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TriMark USA, Sacred Rights, and Expectations Investing

Restructuring Analyst
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Welcome to the first Restructuring newsletter,

Thank you for subscribing.

Today, we will learn more about:

[Exclusive] TriMark USA

[Exclusive] Sacred Rights

[Exclusive] Expectations Investing

TriMark USA

In 2017, Centerbridge Partners and Blackstone Tactical Opportunities Fund acquired TriMark USA, the largest restaurant supply and equipment company, in an LBO with $800M of term loans. TriMark was acquired from Warburg Pincus, which had grown the firm from $1B to over $1.8B, and had acquired Hockenbergs, RW Smith & Company, and Adams Burch. Jefferies, Barclays, Nomura and Citizens bank provided committed financing, and the loans offered lenders first and second recovery priority in the event of a default, split between a senior tranche worth $560M, and a junior tranche at $235M. The transaction was valued at $1.265B, implying a 10x EBITDA multiple. TriMark was an attractive acquisition due to its historically stable revenue growth, long-standing relationships with over 80,000 customers, and defensible market position. However, due to COVID-19 the foodservice equipment industry was negatively affected due to the industry's sensitivity to consumer demand and lockdown restraints. This led to TriMark USA facing a liquidity crisis and requiring additional financing to continue operations.

Thus, a committee was formed to work on determining any additional liquidity, and to explore potential pro-rata financing options. A new deal was reached which created a new class of lenders by amending the initial agreement. This deal included creditors, Ares and Oaktree Capital offering a $437.5M rescue package to Trimark in September 2020. This rescue package was split between a "New Money Tranche" of $120M super-priority "first out" debt which ranked ahead of existing First Lien Term Loans, and a "second-out" tranche of $307.5M of super-priority debt ranked ahead of existing term loans. The New Money Tranche provided $120M of additional liquidity to support the companies working capital to meet improving demand as the industry recovered from the pandemic, and the Second Out Tranche was used to purchase $307.5M of the original First Lien Term Loans at par. Before diving deeper into the transaction, it is important to understand some of the intricacies of the case.

A no-action clause is a provision in an indenture that specifies when and how bondholders can take legal action against the issuer of the debt. These clauses are included to protect the issuer by requiring bondholders to seek approval from the other bondholders before taking legal action. No-action clauses also typically require bondholders to go through an intermediary, such as an indenture trustee, before taking legal action. This helps ensure that the interests of all bondholders are considered before any legal action is pursued. There are some instances where bondholders can pursue legal action against the issuer of a debt instrument, even if it is not specified in the no-action clause of the indenture (the legal document outlining the terms of the debt). Basically, only the trustee can take action against the issuer of the bonds.

