The Distressed Debt Report

News, Information, and Analysis of Distressed Debt in the Middle Market

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MIDDLE MARKET LOAN VOLUME RISES; MARKET REMAINS THIN

by Kirk O'Neil

Middle market lending is recovering, although it still has a long way to go, according to turnaround management firms, investment banks and analysts.

The volume of middle market syndicated bank loans, which include mostly cash flow loans and some asset-based loans, more than doubled in the first three quarters of 2010 compared to the same period last year. The loans generated $7.6 billion in volume compared to $3.1 billion, according to a recent report from Standard & Poor's.

Middle market syndicated bank loan volume is also on pace to surpass 2008's volume of $8 billion by about 25% by yearend. However, middle market syndicated bank lending has a long way to go to reach the levels of 2005, 2006 and 2007, which generated $34.8 billion, $34.2 billion and $28.7 billion, respectively.

The report tracked the volume of loans to middle market companies, with annual EBITDA of $50 million or less. Most of the loans were secured by companies with EBITDA from $25 million to $50 million, said Robert Polenberg, a vice president of research at Standard & Poor's.

"The market is more open than it was in the past two years," Polenberg said. "I think it's a pretty small market still."

He said one of the most significant statistics in the report is the increase in leverage since 2007. Leverage for these loans fell from 4.8-to-1 in 2007 to 3.4-to-1 in 2009, before rising to 4-to-1 in the third quarter of this year.

The report compared the lower middle market leverage to that of large corporate loans to companies with annual EBITDA of more than $50 million, which was slightly higher. Leverage for large

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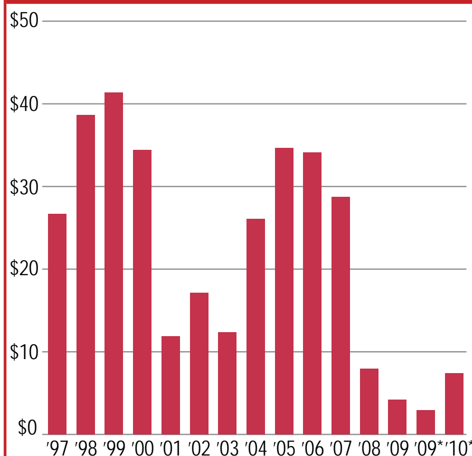
MIDDLE MARKET LOAN VOLUME ($B)



* Q1 – Q3

Issuers with EBITDA of $50M or less

Source: Standard & Poor's

ATLANTA MOST DISTRESSED COMMERCIAL REAL ESTATE MARKET

by Bill Meagher

Atlanta is ground zero when it comes to distressed commercial real estate in the U.S. The evidence, both numerical and anecdotal, is overwhelming.

The city has the nation's highest rate of delinquency on loans packaged in commercial mortgage-backed securities, according to research firm Trepp.

Since 2007, Georgia has had the most failed banks of any state. And those banks, as well as the thrifts still open, have a higher concentration of construction and real estate loans than elsewhere.

The collapse of Atlanta's commercial real estate market comes after the city added 100,000 people a year to its population for a decade. Then in 2008, that growth slowed drastically, but the building that went with

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The Distressed Debt Report

DealFlow Media, Inc.
P.O. Box 122
Syosset, NY 11791
T (516) 876-8006
F (516) 876-8010

subscribe@dealflow.com
www.dealflow.com

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STEVE MADDEN PURSUES UNUSUAL DEAL WITH COMPETITOR

Creditors that own the debt of companies with valuable intellectual property and trademarks may begin an unusual method of obtaining those properties by using debt exchanges in restructuring agreements to avoid jeopardizing their chances of owning them in Chapter 11 filings.

Bankruptcy attorneys say that using debt exchanges to obtain intellectual properties and trademarks is common in Section 363 bankruptcy sales, but not so common in out-of-court restructurings.

It was done, however, in the restructuring of fashion designer and marketer **Betsey Johnson Inc.**, whose competitor **Steve Madden** purchased $27.6 million in Betsey Johnson debt in August. Two months later, Steve Madden converted that debt into a 10% equity interest in Betsey Johnson and acquired Betsey Johnson's trademarks and intellectual property. Steve Madden also took over bank debt that Betsey Johnson had defaulted on in September.

Steve Madden, which is mainly known as a designer of footwear, already had licenses for certain Betsey Johnson products.

