



SWAPPING OUT DEBT

Solving the riddle of debt-asset swaps and triangular deal structures

BY JONATHAN STEIN AND STEVE GALLAWAY

The riddle of “debt-asset swaps” is currently befuddling CFOs, public debt analysts, casino buyers and hedge funds. All look to profit from discounted gaming company debt and the sale of distressed assets. Right now, there is a disconnect between a gaming company and its debt. On the one hand, the gaming company’s debt—whether \$5 billion of publicly traded bonds or \$50 million in privately held notes—is trading at prices that may be 10 cents to 70 cents on the dollar. On the other hand, the gaming company may be willing to retire that debt at face value, as part of its de-leveraging process.

The theory of a debt-asset swap is to take advantage of that disconnect. If one could purchase the gaming company debt at today’s steeply discounted price, and then present it to the gaming company for retirement at face value, then one should be able to profit greatly.

Taking this concept one step further, the hope would be to “swap” the discounted debt for a casino property owned by the same gaming company. By “swapping” debt purchased for pennies on the dollar, the buyer would hope to buy the casino property for pennies on the dollar.

Or so the theory goes.

In fact, debt-asset swaps often fail in practice. Bondholder lawsuits, debt

purchases that do not lead to casino property acquisitions, the ongoing threat of bankruptcy and other pitfalls have often prevented debt-asset swaps from closing. The allure continues, but such logistical problems create a riddle. How do you take advantage of the “spread” between a gaming company’s discounted debt and its face value, to purchase a casino property at a fire-sale price?

It’s becoming clear that the triangular transaction structure described in this article answers this riddle. The triangular transaction structure is practical both for large, public gaming companies and much smaller, privately held companies.

BARTERING DEBT

Perhaps the most important aspect of a successful deal structure is to have a triangular relationship between three parties, not a bilateral relationship between two. And the term “debt-asset swap” is the wrong term. Rather, there is first an agreement to purchase a casino property, and then a “barter” to pay some or all of the purchase price with the discounted gaming company debt.

The triangular deal structure separates the casino property purchase transaction from the off-market block purchase of discounted gaming company debt. As the table on page 30 demonstrates, the triangular structure substantially increases the effective purchase price to the gaming company, while the buyer still enjoys paying

only a fire-sale price for the same casino property. Let's look at each side of the "debt barter" separately.

First, the over-leveraged gaming company sells a casino property to pay down debt. Unlike other casino property sales, the purpose of this sale is to de-leverage the gaming company as a whole. Therefore, unlike other casino property sales, 100 percent of the cash realized must be used to pay down debt.

The gaming company may have no cash of its own to buy its debt. Nor does it want to play any role in purchasing its own debt. Because of its fiduciary and other duties to debt owners, the gaming company can get sued for purchasing some tranches of debt but not others, or for purchasing one tranche of debt from some debt owners but not others. Thus, the gaming company must be shielded from off-market block purchases of its own debt.

Nevertheless, the gaming company is happy to retire its debt at face value. If that debt is "bartered" as part of the purchase price for the casino property, but given credit for only a fraction of face value, the gaming company realizes a higher effective purchase price. The lower the ratio at which "bartered" debt is credited toward the purchase price, the higher the "headline price" claimed by the gaming company for sale of its casino property (see table).

Second, the buyer wants to buy the same casino property at a fire-sale price. A fire-sale price might be a "multiple" of four to five times EBITDA, well below historic norms of seven to nine times. "Cash is king," and those with cash are demanding a huge upside.

The buyer doesn't care if its cash is paid directly to the gaming company, or is used to make an off-market block purchase of discounted gaming company

THE TRIANGULAR TRANSACTION STRUCTURE IS PRACTICAL BOTH FOR LARGE, PUBLIC GAMING COMPANIES AND MUCH SMALLER, PRIVATELY HELD COMPANIES.

debt. If the buyer can buy discounted gaming company debt with the same cash, on the same day, and be assured that it can tender the debt in lieu of cash, it will.

And third, the owner of the gaming company's debt is willing to sell that debt at a premium above market value. Like the impolitic Henny Youngman joke, "Take my wife, please," the third-party debt owner would be delighted to make an off-market block sale of gaming company debt at a negotiated price.

