BAYLOR UNIVERSITY

A Note on Distressed Investing

Buying companies by acquiring their debt

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Our objective in this paper is to provide a pedagogical discussion of the process by which creditors take control of distressed firms. Distress or vulture investing requires a high level of business acumen combined with deep knowledge of accounting, finance, and corporate and restructuring law. Moreover, the process entails active involvement, as opposed to passive investing in publicly traded securities, as the investor seeks control over the distressed firm's equity. The process is made more risky and difficult by the many conflicting interests of creditors and equity holders who work throughout the process to protect their individual interests. We are motivated by the growing number of distress investors, and essential nature of their role to the functioning of capital markets.

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A Note on Distressed Investing: Buying Companies by Acquiring their Debt

by Stephen G Moyer, David Martin, and John Martin[1]

Acquiring control of a company typically involves buying the firm's equity and then assuming its liabilities. For example, when Chevron purchased Atlas Energy in February of 2011, it paid Atlas's shareholders $46.53 per share for their stock and assumed the firm's debt. The net result was that Chevron paid $3.2 billion in cash and assumed $1.1 billion in net debt[2] to complete the transaction. But it is possible to acquire control of a company without paying anything to the firm's current equity holders when the firm is financially distressed and cannot pay its debt obligations in a timely way. In this circumstance the value of the distressed firm has declined such that its equity—and possibly the value of other securities in its capital structure—may be reduced or wiped out entirely if the firm files for bankruptcy or gets restructured outside of court.[3]

The process of acquiring control of a firm's assets by investing in its debt prior to or during a restructuring of its capital is known as distressed or "Vulture" investing.[4] Distressed investing can be thought of as a form of "value investing." Both value and distressed investors invest in securities of firms that they feel are undervalued. However, unlike value investing where returns arise through an appreciation of the purchased security in its original form (e.g., shares of stock), in distressed investing the returns often come from securities received in exchange for the ones originally purchased (e.g., common stock received in exchange for debt purchased in the distressed firm).

The term vulture investor, popularized by Hillary Rosenberg in her book *The Vulture Investors*, comes from the notion that the investor "preys" on the distressed firm in hopes of gaining control over all or a portion of its firm's assets at a bargain price. In this setting, it is not hard to imagine why the atmosphere in which vulture investments are made is frequently contentious, since some of the security

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[2] The term "net debt" refers to total interest bearing debt (short- and long-term) less the firm's cash and marketable securities balance. The reason for deducting cash and marketable securities from the firm's debt is based on the assumption that the firm could, if it chose to, reduce its debt by paying it down using these cash reserves.

[3] For example, on November 29, 2011 American Airlines (AMR) filed for Chapter 11 bankruptcy and its stock closed trading at $0.26 per share, down from more than $8.00 a few months earlier.

[4] The term vulture investing has been used in a broader context than discussed here. One of the more colorful involved the Fortress Investment Group which recently raised a $500 million fund to purchase life insurance policies which pay off when the original purchaser of the policy expires (Leslie Scism, Vulture Investor Battles for Death-Bet Payouts, Wall Street Journal (April 19, 2012).

holders of the distressed firm face the prospect of losing some or all of their investment. These "battles" are usually waged among competing groups of experienced institutional investors who have purchased the various claims at prices they thought were attractive at the time of purchase, and the process can be a zero-sum game where some investors clearly lose. As a result, distressed investors have garnered a well-deserved reputation for being ruthless.

Well-known distressed investors include Leon Black, Martin Whitman, Marc Lazary and Carl Icahn, as well as a growing list of private equity firms.[5] However, many are surprised to learn that mild-mannered Warren Buffett has long been an investor in distressed companies. For example, Berkshire bought $255 million of senior, unsecured notes of Seitel, Inc., a provider of geological data to oil companies, in the hopes of gaining control of the firm which was in bankruptcy at the time. However, the planned takeover failed as Berkshire was paid off and did not get control of the firm.[6]

There is nothing inherently wrong with distressed investing. In fact, distressed investors are a critical component of the U.S. capital markets. Bernstein (2007) suggests that the ease with which corporate debt claims can be traded today means that the holders of the debt of a distressed firm changes rapidly as the firm's distress becomes known. The original lenders, who presumably were anticipating a relatively low risk, performing debt instrument, are replaced by distress investors (i.e., hedge funds and other sophisticated investors) who have the risk-tolerance to participate in the restructuring of the firm.

Thus, distressed investors are a valuable source of liquidity that enables the original investors/lenders to the company to sell their investment and mitigate their exposure to the often risky process of bankruptcy, and as such distressed investors facilitate the restructuring of failed firms.[7] In fact, Baird and Rasmussen (2002) point out that the majority of firms that experience financial distress today never enter bankruptcy. Moreover, as we discuss below, the firms that do enter Chapter 11 often have a pre-arranged plan to expedite the bankruptcy process. The point we want to make here is that the traditional notion of Chapter 11 as the principal forum where creditors, shareholders, and board of

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[5] The list of distressed debt investors is long and growing, however, some of the prominent players include: Anchorage Capital Partners, Angelo Gordon & Co., Avenue Capital Group, Baupost Group, Canyon Capital Advisors, Cerberus Capital Management, Marathon Capital Management, Oaktree Capital Management, Silver Point Capital and Third Avenue Capital. Firms that originally focused on classic private equity investments and now also are active in the distressed investing market include Apollo, Carlyle, and Platinum.

[6] http://www.nytimes.com/2003/12/30/business/company-news-seitel-investors-end-buyout-plan-by-buffett.html.

[7] Bernstein (2007) points out that the revision of bankruptcy law that came with the Bankruptcy Code Act of 1978 was a critical element in the move toward a market driven restructuring process as creditors can now achieve a bargained for, as opposed to a litigated, resolution of the firm's financial distress.

directors negotiate the firm's future is fast fading away.[8] Replacing the old administrated system is a market driven process in which the distressed investor is a key player.

In this article, we discuss a specific form of proactive distressed investing—one that involves acquiring control of a firm's assets by investing in its debt prior to a restructuring event.[9] Lack of awareness of the process by which creditors take control of distressed firms, the growing number of distressed investors, and the importance of the function they play in the economy are the principal motivations for writing this paper.

The paper is organized as follows: In Section 1 we describe the restructuring process in terms of three steps: valuation of the distressed firm's assets, development of a new capital structure for the distressed firm, and execution of the plan to gain control of the distressed firm and implement the new capital structure. Section 2 uses a hypothetical case study to illustrate the three-step process and the fact that distressed investing is more than a mechanical process or mere financial exercise. To successfully navigate the three-step investing process the distress investor must consider a host of legal, financial, and behavioral problems. Section 3 examines the potential for profits from distressed investing in the context of our hypothetical example. The purpose of this discussion is to explore the risk-reward proposition of distressed investing. Section 4 provides a discussion of the factors that conspire to make successful distressed investing difficult. The potential profits from distressed investing come out of various structural and behavioral aspects of the market and the complexity encountered in both valuing the distressed firm and constructing and executing a successful restructuring plan. Finally, Section five offers summary remarks.

1 The Three-Step Restructuring Process

The objective of the form of distressed investing we will be considering here is to acquire the post-reorganization equity of a distressed firm at a discount by purchasing what the distressed investor hopes are undervalued debt claims. We discuss the process of gaining control of the equity of a distressed firm as a three-step process.

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[8] Using a sample of firms that emerged from Bankruptcy in 2002, Baird and Rasmussen (2003) documented that only 24% of bankruptcy filers did not have a plan in place to reorganize the firm at the time of the firm's bankruptcy. This compares to 88% of the filers during the 1980s.

[9] There are other reasons for investing in the debt of a distressed firm by investors who *do not* seek control of the company. Most simply, if the distressed investor believes that the restructuring will ultimately be successful, then purchasing the firm's debt at distressed prices prior to the restructuring can be a way to participate in the value gains of the restructuring. This is a form of passive investing whereby the investor does not seek an active role in the restructuring process but hopes to benefit from the actions of other, more-active investors.

Step 1: *Value the underlying business/assets of the firm*. The fundamental question that must be answered first is what is the value of the firm's assets? This value determines to a large extent which of the firm's creditors will be entitled to receive a partial or full recovery. That is, which creditors are "in the money". Their recovery could be in cash, new securities, or some combination thereof. For example, if the firm's assets are estimated to be worth $100 million and it has outstanding senior debt claims of $150 million together with more junior preferred and common equity, then it is likely that only the senior debt claims will receive at least a portion of the face value of their claim and, unless the company is being liquidated, it will probably receive new debt or equity securities rather than cash.

The last creditor tranche or group that receives anything in the restructured firm is commonly referred to as the "fulcrum security"; since the owner(s) of this tranche[10] of securities tends to gain control of the restructured firm's equity through the restructuring process.[11] To simplify our discussion we will refer to the "fulcrum security" as a single tranche of a firm's debt. In practice the fulcrum security is the tranche or tranches that will receive all or a majority of their recovery in the form of the post-reorganization equity. It is the fulcrum security owners that then will control the equity of the restructured firm.

Step 2*:* *Determine the appropriate capital structure for the restructured business*. Step 2 addresses the issue of how to "re-size" or best capitalize the business given that in most cases some business or economic challenge has caused the business to decline in value relative to where it was when the firm was originally financed. A number of considerations, both financial and political, will be factored into the appropriate capital structure of the restructured firm and this will, in turn, affect the identification of the fulcrum security and the form or type of recovery that the various "in the money" constituencies of creditors will receive.

From a financial perspective, the firm's "debt capacity", might be viewed as the upper limit of how much debt should be left on the firm. Although maximizing leverage is often one approach to improving potential equity returns, it obviously increases risk and thus the parties to the restructuring may view a less levered capital structure as more appropriate. For example, in the

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[10] The term tranche (French for slice) as it is used here refers to a collection of securities that share the same recovery priority. That is, the most senior tranche might consist of a firm's secured debt; the next tranche might include unsecured debt, and so forth.

