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Lenders remedies in the current economic climate: the state of global M&A and restructuring

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Over the past 12 to 18 months, senior lenders including banks, commercial finance companies and hedge funds have tended to take a 'wait and see' approach to their credit portfolios. Many lenders resisted the inclination to push borrowers out – either through the forced sale of all or a portion of the company or through a straight liquidation. If a borrower had ample cash flow to meet a minimum debt service, portfolio managers/workout officers provided short or medium-term forbearance arrangements or amendments. This allowed the company to stumble through the challenging economic environment and, hopefully, to a better outcome for all stakeholders in the future. This is euphemistically called the 'amend and extend/pretend' or 'kicking the can down the road' strategy.

The positive outcome of this strategy is that many companies that were destined for liquidation or fire sale through the last down cycle have been given a new lease on life – at least for the short term. The negative outcome is that this strategy did not solve the problem. Many of these companies have faced a substantial decrease in revenue and a corresponding decrease in EBITDA and net cash flow. These companies continue to be saddled with excess leverage with limited near-term alternatives available to the lenders and other stakeholders. Any stakeholders with an ability to influence the outcome are merely waiting out the storm on the presumption that the economy, credit markets, and ultimately the company itself will turn around and provide more favourable exit opportunities in the future.

The sale of debt provides a lender an effective way to exit a company where the need for capital is imminent and the collateral pool is not sufficient to cover outstanding obligations.

Incremental liquidity requirements are typically easily met by the senior lenders during any amend and extend process. As the process unfolds, however, there may come a time when the company is in need of significant additional capital, either to fund continued losses or to provide working capital to fuel growth. This liquidity void will not be met by the existing equity holders. As their current investment is underwater, any incremental equity infusion is effectively flushing good money after bad. Therefore, any such need must generally be funded by debt and, as such, may create the impetus for a more permanent restructuring or exit.

We have seen many creative structures that lenders and other stakeholders have used to maximise recovery, to minimise additional capital infusions and to streamline the time in which a transaction is closed. A common strategy involves the use of the Chapter 11 bankruptcy process. There have been many high-profile bankruptcy proceedings through which new capital is infused into a troubled company by way of a private equity investor or a strategic buyer. These transactions have been structured as Section 363 sales, where the purchaser acts as a stalking horse and acquires the assets free and clear of all liabilities – leaving the overleveraged capital structure and other liabilities to be reconciled in the Chapter 11 estate.

In these circumstances, an investment banker is retained by the company prior to a Chapter 11 filing in order to identify the strategic alternatives available to the stakeholders, including identifying investors or strategic buyers. This strategy allows the company to obtain a buyer before the company enters into bankruptcy. The advantages of having a stalking horse in place prior to the filing include, first, the fact it minimises the amount of time that a company is in bankruptcy (thus reducing the overall cost to the estate) and, second, it provides a clear path to an exit for all stakeholders including customers, employees, and vendors.

If a formal solicitation for a buyer or for new capital results in an unacceptable outcome – the value of the offers do not meet a minimum requirement for the senior lending group or no stalking horse bidder is found – the lender group is faced with several decisions. The lender group can continue to fund the company on a senior debt basis through a fragile economic environment, or liquidate (the lender group taking the loss and moving on), or structure a deal where the senior debt acts as a stalking horse bidder or a sponsor for a plan of reorganisation.

In this instance, one or more groups of stakeholders agree to provide the necessary capital to reseed the business and, in exchange, take economic control of the company. The strategy can be time consuming and complicated, depending upon the complexity of the capital structure. The strategy can be very effective in either a simple capital structure or a capital structure with multiple layers of debt, (e.g., senior, second lien, seller notes, unsecured trade) as it allows the fulcrum security the ability to eliminate or significantly reduce the debt levels underneath it, and thus, help right size the balance sheet. With that, however, comes the potential for significant infighting and much negotiation. Ultimately, the value of the business and the willingness of a given class to inject new monies will determine the outcome. Again, an adviser to each affected class can assist in identifying solutions and negotiating with other stakeholders.

Another common strategy available to the senior lender community involves the sale of debt. The sale of debt provides a lender an effective way to exit a company where the need for capital is imminent and the collateral pool is not sufficient to cover outstanding obligations. A transaction of this nature can be closed very quickly and can provide a needed lifeline to a struggling company.

As the liquidity need for a company mounts, and strategic alternatives are limited, many ▸▸

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companies turn to existing stakeholders for a lifeline. The current equity providers are usually out of the money and subordinated debt investors, if any, may be unwilling to 'double down'. Secured lenders must look to alternative strategies to maximise recovery, minimise loss and control new working capital exposure. As we have seen in the past 18 months, and are likely to continue to see, lenders have become more creative and willing to exercise their rights in order to ensure an acceptable outcome. ■

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