Berenson Advisory

Berenson's **Restructuring & Recapitalization Practice** advises companies, sponsors and creditors in leveraged and financially distressed situations, with a focus on minimizing and managing financial crises, preserving stakeholder interests and reviving businesses; the practice provides high level, bespoke advice with the firm's senior partners leading the advisory teams.

COVID-19 UPDATE

The economic entropy brought on by the COVID-19 crisis has begun to stabilize as recent incoming data from the jobs market suggests that we found a bottom sometime in late May. However, the timing and pace of the recovery are murky as many critical economic indicators remain unknown. Companies, particularly those owned by private equity ("PE") firms, continue to calibrate their COVID mitigation strategies as they now have more visibility into the damage caused by the crisis. For many, revolving lines of credit have been drawn, employees have been furloughed or laid off and other costs have been cut to the bone – all in hopes of preserving enough value to survive. The PE community faces significant challenges given the leverage profiles of many portfolio companies and its limitations in accessing additional debt and government bail-out programs. PE firms are playing defense by protecting their existing investments and beginning to consider how and when they will go on offense amid what we anticipate to be a pickup in M&A activity in the latter half of 2020.

PRIVATE CREDIT

PE managers (particularly in the middle-market) have increased their returns over the past decade by piling on debt, mainly provided by private credit firms. Even though much of the debt issued by private credit in the last few years has been "covenant-lite" and "contract-lite", the blunt force trauma inflicted by the COVID crisis on the economy has triggered a wave of covenant and monetary defaults that no one could have predicted earlier in the year. Private credit firms have seen their portfolios decimated and accordingly have shifted much of their focus and resources to their work-out departments to process the defaults – many of which were incurred by PE and will require haircuts to keep the businesses afloat. Private credit has always taken a hard-nosed stance on debt write-downs and major contractual changes to debt instruments, but the sheer volume of defaults is impacting their behavior as they try to clear the decks of defaulted loans and stabilize their loan books.

DEFENSE

PE firms have appropriately focused time and capital on their existing portfolio companies' operations, marshalling liquidity and cancelling or postponing M&A activity. New capital from the credit markets for middle-market PE has stalled and government bailout programs have been a dud as most PE firms are either ineligible for or unwilling to tap the Payroll Protection Program and/or the Main Street Lending Program. Without the ability to raise more debt, PE managers must deploy their own dry powder to provide for equity cures or inject equity to effectuate restructurings of their borrowings. According to a poll by EY, managers are ready to do so, as 70% of PE firms will support their existing portfolio companies with fresh equity. Even though re-equitizing existing investments will drag down returns, we have seen some middle-market PE firms use up significant dry powder and recycle capital from their investors to protect their portfolios. However, we expect the dislocation caused by the COVID crisis to present buying opportunities and give PE managers a path toward achieving outsized returns in new investments that can balance the hit to their existing portfolios.

OFFENSE

PE firms have amassed over $1.5 trillion in dry powder that can be deployed in new deals. Massive government support, low interest rates and balance sheet liquidity might make the recovery less traumatic for some sectors, barring a resurgence of the virus. For sectors more acutely impacted, such as travel and leisure, food and beverage, hospitality / events and the like, the structural damage that has been inflicted upon the entire value chain may be permanent. These businesses will likely be bailed out by 1) rescue capital from credit funds, 2) equity injections by PE sponsors alongside debt restructurings and/or 3) acquisition by sponsors or strategic buyers looking to consolidate a space by picking up wounded companies on the cheap. Relatively healthy strategic and financial investors are assessing a landscape now littered with companies that were just fine in February of this year and will be up for grabs in the Summer / Fall. We have been advising clients on both the sell-side and buy-side on deal structures, risks, tactics and financing options in order take advantage of the opportunities that may arise. Below we discuss strategies to pursue distressed targets.

DISTRESSED ACQUISITION STRATEGIES

TRADITIONAL M&A

The months-long freeze in M&A activity has created a backlog of deals that were put on hold, sale processes that were prepped but never launched and PE-owned businesses that would have otherwise started exploring sale options but have instead diverted their energy and focus to operational triage. Even with a challenged credit market, we anticipate a flurry of activity in a relatively healthy M&A market. We expect to see many of these acquisitions funded with less debt, putting pressure on returns over the near-term. This will likely be offset by multiple compression as buyers realize that the multiple expansion created by a record bull market run has had its day of reckoning. We also counsel our clients not to overly fret if a strong acquisition opportunity presents and requires over-equitizing to complete. History has shown over and over that credit markets rebound and refinancing equity-heavy businesses can and will allow for rebalancing of capital structures with only a modest impact on returns.

BUSINESS UNIT OR ASSET SALES

Larger businesses may seek to jettison specific assets or entire business segments to generate liquidity to shore up their own balance sheets. We anticipate seeing more opportunities for attractive and profitable carve-outs in the coming quarters.

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PURCHASE OF ASSETS IN CHAPTER 11/363 SALE PROCESS

Bankruptcy filings spiked dramatically last month and we expect the number to grow as companies seek the protections provided by bankruptcy court to reorganize or sell their assets. While these 363 sale auctions in an insolvency proceeding tend to be competitive, there will be plenty of targets to pursue. Furthermore, acquiring assets through a 363 process ensures the target is free and clear of any legacy liabilities or encumbrances.

RESCUE CAPITAL / LOAN-TO-OWN

While historically the domain of large credit firms, we have seen interest from the PE community in providing rescue capital to businesses that have nowhere else to turn for equity funding if they want to avoid a bankruptcy filing. This capital typically primes the existing secured debt holders and has liquidation preferences that triangulate to equity-like returns.

PURCHASE OF DEBT FOR CONTROL

Given the volume of distressed and/or defaulted loans, private credit firms will be more amenable than usual to selling their debt at a discount to face value. The new investor will then have the ability to enforce their rights in the event of default and take control of the borrower. We are cautious in encouraging equity-only PE firms to pursue this strategy as there is a natural divergence between the core competencies surrounding equity and debt holders and purchasers.

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