Distressed Investment Banking
To the Abyss and Back
SECOND EDITION
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Beard Books
APPENDIX A: OLD EQUITY’S CHESSBOARD – A THEORETICAL VIEW

We are fierce advocates for achieving recoveries for old equity constituencies. And we start from a premise that is controversial to many: *What is in the interests of the company is not necessarily in the best interests of stockholders.*

We do think that stockholders can benefit greatly from boards’ attempts to enhance business value, stretch out the creditors and obtain the deepest discounts from creditors as is possible. Common sense and theory both tell us this. In the rest of this book, we discuss how the company can address maturity extension issues through exchange offers, cash incentives and other mechanisms. Extensions of maturities enable boards to have the opportunity to try to build business values. And we have elsewhere discussed the relative merits of taking out debt at various discounted prices. But interests can diverge.

A clear illustration of the dichotomy between the interests of a company and its stockholders involves the issues of reducing a company’s debt burden. In theory, this sounds great – less debt is better than more debt for a distressed enterprise. In this context, many of our clients frequently ask us if they should effect transactions or otherwise access capital markets to address or even chip away at “Mount Debt.” The answer is not as straightforward as it might seem – it depends on whom you represent and what you want to achieve.

We often like to tell our debtor-side clients that it is a mistake to reduce debt at par if the company is insolvent in the first place. Assume the company has $9 worth of assets and $10 face amount of liabilities. The equity value is 10% under water. Then the company sells $5 of assets to raise cash and repay debt. Now the company has $4 worth of assets and $5 face amount of liabilities. The equity value has dropped to being 20% under water.
We believe that this value destruction can be measured through the use of option theory. The equity of a company whose enterprise value is less than the face amount of its debt can be viewed as an out-of-the-money call option. For illustrative purposes, we assume that this “option” relates to a company with $10 in debt (the strike price) and $9 in asset value (the stock price). We further assume that the option is American-style, that the volatility (see Chapter 6) would be 40%, and that the effective yield on the debt would equate to a 10% underlying common stock cash dividend. Importantly, we use only a two-year life for the warrant, given the time limitations imposed on most restructurings. In this instance, the “black box” option model would spit out a price of $1.10. Using this output, the ratio of debt at face to debt plus equity market capitalization (in this case, market capitalization being the option value) would be 89%, which is certainly consistent with what we regularly see in terms of actual equity trading prices of distressed companies.

Now, let’s start selling assets to pay down debt at par. Selling the first dollar of assets would produce total debt of $9 and asset value of $8. The option model indicates that the option price would have decreased from $1.10 to $0.95. We have shown the relationship of such an asset sale program on these option values across a range of sale assumptions in the chart below.
What is happening is that the absolute differential between debt and asset value remains static, while the percentage differential is increasing. When all other factors are held constant (as we have done), the decline in the absolute numbers is translating into a smaller absolute option value, which is exacerbated by the increasing percentage of being “out of the money.” Said another way – at least from the perspective of stockholder value – you can’t shrink your way to greatness. After all, wouldn’t you rather have $9 of asset value that can be doubled to $18 than $4 that can be doubled to $8?

We have found that this logic resonates with our clients. But CEOs with publicly traded stock (or private equity owners that want to get rid of the annoying creditors) also want to know why they can’t simply issue additional equity and use the proceeds to repay debt, possibly at a big discount. The short answer is that they can (assuming that the company is adequately disclosed through any needed SEC filings), but that a huge part of the benefits would accrue to the debtholders. Meanwhile, option value held by old equity gets destroyed in the process.

Let’s start with the foregoing hypothetical involving a company with a business worth $9 and financial liabilities of $10. For sake of simplicity, we will also assume that the financial liabilities are all *pari passu*. A casual reader skipping the previous paragraphs might wonder what we are talking about in terms of equity values. Why would a company’s stock price have any value under these circumstances when the debt exceeds currently realizable asset values? But an observer of distressed companies would know differently. Distressed underwater companies frequently have significant public equity values. And option values are a big part of the reason.

Now, let’s repay $1 of face amount of debt with $0.90 of new money (*i.e.*, at a 90% price) from sale of new equity securities. The pro forma amount of debt at face value would now be $9, and the asset value would remain at $9. Keeping the other option assumptions static, the black box model would yield a pro forma equity value of $1.41 (which implicitly includes the $0.90 of new equity that just went into the company). In other words, the pre-transaction equity value decreased from $1.10 to a net of $0.51 (excluding the $0.90 that was invested). As the chart below shows, the fate of Old Equity gets worse as more money is raised until the trend finally bottoms out at some point.
At this point, take a deep breath. The company has raised equity money (even ignoring fees and expenses), retired debt at a discount (again ignoring expenses and taxes on debt cancellation) and has managed to increase its equity value by an amount materially less than the amount it raised. In other words, our hypothetical company managed to decrease pre-transaction stockholder wealth, at least in a theoretical sense. Meanwhile, the creditworthiness of the remaining debt would have improved (due to a lower amount of debt in relation to the same amount of assets). In other words, old equity has injected money to strengthen the company – but the creditors have reaped most of the benefit.

