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Darkest Days for DIP Financing Appear to Be Over

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(TMA International Headquarters)

The American economy has recently demonstrated dramatically how quickly capital markets can tighten and how quickly that restriction can reverse itself.

The current restructuring cycle began as a result of the unprecedented upheaval in the banking sector resulting in capital markets clamping shut. While no one thought that the March 2008 collapse (and subsequent shotgun marriage) of Bear Stearns was a good omen for capital markets, by September 2008, when Lehman Brothers was “allowed” to fail, the writing was on the wall for capital markets. If the very lions of Wall Street could disappear overnight, if “toxic” assets had poisoned these and other stalwarts of the credit community, then nothing was safe. In a period of a few months, credit markets all over the world locked up, defaults on corporate securities soared, and the current restructuring cycle commenced.

Not surprisingly, this tightening of credit conditions made it extremely difficult for companies in Chapter 11 to obtain debtor-in-possession (DIP) financing. At the beginning of this restructuring cycle, “third-party” DIP loan providers (*i.e.*, lenders who

are not creditors in a case), completely retreated from the DIP loan market. Debtors and their advisors spent the fall and winter of 2008 and the spring of 2009 going through their contact lists of third-party DIP providers, only to be told that there was no interest in making these loans.

Despite a jump in bankruptcy filings in 2008, new DIP loans were sharply lower than in the most recent restructuring cycles. In 2008, the number of new DIP loans was about 35 percent below the number issued during the economic downturn in 2002.

Interestingly, notwithstanding this downturn, DIP lending might have been the beacon of hope in the broader capital markets in those dark days.

At the height of the last downturn, in 2001 and 2002, DIP loans totaled 2.3 percent and 4.3 percent of overall leveraged lending volume, respectively. DIP lending jumped to more than 30 percent of overall leveraged lending volume during the first three quarters of 2009, emphasizing the shutdown in the general credit markets.

Loss of Leverage

The retreat of third-party DIP lenders from the market at the beginning of the current restructuring cycle not only resulted in a shortage of new capital, but also a real loss of leverage for debtors in their ability to negotiate DIP loans and/or cash collateral agreements with existing creditors. In the absence of third-party DIP lenders, existing creditors were able to extract unprecedented concessions from debtors (which were approved by bankruptcy courts) in terms of rate, terms, and conditions. Most notably, existing lenders, were given great latitude to “roll” or “wrap” prepetition debt into the DIP loan—essentially allowing the prepetition creditor to convert a portion of its claim into an administrative priority. In terms of rates, some of the companies that filed near the beginning of the current cycle were forced to obtain extremely costly DIPs.

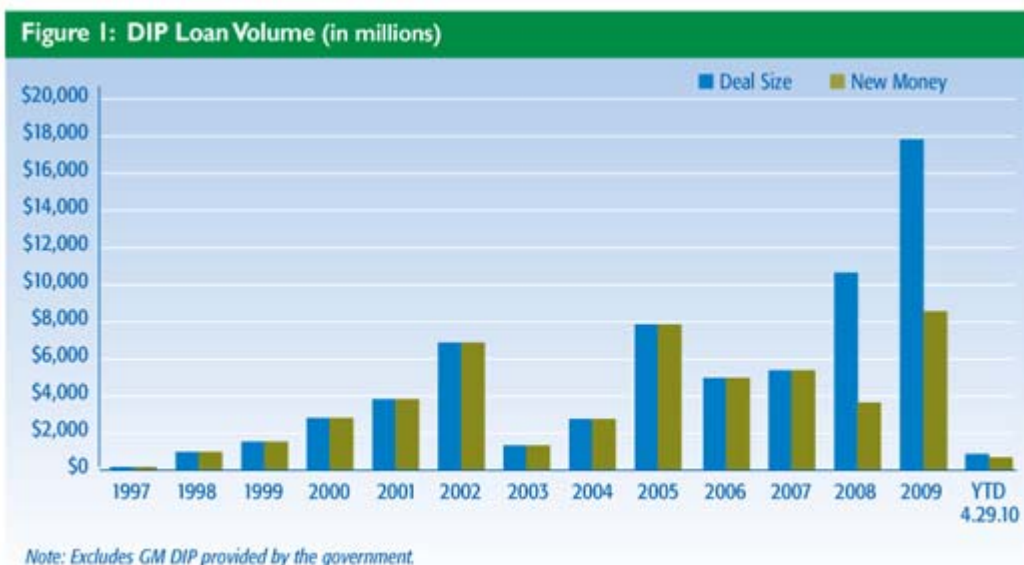
They included:

- VeraSun Energy Corporation, which paid about 16.5 percent on certain of its DIP financing facilities

- Tronox Inc., which paid LIBOR plus 950 basis points on its revolving DIP facility
- Merisant Worldwide, Inc., which paid LIBOR plus 1,100 basis points on its revolving DIP facility
- Chemtura Corp., which paid LIBOR plus 750 basis points on its term loan and non-rollup revolver
- Pacific Energy Resources Ltd., which paid LIBOR plus 1,050 basis points on its DIP facility

Such rates were seen frequently during the beginning of the cycle. In addition, many of the DIP facilities had high LIBOR floors as well, with 3 percent and 4 percent floors quite common, and some—such as the Merisant Worldwide, Inc.’s DIP facility—with floors as high as 5 percent.

While rolling outstanding debt into a DIP loan is by no means a new phenomenon, in 2009, prepetition lenders were as forceful and creative as ever in rolling up debt. Excluding Treasury and economic development councils (EDCs), lenders used almost half of total DIP commitments to roll up existing debt. In addition, in several cases, the rolled up debt had higher rates than the prepetition debt. As indicated in **Figure 1**, while new money advanced under DIP loans in 2008 and 2009 did not compare favorably to prior downturns, when the amount of “rolled” prepetition claims are included, DIP lending was more robust than ever.



In many cases, existing lenders made DIP loans to avoid a liquidation of the debtor that was likely to be disastrous in light of the lack of available acquisition financing. At the same time, making the DIP loan allowed existing creditors to keep control of the restructuring process and eventually to control the debtor's assets. By way of example, in Merisant Worldwide, Inc., Wayzata may have been incentivized to provide DIP financing to facilitate the transfer of the reorganized debtor's equity.

Lenders Emerge

By third quarter 2009, capital markets began to relax and some third-party DIP lending began to come into the market. Some of these were loan-to-own players who used the dearth of capital in the DIP market as a vehicle to obtain another objective. By way of example, Carl Icahn won the bid to purchase Fontainebleau Las Vegas Holdings LLC by using a DIP loan as part of a Section 363 sale credit bid. His bid consisted of a \$51 million DIP loan it provided to Fontainebleau and \$105 million in cash.

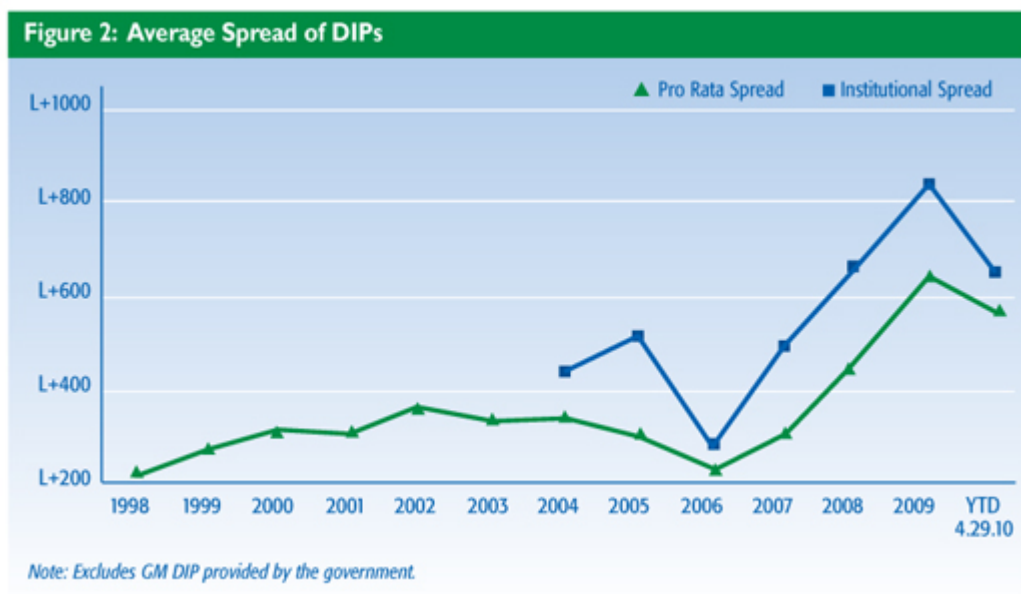
However, controversy ensues when milestones incorporated in DIP agreements allegedly are used to allow lenders to control the bankruptcy process by ensuring that their claims constitute a deal breaker and therefore take ownership of the assets