[11] There are circumstances where the majority of the post-reorganization equity does not go to the owners of the fulcrum security. For example, consider a company that has $100 million of secured bank debt, $100 million of unsecured bonds, and no other securities other than its equity. If the firm were valued at $101 million dollars, the recovery waterfall (discussed *infra*) would technically end within the unsecured bond tranche; however, the majority of the equity would likely go to the secured bank debt.

Washington Group restructuring, the creditors believed reducing or eliminating the perceived risk that the construction firm might default in the future was so critical to winning future business and obtaining project bonding, that the restructured entity initially had no long-term debt.[12] The post-restructuring debt level may also impact which pre-restructuring tranches will receive debt versus equity in the restructuring.[13] Those that receive equity become the new owners of the firm and their pre-restructuring debt tranche is the fulcrum security.

A distinctive feature of distressed investing is that the new equity is typically created by the conversion of the fulcrum tranche(s) of the firm's debt into ownership of a majority of the firm's equity.[14] As a result, the distressed holders of that debt will assume control of the firm's equity and hence control the restructured firm's assets.

Step 3: *Execute the restructuring plan*. In this step the company's pre-reorganization capital structure is replaced by the new capital structure derived in Step 2 either through a bankruptcy or out-of-court process. In the restructuring process, holders of the company's securities are distributed something of value in satisfaction of their claim, unless their securities are deemed worthless or "out-of-the-money" and either "wiped out" in a bankruptcy process or materially diluted in a voluntary exchange. As we noted earlier in Step 1 the distribution can include cash, securities (debt or equity), or some combination of the two.

In certain situations the distressed firm may raise new capital by borrowing or issuing new securities in the capital markets. Such capital is typically used to repay some of the claims of the pre-restructuring creditors.[15] Under the scenario where no capital is raised through the capital

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[12] There are many examples of situations where post-reorganization capital structures contained less debt than what might be argued to be the firm's theoretical debt capacity based on projections. A very recent case involved the proposed reorganization of Hawker Beechcraft Corporation, where the proposed reorganization contemplated only $400 million in debt compared to the firm's prior approximately $2.4 billion in debt. However, given that prospective customers of the aircraft manufacturer are going to be very concerned about its long term viability as this would impact the outlook for future maintenance and part availability, it was likely deemed prudent by the various parties to have an "under-leveraged" company that would implicitly convey to customers that the risk of future financial difficulties was very small.

[13] In many cases it may be that recoveries will include both new debt securities as well as equity. So it may be more accurate to say that the post-restructuring debt level may impact the composition of the recovery in-terms of cash, new debt or new equity rather than suggest it will determine a single form (e.g. debt or equity) of recovery.

[14] In some situations, in addition to "equitizing" some of the firm's existing debt the distressed investor will also invest new capital, typically structured as equity or a junior security convertible into equity, in order for a potentially cash-strapped firm to accomplish certain operating objectives.

[15] In some circumstances some of the cash raised is retained by the company in order to fund the business going forward. However, it is often the case that when third party capital is raised during a bankruptcy it is to be used for exit financing to pay off an onerous debtor in possession (DIP). In the most recent cycle, it was relatively

markets, the firm's pre-reorganization creditors will receive newly issued securities (which can include debt, equity, or some combination) in satisfaction of their claims.

2 Illustrating the Distressed Investing Process—HomeMax Inc.

Since distressed investing can be extremely complicated, we use a hypothetical company named HomeMax Inc. (HomeMax) to illustrate the process. HomeMax is financially distressed and facing the prospect of bankruptcy or an out-of-court restructuring (i.e., workout). The firm was a successful regional home supply retailer operating in the prosperous northwestern U.S. Although it competed with Home Depot and Lowes, it successfully differentiated itself by targeting upscale customers with higher-end appliances and fixtures in combination with superior interior design services.

The HomeMax Story: A Path to Financial Distress

HomeMax was a late-2003 leveraged-buyout by Train & Co. (Train), a well-regarded private equity investment firm, which purchased HomeMax just as the recovery from the 2000-2002 recession began to accelerate. Train paid $562.5 million for HomeMax, which in 2003 generated $75 million in earnings before interest, taxes, depreciation and amortization (EBITDA) on revenues of $500 million. The price paid by Train represented a valuation multiple of 7.5 times (in the industry, and hereafter in this article, this will be expressed as "7.5x") EBITDA, which was in-line with where retailers were being valued at that time.[16] Train financed the acquisition, which included approximately $75 million of

more common to raise exit financing type capital from existing participants in the capital structure via a rights offering rather than using the capital markets.

[16] We assume that the reader is generally familiar with the basic process of corporate valuation using the enterprise value (EV) to Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) approach. Under the EV/EBITDA approach, the EV (which in simple terms is a company's net debt plus the market capitalization of its equity) of a company is compared to its EBITDA and a ratio is developed. At its base the method uses a "relative to peers" methodology that assumes that companies in the same industry (and hence their future cash flow generation capability face a similar set of risks) should be valued somewhat similarly. If the investor believes the prospects for widget manufacturing are likely to improve for some reason and wants to invest in a widget manufacturer, the investor might perform a peer EV/EBITDA analysis and determine how the existing market values several widget makers. Assume Widget Companies A, B & C had EV/EBITDA ratios of 5.2x, 7.7x and 6.8x, respectively. If all things were equal (which they never are but is always the fictitious assumption made) then the investor would be most attracted to A because its future cash flows are selling for less than those of B & C. In simple stock market parlance, the EV/EBITDA relative value approach is similar to the Stock Price/EPS (Earnings per Share) multiple valuation approach. If Widget Companies A, B & C had stocks that traded at EPS multiples of 13x, 18x and 16x, then all things being equal A's stock appears cheaper because you are paying relatively less for a share of its future earnings compared to competitors B & C. Similarly, if the investor wanted a safe U.S. Treasury Bond and saw one 60 month maturity selling for a yield of 3.2% and another 58-month maturity selling for a yield of 3.4%, he would likely buy the 58-month maturity bond and so would other market participants until the price of the 58-month bond was bid up to the point that the bond yielded the same as, or slightly less than, the 60 month bond. In the Treasury market, the assumption of "all other things being equal" is fairly close to reality so one would expect pricing anomalies to be quickly arbitraged

assumed liabilities, with $200 million in secured bank debt, $100 million in senior notes and an equity contribution of $262.5 million. Summary data for the leveraged acquisition are set forth below in Exhibit 1.

Exhibit 1. Summary Data For Acquisition of HomeMax

2003 Operating Performance	($MM)	Sources	($MM)	Uses (Post Acqusition)	($MM)
Revenue	$ 500.00	1st Lien Loan	$ 200.00	Cash	$ 10.00
COGS	350.00	Sr Notes	100.00	Accounts Receivable	20.55
Operating Income	$ 150.00	Assumed Liabilities	74.72	Inventory	61.64
Sell, Gen. & Adm. Exp.	$ 75.00	Equity Contribution	187.78	Goodwill	370.31
Depr. & Amor. Exp.	10.00			Prop. Pl. & Eq.	100.00
Interest Exp	20.00		$ 562.50		$ 562.50
Earnings before Tax	$ 45.00		**Valuation**		
Tax	(14.40)		Latest Twelve Months (LTM) EBITDA		$ 75.00
Net Income	$ 30.60			Valuation Multiple	7.5x
EBITDA	$ 75.00			Acquisition Price	$ 562.50

Initially, the acquisition appeared to be a stroke of genius. As the economy recovered and housing expanded at record rates, sales grew approximately 15% annually and Train's operating execution expanded its EBITDA margin (EBITDA/Revenues) from 15% to 19%. HomeMax began generating so much free cash-flow that Train immediately started extracting dividends and by the end of 2006 had reduced its net equity investment to slightly over $100 million. Had it sold HomeMax at that time for the then going market multiple for retailers of 8.5x EBITDA, it might have generated an investment gain of approximately $800 million!

But, it did not. Instead, impressed with its investment acumen and buoyed by its still bullish outlook for the housing market, Train decided to make a significant acquisition to rapidly expand HomeMax into Northern California—a contiguous, and similarly upscale geographic region—by purchasing HomeLux, a strategically similarly home product retailer. HomeLux, in Train's view, was almost exactly like HomeMax in 2003 but with even better upside potential. In 2006 it generated $500 million in revenue but only $60 million in EBITDA representing an EBITDA margin of 12% compared to the 19% earned by HomeMax's. Assuming Train could quickly integrate HomeLux's operations with HomeMax and generate comparable operating results (if not improved results given the larger operating scale). So confident was HomeMax it could realize significant operating synergies that it agreed to buy HomeLux for a slight premium of 9.0x HomeLux's 2006 EBITDA of $60 million or $540 million. After taking into account $70 million in assumed liabilities, HomeMax financed the transaction with $325

out of the market. In the valuation of companies, the industry might be similar but the strategies, management teams, brand strengths, etc. of all the competitors are typically somewhat different and thus valuation differences will persist because of investors' rational assessments of what those differences in fact imply about the future cash generation capability of that particular company relative to its peers.

million in debt and a $145 million equity contribution (which was actually less than the dividends they had already extracted from HomeMax—so in a sense they were purchasing HomeLux with no additional investor capital). Summary data relating to the HomeLux acquisition is set forth below in Exhibit 2.