The third-party debt owner may be a bank with a surfeit of troubled assets, or a private equity fund facing redemption calls, or a hedge fund that bought the gaming company debt at 10 cents to 60 cents on the dollar. Because current accounting rules require the debt owner to "mark to market," the third-party debt owner books

a profit by entering into an off-market block sale, so long as the negotiated price is above current market value.

The purchase of the casino property is one leg of a triangular deal structure, while the off-market block sale of discounted gaming company debt is a separate leg. The final leg of the triangular deal structure is to use the discounted debt purchased to “barter” for the casino property, in lieu of some or all of the cash purchase price.

The gaming company should only be involved in the purchase and sale of its casino property and the retirement of the debt “bartered.” It is the buyer that uses part of the cash purchase price to do a separate transaction with the third-party debt owner. The buyer must only ensure that the ratio used to credit its bartered debt toward the purchase price is the same as or higher than the negotiated price it pays for the off-market block purchase of discounted gaming company debt.

THE TRIANGULAR DEAL STRUCTURE ALLOWS EACH PARTY TO PURSUE ITS DIFFERENT GOALS SIMULTANEOUSLY.

The triangular deal structure allows different bilateral relationships to be formed between the gaming company and the buyer; the buyer and the third-party debt owner; and finally, the barter and retirement of the discounted gaming company debt. The table on the following page uses three “debt barter” scenarios to illustrate how each party recognizes a different price from the triangular deal structure.

First, the gaming company may want to de-leverage to the maximum extent possible. It would also like to generate a “headline sale price” that is as high as possible. Therefore, the gaming company is looking for a multiple of eight times EBITDA of \$25 million, or \$200 million.

At the same time, the gaming company is willing to accept bartered debt for up to 100 percent of the purchase price. What is important is the *ratio* at which the debt bartered is credited toward the overall purchase price. If the gaming company sets a ratio of 59.4 percent, then it credits the buyer with \$0.594 for each \$1 of debt bartered and then retired.

The three scenarios show the impact of accepting more or less bartered debt. For each \$1 of debt it retires, the effective sale price increases by less than \$1. The table shows how the ratio of 59.4 percent drives the effective purchase price to \$200 million and a multiple of eight times EBITDA. If only 50 percent of the purchase price is paid with bartered debt, then the same ratio only drives the purchase price to \$159 million and a multiple of 6.4 times EBITDA.

Not only does the debt barter yield a higher price to the gaming company, its lenders are happy. Sale of the casino property is truly a de-leveraging event. The impact on the gaming company’s compliance with loan covenants is improved by each \$1 of debt retired, especially when only \$0.594 is credited toward the purchase price.

Second, the buyer still pays a cash purchase price of 4.75 times EBITDA of \$25 million. Using the ratio of 59.4 percent, the buyer receives only 59.4 cents of credit towards the purchase price for every \$1 of debt bartered. However, if the



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Three Debt Barter Scenarios

	100% Debt for Purchase	50% Debt, 50%Cash	100% Cash
Casino Property EBITDA	\$25,000,000	\$25,000,000	\$25,000,000
Casino Property Multiple Desired By Gaming Company	8.0	8.0	8.0
Purchase Price Desired By Gaming Company	\$200,000,000	\$200,000,000	\$200,000,000
Casino Property Multiple Desired By Buyer	4.75	4.75	4.75
Purchase Price Desired By Buyer	\$118,750,000	\$118,750,000	\$118,750,000
Ratio of Bartered Debt Credited Toward Purchase Price	59.4%	59.4%	59.4%
GAMING COMPANY'S PERSPECTIVE			
Face Value of Debt Retired	\$200,000,000	\$100,000,000	\$0
Cash Received By Gaming Company	\$0	\$59,375,000	\$118,750,000
Effective or "Headline" Purchase Price to Gaming Company	\$200,000,000	\$159,375,000	\$118,750,000
Multiple of EBITDA	8.0	6.4	4.75
BUYER'S PERSPECTIVE			
Cash Used by Buyer to Purchase Gaming Company Debt	\$118,750,000	\$59,375,000	\$0
Cash Used by Buyer to Purchase Casino	\$0	\$59,375,000	\$118,750,000
TOTAL Cash Used By Buyer	\$118,750,000	\$118,750,000	\$118,750,000
TOTAL Cash As Multiple of EBITDA	4.75	4.75	4.75
THIRD-PARTY DEBT OWNERS' PERSPECTIVE			
Current Market Value of Gaming Company Debt (Assumed To Be 50% of Face Value)	\$100,000,000	\$50,000,000	\$0
Cash Used by Buyer to Purchase Gaming Company Debt	\$118,750,000	\$59,375,000	\$0
"Spread" Between Current Market Value and Purchase Price	\$18,750,000	\$9,375,000	\$0

