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Report

A Bank Built for A Credit Bust

The Bankruptcy King to Own During The Coming Corporate Default Wave

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Ben Lowe was 25 years old with a genius-level IQ of 170 (10 points higher than Einstein's).

He was also severely addicted to DXM, a chemical found in over-the-counter cough medicine.

Despite his big brain, Ben flunked out of college after one semester. He spent his days staggering around downtown Philadelphia, panhandling and prostituting himself to get cash for more cough syrup.

At her wit's end, Ben's mother called the TV show "Intervention," which coordinates with families to get their severely addicted loved ones into rehab. On national television, Ben's close family and friends, along with a therapist, cornered him in a hotel room. Together, they presented him with an ultimatum: Go to inpatient treatment, or we'll cut you out of our lives.

After some protest, Ben consented to attend treatment. He left the hotel room and embarked on 60 days of intensive detox and therapy.

Sometimes, it takes drastic intervention to ward off disaster.

The business-world equivalent of intervention is just what investment bank Houlihan Lokey does… for distressed companies.

Houlihan Lokey (HLI) specializes in reorganizing companies headed for bankruptcy. It takes the helm, works with damaged companies to help them get back on their feet, reconfigure their business, re-think their strategy, satisfy their creditors, and start afresh with a clean balance sheet.

There's no guarantee that these companies won't "relapse." (Ben Lowe, sadly, did… and died eight years after his episode of "Intervention.") HLI is like a detox center for companies, to give them a shot at turning themselves around.

And the good news – for HLI's business, and its shareholders, that is – is that HLI is getting a lot of "addicts" coming through the door. And it will be getting a lot more in coming months.

That's because the world's economy is on the precipice of a debt crisis unlike any that's ever happened before.

Because of soaring inflation, the world's central banks can no longer deliver the stability that markets have gotten used to. The global economy is facing a complete reset of interest rates, sovereign debt loads, and corporate debt loads without the "cushion" of central bank largesse to soften the collapse.

We call this once-in-a-lifetime credit supercycle **"The Greatest Legal Transfer of Wealth in History,"** because an incredible amount of money will be changing hands as the market melts down.

In coming months there will be unprecedented number of companies in distress… which leads us not only to discounted bond buys, but also to truly shaky companies that need help restructuring in order to keep afloat. And that's where HLI comes in.

HLI is a capital-efficient "special situation" investment that fits perfectly into the broad investment themes of **Porter & Co. Distressed Investing**.

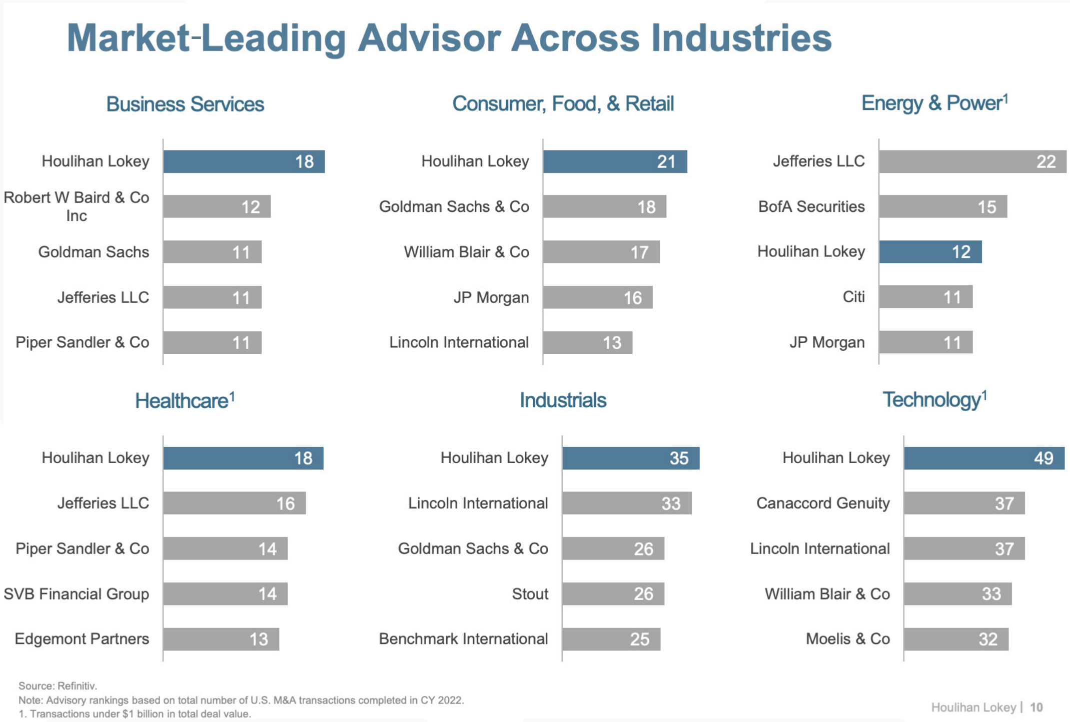
A Capital-Efficient Business That Thrives in All Market Conditions

Companies that focus on financial restructuring are a countercyclical hedge across macroeconomic cycles. When the economy dips, HLI and similar companies benefit… just like when a global pandemic strikes, it's the vaccine makers that thrive.

HLI is run by industry experts who have deep experience evaluating leveraged restructurings. For non-finance types, it's off the radar – based in Los Angeles… some 2,800 miles west of Wall Street.

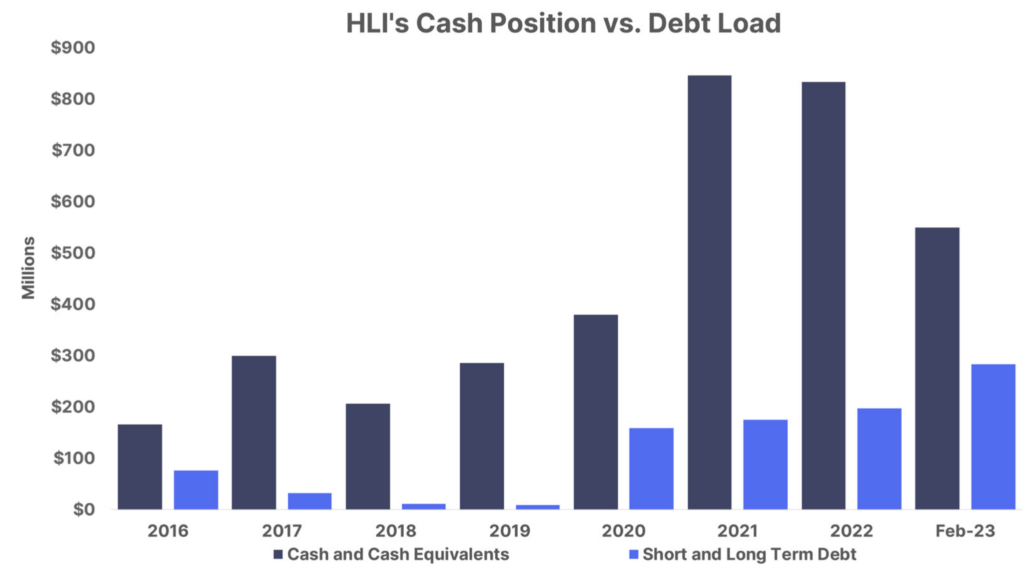
Houlihan Lokey Howard & Zukin was founded in 1972 by Richard Houlihan and O. Kit Lokey, who'd worked together at consulting and accounting giant PriceWaterhouse. They struck out on their own to provide business advisory services to private companies, and were joined by Bob Howard and James Zukin a couple of years later. Today, the company advises large corporations worldwide on deals, fairness, and restructuring, in offices around the world.

