



The Rule of Absolute Priority- In Jeopardy?

Understanding recent developments
2/5/24 General Meeting



incora™

Agenda

- 1** Rule Of Absolute Priority
- 2** Historical Example
- 3** Sample Interview Questions
- 4** Incora Specifics
- 5** Implications

The Rule of Absolute Priority

- **Fundamental Law in Credit investing and RX**

- Generally understood:
 - **All** debt must be paid out at par **before** equity gets any value
- More specific and more important here:
 - **All** more-senior debt must be paid out **before the next tranche** gets any value

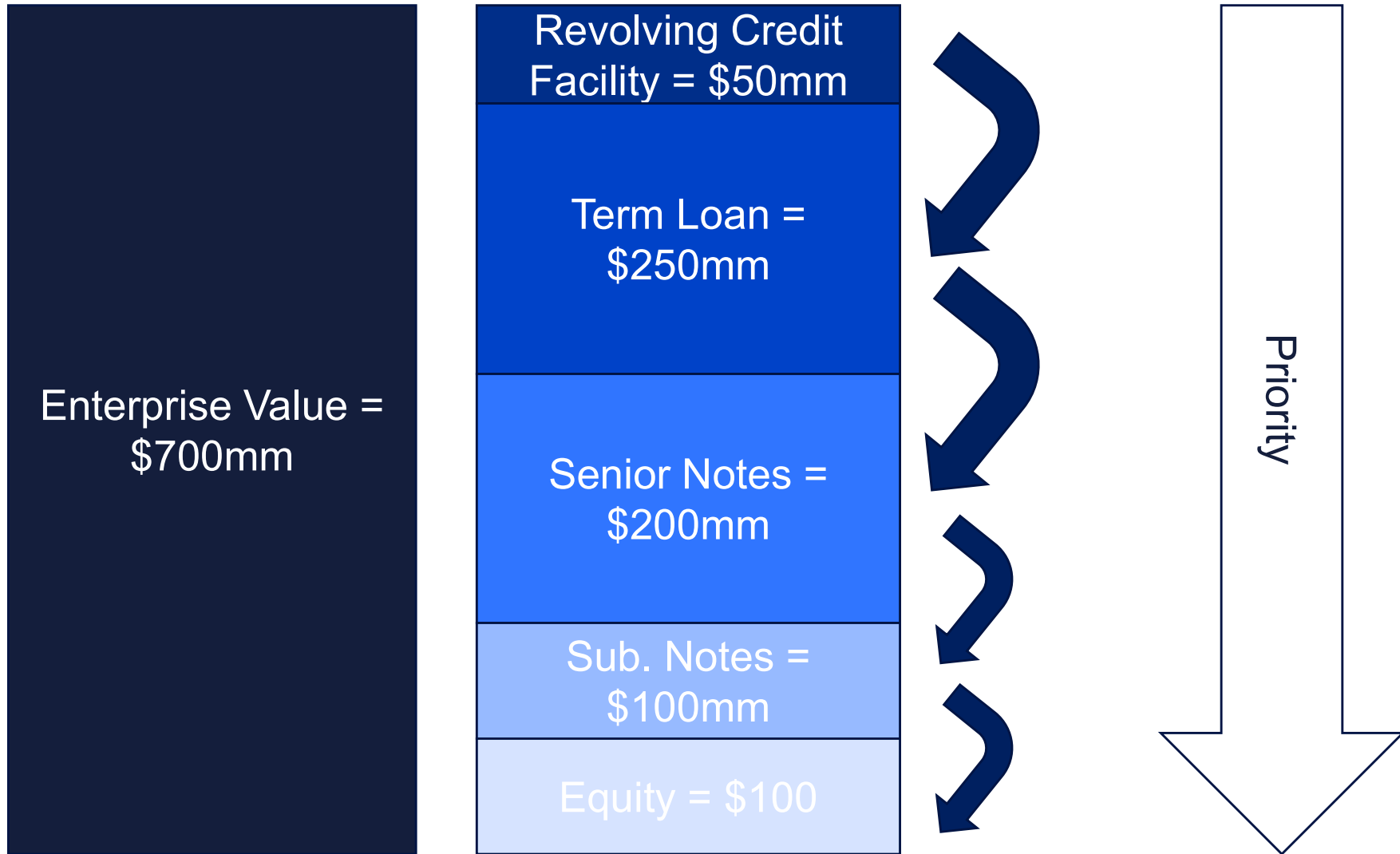
Tranche: “segments created from a pool of securities—usually debt instruments such as bonds or mortgages—that are divvied up by risk, time to maturity” (Investopedia)

