

## AEGON INSIGHTS

# Opportunities stemming from liability management overhang

*Last month we [discussed](#) investing in post-liability management exercise (LME) structures. In this piece, we discuss one way to think about investing in structures with high near-term LME risk.*

Historically, when companies become stressed or distressed, value investing—or investing in a company at a price below its intrinsic value—has been the main philosophical approach.

While that key tenet has not changed, determining the appropriate capital structure position in which to invest (and pinning down that value) has become increasingly complex in the advent of LMEs.

Fortunately, as discussed below, taking a holistic approach to these situations can help navigate and capitalize on this now larger and increasingly robust opportunity set from a value-oriented perspective.

## Sources of value

In such circumstances, we believe at least three new sources of value often emerge:

1. Each part of a company's capital structure prices in the risk that the liability management activity will favor a different part of the capital structure in a zero-sum game, with the aggregate priced-in risk across the capital structure being overdone.
2. Each debt holder prices in additional risk as they assess both the likelihood of a non-pro-rata transaction occurring, as well as their ability to participate (as discussed in our earlier [white paper](#)).
3. Much like in example 1 above, where the entire capital structure doesn't reflect the true enterprise value of the company in aggregate, you also often see separate parts of the capital structure inaccurately pricing in potential LME outcomes on a *relative* basis.

As such, and as illustrated in the following pages, taking a bigger picture view of the capital structure can allow investors to capitalize from the abovementioned inefficiencies and can allow for value-oriented return realization on a disperse range of potential outcomes—with the added benefit of dampening volatility.



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To give context, below we outline one (of many) perspectives/frameworks investors can take in evaluating some of these situations from a value-oriented standpoint.

## Hypothetical illustration<sup>1</sup>

For example, imagine a distressed company with this simplified cap structure:

Tranche	Maturity	Amount	Price	Market Value/ Creation Value
Secured Term Loan	2028	\$1B	85%	\$850M
Total Secured		\$1B		
Unsecured Bonds	2027	\$400M	60%	\$240M
Total Unsecured		\$400M		
Total Debt		\$1.4B		\$1.24B

For illustrative purposes only. <sup>1</sup>Hypothetical examples are for illustrative purposes only and should not be relied upon for investment decisions. Hypothetical or simulated examples have several inherent limitations and are generally prepared with the benefit of hindsight. There are frequently sharp differences between simulated results and actual results. In addition, there are numerous factors related to the markets in general or the implementation of any specific investment strategy which cannot be fully accounted for in the preparation of simulated results, yet all of which can adversely affect actual results. No guarantee is being made that results shown will be achieved.

This hypothetical company has been experiencing fundamental weakness and the market narrative has turned to concerns about liability management—hence the 85% price for the term loan and the 60% price for the unsecured bonds. Let's assume that, for the ease of this example, the consensus/true enterprise value in this case is \$1.2 billion.

Importantly, while determining true valuation is a source of risk, it's a fundamental risk that investors like. And fortunately, distressed investors often err on the side of extremely conservative valuations or higher required rates of return.

Although this hypothetical is an oversimplification, it resembles an archetypal liability management setup that's often seen with two-tiered capital structures at the precipice of a credit event.

## Term loan perspective

In this example, the term loan price (85%) is reflecting a probability that it may get "primed" by all or some of the unsecured bonds, since the bonds' maturity is next in line. Getting "primed" means that the unsecured bonds could leap in front of the term loan in the capital structure. Without diving into the mechanics, it's worth noting that many (if not most) loan documents leave ample room for this kind of transaction. Additionally, and outside the scope of this example, there is also some possibility of additional LME components—such as a new-money component or getting primed by just a "subset" of lenders. (Although the legal technology for many of those types of transactions is now being called into significant question after the recent Serta decisions).