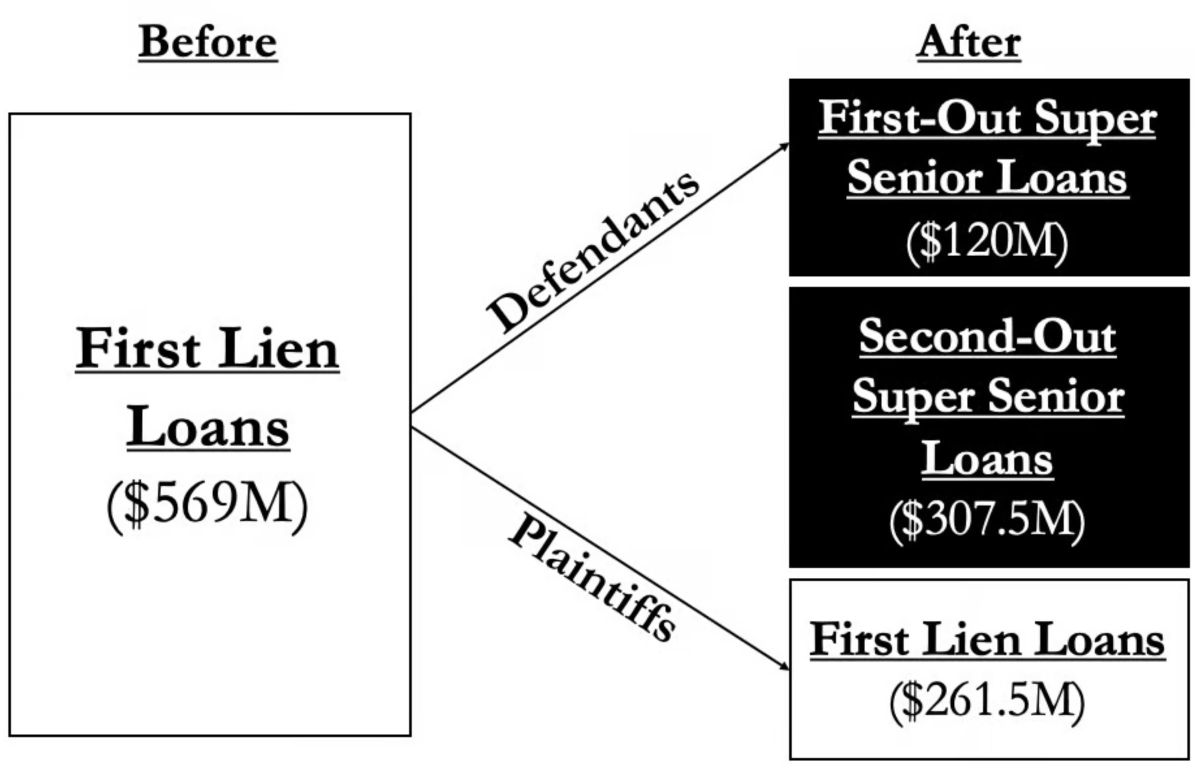
Only when the trustee fails to take action in accordance with the bond documentation, can bondholders take legal action. These exceptions may vary among indentures, but most indentures have a set of common requirements that must be met before bondholders can take action. These requirements may include nonpayment of principal or interest, a minimum number of bondholders (usually 25% or more) seeking a remedy, and the failure of the indenture trustee (a third party responsible for enforcing the terms of the indenture) to take legal action. Bondholders may also be able to take legal action if the indenture trustee has a conflict of interest. In most other cases, bondholders are required to take collective action through the indenture trustee.

The term "sacred rights" refers to specific rights or privileges that are regarded as untouchable or inviolable. The provisions of a restructuring plan or agreement will usually protect these rights, which are normally awarded to a specific group or class of stakeholders. Examples of sacred rights provisions might include the right to receive a certain level of compensation or benefits, the right to participate in certain decisions related to the restructuring, or the right to retain certain assets or property. These provisions may be included in a restructuring agreement or plan in order to provide some level of assurance to the stakeholders that their rights will be protected. Sacred rights provisions are often seen as an important tool for promoting fairness and equity in the restructuring process, and they can help to ensure that the restructuring is successful and sustainable in the long term.

Lenders, such as Z Capital Credit Partners, Golub Capital, Shenkman Capital Management, BlueMountain, and others, sued Trimark USA to void the financing that they received in September, fearing they may be wiped out in a bankruptcy. Defendants included, Blackstone, Centerbridge, Ares, and Oaktree, amongst many others.

What was this agreement? There were three main components: [1] TriMarkentered into a "Super Senior Credit Agreement" where "First-Out Super Senior Debt" was issued to the participating lenders (this was not offered to non-committee LBO loan lenders). [2] "Second-Out Super Senior Debt" was issued in a dollar-for-dollar exchange for the initial debt the participating lenders held in the LBO loan. [3] Covenants were stripped from the original agreement allowing TriMark to incur new debt senior in priority to the original agreement, subordinate the LBO loan's collateral position, and establish a "no-action clause" that precluded lenders from pursuing action against Trimark or other lenders.

The alleged covenant-stripping included removing the Plaintiff's rights to information and removed bargained-for protections. Essentially, this restricted the plaintiff's abilities to make informed decisions on their debt, as they were not sure on whether to keep or sell their debt.