AKA a layer of debt

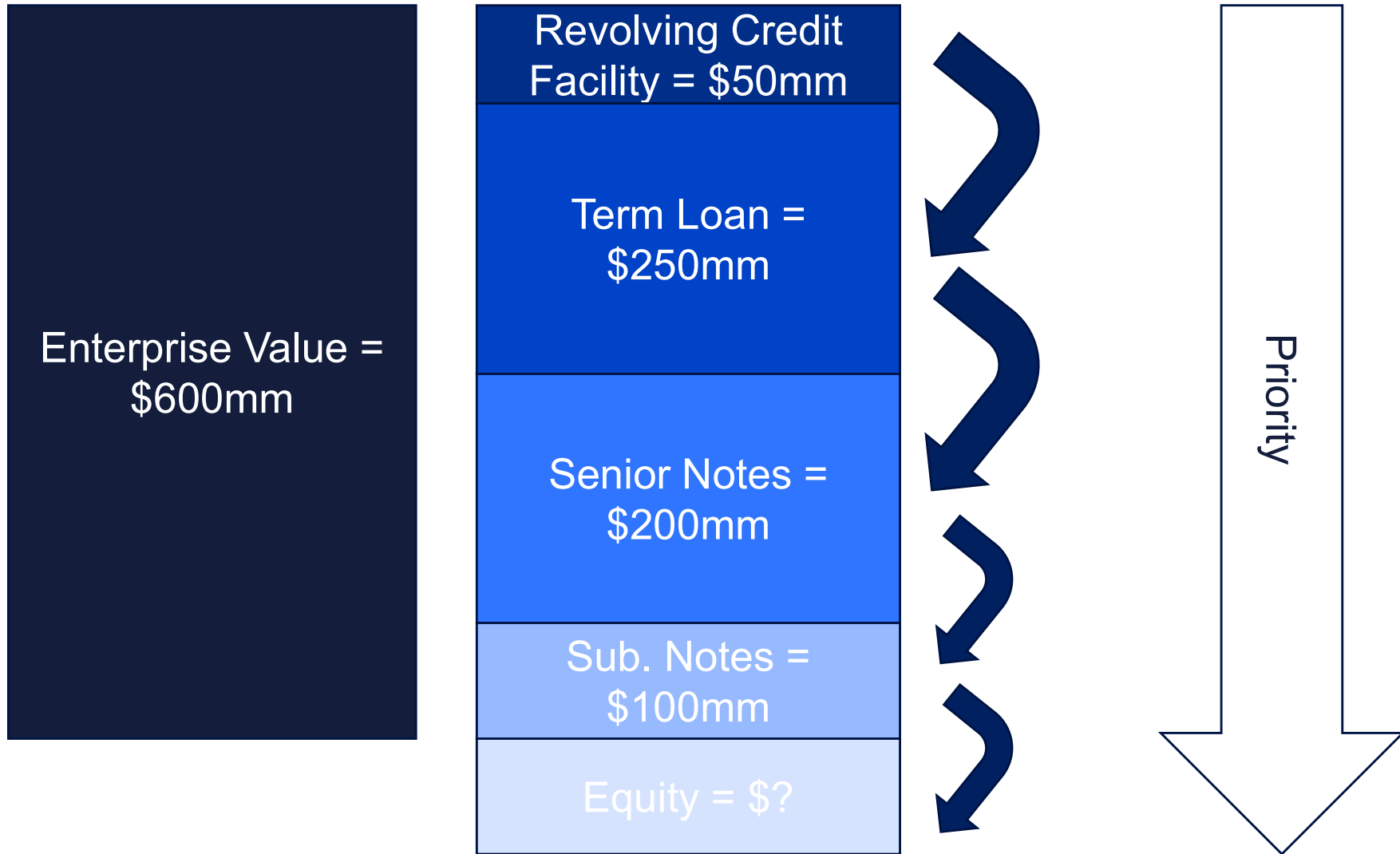
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