Exhibit 2. Summary Data For Acquisition of HomeLux

2006 Operating Performance	($MM)	Sources	($MM)	Uses (Post Acqusition)	($MM)
Revenue	$ 500.00	Addit'l 1st Lien	$ 50	Cash	$ -
COGS	150.00	New 2nd Lien	150	Accounts Receivable	22.00
Operating Income	$ 130.00	New Sr Notes	125	Inventory	60.00
Sell, Gen. & Adm. Exp.	70.00	Assumed Liabilities	70	Goodwill	358.00
Depr. & Amor. Exp.	10.00	Equity Contribution	145	Prop. Pl. & Eq.	100.00
Interest Exp	-		$ 540		$ 540.00
Earnings before Tax	$ 50.00		**Valuation**		
Tax	(17.50)			Latest Twelve Months (LTM) EBITDA	$ 60.00
Net Income	$ 32.50			Valuation Multiple	9.x
EBITDA	$ 60.00			Acquisition Price	$ 540.00

However, things did not go as planned. Train, like almost everyone else, had not foreseen the housing collapse in late-2007 and the significant recession which ensued. The enlarged HomeMax suffered revenue declines of 20% in 2008 and 15% in 2009 and the EBITDA margin collapsed to as low as 6% resulting in moderate negative cash flow (see Exhibit 3 below). While this might have been financed with incremental secured bank debt, the banks had almost completely withdrawn from the market at that time and Train was forced to contribute incremental equity in 2009 and 2010 just to keep HomeMax solvent.

Exhibit 3. HomeMax Post-Acquisition Operating Performance

($MM)	2007	2008	2009	2010	2011
Revenue	$ 1,264.9	$ 1,011.9	$ 860.1	$ 868.7	$ 886.10
Operating Margin	417.4	253.0	215.0	217.2	239.25
EBITDA	215.0	70.8	51.6	52.1	79.75
Interest Expense	47.0	47.0	47.0	47.0	47.00
Capital Expenditures	35.0	20.0	20.0	20.0	22.00
Free Cash Flow	$ 133.0	$ 3.8	$ (15.4)	$ (14.9)	$ 10.75
% Change in Revenue		-20.0%	-15.0%	1.0%	2.0%
Operating Margin	33.0%	25.0%	25.0%	25.0%	27.0%
EBITDA/Revenues %	17.0%	7.0%	6.0%	6.0%	9.0%

HomeMax's Current Financial Condition

Let's assume that it is now the first calendar quarter of 2012. After reviewing the performance data in Exhibit 3 it appears that the economy stabilized in 2011, HomeMax' operations improved significantly and, compared to 2010, its EBITDA improved approximately 50% to $79.75 million during 2011. However, as shown in Exhibit 4 below, at the end of 2011 HomeMax's total debt is $625 million such that the firm's financial leverage is 7.8x EBITDA.

Exhibit 4. Summary Balance Sheet & Capital Structure Detail

Panel a. Summary Balance Sheet Data

	2007	2008	2009	2010	2011
Cash	$ 22.9	$ 26.2	$ 21.2	$ 14.2	$ 24.9
Accounts Receivable	76.2	44.4	35.3	38.1	36.4
Inventory	173.3	207.9	153.2	119.0	109.2
Property, Plant and Equipment	227.2	224.5	222.0	219.8	219.8
GoodWill	803.0	803.0	803.0	803.0	803.0
Total Assets	$ 1,302.7	$ 1,306.0	$ 1,234.8	$ 1,194.1	$ 1,193.4
Accts. Payable	$ 231.0	$ 233.6	$ 174.6	$ 145.4	$ 137.4
Total Debt	625.0	625.0	625.0	625.0	625.0
Total Liabilities	856.03	858.60	799.56	770.45	762.42
Equity	$ 446.6	$ 447.4	$ 435.3	$ 423.7	$ 431.0
Liab.'s & Owmers' Equity	$ 1,302.7	$ 1,306.0	$ 1,234.8	$ 1,194.1	$ 1,193.4

Panel b. Capital Structure at Yearend 2011 ($MM)

EBITDA =	79.75			Marker Price	Leverage
Instrument		Amount	Leverage	Multiple 1	Multiple 2
1L Bank Debt due 12/31/12		250.0	3.1x	100%	3.1x
2L Bank Debt due 12/31/12		150.0	5.x	92%	4.9x
Sr Notes due 6/30/14		100.0			
Sr Notes due 9/30/15		125.0	7.8x	56%	6.6x
Total Debt		625.0			

[1]Market prices estimated.

[2]Leverage at market price calculation assumes more senior tranches are paid off at par.

This poses a serious problem for Train. Given HomeMax's slower growth outlook in general, and the mixed outlook for housing at the end of 2011, the market valuation multiple for firms like HomeMax had declined to 7.0x EBITDA, implying a total enterprise value for HomeMax of only $558 million (i.e., 7 x $79.75 million). Since HomeMax's total debt is $625 million Train is materially underwater, (i.e. it has lost all of its equity investment). Putting Train aside, HomeMax also has a looming liquidity problem because both its first- and second-lien secured notes (herein after referred to as "1L" and "2L", respectively) mature at the end of the current year on December 31, 2012. Furthermore, HomeMax's bankers have advised the firm that it is very unlikely these can be refinanced for at least two reasons: First, the 1L and 2L debt in aggregate represent $400 million or 5.0x leverage, which is significantly more than the 3.0 to 3.5x leverage that lenders are willing to extend in the current climate. Second, the $100 million in senior notes that Train used to finance the original HomeMax buyout in 2004 are maturing in 2014. This is a problem because even if a lender could be found to refinance the maturing 1L and 2L debt, they would be reluctant to do so because in just two years HomeMax will face another refinancing challenge and right now it looks like there is not sufficient enterprise value to cover the senior

notes, (i.e., HomeMax's enterprise value is only $558 million compared to its total debt of $625 million) so the Senior Notes (collectively the senior notes due 6/30/14 and the senior notes due 9/30/15) appear to be impossible to refinance. In other words, even if the secured debt is refinanced, a restructuring or bankruptcy shortly thereafter is a significant risk and few lenders, even distressed investors, like to assume that much risk and uncertainty. This would be particularly true in HomeMax's case. A close examination of HomeMax's balance sheet in Exhibit 4 reveals that tangible assets, the kind of assets that in the worst case liquidation scenario a secured creditor would seize and sell, only amount to $390 million (i.e., total assets less goodwill)[17], well below the $500 million in aggregate 1L and 2L debt. So Train and HomeMax have a problem.

Enter the Distressed Investors

None of HomeMax' travails will have gone unnoticed by the distressed investor community. Exhibit 5 below shows the projected value of HomeMax' various debt tranches over time. The methodology used to derive these estimates is roughly the same as investors would employ in trying to establish the value of the various debt tranches. First, as discussed above, the investor would estimate the enterprise value of HomeMax using recent and expected future operating performance and current market valuation metrics.[18] Then this valuation would be compared against the capital structure, in priority of recovery,[19] to estimate the recoveries that could be expected if the company were forced to file bankruptcy at that time.[20]

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[17] Under GAAP, this figure will usually be presented on a historical cost (less depreciation for depreciable assets) basis. In general, creditors will assume that in a liquidation items like inventory and store fixtures will likely realize significantly less than their GAAP carrying value. So a prospective lender would likely assume that the tangible asset collateral would be worth far less than "book" value which would only magnify the potential risks of making a loan when the risk of a future bankruptcy was significant.

[18] We do not claim that the valuation multiples are representative of valuations during the periods in question, but they are, in our view, plausible given the economic environment at the time. For a more general discussion of the impact of changes in the business cycle on analyst's valuation estimates see Damodaran (2009) or Koller (2010).

[19] Under the "absolute priority" doctrine of the U.S. Bankruptcy Code (BRC), as encapsulated in §1129, recoveries are distributed by priority of class. For example, first the 1L secured loans are paid in full, then the 2L notes until paid in full, then the Senior Notes and, if anything is left over, then the equity. This is sometimes referred to as the recovery waterfall: the recovery bucket of a more junior class does not receive any water (value) unless there is enough water to entirely fill the more senior bucket and then value spills over into the more junior bucket.

[20] Most distressed investors approach an analysis of prospective recoveries fairly conservatively given that there are many risks associated with a prospective bankruptcy. In addition, unless the distressed investor has high conviction about the macro-economic environment they will likely also be conservative on this front.

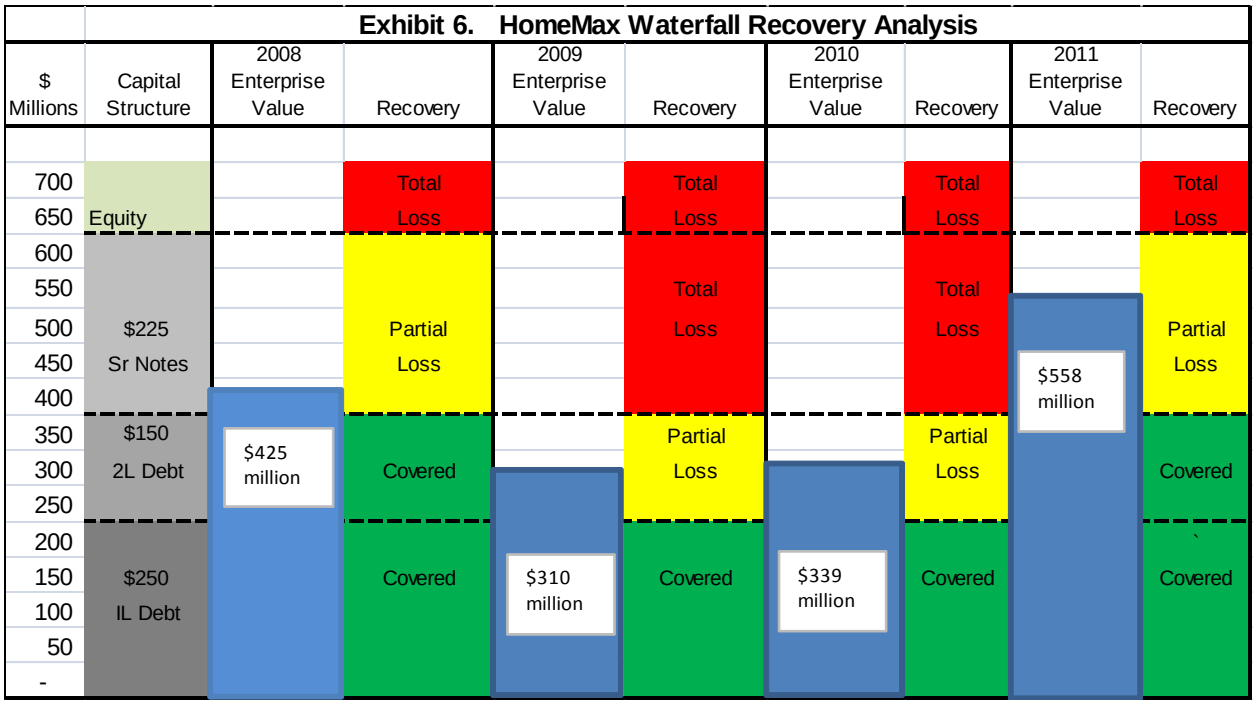
Exhibit 5. Projected Recovery Values of Debt Tranches					
($MM)	2007	2008	2009	2010	2011
EBITDA ($MM)	$ 215.03	$ 70.83	$ 51.61	$ 52.12	$ 79.75
Valuation Multiple	7.50	6.00	6.00	6.50	7.00
Enterprise Value ($MM)	$ 1,612.73	$ 425.00	$ 309.65	$ 338.80	$ 558.24
1st Lien Loan Amount ($MM)	250.00	250.00	250.00	250.00	250.00
Value for more Junior Creditors ($MM)	$ 1,362.73	$ 175.00	$ 59.65	$ 88.80	$ 308.24
2nd Lien Loan Amount ($MM)	$ 150.00	$ 150.00	$ 150.00	$ 150.00	$ 150.00
Estimated Recovery	100%	100%	40%	59%	100%
Value for more Junior Creditors ($MM)	$ 1,212.7	$ 25.0	$ (90.4)	$ (61.2)	$ 158.2
Senior Note Amount ($MM)	$ 225.0	$ 225.0	$ 225.0	$ 225.0	$ 225.0
Estimated Recovery %	100%	11%	0%	0%	70%

