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OPPORTUNITY AND RISK: UNCOVERING AND WINNING THE DISTRESSED DEAL

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SECOND EDITION: PART 1

“There aren’t many deals out there and if my clients are going to commit the time, they want to know that they are going to win. The trends that we are experiencing in distressed investing strategy today clearly reflect this ‘no holds barred’ approach to turnaround dealmaking.”

**- Nancy Peterman, Chair of the Chicago
Business Reorganization & Financial
Restructuring Practice, Greenberg Traurig**



INTRODUCTION

Drawing on the experience and expertise of the “best in class” dealmakers, The M&A Advisor, together with the leading provider of virtual deal management services, Merrill DataSite®, publishes the quintessential dealmakers guide series - ***The Best Practices of The Best M&A Dealmakers***. Profiling the proven strategies and unique experiences of the leading M&A practitioners, *The Best Practices of The Best M&A Dealmakers* series is distributed in regular installments for M&A industry professionals in both print and interactive electronic media. Previously published features and chapters are also available in the online library of Merrill DataSite and The M&A Advisor. We are pleased to present “**Opportunity and Risk: Uncovering and Winning the Distressed Deal**,” which discusses best practices for buyers of distressed companies or its assets. Focused on best practices from both the buyer’s and seller’s perspective, this installment features candid interviews with leading practitioners and analysis of the most current trends in restructuring and reorganization.



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Opportunity and Risk: Uncovering and Winning the Distressed Deal

Introduction

Are today's distressed investors encountering a different set of opportunities and risks in the M&A deal market? Certainly, deal flow continues to be slow as distressed companies take advantage of excess liquidity and lower interest rates to solve their problems. Some deal experts would contend that this climate of excess liquidity has resulted in a tight deal market, in which a handful of viable targets are attracting creative negotiating and multiple bidders.

However, not all dealmakers subscribe to this opinion. According to Bill Repko, a leading expert in the Restructuring world and Co-Founder of the Evercore Partners' Restructuring and Debt Advisory Group, we may be experiencing a tighter deal flow for some of the right reasons. "There is no question that 'amend and extend' and the ability to refinance ahead of impending maturities is a factor, but I don't think it's the governor of what is going on," he said, "I think we're in a recovery, even though people don't like the fact that we're growing slowly and unemployment is still high. The fact of the matter is we had a "near death" experience. The recovery period is going to be long, but I think it's on track."

That's the good news – we're heading back to a better state of financial health. Nonetheless, investors are finding that good opportunities are hard to come by. So where should distressed investors look for potential targets? One approach is to focus on industries in distress; another is to identify specific operational challenges that are forcing companies to reorganize. Yet another is to monitor negative cash flow and other financial signals.

In previous chapters, we provided an overview of the best practices employed by the best distressed dealmakers to identify target opportunities.¹ As a follow up, in this chapter, we'll focus on the characteristics of the current distressed M&A market and how leading dealmakers² are identifying value. On the following pages, you'll find insights into the following areas:

- I. Uncovering the Opportunities in Today's Environment
- II. Challenges for Buyers and Sellers
- III. Creative Approaches to Ensure Winning the Deal
- IV. A View Ahead

1. See "Part 5: Special Feature on Distressed Investing, Restructuring & Turnarounds," Best Practices of the Best Dealmakers, Merrill DataSite® and The M&A Advisor, 2013.

2. Many of the observations found here were also shared by dealmaking experts and recorded live at a recent M&A Advisor Distressed Investing Summit held in Palm Beach, Florida. For more information, please contact M&A Advisor.

Today's distressed investors have to dig deeper to find potential targets

I. Uncovering Distressed and Turnaround Opportunities

Focus on Industry

Certainly, many companies have been able to avoid restructuring through access to cheap capital, a trend that definitely has impacted the pipeline of restructuring opportunities available to buyers. As a result, today's distressed investors have to dig deeper to find potential targets. One strategy is to focus on declining industries. According to IBISWorld, the world's largest independent publisher of U.S. industry research, an industry is "dying" if fits three of the five following criteria:

- The sector is growing slower than the GDP.
- There is a slow decline in the number of industry players. M&A activity has slowed and there are no new entrants entering the market.
- The product has become stagnant; there are no new product or service developments.
- There are no new technological changes. There is no R&D money being invested to advance the product through technology.
- There are no new consumer markets or demographic groups being targeted and there is a drop-off in their current markets.

Based on these criteria, IBIS World's analysis yielded the following industries in decline:

- Printing and paper products
- Lawn and garden products
- Family recreation centers
- Consumer and trade product manufacturing
- Apparel and fashion accessories manufacturing

So if you found a company that is a potential distressed investment, what can you do to help turn it around? Following are some strategies that have worked in identifying opportunities in such declining industries.