As part of the restructuring agreement, Steve Madden signed licensing agreements with Betsey Johnson Inc. to allow the company to continue using the name on its stores and to manufacture and sell women's apparel under the Betsey Johnson and Betsey Johnson Collection brand names. Steve Madden also provided Betsey Johnson with a $3 million secured term loan.

Private equity firm **Castanea Partners** has been a partner with Betsey Johnson Inc. for the past three years and agreed to support the company with an additional equity investment.

A Steve Madden spokesman did not respond to a request for comment from *The Distressed Debt Report*.

"There's not as much protection for trademark licensees as other IP licensees under the bankruptcy code," said Elaine Ziff, an attorney with the **Skadden Arps Slate Meagher & Flom** law firm in New York. "If the creditor is also a licensee of the debtor's mark and feels insecure about the debtor's financial position, then the creditor may want to take control of the license mark, rather than take the risk that the debtor will go bankrupt and be able to reject the license."

Ziff said that taking a lien in the debtor's intellectual property to secure a loan does not guarantee that the creditor will get ownership on the IP in the event of default.

"The creditor is entitled to the value of the outstanding loan," she said. "The IP may go to the highest bidder at the foreclosure auction."

Jeanne Darcey, an attorney with the law firm of **Sullivan & Worcester** in Boston, said she has seen investors and non-traditional lenders purchase debt to convert into equity and intellectual property in a restructuring to add to their portfolios, but rarely has she seen competitors use the strategy, as Steve Madden did.

"If I was operating a company, I'd be concerned about borrowing from a competitor," Darcey said. "Competitors will do that often in a bankruptcy context. I'm a little surprised to see it outside of the bankruptcy context."

Jose Esteves, an attorney at Skadden, said that if a debtor's debt is valued at a discount, it's likely that a creditor would use the debt to take control of intellectual property that it believes has value.

"Investors in IP increasingly view bankruptcies as presenting opportunities to find IP at bargain prices," he said. "They may find value and seek to control IP while letting the business continue."

Ron Meisler, also an attorney at Skadden, said that similar situations may occur in customer-vendor relationships where the customer needs the vendor to

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provide a product which uses the vendor's IP.

"If the customer is worried that the vendor is in financial distress, then the customer may take control over the vendor's IP and license the IP back to the vendor," Meisler said. "If the vendor goes bankrupt, then the customer has access to the IP to enable it to continue to manufacture the product."

Ancela Nastasi, an attorney with law firm **Richards Kibbe & Orbe**, said that two competitors, such as Steve Madden and Betsey Johnson, may choose the debt exchange route in restructuring to avoid having the Betsey Johnson brand damaged by a bankruptcy.

"It enables them to have an out-of-court settlement that can enhance the value of the IP," Nastasi said. "No matter what your situation is, if you go through bankruptcy, your brand gets tarnished. If you can do it out of court, you do your company a good service." —*KO*

U.S. High-Yield Default Rate Falls, Fitch Says

The trailing 12-month default rate on U.S. high-yield bonds fell by 100 basis points last quarter to 3.5%, continuing its post-recession decline, Fitch Ratings said. The default rate stood at 13.7% at the end of last year.

Default amounts were higher in the third quarter of 2010 as eight companies defaulted, affecting a combined $2.5 billion in bonds. That compares with the second quarter, which recorded three defaults for a combined $800 million.

The issuer default rate, which tracks the percentage of bond issuing companies that default, stood at 1.6% through September and is expected to rise to between 2% and 2.5% by yearend.

The par-based rate, which tracks the dollar volume, stands at only 0.5%, since default sizes are smaller this year. The average size of bonds outstanding per defaulted issuer has fallen to $265 million, compared to $786 million per defaulted issuer in 2009. The par-based default rate is expected to finish the year at 1%.

In the first three quarters of 2010, 19 companies defaulted on $5 billion in bonds, compared with 131 companies and $90.3 billion in bond defaults in the same period of 2009. Three sectors have accounted for almost half of the defaults this year with broadcasting and media, banking and finance, and building and materials each producing three defaults. The largest corporate default this year was from video store chain **Blockbuster**.

Debt exchanges accounted for five of this year's defaults, but they also produced much higher recovery rates at 88.9% of par, compared to 35.2% for other defaults, such as missed payments and bankruptcy filings.

High-yield bond issuance continued to grow as $200 billion in new bond sales were recorded in the first nine months of the year. Proceeds were mainly used for refinancing existing loans and bonds.

