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SPECIALISTS IN HIGH YIELD AND SPECIAL SITUATIONS INVESTMENTS

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A Rosetta Stone for “Workouts”

Important Concepts and Terminology Relating to Restructurings

- Investor bias toward restructuring debt instruments is generally negative
- In some cases, investors can minimize losses and even generate attractive returns by holding defaulted positions
- Legal, structural, and fundamental analysis in restructurings is complex and specialized
- This paper seeks to provide a high level overview of certain concepts DDJ believes are especially relevant in the context of a financial restructuring

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Stony Brook Office Park | 130 Turner Street | Building 3, Suite 600 | Waltham, MA 02453
Phone 781.283.8500 **Web** ddjcap.com

Investing in securities that have a high risk of a default and an ensuing restructuring has its own lexicon

Introduction

When many investors hear terms like “default” or “bankruptcy”, negativity and losses probably come to mind, and for good reason. Over the past 25 years, on average, when a high yield bond has defaulted, investors lost almost 60 cents on every dollar invested.[1]

However, the range of the actual value recovered can vary widely. In simple terms, with a 25-year average loss rate of around 60%, the value recovered averages around 40%. But this figure represents a mean average, one in which outliers can have a big impact. As such, depending on the specific facts and circumstances, there are certain bonds that end up recovering almost nothing and others that may recover 90 or even 100 cents on the dollar, to arrive at the 25-year average of 40%.

Clearly, there are investors that pursue strategies focused on capturing value amongst defaulted (i.e., “non-performing”) or near-default securities. However, with the right acumen, investors that target performing non-investment grade corporate debt that is affected by a default, can also, in some cases, minimize their losses and even generate attractive returns by holding a defaulted position over a longer time horizon rather than seeking to monetize in the short-term. Doing so, however, requires skills and knowledge that may be somewhat foreign to investors that target performing debt instruments.

Like any specialized investment strategy, investing in securities that have a higher risk of a default and an ensuing restructuring has its own lexicon. This paper is meant to touch upon a number of such terms in a context to provide some clarity on a complicated topic. While DDJ’s main strategies are focused on investing in performing debt instruments, market and business conditions change over the life of an investment, and we know well that compelling investment opportunities can arise from these types of challenging circumstances.

The paper is divided into four sections: the first three organized in a sequential fashion, mimicking a distressed situation unfolding, with the final section touching upon a few concepts relating to a creditor’s preliminary analysis of its position in a potential workout scenario.

[1] JP Morgan Default Monitor, March 31, 2016.

Section 1: When a Default Appears Imminent

The following terms are particularly relevant to the period of time leading up to and including a default. Many other terms presented in subsequent sections of this paper build off of some of these “basics”:

Default: there are two main categories of defaults, “covenant/technical” and “payment”.

> **Covenant/Technical Default:** occurs when a debt issuer does not comply with a term or condition of its debt documents (other than a payment default). A common technical default would be the violation by an issuer of an affirmative or negative covenant. For example, if an issuer is required to deliver monthly financial statements to its creditors within fifteen days of month-end yet fails to do so on time, a technical default of such affirmative covenant has occurred.

> **Payment Default:** occurs when an issuer fails to make a payment of interest or principal when due.

Depending on the underlying reason for a covenant/technical default, these defaults can often be “cured” through negotiations among the issuer and its creditors. In certain circumstances, creditors will negotiate for a fee to allow the issuer sufficient time to repair whatever event triggered the default (or, in some cases, to waive the default altogether without a requirement by the issuer to cure). In the example above, perhaps the monthly reports were delayed because of an inventory-count software issue, which the issuer is able to remedy within an agreed-upon amount of time in exchange for a modest fee that is paid to the creditors for their consent to such extension of time. In other instances, however, a covenant/technical default can serve as a more serious harbinger of material problems still to unfold at the issuer. One example would be a breach of an agreed-upon financial covenant, thereby signaling a weakening of the issuer’s financial condition and a possible payment default in the future.

Payment defaults often reflect significant creditworthiness concerns and may result in the creditors desiring to swiftly enforce remedies for payment against the issuer.