The volatility of HomeMax's EBITDA and the related valuation may appear startling. However, many enterprises can have drastic swings in operating performance and what has been modeled here, while severe, is not implausible.[21] When investors confront such volatility, particularly the original lenders who were hoping for a reasonably certain return of capital as their primary investment scenario, they understandably become concerned about the viability of highly leveraged businesses. This is what creates the opportunity for the distressed investor—but it is obviously not a risk-free endeavor. For example, in 2009 when HomeMax incurred almost $15 million in negative cash flow (Exhibit 3) and it was very unclear that the housing market had bottomed, its viability would have certainly been in question.

The recovery implications of the volatility in enterprise value observed in Exhibit 5 are illustrated graphically in Exhibit 6 as a "waterfall" recovery analysis. The notion of the waterfall is a euphemism for the value that is available to fund the recovery of the money owed by HomeMax to its various classes of creditors. In 2010, for example, while there appeared to be sufficient value to "cover" 100% of the 1L debt, 60% of the 2L debt, and none of the Senior Notes. Thus one would have expected that the trading value of the 2L debt to have been in the 50s or lower (realize that if the distressed investor only believes the recovery value is 60, he will have to bid less in order to make a profit).

[21] The main driver of the decline was a 20% decline in sales which is not unheard of for retailers. For example, during the decade beginning in 2000 Home Depot (HD) experienced double digit annual changes in sales in seven of ten years with sales increasing by 19% in 2001 and falling by 14% in 2008. Faced with a decline in revenues and an inability to immediately adjust overhead, a 5% decline in gross margin is not uncommon.

Exhibit 6. HomeMax Waterfall Recovery Analysis



The senior notes would trade at even larger discounts—perhaps between 10 – 25% of par. Why would anyone be willing to pay 20 for notes that appear to have no recovery value? There are several reasons. First, the investor would consider the probability of getting one or more years of the 10% coupon. If the investor thought it was reasonably likely he would receive one year of coupons, then his effective net cost would be reduced to 10. If the investor thought HomeMax would pay the coupon for two years, then he would recoup his investment and yet still have a claim which effectively represents substantial option value if HomeMax recovers.

Second, the distressed investor would consider what Train might be willing to do. As of 2009 or 2010, Train was clearly out of the money based on the valuation, but if Train believes that HomeMax' operational challenge is simply due to a cyclical downturn in the economy, then Train may be willing to inject additional equity to preserve their option value. After-all, the negative cash flow of $15 million in 2009 is only 6% of the $250 million Train has invested—would they be willing to invest 6% more to extend their option?

In addition, the distressed investor would recognize that Train inherently has better information about the situation regardless of the amount of research effort the distressed investor devotes to the investment. Do they see ways of cutting more costs rapidly? Are most of the stores cash flow positive with a few that have serious problems? If so, would shutting down the weak performing stores solve the problem? At the extreme, the skeptical investor may wonder whether reported results represent the

"best" Homemax can do or whether a myriad of subtle revenue deferral or expense acceleration techniques have been used to "sandbag" performance in an effort to scare investors.

Another possibility the distressed investor might contemplate is whether Train might decide to start buying the Senior Notes—which as we will see when we discuss a restructuring shortly, could be another strategy for Train to continue its equity participation in HomeMax. If Train becomes a big buyer of the Senior Notes they may push up the price to say 30, and the distressed investor who purchased at 20 might sell and walk away with a quick 50% profit (plus any coupon income). So depending on how savvy, aggressive and/or committed the distressed investor believes Train to be, there are several potential scenarios that could benefit a deeply discounted investment in the unsecured notes.

The Restructuring Dynamic

After our little exercise in time travel back to 2009 to better understand the thought process of the distressed investor, let's return to the beginning of 2012 and examine the challenge facing HomeMax. As mentioned above, HomeMax/Train has been advised by their bankers that it will be impossible to refinance the 1L and 2L debt maturing at the end of the year. Practically speaking, the logical course for the parties to take is to attempt to negotiate a voluntary restructuring with the existing creditors and if that proves unsuccessful, file for bankruptcy when the secured debt matures and non-payment causes a default.

To understand this, we will first explain the economic/negotiating position of each of the parties to the negotiation. Given the colorful and sometime vitriolic personalities of some distressed investors, one might get the impression that restructurings are determined by who yells the loudest or makes the most outlandish threats. But as a practical matter, the parties are sophisticated and rational and thus the resolution will generally turn on the legal and economic leverage of the various parties involved.

The Owners—HomeMax/Train

Why would HomeMax/Train (we group these together because Train, HomeMax's owner, will effectively be making the decisions even though technically the HomeMax Board of Directors will be the explicit actor) see it as being in their best interest to negotiate a voluntary restructuring? The economic answer is that voluntary restructurings are much less expensive than bankruptcy—in both direct and

indirect costs.[22] So at one level, it's just a matter of economic efficiency. However, Train will view itself, even though it is underwater in the current market context, as having option value in its equity stake. In particular, given that HomeMax's operations seem to be improving, Train could reasonably believe that if they could just hold-on for a couple more years, perhaps HomeMax' value would return to its 2007 level and Train would once again have a profitable investment. So Train will be interested in a voluntary restructuring so long as it retains an amount of equity value that is comparable to, or better than, what it might receive in a bankruptcy. If the creditors are dogmatic and refuse to give Train any equity value, then Train may view itself as better off in a bankruptcy where perhaps they can delay the process and hope that continued improvement in the general economy will lead to a higher market valuation at the end of the Chapter 11 reorganization process. Specifically, if the bankruptcy filing isn't until the end of 2012, and it takes at least a year to go through the process, then Train will argue that HomeMax should be valued with reference to the outlook in 2014, which could be materially better than today. If the creditors don't offer Train something, it has little or nothing to lose by pursuing this strategy.

The Creditors

How will the various creditor constituencies look at the situation? As a general matter, they also recognize that a voluntary restructuring is less costly than bankruptcy, so they will prefer that approach as long as it leaves them at least as well-off as if there was a bankruptcy.

Secured Creditors

Looking back to Exhibit 5 it seems fairly clear that HomeMax is worth well in excess of the $250 million owed to the 1L lenders. Consequently, the 1L lenders are in a fairly safe position and will likely not play a very significant role in the restructuring negotiations. The 1L lenders will be confident that in a bankruptcy they will recover full value so they will not accept anything less than this in the voluntary restructuring. All the parties will likely see it this way, so it will just be a "given" from the outset that any restructuring has to give the 1L's full value. But this could mean either finding funds (a new third party

[22] Direct costs include legal, accounting and other fees associated with a formal bankruptcy process. Indirect costs include such items as distraction of management time from the business or an outright deterioration in business performance as a result of the bankruptcy.

loan, or new loans from the other creditors or Train) to have the 1L paid off, or negotiating a loan extension that the 1L lenders, in their discretion, find attractive and would voluntarily accept.

What will be the perspective of the 2L creditors? Based on the assumed 2011 valuation of $558 million (Exhibit 5) it is fairly clear that the 2L lenders would enjoy a full recovery in a bankruptcy and thus they too will approach the voluntary restructuring with the view that they should get at least a full recovery. However, the 2L creditors are in a very interesting position because of the debt capacity issue discussed earlier. The impetus for the restructuring is the fact that the capital markets will not refinance all the secured debt. Assuming new lenders might provide $275 million in new secured loans (approximately 3.5x 2011 EBITDA of $79.75 million), the $250 million of 1L debt could be refinanced, but only $25 million of the 2L's $150 million outstanding amount could be refinanced. So the holders of the 2L, which we will assume contain some new distressed investors that purchased notes at a discount, will recognize that they must accept equity because that would be the likely outcome in a bankruptcy. Of course, from the perspective of the distressed holders, this was likely their strategy all along. Indeed, they might be disappointed that HomeMax operations improved so quickly because if they purchased in 2009 they may have hoped to get all of HomeMax's equity. The bottom line is that the 2L holders will not accept less than $150 million in value (i.e. cash or new securities) in the voluntary restructuring, but whether this will be all equity or some mix of cash, debt and equity must be negotiated. It should be noted that, given the valuation, the trading value of the 2L notes will likely be fairly close to par and this market assessment will be a further negotiating lever supporting their demand for a par recovery.