HLI has advised on over $10 trillion in deals over its five-decade history. It is diversified across a wide set of geographies, industries, and business segments with a focus on mid-cap firms (between $2-$10 billion in market cap).

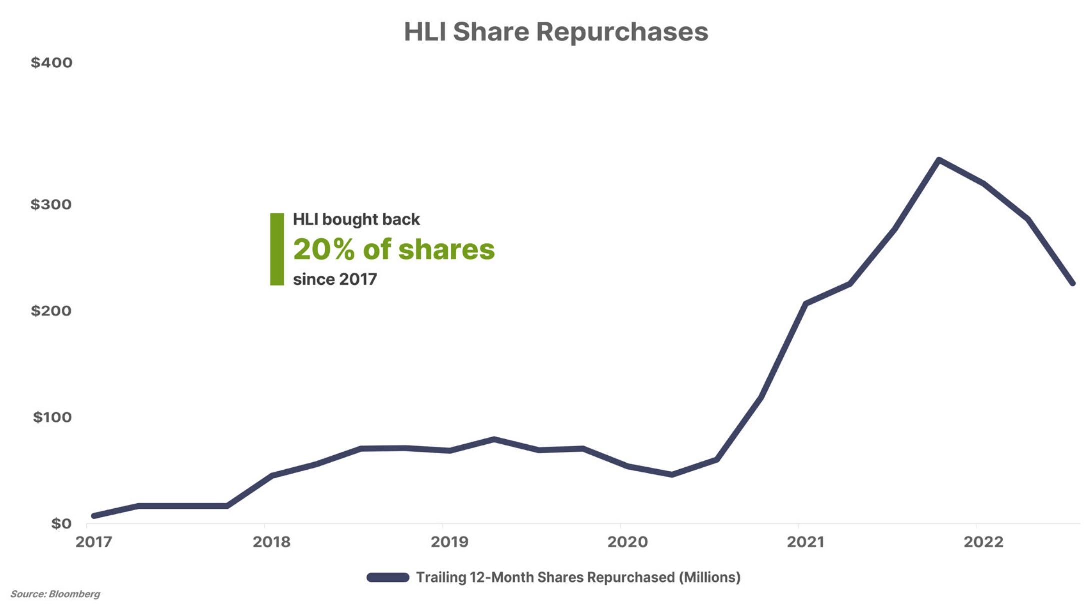


By maintaining a broad, diverse base of clients, HLI can apply its extensive experience to plumb the market dynamics affecting each restructuring situation. HLI advises both companies and creditors – it serves more than 2,000 clients each year – at all levels of the capital structure, to provide holistic advice to their clients. No client base segment accounts for more than 18% of revenues. It's built its business in part through buying the best of its peers and competitors, including companies like Fidentiis Capital, Freeman Capital, and GCA.

HLI maintains a rock-solid balance sheet – with cash and cash equivalents consistently greater than its outstanding debt.



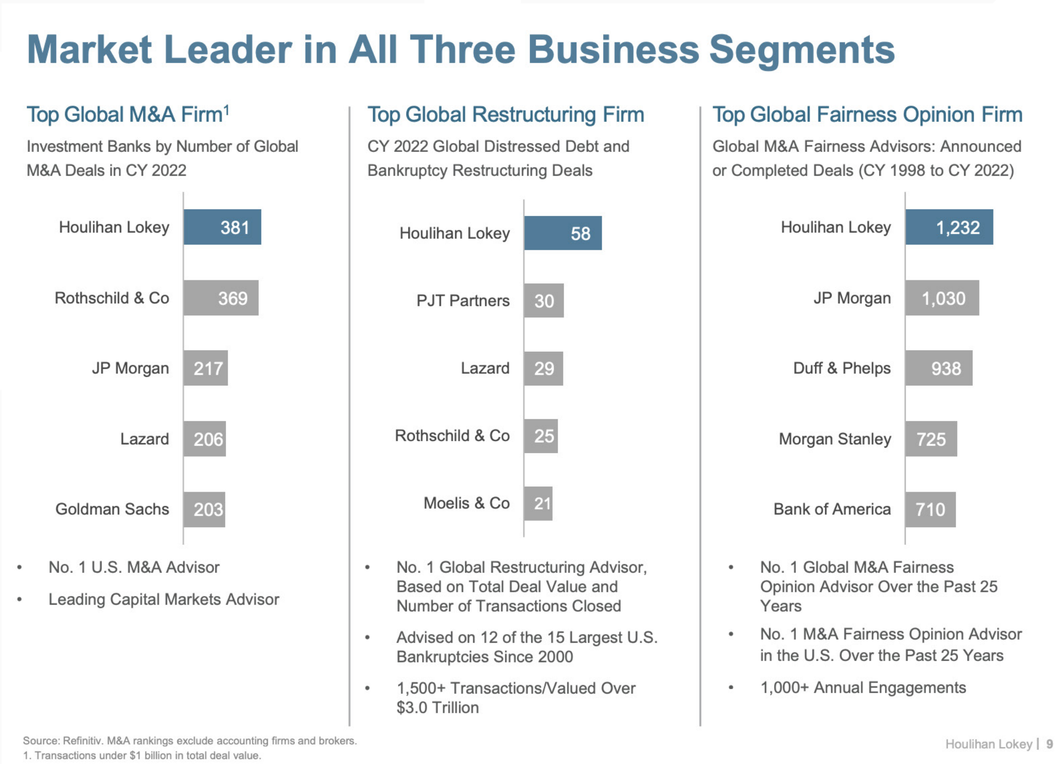
It's a highly capital efficient business model. HLI generates more than $1 million in revenue per employee while its free cash flow margins have averaged 28% over the past five years. This means HLI can return capital to shareholders, via generous share repurchases and dividends. Since 2017, HLI has reduced its total share count by 20% through repurchases, and today pays out a 2.2% dividend.



The strength, balance and capital efficient features of HLI would put it on our short list of stocks to buy... and the restructuring element of its business – while will stand to benefit in the upcoming surge of distressed corporate situations – makes HLI uniquely suited for our **Porter & Co. Distressed Investing** portfolio.

Houlihan Lokey has three major divisions, and it's a market leader in all of them: Corporate Finance, Financial Restructuring, and Financial and Valuation Advisory. HLI was the #1 M&A advisor globally based on the number of transactions in 2022. It's also the #1 most active fairness opinion advisor by volume for the past 25 years.

And – most interesting to us – it's the #1 restructuring advisor globally, based on deals and value. It has the largest restructuring practice of any investment bank worldwide, completing 1,500 reorganizations with total aggregate debt claims over $3 trillion since 1988.



The firm's corporate finance group serves companies, funds and governments. Its main service is M&A: helping companies buy and sell themselves and their divisions. In Q4 '21 alone, Houlihan earned $716 million in corporate finance fees. Houlihan Lokey helped close 600 transactions in the year ended March 2022, with 238 of those in the December quarter. The bulk of its fees come at the end of a deal.