Realigning a Product Line in Decline

In some instances, investors have found success by identifying a company in a declining industry and transforming some of its assets to produce new products that will allow them to enter new markets. For example, Michael Fieldstone, a partner at private investment firm Aterian Investment Partners, has seen this strategy work well in the paper products industry.

“The demand for traditional printing and paper products may be in decline but the need for sanitary paper products has increased, particularly in Asian countries,” Fieldstone said, “We’ve seen some managers of plants make a capital expenditure investment to switch over some of the product mix and export more sanitary products to China and other Asian countries.” According to Fieldstone, these companies are capitalizing on the assets being on the ground in the U.S., and also on cheaper U.S. energy costs. “For example, natural gas, depending on where you are and what the conversion rates are, fell below \$3 last year and could be \$3 to \$4 this year,” he said, “In BTU, if you get the same natural gas in Japan, it’s above \$15.”

Finding Opportunities Where the Government is an Ally

The bankruptcy case of Manistique Paper highlights another potential angle. As the major employer in a remote regional area, when Manistique Paper began having problems, they became the community’s problems. As a result, the local government and community were motivated to work with investors to find a viable deal that served the interests of all parties. Noted Sharon Levine, a partner at business law firm Lowenstein Sandler LLP, “what we’ve seen is that when there are hard manufacturing assets in remote geographical areas in the U.S., there’s opportunity often at the price point the purchaser wants to pay because of the government subsidies.”

In these cases, there is an opportunity to garner financial support from the government if the deal creates jobs or contributes to the economic continuation of a specific area. “So for example, with Manistique, there was a lot of government involvement and government subsidies,” said Levine, “When it came to the exit financing, the acquirer actually bought the assets with very little money down because the debtor in possession (DIP) lender became the exit lender. However, they wanted to reduce their exposure, so the local government actually funded half of the facility.”

When an industry sector is dying or becoming weaker, people can become overly pessimistic about its prospects

Although this scenario highlights a troubled company in a declining industry, it may also be a good strategy in healthy sectors where companies are primary employers in remote geographical regions.

Looking Beyond the Pessimism

“Sometimes when an industry sector is dying or becoming weaker, people can become overly pessimistic about its prospects,” said Rob Kampfner, partner, Financial Restructuring and Insolvency Group for international law firm White & Case, “That’s what happened with Six Flags Entertainment Corporation.” However, by avoiding assumptions and digging deeper, value can be found in troubled companies.

According to Kampfner: “When Six Flags filed for Chapter 11, it had \$1.1 billion of senior bank debt. It had \$400 million of bonds at the operating company level and it had \$800 million of bonds at the parent level. The company came in with a prearranged plan of reorganization with their lenders that would basically wipe everyone out but the lenders and give the company to the lenders, based on an evaluation that took place right after Lehman and the Mexico SARS scare, a health scare that basically shut down Mexico, where one of the company’s parks was located. There was no revenue coming out of that park for that month, so they put in a low-ball valuation, and tried to squeeze everyone out and convince the bankruptcy court that there was literally no value in this company.

The bondholders at both levels immediately smelled a rat. The SFO bondholders attempted to basically take out the banks and take over the company. But our clients, the bondholders at the parent level, thought that even that wasn’t enough value and that we could, in essence, take out both the banks and the bondholders and add more value to the estate. So we ended up having a contested confirmation hearing. We raised \$1.2 billion of new debt to take out the old debt and we raised \$750 million in a rights offering. We had to fight management for the right to do that, but ultimately we were successful and today Six Flags is making money hand over fist and doing very, very well. The message there is sometimes people get too negative. If you have a vision and your constituencies are

ready to step up, there's a lot of opportunity, even in a dying industry.”

Identifying Troubled Companies with Good Brands

In many cases, a troubled manufacturer's brand may be of more interest to investors than its other assets. The unwinding of Hostess Brands, Inc. is an excellent example of the power of the brand. When the 82-year-old company filed for bankruptcy in January 2012, it cited \$982 million in assets and debt of \$1.43 billion. Experts painted a dismal picture of the company's valuation. However, the company's ability to monetize its brand has yielded surprising results. With 30 brands, 36 plants and various other assets, the bankruptcy has attracted multiple bidders who are interested in their iconic brands. According to Amy Edgy Ferber, partner at global law firm Jones Day, who is serving as debtor's counsel for Hostess, “There has been so much interest that the company's liquidation value may now be as much as twice what we actually thought at the onset of the case.”



