CORPORATE

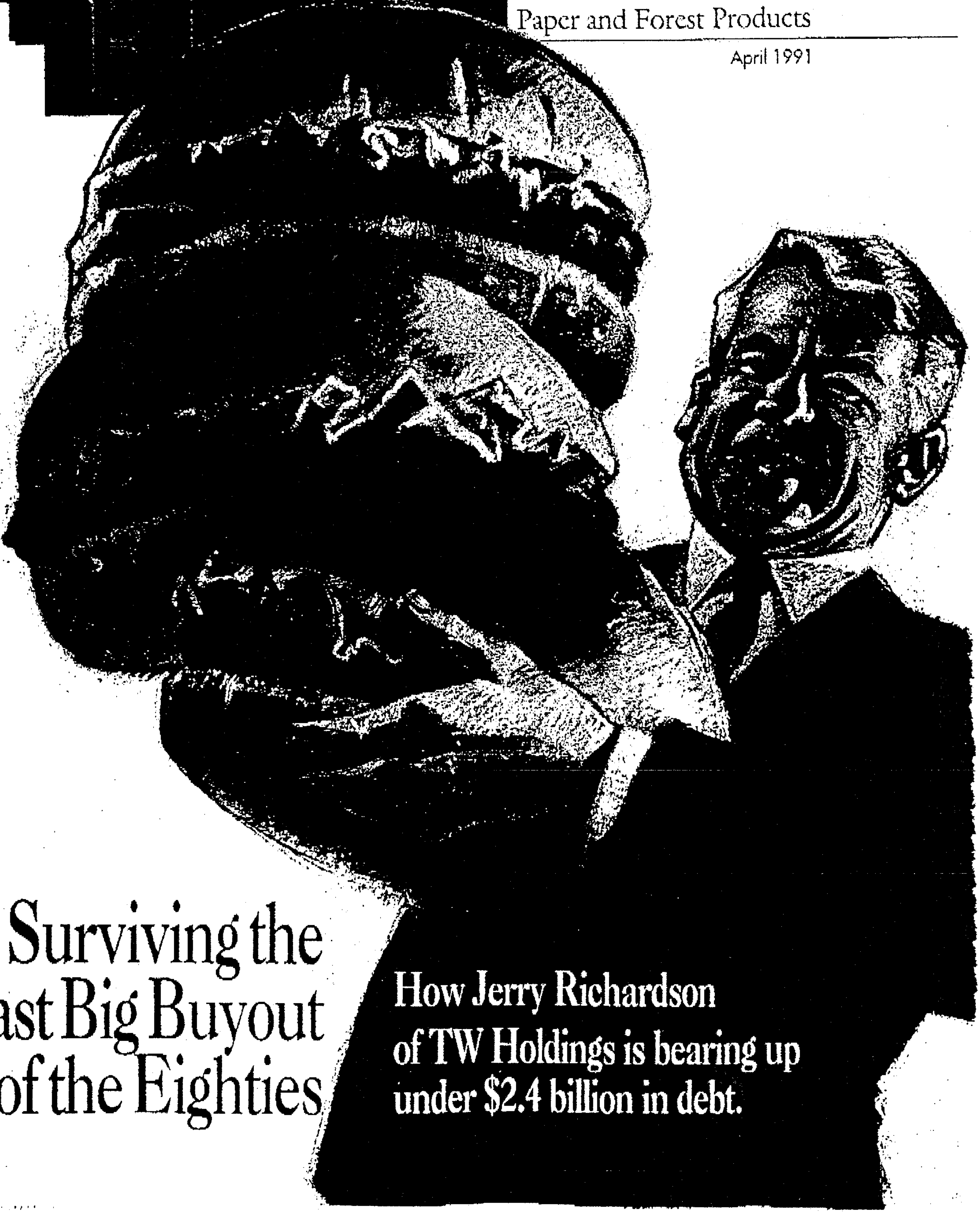
Raise Equity or Die

Trompe L'Oeil Finance

INDUSTRY FOCUS:

Paper and Forest Products

April 1991



Surviving the Last Big Buyout of the Eighties

How Jerry Richardson of TW Holdings is bearing up under $2.4 billion in debt.