Its second division, financial and valuation advisory, serves as a kind of third-party

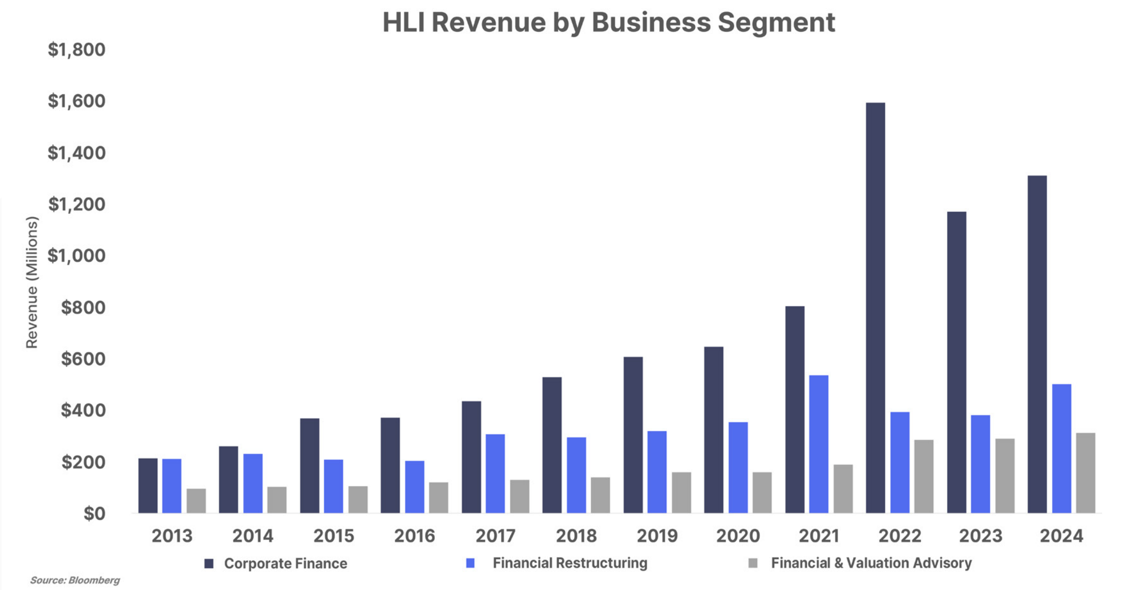
"Kelley Blue Book" for companies, to evaluate businesses' debt, shares, and deals.

And the third division, restructuring, is the one that will be key during the current credit cycle. More about that business in a moment....

HLI's core businesses complement each other during cycles. The M&A business is strongest when markets are strong, the cost of capital is cheap, and liquidity is flowing. But the other two sections – restructuring and financial advisory – are stronger when the economy is decelerating.

During downturns, demand rises for financial opinions, valuation and transaction and advisory services. And debt and bankruptcy restructuring – the part of the business we're most interested in – is tailor-made for distressed market climates.

The figure below shows HLI's revenue broken down by business segment, as well as consensus revenue estimates for FY 2023 and 2024. (HLI's corporate finance segment saw an increase in closing transactions but was offset by lower average transaction fees towards the end of 2022, as higher rates pressured deal-making activity.)



HLI's corporate finance segment grew due to easing financial conditions since the Covid pandemic. While the corporate finance segment expanded in the low-rate, high-liquidity environment, the financial restructuring segment slowed.

But when the tide turns, and mid-sized companies are forced to refinance their loans, bonds, and other debt obligations, HLI's restructuring business is positioned to thrive. Right now, we're entering an unprecedented credit meltdown that we like to call "**the greatest transfer of wealth in history**." As the easy money era grinds to a halt, many companies will run out of liquidity and face bankruptcy. And that's where skilled restructuring firms like HLI come in...

The Bankruptcy Boom

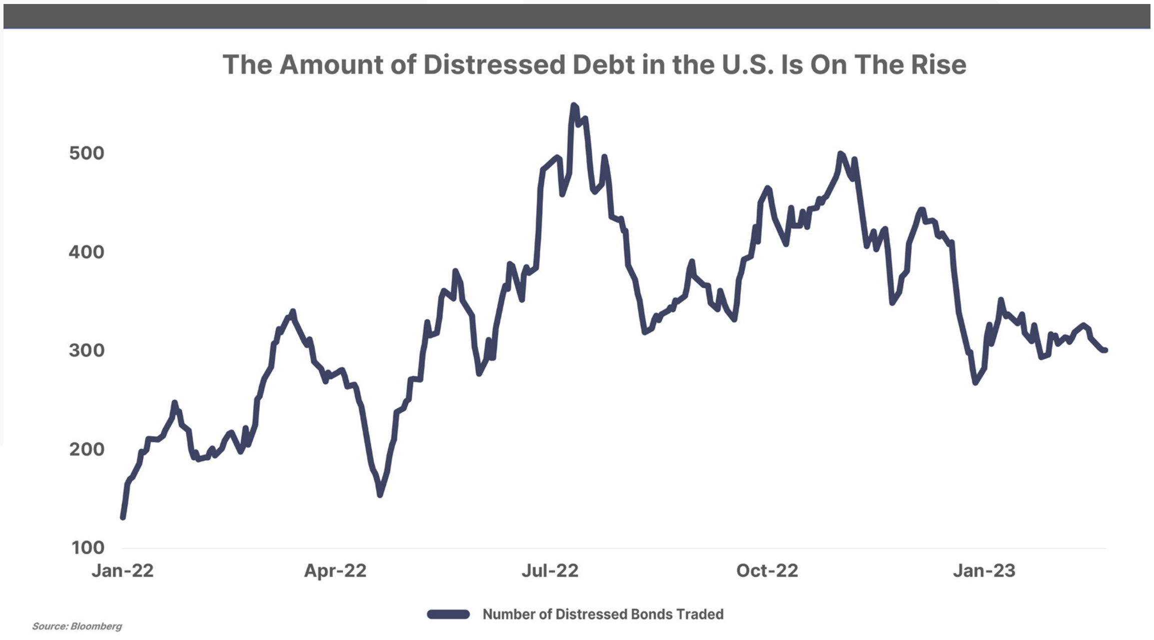
In the wake of the global economic crisis, the Federal Reserve created nearly $8 trillion in new credit, while keeping interest rates pinned at zero. That allowed fundamentally unsound companies to borrow like there was no tomorrow.

But now, higher interest rates are creating deep distress for an economy built upon the fragile foundation of cheap money.

By year-end 2022, Jerome Powell and his Open Market Committee associates had jacked the key Federal Funds rate all the way from 0.25% to 4.25% to combat rampant inflation. Unstable companies that took out debt during the pandemic are at even greater risk than healthy ones that went overboard in borrowing.