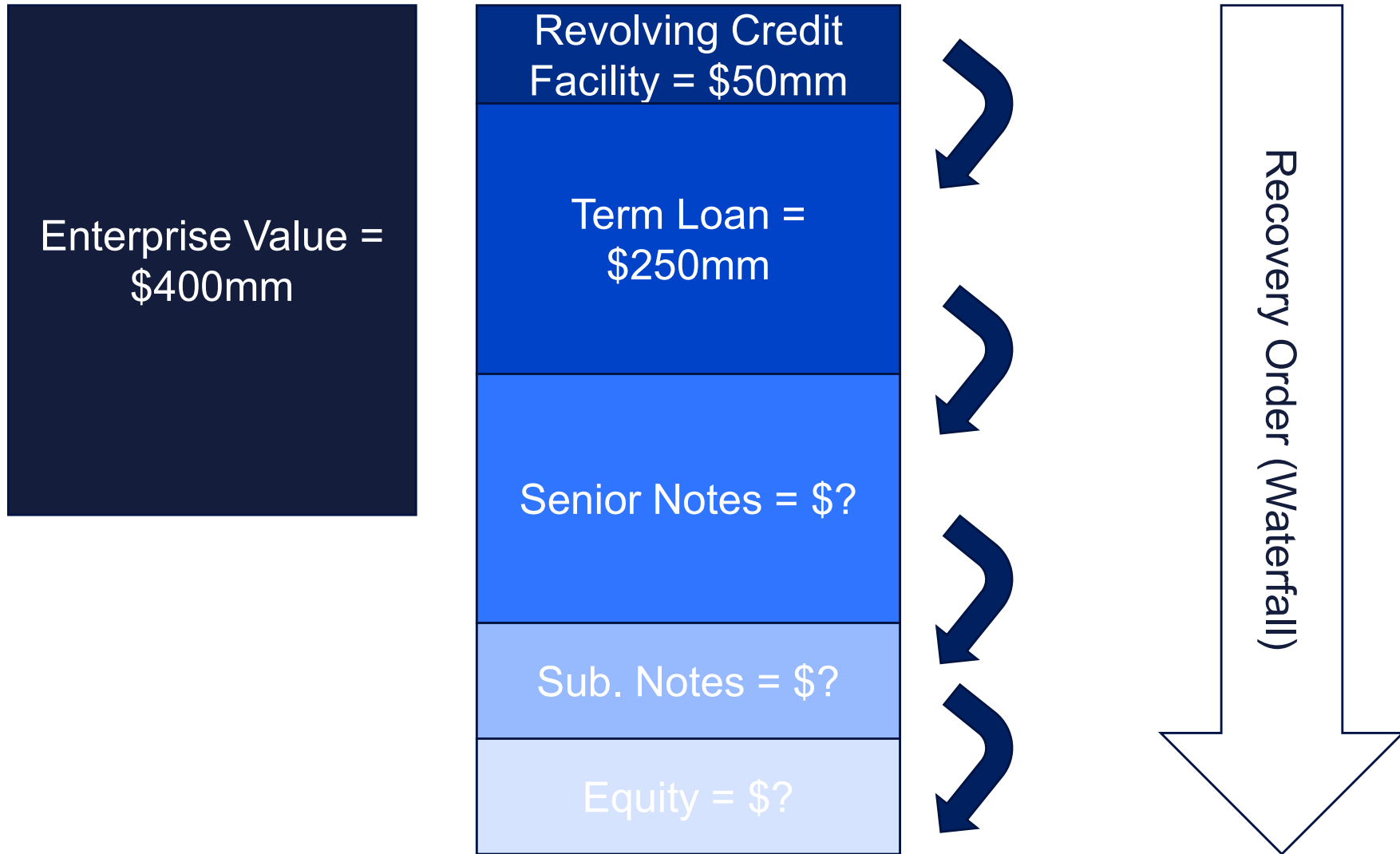
Capital Structure Example