Amy Edgy Ferber
Partner, Jones Day

Hostess is one of many examples where distressed investors have identified troubled companies with a powerful brand they can mine for value. Others, including the Sharper Image, Kodak and Polaroid have been acquired primarily for the potential value of the brand. Sharper Image, along with bankrupt brand names Linens 'n Things and Bombay, has been purchased by a partnership of two liquidators, Hilco in Toronto and Gordon Brothers in Boston, for about US\$175 million.³ The Sharper Image name is already on new merchandise that appears in Macy's, JCPenney and Bed Bath & Beyond. Linens 'n Things is selling through a website. Bombay is expected to become a line of furniture. The payback? Jamie Salter, former chief executive of Hilco, “predicted a billion dollars a year in sales for Sharper Image and Linens 'n Things in each of the next five years,” according to The New York Times.⁴

Sometimes, a brand that has lost its luster in one country may still offer significant value by attracting buyers from other parts of the world. For example, when Penthouse magazine filed for bankruptcy in the U.S., the company found little interest among local investors. However, the results were very different when international bidders entered the market, according to Levine, whose firm served as committee counsel for Penthouse. “At the beginning of that case, the bonds and the debt were trading at well below par, maybe even less than fifty cents on the dollar. A lot of people traded out,”

3. Amy Zipkin, “Brand Names Live After Stores Close,” The New York Times, 4/14/09.

4. Barry Silverstein, “After the Fall: What Really Happens to Bankrupt Brands,” www.brandchannel.com, 9/7/09.

For companies in distress, establishing the brand's value to potential bidders can be extremely challenging

she said. “However, at the end of the day, the Penthouse name was sold to a website in China, and the return to creditors was 100 cents on the dollar plus interest.

However, arriving at a good valuation is far from easy, and rarely do the numbers work out as in the case of Penthouse. For companies in distress, establishing the brand's value to potential bidders can be extremely challenging. Indeed, most brand-valuation models are based largely on forecasting future cash flows based primarily on the brand's current value. As a result, these methods tend to underestimate potential value by repositioning and extending stale and mismanaged brands.⁵

Business leaders who have a good understanding of the strength of their brand are in a much better position to use that strength to navigate the company to a more stable position. Readers Digest, for example, has built the staying power of its brand into its strategy to file Chapter 11 bankruptcy to reduce its debt load. As a recent Bloomberg article noted, “Exploiting Reader's Digest's iconic brand is the latest strategy for its private equity owners, who put the 91-year-old publisher into bankruptcy to shed \$465 million in debt as consumers shift to electronic media.” While acknowledging the transformation of print media to digital media, the company's messaging is focused on its position as a strong brand that has value now and in the future. Bankruptcy, as this point, is simply a vehicle to shed debt and accelerate their transformation.

It is likely that brand equity will continue to rise in the estimation of distressed investors. As brand consultant Barry Silverstein noted, “In times past, a bankrupt brand might have been abandoned. But today, bankrupt brands represent a new business opportunity for companies to acquire a well-known name for below-market value and revive it. With the expense of launching a new brand, it may in fact be cheaper to keep a bankrupt brand going, as long as it can remain viable, fresh and current.”⁶

5. Alexander Chernev, “How Much is a Twinkie Worth?” Bloomberg Businessweek, 12/6/12. <http://www.businessweek.com/articles/2012-12-06/how-much-is-a-twinkie-worth>

6. Timothy John Carter and James F. Wallack, “Buying Brands Out of Bankruptcy,” www.retailadadvisor.com, 4/4/12.

Other Areas of Opportunity

Of course, deal experts point to companies across all industry sectors in the middle market as an important source of potential opportunities. This is because, for many public and privately held companies in this group, access to capital from traditional lenders remains out of reach. As a result, many companies are taking the steps to sell assets and restructure operations and debt in order to avoid a court-mandated sale at a later date. To gain a sense of where potential targets may emerge, many investors look for signs of negative cash flow and leverage signals, according to report by Schulte Roth & Zabel.

According to the report, which was based on feedback from private equity practitioners and hedge fund investors, “Respondents overwhelmingly use negative cash flow as their main indicator that a company or asset is distressed; 51 percent also use leverage signals. The two indicate a company is unable (or nearly unable) to make regular debt payments or refinance approaching maturities, which are highly likely to trigger distressed sales.”⁷

Additionally, deal experts point to several industries that are not necessarily in decline but are facing challenges in moving forward. In the Schulte, Roth & Zabel survey, energy, and industrials and chemicals were the top two sectors respondents identified as offering the best opportunities for distressed acquisitions both within and outside the U.S. Additional sectors were cited by other deal experts.

