

Rights Offerings Provide 'New' Solution to Classic Leverage Problem

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Driven by expanding leverage multiples, improved liquidity, and a competitive search for increased returns among institutional investors, rights offerings are a useful and increasingly commonly used tool in today's business restructurings.

Since the advent and maturation of the high-yield markets in the 1980s, leveraged capital structures have been composed primarily of a layer of secured bank debt provided by traditional bank syndicate lenders, followed by an unsecured layer of senior and/or senior subordinated bonds. The traditional bank syndicate lenders were led by money center banks as agent, which would act in concert with other lenders functioning as collateral agent or syndication agent. This syndicate of lenders formed an identifiable group at the top of the capital structure with whom a company/borrower would interface.

Inherent in this established order was the management of a collateral package securing the obligations under the credit facility. This usually consisted of a first lien on all assets of a company, including a pledge of the company's stock, and a pledge of 66 percent of the stock of foreign subsidiaries. Collateral generally was shared only among the secured lenders, with the exception of individual mortgages, equipment leases, or other discrete obligations backed by individual assets. Higher amounts of leverage were obtained via unsecured high-yield bonds or possibly mezzanine loans that contained warrants or other equity-based yield enhancements.

Much attention has been focused on the emergence of the modern second-lien marketplace. The volume of second lien new issuance grew from about \$630 million in 2002 to more than \$28 billion in 2006 (Figure 1). The \$12.7 billion of second lien issuances from 59 deals completed in the first quarter of 2007 represents another high water mark for the market.

This asset class is driven primarily by acquisition financing, particularly for private equity-related leveraged buyouts and recapitalizations.¹ The increased amount of secured leverage in capital structures has profoundly impacted the restructuring market (Figure 2).²

It is considerably more complicated to

restructure around extensive levels of secured debt because, broadly speaking, secured creditors have rights to "adequate protection," which must be negotiated and cannot be "crammed down" with equity absent their consent. Adequate protection safeguards a

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Figure 1: Volume and Number of Second-Lien Loans, 2002–2007

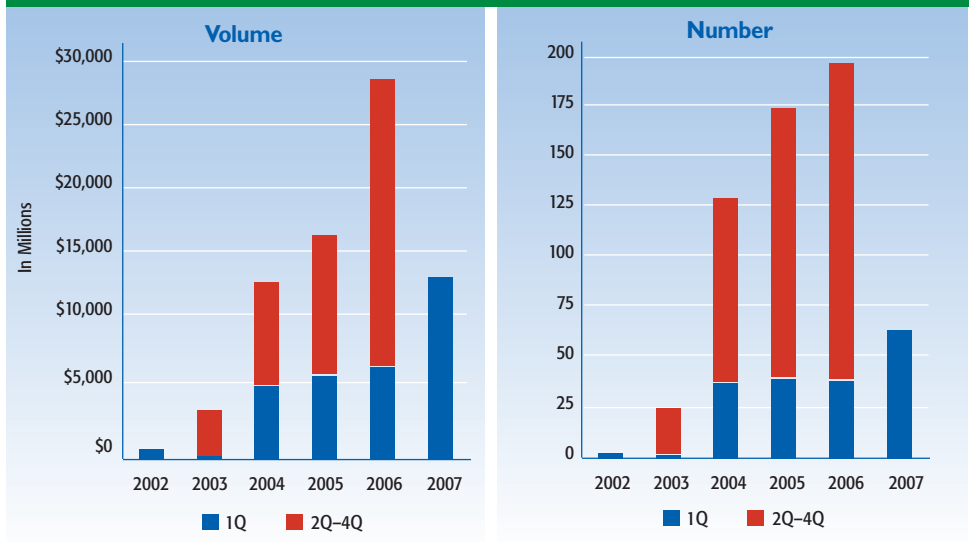
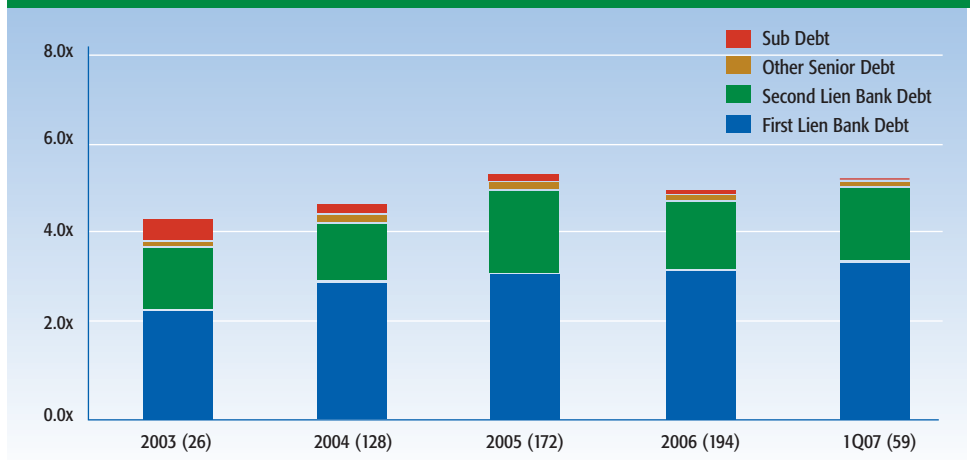


