

Argyle Conversations

by ARGYLE EXECUTIVE FORUMSM

featuring

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Highland Capital Management L.P.

&

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Co-Chairman, Business Reorganization
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The survival and distressed investment strategies of middle-market companies in a post-bull market was the topic of a January conversation between James Dondero, co-founder, president of Highland Capital Management L.P., and Bruce Zirinsky, co-chairman of business reorganization and bankruptcy practice at Greenberg Traurig.

James Dondero James Dondero is co-founder and president of Highland Capital Management, L.P. He is responsible for determining and ensuring execution of Highland's strategic investment and operational initiatives. James has over 25 years experience in the credit markets. He currently serves on the boards of directors of American Banknote Corporation, American HomePatient, NexBank and Safety-Kleen System. Prior to founding Highland, James served as chief investment officer of Protective Life's GIC subsidiary and helped grow the business from concept to over \$2 billion from 1989 to 1993. His portfolio management experience includes mortgage-backed securities, investment grade corporates, leveraged bank loans, emerging markets, derivatives, preferred stocks and common stocks. From 1985 to 1989, he managed approximately \$1 billion in fixed income funds for American Express. Prior to American Express, he completed the financial training program at Morgan Guaranty Trust Company. James is a Beta Gamma Sigma graduate of the University of Virginia with a B.S. in commerce with concentrations in accounting and finance. James is a CPA and a CMA. He has earned the right to use the Chartered Financial Analyst designation in his business dealings with the Financial Industry. Regulatory Authority (FINRA) and various state and federal agencies.

Bruce Zirinsky Bruce R. Zirinsky is chairman of Greenberg Traurig's Global Business Solutions Group and co-chairman of the firm's business reorganization and financial restructuring practice. He has focused his practice on U.S. and international financial restructurings and reorganizations for almost 40 years.

In 2008, *The American Lawyer* named Bruce a "Dealmaker of the Year" for his lead role in the highly successful Chapter 11 reorganization of Northwest Airlines. He is one of the premier bankruptcy and restructuring attorneys in the United States and has represented debtors, creditors, investors and other parties in large and complex restructurings, reorganizations, acquisitions, financings and litigation, covering a broad range of industries and issues. Bruce has played a major role in the restructuring, reorganization, sale or acquisition of many large, complex businesses in the airline, telecommunications, energy, health care, manufacturing, retail, food services, financial services, real estate, rail car, shipping, forest products, petroleum, computer, media, casino gaming, and hospitality industries, among others. He has led a number of recent significant matters, including the acquisitions of Crescent Realty, LandSource Communities and a consortium's bid to acquire Extended Stay Hotels. Bruce is currently representing creditors in the American Airlines, General Motors and Abitibi-Bowater Chapter 11 cases. He is also currently acting as lead counsel in several out-of-court restructurings.

Bruce's clients include numerous *Fortune* 500 companies; public and private companies; commercial banks; investment banks; insurance companies; asset management, private equity and investment funds; and other business enterprises. His practice encompasses counseling debtors, secured and unsecured creditors, creditor committees, public bondholders, shareholders, and investors involved in many of the largest and most complex U.S. and international reorganizations and restructurings, financial transactions, litigation, and mergers and acquisitions.

He has been regularly selected for inclusion in *Super Lawyers* magazine and listed in *Chambers & Partners USA Guide*, an annual listing of the leading business lawyers and law firms in the world and *Best Lawyers in America*®.

Bruce holds a J.D. from New York University School of Law and a B.S. from Cornell University.

Bruce Zirinsky: What is the history and focus of your role at Highland?

James Dondero: Highland began as a credit shop made up of former bankers, former credit guys, former accountants who were mostly loaning money—and not always being repaid. In the early 1990s, we were pioneers among non-traditional lenders along with insurance companies and mutual funds. Over time, we diversified into distressed investing, including distressed-for-control private equity investing where we help operate portfolio companies, and into hard assets like real estate, timber, oil and gas.

Are you focused only on those specific areas or does financial potential determine other areas where you're also active?