Unsecured Creditors

Finally, we consider the perspective of the Senior Note holders? First, we should note that even though there are two issues, one maturing in 2014 and one in 2015, assuming their terms are the same, they will essentially work together as a group because in a bankruptcy they would both be in the same class and the maturity difference would be irrelevant. As they consider the alternative of a bankruptcy, they will perceive more potential volatility or risk than the holders of either the 1L or 2L. Per Exhibit 5, the current valuation implies a recovery to them of 70%. But if there is a bankruptcy and the out-of-pocket costs associated with the bankruptcy are $30 million,[23] then their recovery could fall to 57%.[24] In

[23] Bankruptcies are expensive for a myriad of reasons, the most prominent of which are the retention of large numbers of professionals to either assist the debtor or represent the various creditor groups, almost all of which are usually paid for by the debtor and thus represent a reduction in the firm's value. In the HomeMax case, it is likely that each of the 1L's, the 2L's and the Senior Notes would have their own lawyers (in fact, there could be two sets for each of these constituencies if the Indenture Trustees and the holders were separately represented) and financial advisors paid for by the Company. There would also be extra accounting services and perhaps even an operational turn-around firm employed. Whether the total bill for these professional services and the

addition to the out-of-pocket costs, the business might be harmed by the bankruptcy, because of negative press or the defection of key employees. If this were to happen then the recovery could fall even more. Also, in a bankruptcy the unsecured notes would not receive current interest payments where as it is very likely that the 1L holders will continue to get paid interest[25] which adds to the perceived cost of bankruptcy. On the other hand, they will also look at HomeMax's improving operating trends and believe that to the extent bankruptcy actually gave the company/economy more time to heal and improve, its valuation their recovery could improve. These notes will likely have largely traded to distressed investors. If these investors bought in the 20s, then they are probably already sitting on attractive mark to market gains (if the implied recovery is 70 then the notes would likely be trading somewhere in the 50s).[26] Also, they will fully expect to receive their recovery in equity—it's just a question of how much of the equity they are able to negotiate for themselves.

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other administrative costs attendant to the process would total $30 million is hard to estimate but is certainly plausible if there were various litigations among the parties. By way of extreme example, the administrative expenses in the Enron and Lehman Brothers cases exceeded $1 billion.

[24] As analyzed in Exhibit 5, based on the assumed valuation in 2011, the base-case recovery to the Senior Notes would be $158.2 million, or 70%. However, if a bankruptcy were required to effect reorganization and the process cost $30 million, then the recovery to the Senior Notes would be only $128.2 million, or 57%.

[25] In general, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (hereafter referred to simply as BRC) provides that a secured creditor may receive post-petition (i.e. after the bankruptcy filing) interest to the extent the value of the collateral exceeds the secured claim. Further, BRC §363 provides that if the bankruptcy estate wants to continue to use the secured creditor's collateral that it must provide the secured creditor with "adequate protection" that the continued use of the property will not result in a decline in the collateral's value (e.g. assume trucks are the collateral and the business wants to continue operating the trucks which will result in some deterioration in their value). BRC §363 gives a secured creditor grounds to object to the continued use of the collateral, so as a general matter of practice to avoid the delay and expense of litigation the debtor will typically offer to pay the secured creditor on-going interest payments as compensation for the continued use of the collateral. In the HomeMax case, the 1L holders would almost certainly be paid post-petition interest. The 2L holders would likely also be paid given the apparent amount of over-collateralization (i.e. Enterprise Value greater than the amount of secured debt), but if a bankruptcy filing had occurred in 2009 or 2010 when the 2Ls were under-secured (i.e. Enterprise Value less the 1L Debt less than the 2L Debt) then they would likely not receive post-petition interest.

[26] It's dangerous to speculate where a security with this much option value would trade going into a restructuring. If the valuation implies a recovery of 70 this is a logical cap. Any investor buying the note would want to make an appropriate risk-adjusted return so they would want to pay less than 70, probably significantly less, given the risks. The general math the distressed investor would use to determine the desired purchase price would involve determining the present value of the expected future recovery. This calculation involves first projecting the amount of recovery and the time until that recovery was received and then discounting back using a risk-adjusted desired return hurdle (e.g. 20 – 30% for equity risk like investments) to the date of prospective purchase to estimate the desired purchase price. So if it were December 31, 2011 and the investor expected to receive 70 on December 31, 2012 and, given the perceived risks, the required return on investment was 25%, a present value calculation would imply a bid price of 56.

Summing Up the Negotiation

We can summarize the framework for the negotiation as follows: The unsecured note holders have the least amount of leverage but to the extent that the 2L holders want to avoid the cost and risk of a bankruptcy, it will be in their interest to give the Senior Notes a meaningful recovery to obtain their cooperation. Similarly, both the 2Ls and the Senior Notes will likely accept that they will have to give Train some amount of equity (which will include some equity to management to make sure they are properly incentivized) simply because the voluntary restructuring is much more likely to be successful if management/equity is supportive.

The exact dynamics of, or diatribe within, the negotiation are unpredictable and will be influenced by the personalities of the participants. The major points of discussion will be exactly how the company should be valued, how much debt there should be, how the equity should be split, etc. And every additional quarter or even month that passes will be factored into the conversation so the parties may have differing senses of urgency.

A Potential Stumbling Block—The Holdout Problem

At this point it is important to raise one other important dynamic that inevitably develops and is among the most common reasons voluntary restructurings fail to occur even though they are economically more efficient: the holdout problem. We will expand upon the actual mechanics of how a voluntary restructuring is affected later, but it is important at this point to note that voluntary restructurings basically involve the parties voluntarily exchanging the securities they hold for new securities or cash. One of the reasons why it is essential to have management or the equity holder's cooperation is that if the exchange is going to involve the issuance of additional stock by the company[27], then both management and the equity holders' cooperation and consent is essential. However, to participate in the exchange is a voluntary decision for all holders and under American law[28] financing contracts do not allow a decision

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[27] In general, the corporate laws of most states require that the Board of Directors of the company approve any issuance of new stock and typically a corporation's by-laws will require shareholder consent if a material amount of new stock is to be issued. Since HomeMax is privately held by Train it might be possible to avoid the issuance of new stock by having Train just transfer a portion of its stock to another constituency. As a practical matter in most restructurings where creditors receive part of the company's equity this is accomplished through a new issuance of securities. This will often lead to another layer of complexity because of the need to comply with securities laws, but since HomeMax is privately held (in the present hypothetical) these issues should be manageable.

[28] §316(b) of the Trust Indenture Act of 1939 (any bond financing of over $5 million generally requires compliance with the Trust Indenture Act) prevents a change to the key economic provisions of the bond without the consent of the affected holder. Bank loans are not subject to the Trust Indenture Act, but as a matter of practice they uniformly incorporate this same concept. It should be noted that this is not always true internationally. For example, England's Companies Act allows amendments of material financing terms if they are consented to by

of a majority or even supra-majority of holders to change the major economic terms (i.e. coupon rate, principle amount or maturity date) of a financing agreement. If an individual Note holder does not want to participate in the exchange, then those notes must be paid in accordance with their terms. The dilemma this raises, and it primarily is a problem for the notes in the HomeMax case, is that even if the majority of the Senior Note holders negotiate a deal that gives them a greater than expected 75% recovery, a single holder can, by not participating, keep his notes and be fairly assured of receiving a 100% repayment in 2014 or 2015 when they mature because HomeMax should be significantly stronger financially.[29] This dynamic creates the risk that not enough holders will participate to meaningfully reduce the company's debt burden and thereby frustrate the original purpose of the transaction.

There are a few techniques that are used to try and coerce the cooperation of the debt holders. While beyond the scope of this article to explore in detail, the basic construct is for those holders that do participate to exchange into an instrument that is senior, from a credit perspective, to the security being exchanged. This confronts the holdout with the risk that if the company ultimately files for bankruptcy before the holdout's claim are paid, they risk a reduced or even zero recovery due to the credit seniority of the participating holders. As a practical matter, the best scenario for success is to have a very high percentage of the security in question held by a small group of holders who are involved in the negotiation. If, for example, four distressed investors had collectively accumulated 95% of the Notes and all had taken part in the restructuring negotiation and agreed to participate in the exchange, then the chances of success are much greater.

The Plan to Restructure HomeMax

What is proposed below is but one possible restructuring outcome. Other scenarios might have been negotiated depending on the predilections of the constituent parties; however, the one presented here is plausible. Specifically, the key features of the plan include the following:

1. HomeMax will enter into a new $275 million 1st lien (3.5x leverage) term loan and use the proceeds, among other things, to pay off the existing 1L loan. HomeMax will also issue 9,900,000 new shares of common stock, which will effectively dilute the original 100,000 outstanding shares held by Train. Subtracting the $275 million loan obligation from the 2011 estimate of enterprise value found in Exhibit 5 of $560 million (we round up from $558.25

75% of holders. Other jurisdictions have what are characterized as "collective action" clauses, which allow amendments of material terms with the consent of a majority or super-majority.

[29] Even better, if the voluntary exchange is completed and only his few Notes remain outstanding, then because of the relative certainty of their repayment their market trading value will increase close to par—so there will be no need to wait for two or three years to realize the extra return.

million to simplify the numbers),[30] the implied equity value for HomeMax is $285 million or $28.50 per fully diluted share.

2. The existing 2L notes will in aggregate receive $150 million in the form of the remaining $25 million of the new loan proceeds plus $125 million in newly issued shares (which is 44% of the restructured firm's equity). Holders of the 2L notes will have the opportunity to exchange each existing note for $166.70 in cash and 29.37 shares of stock, which represents an equity recovery of $837.045 ($28.50 per share x 29.37 shares) for an implied aggregate per bond recovery of $1,003.745 ($166.70 in cash plus $837.045 in equity).[31]
3. The Senior Notes will in aggregate receive 51.50% of the newly issued shares. Holders will have the opportunity to exchange each existing Note for 22.66 shares of stock (aggregate value of $646) for an implied per bond recovery of $646.
4. Train will receive 2.00% of the newly issued shares. When combined with its existing 100,000 shares it will hold 2.98% of HomeMax's fully diluted shares with an implied value of approximately $8.5 million.
5. Management will be granted 2.0% of the newly issues shares with an implied value of approximately $5.6 million.