Capital Structure Example



Capital Structure Example



Pro Rata Recovery

Is everyone the same?

- After understanding the idea of the rule of **Absolute Priority**, we understand that **different tranches** of debt will have **different recoveries** (intrinsic values) due to seniority
- **Pro Rata**: “in proportion,” i.e. **same tranche, same recovery (rate)**
- Essentially all credit docs have defined a Pro Rata treatment that within a tranche of debt as a “sacred right”
 - It would take unanimous consent (all holders voting) to have different recoveries within the same tranche

I own \$50m (face value) of the Senior Notes, while Harrison owns \$100mm (face value). What amount do we each recover?

Hint: What proportion do we each get?

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Question 1: Simple Multiple

- Should be straightforward...
-

McCollumCo makes \$100mm in EBITDA each year and currently trades at a 8x EV/EBITDA multiple. It has a \$300 TL and \$300 in bonds. What is the implied equity value?

Question 2: Simpleish Multiple

- Should be doable
-

McCollumCo's EBITDA declines to \$65mm and it trades at the same multiple. Where do each of its securities trade?

Question 3: Easy

- Should be VERY doable
-

SmithCo's EBITDA is \$50mm and it trades at 10x EV/EBITDA. SmithCo at one point had a \$100mm TL and had \$100mm in notes due 2025. He recently issued \$200 in notes due 2027 that are in the same tranche as the 2025 notes. What is the equity value?

Question 4: More Pari

- Kinda hard
-

EBITDA declines to \$30mm. Where do the securities trade?

Would you rather own the 2025 or the 2027?

Continued

What could 2027 notes contain in the docs that would protect these creditors?

Question 5: Accounting and EV understanding

- **Very different**

- A company has EBITDA of 200 and it's trading at 3.5x EV/EBITDA. 33.3% tax rate. It owns a 200 dollar factory with 10 year useful life. No amortization. Debt/EBITDA leverage ratio is 2x. There is a term loan of 100 with a 5% interest rate. The rest of the debt is bonds, and there is no pref equity or noncontrolling interest. No cash. Its PE is 3x. What is the bond's interest rate?

Question 5: HL Interview Question (skip until end and do in groups)

- Let's say that Company A owns 80% of Company B and 100% of Company C. Company B has provided a guarantee to Company C (to the benefit of Company C). Company B has \$70 in EBITDA, valued at 10x, with \$500 in debt. Company C has \$50 in EBITDA, valued at 5x, and \$300 in debt. Which option would give you a higher return: buying all of Company A's equity for 90 cents per share (100 shares outstanding), or buying Company C's debt (one year, 10% coupon) for 90 cents on the dollar (you buy \$100 of notional)?

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Incora's Controversial Restructuring

BACKGROUND ON COMPANY

- Incora was bought just before the pandemic by Platinum Equity for ~\$2.25B, with ~\$2B in debt
- The company was formed through the merger of Wesco and Pattonair
- Company primarily manages supply chains the Aerospace and Defense industry

DISTRESS

- From 2H 2021 – 2022, the company faced a liquidity crunch, where ~\$200M of new capital was likely needed to prevent Ch 11
- **Debt overhang** meant the sponsor, Platinum, was unlikely to inject the additional capital
- Company devised a solution with creditors to provide liquidity through a creative transaction

