Distressed Debt and Special Situations

Interview preparation summary · PC track

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INT.CD.1.a · When it goes wrong

Read the early-warning signs in a borrower, tell a covenant breach from a payment default, and choose between a waiver, an amendment, an equity cure and enforcement.

Distress rarely begins with a missed payment. Lenders see it first in numbers they already receive: EBITDA drifting towards the covenant level, shrinking headroom, a revolver drawn to fund losses, late compliance certificates, stretched suppliers and a sponsor that stops returning calls. The core test is headroom, the percentage by which EBITDA can fall before a maintenance covenant trips, read beside cash interest cover and liquidity runway in months. A covenant default gives the lender rights, not a duty to act: it can waive, amend, ask for an equity cure or accelerate. A payment default is different because cash has stopped. Amendments are typically priced with a fee, a higher margin, tighter reporting and often sponsor equity or a paydown. Forbearance is a temporary promise not to enforce. Amend and extend only helps if the business can recover inside the new maturity. The usual mistake is treating the breach as the problem when the question is whether the debt can still be serviced and repaid.

WORKED EXAMPLE: HEADROOM AND THE RESPONSE AT BRINDLE PACKAGING

You lead a 60.0m unitranche to Brindle Packaging, an invented sponsor-backed business. Net leverage covenant is 4.50x, tested quarterly. Last twelve months EBITDA is 14.0m, down from 18.0m. Cash interest is 10.5% a year (base rate 4.0% plus 6.5% margin), capex is 4.0m, cash tax 1.2m, and the loan has no amortisation. The sponsor says a recovery is coming. How much headroom is there, how fast could it go, and what do you ask for? Convention: net debt equals gross debt for simplicity, annual figures, no cash balance.

Answer: Headroom is 4.8%, which is thin, and cash after interest is only 2.5m. I would amend, not enforce: fee, higher margin, tighter reporting and a sponsor paydown of about 6.0m if EBITDA falls to 12.0m.

> **Interview tip:** Say headroom first as a percentage, then cash cover, then the ask. Interviewers listen for whether you separate a covenant problem (rights and leverage) from a cash problem (survival), and whether you ask for something in return for any relief.

INT.CD.1.b · When it goes wrong

Estimate recoveries by class from enterprise value using the order of claims, and identify the fulcrum security.

When a borrower cannot repay, value is shared by priority, not by size of claim. Start with enterprise value: stressed EBITDA times a distressed multiple, or a liquidation estimate of assets. Deduct the costs of the process (advisers, trustee or administration fees, any super-priority financing). What remains goes down the waterfall: super-senior and revolver, then first lien, second lien, unsecured debt and trade claims, then equity, each paid in full before the next is touched. The class where value runs out is the fulcrum security, and it usually receives the equity of the reorganised company, so its holders negotiate the plan. Claims should include accrued interest and, for a revolver, drawn amounts and letters of credit. The common mistakes are using a peak or going-concern multiple on trough earnings, forgetting process costs, and mixing up secured value with the whole group when assets sit in different entities. Another is ignoring that a one-turn change in multiple can move the fulcrum from one class to another.

WORKED EXAMPLE: WATERFALL FOR HARROWGATE FOODS

Harrowgate Foods, invented, has stressed EBITDA of 16.0m. Claims: revolver 10.0m (super-senior, fully drawn), first lien 80.0m, second lien 30.0m, unsecured notes and trade claims 40.0m. Process costs are 4.0m. What does each class recover at a distressed multiple of 6.0x, and how does the answer move at 5.0x and 7.0x? Convention: all claims include accrued interest, a single entity, value paid strictly in order.

Answer: At 6.0x the revolver and first lien are paid in full, the second lien recovers about 7% and unsecured nothing, so the second lien is the fulcrum. At 5.0x the first lien recovers 82.5%, so the fulcrum moves up.

> **Interview tip:** Always state enterprise value, deduct costs, then walk class by class and name the fulcrum. Then say how far the multiple has to move for your class to be impaired: it shows you know the answer is a range, not a point.

INT.CD.1.c · When it goes wrong

Compare restructuring routes and explain how a debt-for-equity plan allocates new debt and equity, tested against liquidation.

Once a business cannot carry its debt, lenders choose between routes. A waiver or amend and extend leaves principal intact and buys time. It works when the problem is liquidity or timing, not leverage. An out-of-court exchange or consensual restructuring resets the capital structure by agreement, often needing high class thresholds. A formal process (a court-supervised plan, scheme or administration, depending on jurisdiction) can bind dissenters but costs time and fees. In a debt-for-equity deal the business keeps only the debt it can service, often a multiple of normalised EBITDA, and the excess claims become equity, allocated by priority. Each class should do at least as well as in liquidation, the best-interests test. Compare plan value with the liquidation recovery, and haircut plan value for execution risk. The usual mistakes are treating equity received as cash, assuming the plan value without checking leverage capacity, and ignoring that the new owner needs fresh money and a competent management team.

WORKED EXAMPLE: DEBT-FOR-EQUITY PLAN FOR TESSEL LOGISTICS

Tessel Logistics, invented, has normalised EBITDA of 15.0m and debt of 120.0m: first lien 90.0m and second lien 30.0m. The plan values the business at 6.5x EBITDA and leaves 60.0m of new first-lien debt (4.0x). Liquidation would raise 55.0m net. How should the plan split value, and does it beat liquidation for the first lien? Convention: no new money, no cost deduction beyond that in the 55.0m.

Answer: The plan hands the first lien 60.0m of new debt plus 80% of the equity, worth 100% of its claim at 6.5x, against 61% in liquidation. The second lien gets 20% of the equity, 25% of its claim.