The surge in bond issuance has extended debt maturities as 87% of the new bonds sold in 2010 will mature in 2016 or later and 65% mature in 2018 or later, Fitch said.

Fortress Scoops Up Large San Francisco Apartment Complex

The acquisition by **Fortress Investment Group** of San Francisco's Villas Parkmerced apartment complex marks the fourth time in the last 18 months that the acquisition of large rent controlled complexes has failed while the property ended up in default.

The 144-acre, 3,221-unit complex was previously purchased in 2005 for $675 million by a joint venture of **Stellar Management** and **Rockpoint Group**. The JV utilized $602 million in debt from **Deutsche Bank** along with $73 million of their own equity. The game plan was to convert rent controlled units to market rate, with the bottom line being pumped by the arbitrage between the restricted price and the much higher market rate.

A spokesman for Fortress confirmed that the firm now owns a controlling interest in the 70-year old complex. Fortress had previously acquired the $52 million mezzanine loan on the property. Both the $350 million A note and the $200 million B note on the property had landed with **Aegeon USA Special Servicers** in May after the joint venture defaulted. Fortress negotiated an extension on both notes until February 2011 in exchange for a $5 million capital reserve fund, curing the default, and paying fees on the extension.

Fortress has positioned itself for an upside beyond any conversion of units. The Stellar-Rockpoint JV submitted plans to the city of San Francisco for a substantial expansion of the Parkmerced property to build out to about 8,900 units over 30 years. The proposed plans await public hearings before the city planning commission.

Rockpoint remains the minority partner in the complex with a 25% interest. The Boston-based equity provider did not return calls seeking comment on the change in ownership. Likewise, Stellar did not return a phone call regarding its loss of Parkmerced.

The default of Parkmerced marks the second time that Stellar and Rockpoint have come up short on a big move in the apartment market. The partners purchased Riverton House in Harlem, New York, for $131 million in 2005. A year later, the property was refinanced with two loans totaling $250 million. But the conversion of controlled units to market was too slow. Earlier this year, the complex was purchased by **Wells Fargo** at foreclosure for $125 million.

Both Riverton House and Parkmerced were built by **MetLife** in the 1940's as enclaves for the middle class returning from World War II. MetLife also built Stuyvesant Town and Peter Cooper Village in Manhattan, another complex that ended up in a $3 billion default after a plan to replace rent controlled units with market rate came up short.

Earlier this year, a joint venture of **Page Mill Properties** and the **California Public Employees Retirement System**

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(CalPERS) defaulted on a loan in East Palo Alto, Calif., backed by 1,700 units, after conversions from rent controlled to market units went too slowly. CalPERS lost its $100 million equity investment.

Royal Bank of Canada to Buy Alternative Investor BlueBay

Royal Bank of Canada agreed to acquire alternative investment manager **BlueBay Asset Management** for $1.53 billion, the companies said.

London-based BlueBay manages alternative investment strategies, including distressed debt, for institutional and high-net worth individuals in the U.S., Europe, Asia, Australia and the Middle East. The company currently has $40 billion in assets under management.

BlueBay would become a part of RBC Global Asset Management once the pending sale closes in December.

Highland Says BofA Derailed Debt Sale

Highland Capital claims in a lawsuit that **Bank of America** wriggled out of a deal to sell Highland a discounted $15.5 million loan after BofA learned that positive developments for the issuer meant the loan would soon be trading at par.

"BofA failed to negotiate in good faith to settle with plaintiffs in order to scuttle the deal and capture this profit for itself," the suit says.

BofA has responded with a court filing denying Highland's allegations.

The suit does not specify the nature of the information BofA allegedly obtained. But the borrower, **Regency Hospitals**, was acquired by **Select Medical Corp.** this June in a $210 million transaction that involved the purchase of Regency's equity and assumption of some liabilities.

Highland first filed the suit in a Texas state court in July. BofA has had the action moved up to the U.S. District Court in Dallas.

Dallas-based Highland manages about $22 billion in assets including structured products, bank loans, high-yield credit, and distressed debt.

Highland's suit claims it learned in November of 2009 that BofA wanted to sell its $15.5 million interest in a credit agreement between Regency Hospitals and various lenders. BofA sought to sell the interest at 93.5% of par.

Highland agreed to purchase the loan, the suit says.