buyer can make an off-market block purchase of that same debt at 59.4 cents on the dollar (or less), the cash it spends to buy the casino property is the same.

In the three debt barter scenarios, the buyer tenders more or less debt for barter, but its fire-sale purchase price of \$118 million remains the same. It has allocated a fixed amount of cash and not paid more than 4.75 times EBITDA.

And third, the third-party debt owner has "marked to market" the gaming company debt. We assume the gaming company debt has a current market value equal to 50 percent of face value. The third-party debt owner sells this debt to the buyer in an off-market block at a negotiated price above current market value. The gaming company is not involved and neither are its fiduciary duties.

In such an arm's length transaction, there is no tender offer and a price is simply negotiated between a willing seller and a willing buyer. In this example, where the buyer pays an average of 59.4 percent of face value, there is a "spread" of over \$18 million. The spread may be shared among the debt owner, the buyer and the investment bank arranging the off-market block sale.

TWO INVESTMENT BANKS, NOT ONE

Another important aspect of a debt barter is to hire two investment banks, not just one. Today, investment bankers return phone calls better than ever, and you might as well use two of them, because trust me, *both* will have time to work on your project! Joking aside, the buyer should engage separate investment banks for each side of the triangular deal structure.

One investment bank should be engaged to negotiate the casino property purchase transaction. It should focus only on managing the casino property purchase and the bilateral relationship between the gaming company and the buyer.

The first investment bank should set the appropriate purchase price, fix the ratio at which bartered debt is credited toward that purchase price, and set the amount of debt to be bartered. This investment bank earns its fee based on the purchase price, and the fee is structured and paid in the usual manner.

The second investment bank should be engaged to execute a series of off-market block purchases of the discounted gaming company debt. The bank should approach third-party debt owners individually, and individually negotiate the

off-market block sales.

The second investment banker should fix the price for each off-market block sale, the size of the block sold, and especially the conditions for closing this sale. The second investment bank earns its fee (or commission) based on the size of the off-market block purchases.

FIVE MECHANICAL POINTS FOR A SUCCESSFUL TRIANGULAR TRANSACTION

Mechanics are a touchy subject, and never more so than in a triangular transaction. For this reason, one law firm should be engaged simply to coordinate the two sides of the triangular transaction. That firm can work with larger firms employed by the various parties, but its focus must be on communicating *between* the gaming company, the buyer, two investment banks, and a numerous group of third-party debt owners. The absence of this coordinating function is one reason why some "debt-asset" swaps have failed in the past.

First, there should be two separate sets of documents. The first set of documents would include a purchase sale agreement for the casino property. The purchase sale documents set forth the purchase price, the ratio at which discounted debt may be bartered, and how gaming company debt will be retired.

The second set of documents would include a debt purchase agreement. The debt purchase documents assign the debt from the third-party debt owner to the casino buyer, and set forth the negotiated purchase price, the size of block of debt purchased, and the closing conditions for the debt purchase.

The buyer is making off-market block purchases of debt issued by a different company. It should have no obligation to offer the same price to different debt owners, or to offer the same price on one day that it offers on the next. Nor does it have any obligation to buy all of the gaming company's debt that any third party may wish to sell.

Second, the delayed closing date for both transactions could be as much as six to nine months in the future, given regulatory approvals and other conditions required for closing. To protect the gaming company, the buyer must be given no more than 60 days to secure the debt and/or cash that it will use to close the transaction. Nevertheless, the negotiated price for the off-market block sale does not change, nor does the ratio at which the bartered debt is credited toward the purchase price.