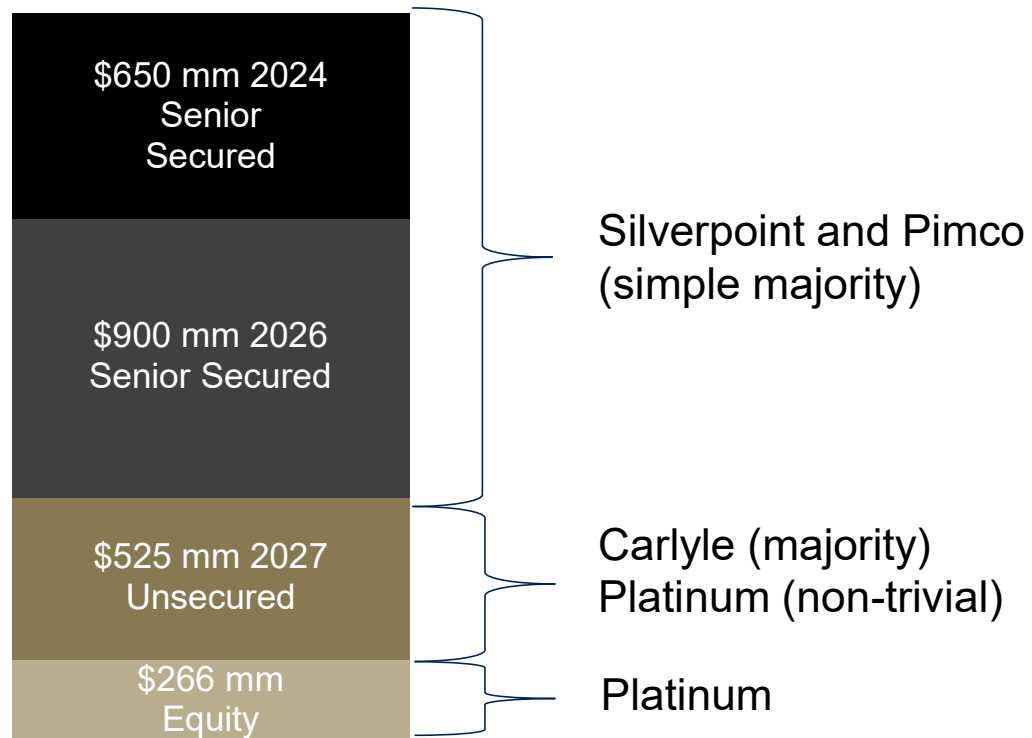
SIGNS OF STRESS

- Incora's industry was very exposed to pandemic headwinds as demand for their supply chain solutions dried up
- High debt load assumed stable earnings, which were massively impacted by the pandemic
- EBITDA declined to \$80M in Sep-21. Was \$350M in Jan-20 when transaction closed.

CAPITAL STRUCTURE OVERVIEW

- \$650M 2024 Senior Secured Notes
- \$900M 2026 Senior Secured Notes
 - Note: senior secured notes had 1L on substantially all the company's assets
- \$525M 2027 Unsecured Notes
- \$266M Equity
- Leverage ratio: ~26.0x

Capital Structure and Major Players



The Uptier Transaction

PROBLEMS

- \$200M liquidity needed to effectuate a turnaround
- Platinum unwilling to inject new equity

BENEFITS OF THE TRANSACTION

- SSNs were trading at below par and this transaction took them out at par, while also moving them into a higher priority in the capital structure

SOLUTION FOR SENIOR SECURED NOTES

- Pimco and Silverpoint (advised by Evercore) held a simple (50+1%) majority of the senior secured notes
- Majority holders of SSNs proposed a transaction whereby they would exchange into new, higher priority notes while investing new money into the company at the same higher priority

UNSECURED NOTES

- Majority held by Carlyle with Platinum holding a material amount
- These also uptier into newly created notes(1.25L) which are junior to the new 1L notes created in the SSN transaction, but senior to the minority existing SSN creditors

Note: Both transactions are **non-pro rata**

What would have been the effect if these were pro rata transactions and why would that solution be unlikely to work given what you know about out of court restructurings?

Completing the Transaction

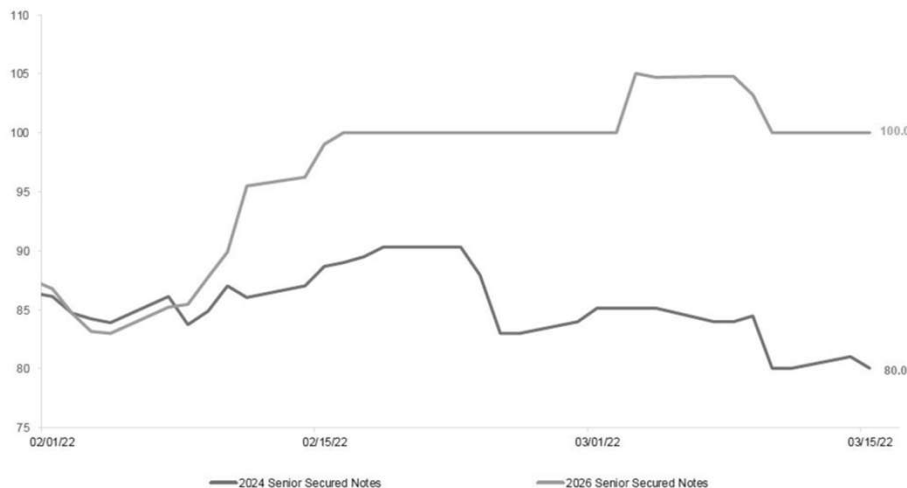
SIMPLE VS SUPER MAJORITY CONCEPT

- The credit docs required in this case for creditors to have a super majority (66.7%) of the notes to amend the documents and release liens on collateral
- Minority holders saw the transaction playing out and moved to establish a blocking position (33.4%) of the 2026 SSNs, which they were successful in doing by late Feb-22

