Betting on the Equity in Bankrupt Companies

Generally it's a bad idea, but right now many companies in Chapter 11 are not insolvent. Here's how to assess the prospects

By Aaron Pressman

In the two weeks before General Motors' widely anticipated bankruptcy filing on June 1, its shares dropped steadily from almost $2 to as little as 51 cents. Since the filing shares have jumped around, regularly gaining and losing more than 20% a day.

It's not unusual to see such volatility in stocks of distressed firms before a Chapter 11 filing, as investors try to determine if a company will survive or be liquidated. But where investors specializing in already-bankrupt companies once focused only on buying bonds and loans, now the equity is in play as well. "There are lots of opportunities," says Alex Jurshevski, CEO and portfolio manager at Recovery Partners, a distressed-asset investment firm in Toronto.. 'but they are typically incredibly complex to evaluate."

To file for bankruptcy, a company is supposed to be insolvent, with debts exceeding assets. Since debtholders must be paid back before existing shareholders see a penny, typically equity owners are wiped out. But that's not always the case now, with companies ending up in Chapter 11 not because they can't make interest payments but because they can't get new loans or refinance debt.

Exhibit A in the new environment: Mall owner General Growth Properties (GGP), whose shares rose from about 25 cents to almost $3 since it filed for bankruptcy in April. High-profile hedge fund investors such as Bill Ackman of Pershing Square Capital Management and Whitney Tilson of T2 Partners have argued that the company's assets likely have enough value to cover debts and leave money for shareholders. (On June 8, Ackman was named to General Growth's board.) "Generally, buying equity of bankrupt companies is a bad idea," says Tilson. "But every once in a while it's a good idea."

There are precedents for shareholders surviving liquidity-driven bankruptcies. When power plant operator Mirant filed for bankruptcy in 2003, it was sinking in a sea of maturing debt and high natural gas prices. Shareholders were to be wiped out under an initial reorganization plan. But they gained a share of the reorganized company, in part by arguing that falling natural gas prices would increase future profits. "If a company is truly insolvent, there's not going to be anything left for shareholders," says K. Scott Van Meter, managing director at consulting firm LECG and an experienced restructuring professional. "That's different than in a crisis that prevents firms from getting financing."

One early tip-off investors should consider is whether a bankruptcy judge has officially sanctioned a committee to represent equity holders. In the past equity holders were generally locked out of official negotiations over restructurings. But increasingly judges are recognizing that there may be value left after creditors are paid off. Assets may turn out to be undervalued, an industry's dynamics might improve, or a lawsuit or fraudulent conveyance action against debtholders or management may yield a settlement. Investors should follow the Chapter 11 case of Pilgrim's Pride, which had an equity committee approved in May, and TXCO Resources, which filed for bankruptcy in May and could have such a committee approved soon, says Van Meter.

Another intriguing situation exists at Tronox, the chemical unit spun off of oil and gas producer Kerr-McGee in 2006. After filing for bankruptcy in January of this year, Tronox sued Kerr-McGee in May, contending it was saddled with hidden environmental liabilities and excessive debt before the spinoff. Kerr-McGee, which has since been acquired by Anadarko Petroleum (APC), has denied the charges. Van Meter says it's a case for investors to watch since the claims could result in a large settlement for shareholders.

In the energy sector, some companies filed for bankruptcy after getting squeezed between the credit crunch and plummeting oil prices. But oil prices have rebounded, increasing cash flow as well as the value of potential drilling sites. That's one issue equity holders may raise at TXCO Resources, which listed assets of $432 million and debts of $323 million in its bankruptcy filing. Analyst Chris Pikul at investment bank Morgan Keegan says shareholders could emerge with a valuable stake in the reorganized company. The shares have been trading for less than 25 cents since the filing; he thinks they could be worth $1.50 to $5.

Pros say to stay away from situations where a company's entire industry is suffering, as is the case with airlines, homebuilders, publishers, and financials. For example, shares of Yellow Pages publisher R.H. Donnelley sank to about 5 cents after it filed for Chapter 11 protection in May. The company, which lost $2.3 billion in 2008, has proposed a plan wiping out shareholders and giving bondholders total ownership.

Investors who shunned R.H. Donnelley might have been recalling the experience of Delphi shareholders. The auto supplier filed for bankruptcy in 2005 and an initial reorganization plan would have given shareholders stock in the new entity and warrants to buy more shares. But with sales at the Big Three automakers plunging, Delphi's outlook has dimmed. A revised plan announced on June 1 wipes out shareholders. That outcome worries investors considering shares of General Motors or auto parts maker Visteon (VC). The U.S. and Canadian governments' involvement further complicates the issue. "The governments are very big players here, and it's very difficult to determine what is going to be valued and what will not," says Recovery Partners' Jurshevski.

Where does all of this leave General Growth? Unlike some rivals, it hasn't been hurt much yet by the demise of dozens of retail chains. In April the company said it had a vacancy rate of less than 10% and net operating income in 2009's first quarter of $555 million. The declared value of its 200 malls and other property carried on its books of $29 billion already exceeds its debts of $27 billion.

Hedge fund manager Ackman and others argue that the assets are worth much more than $29 billion. In a 68-page presentation Ackman sent to some institutional investors in late May, he figured that based on cash flows and assets, shares could be worth $9.11 to $21.50 after a reorganization. Tilson, who shorted General Growth before the bankruptcy, bought a small position for his funds at under $1 a share. At $3, the potential payoff is large enough to outweigh the real possibility that it won't survive, he says.

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