Corporate Rescue Financing: A New Growth Industry

by
Anthony J. Gumbiner, Chairman

The Hallwood Group Incorporated*

***Note:** Hallwood Group Inc. is the only merchant bank with shares listed on the New York Stock Exchange and The Stock Exchange, London. Rescue financing is a specialty service of the bank.

The stop-go inflation and sustained periods of abnormally-high interest rates over the past decade have pushed many companies toward the edge of bankruptcy. This phenomenon has now made corporate rescue financing a new growth industry, rather than the occasional merchant banking service it was in previous financial eras.

Since 1971—first as a private company and since May, 1984 as a publicly-owned one—Hallwood has specialized in providing sophisticated corporate rescue financing for financially-distressed, publicly-owned corporate clients. To support our rescue plans, we have assembled an international network of first quality institutional investors who act, in effect, as sub-underwriters for Hallwood merchant banking projects. These sub-underwriters include leaders in the capital markets of the United Kingdom, Switzerland, The Netherlands, Hong Kong, and Japan. Further, we have developed our own central staff of experts in merchant and commercial banking, bankruptcy law and specialized financial analysis.

In a principal financial analytical activity, we conduct a proprietary, computer-based research effort daily to first identify and then closely track potential corporate rescue clients. In general terms, steady—perhaps daily—deterioration in certain traditional and less-traditional balance sheet ratios identifies companies to us as clear candidates for our special financial rescue restructuring service. Presently there are some 400 U.S. companies alone which we are closely tracking as prime candidates for restructuring; and, in view of the sustained decade or more of high interest rates, it is not surprising that the numbers of financially-distressed companies continue to expand. For the benefit of our own fee earnings for restructuring, the growing market of restructuring candidates allows Hallwood greater selectivity in planning for restructuring projects. We can concentrate, for example, on potential client companies with solid asset bases. Those quality assets will help attract investment in shares of the restructured company and give the client company a firm foundation for on-going future progress.

Procedurally, and before even a first approach to a potential restructuring client, we draft a detailed plan that will convert the client's negative net worth and cash flow to positives and its deficits to earnings. The overriding objective is to so plan a financial rescue of the company that it will fully maintain its operating integrity and avoid liquidation. Thus, managements of potential restructurings normally welcome Hallwood's restructur-

ing plans. Moreover, it would be rare indeed for a publicly-owned company facing imminent bankruptcy not to consider with high priority attention a genuine rescue offer from a competent, experienced source.

Our basic approach to restructuring involves two general steps:

1. We negotiate with creditor banks to retire all debt for cash at a deep discount.

2. We finance the debt retirement through issuance (following in the U.S. of course of full SEC approvals) of a deeply-discounted rights offering to purchase shares in the restructured company.

Effective negotiations with creditors—principally banks—are essential to a successful restructuring. As part of our working agreement, typically a company's board temporarily delegates to us sufficient authority to negotiate successfully. Ultimate control of course is always with the shareholders—both those who held original shares and exercised their rights to new shares in the rights offering, and new institutional investors who may become shareholders by purchasing in the offering.

Frequently, we find that creditor banks of distressed companies have already designated their loans as "nonperforming" and have assigned them to work-out groups within their commercial loan departments. In addition, federal regulations may indeed have forced the bank to write down the value of such loans to amounts that could be expected from liquidation in bankruptcy. With the long process and uncertain results of bankruptcy, write-downs of 50 per cent or more are not uncommon.

Our proposal to the banks is to settle debt for approximately the net amount they would receive on completion of a bankruptcy plan, after considering the usual costs of the bankruptcy and the loss of interest while waiting for final payout.

After reaching formal agreement with a client and its creditors, we then engage a major accounting firm to conduct a thorough financial investigation of the company, and we also employ the services of suitable consultants and appraisers to evaluate its assets. To complete our analysis, we make certain that management has not been involved in malfeasance or malpractice in bringing the company to its current state.

We then prepare a prospectus-proxy statement and arrange to convene a shareholders meeting to approve the plan of restructuring.

This process usually takes from four to six months.

In the offering of rights, new shares are priced at least 25% less than book value of the restructured company, or in some cases, of the company's revalued asset base. Nevertheless, our experience has been that most current shareholders—perhaps dispirited by their company's problems—do not respond well. More recently, however, as our techniques have become better understood and appreciated, more and more shareholders are either exercising their rights and purchasing new shares, or they are selling their rights in rights markets which we create. Thus the general investing public also has an opportunity to participate in a Hallwood-planned rights offering as well as shareholders and underwriters.