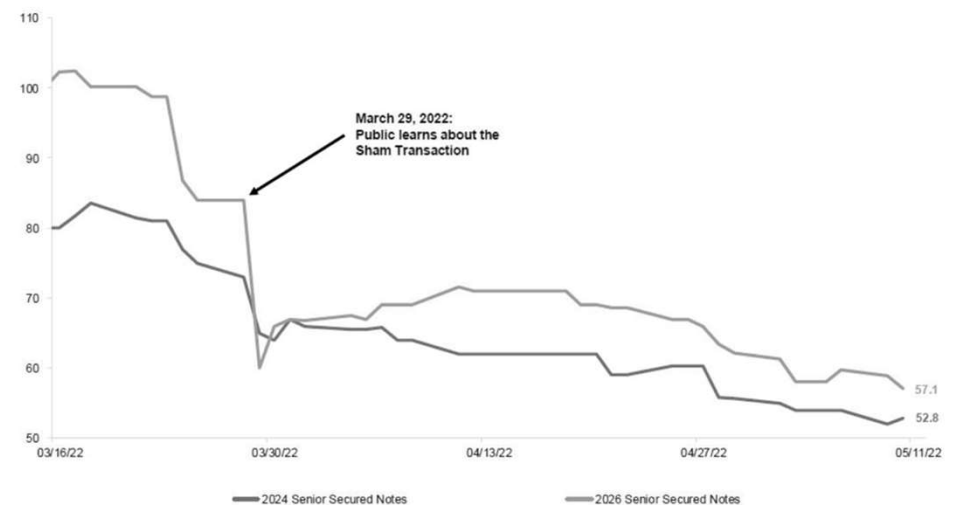
GETTING AROUND THE BLOCKING POSITION

- Minority creditors' solutions were not as attractive as the uptier from a new-money perspective
- The company effectuated the uptier at the end of Mar-22 by issuing \$250M of "ghost" 2026 notes **only for the favored noteholders** to purchase, which gave them a supermajority in the 2024 and 2026 notes

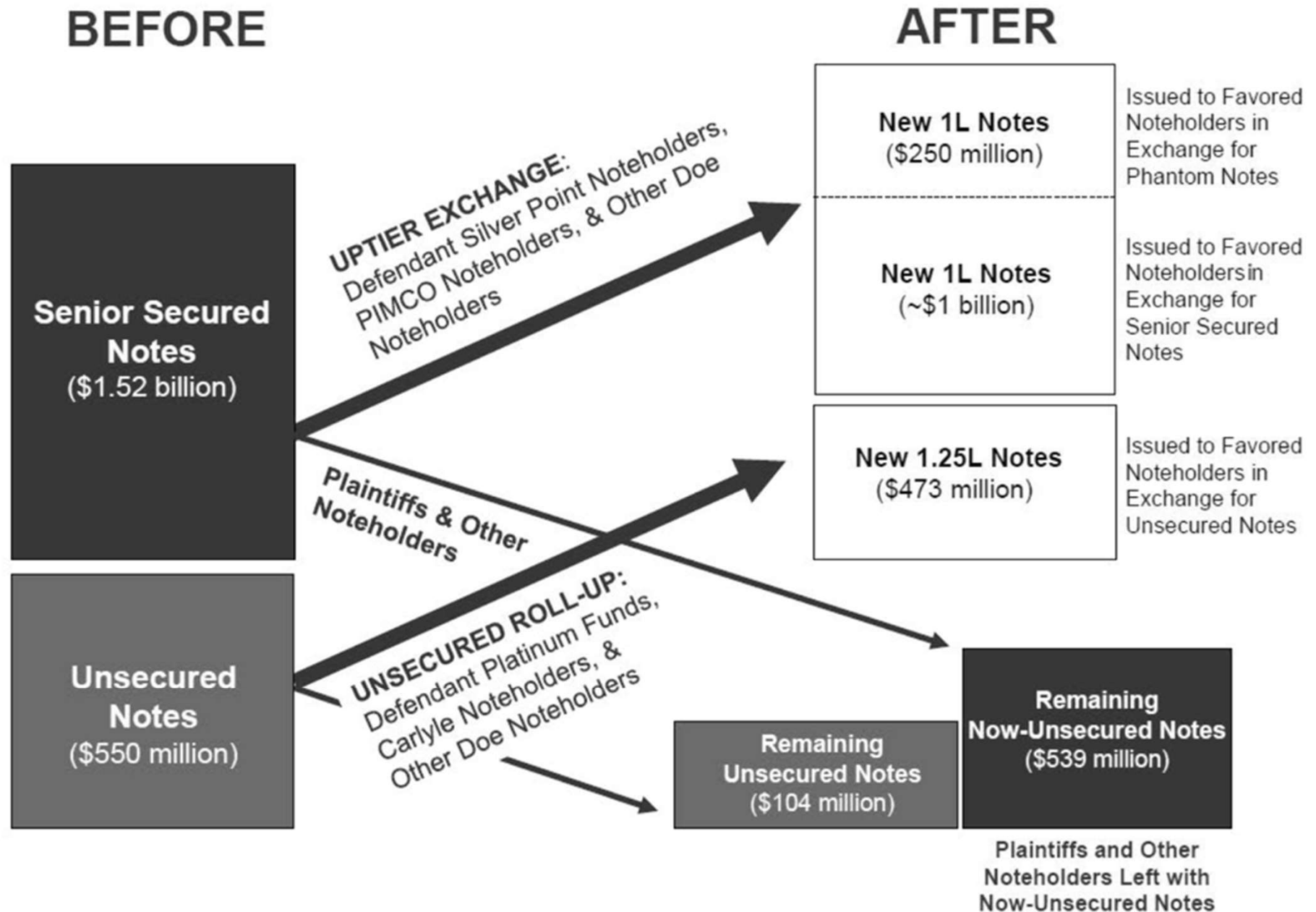
Trading Prices of Senior Secured Notes: February 1, 2022 to March 15, 2022