through a credit bid when other bidders do not have sufficient time to make competing bids. Extremely expedited sales mandated by milestone provisions are being contested for conflicts and self-dealing.

For example, Propex secured from a hedge fund a \$65 million DIP that contained a milestone provision granting only about 90 days for the debtor to sell the assets. The committee of unsecured creditors objected, claiming that the agreement amounted to a fire sale. While the hedge fund ultimately acquired Propex in the Section 363 auction, a bidding war occurred and increased the final price by more than 30 percent.

In some cases, strategic consideration might be a critical factor in determining whether an investor is willing to put up a DIP loan. For example, in October 2009, DBSD received DIP proposals from DISH Network, which also purchased the debtor's first lien credit facility, and Solus, one of the largest shareholders in TerreStar, a rival S-band satellite operator. Ultimately, an ad hoc committee of second lien holders provided the DIP. However, Sea Launch did receive a \$25 million DIP loan from Space Launch Services LLC, a company that is associated with Excalibur Almaz, an international space exploration company looking for a synergistic relationship with Sea Launch.

As markets have continued to improve, spreads on DIP loans have begun to decrease. As illustrated in **Figure 2**, according to Standard & Poor's, spreads on DIP revolving credit facilities and institutional DIP term loans have dropped from 641 and 823 basis points in 2009 to 588 and 640 basis points, respectively, for the first four months of 2010. In fact, there have been a number of cases in which debtors have obtained replacement DIPs to take advantage of cheaper financing.



For example, Tronox Inc. obtained a replacement DIP priced at LIBOR plus 700 basis points, which repaid its existing DIP priced at LIBOR plus 950 basis points. Similarly, Cooper-Standard Automotive Holdings Inc. obtained a replacement DIP at the end of 2009, which saw interest rates on the DIP drop from LIBOR plus 950 basis points to between LIBOR plus 600 to 700 basis points. At the same time, the LIBOR floor was reduced from 3 percent to between 2 percent and 2.5 percent.

Notwithstanding a slow start to 2009, debtors obtained more than 390 DIP loans totaling more than \$62 billion, compared to 345 DIP loans totaling only \$18 billion in 2008. Even after removing government-funded cases from the total, debtors secured \$22.5 billion in DIP financing in 2009.

Control or Acquisition

The overall state of the DIP financing market has changed over the last couple of years as the broader credit markets have changed. Lower yields due to improvements in the overall credit markets have resulted in lower rates in the DIP loan market as well.

While it is difficult to say precisely what DIP yields will be over the next year or so, it seems very likely that the worst part of the credit cycle is over and DIP yields are not

going to reach the same levels as they did in late 2008 and early 2009. Even though yields on DIP loans are not at their peak levels, the loans will still likely be used for similar strategic reasons—protecting existing debt positions or controlling restructuring processes or acquiring assets through credit bids.



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