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- **Downside case:** Taking the most conservative view for the downside, in the event that the secured term loan gets primed by the entirety of the unsecured bonds at par and the company files for bankruptcy (crystallizing the \$1.2 billion valuation), the term loan would recover 80%, representing a 5-point loss from the current 85% price.
- **Upside case:** Represents no priming and the outcome in this scenario is straightforward: par. That represents 15 points of upside from the current 85% price. Whether in bankruptcy (which is well covered by the \$1 billion outstanding and the \$1.2 billion enterprise valuation) or out of bankruptcy, there is always a chance that the business turns around and the company can pay its debts when they come due.
- **Implied probabilities:** Considering *only* these two states of the world (and assuming the contractual interest rate is an appropriate market yield ex-LME potential), with 15 points of upside and 5 points of downside, the market is implying a 75% probability of the discussed liability management transaction.

## Bonds Perspective

The unsecured bond price (60% of face value) reflects significant uncertainty about the company's ability to refinance its 2027 maturity. On a recovery basis (equitization of the capital structure), this bond is worth 50% with its current position in the capital structure and against a \$1.2 billion valuation.

Outside of business recovery and enterprise value improvement, the upside here stems from the priming potential as detailed above, where the company may look to address the unsecured bonds' 2027 maturity by offering them (or utilizing) lien capacity that is structurally senior to the term loan. This may happen at par (as we assumed in the term loan downside case). But since the company has strong negotiating power, it will likely be structured coercively and extract a discount.

- **Upside case:** To be conservative, let's assume the unsecured bonds are offered an up-tier exchange, with the exchange consideration being worth 80 cents on the dollar. That represents 20 points of upside from the current 60% price.
- **Downside case:** With a \$1.2 billion valuation (in the current capital structure position) the bonds are the fulcrum security with a recovery value of 50%, representing a downside of 10 bond points.
- **Implied probabilities:** In these two hypothetical examples, with 20 points of upside and 10 points of downside, the implied probability of the discussed liability management transaction is 33%.

## Putting it all together

Simplistically speaking, with an 85% current price in the secured term loan and a 60% price in the unsecured bonds, only \$1.09 billion of value is being represented in the capital structure, which compares favorably with the \$1.2 billion estimated enterprise value.

In addition, given the zero-sum nature of liability management transactions, the inverse probabilities implied by each tranche should line up with each other and total 100%. But, as is more often the case and as is illustrated

above, they do not given the uncertainty in the stressed business, as well as the capital structure maneuvering that may occur.

To take advantage of these observations, an investor could put together a position holding both tranches. As evidenced in the table below, this setup positions investors to capitalize on the value inefficiency and with the goal of reducing/eliminating much of the volatility associated with the potential liability management.

Position	Tranche	Face Amount	Current Price	Market Value	LME P&L	No LME P&L
Long	Term Loan	\$1,000,000	85%	\$850,000	(\$50,000)	\$150,000
Long	Bonds	\$1,000,000	60%	\$600,000	\$200,000	(\$100,000)
			Total Invested:	\$1,450,000	\$150,000	\$50,000

For illustrative purposes only.

In the above example, buying \$1 million face value of each tranche would enable an investor to create a very low-risk position with respect to the two liability management states of the world discussed: with an LME and without an LME. And, importantly, because the aggregate values of each tranche at market value are less than the total enterprise value, there could be positive portfolio profitability in both scenarios.

While this example is an oversimplification, the key takeaway is that by setting up a position in this manner (or at least with this general framework in more complex capital structures/situations) one could, theoretically, significantly boost risk-adjusted returns.

However, and again outside the scope of this oversimplified example, it's worth noting that there is additional risk that needs to be assessed at the onset of trouble. Accordingly, distressed investors need to tread carefully in such situations for every situation is different and carries with it its own set of novel risks.

## Key Takeaways

The main principle here is that there is a limited amount of value (the enterprise value), which may flow to the bond or the term loan depending on which direction the company decides to move its balance sheet in terms of liability management transactions. Both tranches are pricing in the risk of that value not flowing to them, but often they are pricing it differently and too conservatively.

By having the flexibility to invest across the capital structure, long-only investors can, in theory, both capture value and reduce risk through capital structure diversification while at the same time profiting from the relative dislocation between tranches.

Investing in distressed loans and bankrupt companies are speculative and may be subject to greater levels of credit, issuer, or liquidity risks, and the repayment of default obligations contains significant uncertainties; such companies may be engaged in restructurings or bankruptcy proceedings.

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