Corporate Restructuring: Will the Force Awaken?

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For those of us in the trenches of lower middle market special situations, there are signs of a coming disturbance in the Force.

No one knew what the disturbance was at the beginning of 2007, but we soon found out it was subprime mortgages. Who knew in 2007 that my old employer, National City Bank, a conservative regional bank based in Cleveland that bought my firm in August 2006, was one of, if not the, largest originators of subprime mortgages in the country and was the largest bank not to get federal Troubled Asset Relief Program (TARP) money in 2008?

NatCity was subsequently sold to PNC Bank for next to nothing. Fortunately for me and my partners, that allowed us to buy SSG back in 2009 for far less than we had sold it for! Our opportunistic exit from a traditional banking structure foretold, unbeknownst to everyone at the time, a shift in the capital markets. No longer would banks be the primary sources of capital in the middle market and below.

Certainly, subprime mortgages won't be the catalyst for this new disturbance. Equally certain, I firmly believe, is that the Federal Reserve is finally going to raise interest rates, though only modestly. Thank goodness, because I've been "Yellen" about that for a long time! The era of a central bank artificially created stimulus must now end for the market to normalize, with winners and losers. The artificial stimulus for the past seven to eight years has driven the equities market to new highs, while interest rates remain near zero. Many analysts today have concluded that equities are overpriced in a continuing low-growth environment.

However, one constant in the universe is the institutional search for yield. That primordial capitalistic instinct in the recent cycle since 2009 has led to a tremendous volume of inexpensive capital and an unprecedented growth of capital providers.

When the *Wall Street Journal* began its "Bankruptcy Examiners" series in March 2014, the very first topic was whether the current environment of liquidity had put corporate restructuring on life support. My response at the time was that Fed policy had induced a coma that had the restructuring industry wondering when it was going to wake up. For years now, borrowers have been able to refinance, curtail debt service, and extend maturities through multiple sources, including hedge funds, high yield bond markets, commercial finance companies, banks, publicly traded business development companies (BDCs), and indirectly through collateralized loan obligations (CLOs).

The restructuring business in the lower middle market has been relatively unaffected by the surge in liquidity. Management in these companies cannot easily access capital to overcome industry cycles, overleverage, and underperforming operations, which has resulted in a steady flow of distressed M&A opportunities. The question is whether the consistent restructuring activity in the lower middle market will be a catalyst for disturbance in the larger markets.

The same abundance of capital that has slowed restructuring in larger companies has driven healthy company transactions. The frothy M&A activity in the middle market over the past several years has led to even larger megadeals in the past year. Those deals have been financed by the money center banks that are now having trouble syndicating the loans before year-end. If those loans have to be sold below par to get them off the balance sheets of those banks, the center cannot hold, and that's a disturbance that will be felt throughout the market.

As Yoda said, "Always pass on what you have learned." Excess liquidity eventually leads to unsustainable quality, which drives corporate renewal activity at all levels. The saga continues.