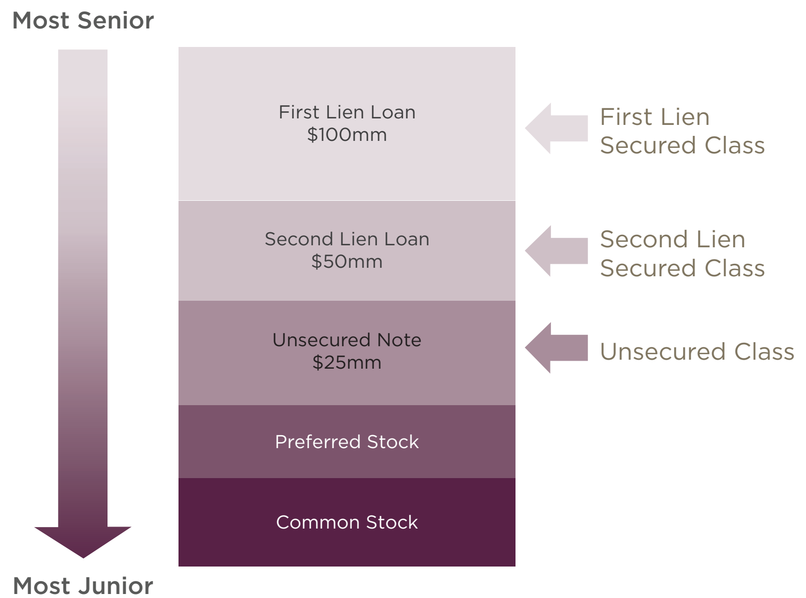
Certain defaults (including most covenant/technical defaults and often payment defaults related to interest or fees) usually include a “grace” or “cure” period, which is our next important term.

Grace/Cure Period: a period of time following a default in which an issuer is contractually permitted to either make a scheduled payment without incurring any penalty, or to repair the condition that caused a technical default, as applicable; until that time period has run, the “default” will not mature into an “event of default” under the applicable credit documentation (thereby enabling the creditors to begin to enforce remedies). For example, most high yield bond indentures permit the issuer thirty days to cure a failure to pay interest when due. Oftentimes, an issuer will utilize the grace/cure period to negotiate new terms and conditions (which may also be accompanied by a fee or an increased coupon) with their creditors. However, if the grace/cure period expires and the default remains uncured, creditors may organize and collectively agree to enforce certain remedies against the issuer, including the ability to accelerate the maturity of the debt. Alternatively, pending resolution of the underlying issue, creditors may agree to hold off on taking such actions (“forbear”) in order to continue negotiations with the issuer, or otherwise to make the necessary preparations for a prearranged Chapter 11 bankruptcy filing.

Acceleration: a right held by creditors to declare that the debt that they are owed is immediately due and payable. This is an option available to creditors only upon the occurrence of a default that has matured into an event of default, and is not an enforcement tool that creditors use lightly, as it usually precipitates a bankruptcy filing. Accordingly, the threat of acceleration is powerful, and typically the debtor’s management and equity holders are strongly incentivized to conduct discussions with its creditors to avoid such an outcome.

Debt Class: a group of creditors that hold debt with similar debt characteristics, such as the same priority lien (security interest) in the assets of an issuer, or creditors holding claims that are otherwise treated as part of a certain debt class according to bankruptcy laws, such as employee claims for wages or trade claims (which are both treated as unsecured debt claims).

Exhibit 1: Debt Classes of a Multi-tiered Capital Structure



Numbers stated above are hypothetical and for illustrative purposes only.

Exhibit 1 sets forth a multi-tiered capital structure with several tranches of debt. While each of the first three tranches represents a debt class, each debt instrument noted above may not be the only member of its class. For example, an unfunded pension liability would effectively increase the size of the unsecured class, which also includes an unsecured note issued by the company as set forth above. Because the interests of different debt classes often conflict, creditors of each class usually make an effort to work in concert to leverage their collective strength.

For a corporate issuer, there are two kinds of bankruptcy processes it can elect to pursue

Section 2: Once a Default Occurs & Thereafter

If a grace period expires before the issuer has remedied (or otherwise obtained a waiver of) the underlying default condition (e.g., non-payment of interest, etc.), an event of default occurs under the debt documents and accordingly, certain creditors may have the right to enforce remedies (including the right to accelerate the debt in full, as described above). Creditors are unlikely to enforce remedies for "minor" or technical defaults, as the costs of enforcing such remedies often dwarf the expected benefits (as compared to a negotiated resolution); however, the occurrence of a significant event of default for which lenders are likely to enforce remedies leaves an issuer with, essentially, two choices: to seek an out-of-court reorganization or to seek protection from creditors through a bankruptcy proceeding.