Surviving the Last Big Buyout of the Eighties

How Jerry Richardson of TW Holdings is bearing up under $2.4 billion in debt.

By ALYSSA A. LAPPEN

Football fans thought Jerome Richardson was nuts to quit the Baltimore Colts in 1961. After only two years, the promising Rookie of the Year gave up a $9,750 salary and playing wide receiver to Hall of Fame quarterback Johnny Unitas for a $4,000 investment in the first franchise of an unknown hamburger joint called Hardee's. But Richardson's big gamble paid off. He and his college football buddy, Charley Bradshaw, parlayed that single Hardee's restaurant into Spartan Foods, a small fast food empire that they took public in 1969. The duo sold Spartan to Trans World Corp. in 1979 for $80 million.

Today, the 6-foot-5 Richardson is gambling again. But this time the odds seem much longer. He is CEO of TW Holdings, the LBO with the dubious distinction of having been the last highly leveraged deal of the Eighties to close. With $3.7 billion in annual sales from fast food restaurants and an institutional food service business, the company must tackle a $2.4 billion tower of debt. And this time Richardson's partners are not homespun pals. They are New York's much-feared Coniston Partners—Keith Gollust, Paul Tierney, and Augustus Oliver—who won the company with a $3 billion bid in July 1989. Richardson, 54, figures that if Coniston had not bought TW Services, someone else would have.

Coniston Partners' opening $2.5 billion salvo in October 1988 followed attacks on TW by Odyssey Partners in 1983 and Ronald Perelman in 1986. Ultimately, Coniston forced the board of TW, which was left behind when TWA was spun off in 1984, to take bids from Marriott and Kohlberg Kravis Roberts, among others.

OPPORTUNITY TO GROW

Now that Gollust, Tierney, and Oliver own 52 percent of TW, Jerry Richardson seems almost happy to have them on his team. "It would have been difficult if we'd had to sell [core] assets to make the deal work," he says in his 16th-floor office at TW Holdings' elegant new headquarters in Spartanburg, South Carolina. But the company's new owners promised not to break it up, and so far, the Coniston boys have been as good as their word. "With our debt and our partners, we have an opportunity to grow," says a hopeful Richardson.

TW Holdings is already huge. It's the nation's fourth-largest food service company after PepsiCo, McDonald's, and Marriott. The Spartan Foods subsidiary is the largest and most successful Hardee's franchisee and also owns 213 Quincy's steakhouses in nine states. TW owns and operates most of the restaurants in the Denny's chain, which grossed more than $1.4 billion last year. And its Canteen unit has some $1.4 billion in annual industrial and national park food service contracts. Last but not least is El Pollo Loco, a $100 million grilled chicken chain based in California.

Although the TW portfolio is crammed with good businesses, the deal that Coniston and Richardson crafted to buy this imposing outfit trashed its balance sheet. Debt more than doubled from $1 billion prebuyout to $2.4 billion. And characteristic of the late Eighties buyout, roughly $700 million of the $2.4 billion filling TW's horizon is junk.

Sure there's equity in the deal. Coniston put up $187 million or so to buy its first 19 percent stake in TW Services. But when the two-stage LBO finally closed in December 1989, Coniston traded more than $50 million of that equity for senior notes and junk debt and took back more than $10 million in cash. In all, the current book value of TW's equity is only about $140 million. Back out the company's $1.4 billion in goodwill and tangible net worth is negative to the tune of more than $1.2 billion.

The debt structure is enough to make the hardiest of souls blanch. The company owes some $977 million to a 45-bank syndicate led by Citicorp—$677 million of it at rates that float between 1.5 percent above prime and 2.5 percent above LIBOR. Below that is $200 million in senior notes paying 15 percent; $150 million in floating rate senior notes, now at about 13 percent; and $100 million in junior convertible bonds paying 10 percent.

