current economic climate, fewer sources of DIP financing are available to support a restructuring.

### **Beware of Pitfalls**

While the market is ripe for distressed investment opportunities, investors should remain wary when trying to catch the proverbial falling knife. The increasingly difficult economic environment has not just struck Wall Street; it has hit home on Main Street, USA, as well.

The harsh reality is this: Many companies are too far gone for revitalization efforts, and it's not as simple as going back to the past to try to remedy things retroactively. Investors must ensure they have sufficient liquidity to turn the company around — a process that

generally will take longer and cost more than initially assessed.

Due diligence is a must for successful investing in these distressed times. And with due diligence, the proper mindset and ready cash, investment is not just a possibility. It can be a reality if it's done carefully and smartly, with plenty of preparation. [abfj](#)

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