Figure 2: Average Debt/EBITDA Ratio for Transactions with Second-Lien Loans (2003 – 2007)



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secured creditor from a decrease in the value of its position, including interest, during a bankruptcy case.

Adequate protection may be provided in a number of ways, such as periodic cash payments, additional or replacement liens, or other relief that protects a creditor's ongoing interest in its collateral. Accordingly, to generate a recovery for themselves, holders of unsecured claims beneath high levels of secured debt have no choice but to consider payment in full to the secured holders. This hierarchy implies that the consequences of not finding a way to refinance or otherwise satisfy secured debt can be extremely negative for unsecured claim holders.

In this context, a rights offering among holders of the subordinated or unsecured class — or even equity holders — to raise the capital necessary to refinance secured debt (or, from the perspective of equity holders, unsecured creditors) can provide, at a minimum, an attractive defensive option and may present an opportunity to buy equity at a discount, depending on individual circumstances.

Second Chance for Investors

A rights offering is a method of raising capital in which current investors receive short-term warrants to purchase newly issued securities on a pro rata basis. Typically, the offering price is at a discount to the quoted or implied market price of the securities. The deeper the rights offering discount to the market price is, the more costly is the decision of existing holders who choose not to participate in the rights offering.

There are two types of rights offerings:

1. An "uninsured" offering, for which no large holder or outside funding source guarantees to purchase unsubscribed rights
2. An "underwritten" or "backstopped" offering, for which a pre-existing guarantee to purchase unsubscribed rights exists

Historically rights offerings were a far more common form of equity issuance than they are today. Previously, rights offerings were used to raise equity in situations that involved high ownership concentration and significant insider participation. While rights offerings are still the dominant method of public issuance on certain exchanges, particularly in Scandinavian countries, their use in U.S. capital markets by companies with widely dispersed ownership

waned by the early 1980s due to a perceived market risk from poorly subscribed rights offerings.³

Several additional factors are present in many rights offerings. Over-subscription rights allow existing holders to over-subscribe to an offering by a percentage of their holdings. For example, a 50 percent over-subscription right would allow a holder to purchase up to 150 percent of its original holding amount, assuming sufficient availability in the overall offering. To the extent that there is not enough available subscription to the rights offering, holders desiring to take advantage of the over-subscription right could participate ratably in the remaining unsubscribed shares.

Over-allotment in a rights offering is identical to an over-allotment in a traditional underwritten deal. It allows a predetermined amount of additional shares to be issued at the issue price if the offering is fully subscribed and demand still exceeds supply.⁴

Detachable rights can be separated from the underlying equity and sold independently. This feature allows holders who do not want to or cannot participate in the rights offering to monetize the option value of their right and offset the dilution caused by not participating. These rights usually are not seen in a bankruptcy context because the detachable right, independent of the underlying claim, generally is believed to jeopardize a debtor's exemption from Securities and Exchange Commission (SEC) registration.⁵

Market Is Ripe

The increased use of rights offerings today is based on numerous current market factors. One of the most significant is the highly liquid capital markets for distressed and defaulted securities, resulting in debt flowing into the hands of sophisticated holders. Investors searching for yield today are looking for any means available to increase returns, and rights offerings present several potential ways to capitalize on an existing situation.

