From Lemons to Lemonade: Post-Bankruptcy Investing

By John Deysher

How would you have liked to have purchased reorganized Kmart stock at $15 per share (current price $104)?

Or reorganized Metals USA at $4.50 (current price $18)?

Both firms have recently emerged from bankruptcy, and the stocks have transformed from lemons to lemonade. Properly executed, post-bankruptcy investing can be a portfolio sweetener.

I'm not talking about taking a flyer on once high-flying shares that now trade for less than a dollar—most of those become worthless.

Nor am I talking about buying debt instruments of companies *prior* to bankruptcy and participating in the reorganization process. That's best left to the pros.

I'm talking about buying the stock of newly reorganized companies after much of the uncertainty has been removed.

Companies normally file for bankruptcy because of cash flow problems and an inability to pay their bills (interest or principal payments, rent, taxes, payroll, vendor invoices, etc.). The two most common types of filings under the Bankruptcy Code are Chapter 7 and Chapter 11.

In a Chapter 7 filing, a trustee is appointed to oversee the liquidation of a company with proceeds used to pay off creditors, employees, Uncle Sam, and ultimately shareholders—if there's anything left.

Far more common is the Chapter 11 reorganization, where the debtor is given time to reorganize its affairs while it continues as a going concern, preserving jobs and keeping productive assets in place.

Usually, in Chapter 11 reorganization all prior equity (old shares) is extinguished or substantially diluted and new ownership (and control) rests with the creditors. These creditors are typically banks and senior lenders, including bondholders who hold collateralized or senior inter-ests. Subordinated bond or unsecured note holders may obtain some ownership, but the common holders are usually (but not always) wiped out.

Once a firm files for Chapter 11, a judge in the appropriate legal jurisdiction is appointed to oversee the reorganization process. It's the judge's job to move the process forward fairly and quickly, since bankrupt firms face a constant erosion of value as customers, employees and vendors go elsewhere. However, it's not always easy as there are often multiple creditor and equity classes who have each hired their own lawyers to pursue their specific interests. Each attempts to outmaneuver the rest to maximize their own benefits.

Plan of Reorganization

Typically, the debtor management will piece together a Plan of Reorganization that allows the firm to continue in business while satisfying various creditor and equity claims.

During the process, a multiyear business plan is developed (complete with financial projections) allowing a value to be placed on the reorganized entity. Portions of the "value pie" are then divided among creditor and equity classes, usually according to seniority and size of original investment. Typically they end up with some combination of restructured debt (for example, convertible to equity), preferred shares (possibly convertible), common stock or warrants. Ultimately, the plan is approved by the judge and put to a vote by all interested parties. If confirmed, new securities are distributed and the debtor emerges with a new start on life and is absolved of its pre-bankruptcy obligations. If not, additional negotiations usually ensue until terms are reached that satisfy everyone.

This process can take anywhere from six months to several years depending on the company's size, complexity, the number of parties involved and other issues. On average, it takes one to three years.

As the process winds down, the key Disclosure Statement is produced, which includes the Plan of Reorganization and all supporting information. This is filed with the court and the Securities and Exchange Commission (SEC), usually with little fanfare. It is typically many pages long and contains many key details investors need to know. (See accompanying box for an example of what's included.)

As you can see, the Statement includes a wealth of information about the reorganized company. It is written by high-priced attorneys and bankers and is well worth reading.

How can you get a copy of a Disclosure Statement?

I've generally found them in one of three places:

1. On the company's Web site perhaps under "Chapter 11 Reorganization" or "News Events."
2. In a Form 8-K ("disclosure of material information") filed with the SEC via the EDGAR Web site (www.edgaronline.com). Unfortunately, you have to wade through many filings to find the right 8-K filing. The best shortcut I know of to find the correct 8-K filing is to call the company's investor relations department, or general counsel's office, and ask what day the Disclosure Statement was filed with the SEC. Once you know the date, you can check all of the 8-K filings for that day. Note, however, that often the Disclosure Statement is part of a much larger 8-K, so you must plow thru everything else to find it. Patience is key.
3. If you can identify the law firm representing the bankrupt firm, they may be able to point you to a legal (sometimes their own) Web site containing it.

