The Changing Face of Distressed Debt in the U.S. Middle Market - By Michael Goodman, SSG Capital Advisors, L.P. - *Financier Worldwide*

The latter half of the 1990s in the U.S. was characterized by a healthy economy and an extremely liquid capital marketplace. As a result, distressed creditors with lenders seeking exits often had the luxury of options beyond an expedited sale of the business. Asset-based commercial finance institutions were aggressively refinancing more conservative and regulated commercial banks, often with credit facilities inclusive of cash flow components. Moreover, there were subordinated debt providers and equity sources that could supplement a new senior credit facility to take existing lenders out unimpaired.

Almost overnight in late 2000, senior credit markets tightened considerably and junior capital providers became more conservative when many of their investments were rendered unprofitable as the U.S. economy soured. As U.S.-based investment bankers specializing in distressed situations, SSG Capital Advisors' troubled clients were left with few options and were often forced to either sell their businesses quickly or liquidate assets. A temporary downturn in financial performance coupled with an anxious lender could quickly and permanently destroy equity value.

This icy environment has only recently exhibited signs of thawing, but amidst the deep freeze, the U.S. capital marketplace adapted by sprouting new non-traditional options for companies with distressed credit. A proliferation of hedge funds entered the market over the last two years to fill the void that was once occupied by more aggressive senior and junior capital providers. The hedge funds are unregulated, leaving them with the flexibility to address middle market capital needs with innovative structures, covering every stratum of the balance sheet.

The market for the direct purchase of distressed public debt had been developed for several years. However, more recently, hedge funds have targeted the purchase of non-publicly traded senior debt instruments, thereby allowing for entrée into the middle market where much of this debt resides. By purchasing distressed senior debt, often at a discount, the hedge fund buys into a position of influence on the balance sheet, leaving them with multiple exit strategies to realize a profit. In some instances, the hedge fund will continue to operate as the company's senior lender, awaiting a turnaround, ultimately hoping to generate returns by refinancing the debt at face value which they purchased at a discount. In other instances, the hedge fund can facilitate a restructuring of the balance sheet that usually includes a conversion of at least some of their senior debt to equity.

Many of these funds have been perceived as simply vulturistic, opportunistically disregarding the goals and objectives of various stakeholders for their own gain. However, as a more competitive market has emerged, these same hedge funds have become more solution oriented.

A recent transaction consummated by SSG exemplifies a hedge fund approaching a distressed credit creatively and thereby meeting the objectives of the various stakeholders. Earlier this year, SSG was retained by a U.S.-based designer and distributor of picture frames. The client had been adversely impacted over the last few years by the poor upscale retail environment as well as decreased margins due to the overall shift of retail sales from small independent gift and photo stores to larger chain department stores, mass merchandisers and specialty stores. Further, the company had only recently implemented an operational turnaround to combat inefficiencies in sales and distribution.

Near-term liquidity issues required an immediate infusion of capital through either a sale or recapitalization. Traditional capital sources were unable to devise a structure to provide neither sufficient liquidity to the existing lender nor adequate working capital to the business going forward. Due to the turnaround nature of the business, strategic and financial acquirers, although interested, were unwilling to deliver satisfactory value to the shareholders. However, an innovative hedge fund was able to deliver a recapitalization that provided liquidity to the existing senior lender, provided incremental capital into the business and allowed the existing owners of the company to maintain a controlling interest. Although the newly infused capital is expensive, it still affords the company precious time to complete its operational turnaround, thereby maintaining and enhancing the value of the equity.

Many of these new hedge funds have been able to raise large pools of capital, so they are not going away even with the traditional marketplace showing signs of increasing liquidity. For distressed credits in operational transition, these creative capital sources can be the only means to maintain equity value in a time of crisis.

Michael Goodman is a Vice President at SSG Capital Advisors, a boutique investment bank with 15 professionals in Philadelphia, New York and Cleveland with expertise in advising distressed middle-market companies in the U.S. and Europe.