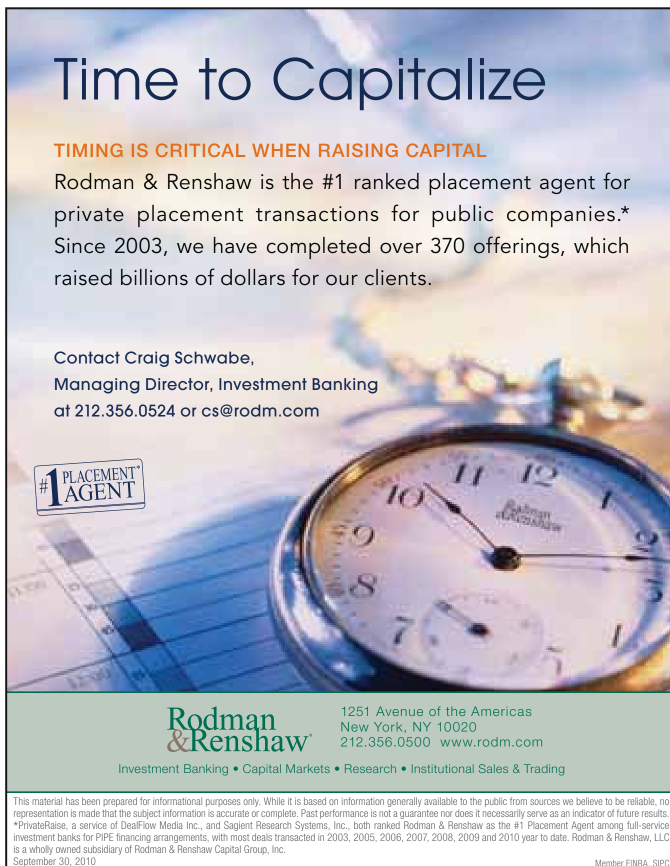
But after Highland and BofA reached their initial agreement on Dec. 3, BofA allegedly began demanding terms for the transaction that did not comply with market standards set by the Loan Syndications and Trading Association. The LSTA is a trade association that publishes standardized contracts for debt-trading transactions.

BofA allegedly demanded that Highland pay legal costs and provide indemnification for legal claims. Highland alleges these terms were not required in previous loan transactions between it and BofA.

The sale did not settle, according to Highland's account, and now the Regency loan is trading at par. Highland claims that after Dec. 3, BofA learned of developments that would cause the loan interest to trade at par and consequently backed out of the deal.

Attorneys for Highland and BofA declined to comment.

On Oct. 5, the court asked the two firms to mediate the dispute before proceeding to trial.



Workflow Uses Chapter 11 to Work on Balance Sheet

Workflow Management Inc. filed for bankruptcy after some of its lenders would not agree to a restructuring plan that would have preserved the interests of equity holders.

The company filed for Chapter 11 protection on Sept. 29 in the U.S. Bankruptcy Court in Norfolk, Va.

The Dayton, Ohio-based publisher and distributor of marketing material began restructuring in early 2008, after riding a revenue roller coaster from $327 million in 1997 to over $1 billion in 2005 and back down to around $600 million last year.

After suffering liquidity problems and declining EBITDA during the credit crisis, the company cut costs and made manufacturing and distribution center changes that arrested the decline. Last year's $60 million in EBITDA was

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up about 30% from the previous year's and the company paid down about $90 million in debt.

Still, Workflow Management ran into trouble when it could not reach an agreement with a first lien lender regarding a second lien facility. At the same time, a second lien lender did not get onboard with a plan to refinance first lien debt.

Workflow filed for Chapter 11 when some $40 million in payments were coming due at the end of September.

Workflow went private in a 2004 transaction with private equity investors **Perseus LLC** and **Renaissance Group**. The company acquired Relizon in 2005 and began issuing over $100 million in common and preferred stock to investors including Perseus and Workflow affiliate **WF Capital**.

In the same year, Workflow received a $275 million first lien term loan and a $35 million revolver arranged by **Credit Suisse**. First lien lenders are currently owed $146.5 million.

Silver Point Finance is the agent for second lien lenders that provided a $140 million term loan, which led to $196.5 million in obligations at the end of September.

As the company ran into problems servicing its debt, provisions on some of the loans hindered further borrowing.

The company has also been unable to pay a $58.5 million 16% convertible note issued by WF Capital to Perseus in 2009. The note came due in September of last year.

WF Capital also owes $20 million on a note to **Branch Banking and Trust Co.** and $12.5 million on a subordinated 12% promissory note issued to **Carlyle Group**.