The clever reader may ask whether we sandbagged the analysis by limiting the discount to only 10% (i.e., a 90% purchase price). Just to show that we didn’t, we looked at the effect of increasing the purchase discount for a $1 debt retirement, everything else held equal. As the chart below shows, things get better with a bigger discount. But they don’t get back to the “do nothing” level of the option at this discount level. In order to make sense for old equity, the discount may need to be so great that it would be wildly impractical to achieve with $9 of realizable asset value.
Astute readers will also know that trying to base restructuring strategies on option analysis alone is very risky business. Any financial assumptions going into the model, not to mention the option methodology itself, are open to serious question. Nevertheless, it is critical to take note when theory so strongly confirms our “gut feel” conclusions that selling assets or raising equity simply to repay debt may not be a good idea.

Please understand that the “gut feel” determinations that we have may not be the same as that of others who do not till these fields. Our compass direction is influenced by our experience that old equity constituencies do much better if debt is not retired through asset sales or injection of new money until the end of the restructuring process. Further, depending upon a debtor’s cost of capital, a stretch-out in which the debt remains outstanding can be superior in many situations to even retiring debt at a big discount.

Of course, the analysis simply puts a finer point on our “gut feel.” And of the two ways to fund debt retirement, the analysis indicates that indiscriminate use of new sales of stock is even worse than an asset disposition program. Of course, when faced with no alternative, sometimes companies have to take such steps just to save the company, although existing stockholders may suffer as a result.
Given the mathematical exercises above, it is clear to us that there are numerous scenarios in which the company itself may benefit, and the stockholders may lose out. Among other things, asset and stock sale programs effect a wealth transfer from stockholders to bondholders. To the surprise of many lawyers, this concept applies to fairness opinions for companies and transactions in this context. As we indicated above, what is a fair restructuring transaction to the company may not necessarily be fair to its stockholders.

In our simple example above, it seems to us that old equity could obtain a better result for itself if it directly purchased the debt at a discount, rather than have the company effect the repurchase. Old equity could potentially benefit from an enhanced control position through ownership of the debt. Initially at least, if the debt remained outstanding, old equity would benefit from any excess of value over purchase price on the debt. Moreover, since the capital structure would be unchanged, so would option value as it related to the common stock itself. In other words, in a strict sense old equity would not be in a worse position, and actually could be in a better one.

On the other hand, due to the purchase of the debt, old equity (viewed from the entirety of its debt and equity holdings) would have increased its “skin in the game.” This actually could create problems for old equity in pursuing various aggressive negotiating strategies. Moreover, there are risks involved if a court found that old equity acted inappropriately and imposed penalties (such as subordination of recoveries on its debt ownership position) on old equity.

Despite these very real drawbacks, old equity may find that making a debt repurchase on its own could be a wise decision. Having ownership at various levels in the capital structure can potentially outweigh any such risks.

If you agree with our logic, the board may not always be in the best position to take up the cudgel to promote old equity’s interests. It may do what it can, but beyond a certain point, the tools available to the board may advance old equity’s cause only so far. Old equity needs its own tool kit.

The tools we would choose for old equity include the following:

- **Board control.** The ability to be at center stage, be privy to financial and other information and to be able to make corporate decisions as to bankruptcies or sales is of incalculable value. Until this control is changed (e.g., by a court), whatever demands are made by other
constituencies can be countered with conditions and counter-demands from the board. Of course, indiscriminate use of board control can be criticized and can get the control person in hot water.

- **Money.** Particularly as long as old equity controls the situation at the board level, any money the company has (or can raise through a rights offering or otherwise) can potentially be used effectively. If old equity determines that a direct investment in the company to repay debt would be inefficient, old equity could buy the debt itself as a discount and use it as currency in the restructuring. Or it could initiate creative exchange transactions to the same effect.

- **Tax Losses.** In many restructuring situations, the company has lost money for years and the cumulative tax loss can be a valuable asset. Old equity can influence whether the value of this asset is diminished through a “change of control,” particularly in an out-of-court context. Frequently, this can be a significant incentive for the creditors to want to negotiate directly with old equity.

All too often, we see boards try to do the right thing for old equity constituencies, and try to chip away at the debt with the expectation that the benefits will accrue to the stockholders. Unfortunately, the beneficiaries tend to be the holders of the debt, rather than the equity.

We are big believers in advancing old equity’s cause, and think that old equity should focus on developing – and using – its tool kit.
Distressed Investment Banking – To the Abyss and Back
2ND EDITION

This updated and revised book on the restructuring of troubled companies provides an insider viewpoint on the methods and complexities of this fascinating area of investment banking. The authors explain the role of investment bankers in troubled company situations and convey difficult concepts in readily understandable terms.

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