Hallwood Group acts as the main underwriter. We agree to purchase any shares not subscribed for by shareholders—the latter of course have first opportunity to purchase. We then resell any remaining such shares to our international institutional investors. These institutions—including some of the world's most respected pension funds, unit trusts, insurance companies and money managers—each take only relatively small percentages of the underwriting risk, and they hold their shares as passive investments. Although they receive a small underwriting commission, they are mainly attracted by a confidence in Hallwood's ability to plan and implement a restructuring that will enhance their investment.

Our fee for restructuring services is usually 10 per cent of the company's outstanding equity, payable in its shares. Normally, we would expect to maintain this position as a long-term investment. In addition, to ensure that the newly restructured company adopts adequate financial and budgetary controls and conservative management practices, a Hallwood representative is elected to the company's board of directors. We have no interest in managing the company's operations, however. We consider our position on the board similar to that of any other outside director, and we are more concerned with the company's financial statements than its management practices. We want to ensure that the mistakes of excess of the past are not repeated. Once again, the companies we select as potential clients are basically sound enterprises that in recent years were plagued by forces outside their control. We feel that the managements of such companies—which have usually had many years of successful growth before encountering problems—emerge from our restructuring even more experienced and

they will thus perform better than any new, untried management might should problems arise again.

One of our main advantages in working with a distressed company is that we are not burdened with the legal problems of equitable subordination as banks would be. For example, if a bank work-out group were to propose our type of detailed, hands-on restructuring plan, the bank could be deemed to be exercising shareholder control, and thus it could subordinate its secured debt into equity. In a bankruptcy, this subordination could leave a bank with virtually the lowest priority claim —after all unsecured creditors in fact.

As a merchant banker, Hallwood has no such constraints. We are able to direct a company's affairs to the extent necessary to achieve an effective restructuring. Because of this ability—and our record of successful restructurings—we enjoy excellent relationships with bank work-out groups. In fact they consider us a very positive resource in resolving some of the most problematic loans.

Another advantage we have in negotiating with creditor banks is our dispassionate position as a third party. In prolonged direct negotiations between a company and its creditors, relationships tend to deteriorate to the point where further efforts are ineffective. With our objective approach, our history of successful restructurings, and our substantial financial resources, we can inspire confidence in an aggravated lender, and thus secure the best possible terms in settling loans.

Typical REIT Restructurings: During the early Seventies, the real estate investment trusts were often caught up in a disaster scenario of rapidly rising interest rates. The problem was unbearable bank debt on many REIT balance sheets—a condition that could be successfully corrected by Hallwood's program of debt settlement and equity infusion. Thus Hallwood became well known in the decade for a series of restructurings of major real estate investment trusts, including Institutional Investors Trust, First Pennsylvania Mortgage Trust and UMET—all with New York Stock Exchange listings.

1. **Institutional Investors Trust.** Hallwood's restructuring plan for this NYSE-listed REIT had three elements: a) Issuance of 27.2 million new common shares at 65 cents per share by means of a rights offering; b) Payment of 750,000 new common shares—plus $7 million in cash, plus transfer of a wholly-owned subsidiary to creditor banks for settlement of $36 million in debt; and c) Redemption of $10.4 million

of subordinated notes on the basis of 40 cents for each dollar of principal. It happened that just four weeks after this IIT transaction was completed, Hallwood and its underwriters sold their shares to Unicorp Canada Corporation and Hess International Corporation at $1.25 per share (nearly double the price of the shares in the offering).

2. **First Pennsylvania Mortgage Trust.** In 1980 shareholders approved Hallwood's plan of financial restructuring for this NYSE-listed REIT. Bank debt of $47 million was satisfied by $20 million in cash, a property that was being carried at no value and 3.4 million common shares in the restructured company. Issuance of rights to purchase seven new shares at a price of $1 per share for each share held raised $20 million for debt retirement. In this case, Hallwood's sub-underwriters took up 80 per cent of the rights and subscribed to an additional 3.1 million. After restructuring, the company was renamed Atlantic Metropolitan Corp. Later, on April 30, 1984 Atlantic was merged into the newly-formed Hallwood Group Inc., a Delaware corporation.

3. **UMET Trust.** In a Hallwood restructuring plan consummated in 1981, this REIT (also NYSE listed) retired $29.9 million of its bank debt for $18.6 million plus 100,000 shares of UMET. The cash was raised by issuing rights for 2.1 million new convertible preferred shares at $9.50 per share. Shareholders exercised rights to purchase 50,000 shares. Hallwood underwriters purchased the remaining shares. Additionally, 900,000 new common shares were issued to underwriters. On April 30, 1984 this company, too, was merged into The Hallwood Group Inc.