Workflow said in court documents that equity holders and creditors will be fully paid back in the Chapter 11 process, which it is employing "solely to resolve certain balance sheet issues that they have not been able to resolve consensually with certain of their lenders."

TerreStar Networks Files Chapter 11, Seals Restructuring Pact

TerreStar Networks Inc., a Reston, Va.-based mobile satellite service operator, filed for Chapter 11 bankruptcy and has reached a restructuring support agreement with its largest secured lender, **EchoStar Corp.**

TerreStar Networks, a majority-owned subsidiary of **TerreStar Corp.**, said it hopes the restructuring will reduce a $1.4 billion mountain of debt that it had incurred as of June 30.

EchoStar has agreed to a restructuring process that will include a debt-for-equity conversion and will also backstop a $100 million rights offering.

TerreStar secured a $75 million debtor-in-possession facility through EchoStar.

Murray & Burnaman Opens Distressed Debt, Bankruptcy Advisory Firm

Murray & Burnaman LLC, a financial advisory practice which will focus on distressed debt, corporate reorganizations, distressed real estate and specialized bankruptcy services, opened for business in New York.

The firm's partners, Marti Murray and Buck Burnaman, have a combined 50 years of financial advisory experience as investors in distressed debt.

Murray previously founded **Murray Capital Management**, a distressed debt hedge fund firm which was acquired by **Babson Capital** in 2008 after 13 years of independent operation. She retired as portfolio manager in 2009.

Burnaman previously was a founding shareholder of middle market specialty lender **NewStar Financial** and head of the firm's structured products group.

Naknek Electric Association Files Chapter 11

Naknek Electric Association, a Naknek, Alaska, cooperative electric utility company, filed for Chapter 11 bankruptcy, claiming financial difficulties from mounting unsecured debt and a stalled geothermal facility development.

The electric company listed in its filing more than $23 million in unsecured trade debt as part of $55 million in liabilities, as well as about $55 million in assets. Naknek Electric reported more than $332,000 in cash on hand and about $290,000 in accounts receivables.

The company had been developing a geothermal facility that it expects to provide up to 60% of its customers' summer power requirements. Naknek Electric said that the project faced cost overruns, credit reductions, unexpected regulatory requirements, and reductions in anticipated grants.

The company filed Chapter 11 after a number of creditors filed liens against the geothermal facilities. Naknek Electric hopes to secure financing after restructuring its debt to complete the geothermal project.

Odeon Capital Group Opens Chicago Office

Odeon Capital Group, a New York-based fixed-income broker-dealer that offers full-service trading in the high-yield and distressed debt markets, expanded its services to the Midwest with the opening of a Chicago office.

Odeon Capital said it hired Derek Rose, a 23-year veteran of the securitization industry, as senior vice president to lead the office's trading desk. Previously, Rose was a senior vice president and head of asset-backed and commercial mortgage-backed securities trading for **Southwest Securities**.

Capitol St. Regis Safe from Auction Gavel, for Now

The on-again, off-again, on-again auction of the venerable St. Regis Hotel in Washington, D.C., is off again, according to **Harvey West Auctioneers**.

The 84-year old hotel owned by Irish private equity firm **Claret Capital** has

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The following table includes data about publicly traded companies that have filed for bankruptcy in the 30 days through Oct. 21. Data is provided by Capital IQ.

Public Company Bankruptcies

Company (Ticker)	Date	Enterprise Value (M)	Market Cap (M)	Revenue (M)	EBITDA (M)	Net Income (M)	Total Debt (M)
Electronic Game Card Inc. (OTCPK:EGMI.Q)	Sept. 28	-9.72	0.14	13.1	7.57	7.38	0
Tamalpais Bancorp (OTCPK:TAMB)	Sept. 24	139.4	0.04	-25.4	-	-37.6	139.0
Blockbuster Inc. (OTCPK:BLOA.Q)	Sept. 23	896.3	8.26	3,722.40	33.9	-683.1	963.6

been rumored to be on the auction block, as Claret has failed to keep up with debt payments on $135 million in loans originated by **Barclays Capital**. On at least two occasions, Maryland-based Harvey West has scheduled a gavel to swing on the 175-room hotel located just two blocks from the White House.

The Washington Post reported Oct. 18 that the hotel was in the midst of a foreclosure and would be auctioned last Friday. Two different newspapers in Ireland reported the next day that the auction had been scrapped and that Claret and Barclays were in negotiations regarding a loan workout.