Basically, the new agreement secured the lenders' debt by the same collateral that was securing TriMark's First-Lien Debt; the newly created classes would have priority on TriMark's assets if the company filed for chapter 11. Additionally, the original First-Lien Lenders were not provided the opportunity to exchange their original First-Lien Debt for the new debt. This caused the First Lien Debt which was originally trading at 50 - 70 cents on the dollar, to drop to 0 - 10 cents on the dollar.

The plaintiffs' first action seeks [1] a declaratory judgment that the original credit agreement as amended by the participating lenders is void and not an enforceable contract; [2] the participating lenders and TriMark breached the original credit agreement and their "sacred rights"; [3] the defendants breached the 'implied' covenant of good faith and fair dealing; [4] the transaction violated the New York Uniform Voidable Transactions Act: [5] that TriMark's equity sponsors (Centerbridge and Blackstone) engineered the transaction that led to the subordination of their loans.

What was the outcome? [1] Majority lenders argued that the minority lenders lacked standing to bring this matter to court due to the no-action clause. The court ruled this was atypical, calling it a "preemptive self-pardon" and was denied. [2] The original credit agreement prohibits defendants from placing any debt above the minority lenders' position in the waterfall ("even if the order of distribution remains facially unaffected"), therefore the minority lenders had a "plausible argument" to bring the matter to court. [3] The court dismissed the claims that the defendants breached the good faith covenant. [4] The court dismissed the claims that TriMark's equity sponsors orchestrated the transaction. Overall, the decision seemingly provided a free pass to those who engineered the uptiering transaction.

The ruling regarding covenants of good faith is interesting as it potentially damages all practical legal use of the covenant. Additionally, the decision on no-action clauses may cause lenders to rethink the contractual provisions contained in their credit agreements as it was ineffective to bar non-participating creditors' claims.

On January 7th, 2022, lenders came to a mutually agreed resolution. Tranche A Loans under the "Super Senior Credit Agreement" will retain their priority over the Tranche B loans, and all outstanding First Lien Term Debt (from the original agreement) can be exchanged on a dollar-for-dollar basis for Tranche B Loans (from the amended agreement). This is important as the plaintiffs initially argued that they were not provided the opportunity to exchange their first-lien loans in the amended agreement.

Source 1, *Source 2*, *Source 3*, *Source 4*, *Source 5*, *Source 6*, *Source 7*, *Source 8*, *Source 9*, *Source 10*, *Source 11*

Sacred Rights

In the above section about TriMark USA, the topic of Sacred Rights was briefly mentioned. Let's have a deeper look. To give a brief overview, sacred rights are inviolable provisions in a creditor agreement that may protect your rights to receive scheduled payments of principal and interest, rights to certain assets or property, or the right to participate in decisions during the restructuring process. With debt priming and other forms of Creditor-on-Creditor Violence becoming common in today's environment, understanding the limitations and usage of sacred rights becomes increasingly important. On the following page, the various types of sacred rights will be discussed, followed by a presentation of the different levels of sacred right lien protection, including the 'strong version', 'semi-strong version', and 'weak version'.

Credit agreements protects lenders interests in an equitable manner, governed by a majority rule, except for a list of "sacred rights" that each lender has a veto right over. Various types of sacred rights includes decisions to change pro rata sharing, extend maturities, release collateral, reduce scheduled payments, reduce interest margins, and increase lenders' commitments. It is obvious why sacred rights plays a critical role in lender-on-lender violence. Previous cases we detailed, such as, Serta Simmons, and Trimark were significant as before those cases it was assumed that sacred rights protected nonparticipating/minority lenders from priming transactions. The Serta Simmons case specifically highlighted that the majority of credit agreements do not actually require consent of lenders to pass amendments that subordinated senior priority claims.

As a result of these various priming cases, creditors have successfully argued for expanded sacred rights provisions. The new sacred rights aim to combat priming transactions by giving lenders a strong veto power over lien subordination amendments. These new sacred rights can be grouped based on their ability to effectively prohibit lien subordination: the "strong-version" strictly prohibits lien priming amendments with no exceptions, the "semi-strong version" prohibits lien priming except when the priming debt is offered to all lenders on the same terms, and the "weak version" is similar to the "semi-strong version" but does not require the priming debt to be offered on the same terms to all participating lenders.