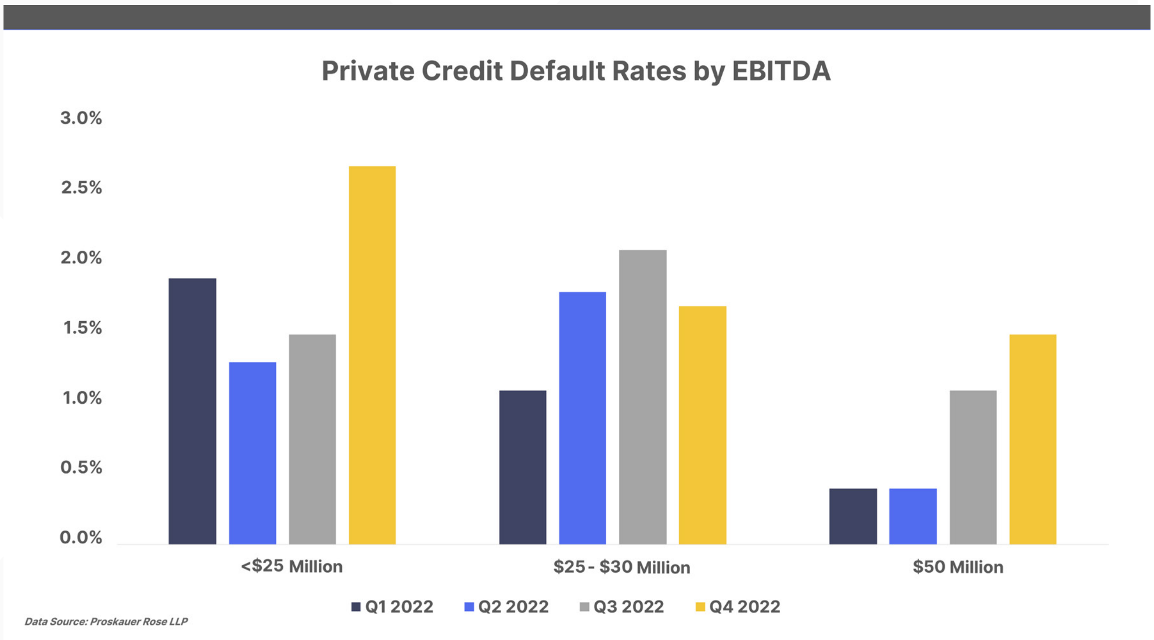
Some companies were on the brink of bankruptcy and issued debt to ensure they'd make it through the pandemic, but these companies are faced with entirely new problems now that the Fed has raised rates and the "liquidity rush" is over. Companies that still have weak balance sheets, or are burning through cash, will now face challenges accessing capital in an environment of higher rates.

As an indicator of how many companies are facing bankruptcy, the number of corporate bonds that are characterized as distressed in U.S. markets has exploded nearly four-fold since the end of 2022... from 112 in late 2021, to 301 in February 2023.

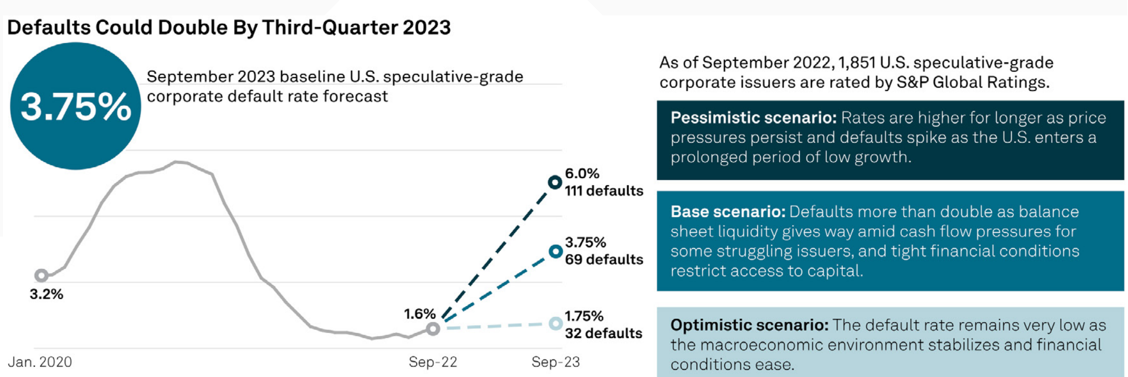


The number of private companies that are unable to service the interest on their debt is also rising...

Private credit is a significant asset class that's grown from just $41 billion in 2000, to an extraordinary $1.4 trillion as of the end of 2022. And now, default rates in the private credit market are rising... for example, default rates for companies with less than $50 million in EBITDA increased to 1.1% in Q3 '22, compared to 0.4% in the prior quarter.



Meanwhile, analysts at ratings agency S&P Global project a doubling in the default rate by the third quarter of 2023:



Data as of September 2022. Sources: S&P Global Market Intelligence's CreditPro® and S&P Global Ratings Credit Research & Insights.

Along with this "bankruptcy boom," we're about to see a corresponding upswing in the restructuring business: last-ditch interventions for companies on the verge of default.

And that's where Houlihan Lokey excels.

More Bankruptcies Means More Restructuring

Big, headline-grabbing bankruptcies, like General Motors, Lehman Brothers, and Enron, generally have two things in common: They're Chapter 11 filings, meaning the company is allowed to restructure and reorganize. And: Houlihan Lokey has been involved.

Houlihan Lokey advised major parties-in-interest in 12 of the 15 largest corporate bankruptcies in the U.S.

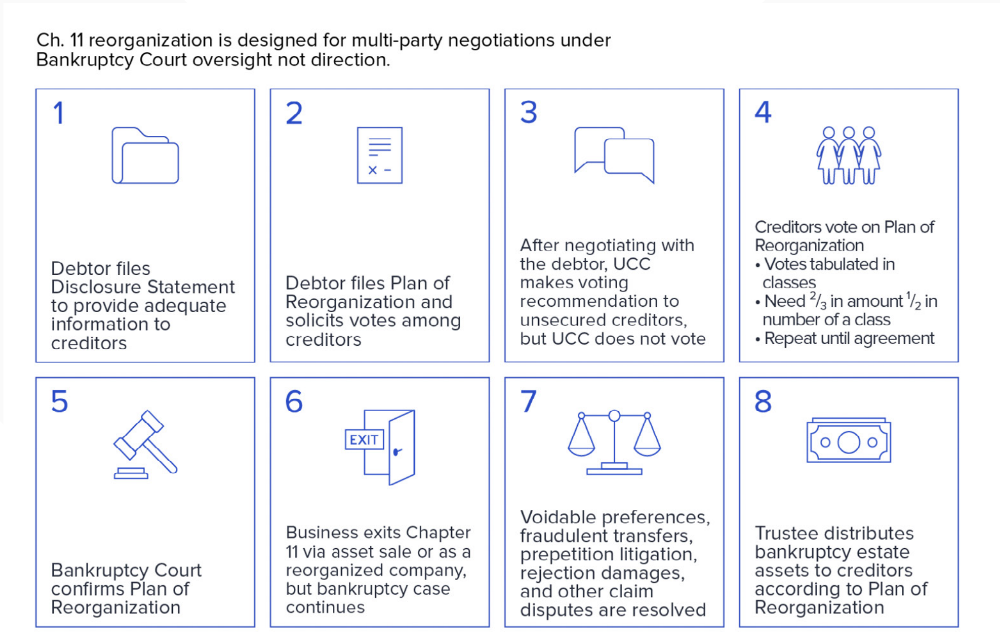
Advisor in 12 of the 15 Largest Bankruptcies 2000-2022

Company	*Assets ($bn)*
Lehman Brothers Holdings Inc.	691.1
Washington Mutual Inc.[1]	327.9
WorldCom Inc.	103.9
General Motors Corporation	91.0
CIT Group Inc.	80.4
PG&E Corporation (Pacific Gas) (2019)	71.4
Enron Corp.	65.5
Conseco Inc.	61.4
Energy Future Holdings Corp.	41.0
MF Global Holdings Ltd.	40.5
Chrysler LLC	39.3
AIG Financial Products Corp.	37.7
Thornburg Mortgage Inc.	36.5
Pacific Gas & Electric (2004)[2]	36.2
Refco Inc.	33.3