Funds focused on distressed investing and special situations have raised billions of dollars in the last 18 months — much of which still needs to find a home. Rights offerings provide a means of putting more capital to work without a fund manager having to find new investment ideas (particularly in this low-default environment). Furthermore, funds with large positions in a company can negotiate for rights offerings and, by virtue of their sizeable positions, exert significant influence over factors that drive recovery.

In recent Chapter 11 proceedings for Foamex, a nationwide foam producer, the company adopted as one component of its plan of reorganization a \$150 million rights offering backstopped by a group of significant equity holders. Rights to purchase additional equity of the reorganized company were given to existing equity holders and, as a contingency, the group of significant equity holders agreed to backstop the rights offering to ensure its successful completion.

As evidenced by a very high subscription rate, the rights offering ultimately was successful. It allowed existing equity holders to retain control of the company and provided, in conjunction with a large debt-financing package, the proceeds necessary to fully satisfy secured and unsecured claims. The case is an example of junior members of the capital structure using a rights offering (and their deep pockets) to create optionality and to maintain a stake in the reorganized company.

Funds also may be able to negotiate favorable valuations, based on their willingness to provide capital in a situation where that capital is necessary. A relatively low valuation creates an opportunity for funds to capitalize on less sophisticated or liquid investors that do not appreciate the significant dilution that can result from lack of participation in the offering. To that end, investors could offer even more capital than necessary at times in an attempt to capture value that might otherwise be available to other stakeholders.

Backstopping a rights offering also allows a fund to act like an underwriter, thereby generating a substantial commitment fee. In the bankruptcy context, rights offerings provide a tool to increase value by allowing otherwise potentially out-of-the-money participants to buy in and protect their positions.⁶

While **Figure 3 (see page 3)** highlights announced or completed rights offerings, it is worth noting that the chart alone summarily understates the level of rights offering discussion in today's marketplace. For example, Delphi has had among its various recapitalization alternatives a proposal from Cerberus, Appaloosa, and Harbinger permitting not only the plan sponsors to participate in the rights offering, but also to reserve a portion for old equity holders as a way of offering recoveries to a constituency that otherwise may have faced a different recovery picture.

At the time of this writing (April 2007), Cerberus has withdrawn from the consortium, but the framework remains and illustrates the level of rights offering activity present in the

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Figure 3: Announced or Completed Rights Offerings

Transaction Date	Issuer	Backstop Purchaser	Description	Total Offering Size	Gross Spread ⁽¹⁾
TBD	Northwest Airlines	J.P. Morgan Securities	Offering to general unsecured creditors of the consolidated debtors	\$ 750	2.67%
12/21/06	Delphi Corporation ⁽²⁾	Consortium of investors including Appaloosa, Cerberus and Harbinger	Chapter 11 case; rights offering backstop by potential plan investors to existing shareholders as part of exit financing	2,205	2.50%
10/13/06	Foamex International ⁽³⁾	Five large shareholders	Chapter 11 case; rights offering to common and preferred shareholders as part of exit financing	150	6.33%
06/29/06	Owens Corning	J.P. Morgan Securities	Chapter 11 case; component of \$4.6 billion exit financing	2,187	4.57%
05/08/06	Silicon Graphics	Quadrangle Debt Recovery Advisors LLC, Symphony Asset Management LLC and Watershed Asset Management LLC	Offering to certain secured and unsecured noteholders	50	2.00%
03/23/06	J.L. French Automotive Casting ⁽⁴⁾	Certain Second Lien holders including seven initial backstop purchasers	Chapter 11 case; second-lien debtholders participated in offering with an expected range of \$110 million – \$130 million	130	2.00%
02/23/06	USG Corp.	Berkshire Hathaway	Chapter 11 case; shareholders participated in rights offering as component of \$5.6 billion exit financing	1,800	3.72%
06/10/05	Loral	MHR Fund Management LLC and P. Schoenfeld Asset Management, LLC	Debt rights offering to certain noteholders	120	5.00%
04/29/04	Air Canada	Deutsche Bank AG	Chapter 11 case; rights offering to creditors as part of exit financing for general corporate purposes	619	1.50%
10/24/03	Australia and New Zealand Bank	NA	Offering to common shareholders; proceeds for working capital	2,514	0.75%
09/16/02	Chartered Semiconductor Mfg. ⁽⁵⁾	Merrill Lynch	Offering to common shareholders with more than 60% allocated to single shareholder; proceeds for capital expenditures, working capital and general corporate purposes	251	1.26%
08/13/02	Ericsson Telephone Company	Morgan Stanley, SEB/Enskilda, Goldman Sachs, Handelsbanken and Salomon Smith Barney	Offering to common shareholders; proceeds a component of recapitalization	3,140	4.00%

