Financial and Economic Crisis – Law Firms

TALF, Stimulus And Troubled Assets Deals

The Editor interviews ***David H. Joseph****, Partner, Stradley Ronon Stevens & Young, LLP.*

Editor: Please tell us about your role at the firm and your background in corporate practice.

Joseph: I am a partner in our Business Department and co-chair of our Structured Finance and Securitization Practice Group. My corporate practice also includes traditional M & A work, securities, finance and private investment funds. We formed our Distressed Assets Team in order to more effectively bring the collective expertise of lawyers from different practice areas to bear on the issues and problems that our clients are facing in today's volatile markets.

Editor: What groups are primarily involved in your Distressed Assets Team?

Joseph: Our Distressed Assets Team consists of transactional and regulatory lawyers who practice in the areas of private investment funds, securitization, real estate, private equity, bankruptcy and tax, as well as litigators.

Editors: How do you define "distressed assets" for the purposes of the team's activities?

Joseph: "Distressed assets" are commonly defined as assets that are either not performing or are underperforming. In the context of an asset-backed security or a mortgage-backed security, it could be a security that is not flowing cash according to projections, or not flowing cash at all. If you are talking about a business, it could be a highly leveraged company with a sustained negative trend in revenues or profits that is now unable to meet its debt service or financial covenants.

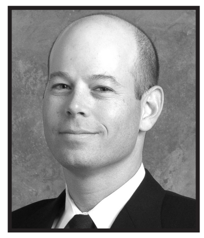
Editor: How has the current economic and political environment affected the market for distressed assets?

Joseph: The fact that the economy is very difficult actually creates an opportunity. As the larger economic picture worsens, more assets become distressed; this creates a larger spread in terms of the arbitrage between the price at which the asset can now be acquired and its intrinsic value. However, the current absence of liquidity in many markets, coupled with a lack of clarity and confidence in the ultimate form of government intervention, has created severe problems in terms of pricing assets that typically trade freely in secondary markets like private-label mortgage-backed securities, mortgage loans and other financial assets. We need the federal government to provide a clear, detailed picture of the regulatory and bailout measures it is looking to undertake.

Editor: How will the recently announced federal proposal to deal with toxic assets held by financial institutions affect the market for those assets?

Joseph: If the new financial stability plan works as intended, it will certainly help, as most of the proposed measures are designed to stabilize housing markets, stimulate lending and increase liquidity in capital markets. Of course, there is plenty of skepticism because the Treasury released few details.

One of the key components of the new pronouncement is the expansion of the Term Asset-Backed Securities Loan Facility (TALF). Under this program, the government will provide financing for the purchase of newly issued asset-backed securities. One of the criticisms of the initial TALF was that it did not extend to the most troubled asset classes: private-label residential mortgage-backed securities (RMBS) or commercial mortgage-backed securities (CMBS). The expanded TALF now expressly includes CMBS, and Treasury has indicated that it may also be extended to private-label RMBS. The hope is that expanding TALF to these asset classes and increasing the amount of funds available up to $1 trillion will stimulate new securitization issuance, which would have the downstream effect of restoring lower-cost financing to the residential and commercial real estate markets.



David H. Joseph

Editor: Wasn't the private sector's involvement also designed to create a competitive situation that would create a floor?

Joseph: Yes. Perhaps the most exciting part of the new pronouncement for investors in distressed securities and financial assets is the $500 billion Public-Private Investment Fund that will purchase existing toxic assets. While the TALF program aims to create low-cost funding for new deals going forward, the Public-Private Investment Fund is intended to remove some of the backlog of distressed assets that are already on companies' balance sheets. So, you have one program designed to jump-start the new issuance market and another geared toward cleaning up and creating liquidity for existing assets. While it's not yet clear exactly how this new fund will work, the key is that it will be purchasing these currently illiquid assets. There is plenty of money on the sidelines waiting to get into the secondary market and begin purchasing existing distressed securities and financial assets. Hopefully, the Public-Private Investment Fund will help with price discovery and thereby restore freer trading in these assets.

Editor: Do you feel that your Distressed Asset Team is set up in such a way that it can serve investors who are interested in getting involved in this growing market?

Joseph: Yes, this goes hand in hand with our reasons for forming the team. We are seeing more and more of our clients looking to get involved in distressed asset markets. The depth and breadth of our team's experience positions us to help our clients participate in what likely will be an historic investment opportunity. We can provide an end-to-end solution: structuring vehicles to acquire assets, handling the acquisition and disposition of assets, addressing regulatory, bankruptcy and tax concerns, and creating and implementing strategies to maximize return on a portfolio of distressed assets.

Editor: One question investors have in their minds is whether this is a good time to buy distressed assets with the prices of everything continuing to fall.

