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Distress calls

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Saratoga Partners' Christian Oberbeck

Distressed debt has increasingly entered the calculus for private equity investors, and New York midmarket firm Saratoga Partners is no exception. Managing partner Christian Oberbeck is among those who subscribe to the notion that investing in discounted or distressed corporate debt is ultimately not too different from equity investing. He believes it will constitute the new wave of dealmaking for financial sponsors in the foreseeable future.

Oberbeck, 49, who joined in 1995 to co-manage the firm, said the current recession will lead to "substantial" defaults, which in turn will represent opportunities for investors. Founded in 1984 as the corporate buyout group of Dillon, Read & Co., Saratoga Partners claims something of a track record in this regard. The firm invested in Data Return Inc., whose assets it acquired from failed e-commerce outfit Divine Inc. out of bankruptcy in 2003, then sold it four years later to Terramark Worldwide Inc. for a 4 times return multiple. Its third fund wound up last year with a 4.2 times return multiple.

Managing more than $750 million in committed and invested capital, the firm focuses on companies valued up to $400 million. Oberbeck, who graduated from Brown University with a B.S. in physics and a B.A. in mathematics and has an M.B.A. from Columbia University, recently spoke with The Deal.

The Deal: *What's your view of the economic storm for portfolio companies?*

Christian Oberbeck: It's clear that this is going to be a very deep and prolonged recession. It's probably going to be on the longer side at a minimum than what we've experienced. The magnitude of the decline in earnings for companies will be fairly substantial, which means there will be a lot of defaults. Earnings levels will fall substantially below where the debt was structured. Structures will not fit business performance broadly. We're seeing the early effects on vulnerable sectors, like automotive and retail. But unlike the tech downturn and the real estate collapse in the early '90s, this is a credit collapse, and credit shoots across every industry.

How soon before we see a real spike in defaults?

The most economically sensitive are going to get hit hard really fast. But it's a process. A very important date is March 31 because so many companies will be reporting year-end results by then. There will be tremendous challenges to auditors who have to give unqualified opinions.

With debt maturities coming up in the next 365 days, and without a clear path for refinancing, there'll be a lot of pressure on auditors. Having a qualified audit is usually a default trigger. I think we'll see a lot more defaults right after March 31.

Covenant-lite terms are not necessarily protections?

It doesn't mean you're not going to default with covenant-lite debt. It just means there's no early warning signal. It goes straight into payment default, and often straight into bankruptcy. These debt structures did not contemplate Ebitda falling by 20% — many of them were made around growth scenarios. In a declining earnings environment, it's just a matter of time before you see defaults.

The question is, is this a 2009 recession with 2010 recovery, or is it 2009 and 2010 recession? If it's the latter, it'll be much more difficult in curing these defaults because in order to cure a default you need to commit to an earnings target.

That's why we're not seeing more sponsors putting in equity cures?

You're seeing some of that. But the issue sponsors have to address is how much equity they need to put in to cure a default and does it solve a problem permanently, or does it defer a reckoning. In some cases, they'll say, "We haven't had trouble meeting this covenant, and we're going to make the next four quarters." Depends how far off-plan a company is.

What's your sense of the refinancing risks for lenders?

Clearly lenders react to the quality of the businesses, the franchise and the sponsors. Even if a company is losing money, but if there's a good reason to believe it will stop losing money, that should give lenders confidence. The fundamental problem is, we're coming off the peaks in corporate earnings. Now earnings are down, in some cases significantly from the peak, and the leverage available is down significantly from the peak, so you get a double hit. Say 5 times leverage was available at peak earnings, but earnings declined by 20% last year, and the leverage ratio is down 3.5 times. So you can only get 3.5 times 80% earnings.

Combine that with a substantial level of uncertainty about the direction of earnings. How much conviction does a management team have in what their earnings will be in 2009? People are saying there's just no visibility. It happens up and down the capital structure. There hasn't been a credit collapse of this magnitude because the level of leverage in the system had never been as high.

Sponsors say they're focusing on buying corporate debt in the absence of deals. How prevalent is the practice?

This is a response to the vacuum in capital. If there's enough of a discount and you've done your analysis well, you can do very well. There are two approaches: You buy the debt as an asset class. Traditionally that's not what private equity has done. There's a trading element, a lack of control and the ability to influence events. It's a whole different way of doing business.

The other way is to invest in the debt as a means to ultimately buy the company. That's the way a lot of private equity deals will be done in the next cycle.

They're talking about buying debt in their own portfolio companies, or other companies?

Both. If you have control of the company and it goes into default, and its senior debt is trading at a discount, it might make sense to buy that debt. That's another way to do an equity cure. Maybe ultimately if the company is restructured, you convert debt to equity. This is what's going to have to happen — there's going to be a lot of restructuring where these companies have too much debt. … It's a little early in the game, but it will progress very rapidly.

Why should institutional investors back sponsors going into areas where they may not have the requisite skill sets?

If you have debt that trades at a discount, it's really like equity. Distressed debt is a form of equity, it just hasn't changed form yet. If a company can't pay its debt, generally in a restructuring some portion of that debt gets converted to equity. The first step involves a little different skill set in buying bonds in the market, but you're basically buying another entity. Private equity has historically bought investments in a single transaction. In this environment you have to take multisteps. It takes awhile to assemble. You may not have control along the way, but your goal remains the same.

The traditional private equity route is in hiatus right now. People are not selling their businesses, and there's very little debt available for acquisitions. Meanwhile, the big need for capital is in the context of restructuring the existing balance sheet. That's a significant opportunity for traditional private equity firms. The skills set is different, but some firms have a lot of experience. We think the combination of distressed debt investing and buying companies out of bankruptcy will be the new wave.