Out-of-Court Restructuring: a process in which the issuer and its creditors work together to restructure its balance sheet outside of a bankruptcy court. An out-of-court restructuring is typically faster and less expensive than bankruptcy and the issuer is able to avoid the negative connotations associated with a bankruptcy filing (e.g., to its creditors and suppliers). Conversely, the biggest downside to an out-of-court restructuring is that all creditors need to agree on contractual modifications of certain "sacred rights" held by the creditors, such as extensions of maturity or changes in security type, which frequently need to be altered for the restructuring to be successful. Depending on the total number of creditors throughout the affected classes, obtaining the consent of each creditor may be a momentous task. In addition, without a court's involvement, an issuer has fewer options available to improve its financial condition unilaterally. For example, in a bankruptcy, issuers can reject certain types of disadvantageous contracts and completely "wash away" certain liabilities; such an option is not available to issuers that pursue out-of-court restructurings.

Bankruptcy Protection: for a corporate issuer, there are two kinds of bankruptcy processes that it can elect to pursue through the U.S. legal system.

- **Chapter 7 - Liquidation:** a court-driven process by which the assets of a debtor are sold for cash, with the creditors receiving all proceeds (after expenses) until paid in full. Once all proceeds from asset sales are distributed to creditors (and, if any remain available, to equity holders), the debtor is dissolved.

- **Chapter 11 - Reorganization:** in this type of proceeding, the debtor remains in control of its business and the bankruptcy court acts as an intermediary between the debtor and its creditors. Seeking to reorganize through a bankruptcy proceeding provides the debtor with numerous benefits, including the inability of its creditors from enforcing on their claims (such as selling off the debtor's assets) as well as the aforementioned ability by the debtor to reject certain liabilities.

Also, unlike an out-of-court restructuring, which requires the unanimous consent of creditors to modifications of certain important terms of a debt instrument, approving a plan of reorganization, which will usually modify some of these “sacred rights” discussed above, requires only the consent of both two-thirds of the total claim amount of such debt class and a majority of the number of holders within such class. Furthermore, a debtor can obtain approval from the bankruptcy court to unilaterally eliminate certain liabilities that are deemed to be detrimental to the going concern of the business, subject to a court–approved payment to the creditor for such rejection. For example, in many retail bankruptcies, the debtor may close money-losing stores and reject any remaining lease obligations of that store, simultaneously cutting expenses and eliminating debt.

The downside to a Chapter 11 bankruptcy is mostly related to cost and time; it is a slow, time-consuming, legally-intensive process that can take years to complete and the debtor must obtain court approval for any significant action taken during the proceeding. Such a route may prove to be administratively cumbersome, as well as quite costly to the debtor (which generally is responsible for the oftentimes significant legal costs incurred by its creditors in connection with such bankruptcy). Moreover, the debtor’s image may be indelibly tarnished simply for seeking bankruptcy protection in the first place.

Section 3: Chapter 11 Bankruptcy Terms

Once an issuer files for Chapter 11 bankruptcy reorganization, certain legal doctrines and documents circumscribe decisions and actions by both a debtor and its creditors in bankruptcy. While the following terms are not exhaustive, they represent common constructs that creditors may face.