4. **Stanwick International Corp. SA** (formerly Schlesinger International Fund). This former open-ended investment fund—is listed on the Luxembourg Stock Exchange. Stanwick was used as a vehicle to acquire the assets and liabilities of The Twenty Seven Trust, a liquidating trust formed following the bankruptcy of Chase Manhattan Mortgage Realty Trust, a NYSE-listed REIT, for the purpose of holding those assets of the trust which accrued to its twenty-seven creditor banks following the REIT's bankruptcy. Interallianz Hallwood purchased the assets and liabilities of the Twenty Seven Trust for $34 million in negotiations with Chemical Bank, lead bank of the bank shareholders of the Trust. Stanwick raised the $34 million purchase monies by issuing 898,345

new ordinary shares at $21.15 per share, and a $15 million fixed rate 15 per cent Eurobond with a 10-year maturity. Both the equity issue and the Euro financing were fully underwritten by Interallianz Hallwood and Interallianz Bank and placed with institutional investors in the United Kingdom, Switzerland, Holland, Japan and Hong Kong.

Recent Restructurings: More recently, Hallwood has been focussing its corporate rescue restructuring service on oil drilling and certain other manufacturing industries now under heavy financial pressures in the mid-Eighties. One program, for Saxon Oil Company (NASDAQ: "SAXO") was completed in December, 1984. An account of the facts as they developed in this case well illustrates the complexities that can drastically impact what in other eras might well have been a tenable range of business risk which becomes wholly untenable in a period of very high cost debt.

Saxon Oil Company was started in the late 1960s by Bill Saxon who retained ownership of all shares. For twenty years the company achieved outstanding success in oil and gas exploration, development and production to become the fifth largest independent oil company in the United States. The company operates over 500 wells in the Sprayberry Trend area around Midland, Texas. It has formed 29 limited partnerships—drilling programs involving 5,500 investors—and it has been rated by recognized authority as one of the three best performers in the country.

In 1981, 20 per cent of the company's stock was offered to the public and sold. The shares were very well received in the then-prevailing mood among investors concerning oil and gas companies, and the shares moved up rapidly in trading from an offering price of $25 to a high of $44. The latter price was reached on the news that Saxon had become a major player in the Fletcher natural gas field of the Anadarko Basin in Oklahoma.

Saxon's Fletcher project, in fact, captured the attention of oil and gas investors throughout the world. Fletcher was a "deep gas" field and therefore free of price regulation. An uncompleted test well four miles deep revealed a vast gas field with botton-hole pressures sufficient to value each producing well at a half billion dollars at the then-prevailing deep-gas price of $9 per thousand cubic feet. Drilling a well four miles deep required the ultimate in technology at a cost of some $10 million per well—an awesome figure which, however, represented only a small fraction of potential possible return. The risk/reward ratio proved irresistible.

Borrowing heavily, and from trade customers as well as banks, Saxon Oil purchased enough acreage in the Fletcher Field to drill 70 wells. Drilling began with enthusiasm. Besides the burden of high interest debt, the company could not have anticipated devastating governmental regulatory changes to come.

The estimated profitability of deep gas depended on the Carter Administration's price control system which allowed a free market in deep gas but required all other gas to be sold at prices between 15 cents and $3 per thousand cubic feet. When President Reagan then decontrolled oil and gas prices, deep gas could no longer be produced profitably. Saddled with $180 million in debt, and unable to profitably develop its Fletcher property, Saxon Oil found itself in the center of an economic disaster, and on the edge of bankruptcy.

As a result of a Hallwood program of restructuring, however, Saxon Oil has moved from a negative to a positive net worth of $40 million. Its present properties, with the Fletcher Field totally out of the picture, have no unsecured drilling risks and they offer considerable opportunities for infill drilling and greater profits. At the low value placed on its reserves in the restructuring, moreover, the company is well protected against possible declines in oil prices.

In concluding, I would emphasize that service in the best current and future interests of our corporate restructuring clients, including all their present and prospective shareholders and all their former or future creditor banks or others is the essence of a successful corporate rescue restructuring. Client companies from whatever industry which have via Hallwood plans seen their former excessive debt transformed to new equity emerge from rescue in a state that will allow them to return to the high earnings levels they once knew. To provide service of exceptional value to our corporate clients—whether a restructuring or other service—is the constant work and goal of The Hallwood Group Inc.