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IF EXECUTED PROPERLY, THE TRIANGULAR STRUCTURE CAN BENEFIT THE GAMING COMPANY, ITS LENDERS, THE BUYER AND THIRD-PARTY OWNERS OF THE DISCOUNTED GAMING COMPANY DEBT.

Third, what may change over time is the amount of debt that the buyer decides to barter. This is only if the gaming company is willing to accept a range of bartered debt. The key point is that no one really knows how much debt will be bartered, so the final purchase price realized would also be somewhere within a range. The buyer should try to reduce its obligation to make only “commercially reasonable efforts” to purchase debt.

For its part, the gaming company should try to require the buyer to surmount certain “hurdle” levels for bartered debt. It may even have the negotiating position to simply demand a \$200 million purchase price for the casino property. In this circumstance, the gaming company does not set any ratio for debt bartered, and the buyer is left to successfully negotiate its off-market block purchases of discounted gaming company debt. The negotiated block purchases then must be completed at low enough prices to bring the buyer’s effective purchase price for the casino property within its own range of tolerance.

Fourth, the gaming company may not have to pay taxes on retirement of the bartered debt. Under the new federal stimulus bill passed by the Obama administration, in some situations, the gaming company may be forgiven gains realized upon retirement of its debt. In essence, a portion of the sale price for the casino property may be tax-free.

And fifth, the third-party debt owner does face uncertainty. Its off-market block sale may or may not close, and it must wait up to 60 days to find out. This is a fact of life, but then again, the third-party debt owner gets a premium for its trouble.

One way for the third-party debt owner to manage its risk and maximize its profit is to avoid selling 100 percent of the gaming company debt in its portfolio. While this transaction is pending, other offers to buy may come along. Furthermore, if the off-market block sale transaction does go through, the gaming company’s remaining debt will no doubt gain in market value. The de-leveraging of the gaming company moves it away from the threat of bankruptcy and toward face value.

In a way, the third-party debt owner then gets two premiums. It receives a premium on the off-market block sale transaction above current market price. It receives a second premium on the debt that remains in its portfolio, which increases in market value as the gaming company de-leverages.

THE INHERENT RISK OF A ‘DEBT-BARTER’ TRANSACTION

While the triangular structure of the “debt barter” should prove more practical than the “debt-asset swap,” it has its pitfalls. If executed properly, the triangular structure can benefit the gaming company, its lenders, the buyer and third-party owners of the discounted gaming company debt.

However, both sides of the triangle must be handled carefully, or the deal could fail under the weight of its own complexity. And even if the deal between

the gaming company and the buyer is signed, the volatility of the bond market could undermine the transaction.

First, for the debt barter to work, there must be enough gaming company debt available for sale at a discounted price. The price of publicly traded bonds and privately traded debt instruments is highly volatile.

Furthermore, transactions involving publicly traded bonds larger than \$1 million usually

must be registered with the SEC. Wall Street investors share information at light speed. While the exact number of bonds traded does not need to be disclosed, large transactions will likely raise eyebrows and could easily drive up the market value of the gaming company debt before all of the off-market block purchases are negotiated.

To help mitigate this risk, the use of non-disclosure agreements, non-binding letters of intent, or documents that clearly show the contingent nature of the transactions contemplated are all helpful. Most helpful of all will be using an investment bank that knows who willing debt owners are, and how to execute trading assignments swiftly and with discretion.

And second, when agreeing to a purchase price with the gaming company, it may be better for the buyer to *not* have a letter of intent signed with gaming company, but rather a less formal agreement. Once an LOI is signed, the gaming company may be required to make a disclosure to the SEC. Once this disclosure is made, the current market value of the gaming company debt may increase, making it more difficult to acquire at the “barter” ratio and close the deal.

If a less formal arrangement with the buyer does not need to be disclosed to the SEC, this danger is averted. However, the buyer now faces a greater transaction risk, as the gaming company may decide not to move forward with the transaction. With many gaming companies, appreciation for a handshake agreement minimizes this risk, and in the eyes of the authors this is not necessarily a real threat.

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The authors would like to thank Frank Fantini and Fantini Research for its critical review.