RECENT EVOLUTIONS IN DISTRESSED LENDING FOR RESTRUCTURINGS

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Distressed lending is a financing opportunity that comes from working with a company that is in the process of a restructuring. With today's competitive landscape and the availability of capital, leverage levels and EBITDA addbacks are at all-time highs, and the thoroughness of due diligence is at an all-time low.

These facts alone will likely result in additional distressed lending opportunities for some time. Considering other factors, such as trade wars, political unrest, changing interest rates, budget deficits, election concerns, and a recession at some point, things could soon get really busy for professionals in the turnaround and restructuring industry.

Distressed lending has evolved in interesting ways recently, some

with negative implications for lenders or borrowers and some less so. This article examines several of these developments.

Limited Restructuring Experience Creates 'Zombies.' Substantial amounts of capital have been raised by business development companies (BDCs), private credit funds, and other alternative asset vehicles to invest in middle market financings. A significant portion of these funds was raised to finance sponsor-backed buyouts, but competitive pressures to deploy capital are driving many of these firms into distressed lending.

Many of the teams that raised this capital do not have significant experience in workout or distressed credit situations. Therefore, these deal teams may lack the skills and relationships required to evaluate this type of opportunity thoroughly or to manage an existing credit appropriately once performance has deteriorated.

The judgment to determine when to handle a situation with kid gloves, when to be firm, when to force stakeholders to support the business with additional capital, and when to force a sale or bankruptcy process is generally developed through years of experience. The key relationships necessary to navigate a restructuring with the assistance of restructuring advisors, liquidators, distressed investment bankers, and bankruptcy/restructuring counsel are built through the experience of having "been there, done that."

Additionally, the current period of economic expansion has produced managing director-level professionals who have never experienced a recession. A 35-year-old deal professional has only worked in a relatively healthy macroeconomic environment throughout his or her entire career. Having managed a portfolio of middle market debt investments through a recession often provides an expensive education in terms of losses and personal stress. However, the lessons learned in the process are invaluable.

Recently, many restructuring opportunities have come to market when the businesses were "zombies," or too far gone to be saved. Due to a lack of active account management or a full understanding of available options, these companies often don't have enough liquidity—and therefore time—to raise incremental capital or facilitate an orderly sale. Waiting for business performance to improve rather than undertaking a proactive workout strategy often leads to further business deterioration and value destruction. Outcomes for all stakeholders often end up worse than they should have been, and companies are failing that could have restructured.

Sponsor Support Is Not a Given. Sponsors generally are looking to make two to three times their money over a fund's lifetime investment period. The strong economic run of 10+ years has been good for acquirers of businesses. Leverage levels and purchase prices are up, allowing for continued M&A activity at attractive exit multiples.

However, if a distressed business is one of the last remaining investments in an older fund, it is unwise to assume

continued on page 20

continued from page 19

that a sponsor will support it with additional equity. The sponsor may have already achieved or exceeded its target returns and therefore lack incentive to support a distressed portfolio company with new high-risk dollars.

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A Proactive Approach Is the Best Course. The strength of the current fundraising environment has led to pools of capital willing to invest across the full risk spectrum of a company's lifecycle. Just as the market is making new deal opportunities increasingly competitive for lenders, it is also creating options or "saves" in restructuring situations that would not have been available in the past. If the debt investor is proactive in managing the credit, capital solutions are usually available. Assuming the company still has a reason to exist, an investor can capitalize on the current frothy debt markets to trade out of the position or find another capital source willing to take the incremental risk to stabilize a situation.

In addition, the ability to find value in assets has grown with increased capital markets activity. The asset categories investors are willing to lend against, or acquire, when a business is in distress are more extensive than ever. Examples include brand names, IP addresses, customer lists, music libraries, etc. The proliferation of licensing businesses, which have few employees and low fixed costs, has made each of the aforementioned asset classes easier for investors to monetize and manage upon acquisition. These businesses are providing another way to get out of a tough credit.

The Benefit of Technological Disruption. Although technological disruption has created many of the restructuring opportunities that exist today (*e.g.*, Amazon and the total chaos it has created in retail), technology and the resulting access to information can lead to improved potential recoveries and access to capital.

Company information systems are better than ever at providing the data required by a potential investor to evaluate an investment opportunity and perform due diligence. Historically, this was a manual process that led to delays and open questions that ultimately would result in no deal. Once the data are collected, data rooms, email, and other information distribution resources can be used to further share this diligence. Although not perfect in most situations, the likelihood is high that information is available to fully evaluate a potential investment.

When considering restructuring alternatives, timing is key. The ability for investment bankers and advisors to quickly locate potential capital providers or acquirers anywhere in the world can be facilitated right from their desktop using paid database resources or even free internet resources. Communicating with these global solution providers is easier than ever, and foreign capital sources can often be an option.

Conclusion

The evolution of capital providers with limited restructuring experience, a robust capital market motivating different investors in interesting ways, and technological advances have all affected how distressed lenders should be thinking about new opportunities as well as their existing investments. Investing opportunities will continue to evolve and can change quickly. Therefore, each one needs to be monitored tirelessly to optimize performance and recoveries.