That's a big question. We try to keep our fingers in all different aspects of credit. Sometimes that means hard assets, sometimes bank loans, sometimes bonds, sometimes distressed; generally, wherever we can handicap the amount and timing of cash flows. Most of our efforts are in the below investment-grade sectors. We're a big believer in diversification, as are most of our clients. We keep a broadly diversified presence but will opportunistically move to overweight sectors that are out of favor.

For the year ahead, I would emphasize the relative value of collateralized loan obligations (CLOs), both the debt tranches (triple-A, double-A, single-A, triple-B, and double-B) and the equity tranches of pre-existing CLOs. We're in a period when a lot of the big banks and other historic players, as part of Basel III, the global committee on banking regulations, are being told to de-emphasize securities and to get back into straight, regulated banking. So, there's an overhang in most large banking institutions of securitized product.

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We see the concern and malaise in Europe but we don't expect much actionable opportunity, which departs from the general consensus. However, you're seeing people seek to raise what I'll call platitude funds: A \$5 billion fund or a \$10 billion fund to make a “chance-of-a-lifetime” buy of distressed assets in Europe. Everybody knows that Europe is on the ropes. So the people try

to say “If A, then B, then there must be an enormous amount of selling coming.” But many of the people who are doing these platitude funds are the same people who created platitude funds last year to buy commodities they thought were their once-in-a-lifetime chance to get ahead of the Chinese. And all those funds are now down 50 percent, 60 percent.

I don't believe there will be wholesale selling in Europe. Most European financial institutions are levered 40 or 50 times over; you can't sell many assets at 30, 40, 50 cents on the dollar and stay in business. Europe must come up with a solution that lets the banks move and term-out bad assets, so to speak, and stretch their resolution over a long period of time to allow for option value and potential recovery. This would essentially create a “good bank/bad bank” structure. Europe is neither in the position nor inclined to wholesale their economic assets at 30, 40 cents on the dollar to hedge funds in New York. I just don't see it.

Where and what is your presence in Europe?

A London operation that manages CLOs and below-investment grade debt. And, in Zurich, we're working on new initiatives that I can't talk about specifically.

In the nearer term, do you see distressed opportunities in the United States, potentially, as more fruitful than those in Europe?

Yes. In the United States, the bankruptcy code is well known and understood. In much of Europe, terms of bankruptcy are yet to be defined. Handicapping the timing and likelihood of cash flows in Europe, through a bankruptcy or restructuring process, is difficult. Bottom line, it's very difficult to map out reliable exit strategies for distressed investments throughout the European continent.

Today, you're strategically focused on natural resources and energy. What opportunities exist in those sectors?

We just had our final close on our first energy private equity fund, with a total of over \$160 million in capital. We're focused on making direct investments in ongoing oil and gas development

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projects, particularly smaller independent operators, making investments in the range of \$5 million to \$30 million per project. We are overturning a lot of rocks and doing a lot of work but the returns already are being nicely borne out. It is a smaller part of the market but one where we think there is a lot of value for investors. Now, we couldn't put \$2 billion in that niche but we can work very adequately with several hundred million; so, that's what we're doing.

Are you doing any investing in Canada?

We had a bad experience 10 years ago in Quebec where the bankruptcy code didn't honor debt ahead of equity and that has kept us out of that province. But we have been more active in other areas of Canada.

There seems to be a consensus that the current lending environment is affecting the middle market most significantly. Given that a lot of your funds focus is on the middle market, what's your outlook?

The difficulty in getting middle-market financing itself today is somewhat a natural outgrowth of too much financing in a bull market. What do I mean by that? For 30 or 40 years, if you were small, if you were your dad's garment-maker, a family business, you were very heavily dependent on a management team that was also very small and usually dependent on one or two contracts. Because of inherent business risk, the only financing available was asset-based lending. You got advance rates against your inventory, your receivables, your real estate, et cetera, and that was it. No lender would take unsecured risk on that small business. But in a bull market, a lot of smaller companies dressed themselves up to look like a big company, even if they were

still small and concentrated. They started getting loans that were either only partially securitized or largely unsecured. In a rough economy, their operations went sideways. When they try to refinance, no one wants to continue lending to them on a cash-flow basis.

