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Meet The Manager

Focus on the Journey

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Longroad is both the name of Paul Coughlin's firm and his philosophy of distressed investing - namely, that it is a struggle. The partners at Stamford, Conn.-based Longroad Asset Management thrive in situations that involve a great deal of complexity. The firm seeks to buy the deeply discounted debt of companies overlooked by Wall Street and takes an activist role in the restructuring process. Coughlin, the founder and managing partner, spoke recently with PrivateEquityCentral.net about his firm's control investing approach, why buying debt is a cheaper way to own a company, and how distressed investing is like doing an Ironman triathlon.

PrivateEquityCentral.net: There are many different ways to approach the distressed market, some of which look more like hedge fund strategies and some of which look like private equity. Where do you fall on that spectrum?

Paul Coughlin: The private equity firms that say they buy distressed companies end up buying them at auction, either as a stalking horse bidder or through funding a plan of reorganization. They want to be assured there is going to be a change of control prior to making the investment. Hedge funds are unlikely to play anything that is very illiquid – they're going to stick with the trading strategy. What we're trying to do is get involved earlier in the process, making our entrance through the debt, thus having a lower creation multiple.

PEC: How do you gain control of the company?

PC: We prefer to buy close to a third of the debt. The reason why we prefer this strategy is because in any sort of restructuring or bankruptcy, you need a two-thirds "yes" vote to get the deal done. Instead of purchasing 67% of the debt, you buy 34% of the class, which essentially gives you negative control and makes it difficult for anyone to maneuver around you during the restructuring process. Normally what happens is we will assume a leadership role in a restructuring, at which point additional bondholders will enter our investor group. So if you own 20% of the bonds and you stand up and announce, "Okay, this is our plan - we're going to hire counsel and fight for a better deal," you're going to have a significant amount of the bondholders join you.

PEC: What is "negative control?"

PC: Negative control is when you acquire a 34% position in the asset class. With this control you can essentially block the deal. And if it gets into a restructuring or a bankruptcy, the only way a deal can be forced down on you is when you have to be what is called an unimpaired creditor, which means you basically have to get paid in full. So if you buy something at a discount and they are willing to pay you in full, that's okay. It's all about making money.

With negative control you can have all the benefits of control without the additional

investment. If you are the leader of the creditors' committee, even though you have a third of the debt, you end up having a large say in the new board, the type of securities issued to the creditors and the corporate governance.

For example, we were involved in a situation called Southern Mineral where we controlled 17% of the debt. We went to court to fight the company on exclusivity, and all of a sudden we had 40% of the debt in our investor group. By standing up and announcing, "We're hiring the lawyers; we're taking control of the situation," we were able to influence the selection of five of seven board seats, the package of securities that were distributed, and I was elected chairman of the board.

PEC: What are the benefits of buying a troubled company's debt?

PC: We try to find attractive situations, which we call math problems - for instance, a company that is generating $20 million of cash flow and has $17 million of interest expense. There is nothing wrong with the business, it is just poorly capitalized and there is not enough money after interest expense to reinvest in the business. We want to go into those situations and obtain negative control; buy 35% to 40% of the deal. One of two things will happen. You'll either have a normal liquidity event, which would be an asset sale, sale of the company, refinancing, rights offering, or the sponsor puts up additional capital. That piece of paper trades up significantly or matures. Or, you buy a large piece of the debt, then enter the restructuring as the significant creditor and take the lead role, where you will be able to dictate the timing and the payment to be received. You're not paying a premium for control.

The other thing about using debt as an M&A tool versus equity is that you do not have any SEC filing requirements. If you were to try to buy equity in a publicly traded company, at 5% you would have to announce your intentions. At 10% you become an insider. So it's not cost-prohibitive to buy a company through the debt.

When we acquire control, we would like to invest additional capital in order to grow the business. Most of these companies are capital constrained.

PEC: Where do you see opportunities and how do you source your distressed deal flow?

PC: Where there's an information vacuum, that's the stuff we want to focus on.

The last fixed-income liquidity bubble was about two years before the Internet bubble – 1998. In 1998, you had many broker-dealers; companies making markets on the wire. Fast forward to today. Alex Brown was bought by BT, which was bought by Deutsche Bank. Firms are going under or merging. There's been a massive consolidation on the broker dealer side. Nowadays, everyone wants to be much more of an agent than a principal, which takes a massive amount of liquidity out of the system. Go to the buyside – the big mutual funds are saying to the broker-dealers, "We want big deals, we want liquid deals, we want analysts following them." So all the smaller deals, due to economies of scale, are no longer being focused on. If you're running a trading desk, you're going to focus on trading a billion dollars of Kmart or Worldcom or Qwest – pick your poison. You can trade those and you can make an eighth or a quarter. It's a volume business. You're not going to focus on a $200 million deal, because how many times can you turn it?