Strong version: What do these sacred rights look like in credit agreements? Here is an example of a "strong-version" found in a credit agreement from Viad Corp: "No amendment or waiver of any provision of this Agreement or any other Loan Document, and no consent to any departure by the Borrower or any other Loan Party therefrom, shall be effective unless it is in writing and signed by the Required Lenders and the Borrower or the applicable Loan Party... however, no such amendment, waiver, or consent shall... (1) subordinate, or have the effect of subordinating, the Obligations hereunder to any other Indebtedness, or subordinate, or have the effect of subordinating, the Liens securing the Obligations to Liens securing any other Indebtedness without the prior written consent of each Lender directly and adversely affected thereby."

Semi-strong version: If priming transactions are such an issue, why do creditors allow the possibility of lien subordination to occur, instead of including "strong-versions" in credit agreements? The appeal is that since the priming debt is offered to all lenders on the same terms, there is still potential to participate in a beneficial transaction without harming other creditor groups. For example, in a credit agreement by Tupperware Brands, it states: "None of this Agreement, any other Loan Document, or any provision hereof or thereof may be waived, amended, or modified except with the consent of the Required Lenders; provided that no such agreement shall... (E) subordinate all or substantially all of the Collateral... without the written consent of each Lender, unless each adversely affected Lender has been offered a reasonable, bona fide opportunity."

Weak Version: As previously mentioned, the "weak version" is effectively the same as the "semi-strong version" but does not require the prime debt to be offered on the same terms. The importance of the "same terms" requirement found in the "semi-strong version" is that it limits the types of consent fees or incentives that can only be offered to preferred lenders. However, in the "weak version," the borrower is not restricted in this way. What is the appeal of this? The appeal is that it gives borrowers significantly more flexibility to obtain consent through side deals with their preferred lenders, such as by offering to purchase their loans at a premium on the open market.

Source 1

Expectations Investing

Unlike a stable bond which is easier to value because the future cash flows are printed on it, stocks have a lot of uncertainty regarding future returns. Traditionally, investors have performed DCF valuations to try to calculate the intrinsic value of a stock. However, Michael Mauboussin suggests that people approach it backwards (“Reverse DCF”) and instead look at the future cash flows that would lead to the current share price. By doing this, an investor will have a sense of the expectations that are being baked into a given stock price and what a company would have to do to exceed those expectations.

The markets expectations for a company’s future performance are largely driven by the company’s future sales growth, operating margin, and incremental investment efficiency.

While oftentimes great businesses make great stocks to invest in, this is not always the case. A great stock is one that is trading at a price below intrinsic value and sometimes great businesses are overvalued. A great business might trade at such a high stock price that it could never live up to the expectations that are being baked into the stock. Conversely, sometimes bad businesses make great investments because they have been neglected by the market and offer great value to investors. It is all about having a variant view on the company's future performance than the expectations that the market has.

In 1988, Warren Buffett invested in Coca Cola (KO) which has now become one of the most iconic investments of all time. In 1988, KO was trading at 10x EV/EBIT despite being one of the most iconic brands in America and having a lot of untapped pricing power and opportunities to continue to expand internationally. Because of the markets low expectations for KO's future, when the company performed well over the next decade (9% annualized revenue growth & gross margin went from 56% to 70%) the stock price went up 18-fold producing a ~35% annualized rate of return for Buffett on his investment. Recognizing when a company is likely to exceed expectations significantly can lead to incredible returns!

By 1998, KO had all time high expectations for the future trading at a 33x EV/EBIT despite having little additional room for growth across the world and having used up almost all of its pricing power. The hype surrounding the company due to its phenomenal returns on capital and stock price appreciation over the last decade had caused the stock to become overvalued. From 1998 to now, KO has provided only a ~4% annualized return including dividends to its investors (less than the yield of a 30-year US treasury bond in 1998) due to the insurmountable expectations that were being baked into the share price.

Source 1

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