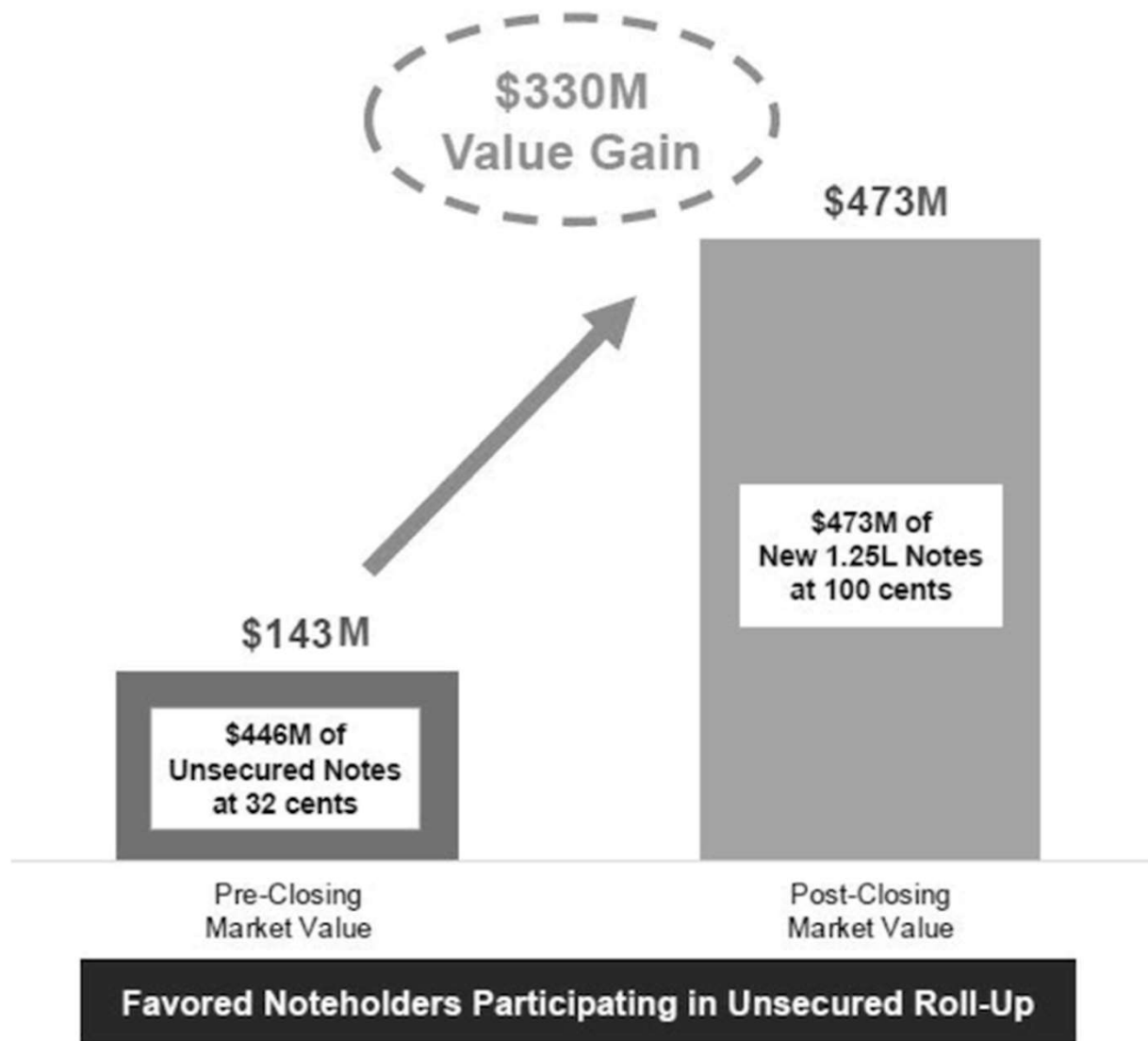


Trading Prices of Senior Secured Notes: March 16, 2022 to May 11, 2022



Transaction Overview





(1) Values are based on information currently available to the Plaintiffs and reflect various assumptions and estimates