The effect of the proposed voluntary restructuring is summarized in Exhibit 7. Reflecting on the negotiating dynamics described above, we can sum up the deal as follows:

- The 1Ls receive 100% of their claim out of the proceeds from the new 1st Lien financing..
- The 2Ls receive a full recovery (albeit in both cash and equity).
- Train and management were able to extract about $14.1 million of value, compared to a potential $0 recovery in a bankruptcy. This sum is about 50% of what a bankruptcy would have cost had they not cooperated.
- The Senior Notes are theoretically better off in the restructuring since the estate would have lost an assumed $30 million in value due to bankruptcy costs.

Now let's consider the deal from Train's perspective. They may have calculated that they could have gotten more by forcing a bankruptcy and extending their option to take advantage of a potential economic turnaround. However, for this to work out, the enterprise value of HomeMax would have had to increase to $669.1 million, or an additional 20%. The basic analysis behind this conclusion is that for the value of

[30] This assumes that the equity for debt exchange elimates all the 2L and Note debt.
[31] The modest premium to par value that this recovery implies is not uncommon and fairly trivial in the broader scheme of the reorganization.

the equity of Train and Management to equal the $14.1 million in the settlement, the enterprise value of HomeMax must be $669.1 million:

$$\underset{Value}{Equity} = \underset{Value\ (EV)}{Enterprise} - \underset{Value\ Debt}{Total\ Face} - \underset{Costs}{Bankruptcy}$$

$$\$14.1\ million = \underset{Value\ (EV)}{Enterprise} - \$625\ million - \$30\ million$$

$$\underset{Value\ (EV)}{Enterprise} = \$14.1\ million + \$625\ million + \$30\ million = \$669.1\ million$$

Given all the risks associated with a bankruptcy and achieving that goal, they may have felt $14.1 million, plus the optionality in the stock, was a decent deal.

Exhibit 7. Restructuring Analysis

Class	Original Debt ($ millions)	New Debt ($ millions)	Original Shares of Stock	New Shares of Stock	Total Shares	% New Shares	% Shares	Shares per Note	Recovery $*	Total Recovery $
New IL Loan		$ 275								
New HomeMax Stock				$ 9,900,000						
Original IL	$ 250	(250)		-	-				$ 1,000	$ 250,000,000
Original 2L	150	(25)		4,405,500	4,405,500	44.50%	44.06%	29.37	1,003.71	150,556,750
Sr Notes	225	-		5,098,500	5,098,500	51.50%	50.99%	22.66	645.81	145,307,250
Equity			100,000	198,000	298,000	2.00%	2.98%		8,493,000	8,493,000
Management			0	198,000	198,000	2.00%	1.98%		5,643,000	5,643,000
Total				$ 9,900,000	$ 10,000,000	100.00%	100%		$ 14,136,000	$ 560,000,000

*Recoveries for the 1L, 2L and Sr Notes are shown per note. Therecoveries for the equity holders are shown in aggregate.

The Notes are the group that in this scenario conceded value relative to their initial implied recovery of 70 to get the deal done. Their implied recovery was 64.6, primarily because the entire "tip"[32] needed to get Train's cooperation came from them. It is worth mentioning that we basically posited that this group may have been able to purchase their stake in the Senior Notes in 2009 when the trading levels may have been in the 15 – 25 (% of face value) range. So they had already made substantial returns on their investment. Thus, to concede a few points to minimize the risks attendant to a bankruptcy seems like a good decision.[33] Furthermore, the Notes will in aggregate own 51% of fully diluted shares so they

[32] "Tip" is distressed investing industry jargon for the concept of "giving value" to an ostensibly "out-of-the-money" constituent in order to obtain their cooperation/support for a plan or process.

[33] It is important to note that an investor's investment cost, or basis, can influence their willingness to accept a particular outcome. For example, and we'll discuss whether this is economically rational in a moment, if the holder was an original investor who paid 100 for the note, then an expected recovery of 64.5 may seem like an unpalatable loss. In contrast, if the distressed investor purchased at 20, to accept a recovery of 64.5 v 70 is to reduce their profit from 250% to 233%. Of course, a rational economist would say that the par investor's cost basis of 100 is an irrelevant sunk cost. The only relevant data is that if you accept the deal you get 64.5, if you reject the deal and there is a Ch 11 then you get 59 because of the incurrence of the bankruptcy costs and thus the rational decision is to accept the 64.5. However, behavioral economists have noted that cost basis often influences investor decision making. For example, see Ert and Erev (2008).

may ascribe a "control premium" to their position that isn't reflected in the mathematical derivation of share value.

The Mechanics of the Voluntary Exchange Offer

We have discussed conceptually how HomeMax gets from the recognition of their refinancing related liquidity problem to its resolution via a voluntary exchange offer that transfers control of the company to distressed investors. Next we discuss what concrete activities would happen for this to be accomplished. No two situations are identical, but the first step that needs to occur is for the various parties to begin a dialogue. Sometimes this will be from management and/or the equity sponsor being pro-active and requesting a meeting with its significant creditors. However, the equity sponsor may think this signals weakness and wait for the other side to make the initial approach.

If management decides to be proactive, they will typically engage special bankruptcy/workout counsel and retain a specialized financial advisor to help them assess their options. When they have a plan formulated, the financial advisor will then use its market intelligence resources to identify who are the major holders of the various debt tranches. For the 1L bank debt this will usually be the agent bank. For the 2L and the Senior Notes this will require approaching various distressed investors who the financial advisor believes have been accumulating positions. While a bit of a dramatization, the initial conversation with the distressed investor might go as follows:

> Financial Advisor: Hi, we understand you own a lot of HomeMax Senior Notes. As you are probably aware, the Company may face some liquidity problems in the near future and would like to invite you to join an *ad hoc* committee to discuss solutions that might be mutually beneficial to all parties.
>
> Distressed Investor: I don't see any problem. I expect them to pay me the money I'm owed or I will own the company.
>
> Financial Advisor: That's probably not a very realistic scenario, would you like to discuss ways of avoiding the $0 recovery you prospectively face if the Company is forced to liquidate.

After some additional witty repartee, the distressed investor will probably view it as advisable to engage in the process. When investors owning a majority or significant percentage of the classes have been identified (and these may be distressed investors as well as original investors that never sold at the lows), they will have a conversation among themselves to see if they can agree on how to proceed. As a practical matter, the community of distressed investors is fairly small and they will likely know each other from prior deals. The first agenda item will be deciding which lawyer to hire to represent them at company expense. Next they will likely also select a financial advisor to represent them, again at

company expense, since the economic interests of the 2L Notes and the Senior Notes are in significant conflict, they will likely each insist on their own professionals for advice.

With the various advisors in place, a series of meetings commences with the objective of negotiating the voluntary resolution. Typically the professionals carry out the majority of these negotiations, after formulating strategy with the investors they represent, but sometimes investors will get involved at critical junctures—particularly when negotiations have stalled and some direct "horse trading" must occur to advance the process. There will often be veiled threats made that we have not discussed. The Senior Notes might, for example, threaten to sue Train for mismanagement or because it took out dividends which, they will allege, made the company insolvent. Train might suggest that the 2L security related documentation is defective and that if the Senior Notes really want to pursue their litigation that HomeMax will almost certainly end up in a nasty Chapter 7 liquidation where the Senior Notes will receive nothing. Such is the day-to-day life of a distressed investor. In the end, rational minds usually prevail and the framework for an agreement is developed and the practical issue becomes "can it be affected or will there be too many holdouts".

Mechanically this usually starts with one of the lawyers. For example, Company's counsel typically drafts a term-sheet that then gets refined and agreed to by all the parties. Then various contracts and/or securities law related documents will need to be drafted. Since HomeMax will need to issue a massive number of new shares, it will need to obtain Board of Director and shareholder approval—but these are basically technicalities given that Train is in control. In the final steps, a formal and legally binding offer of exchange will be delivered to the holders of the 2L Notes and Senior Notes. Because of the ever present holdout problem, these exchange offer documents will always condition effectiveness on a very high participation rate. In other words, they will typically contain a clause that says unless at least 95% of the outstanding securities participate in the proposed exchange, then none of the securities tendered for exchange will be accepted and the exchange will not occur.

If all of the terms of the exchange offer are satisfied then the documents will set forth in detail the exchange mechanics. This basically entails the holder delivering the note to the company whereupon the company will cancel the note and give the holder the new securities that the exchange offer documents specify (e.g. each note would be cancelled and receive 22.66 shares of HomeMax common stock in exchange). As a practical matter this is now just a matter of electronic postings credited to an account.

What if a Voluntary Restructuring cannot be completed?

As can be deduced from the discussion above, there can be many reasons why a voluntary restructuring, even though often economically sensible, cannot be completed. The primary problem is

usually the holdout problem. However, sometimes it is simply not possible to negotiate an agreement among the parties. In the HomeMax case, it would be easy to disagree about the valuation. The 2Ls might strongly believe that HomeMax is only worth $450 million and demand a much larger percentage of the fully diluted shares to make them whole. If the holders of the Senior Notes believe they would do better in a bankruptcy, after all risks and expenses are factored in, then the two parties might never reach an agreement.

If no agreement can be reached or the exchange fails because of holdouts, then the company will likely be forced to file for reorganization under Chapter 11. While beyond the scope of this article to discuss in detail the intricacies of Chapter 11 reorganization, essentially Chapter 11 reorganization is a court supervised restructuring process that has, as one of its important powers, the ability to force the participation of holdouts. Basically if the statutorily prescribed majority approves the proposed treatment of creditors in a Chapter 11 plan of reorganization,[34] then the terms of the plan are imposed on everyone in the class. So the holdouts are forced to participate.