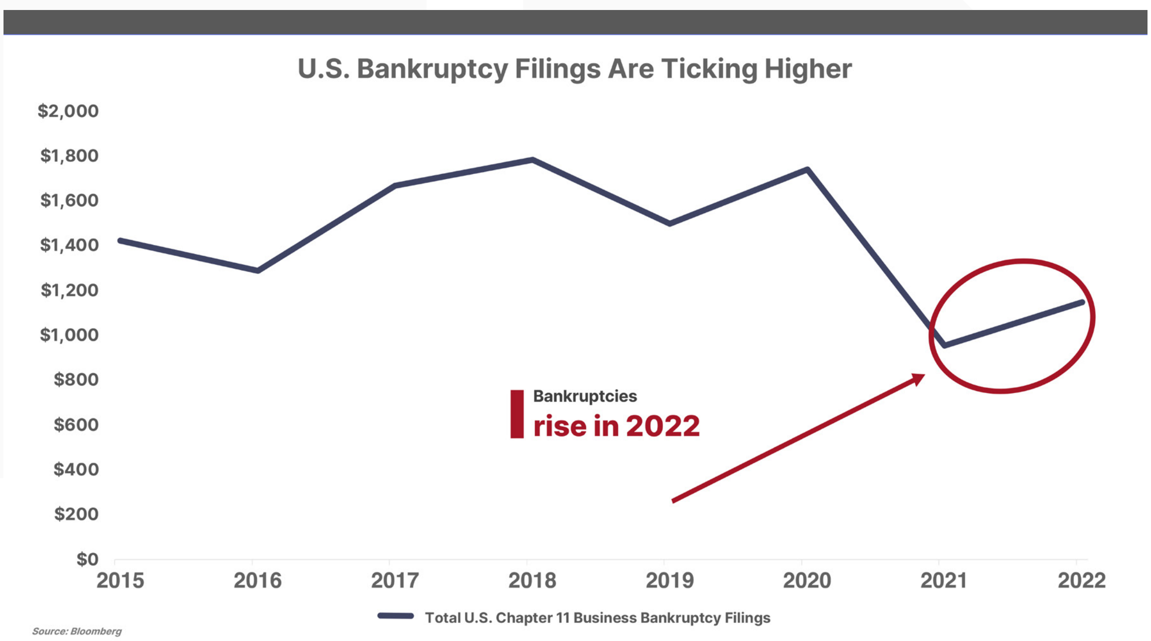
(1) Houlihan Lokey advised certain creditors of the Washington Mutual Receivership. (2) Houlihan Lokey advised a group of noteholders of Pacific Gas & Electric subsidiary National Energy Group Inc.
Source: BankruptcyData.com and Debtwire, January 2023.

Chapter 11 reorganizations have several goals: consolidating debts so that creditors receive as much cash back as possible; giving the distressed business "breathing room" to get back on its feet; and, most importantly, offering a fresh start with a new balance sheet for a company that would otherwise be liquidated.

Along the way, the structure of the business may change drastically, with layoffs, reorganizations or new management. It's a delicate, multilayered process (the chart below offers a partial snapshot of the complexities involved)...



Along with private credit defaults and distressed corporate bonds, Chapter 11 bankruptcies are rising, as shown below.

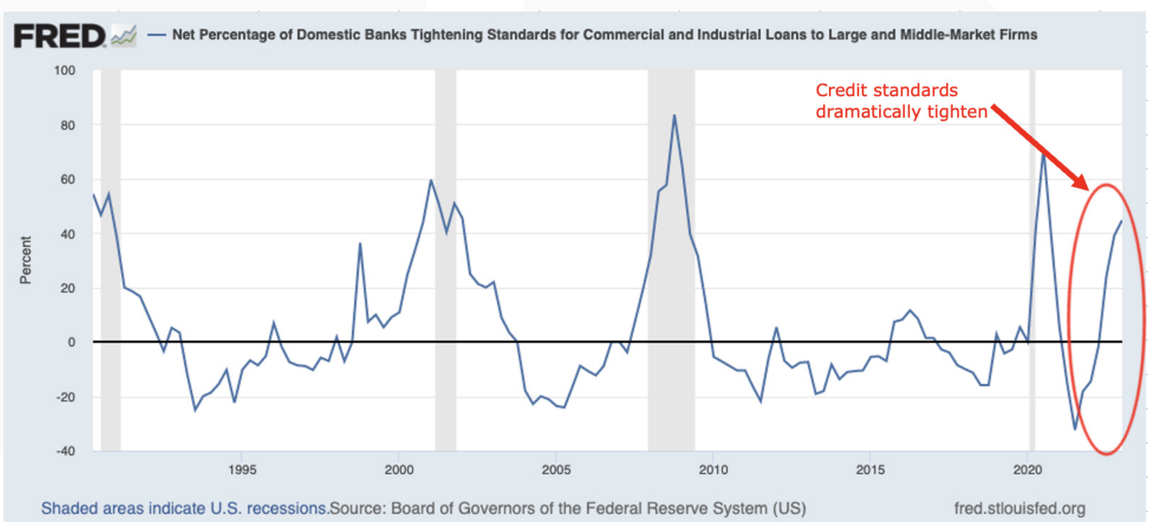


And Houlihan Lokey is there for the pain. With 35 offices worldwide, HLI has a finger in every flavor of bankruptcy pie imaginable. In 2022, as Chapter 11s ticked up sharply, Houlihan Lokey advised on more global distressed debt deals than any other investment bank:

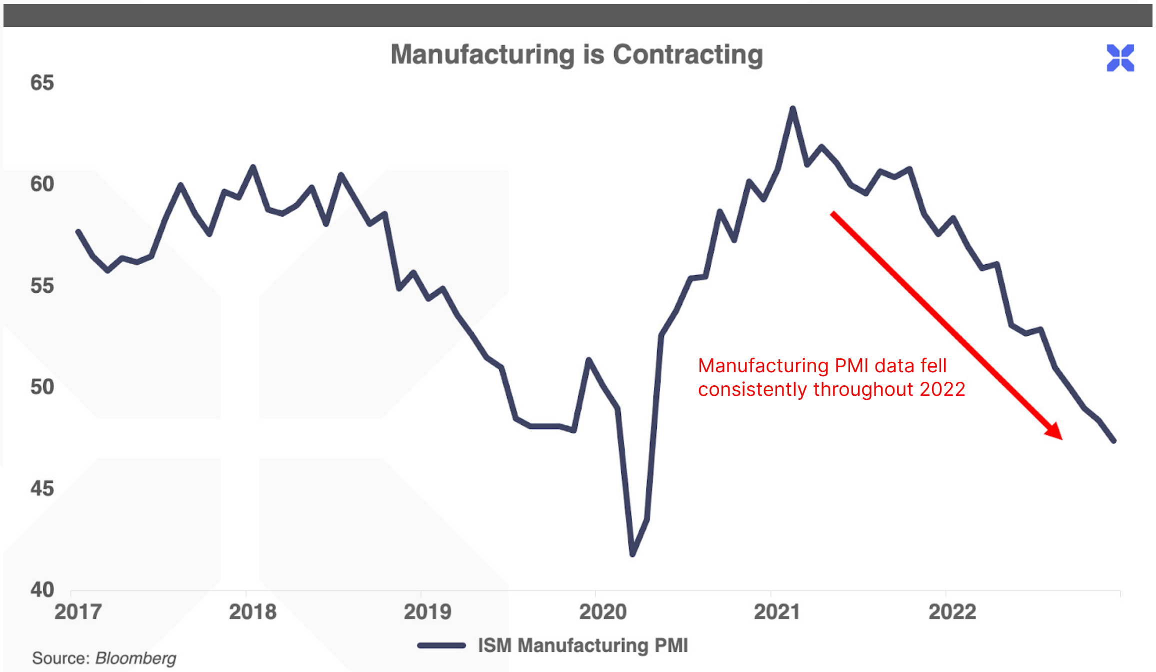
In the U.S., a number of red flags indicate that the country is headed for an extended recession. After all, the U.S. economy runs on credit.