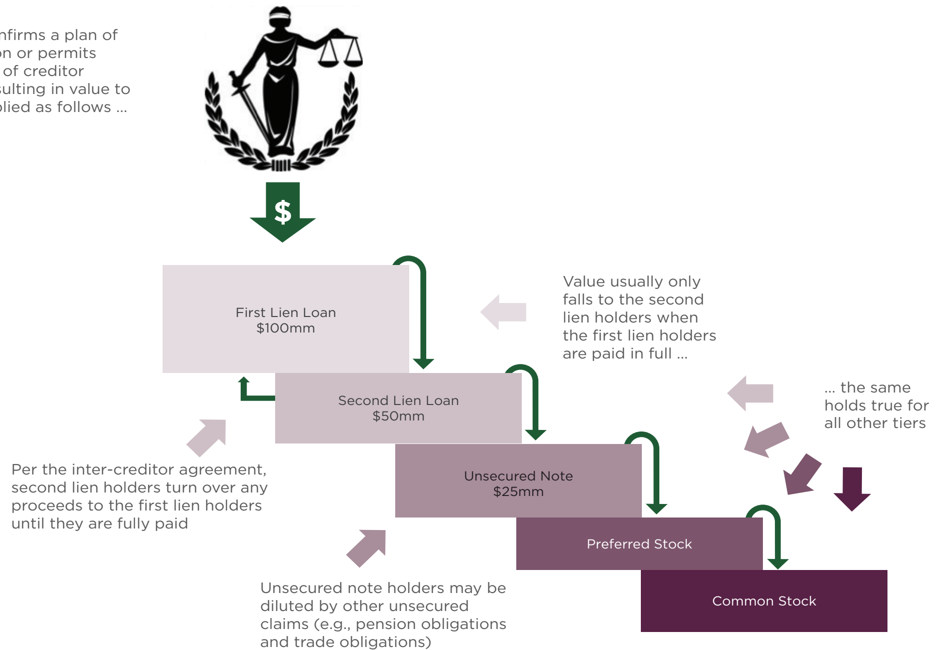
Plan of Reorganization: the crux of a Chapter 11 case, the plan of reorganization is the document filed with the bankruptcy court in which the debtor sets forth how it will repay its creditors together with the reorganized capital structure of the issuer upon emergence from bankruptcy. Only impaired creditors are permitted to vote for or against a plan of reorganization, and as a general rule, at least one class of impaired creditors must vote in favor of a plan of reorganization for a bankruptcy court to confirm it. Creditor classes that are paid in full under a plan are deemed to approve it, while creditor classes that are out of the money are assumed to reject the plan.

Automatic Stay: a provision embedded in the U.S. bankruptcy code that prevents creditors from enforcing remedies against the debtor immediately upon its filing for bankruptcy in court. The time period of the stay is determined by a judge and is meant to provide the issuer with time to restructure its balance sheet without continually fending off actions by its creditors to sell assets or otherwise enforce remedies against it.

Absolute Priority Rule: a basic principle of bankruptcy law that stipulates the order in which capital providers receive value from either a liquidation or a reorganization. The rule is intended to ensure that the most senior creditors receive a recovery before any junior creditors (as well as any equity holders) receive anything. It also provides for the “fair and equitable” treatment of any class that does not accept the plan of reorganization and is impaired, which is another tenet that drives the court’s decision-making process.

Waterfall: an offshoot of the absolute priority rule, this is a commonly-used term that relates to the specific amounts of value that each class must be repaid before any residual value can be distributed down the value chain to more junior classes. Exhibit 2 graphically depicts how the waterfall of value flows down a capital structure.

Exhibit 2: The Waterfall



Numbers stated above are hypothetical and for illustrative purposes only.

Adequate Protection: the concept that as the bankruptcy process unfolds, secured creditors should receive some form of assurance that the value of their collateral does not decline. Secured creditors may receive compensation in the form of current interest payments as well as replacement/additional collateral. Adequate protection is a meaningful advantage for secured creditors as compared with unsecured creditors during a Chapter 11 proceeding.

Creditors' Committee: in both in-court and out-of-court reorganizations, groups of creditors will usually organize themselves into committees both formal and *ad hoc* committees. Typically, both the class providing the debtor with ongoing liquidity during a restructuring process (typically the revolving lenders) and the fulcrum class (the holders of the security that is partially in the money and partially impaired, and therefore likely constitutes the new "equity" in a restructuring) will have the most influence on a restructuring process.[2] These committees, which typically comprise the largest holders of these respective debt classes, generally wield significant power. In a bankruptcy proceeding, the court will usually factor the views and suggestions of various creditor classes into its decisions.

Blocking Position: where a single creditor or a group of creditors owns over one-third of the face amount of a debt class. In a Chapter 11 proceeding, two-thirds of the principal amount of debt and a majority of the holders of an impaired class must approve a plan of reorganization, and accordingly the holder(s) of a blocking position can reject (or block) the

[2] Depending on the nature and extent of a debtor's liabilities, the unsecured creditors class and corresponding committee (even if not the fulcrum class) may also carry significant weight in restructuring negotiations as well.