> **Interview tip:** Give the new debt, then the equity split, then the comparison to liquidation. End with the risk that the recovery is paper until the equity is sold, which shows you think like a lender who becomes an owner.

INT.CD.2.a · Special situations

Explain rescue and debtor-in-possession financing, including super-priority, roll-ups and how to size and price it.

Rescue financing lends new money to a business that is in or near a restructuring so that it can keep trading. In a court-supervised process it is often called debtor-in-possession (DIP) financing and is typically given priority over existing debt, sometimes by priming existing liens, because the lender will not lend into the same risk it is trying to escape. The case for lending is that new money buys time and preserves going-concern value above the liquidation value. A roll-up converts some of the lender's existing debt into the new super-priority facility at par, an extra return on the old claim. Sizing starts with the cash the business needs through the process: a thirteen-week cash forecast with a buffer, not a round number. Pricing is high margin, an upfront fee or original issue discount and an exit fee, justified by short tenor and priority. Test coverage against distributable value. The usual mistake is judging a DIP by coupon alone and forgetting the existing holders it primes.

WORKED EXAMPLE: DIP AT CORVANE RETAIL

Corvane Retail, invented, enters a court-supervised process. Existing first lien is 80.0m. A 30.0m DIP is proposed: 20.0m of new money and a 10.0m roll-up of existing first-lien debt, priming the existing lien. Going-concern value with the DIP is 90.0m less 5.0m process costs; without it, liquidation nets 52.0m. The new money pays 13% cash interest, a 2% discount at funding and a 1% exit fee on new money, outstanding nine months. Is it worth lending and what does it earn? Convention: simple annualisation of the nine-month return, no tax.

Answer: The DIP is covered 2.83x, earns about 17% annualised on 20.0m of new money, and the roll-up adds 2.14m of recovery on 10.0m of old debt. I would lend, provided the cash forecast supports 30.0m and the exit is clear.

> **Interview tip:** Give cover, then return, then the roll-up. Mention that you would check the thirteen-week cash forecast and the milestone dates in the facility, because a DIP lender is also buying control of the timetable.

INT.CD.2.b · Special situations

Analyse a loan-to-own entry and a capital-solutions investment by comparing control, cost basis, upside scenarios and the downside.

A loan-to-own investor buys debt, usually the fulcrum or a class that will convert to equity, at a discount in order to control the outcome. The attraction is a low cost basis and the legal tools of a creditor: a blocking stake in the class and the right to propose or vote a plan. Another tool is the ability to credit bid, which means using the debt held as currency to buy the assets without new cash. Returns come from the equity of the reorganised business, so the analysis is an equity analysis: what is normalised EBITDA, what multiple, how much debt stays, how long to exit, and how much new money the owner must add. Capital solutions are the performing-company version: preferred equity, structured debt or holdco financing for a business that has a gap but not a failure, priced with PIK interest, warrants or a priority claim. The usual mistake is looking at the discount to par and ignoring that the position may sit in the wrong class or be illiquid for years.

WORKED EXAMPLE: LOAN-TO-OWN ENTRY AT HALDEN PLASTICS

Halden Plastics, invented, has first-lien debt of 80.0m, trading at 62 (percent of par). A fund buys 55.0m face. Expected plan: the first lien takes 30.0m of new debt plus 100% of the equity and the second lien is wiped out. Reorganised enterprise value is 70.0m in the base case, 55.0m in the downside and 85.0m in the upside, with a 2.5 year hold and no interim cash. What does the fund pay, what does it own, and what does it make? Convention: the fund shares pro rata in the class, no new money, ignore costs.

Answer: The fund pays 34.1m and owns 68.75% of the reorganised first lien. The base case returns 1.41x, about 14.8% a year, the downside 1.11x and the upside 1.71x.

> **Interview tip:** Treat loan-to-own as an equity underwriting. Give cost, scenario values, return, and then say why you hold enough of the class to matter. Mention the downside first when asked if you would do it.

INT.CD.2.c · Special situations

Price a stressed loan from scenario recoveries, expected multiple and break-even recovery, and decide on an entry point.

Stressed pricing replaces yield to maturity with scenario analysis. The price of a loan at 60 to 70 cents on the euro or pound already assumes some default, so the question is whether it assumes enough. Build three or four outcomes, each with a probability, a timing and the cash received: refinancing at par, a restructuring with partial recovery, a liquidation. Add the coupons collected before the event. The expected cash divided by the price gives an expected multiple, and each scenario has its own internal rate of return. The break-even recovery, the amount that must be returned in the main downside to get your money back, is a better test of safety than the headline yield, because it says how much of the claim can be lost. Cheap relative to par is not cheap relative to value. The usual mistakes are applying probabilities that are optimistic by habit, forgetting the timing of recoveries, which can stretch for years, and treating a price drop as an opportunity before checking that value, not sentiment, drove it.

WORKED EXAMPLE: ENTRY PRICE ON A STRESSED FIRST LIEN

A first-lien loan in an invented business, Wexby Controls, trades at 62 (per 100 of par) and pays a 9% cash coupon annually. Your scenarios over the next two years: refinancing at par at the end of year 2 (40% probability), a restructuring at the end of year 2 that returns 80 on the claim after one coupon (40%), and a liquidation at the end of year 1 returning 45 with no coupon (20%). Is 62 a good entry? Convention: annual coupons on par, per 100 of par, no costs.

Answer: Expected cash is 91.8 on a price of 62, a 1.48x expected multiple. Break-even recovery in a restructuring is 53, against 80 expected, so there is a 27-point cushion. Attractive, with the refinancing probability the assumption to test.

> **Interview tip:** Always give the scenario table, the expected multiple, the break-even recovery and then the assumption that matters most. Do not quote a single yield.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.