When America's credit engine sputters, so does the economy.

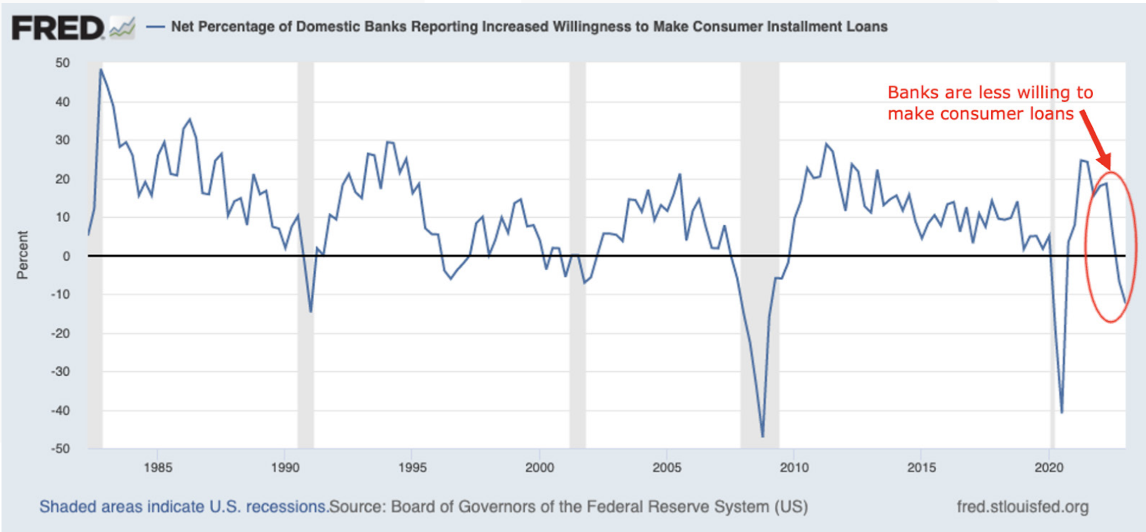
Bank lending standards have historically been a leading indicator of economic growth. Recent data shows a sharp increase in banks tightening lending for commercial and industrial loans. As the chart below shows, tightening lending standards have preceded every recession in the last three decades:



Tighter lending in the commercial and industrial sectors has translated into a sharp and persistent decline in manufacturing activity. This shows up in the purchasers' manager index (PMI) – a survey of purchasing managers in the manufacturing sector that indicates whether their businesses are expanding or contracting:

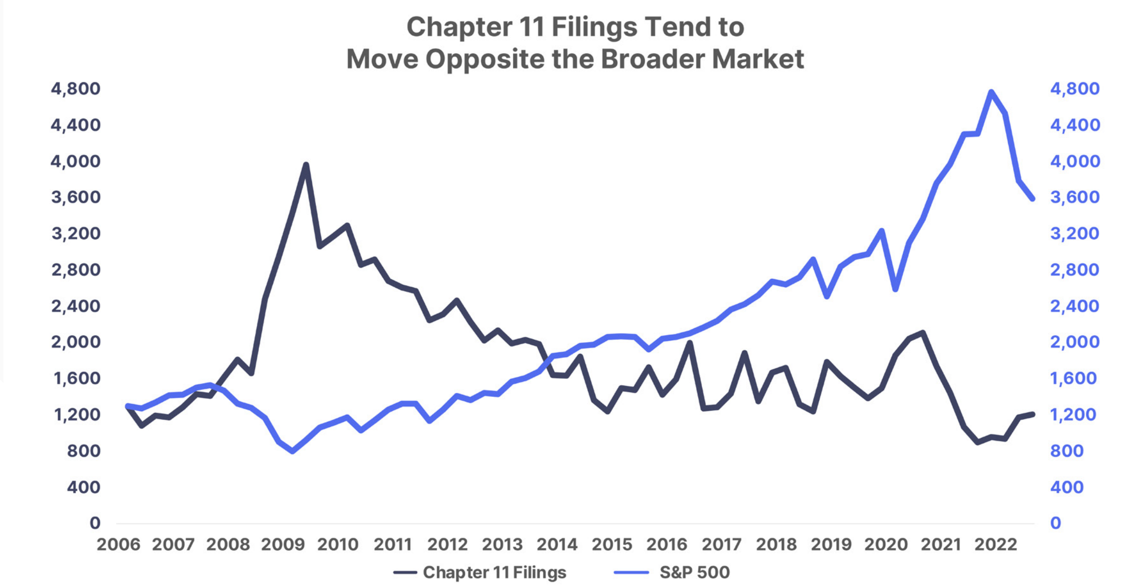


Meanwhile, banks are also tightening lending standards for consumer loans – another reliable leading indicator for an economic recession. Over FY 2022, the percent of U.S. banks reporting an increased willingness to make new consumer loans has plunged deep into negative territory:



A looming recession means more pain for businesses... and Chapter 11 filings always rise during recessions and bear markets. In the wake of the Great Financial

Crisis in 2008, 210 public companies in the U.S. filed for bankruptcy protection, more than 50% higher than the previous year. The post-dot-com era was no different, logging a record of 263 filings in 2001.



The latest Chapter 11 boom is just getting underway as recession rumblings begin, and Houlihan Lokey has already seen its restructuring revenue rise over the past two quarters. In the last nine months of 2022, the Financial Restructuring segment closed 68 transactions, up from 65 compared to the same period in 2021. (Meanwhile, the number of corporate finance deals contracted in the last nine months of 2022. HLI only closed 363 transactions in this segment compared to last year when it closed 456 transactions.)

In fiscal year 2022 alone, Houlihan Lokey generated BW28 an average of more than $4.3 million of revenue from each restructuring deal. That compares to more than $2.6 million and $130,000 for its corporate finance and FVA segments.

Why is HLI the "go-to" restructuring firm? One word: Experience.

Eats, Shoots, and Leaves

HLI is nearly double the size of its closest competitor, Rothschild, based on deal flow. HLI's real strength lies in its depth of knowledge and experience evaluating complex, highly leveraged situations. The company has earned its reputation working on some of the largest and most complex restructurings and providing favorable outcomes for their customers.

In 2021, prestigious financial journal and database *The Banker* named HLI

“Investment Bank of the Year for Restructuring,” with good cause. That year alone, HLI handled a spate of sensitive, high-profile reorganizations, including a $1.3 billion restructuring for Guitar Center, a $1.2 billion case for Virgin Atlantic, and a massive $3.3 billion proceeding for Singapore-based Pacific International Lines.

Two other major restructuring cases that year merited mention by *The Banker:* Turbocharger manufacturer Garrett Motion was going through Chapter 11 bankruptcy and was offered $2.1 billion for the outright purchase of its business. HLI came in and through complex negotiation, helped to raise an additional $1 billion, ensuring all creditors were paid in full. The company exited bankruptcy and is back to solvent operations.

HLI also handled the negotiations on behalf of aviation cargo handler Swissport International where it managed a $2.4 billion debt restructuring plan that achieved significant deleveraging for the balance sheet, putting Swissport in a strong financial position for the future. HLI completed a comprehensive financial restructuring, and Swissport ended up with a significant amount of liquidity from a new term loan and a cash position of EUR500 million (about $527 million).

Like the comma-challenged panda on the T-shirt, HLI “eats, shoots, and leaves.” It charges in, fixes a company’s problems efficiently and quickly, and then moves on to another mega-deal.