Claret Capital representatives declined to comment regarding the St. Regis.

A spokesman for Barclays confirmed that Claret wasn't current on its debt. According to a source familiar with the situation, Barclays is not talking to Claret regarding any sort of loan extensions or discounted payoff. Barclays holds both a first mortgage and a mezzanine loan on the hotel which carries an Italian Renaissance style. The source said that Barclays has not foreclosed on the hotel.

The St. Regis, which opened in 1926 with President Calvin Coolidge cutting a ribbon on the front doors, represents Claret's only U.S. asset. The equity firm purchased a 90% stake in the hotel from a joint venture of **Brickman Associates** and **New Valley LLC** in 2007 for $170 million, a per-key price of almost $1 million. The joint venture had acquired the hotel two years earlier for $45 million, but embarked on an ambitious $80 million rehab of the property.

Starwood Hotels operates the hotel under it St. Regis flag on behalf of Claret.

Besides 175 rooms, the hotel has 33 suites, almost 10,000 square feet of meeting space, a spa, a restaurant and bar.

Verdero Capital Acquires Starfire Systems Out of Bankruptcy

Verdero Capital, a private equity firm that acquires and restructures distressed businesses, purchased specialty materials company **Starfire Systems** out of bankruptcy.

Starfire Systems, based in Schenectady, N.Y., supplies specialty silicon-based materials, ceramic forming polymers, engineering systems and prototypes to high-tech customers.

Verdero said in a statement that it plans to pump capital and resources into Starfire to spur the company's growth.

Nicos Polymers Group Files Chapter 11

Nicos Polymers Group, a Nazareth, Pa.-based industrial plastics recycler, filed for Chapter 11 bankruptcy.

The company said that declining sales and liquidity issues connected to its debt obligations forced it to file bankruptcy.

Nicos Polymers, which is owned by **CrownBrook Debco**, reported debts of about $22 million and assets of about $4.3 million in its bankruptcy filing.

The company listed its major debts as $18.3 million owed to **Fifth Street Mezzanine Partners II** and $3.13 million in subordinate debt owed to Nicos P&G, which CrownBrook Debco used to finance the acquisition of Nicos Polymers three years ago.

Nicos Polymers Group secured $1 million in debtor-in-possession financing from David Krinsky on a one-year term, priced at one-month LIBOR plus 5%, with a 2.5% fee. Fifth Street Mezzanine Partners had refused to provide DIP financing, according to the bankruptcy filing.

Hirings and Firings

R.W. Pressprich & Co., a fixed-income and equity broker-dealer, promoted Alex McWilliams to high-yield sales manager, focusing on distressed bonds, bank debt, high-yield bonds, convertibles and equities.

Wilson Sonsini Goodrich & Rosati hired Charlotte Kim as a partner in the law firm's corporate finance practice in New York.

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Continued from front page

it didn't immediately stop. Now, unemployment, which has historically been lower than the national average, is in the double digits.

That's left around 20% of the available office space vacant in the Atlanta area, according to CoStar Group. The vacancy rate is 27% in the stylish Buckhead neighborhood.

"With all of the growth that took place over the years in Atlanta, the banking and construction industries are so closely linked, that when one began to have problems, so did the other," said Xu Cheng, an economist with Moody's.

And there is no doubt that banks in Georgia have had their challenges. Since 2007, Georgia has watched 47 lenders shut their doors, most under a crushing load of underperforming and non-performing real estate loans.

"There are three areas that caused problems in those banks," said Tom Dujenski, Atlanta regional director for the Federal Deposit Insurance Corp., responsible for seven states. "There was substantial competition among banks, as well as a higher concentration of commercial real estate loans and loosened underwriting practices."

From 2000 through 2008, FDIC data shows that 118 new banks were created in Georgia. Outside of Texas and Illinois, no state in the country has more banks than the Peach State.

"You have to remember, even though the FDIC is in charge of regulating banks, it is pretty much a case of the free market," said Walt Moeling, a partner in the banking practice of law firm **Bryan Cave** in Atlanta. "If you have $40 million, sophisticated investors, a business plan that stands up to scrutiny, you can start a bank here."

It is worth noting that the big national banks in Georgia are not the ones ending up on the FDIC shut-down list. It is the community banks that have had to compete so hard against each other for their sliver of the pie.