Richardson and CFO Walter Brice also face $397 million in zero coupon bonds, which accrete at a whopping 17 percent per year. When the zeros turn cash pay in 1994, the principal will have escalated to $712 million. As if all that were not enough, there is $385 million in 11 and 10.25 percent mortgage bonds on restaurants peddled last year to help retire a $450 million bridge loan, and a revolving $250 million credit line that the company can tap for up to 10 months per year. "A lot of deals were premised on refinancing, asset sales, unrealistic appreciation of cash flow, or the expectation that the market would go up," says Coniston's Oliver. "That was not the case here. We knew we had the cash flow before we did this deal."

A NARROW ESCAPE

Perhaps Oliver and Richardson think this capital structure is viable because they almost created an even more highly levered balance sheet. When the junk bond market collapsed in October 1989, they were out trying to sell an even riskier deal to investment bankers. That plan called for Coniston to take back some $155 million of its equity at the closing and sell about 40 percent more junk. In short, Coniston would have owned 52 percent of TW for only $32 million. Had that deal flown, the ensuing recession would have landed some big flies on TW's fast food. But luckily, it was a no-go.

When the financing plan collapsed, Coniston had already bought most of the old TW stock and was on the hook for $1.1 billion in bridge loans. To save the deal, Coniston was forced to leave most of its equity in TW and take a $50 million piece of the floating rate senior notes. TW's investment bankers at Donaldson Lufkin Jenrette took the other $100 million in senior notes. The Citicorp-led bank syndicate stepped up for much of the rest.

But even with the improved structure, Richardson and Brice won't have it easy. To cover cash interest payments, TW must pump out at least $225 million a year, says Michael Mueller, a restaurant analyst at San Francisco's Montgomery Securities. Not to mention another $400

PHOTOS BY TOMMY THOMPSON/BLACK STAR

CEO Jerry Richardson *expects TW Holdings to pay off its debts on schedule. "It's going to be close, but it keeps you on your toes," he says.*

Steve McManus, *head of TW's 485 Hardee's, spends most of his time in the field. "The thing I dislike the most is the financial stuff," he confides.*

million or so between now and 1994 to meet scheduled principal payments on bank debt. Come 1994, when the zeros kick in, interest payments will rise to around $300 million a year. In short, TW Holdings will have to increase cash flow by at least 6 percent per year just to stay even.

Difficult? Yes. Impossible? Not according to Jerry Richardson. "We have a real commitment to making sure that this does not turn out to be a poor investment for anyone, whether it be our partners at Coniston, the banks, the people who bought our bonds or the stockholders," he asserts. "I know that we can make this thing work. It's going to be close, but it keeps you on your toes."

Surprisingly, Richardson has put real money—not just paper—where his mouth is. With the change in control, he earned a $2.2 million golden handshake. But he also swapped his 73,250 shares in the old TW Services—worth some $2.5 million at the buyout price of $34 per share—for 630,000 shares in the new TW Holdings. He cut a $13.5 million check for another 3.4 million shares when the deal closed and has since picked up 14,000 more shares at an average cost of $5.45, according to Ft. Lauderdale's Invest/Net Group. In all, Richardson may have invested nearly 15 percent of his net worth in TW.

And Richardson isn't alone. His entire management team has equity in the deal. "No, we don't like this debt," says CFO Brice. "But the fact is, it's there. And we didn't have a bunch of managers cut and run when Coniston came in." Together, the company's operating men own more than 4 percent of TW's stock, worth some $18 million at the recent price of $4.06 per share.

The Coniston boys are likewise confident about their first takeover. "Obviously in any highly leveraged situation, given the events over the last few years, you have to be very careful about making wild projections," says Oliver. "But this is a company that has been historically recession resistant in a business that has been historically recession resistant."

