

Some Cracks in the Façade... Funds Contemplate “The Next Wave”

While the “next wave” of distressed businesses may not have reached the offices of hedge and equity funds yet, it appears the tides may be changing. How will these players deal with the credit crunch? NachmanHaysBrownstein, Inc.’s Howard Brownstein and Tate Pursell discuss the state of these investors’ markets.

By Howard Brod Brownstein and M. Tatum Pursell

Theo Punaval¹ sat in his midtown New York office and contemplated the computer screen on his desk. Quarterly results from the companies in his private equity fund portfolio were in, and he stared at the Excel spreadsheet on his computer even though he’d already read it a dozen times. How could three of the investments under his charge go south at the same time? He glanced at the newspaper headline on his desk: “The Private-Equity Retreat Begins.”²

He looked through that morning’s e-mail traffic. First City Bank was requiring a capital infusion from Theo’s fund in order to waive the covenant defaults of Click! Media, one of his earliest portfolio companies. Midwest Municipal Systems, a promising investment from just last year, was behind on its debt service, and some if its debt had been put into a securitized pool — it had seemed like a brilliant move at the time — but now Theo couldn’t even find anyone to talk to about a forbearance. And Gem Display, Theo’s pet project, a roll-up of point-of-purchase display suppliers, had absolutely hit a wall. Gem’s biggest customer had taken its work in-house, and the rest of its customers seemed like they had lost interest in in-store advertising.

In each of these situations, some of the best people, especially sales reps with “portable” accounts, were starting to jump ship. The management teams that had seemed so capable just a short time before, now appeared to be alternately confused about what to do, yet unwilling to listen to Theo’s suggestions. Most of the time they were in utter denial, sure that things would somehow turn around soon but unable to articulate why. None of these management teams had ever been through a downturn in their businesses before. He had just received a call from a senior lending officer at Gem’s bank, asking whether Theo intended to “step up to the plate,” and intimating that if he didn’t, the bank wouldn’t fund any more deals by Theo’s fund.

To make matters worse, Theo himself didn’t know what to do. He had joined The Themistocles Fund³ following four years at Morgan Fairchild Bank in NYC and London after earning his MBA. At Morgan Fairchild, Theo had distinguished himself on the derivatives desk, trading arcane tranches of obligations owed by distant and unknown companies, or pools of obligations of anonymous debtors. While there had been an elective

offered in his MBA program in turnaround management, few of his friends had taken it, scoffing at the thought that any company, which interviewed at their prestigious business school, would ever have a problem. Instead, everyone took investment banking and courses on hedge and private equity funds. He had gotten straight A’s in those courses, but had never worked in a company like those in his portfolio.

He sat on the board of directors of all three and, until recently, all of the news had been good. The first suggestion of any problems had occurred several months earlier, but the management teams of each company had explained those away and had seemed quite unalarmed. Theo wondered if more could or should have been done back then.

At the weekly meeting of fund principals this morning, Theo had found out he wasn’t the only one on the hot seat. Two other principals had problems in their portfolios. One reported that he had even met with a bankruptcy lawyer the day before. The fund’s CFO discussed the amount of leverage on Themistocles’ balance sheet, and that its loan covenants required “marking to market” its investments on a quarterly basis. He predicted he’d be having a “difficult conversation” with the fund’s bank group when the quarter ended. In the meantime, the “carry” earned by the fund and its principals had been curtailed substantially, and the base draw that the principals received had been discontinued indefinitely.

Theo was shaken. He didn’t know what to do. His fellow fund portfolio managers were no better prepared than he was. One of them had a background in engineering and had worked in an operating company before returning to business school, but none of them had ever been through a turnaround, much less a restructuring or a bankruptcy reorganization.

Waiting for the Next Wave to Strike

The above scenario is not far-fetched. While the “next wave” of distressed businesses may not have reached the offices of hedge and equity funds yet, it appears there may be cracks in the façade. Sources of senior debt, like regulated depository institutions and first-line finance companies, have already toughened credit terms, even if it seems to these traditional competitors as if like funds are still pushing money out the door.

Recent gyrations in capital markets — especially abroad — surrounding the subprime mortgage meltdown suggest that the wave has already begun. Several large proposed debt deals have had to be pulled off the market where only a few months ago they would have sailed through. Commentator after commentator has marshaled the arguments: rising interest costs, overleveraged companies, inflated multiples, and an intractable war in Iraq, just to name a few.