That is the overhang in the market right now. And a lot of middle market companies are struggling because they don't deserve to have as much leverage as they do have.

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As they continue to struggle in a low-growth, high-tax environment, the big guys, who are having their own growth problem, will start to focus on smaller competitors and figure out how they can capture business away from these smaller firms. A lot of small, mid-sized companies are going to have difficulty demonstrating that they have a reason to exist, or that they can defend

themselves from larger industry players. I do think that the default rate among middle market companies will be significantly higher—probably two to three times higher—than the default rate among larger companies.

Does that create opportunities for Highland, and others, who invest in these markets?

Sure. There are always distressed opportunities in the middle market. I think the firms that are best positioned to help investors capture these opportunities are those, like Highland, who have experienced teams that can do the hard, hands-on operational work required to identify the best opportunities and help turn the distressed middle-market companies around. For us, it is important to be proficient in both the board room and on the factory floor.

One of the factors that distinguishes Highland from other funds that invest in distress is that Highland tends to take a more activist, longer-term view of the distress companies it invests in. What other situations and approaches distinguish Highland?

We believe you have to have the operational capability to turn around these distressed companies. I think the dedicated commitment we have made to build an internal team to do this work with our portfolio companies is differentiating. We have over a half a dozen people internally who came from great strategy and operational training grounds such as Bain Consulting and McKinsey & Company and GE and Toyota. This allows us to bring experience and expertise to complex situations.

I also think our sourcing approach is special. As a leader in the leveraged finance market, we have a large research team—32 fundamental analysts outside of our private equity team—who can help monitor the high yield credit universe and identify potential distressed situations. The middle market can be opaque, as it is mostly comprised of private companies, often with small lending groups. Having our large credit research platform provides insights and first looks that many cannot and do not have.

We also have a dedicated restructuring team with legal backgrounds to help be more economically effective in the middle market when those companies can't afford the huge, huge expenses of big New York law firms and restructuring firms—even if sometimes, in certain situations, you need and use the expertise, diligence and quality of New York firms such as yours.

Thank you. Years ago, when GE Capital was still GE Credit, I did a lot of work with them. Their slogan was 'when we have lemons we make lemonade.' With experience, they realized—as you've said—that to be strong investors on the sub-investment grade level you must bring operational expertise to bear. You must be in a position to take control of situations where your debt can't be repaid. You take control of the company, using your ability to grow and enhance the value of the company as your exit strategy. But that takes a much longer-term view than that of many traditional commercial lenders. If they can, they'll just sell it to the highest bidder.

Exactly. We also align our interests through long-term compensation, which is becoming commonplace on Wall Street. So, we're able to have the alignment of interest with our investors and the consistency of looking at things on a long-term basis and being able to handle it, soup-to-nuts, make lemonade out of lemons.

And most of our legal functionality, in terms of pursuing bad sponsors or underwriters, has gone up enormously as we've been fighting for our investors at various different funds. This is another way to follow a long-term mindset, by not throwing your hands up in difficult situations.

Do you sense, as I have, a greater tendency of creditors to fight amongst themselves, even while the borrower is struggling to broker a deal?

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That's a big issue. And some of today's smaller to mid-sized companies with a few hundred million in revenues can lose the whole circus by getting into a protracted fight on the evaluation side or over how it gets split between different constituencies. Mostly, you're better off reaching a compromise early or getting people at one level to contribute new money just to take out those with whom they would be squabbling. Otherwise, you'll be spending it all on legal fees.

Do you also notice a trend away from Chapter 11 and toward parties making greater effort to get things done outside court?

Yes. During the bull market, everybody wanted to have 100 percent control of everything because they thought they were 100 percent brighter than everybody else. Now, I think, everybody's realizing that there are benefits to having an extra set of eyes, of teamwork, of everybody figuring how to play in the sandbox together.

Consensus is a definite trend. Like-minded investors coming together to trust each other—that is another trend we have embraced. ■