Speaking in very broad terms, the process of a larger Chapter 11 is similar to the voluntary restructuring process. Typically it will be in everyone's interest to plan a Chapter 11 process that is as inexpensive as possible. Such pre-negotiated Chapter 11 bankruptcies are often referred to as "pre-arranged" or "pre-packaged" bankruptcies.[35] Expenses incurred in Chapter 11 are usually a function of legal fees which are directly tied to failure to reach agreements about fundamental issues in advance. Accordingly, it is usually in the best interest of most parties' to try and reach a broad agreement on major issues in advance of the technical filing of a Chapter 11 petition. To that end, the company will go through the same process of selecting lawyers and financial advisors and try to have a dialogue with its creditors to develop some general agreement on a Plan in advance.

Once a Chapter 11 petition has been filed, an unsecured creditor committee will be formed. The Company will be given the first opportunity to present a Plan of Reorganization ("Plan"). To do that it

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[34] Under BRC §1126 for a class of claims to consent to the plan 50% of the voting holders and 66.66% of the claim amount voted must approve of the terms of the Plan.

[35] The difference between a pre-arranged and a pre-packaged bankruptcy is one of contractual legal support. In the pre-packaged scenario, the negotiated plan will have sufficient support from the impaired creditors to the plan that they will sign a "support agreement" contractually obligating them to vote in favor of the plan once the bankruptcy petition is filed. In the pre-arranged scenario, a proposed plan that has significant support of the impaired creditors will be filed, but there will not be a binding support agreement to ensure approval of the plan in the voting process. Either method materially expedites, and hence reduces the cost, of the Chapter 11 process. It should be noted that the 2005 amendments to the BRC effectively eliminated the common prior practice of courts granting virtually endless extensions of the debtor's exclusive right to propose a plan by amending §1121(d) to create an 18 month limit on exclusivity. This amendment has had the effect of promoting more pre-arranged or pre-packaged bankruptcies.

will negotiate with the Official Unsecured Creditor committee and other creditor constituencies (i.e. in the HomeMax case, the 1L and 2L holders) to see if a plan that everyone will support can be developed. At some point, whether every creditor agrees or not, the Company will typically formally propose a Plan which in substance could be similar to the proposed voluntary restructuring terms provided for above with the exception that Train would likely not receive any equity unless HomeMax' valuation improves. This process involves obtaining the Bankruptcy Court's approval to solicit creditor votes in support of the Plan. If the Court approves that step of the process, then (similar to the formal exchange offer) a document called a Plan Disclosure Statement and the Proposed Plan of Reorganization will be sent to all the affected creditors who will have the choice of voting to accept the treatment the Plan proposes for their claim. For example, the HomeMax Plan could propose to cancel the Notes and convert them in to 22.66 shares of new stock—just like the Exchange Offer. If the requisite majorities of the various classes of creditors entitled to vote approve the Plan, then it will usually be easy to convince the Court to subsequently confirm or approve the Plan.

Sometimes individual classes of creditors will approve the Plan while other classes will not. In this case the Plan proponent (usually the Company) can ask the Court to confirm the plan over the objection of a dissenting class. This can lead to contentious (i.e. expensive) litigation before the Court to try and resolve the matter. If no creditor classes approve the Plan, then confirmation cannot even be requested and the process starts over but the Court may allow the creditors (as opposed to the Company which is given the initial opportunity) to propose a Plan. In the worst case scenario where a Plan which the Court can confirm is never developed, the case may be converted to Chapter 7 liquidation—which usually results in lower recoveries for all creditors and thus is a powerful incentive for them to make concessions that would make a confirmable Plan possible.

Because the Chapter 11 process and outcome can sometimes be very similar to a voluntary reorganization, one of the common techniques used to coerce hold-outs into participating in the voluntary reorganization is to basically combine the exchange offer with what is called a pre-planned Chapter 11 filing.[36] In this approach, the exchange offer document will effectively say, if the conditions for the exchange offer aren't satisfied, then the company will immediately file a voluntary petition under Chapter 11 and propose a Plan of Reorganization that essentially has the same terms as the proposed voluntary exchange offer. As applied to HomeMax, this strategy would try to force participation by all of the holders of the Notes by effectively saying the exchange is inevitable, the only difference is that if you

[36] See, for example, the Travelport exchange offer proposed in October 2011 which had an accompanying Plan of Reorganization attached in the event insufficient participation in the exchange offer occurred.

don't cooperate and force a Chapter 11 the stock you receive will be worth less because of the higher bankruptcy expenses.

However, it should be noted that there can be many issues that will make a voluntary restructuring ineffective. In fact, a better way of thinking about the issue is to note that a voluntary restructuring is likely only appropriate where the primary problem facing the company is its capital structure. If the basic issues are something more fundamental to the company's operations, then Chapter 11 may be the only path that can solve its problems. For example, what if HomeMax had a large percentage of its stores generating negative cash flow due to contract rental rates that were too high, (i.e., current market rates for its competitors were much lower). Although we won't digress to discuss them, Chapter 11 offers tools for dealing with this type of problem. Alternatively, HomeMax could have an uncompetitive collective bargaining agreement. Again, often times Chapter 11 is the only way to deal with this type of issue.

3 How Profitable is Distressed Investing?

How does one analyze the potential investment return to the distressed investor in the HomeMax example? The first issue is determining a comparable basis of analysis. Let's consider an investor in the Notes. That investor exchanged the Note for 22.66 shares of stock at the end of 2011 and, at the time of exchange the shares were valued at $28.32 (see Exhibit 8). But what did they "cost" the investor? That depends on when the Notes were purchased and the then trading levels. For example, assume that the investor bought the Notes at the end of 2010 for a price of 50.[37] The effective cost of the equity actually received in the restructuring then would be $22.07/share.[38] Thus, just through the exchange offer the investor had more than a 28% improvement in value (28.34% appreciation to be precise) of the investment in simple terms. Moreover, the owner of the Note also received two interest payments of $5

[37] Is this a realistic price? Exhibit 5 indicates that in 2010 the projected recovery value of the Notes was 0. Why would the distressed investors have been willing to pay 50? There are several real world dynamics that come into play. First, HomeMax is clearly a cyclical business, so all investors will use more of a normalized EBITDA rather than a bottom of the trough number for valuations. Second, it takes both a buyer and a seller to create a trade. Although perhaps irrational, when holders experience severe price declines in their holdings, if they believe there are plausible recovery scenarios they prefer to hold and retain the optionality of a recovery rather than sell out at a severe loss. So while the distressed investor would of course have preferred to buy the Notes cheaper (and undoubtedly started bidding them lower) ultimately a price where there are willing buyers and sellers must be achieved. Finally, it usually takes a number of trades to amass a significant position all of which can be at different prices thus the average position accumulation cost can reflect both higher and lower purchase prices.

[38] If the note was purchased at 40 that implies a $400 price divided by the 22.66 shares per note received in the exchange offer: $400/22.6 = $17.65

each which increases the holding period return to 51%. But the distressed investor will always be looking forward and attempting to estimate future performance and the implications for the return on investment.

Assume that Exhibit 8 below is the investor's projected performance for HomeMax for 2012 and 2013.

Exhibit 8. HomeMax Operating and Valuation Projections

	2010	2011	2012E	2013E
Revenue	$ 868.73	$ 886.10	$ 912.68	$ 949.19
Growth %	*1.0%*	*2.0%*	*3.0%*	*4.0%*
EBITDA	$ 52.12	$ 79.75	$ 109.52	$ 132.89
EBITDA %	*6.0%*	*9.0%*	*12.0%*	*14.0%*
Valuation Multiple	6.50	7.00	7.25	8.25
Enterprise Value	$ 338.80	$ 558.24	$ 794.03	$ 1,096.32
Less Debt	625.00	275.00	275.00	275.00
Equity	$ (286.20)	$ 283.24	$ 519.03	$ 821.32
Per Share	NM	$ 28.32	$ 51.90	$ 82.13

If these projections are even close to being realized then the distressed investor should realize very attractive investment returns. But this assessment is based on the *estimated* enterprise value (and corresponding equity value) of the restructured firm, not on realized values.

If HomeMax were a publicly traded firm, it would be apparent from trading prices how the marketplace values the restructured firm. Since HomeMax is a private firm the distressed investor will not have independent market validation, but he would likely know within a year whether he had made a good investment (because of the firm's operations). He would then have to confront the complicated problem of how to exit or monetize the investment. In market environments where there is strong investor demand for initial public stock offerings (IPOs), this approach might be used—in effect selling the company to the public market. Alternatively, the new equity holders could try to sell HomeMax to a strategic or, more commonly, a financial buyer. However, the interest and ability of such investors can be cyclical, which is a further risk element the distressed investor must consider.

To examine the possible returns to the distressed investor, consider the range of potential levels of EBITDA for 2012 in combination with different EBITDA valuation multiples shown in Exhibit 9. For example, if HomeMax generates approximately the same EBITDA in 2012 that it earned in 2011 ($79.75 million) and the valuation multiple is the same (7.00x); the enterprise value of the firm will be $558.3 million (Panel A), and the per share value of the firm's equity will be $28.33 per share (Panel B).

Distressed investors typically use two metrics to measure the return on investment. The first is the so-called cash on cash return. For example, assume the investor paid X for the investment and in

aggregate (including interest and fees) recovered Y then Y/X measures the ratio of value received to invested capital. In panel C, the estimated cash on cash return is calculated assuming a purchase at the end of 2010, the receipt of interest during 2011,[39] and a monetization at year-end 2012 at a range of valuations. For example, assuming EBITA is equal to $79.75 and the valuation multiple of EBITDA is 7 then the estimated value of HomeMax's shares of stock is $28.33.