One grisly prediction has us only a “suitcase bomb” away from a recession. Other more sanguine observers predict only industry-specific problems, but no structural issues, citing the much broader array of capital providers that have entered the markets over the last several years.

And yet, the economy soldiers on unperturbed, with growth, unemployment and inflation all pointing to continued good times. Some have suggested that we feel guilty about the legs of the current strong economy, and are trying to talk ourselves into a downturn. Maybe, as many say, the amount of liquidity pouring in through hedge and equity funds is simply overpowering, sufficient to neutralize any degree of financial leverage, any level of over-optimism, any amount of bad political or economic news.

For several years now, Chapter 11 has been used mainly to disinfect and bless a sale rather than to restructure debt and equity. The wide availability of second lien capital and the complex relationships between tranches of debt may make the next wave a shoving match in the conference room rather than a race to the bankruptcy courthouse. And as long as a fund is willing to write a check, issues quickly disappear.

As a venerable ancestor used to say, “There’s no problem until there’s a problem,” meaning that until the water in the pond is lowered, the rocks may never appear. So the level of preparation — or lack of same — of funds for “the next wave” may never be discovered. Whether fund managers will be caught flat-footed, like our hero Theophilus PunaVal, remains to be seen.

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Of course, some funds regularly play in the distressed arena and are conversant and comfortable with the methods of corporate renewal. Such investors go in with their eyes open to the risks involved, and aren’t surprised when things don’t go as planned. Many of these have included within their organizations experienced workout lenders with a nose for trouble; others have a bench of industry executives ready to send into the game if necessary.

While the latter may not be experienced in dealing with business distress, some funds have forged strong relationships with leading turnaround firms on whom they rely both for “front-end” due diligence as well as back-end troubleshooting. One leading fund investing in distressed businesses plans to take a more hands-on approach, installing a new CEO from the beginning rather than giving the former management team (that got the company into trouble) another chance. This fund also plans to bring an experienced operating executive on-staff to supplement their existing relationships with turnaround firms.

However, for the funds that haven’t (intentionally) invested in distressed deals, and instead have launched themselves on a different sort of high-risk trajectory involving increased multiples for valuation and few safeguards against disappointing performance, the questions about

their degree of preparation remain. How many of their managers have ever been through a downturn, have ever managed a company through a restructuring or a reorganization, or understand the process of corporate renewal? How many really understand the businesses of their investments, what the profit drivers are, what the risks are, and how to monitor and manage them?

Seth Lehr of LLR in Philadelphia says, “Our returns are determined by our possible losses, not our wins,” so LLR doesn’t employ significant leverage and keeps itself vigilant about possible changes in the fortunes of its portfolio companies. Although LLR itself doesn’t invest in distressed companies, it is knowledgeable about the process of corporate renewal, including bankruptcy reorganization if necessary. While not naming names, he sees many other funds as far more leveraged, and therefore more susceptible to a downturn. While he doesn’t know their organizations intimately, he suspects that the relative youth of many portfolio managers implies they haven’t been through the bottom cycle of the economy and haven’t learned hands-on how to manage business distress.

The Buyers Come Charging In

Theo picked up the phone, and called one of his buddies at Blitzkrieg Capital, a few blocks away. Blitzkrieg had been sniffing around Themistocles’ portfolio for weeks, preferring to buy portfolios of investments made by other funds rather than originate its own. He rattled off the stats on Click! Media, Midwest Municipal Systems and Gem Display from memory.

He was honest about the current situation at each company, the challenges that each faced. But he made up a story about wanting to monetize some of its investments in order to make some fresh new bets in hot industries like gaming, so, Theo bravely explained, he wouldn’t think of selling at less than its original acquisition cost. Theo swallowed hard and waited to hear his reply. “I’ll have a letter of intent for all three on your desk by the end of business today,” he told Theo. **abfj**

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ENDNOTES:

- 1 “Theophilus PunaVal” is a fictitious name.
- 2 The Wall Street Journal, August 27, 2007
- 3 Themistocles was an Athenian general and statesman who said, “I cannot fiddle, but I can make a great state of a small city.”