What's Included: Atlas Air Worldwide Disclosure Statement Table of Contents

1 Introduction including Summary of Distributions under Plan
2 Explanation of Chapter 11 and Plan of Reorganization
3 Voting Procedures and Confirmation Requirements
4 Background of Debtor—Business Description, Management, Events Leading to Chapter 11
5 Assets, Liabilities, Financings and Capital Structure
6 Financial Information including Historical Financial Statements
7 Legal Proceedings including Shareholder and other Litigation, Regulatory Investigations
8 Post-Bankruptcy Operations and Significant Events in Bankruptcy
9 Description of Plan including Designation and Treatment of Claims and Interests
10 Means for Execution and Implementation of Plan
11 Restructuring Program, Business Plan and Feasibility
12 Estimated Reorganization Valuation and Allocation of New Common Stock
13 Certain Factors to be Considered including Inherent Uncertainty of Projections
14 Resale of Securities Received Under the Plan
15 Alternatives to Plan and Liquidation Analysis
16 Certain U.S. Federal Income Tax Consequences of Plan
17 Conclusion and Various Exhibits

Recognizing Lemonade

At this point, potential investors in post-bankruptcy shares have several things going for them that may produce an undervalued security:

- Very little Wall Street analyst coverage. Once a company files for bankruptcy, research coverage usually dries up completely. This aversion frequently causes the security markets to underestimate the potential of the reorganized company.
- A skeptical investing public that has already been burned owning pre-bankruptcy shares and has no interest in owning shares of the same company again. Indeed, many firms change their name upon emerging to avoid this tarnished image.
- Reluctant shareholders, like banks and senior lenders, who are not natural holders and are anxious to unload their new equity securities as soon as possible.
- Full knowledge of operating fundamentals as detailed in the Disclosure Statement.
- Often, expensive leases and union contracts are renegotiated, high priced or incompetent executives are replaced, headcounts are reduced and operations are streamlined.
- New management team that has proper incentives to get the share price up.
- Fresh-start accounting, which provides a stronger balance sheet.
- Significant net operating loss (NOL) carryforwards to shelter future income streams.

It should be obvious, however, that not every firm emerging from bankruptcy is worth investing in. Many of these companies emerge highly leveraged, or with impaired business models. Consequently, some companies that have emerged from bankruptcy re-enter Chapter 11—this is known informally as a "Chapter 22" bankruptcy. For instance, US Airways recently filed Chapter 11 again because of high debt and a non-competitive cost structure. Similarly, Pillowtex (the maker of Fieldcrest and Cannon brands) filed Chapter 11 again and is being liquidated, a victim of low-cost imports.

What Should You Look For?

It is critical for any potential investor to go beyond the details of the Disclosure Statement. Apply the same type of analysis you would to any other security, by evaluating such things as:

- Balance sheet strength,
- The company's main lines of business,
- Major customers and competitors,
- Depth of management,
- The competitive environment, including any barriers to entry, the risk of substitute products, and capital requirements, and
- Insider ownership.

During your analysis, it is important to recognize that the Disclosure Statement financial projections may be too optimistic. Make sure in your evaluations that indicated sales growth, margins and capital requirements are in line with other public comparables or competitors. Distressed and bankrupt firms tend to minimize investments in property, plant and equipment, so make sure this amount is reasonable going forward.

You should also:

- Seek companies with incentivized managers who take most of their compensation in options, restricted stock or bonuses tied to specific performance metrics.
- Avoid companies that remain highly leveraged after bankruptcy—this is a prime cause of failure among reorganizations that don't make it.
- Avoid companies that operate in industries with chronic excess capacity. Airlines and textile firms have been plagued with excess capacity for years.

In addition, keep an eye on the SEC filings via the EDGAR Web site (www.edgaronline.com). This may be the only way reorganized companies initially communicate with the investing public.

If you do find a promising company, don't rush to buy too quickly. Share prices of recently emerged firms tend to drop initially as creditors sell shares. The Disclosure Statement often indicates who's getting how many shares, and that will give you some idea of potential supply.

Finding Post-Bankruptcy Candidates

Unfortunately, there are no specific SEC forms a company files when emerging from bankruptcy. The juicy details are usually buried in an 8-K (disclosure of material information). However, there are a few sources dedicated to investing in distressed companies and those in process of reorganizing, although they tend to be pricey:

- ***The Daily Deal.*** Published daily ($498/yr.) or weekly (***The Deal***; $249/yr). Provides a wealth of information on corporate transactions of all types. Useful feature: bankruptcy calendar. (For more information, go to www.thedeal.com.)
- ***BankruptcyData.com.*** A very good site with user-friendly links and information. The ***Bankruptcy Week newsletter*** costs $500/yr. and is dedicated to bankruptcies and firms proceeding through reorganization. It contains lots of good detail on specific filings, timetables and court dates. (For more information, go to www.bankruptcydata.com.)

Conclusion

Post-bankruptcy investing can offer unique investment opportunities in good markets and bad. There are often tremendous bargains hidden under clouds of uncertainty and public financial disgrace.

By waiting until after a firm emerges from bankruptcy and doing your homework, you can mitigate many of the risks of investing in troubled companies.

But patience is key. And remember, many reorganized firms enter "Chapter 22."

Caveat-emptor. ▲

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