KEEP THE HYPE GOING

Just weathering the recession won't do the trick for this food service company. It needs to grow—and fast. Head across Spartanburg from TW's gleaming new headquarters and you get an idea of how. It's 7:30 A.M., and an unannounced H. Stephen McManus, head of TW's 485 Hardee's restaurants, sits in the parking lot of the Asheville Highway location, clocking the team at the drive-through window. Customers call in orders at a menu board, then pull up. As fast as they can hand over their money, they've got their bags. In 70 seconds, ten cars drive through. "Wow!" McManus scribbles on a card, which he hands to the gratified young man at the window when he picks up his own juice and coffee. "We like to keep the hype going," he explains. That's one reason this outlet grosses $1.5 million a year.

Next McManus swings by a few competing McDonalds, Arby's, and Burger Kings. There are no lines at their drive-through windows and their parking lots are half full. "Forty-two direct competitors in our system went out of business last year, including Jack's, Wendy's, and Burger Kings," McManus gloats. But he's not relaxing. Hardee's offers incentives like free coffee for senior citizens, cheap birthday parties for kids, and coupons for free ice cream whenever customers are less than satisfied. "Our average sale was $2.64 in 1990, up from $2.55 in 1989, and we can raise that higher."

A 21-year veteran of Spartan Foods, McManus isn't worried. Last year, he got the funds to open 19 new Hardee's. This year he plans to build 32 more. But for McManus, the bottom line is doing his job right. "The thing I dislike the most is the financial stuff," he confides. "It's not that I don't understand it. But I'd rather be working with people in these restaurants, motivating them."

One hears similar can-do talk from Bernard Scott, the new head of TW's Denny's chain, who also spends most of his time in the field. "You always have the debt on your mind, but we're very focused and we feel we can accomplish what we set out to do," he says. A 17-year veteran of Denny's, Scott has seen big improvements since TW bought the chain for $800 million in 1987. Richardson, then TW's president, began donning aprons in Denny's kitchens just as he'd done at Hardee's since 1961. Word spread fast, lifting morale. Now, more than half of TW's Denny's have been remodeled.

TW's biggest cheerleader, though, is Richardson. He works 17 hours a day to lead his team to glory. "There are no magic wands in the restaurant or food service business," he says. "But to be successful is not complicated. You have to have the right team in place, people have to work hard, and people have to be happy."

To outsiders, fast food may not seem a likely candidate for leverage, particularly given the savage price cutting now going

LOCAL HERO

On a clear day in Spartanburg, South Carolina, you can see TW Holding's sparkling 18-story office tower at the corner of East Main and Converse from 20 miles away. "The tower," as proud locals call it, replaced an abandoned hotel and an empty J.C. Penney, and has transformed the town since opening last April. Now some 3,000 workers are pumping millions into the local economy and developers are putting up more offices nearby. For this miracle, city fathers thank CEO Jerry Richardson, who sold the idea to TW's old board.

"Jerry Richardson is a great leader," says textile magnate Roger Milliken, who has been promoting Spartanburg and its airport since moving Milliken & Co.'s headquarters there back in 1954. Says Ben Haskew, head of the Spartanburg Chamber of Commerce: "He's my definition of a model business leader because all through his career, he's given back to his community, his church, his college—and not just his time."

Richardson's next civic project is on a much bigger scale. He hopes to bring a new National Football League franchise to Charlotte, North Carolina. "It's important because the Carolinas have been great to us and should have their own team," he says. So important that Richardson's son Mark, 30, heads the project, and his wife and two other children also plan to invest. Richardson even hired sports marketer Max Muhlemann, who helped Charlotte win its National Basketball Association franchise in 1989. "We've come from the back of the pack to being one of the leading contenders for the two NFL expansion franchises that will be awarded for the 1993 season," says the younger Richardson. "We expect to find out in the next 6 to 12 months whether we've been awarded a franchise."