... a creditor's critical analysis and swift engagement in the event of a likely restructuring is essential

approval of a plan. Consequently, a blocking position provides significant negotiating power to the holder(s) of any class that is needed to approve the plan.

Debtor-in-Possession (DIP) Loan: a loan made to a debtor while it is in bankruptcy. Once the issuer has filed for Chapter 11 bankruptcy protection, it is referred to as a debtor, yet it retains the power to operate its business during this period. A DIP loan is usually senior to all other debt obligations and provides necessary liquidity to the debtor through the bankruptcy proceedings so that it can continue to fund its operations until a successful exit.

Section 4: When a Creditor sees a Restructuring on the Horizon

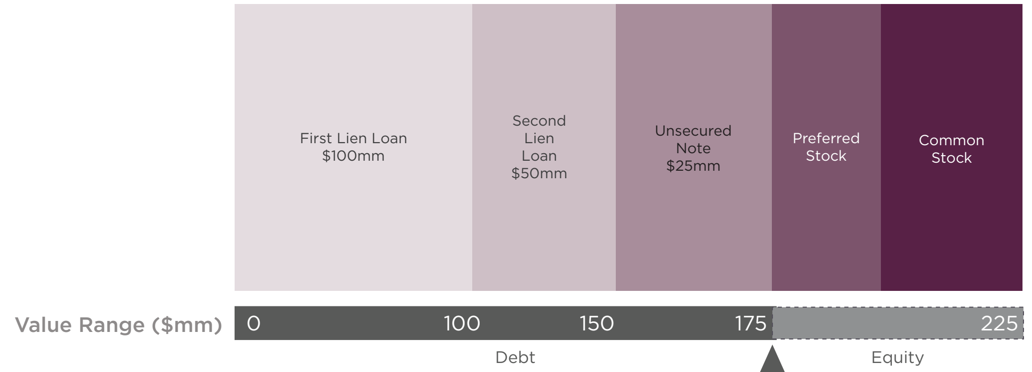
A creditor may have warning of an impending restructuring (a struggling issuer within an industry in secular decline is a good example) or there may be an unexpected event that precipitates a restructuring (e.g., a loss in a material lawsuit or the termination of a large customer account). In either case, a creditor's critical analysis and swift engagement in the event of a likely restructuring is essential to one's understanding of what rights and remedies may be available as well as how to best position oneself for a potential workout of the business. A creditor analyzes its position using several data points in such a situation, and certain concepts a creditor will likely need to understand in such a review are noted below.

Intercreditor Agreement: a contract that sets forth the rights of different secured creditor classes vis-à-vis one another (e.g., between the first and second lien creditors). An intercreditor agreement will usually stipulate what actions a junior secured creditor class may take after an event of default as well as include a specific provision regarding the order in which secured creditors may be paid from enforcement actions. For example, in Exhibit 2 above where the debtor has both first- and second-lien creditors, the intercreditor agreement will likely require the second-lien creditors to turn over any proceeds it receives from an enforcement of remedies until the first-lien debt is repaid in full. Understanding how an intercreditor agreement may impact a creditor's actions in a restructuring is a key component of understanding how that investment may fare in a workout.

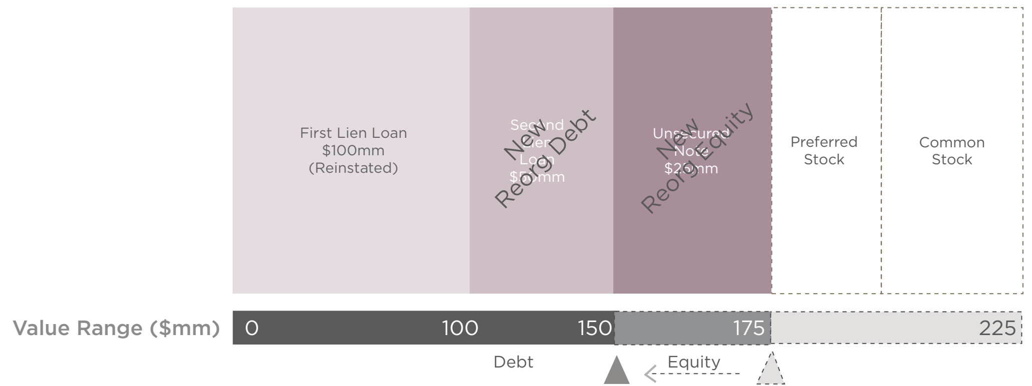
Fulcrum Security: refers to the debt class in a debtor's capital structure that receives the majority of equity in a reorganized issuer as part of its recovery. In Exhibit 3 below, a theoretical issuer's capital structure is shown both prior to and following a reorganization. As noted above, the fulcrum class often has the most leverage in a bankruptcy proceeding as creditor classes above it are in the money (and typically deemed to consent to a plan of reorganization) while classes below it are out of the money (and deemed to reject the plan of reorganization). Understanding where an investment sits vis-à-vis the fulcrum security is crucial to determining the likely treatment of that investment in a bankruptcy, and is dependent upon a creditor's ability to accurately determine the total enterprise value of the issuer. That determination will also inform the way a creditor views an out-of-court restructuring compared with a bankruptcy proceeding, as the treatment of their security may be more favorable in one circumstance than the other.