The second return metric is the investment's internal rate of return or IRR. In panel D we compute the expected internal rates of return (IRR) over the same time period assuming the same range of exiting valuations and interim cash flows. For example, in the investor's "base" case where 2012 EBITDA is expected to improve to $109.52 million, assuming no change in valuation multiple, the value per share is expected to increase to $49.16 per share for cash-on-cash return of 2.68x and an IRR of 56.4%. But as can also be seen in Panel D, the distressed investor faces significant downside risk should the economy falter or if management in unable to improve the integration of HomeLux into the company. In the most extreme case considered earlier in Exhibit 7, in which EBITDA drops back to $60 million and the multiple falls to 6.0x, the distressed investor is assumed to have an IRR of -12.2%! Clearly, the potential rewards of distress investing are great but so are the possibilities of loss. In sum, the ultimate success or failure of the restructuring depends on the firm's ability to generate cash flow (EBITDA) as well as on general market conditions that determine valuation multiples.

[39] The analysis here assumes that the investor made a conservative assumption that he might not receive interest during the restructuring negotiation, which would almost certainly have been the case if HomeMax were forced to file for Chapter 11 protection. However, as presented it is likely that if HomeMax had sufficient cash in 2011 it would likely have continued to pay coupon payments on the Notes just to avoid a payment default.

Exhibit 9. Equity Returns for Distressed Senior Note Investor

Panel A. Estimated Enterprise Value in 2012

EBITDA	EBITDA /Valuation Multiple		
	6	7	8
50.00	300.0	350.0	400.0
60.00	360.0	420.0	480.0
70.00	420.0	**490.0**	560.0
79.75	478.5	558.3	638.0
109.52	657.1	766.6	876.2
120.00	720.0	840.0	960.0

Panel B: Estimated Equity Value Per Share in 2012

EBITDA	EBITDA /Valuation Multiple		
	6	7	8
50.00	2.50	7.50	12.50
60.00	8.50	14.50	20.50
70.00	14.50	21.50	28.50
79.75	20.35	**28.33**	36.30
109.52	38.21	**49.16**	60.12
120.00	44.50	56.50	68.50

Panel C: Estimated Cash on Cash Return at YE 12
Sr Note Creation Cost of $22.07/share

EBITDA	EBITDA /Valuation Multiple		
	6	7	8
50.00	0.57x	0.79x	1.02x
60.00	0.84x	1.11x	1.38x
70.00	1.11x	1.43x	1.74x
79.75	1.38x	1.74x	2.10x
109.52	2.18x	**2.68**	3.18x
120.00	2.47x	3.01x	3.56x

Panel D: Estimated Internal Rate of Return on Investment at YE 12
Sr Note Creation Cost of 422.07/share at YE 10

EBITDA	EBITDA /Valuation Multiple		
	6	7	8
50.00	-40.8%	-16.08%	1.4%
60.00	-12.2%	7.35%	23.2%
70.00	7.3%	25.61%	41.1%
79.75	22.8%	40.72%	56.2%
109.52	59.7%	**77.96%**	94.3%
120.00	70.5%	89.08%	105.8%

4 Why Distressed Debt Investment Opportunities Exist?

Money gets made in distress investing, like value investing, by looking for opportunities to purchase the securities of undervalued firms. But why do these opportunities exist? In the discussion that follows we offer a discussion of the factors that make this type of investing difficult. After all, if everyone could do it, the opportunities to engage in distress investing would disappear very rapidly. Specifically, here are some specific reasons why we might expect the securities of financially distressed firms to trade at prices lower than their intrinsic value:

a. Information Asymmetries—Information about distressed company securities is sometimes hard to come by. For example, many material events—such as a Judge's comments or rulings made on an issue in Bankruptcy Court—will not receive broad news coverage, particularly in smaller cases. Thus, unless the investor is attending the hearing (which is certainly not costless), or watching the bankruptcy docket closely, the event may only be known by a small fraction of investors.

b. Market frictions—The market for distressed securities is very illiquid and there will be a significant "bid/ask" spread when purchasing a distressed instrument. For example, the bid might be 40 and the offer 42. Usually with some negotiation a more mid-point price is found—but on its face what this "spread" implies is that if the investor really wanted to buy the security today (perhaps in anticipation of a favorable development) they would have to "lift the offering" and pay 42 to be certain of making the purchase. Then assume whatever they hoped would happen did not happen or did not have the impact they had expected and they want to sell. Assuming no price movement or change in spread, the investor would have to "hit the bid" and sell at 40. So in a stable market the "in and out" trade would "cost" 2 points or 4.7% of invested capital. That represents a very high transaction cost and thus only investors with very high conviction and a longer expected holding period tend to participate.

c. Behavioral Distortions and "Irrational" Transaction Motivations—In large markets, like the U.S. Treasury market or a large-cap equity market, there are literally thousands of active participants and theoretically almost any investor could participate. However, in the market for distress securities, the relevant universe of potential investors is much, much smaller, and many potentially well-informed potential participants (e.g. a high yield bond fund) may not be able to participate because the terms of their investment management agreements will frequently preclude them from purchasing "CCC" "D" or "NR" rated securities many potential market participants may not be able to take advantage of an undervalued (in their view) security because of its credit rating. Further, many institutions' investment guidelines may require them to sell

securities if their ratings drop below a certain level (typically B3/B-). As firms become financially distressed, ratings agencies typically (albeit sometimes with a lag) reduce their ratings to reflect the increased default risk and when the ratings fall below certain threshold, the certain investors may be "forced sellers" regardless of the view they many hold that the security is trading below intrinsic value.[40] Such "irrational" or non-economic behavior can lead to price distortions in the market.

d. Intestinal fortitude. Investing in distressed firms can be likened to running into burning buildings. Howard Marks, Chairman of Oaktree Capital Management suggested that opportunities to invest in distressed debt often follow a "period of lax lending practices by creditors followed by a period of fundamental and psychological weakness."[41] This is because, in his view, in true "bull" markets the consensus investor outlook is that the positive cycle will go on indefinitely and thus credit protections are less important since the value of assets will always increase. But the opposite occurs in bear markets where the consensus outlook is so negative that prices decline to the point there is very little downside risk. Thus the opportunity to profit from investing in distressed firms is often tantamount to following a contrarian strategy

e. Specialized skills and knowledge are required—The distressed investment community is quite small compared to the general fixed income and equity markets. Although the distressed investing field has grown, there are far fewer experienced investors and much less capital committed to the area than the more general fixed income or equity markets.

f. Risk and uncertainty—distress investing involves much more than good financial intelligence. Identifying good prospects is just the first step in what can become a lengthy process involving negotiations among multiple security holder groups that may not produce a restructuring plan that all security holders can agree to, in which case the costs and uncertainties of the legal system are added through a potential bankruptcy process. Distressed firms can languish in the netherworld between healthy operations and bankruptcy for an extended period of time. Moreover, with distress investing there is a very real prospect of investments where a zero recovery is possible. For example, although HomeMax's financial future may have been doubtful, the firm's management could retain control over the assets as long as they simply continued to pay debt service and remain in compliance with debt covenants. In this situation, where the potential for

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[40] It should be noted that such investment guidelines typically provide the investor/investment manager with a reasonable time period to liquidate the down-graded security (to avoid forcing sales in a potentially over-sold market condition) but nonetheless, at some point the investment manager may be obliged to sell even though she may perceive the security as under-valued.

[41] The Guide to Distressed Debt and Turnaround Investing, edited by Kelly DePonte, Private Equity International, London, 2007, p. 13. Also, see http://www.rationalwalk.com/?p=11091.

restructuring the firm's capital structure is uncertain, the values assigned to the firm's securities can deviate from their intrinsic worth for an extended period of time.

If the successful restructuring of the firm is highly uncertain, then the distressed investor would require appropriate risk-adjusted returns for assuming the risks associated with undertaking the restructuring. In other words, if the firm's securities were trading at their expected recovery value after a restructuring, the investor would have no incentive to undertake the risk inherent in the restructuring. Some discount to estimated intrinsic value, sometimes referred to as "margin of safety"[42], would be necessary to entice the distressed investor to undertake investment. How big the discount would have to be would depend upon the perceived risk of failure and the worst-case recovery expected in that scenario. As pointed out above, because HomeMax has a relatively small proportion of tangible assets on its balance sheet, in the event of a liquidation the recovery to even the secured creditors may be nominal. The distinction we are making here is between investing in the equity of a once distressed firm that has completed a restructuring and investing in a currently distressed firm facing a risky restructuring; since any rational investor would prefer the certainty of the former, a discount is required to attract participation in the latter.

5 Summary

What happens to good businesses that take on too much debt financing? The answer is that they have a propensity to default, which results in their being restructured and beginning operations anew. Although often reviled, distress or vulture investors are the instruments of change that carry out such restructurings in the hope of reaping substantial rewards for themselves (and their investors in the case of distressed funds). Their actions result in the restructuring of troubled companies whose capital structures include more debt than its cash flows can service (i.e., the firm is over-leveraged). Once restructured the company can continue operating as a viable business thereby avoiding the necessity to liquidate the firm's assets and lay off its employees.

In this article, we review the process by which corporate restructuring takes place. The distressed investor acquires a portion of the debt in the distressed firm that will be transformed into the equity of the firm should it go into default. He then seeks to re-capitalize the firm with a capital structure that is better suited to the distressed firm's existing or expected cash flows. The negative connotations of distressed investing come out of the "re-shuffling" of investor claims that is involved in creating the new capital structure and any adverse effects that the restructuring might have on the interests of the out-of-the-

[42] This phrase was entrenched in the vocabulary of value and distressed investors by Klarman (1991).

money prior investors or the operations of the firm. In the latter case, the restructuring may involve cost cutting that leads to employee layoffs and/or reduced benefits to the firm's remaining employees.

To be sure, there are other ways that investors can engage in a form of distressed investing that do not involve attempting to gain control of the firm. For example, in the HomeMax example we use to illustrate distressed investing, holders of either the 2L Notes or the Senior Notes could have just sold their holdings when prices appreciated in 2011. They did not have to stick around and exchange their claims for common stock and become part of the equity of the firm.

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