Take Virgin Atlantic as a prime example. In 2019, the airline founded by Sir Richard Branson was carrying 6 million customers per year. As the Covid-19 pandemic hit, passenger volumes plummeted by 98%. The airline tried everything to stay afloat: workforce reductions, pay cuts, fleet retirements, closing gates and even a temporary shift to cargo-only flying. But it was on financial life support.

That’s where HLI came in…

Houlihan Lokey started negotiations for raising third-party financing and worked with key stakeholders to restructure debt. In April 2020 it was announced that HLI would be working on the deal and by mid July, the firm had secured support from stakeholders to keep the company solvent. HLI also assisted in negotiations with the UK government.

None of this would be possible without the most seasoned team in the business…HLI’s CEO, Scott Beiser, has been with the firm for 39 years. His entire management team has served for an average of 34 years… an anomaly among other public investment banks whose leaders are in the corner office, on average, 8.4 years before stepping down.

*Source: **Houlihan Lokey Investor Presentation**, January 2023 p. 7*

In the words of co-president Scott Adelson, Houlihan Lokey has

> *"the largest group of people focused on private finance in the world. They not only understand their particular cog in the machine but the whole end-to-end financing solution."*

Why Now Is the Time to Buy HLI Shares

Bankruptcies and restructuring happen all the time, but when the economy falters, the countercyclicality of restructuring begins to shine. It happened in 2008, it happened in 2020, and as inflation and high interest rates stick around, it is happening again.

Over the last two years, central governments across the globe injected liquidity into the system – and essentially delayed many sinking companies from needing to restructure.

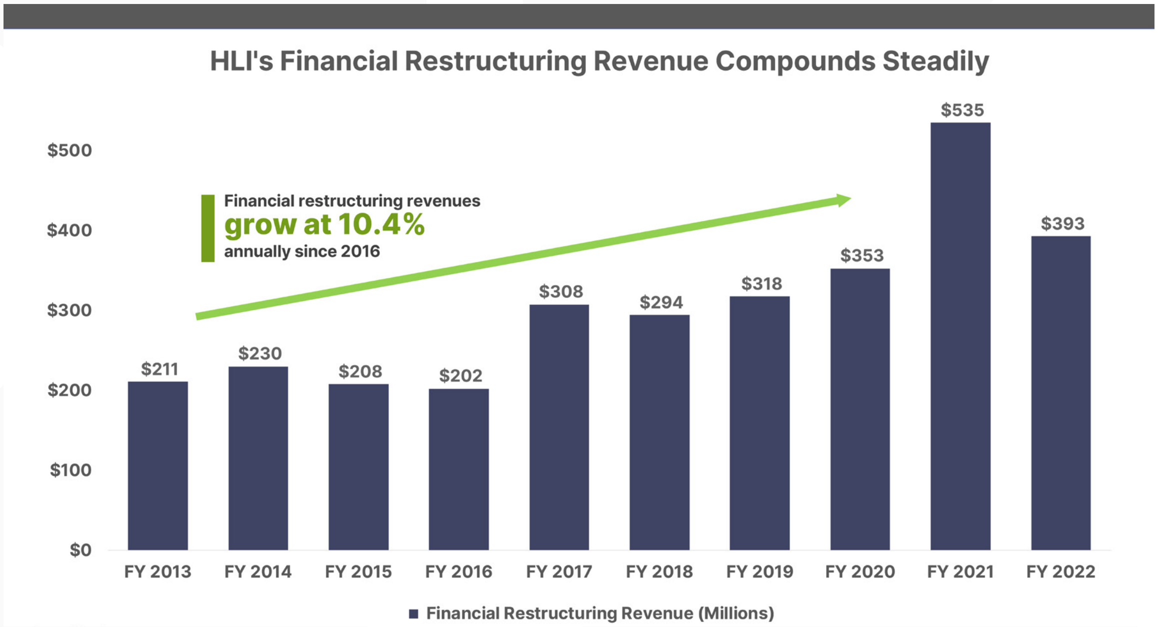
Until now, this funding, combined with massive amounts of stimulus and liquidity post-2008 financial crisis, has helped to keep corporate distress low. However, as the support has wound down, the tide has come in to show the true balance sheets.

As Warren Buffett famously said,

> *Only when the tide goes out do you discover who's been swimming naked.*

Record levels of company leverage, inflation, supply-chain issues, geopolitical events and contracting monetary policy are all playing into what could be the best years ever for the restructuring business…

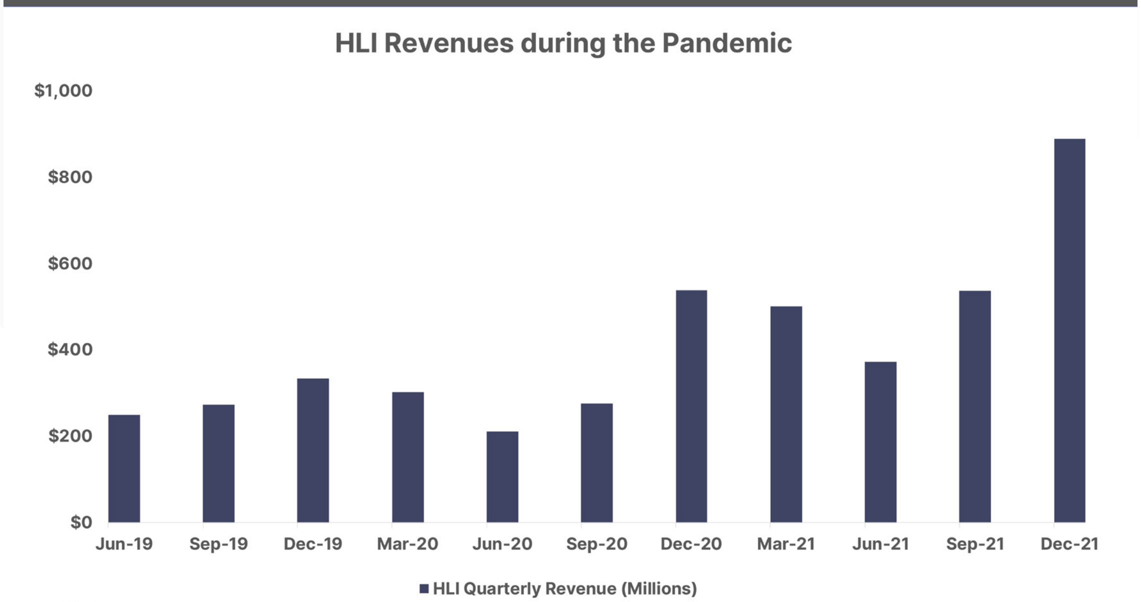
The chart below shows steady growth for HLI's restructuring revenue over the past ten years. (While FY 2022 saw revenue drop significantly from 2021, we view this more as a reversion to the mean, triggered by post-pandemic stimulus money).



In 2016, HLI's financial restructuring business did roughly $200 million in revenue. Fast forward to 2022 (the aforementioned "off year"), when it still made almost $400 million for a compound annual growth rate (CAGR) of 10.4%. Restructuring – a remarkably stable and growing business – makes up approximately 30% of HLI's revenue on an average year.

And the coming few years promise to be well above average…

The "Covid crash" in 2021 gave a glimpse at the revenue that widespread corporate distress can bring to a leading restructuring firm. HLI's business boomed during the fallout from the pandemic, with revenue jumping 58% in the second half of 2020 compared to the first six months of 2020. Revenue increased by 73% in 2021 compared to 2020.