Exhibit 3: Determining the Fulcrum Security

Case 1: Company Valued at $225mm



Case 2: Company Value Impaired, now $175mm



Numbers stated above are hypothetical and for illustrative purposes only.

In Case 1, prior to a reorganization, an issuer is valued at $225 million with a debt capital structure consisting of three tranches that amount to $175 million. Preferred and common stock with a value of $50 million sit junior to all of the debt classes.

Case 2 demonstrates what happens when the same issuer's value declines to $175 million from $225 million. According to the absolute priority rule, if there is only value sufficient to compensate the debt holders, the original preferred and common stock holders receive nothing.

Moreover, to provide the emerging entity with a sustainable capital structure and a sufficient equity "cushion" (to reduce the risk of a subsequent restructuring), some of the existing debt must be converted to equity. Consequently, the $25 million unsecured note becomes "equitized" and the holder becomes the owner of the new equity of the restructured issuer; in this example, this unsecured note would constitute the fulcrum security.

Creditors may have very different responses to a potential workout

Examples of Investment Strategies in a Restructuring

Upon reviewing the likely positioning of an investment in a restructuring, a creditor may choose among several possible options. For example, a creditor may choose to swiftly exit the investment to avoid the uncertainties and downside risk associated with holding a defaulted investment; restructurings are oftentimes onerous and time-consuming, and many creditors, even those regularly trafficking in the high yield space, may have a mandate to avoid such circumstances altogether.

Alternatively, a creditor may choose to simply “stay the course” and hold its investment through the default in the hopes that the investment will prove fruitful upon a successful restructuring of the issuer’s balance sheet; such an approach entails risk, especially to the extent that a creditor holds a relatively small position in a debt class and accordingly does not have the ability to exercise meaningful leverage over the restructuring process.

Finally, a creditor may choose to “protect” its position by adding to its existing investment in a certain debt class, or by entering into agreements with other holders of that class, in order to obtain either a blocking (one-third) or a controlling (two-thirds) position such an approach will enable such a creditor to have significant influence throughout the course of the restructuring process, as well as post-emergence from a successful restructuring.

We have touched on a few of the myriad of factors that a creditor would analyze in assessing the likely effect a restructuring would have on an investment and as noted above, creditors may have very different responses to a potential workout of an issuer. A creditor’s knowledge of the issuer’s business fundamentals as well as a keen understanding of the legal constructs in play are crucial in making an informed assessment of the consequences of a potential restructuring.

Conclusion

Biases can sometimes drive investment decisions. Within the corporate debt market, to many investors, defaults and bankruptcies often carry negative connotations. For such investors, not only is the legal system complex and specialized, but the manner by which an issuer is valued changes dramatically when in bankruptcy. Such a combination of unknowns leads many investors to simply exit stressed and distressed positions, oftentimes at prices that are not necessarily reflective of fair market value. However, for a relatively small universe of investors, these unknowns may be greatly minimized by both a deep understanding of the law, as well as by performing rigorous credit analysis in their assessment of each high yield bond or loan investment opportunity.

Hopefully, this paper provides readers with a high level overview of a complex topic, and builds a foundation for understanding a commonly misunderstood, yet potentially critical, area of investing within the non-investment grade corporate debt universe.

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For information on DDJ's investment capabilities, please contact:

Jack O'Connor

Head of Business Development and Client Service

joconnor@ddjcap.com

Phone 781.283.8500

Web ddjcap.com

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