The worst of it may not be over for Georgia banks. Foresight Analytics, of Oakland, Calif., has 80 banks in Georgia on its watch list of lenders that the research firm believes are in danger of being closed. Moreover, for each of the last three quarters, Georgia is the only state in the country to show an increase in the number of banks making the Foresight watch list. "It's been a bit of a perfect storm in Georgia," said Matt Anderson, a principal with Foresight. "Smaller banks with high concentrations of construction and real estate loans, and then capitalization and liquidity becomes a problem and real estate stops performing very well."

Michael Bull heads up **Bull Realty** in Atlanta and hosts the Commercial Real Estate Show, a national radio show. "You need to remember that while the competition between banks was fairly stiff, the returns were good," he said. "The trouble was that when the music stopped, there were no chairs at all."

The competition was just part of the problem. FDIC data shows that banks in Georgia had a collective loan concentration for real estate as high as 387% of total risk-based capital. It's generally expected in the banking industry that a concentration of 300% or more will get the attention of the FDIC examiners.

Underwriting, or more to the point, a shortage of quality underwriting, helped boost the level of distress in Atlanta. "There is no doubt that there was some irrational exuberance," said Moeling of Bryan Cave.

"We do know that the overall quality of some of the underwriting was loosened as banks tried to compete, and it's one of the areas we are concentrating on going forward, getting back to basics where underwriting loans is concerned," the FDIC's Dujenski said.

The bottom line with respect to the banks is, "there were too many banks, with too much in construction and too much leverage," Moeling said.

But the closing of banks only tells part of the story in Atlanta. "Atlanta had so much growth over a prolonged period that when it slowed, it affected many things," said Moody's Cheng. "Unemployment rose, which impacted home sales, residential construction and consumer spending."

Fewer jobs also spelled trouble for existing apartment complexes and office buildings as vacancies increased for both.

A decade of hearty population growth had also contributed to a robust construction pipeline in subdivisions as well as office tower and multifamily projects. "To be fair about it, there was some speculative projects being built," Bull said.

A Monument in Buckhead

A quartet of Buckhead office buildings has come to symbolize the meeting of top-of-the-market speculation and bottom-of-the-market timing. Opening in 2009 and this year, the four unanchored buildings dumped 2 million square feet of space on a market where the vacancy mark has flirted with 20%.

Much of the financing for the buildings destined to alter Atlanta's skyline as well as bottom line were originated by Wall Street investment banks as CMBS loans. At the height of the run-up, these loans were often underwritten to leverage of 85% or 90% and carried interest-only periods as long as the full term of the loan.

The banks would package the loans into securitizations and sell the bonds to investors, dumping the portfolio risk and pocketing the fees. And that structure worked well until the credit markets seized up and CMBS lending disappeared almost overnight. In 2007, $230 billion in CMBS debt was originated, comprising 40% of the debt used in the red hot U.S. commercial real estate market. In 2008, that number plummeted to $12 billion.

While CMBS delinquency nationally is 9.05% according to Trepp, in Atlanta

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that figure is 13.9%. In some property sectors, the numbers are staggering. Multifamily carries a 23.6% delinquency rate while hotels are 18.8% and office checks in at 15.3%. "When you look at Atlanta, you see a lot of lax underwriting, overbuilding, lots of interest-only and too much pro forma," said Paul Mancuso, an executive vice president for Trepp.

Mancuso expects things to get worse before they get better. "Retail is the next shoe to drop," he said. "There are some leases coming up that are going to cause more problems in malls and impact loan performance." Loans packaged in CMBS on retail properties in the Atlanta area are currently just 6.4% delinquent, according to Trepp.

Ben Thypin, an analyst at Real Capital Analytics, sees overbuilding as a problem that is not going away. "We all know that Atlanta saw a large inflow of people, and some building goes with that," he said. "But the suburbs around Atlanta have become a problem. There are suburbs I have never heard of where the building just kept going."

Some Optimism

But there are signs that not everyone thinks that Atlanta requires more time to recover. **Sol Melia**, the Spain-based hospitality company, opened its first U.S. hotel in Atlanta this month, launching a $35 million rehab of the Marriot Renaissance.

Cantor Fitzgerald, which has rolled out a new CMBS origination platform, has opened an office in Atlanta.

And the homegrown equity investment firm **Brookdale Group** has been raising funds to target its core investment strategy of acquiring suburban office buildings.

Bill Meagher may be reached at bill@dealflow.com.