The opportunities come from the illiquidity of the smaller names in the public junk market. For example, a couple of months ago, Merrill Lynch took out every issue under $100 million from their high-yield index. We are seeing opportunities from the commercial banks that have done roll-up strategies. For example, if a bank wants to sell its exposure to Kmart or Global Crossing, they're going to sell it to the Street. But

many large banks also have a fair amount of middle-market loans. You can't educate the Street on a $5 million loan. Banks tend to have periodic sales where you'll get a book and there'll be 20 names, $200 million face. We like to focus on those situations.

PEC: There are a lot of small to medium companies out there with discounted debt. How do you sort the good opportunities from the bad?

PC: My background is mainly financial analysis. I've had a lot of operating experience lately, but mainly financial analysis. The first thing we did in forming Longroad was put together an advisory board that has 16 senior operating people within various businesses. They are our eyes and ears. We find companies in the information vacuum that we like, then approach the right person on our board and say, "Here's the company; here's the board; here's the management; here's a sample of the competitors." They help us find out what they can through their network at the ground level. Is it a good industry? What's their competitive position? Are they good people? Is there a product coming in from Canada we do not know about? Is there a new competitor from Europe? This is the type of information that is always going to blindside you. The advisory board is there to help us avoid the bad investments.

PEC: There's been a lot of enthusiasm for the distressed strategy, and this has led to many new entrants to the field of managers. How do you stand out from the pack?

PC: I think one of the things that we have going for us is that we have a diverse tool box in terms of each person bringing a specific skill set to the team. One huge advantage is that we have the use of operating executives in the decision-making process. The other thing is, we have done this before. Our strategy is not just in theory. As you can see with Southern Mineral, it was soup to nuts – we bought the debt, took control of the company and sold it for a significant profit.

The strategy that we're employing is in the middle-market of distressed. We're not investing in the Kmarts and the Worldcoms because that, to me, is becoming a more efficient business. If you sit in front of a Bloomberg, you're going to have 100 e-mails per day of quarter-point spreads in those markets. I don't want to focus my time on that. We focus on the lower end of the scale, with an enterprise market of, say, below $250 million. Our enterprise value could be the average investment size for one of the bigger funds. If you're running a $3 billion distressed fund, you are not investing five million dollars. The hedge fund guys will not play this game – it's too illiquid. And as I mentioned before, the private equity guys are only willing to get out the checkbook once they know there's going to be a change in control.

PEC: So middle-market buyout firms present a huge exit opportunity for you. . .

PC: Absolutely. Most deals these days, people are looking at a PowerPoint presentation that has been put together by somebody. We actually compile the book. We want to buy the math problems. If there is a business that is financially challenged, we will go in, buy the house, mow the lawn, and paint the house. We may or may not evict the tenants. If you have good management, you let them stay, if you have bad management, you replace them. But after the cosmetic changes, such as restructuring the balance sheet, someone is willing to pay a higher premium.

PEC: How long do you typically hold an investment?

PC: In some cases, you'll get taken out through an asset sale. In other cases you'll be able to do a quick fix and flip. On average, I'd say two to four years. For the Southern Mineral transaction, we got involved in August of 1999. We signed a definitive

agreement the next December and sold the company in June 2001. But it's rare that you're going to flip something quickly.

PEC: What types of skills does a team in your space need?

PC: You need someone with an appreciation of creditors' rights and bankruptcy litigation. You need the diligence on the indentures, credit agreements, so that if you do get into an issue you need someone that can act on the pressure points. You need someone who can manage the transaction, who has had the prior experience. You need people that can source public and private paper. We have someone with a CPA background on the team to help sift through the financials. You need operating experience and financial experience. Capital is fungible, you can get it anywhere. Experience is important. In a restructuring or a negotiation, you have a choice of the several avenues: removing them from the process, offering a dignified exit strategy, or providing a financial package. You might be negotiating with someone that's digging in their heels and you need to remove them from the process. You'll have another situation where it's a family business and you might offer some options and a board seat and they are willing to walk away. Then there's the person who willing to go away for a price. Having done it for a long time, you learn what to expect. If you use the wrong method in the wrong situation, it can hurt you. The whole goal is to preserve value.

PEC: You've done three Ironman triathlons, including the Ironman in Hawaii. What did those teach you about the distressed game?

PC: You have to focus on the journey, not the destination. When you're in the water, you need to think about being in the water, and when you're on the bike, you think about the bike, not the run. Both in business and with the Ironman, you're going to have highs and you're going to have lows. The key thing for both of them is to keep moving forward.