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A SPECIAL REPORT

Credit rerun

Z CAPITAL PARTNERS' JAMES ZENNI

by VYVYAN TENORIO

HEDGE FUND AND DISTRESSED INVESTOR James Zenni's baptism by fire came early in his career as a fixed-income manager at Kidder, Peabody & Co. Except that it was more like a conflagration.

In the late '80s, Zenni, who later founded Lake Forest, Ill.-based **Black Diamond Capital Management LLC**, was thrown headlong into the savings and loan train wreck. He and his associates thrived during the debacle, rehabilitating collapsing institutions and buying nonperforming mortgage debt at deep discounts from the Resolution Trust Corp.

"That was really an eye-opening experience with large-scale distressed assets," Zenni recalls. "I remember being in Texas many times, working with S&Ls down there. I saw a great amount of wealth being decimated in the mortgage world."

Maybe it's the specter of yet another financial contagion that goads Zenni to aid struggling businesses with bad balance sheets. Or he's simply very good at what he does. Whatever the reason, his experiences have served him well at Black Diamond, which he started with Stephen Deckoff and other former Kidder Peabody colleagues in 1994 to capitalize on distressed situations. Typically, the firm buys debt or provides debtor-in-possession financing in Chapter 11 workouts, and in certain cases it subsequently converts debt to equity while restructuring the businesses and easing their exit out of bankruptcy. Its toehold approach yielded profitable outcomes in its acquisitions of airport baggage cart company **Smarte Carte Corp.** of White Bear Lake, Minn., minimill operator **Bayou Steel Corp.** of LaPlace, La., and **PTC Alliance Corp.**, a Wexford, Pa., maker of steel tubing and parts.

"By being in the bank debt, on the private side of the information almost exclusively, you become far more intimate with companies and management," the soft-spoken Zenni says.

Zenni, 52, continues to mine those avenues with nascent **Z Capital Partners LLC**, also based in Lake Forest. Launched last year after Zenni sold all of his 50% stake in Black Diamond in a management buyout, Z Capital has recently raised about $500 million for a hedge fund to invest in senior debt. Its 12-member team came largely from Black Diamond, many of them from the PE side.

Normally publicity shy, Zenni won't comment on reports that his firm is raising a buyout fund of up to $1 billion. But he is candid in explaining the intricacies of the firm's overall game plan. The hedge fund, structured in traditional fashion with a two-year rolling cycle of capital, "is a passive vehicle that looks like a very low-levered finance company at the end of the day," he says. "The CLO market got dislocated over the summer, and as a result, we were able to buy a lot of paper," mostly through the secondary market.

Like Black Diamond, Z Capital usually picks companies that have gone through leveraged buyouts. In Zenni's view, hedge fund and control investing are complementary activities, but they require different structures. Private equity typically has a three- to five-year horizon for investing and harvesting profits. "A hedge fund is not designed for owning majority equity and building value after the fact," he says, hence the separate pools. (Z Capital, for instance, isn't pursuing the CLO structured vehicle business that Black Diamond had expanded.)

"Jim has been in the front lines of crisis since the '80s," says Jim Weissenborn, founder of **Mackinac Partners LLC**, a Bloomfield Hills, Mich., financial advisory firm, who has worked with Zenni on numerous restructurings. "He not only has the experience, but



Zenni
front lines

he has good timing, getting new dry powder where he sees opportunities."

Zenni grew up in Cincinnati, the son of a Lebanese produce supplier. His father died when Zenni was 13, and the family business was eventually sold. After attending Jesuit-run Xavier University, Zenni went to business school, then found his way at Kidder Peabody immediately after.

At the time, the firm was mainly a stock brokerage. Zenni's group built up the fixed-income business, getting a boost when **General Electric Co.** bought it in 1986. "Jim was phenomenally successful at fixed income and was a great salesman who really understood the business," says Martin Auerbach, an independent, New York-based lawyer who works with Zenni as outside general counsel and has known him since the early '90s.

A series of missteps culminating in a bond-trading scandal in 1994 brought down Kidder Peabody, which was sold to PaineWebber Inc. Zenni, who long harbored a desire to focus on principal investing, took his cue to spin out his group.

Those familiar with Zenni say Black Diamond showcased his business judgment, people skills and management strengths, particularly when the firm would play tough on financing terms. "He has a terrific capacity for understanding human psychology, and that allows him to take advantage of distressed situations without taking advantage of the people involved," says Auerbach. "He is also an extremely unpretentious and unassuming person who approaches people with tremendous respect."

Black Diamond's private equity BDCM Opportunity Fund LP, which raised $416 million from high-net-worth individuals and institutional investors in 2003, boasts a 2.2 times return multiple on realized and unrealized investments, or a 43% internal rate of return.

What of the mortgage industry's current woes and this summer's credit market turbulence? "I've seen this movie before," says Zenni. "It's the same story today, where home equity loans were based on appraisals without a lot of integrity or were based on fraud." He says, though, that the excesses in the current debt markets "were a lot worse."

Given his points of reference, Zenni is convinced that the fallout could be immense.

"There are differences in opinion on this, but I think if you look at the commercial and residential real estate, it's very much like it was back in the early '90s, when you had very high defaults on both coasts." He foresees high default rates in states like Arizona, Florida, Nevada and parts of California. "I think there'll be opportunities for us to buy debt of companies directly in the space or with indirect exposure to both commercial and residential real estate."

He deftly poses some data points: "The universe of large, syndicated leveraged loans stands at about $1.4 trillion outstanding, and there's about $900 billion of high yield," he says. "You've seen leverage multiples go up; you've got the largest number of companies with leveraged balance sheets than ever before with the highest amount of leverage than ever before, a scenario that almost approaches the LBO mania of the late '80s," he adds.

"Yes, there's still liquidity, which is why credit markets snapped back quicker than I thought, to my chagrin," he says. But amid the universe of companies that are saddled with enormous debt, he believes the magnitude of potential defaults is "pretty substantial."

Even if the economy muddles along on a no-growth-rate basis, he says, "you'll still see companies—particularly those with hard exposure to consumer businesses—get into trouble because they have such high leverage on their balance sheets."

Zenni, who is married, spends a lot of time on the road, a task made easier by being in Chicago, he says. Being in the Midwest has other advantages, he says, with a nod to the summer's events. "I've seen enough examples where folks get caught up in their own stories," he says. "Frankly, I like being out of mainstream Wall Street because I think you can keep your head a lot clearer when you're not inside the storm."

Spoken like a true Midwesterner. ■



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