If the NFL franchise materializes, it will cost big bucks. Prices have gone up a lot since 1974, when the NFL sold the Seattle and Tampa Bay franchises for about $16 million each. The Seattle Seahawks sold in 1987 for an estimated $99 million. The Dallas Cowboys went for an estimated $140 million in 1989. (Both deals included practice facilities.) Robert Tisch recently bought half the New York Giants for a rumored $60 million. Mark Richardson estimates the franchise in Charlotte could run about $100 million.

No problem, he says. As partners, his family has lined up 11 other moneyed Southerners, including the Belk Stores' John and Tom Belk, Bissell's H.C. "Smokey" Bissell, and Bowles Holowell's Erskine Bowles.

To play ball, the team would also need a new stadium. So Richardson's investment group proposes to build one. Not just any old sports stadium, mind you. A 70,000-seat, single-purpose stadium, which could cost another $125 million. The city of Charlotte has already bought the land. But Richardson's partnership plans to build and own the stadium itself. On the advice of NCNB and consultants from Arthur Andersen, the group figures on financing the stadium through sales of luxury boxes, equipped with big-screen television, sound systems, and private rest rooms.

There's no certainty that Richardson will win his coveted team, of course. But if he does, you can bet that the team's balance sheet will look a darn sight better than that of TW Holdings. Why? In the past, the NFL has not allowed a team's owner to borrow more than $35 million against stock in the franchise.

on in the hamburger chains. But plenty of food service companies have been LBOs. Some have bombed, namely Copeland Enterprise's Church's Fried Chicken and Popeye's, and Jerrico's Long John Silver's. Others such as ARA Services and Shoney's have done very well.

So far TW's results look pretty good. In the first year of operation, the LBO increased sales by 6 percent, to $3.7 billion. Cash flow grew 12 percent, to $444 million. The company thus easily covered interest along with $145 million in planned capital expenditures. Richardson even prepaid $40 million in bank debt. Impressive, given the recession. "Last November everyone seemed resigned to the fact that we were not going to make our plan," says TW General Counsel Louis Howell. "But Jerry hung in there, telling folks that we'd just have to double our efforts."

Still, TW ran short of its plan by about $5 million on both revenues and income. Denny's, which added 29 restaurants last year, showed a fabulous 20 percent gain in cash flow, to $186 million. Volume was also up at Quincy's, where cash flow grew 18 percent, to $41 million. But at Hardee's, competition kept cash flow growth to only 5 percent and cut into margins. Canteen's revenues, hurt by layoffs in the auto, defense, and aerospace industries, were flat and its cash flow grew only 6 percent, to about $120 million. There are also huge opportunities at El Pollo Loco, where cash flow was off 25 percent, to $12.5 million because there's a chicken war raging in California.

But smart money seems to be hanging in. Mutual Series Fund, managed by Michael Price, owns 600,000 shares. Wertheim Schroder, which reportedly picked up the stub stock from its arbitrage desk more than a year ago, is holding more than 800,000 shares. Kemper Financial Services has more than 5 percent of the stock and some debt, says Vickers Equity On-Line, a stock tracking service. Says Kemper analyst Rémy Fisher: "We expect their cash flow to grow 5 to 8 percent this year and about 10 percent once the economy snaps back."

The New York investment firm of Baker Nye also holds nearly 1 percent of the stock and some of the junk. Says partner Jeffrey Greenblatt: "You'd be surprised how many fast food places don't understand how to serve hot foot hot and cold food cold. You won't see that in any of Jerry Richardson's outlets."

The consensus among these savvy investors is that TW will get much of the growth it needs from a $150 million annual capital spending program. If things get tough, they figure, it won't be until 1993, when scheduled payments of bank debt rise over $100 million per year. And the capital spending program can provide a cushion if needed.

Yet TW's bankers remain confident. Listen to NCNB Corp. Chairman Hugh McColl, who has been lending Richardson money since 1961. "At one time, they owed us $10 million on a net worth of zip, but in the fast food business you can operate with negative working capital. You buy hamburgers and buns on 30-day terms and sell burgers daily," says McColl. "You can operate with more debt than equity because you're turning the inventory so fast. It took me a long time, as a young loan officer, to get the people at the bank to understand that."