Source: Bloomberg

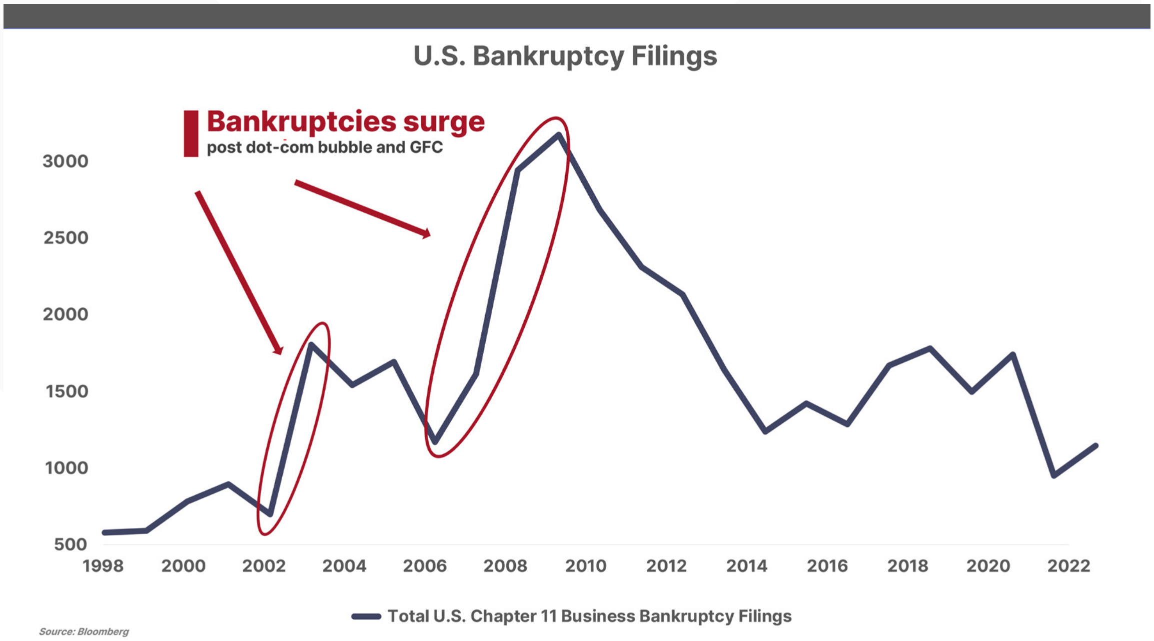
Keep in mind, the pain of 2021 was brief compared to the debt-fueled devastation that's likely approaching.

Today, we face a global synchronized "**Minsky Moment**" – a period of financial instability, as high inflation forces central banks to replace the cushion of easy money with the most aggressive monetary tightening campaign in a generation. The global economy now faces a complete reset of interest rates, sovereign debt loads, and corporate debt loads without the "cushion" of central bank largesse to soften the collapse.

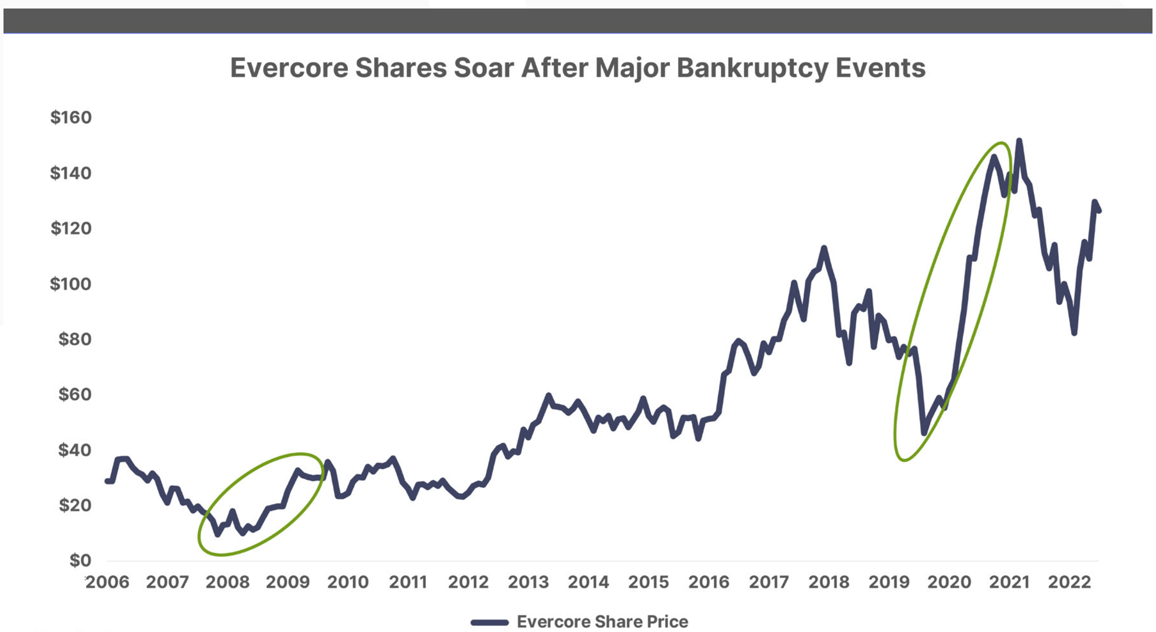
What will happen? Michael Burry, of Big Short fame, says he thinks "**the mother of all crashes**" is en route, and we agree. The world's economy is on the precipice of a debt crisis unlike any that's ever happened before.

Interest rates are not coming down any time soon, and the Fed is set on bringing inflation to its 2% target no matter what the cost. The costs for corporations to borrow money are also much higher, with S&P Global estimating that central bank rate rises will result in an additional $8.6 trillion in debt servicing costs over the next few years. These higher costs have already started to cause a small rise in defaults, which will grow over time.

If bankruptcies surge again like they did after the dot-com bubble, the financial collapse of 2008 and the Covid-19 pandemic, restructuring revenue for HLI could easily accelerate over $500 million over the next year. (Keeping in mind the $600 million figure from the short-lived Covid crash, that's a conservative estimate.)



Other companies in the space are instructive, too. HLI didn't launch its IPO until 2015, but Evercore (EVR), another large-cap restructuring firm, has been public since 2006. Between March 2020 and November 2021, EVR shares soared over 230%. They rose over 300% during the wind-down of the 2008 Financial Crisis. And during the year following each recession, they increased revenue by at least 33% (or 38.8% on average).



Porter & Co.

Over the last decade, American businesses gorged on cheap debt when money was cheap. Now, with the Fed engaging in the most aggressive monetary tightening campaign in a generation, all of that debt is becoming a lot more expensive.

The one-two punch of higher borrowing costs and plunging cash flows will send a tidal wave of defaults washing over corporate America. This will unleash a surge in demand for HLI's corporate restructuring services. HLI will be one of the biggest winners from the coming corporate debt implosion – and when the economy recovers, the lucrative Corporate finance portion of the firm will be right there to advise on ensuing M&A.

HLI's corporate finance segment generated impressive growth during the bull market from 2013 - 2022, with revenues growing from $200 million to $1.4 billion. Now, we expect the restructuring arm to take the lead from the coming wave of corporate bankruptcies. We expect HLI's restructuring segment revenues to grow from roughly $500 million over the last year to upwards of $1 billion per year in 2024.

That's what puts HLI right at the center of **The Greatest Legal Transfer of Wealth in History** – and it's why we want to own shares today.

Action to Take: Buy shares of Houlihan Lokey (HLI) up to $105 per share.