W.R. Grace Stock Soars on Hope of Favourable Asbestos Deal

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Complex and arduous, the corporate bankruptcy process is often misunderstood. While the majority of corporate bankruptcies result in stockholders getting the big zero, in certain cases equity value can be retained. In recent weeks, shares of bankrupt specialty chemicals company W.R. Grace & Co. have rallied sharply on potential shifts in asbestos litigation trends and the potential for government intervention.

W.R. Grace & Co. filed for Chapter 11 bankruptcy protection in April 2001 in the US bankruptcy court for the district of Delaware on mounting asbestos litigation. As a result, just about every Wall Street equity analyst dropped coverage of the stock. However, there has been renewed interest lately. After hitting a low of $1.31 in October 2001, shares of W.R. Grace tripled to a recent high of $3.99 before retreating a bit to around $3.35.

Now Grace's largest shareholder, Charlottesville, Va.-based Peninsula Partners LP scooped up large quantities of Grace shares on the cheap last year. The investor now owns over 10.5 million shares of Grace, or 16 percent of the outstanding shares, at an average price of $2.54.

The investor believes there will be considerable residual value in Grace's common stock after the company emerges from bankruptcy. "It's not unprecedented," says Ted Weschler, managing partner of Peninsula Capital Advisors LLC, an affiliate of Peninsula Partners. "The Grace situation is more analogous to the situation with Texaco years ago and Columbia **Gas** Systems. Both companies went into bankruptcy because of special circumstances-not because of a bad business model."

Mr. Weschler estimates that Grace's shares could be worth nearly four times the current stock price. He first looks at what the shares would be worth without the asbestos taint. "It's a great core specialty chemicals operation, relatively non-cyclical and led by a great management team," he says. "Last year they had earnings per share of $1.20. If you put a long-term market multiple on $1.20, which Grace would certainly have without the asbestos taint, that's a $24 stock." Estimating around 50 percent dilution through the bankruptcy process as debt holders and asbestos plaintiffs get a large share of equity, he arrives at fair value of between $12 to $13 per share.

What lit a fire under shares of bankrupt companies with asbestos litigation recently was a report on April 9 by CNBC's David Faber that bondholders led by Carl Icahn and asbestos plaintiffs of auto parts maker Federal-Mogul Corp. had reached a settlement giving asbestos claimants 50.1 percent of the new equity in Federal-Mogul and bondholders the other 49.9 percent. While that deal would leave shareholders with nothing, investors found encouragement that such a deal demonstrated that as-bestos plaintiffs were willing to accept 50.1 percent of the equity rather than all of the equity as they have laid claim to in the past.

Although Federal-Mogul subsequently denied it had reached such a deal, shares of a number of bankrupt companies have maintained much of their hefty gains, including Grace.

"The big difference between Federal- Mogul and Grace is that Federal-Mogul has a ton of debt," Mr. Weschler points out. "So the argument is made that in Grace, the equity is more analogous to the position Carl Icahn has in Federal-Mogul."

While Grace is one of a number of companies that filed for bankruptcy because of mounting asbestos litigation, one key difference is its relatively light debt load. With cash and equivalents of $146.3 million at the end of March and debt of $534.5 million, the company has net debt of just $388.2 million, or less than 2x Grace's EBITDA (cash flow) while Federal-Mogul has net debt of around $4.4 billion as of year end, or roughly 9x EBITDA, notes Mr. Weschler.

Grace chief financial officer Robert Tarola says the rise in the company's stock price could be attributed to investor optimism about asbestos litigation spreading to a number of large companies, widening the circle of potential defendants and thus reducing the ultimate cost for Grace.

Fraught with uncertainty, the bank-ruptcy process involves negotiations between the company (debtor), creditors (debt holders), asbestos plaintiffs, and pretty unique in Grace's case, shareholders.

Back in June 2001, at the request of Mr. Weschler, the bankruptcy court appointed an Official Committee of Equity Security Holders. Mr. Weschler was appointed chairman of the equity committee in July. "That gives us a seat at the table," he says.

With regard to asbestos litigation, the tide of public opinion appears to be turning against certain plaintiffs and could spur legislative reform. An April 25 article in The Wall Street Journal highlighted the fact that with so many asbestos claimants who are not sick jumping on the bandwagon, the sickest victims are not getting their fair share of the settlements anymore as compared to the 1990s.

"Clearly there's a lot of push back against the plaintiffs' bar on asbestos in general," notes Banc of America Securities analyst Mark Gulley. "There are two kinds of asbestos claimants-those that are sick and those that aren't. What's happening is that there's so much money flowing to the plaintiffs that aren't sick that it's leaving a lot less for the people that really deserve it."

While still in bankruptcy and receiving little attention, Grace keeps chugging along. First quarter net income fell 15 percent to $12.4 million (19 cents per share), including the impact of $3.5 million in higher pension costs, a $3.8 million charge for environmental remediation and legal fees, and $4.4 million for Chapter 11-related expenses. Pre-tax income from core operations rose 17 percent to $33.8 million on 5 percent higher sales of $414 million.

Chairman and CEO Paul J. Norris had to write a letter to The Wall Street Journal recently, correcting the publication on its statement that Grace had gone out of business.

"Our business delivered strong results in the first quarter with both Davison and performance chemicals contributing double-digit improvements in operating earnings," says Mr. Norris. Particularly strong were sales of silica products, which were up 10 percent. Catalyst products sales rose 8 percent.

The Peninsula Partners Fund with a little over $250 million under management, is apparently holding Grace shares for the long haul. "The nature of the fund is that anything I put in there I expect to hold for five plus years," Mr. Weschler says.

He may have to hold on for a long time before a resolution. The court has set a bar date of March 31, 2003 for plaintiffs to come forward with asbestos property damage claims and medical monitoring claims related to asbestos, as well as claims of general unsecured creditors. The bar date does not apply to asbestos-related bodily injury claims or claims related to Zonolite attic insulation, which will be dealt with separately. A trial regarding plaintiffs' charge that Grace illegally transferred its Cryovac packaging business in a merger with Sealed Air, in 1998 to shield that unit from asbestos liability is scheduled to start on September 30.

The potential impact of that trial is unknown. "The risk in bankruptcy court is that there are a lot of wild cards that can come out of nowhere and hurt you," says Mr. Weschler. "If the court says Grace was insolvent four years ago when the Cryovac deal was done, that's bad news for me as an equity holder. But if Sealed Air wants to settle the whole thing in return for contributing some money to the estate, that may be good for equity holders."