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corporate loans fell from 4.9-to-1 in 2007 to 3.7-to-1 in 2008, before rising to 4.1-to-1 in 2009 and 2010.

The pick-up in middle market lending may portend an increase in lending, overall.

The asset-based lending universe, which includes about 80,000 lenders, had reported a decrease in asset-based lending in 2009 with $480 billion in volume, compared to $590 billion in 2008, according to the Commercial Finance Association. It was the first decrease in volume, as tracked by the association, since 2001.

The association's most recent quarterly lending index, however, showed a 47.9% increase in new credit commitments from lenders, while the utilization of credit lines increased 35.8% from the previous quarter.

No Cash Flow Lending

Cash flow lending, which had been middle market companies' major source of financing for acquisitions, refinancing and recapitalizations, tailed off dramatically in 2008 with the freezing of the credit markets. Most financial advisors and restructuring pros agree that the high-yield bond market is robust for large cap companies, but most middle market companies can't qualify for that capital.

About the only financing source remaining for middle market companies is asset-based lending to mostly cover working capital and operations, though securing asset-based loans is still challenging for many middle market companies.

"There's some middle market cash flow lending going on, but it would have to be for a pretty good size middle market company," said J. Scott Victor, managing director at investment bank **SSG Capital Advisors** in West Conshohocken, Pa. "No lender would be interested in a company with revenue under $100 million. And it must have pristine credit. The only loans lenders are comfortable with are asset-based loans that have collateral."

Victor said that the cash flow lending market has been almost non-existent since about the third quarter of 2008 after **Bear Stearns** and **Lehman Brothers** failed.

"Cash flow loans are based on future enterprise value and lenders can't get comfortable with that," he said. "Your larger middle market companies with good, positive EBITDA may find cash flow loans. Lower middle market companies will have problems. Healthy companies will get asset based loans. Unhealthy companies will have to be sold."

He said that lower middle market companies will continue to be shut out of the high-yield and cash flow lending markets.

Capital Markets Have Short Memories

"There will also be some mezzanine debt for companies who are performing well," Victor said. "And business development companies will be conservative and smart, looking for good credit and collateral.

"It won't be that way forever," Victor said. "The world of capital markets has a short memory, and the drive for yield drives the loosening of credit. It's only a question of time.

"If the business development companies and collateralized loan obligations come back, you'll see a loosening of credit."

Ted Koenig, president of specialty lender **Monroe Capital** in Chicago, expects the fourth quarter of 2010 to be one of the most active middle market lending periods in recent years because of the impending increase in the federal capital gains tax from 15% to 20% next year.

This year "was an average year, but you're going to see a big spike in Q4," he said. "Because of the capital gains tax increase, you're going to see middle market companies rush to get their loans done in 2010. Guys are busy right now. They're hustling to get deals done by the end of the year. Deals not in the

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pipeline now might not get done in time."

Money for Those Who Don't Need It

Michael Epstein, managing partner at turnaround management firm **CRG Partners** in New York, agrees that asset-based lending is about the only game in town for middle market companies.

"There's not a lot of activity in cash flow lending," he said. "With cash flow lending, you have to believe in the dream. All the forecasts say that the dream right now, while not a nightmare, is not one you want to believe in. There's a lot more activity in asset-based lending because it doesn't rely on the promise of future growth in a time when growth is uncertain.

"Middle market companies aren't finding enough financing," Epstein said. "You need good demonstrative deals. It's hard to get a loan even if you've had good cash flow the past couple of years. You can get all the money you want if you don't need it."

Further proof of a tight credit market, Epstein said, are lenders still operating in the "amend-and-extend" mode.

"We're still staring at a wall of debt in 2013 to 2017," he said. "The pressure eased for 2010 and 2011. I thought a lot of the defaults in 2009 that were cured would have re-defaulted. But they haven't. I find it humorous that the pundits have already declared the recession over. For my clients, it doesn't seem that way. I don't see anything to tell me that the first half of 2011 will be any different from the first half of 2010."

A comeback in mezzanine lending would provide more rescue financing that's needed, Epstein said.

"With mezzanine lending, you get back to the folks looking to get control of businesses," he said. "A meaningful control play is like any rescue financing.

Koenig has a better outlook for 2011, despite the anemic middle market lending situation.

"I'm optimistic for the middle market in 2011," he said. "The market continues to have pent-up demand for buyouts. Lots of capital has been raised with not many transactions completed."

Kirk O'Neil may be reached at kirk@dealflow.com.

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