Viewpoint

One of a series of opinion columns by bankruptcy professionals.

Coming To A Theater Near You: The Stealth Takeover

By Jonathan S. Henes

An opportunity is arising for companies with cash and strong balance sheets to take over good companies with constrained liquidity and bad balance sheets. These takeovers may be described as hostile (and some may well be), but they will not be the garden-variety takeover -- i.e., the acquiring company directly purchases the stock of the target company.

These will be "stealth takeovers," and their execution will require careful planning and a strong stomach. Specifically, the acquiring company will sneak up on the distressed and over-levered target by accumulating debt and using that debt to take control by converting the target's existing debt into the target's new equity through pre-packaged or pre-arranged Chapter 11 case.

Today's distressed company actively participated in the credit frenzy, borrowing vast amounts of money in an attempt to grow its businesses and increase shareholder wealth. The debt of choice was the leveraged loan. As a result, the capital structure of the distressed company is weighted heavily towards secured debt. At the time the distressed company borrowed, its leverage ratio was high based on normalized standards (but that was a sign of the times). As today's global recession is hammering consumption and spending, the company's earnings before interest, taxes, depreciation and amortization is falling dramatically, lowering value and increasing its leverage ratios to absurd levels. The consequence of this is that the value of the distressed company is in the secured debt.

Standard & Poor's estimates that 209 companies could default in 2009. That is the base case. If the base-case scenario ends up being optimistic, Standard & Poor's predicts that almost 300 companies could default. This is a staggering number of companies. It also translates into a huge opportunity for cash-rich companies and firms to effectuate stealth takeovers.

Here is an overly-simplistic illustration of a stealth takeover. (Note that in the real world nothing about a stealth takeover is simple and clearly the price paid, the trading price and the real investment opportunity can only be determined based on, among other things, industry, growth rate of Ebitda, capital expenditure needs, etc.) Distressed Target has $250 million of funded debt. Specifically, $150 million is senior secured bank debt and the remaining $100 million is high yield unsecured notes. The bank debt, which is held by commercial banks, hedge funds and CLOs, is trading at 50 cents on the dollar. The high yield notes are trading at 15 cents. (The public common stock is trading at below a dollar.) Target's Ebitda is $20 million.

Stealth Acquirer wants to own Distressed Target. There are great synergistic opportunities. Stealth Acquirer is not over-levered and has plenty of cash on its balance sheet. It's clear, based on Distressed Target's Ebitda and debt load, that the value of Distressed Target is in the bank debt. Therefore, to take control of Distressed Target is to take control of Distressed Target's secured debt. Notably, the trading of Distressed Target's bank debt is not regulated. There are no rules or reporting requirements. As a result, Stealth Acquirer can purchase Target's bank debt quietly through assignments or participations and amass a large position in the bank debt without Distressed Target knowing. In doing so, Stealth Acquirer can position itself to "takeover" Distress Target.

To further illustrate the transaction in simple terms (remember, it will not be this simple), Stealth Acquirer buys 51% of Distressed Target's bank debt for 50 cents on the dollar, or $75 million. Stealth Acquirer also purchases 67% of the high yield notes for 15 cents on the dollar, or just over $10 million. Distressed Target is about to be in default of bank debt covenants and will need to approach the bank agent for a waiver to avoid a default. Stealth Acquirer, with 51% of the bank debt, is in control of the waiver process. As a result, Stealth Acquirer approaches the Distressed Target with the following proposal, which would be effectuated through a pre-packaged or pre-arranged Chapter 11 plan:

- Stealth Acquirer will convert its $76.5 million of bank debt into 100% of the new common stock of Reorganized Distressed Target,
- Reorganized Distressed Target will reinstate the remaining $74.5 million of bank debt, leaving it less than four-times levered;
- Stealth Acquirer will "invest" $10 million into the plan of reorganization to be distributed on a pro rata basis to Distressed Target's bond holders for a recovery of 10 cents on the dollar; and
- Reorganized Distressed Target will pay its trade creditors in the ordinary course.

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Based on this strategy, Stealth Acquirer purchased Distress Target and Distressed Target emerged from the restructuring process with a stronger balance sheet.

While this illustration is simple, effectuating a stealth takeover is not. A multitude of real world issues exist, including legal, financial, liquidity and practical issues. To deal with these issues, an acquirer would need to plan well, put together the right team of advisers with appropriate expertise and be ready to plunge into the rough and tumble world of distressed investing. In short, commencing a stealth takeover process is risky business. Nonetheless, with no risk, there is no reward and through careful preparation, strong execution, flexibility, creativity and sustained effort, the reward can be great.

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Jonathan S. Henes is a partner in the restructuring group at Kirkland & Ellis LLP. He can be reached at jhenes@kirkland.com.

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ranking liens on a company's assets, were considered fairly safe and yielded good margins.

Today, businesses lucky enough to obtain a bankruptcy loan pay hefty fees, face interest rates of between 5% and 7% above the London interbank offered rate and agree to restrictive terms that often include a sale of the company within months.

Companies with ample cash reserves, however, can tap their liquidity to continue to pay rent, vendors and employees, while they negotiate a restructuring with creditors under the cover of bankruptcy.

"Bankruptcy can help with a lot of things, but one thing a judge can not do is provide you cash to operate," said Don Workman, a partner in the bankruptcy practice at law firm Baker & Hostetler LLP. "If you have cash, even if it's subject to a lien, the court can help you."

Nevertheless, lenders reluctant to extend bankruptcy financing are watching restructuring clients' cash reserves closely because that money is often collateral for pre-bankruptcy loans. Existing lenders are placing much tougher terms and stricter reporting requirements on cash collateral, said Becky Roof, a managing director with restructuring firm AlixPartners' crisis management practice.

Still, companies are better off entering bankruptcy while they have cash because lenders "conceptually understand" the need to use cash collateral, Roof said. Many companies, she says, are making the mistake of waiting too long to face down their problems in this environment.

"There are still companies hoping for a Hail Mary pass on a sales process or hoping that the economy will turn around," Roof said. "They wrongly assume that if they do file for bankruptcy their friendly neighborhood bank will be happy to extend them debtor-in-possession financing."

Indeed, some business, particularly smaller companies that don't generate as much cash from their operations, may wait to the 11th hour to seek protection from creditors, said bankruptcy attorney James Savin.

"To the extent companies are trying to get their lender group on board to provide financing while in bankruptcy, that works against the advantages of a pre-emptive filing," said Savin, a partner Akin Gump Strauss Hauer & Feld LLP.

Knowing the high costs and uncertainly that a long bankruptcy can cause, companies are also often seeking to negotiate prepackaged bankruptcies or distressed-debt exchanges with lenders and bondholders. Both of those processes take time and cause companies to wait longer to file for Chapter 11 protection, Savin said.

Several companies, including auto makers General Motors Corp. and Chrysler LLC, are currently negotiating distressed-debt exchanges with their bondholders.

Some companies that file with cash-on-hand will still seek out bankruptcy loans, Kirkland's Henes said. But a cash stockpile will allow the company time to asses its options and to negotiate better terms with lenders.

"If you don't need the loan, you have a little more leverage in those negotiations," he said.

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