Earnings should also improve as TW moves its Denny's and Canteen headquarters from Irvine, California and Chicago to Spartanburg. Of the 500 employees now working in those offices, TW expects only 100 to stay on. Says Brice, "I'm not going to make any projections, but I can tell you that when we took over Canteen, the top four people left and we cut $17.2 million of overhead in the first year. We cut a similar number at Denny's when we went out there in 1987."

Despite all this enthusiasm, the markets have not exactly given TW a resounding vote of confidence. In the 14 months since the deal closed, investors have been on a roller coaster ride. The stub stock, of which roughly 30 percent is publicly held, has traded as high as $6 per share and as low as $2.50 and recently traded at $4.06.

Prices in the credit markets have been equally volatile. The 15 percent senior notes traded close to par in late 1989, rose to $103 per $100 of face value last July and then bumped between $96 and $74, according to New York's Indepth Data Inc. In March the bid price was $87.25. Similarly, the 17 percent zeros had a bid price of $45.50 a month after their issue but fell as low as $33 before closing last month at $47.75 on accreted value of $55.

TW bonds were not buoyed last year by the company's frantic scramble to pay off $450 million in bank bridge financing by the December deadline. "It was a very close call in a tight market," says Brice. After privately placing mortgages on 240 Denny's in the Japanese institutional market, he had hoped to raise the rest by selling bonds backed by mortgages on 387 Hardee's and Quincy's. But by the time TW began selling the second slug of mortages, credit in the real estate market had dried up. "We knew we had the underlying property values, with profitable enterprises in good locations. But we got mortgages of only 55 to 60 percent on the most conservative property valuations. In a normal market, we'd have gotten 70 percent." The sales closed just in the nick of time.

CFO Walter Brice: *"No we don't like the debt. But the fact is, it's there."*

Brice got another unpleasant surprise when he tried to sell noncore assets to help raise the needed cash. Among these were the Milnot canned food subsidiary, American Medical Systems, a stake in Winchell's Donuts, and the Rowe cigarette vending machine subsidiary. From these, he expected to raise $140 million. As it turned out, he got only $65 million. He made up the difference through sale/leasebacks of the headquarters and on several Hardee's and Denny's.

The markets don't appreciate DLJ's current attempt to sell its $100 million piece of the senior notes either. Says Patrick Fallon, a DLJ vice president: "Everyone understood [at the outset] that it was something we hoped eventually to refinance." But now that the bridge loan has been paid, the credit markets have grown increasingly leary of leveraged deals. Fallon thus allows that placing the notes might "take a good couple of months."

The way Gus Oliver sees things, all this weakness in the markets could provide a chance to buy back some of the high cost debt. How would TW pay for such an offer or get its bankers to consent? "That's a good question," Oliver says. "There's an opportunity, but we have to find a way to do it and we're not there yet." But even if Brice cannot cook up some way to trade junk for less expensive paper, Oliver is sanguine. "Those zeros provide substantial yields to maturity—over 20 percent—so if you're a believer, it's a terrific security to own."

By all accounts, Richardson has always risen to a challenge. Even as a boy in Fayetteville, North Carolina, he was driven. The son of a barber and a department store clerk, "Stick" Richardson played high school football but many thought him too slow to play varsity in college. Diligent practice won him a partial football scholarship to Spartanburg's Wofford College and two years on the Colts. Says Wofford President Joab Lesesne, Jr., on whose board Richardson served for 12 years: "He is absolutely tenacious. If he says he can do something, it will absolutely get done. I don't understand the numbers, but I'll tell you this. I sure wouldn't bet against him."

Richardson clearly is in a different league than when he was a rookie for the Colts or building Spartan Foods. But he's running with the ball. And if anyone can lead the team to victory in this high-stakes game, Jerry Richardson can. ■