Source: SDC, TheDeal, Factiva, and Jefferies research. All values converted to USD.

(1) Gross spread percent based on backstop commitment fee.

(2) Based on publicly available terms as part of a potential framework agreement with a consortium of investors including Appaloosa, Harbinger and Cerberus. Rights offering was included as an addition to our search of public transactions outside the specified dates mentioned above. Note, however, that in light of recent events, Cerberus has backed out of the consortium. As such, this transaction is for illustrative purposes only.

(3) Based on motion dated October 13, 2006 approved by court.

(4) If equity offering is less than \$130 million, backstop commitment fee is 1.00%.

(5) Total rights offering is USD \$628 million. 60.5% includes pre-commitment by Singapore Technologies Pte Ltd and Singapore Technologies Semiconductors Pte Ltd. \$251 million represents total offering underwritten by Merrill Lynch, which is fully backstopped.

High	\$3,140	6.33%
Mean	\$1,160	3.03%
Low	\$ 50	.75%

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market. As long as liquidity remains, stakeholders may stand to benefit from the additional capital and participating investors can seek to augment their returns.

Increased Use

Rights offerings have increased as a direct response to the challenges of restructuring increasingly complex capital structures with multiple layers of secured debt and present a potential source of considerable income to certain players. In addition, rights offerings also have other unique attributes that allow various types of creditors and other stakeholders with a strong valuation thesis and available capital to commit to help protect and enhance their positions. Given present market conditions, one should expect to see expanded use of this tool in the future. [CR](#)

¹ Standard & Poor's/LCD, "Volume and Number of Second-Line Loans 1997-2007," Standard and Poor's: 2nd Lien Lending Review 2005 to Q1 2007, Copyright 2007, Standard & Poor's, a division of the McGraw-Hill Companies, Inc.

² Standard & Poor's/LCD, "Average Debt/EBITDA Ratio for Transactions with Second Lien Loans 2003-2007," Standard and Poor's: 2nd Lien Lending Review 2005 to Q1 2007, Copyright 2007, Standard & Poor's, a division of the McGraw-Hill Companies, Inc.

³ Bohren, Oyvind, B. Espen Eckbo, and Dag Michalsen, "Why Underwrite Rights Offerings? Some New Evidence," *Journal of Financial Economics*, Vol. 46, pg. 223, 1997.

⁴ Miles, James A. and Mark A. Peterson, "An Analysis of Non-Underwritten Rights Offers: The Case of Closed-End Funds," *Journal of Financial Research*, No. 2, Vol. 25, Pg. 187, 2002.

⁵ Waisman, Shai, Partner, Weil Gotshal & Manges, LLP, "Rights Offerings: The New New Thing," from materials presented at The Association of Insolvency & Restructuring Advisors, VALCON: Legal & Financial Perspectives on Business Valuation & Restructuring, Financing and Deal Panel – Who Are The Players and What Are They Looking For?, Las Vegas, February 2007.

⁶ Public and private equity rights offering transactions between January 1, 2001, and November 21, 2006, with transaction values between \$100 million and \$3.2 billion. Compiled by Jefferies & Company, Inc., from publicly available information.

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