Joseph: While no one wants to buy into a falling market, no one wants to miss the bottom either. Based on what we are seeing, some investors believe that certain asset classes are at or near a bottom but other classes are still far from bottom. In the private-label RMBS market, certain tranches seem to have become attractive now and we are seeing some investors starting to buy. On the other hand, I think most people believe the commercial real estate market still has a long way to go before it hits bottom.

Editor: I would imagine that due diligence is very important at this time.

Joseph: Absolutely. Think of a private equity fund with a portfolio of different companies. For that private equity fund, each company is an asset and if one of those companies is struggling under an unsupportable debt load, it is now a distressed asset. I expect that in the near future we will begin to see more and more M&A transactions in which private equity firms are unloading distressed companies and strategic buyers are purchasing the companies at a discount and restructuring them. Considering the distressed nature of these companies, strong due diligence will be paramount, and that is something the lawyer can provide.

Editor: Are there characteristics of your group that make it particularly adept at doing due diligence?

Joseph: Having a broad array of practice groups that we can bring to bear on a comprehensive due diligence review is very helpful. We also have a sophisticated securitization and structured finance practice that is somewhat unusual in a firm outside New York. Therefore, we can bring extensive capital market experience to deals involving distressed securities or financial assets.

Editor: Would the distressed asset deals you are seeing be leveraged in some way or would they be based on funds already in the hands of the investor?

Joseph: I think it's a pretty safe bet to say that you are not going to see leverage to the extent we have seen it in the past, if at all. Most of the funds we have formed have no leverage; the mantra now is "patient capital." Investors generally need to be willing to tie money up in investments that likely will be illiquid, at least in the near term. Bank financing, which really isn't readily available at this point, certainly isn't patient capital. Even in the bankruptcy context, companies are having trouble getting debtor-in-possession financing. If they can get it at all, it is not necessarily on viable terms.

Editor: How important are strategic investors in the picture?

Joseph: I think strategic investors play a key role right now. The door suddenly is wide open for the strategic buyer who has been shut out for the last several years due to the private equity frenzy. Even companies with strong balance sheets are finding it difficult to get bank financing for acquisitions, but it is going to be easier for such a company to get bank financing than for a private equity fund. Even if strategic buyers can't obtain bank financing, those that are well capitalized can often get deals done using some combination of cash and stock.

Editor: Would they tend to come to your firm for input so they can proceed rapidly if a desirable purchase becomes available?

Joseph: Buying a distressed company is different than buying a healthy company. For instance, we may be talking about a company in, or on the verge of, bankruptcy. In structuring that type of acquisition you are going to need the expertise of bankruptcy lawyers. In many instances, it may be more efficient to put the target company through a bankruptcy at the time of purchase in order to purchase a clean company on the other side. These are the types of issues on which we can advise clients in advance so that they are prepared to move quickly when opportunities arise.

Editor: I assume you work with distressed companies who need help making themselves sufficiently attractive to be acquired. Do you have any thoughts on how to do that?

Joseph: Working with troubled companies to help them restructure their balance sheet, recapitalize and replace high-cost debt with equity or longer-term, lower-cost debt is a booming business these days. We regularly handle a fair amount of this type of work, but it has really picked up during this economic crisis.

Editor: The Obama vision as captured in the stimulus plan involves things like infrastructure, broadband, strengthening the national grid, renewable energy, improved medical care, etc. Do you see investors thinking that these are things to invest in?

Joseph: Stock market speculators are chasing all the companies they believe will benefit from the stimulus program. I think we will see more and more private equity investments in those companies as well. I don't think the stimulus is necessarily geared toward mainstream tradable distressed assets like pools of mortgage loans, credit card receivables or asset-backed securities; those markets simply need price discovery because once we have clarity on pricing, liquidity will return. I do however think that we will see capital market ingenuity come home to roost in these nascent markets. For example, there has been a lot of talk recently about the securitization of carbon credits.

Editor: How would you sum up the challenges and opportunities that lie ahead as the various stimulus plans and toxic asset solutions come into play?

Joseph: Usually, the worse the economy becomes and the more distressed that assets become, the greater the opportunity is for an arbitrage play – for an investor to buy an asset that is obviously troubled at the moment but that has a far greater intrinsic value than today's purchase price. In this sense, a down economy is normally a great time for distressed asset investors.

One of the primary problems we face at the moment is the absence of regulatory certainty and the lack of clarity on the government bailout plan. Even with the newly announced initiatives, we don't have details as to how they are going to operate, and we don't yet know the future regulatory landscape. A number of clients are looking at deals but have put them on the shelf for now because they have no idea as to what the regulatory oversight is going to look like. This perfect economic storm is being undermined by the lack of specific, detailed direction from the government. As that picture begins to clear up, I think we will see more deals move forward.

Please email the interviewee at djoseph@stradley.com with questions about this interview.