Twitter Thread by Matt Willes

Matt Willes
@SkolCapital

Today in mezz threads:

Finding collateral where there isn’t any ... aka, my most innovative idea (and I’m giving it to you for free)!



Let’s revisit this thread from my early (active) Twitter days. A few questions you might ask:

1) What was my collateral (why did I make this loan)?
2) Why did I have any leverage with the company at all (short of a foreclosure)?
3) Why did the “deep pockets” buy me out? https://t.co/k7dq2PsNTf

> My typical mezz deals are to companies in 1/3 categories:
>
> 1) M&A
> 2) Growth Capital
> 3) Special Situations ...
>
> Here\u2019s an example on #3:

— Matt Willes (@SkolCapital) August 27, 2020

Let me pick up the story with two assumptions I had going in:

1) I didn't trust the owner/operator (at all)

2) I knew the PE group (that had offered $200 M) well, and I knew who they were proposing to bring in to run the company had they bought it

#2 (plan B) made sense to me



The senior ($ZION) had the collateral locked up and controlled any formal foreclosure/bankruptcy.

The idea of a convertible had some appeal but you can't really do anything with 5-10% of a business



My solution: "default conversion" at an unfair valuation

I negotiated a deal that if the company defaulted (and only if they didn't cure the defaults) I had the option to convert into preferred stock representing a fully diluted 40% of the business



My thinking:

A) This acted as a HEAVY incentive for the company to avoid default.

In later negotiations, I would describe this (fairly accurately) as Thor’s hammer hanging over their heads



B) It was enough to provide an incentive, but not enough to take control. This became important while negotiating the intercreditor agreement with Zions.

I needed (and received) the ability to exercise the conversion outside of the waiting period for other remedies

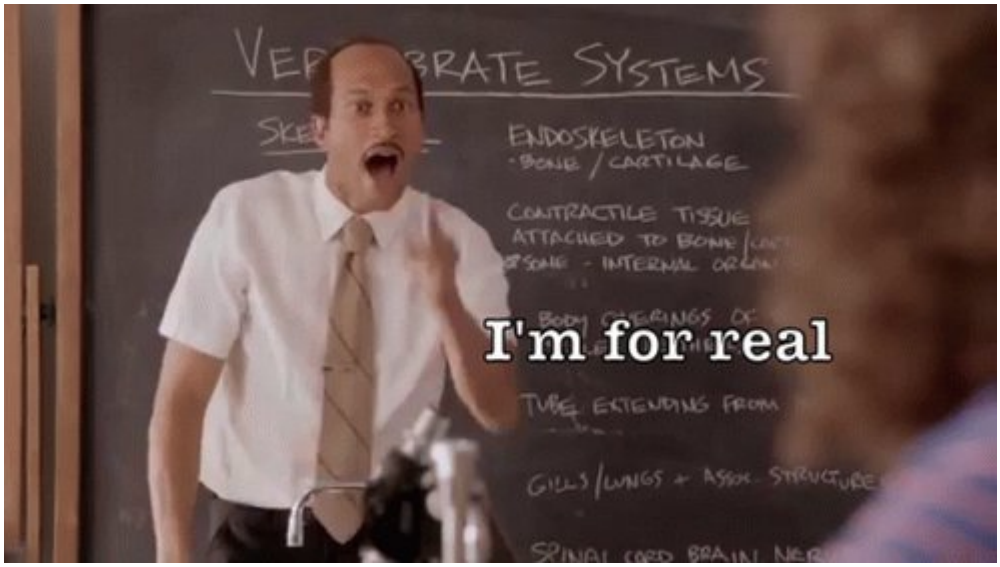


C) It provided optionality ... With a PE firm willing to pay $200 Million for the company, if things didn't go well I was confident I could find somebody to buy 40% of the business for $6 Million



So the answers to the original questions should be obvious, but let's recap:

Collateral) a Default option on 40% of the business. I'm not exaggerating to say this was the ONLY collateral I cared about in this deal because the Senior had everything else locked down



Leverage) Another explanation for default conversion is it can be viewed as negotiating the outcome of a formal foreclosure without:

1) The expense of actually going through the formal process
2) The borrower largely realizing they are in that negotiation

That’s leverage



Motivation) The deep pockets felt (correctly as it turned out) that management wasn’t able to turn the business around. He:

■ Converted into 40%
■ Gave them a series of options to buy the stake back
■ Rinsed and Repeated

He now has control of the biz

My idea on steroids



Final) I’m not proud of the way this ended ... in a very, very small way I feel like Lewis Ranieri.

However, Default Conversion is still a tool that I use in some deals

Mezz isn’t right in every deal, but default conversion can reduce risk and align incentives in some deals



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