Post-transaction

INCORA FILES CHAPTER 11 JUNE 1, 2023

- Incora filed voluntarily in the Southern District of Texas (hoping for a Judge Jones favorable ruling)
- The transaction didn't quite give the company the breathing room needed to turnaround; in fact, it added \$250M in new debt because old debt was exchanged at par
- Used Ch 11 to improve profitability ~\$100M

JONES DEPARTS

- Judge Jones left judgeship after his relationship with a Jackson Walker lawyer was uncovered

COURT PRECEDENT IN SERTA

- Non-pro rata transactions were held up by the SDTX's Judge Jones this year when Serta filed and subsequently exited bankruptcy after reducing debt by \$1.6B
- “financial titans engaged in winner take all...”
 - Was not received well by Apollo, et al.
 - Read more: restructuringinterviews.com

JUDGE ISGUR THROWS A WRENCH IN THE WORKS

- At the start of 2024, Judge Isgur (assigned to the Incora Ch 11) confirmed Incora's PoR, which saw favored noteholders capitulate by, among other things, waiving deficiency claims on 1L debt and discharging 1.25L claims
- Elected not to grant summary judgement in favor of Incora on the contract breach claims.
 - Sacred rights provisions may have been breached

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Implications

What does this mean?

- Not all debt is treated the same, not all debt gives you the same voting importance, not all debt is worth the same
- Previously banks and other holds had “panicked” and sold debt off to distressed HFs, and this practice has slowed down and there is less of a gap between price and value as distressed debt market has grown.
- *However*, this is a cause for panic for some creditors- if you have so little, you’re effectively guaranteed to get rolled up on or up-tiered (or trap doored), and you should right away!

Credit Bois Then



"We're going to seize an Argentinian Navy Ship."



"We demand a pound of flesh."



"Let's pioneer the high yield bond market."

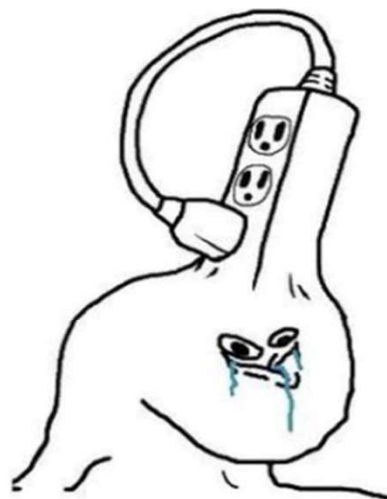


"We'll take the keys."

Credit Bois Now



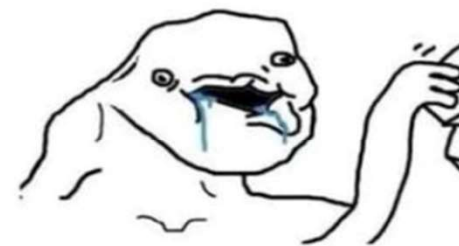
"We're in the Golden Age of Private Credit."



"We need to deploy capital ASAP, covenants be damned."



"90% LTV, looks good to me."



"Amend and Pretend."

Interview Timelines and Materials

- Restructuring applications and interviews have largely opened and timelines have begun to kick off
 - HL RX 1st rounds in ~1 week
 - EVR RX 1st rounds over coming few weeks
 - PJT RX application opened last week
 - Gugg RX 1st rounds and 2nd rounds happening now
 - Lazard RX application open; coming to grounds later this month

- Materials
 - Restructuringinterviews.com is fairly comprehensive (we have mentioned this before many times)
 - Moyer's book is not necessary, but may be helpful for more tech-heavy banks (EVR/PJT)
 - Credit Investor's Handbook – brand new book, first 50 pages is great credit content and last 100 pages is great RX content, although obviously less-detailed than Moyer.
 - Smith willing to *lend* copies of this to students