For example, Durc Savini, managing director and head of the restructuring and recapitalization group for investment banking advisory firm Peter J. Solomon Company, identified three additional sectors. “Having looked closely at the composition to debt out there by industry sector and then by rating, it’s clear that the most risk resides in three sectors – media and entertainment, technology and healthcare,” he said, “For these entire sectors, when you look at the average rating of debt issue and debt outstanding, and whether or not they’re on credit watch for downgrade, these sectors over-express in terms of high risk. As a result, these companies may be forced to sell non-core assets or ultimately go through a sale of the company in its entirety.” In Savini’s view, these are the sectors for investors to focus on.



Durc Savini, Managing Director,
Peter J. Solomon Company

7. Noam Noked, “2012 Distressed Investing M&A Report,” Harvard Law School Forum on Corporate Governance and Financial Regulation, posted 1/10/2013.

There's not a lot of time in bankruptcy anymore for any kind of operational restructuring or the fixing of business problems

II. Challenges For Sellers and Buyers

Numerous dealmakers concur that in today's market, it's not unusual for multiple investors to be bidding on the same asset. This can represent both opportunities and risks for both buyers and sellers. Following are some areas of consideration:

Dealing with Unfamiliar Investors

Experienced dealmakers are well versed at researching potential bidders' behaviors and they do their homework to understand bidders' behavior on previous transactions. This information is part of the decision making process in determining who wins the deal. However, with the influx of international investors from emerging countries into the U.S. distressed market, sellers need to do all they can to vet unknown bidders. Otherwise, they may find themselves dealing with unforeseen actions that can have long-term consequences. Noted Nancy Peterman, shareholder and chair of the Chicago Business Reorganization & Financial Restructuring Practice for law firm Greenberg Traurig, "This past year we had a Chinese-based buyer win the deal and then renege. Trying to actually enforce the sale to get it done or recover some damages, because it did cause severe damage to the price on a go-forward basis, was next to impossible."

One best practice for sellers when encountering unknown international buyers is to seek advice from an advisory service with proven experience and vetted contacts in the buyer's native locale. This approach should help sellers gain intelligence on unknown parties.

Dealing with Compressed Bankruptcy Timeframes

Another challenge, particularly for companies in distress, lies in working in an increasingly compressed time frame that is becoming the norm in bankruptcy filings. The Chapter 11 bankruptcy process may have been intended as a means to allow troubled companies to solve their operational and financial problems, but the process has changed considerably since its inception. Bankruptcy code amendments made in 2005 have yielded a process that allows for little time in court to help the debtor identify ways to solve its problems.

“The trend now is toward having a deal worked out with most of the creditors beforehand, then filing bankruptcy to implement the solution,” said Kathryn Coleman, Partner at law firm Hughes Hubbard and Reed, “There’s not a lot of time in bankruptcy anymore for any kind of operational restructuring or the fixing of business problems. It’s really becoming more of a tool to fix financial problems such as too much debt or maybe some unfavorable contracts with labor. Those kinds of things are being dealt with first, before the filing.”



Kathryn Coleman, Partner,
Hughes Hubbard and Reed, LLP

“The problem with that, in my view as a company-side lawyer,” she continued, “is that quite often the lenders are dictating every item in the case, and there is no room for creativity or flexibility or for value to rise on it is own. The value is determined largely by the creditors at the beginning of the case, and then hacked up in accordance with the way bankruptcy law works, which is secured creditors first, then unsecured creditors and then finally if there is anything left, back to old equity.”

Peter Kaufman, co-founder and president of investment bank and financial advisory firm the Gordian Group, believes that parties are too reliant on the standard strategy of simply allocating value along the value waterfall rather than finding ways to allocate value for those beyond it. “There are a lot of creative strategies that can be employed if you are interested in doing something ‘out of the box,’” he said. “One thing you want to do is try and get liquidity; if you’re the debtor and interested in old equity, you want to try to get sufficient liquidity to be able a fight a vigorous fight in Chapter 11. You also want to be prepared to go to the creditors with ‘carrots’ in addition to ‘sticks.’ That is something that we at Gordian love to do. We are a lot more comfortable if our clients’ needs dictate coming up with sticks as well as carrots to get creditors to do what our client wants.”

It's more important than ever to focus on identifying the potential financial and legal risks relating to fraudulent activities in any target

DEAL NOTES

Creative Thinking Yields Stellar Results for a Distressed Company and Old Equity

Troubled companies can be pulled back from the edge even in the most dire situations when creative thinking prevails, as this case study shared by Peter Kaufman of the Gordian Group illustrates:

“Ramsey Industries, a portfolio company of Gridiron Capital, found itself in a downward spiral as a result of the 2008 economic downturn. The company could no longer support its debt load of \$100 million as revenues fell from \$100 million in 2007 to \$50 million in 2009, and EBITDA fell from \$20 million in 2007 to nearly zero in 2009.

Ramsey was in default under its senior secured and subordinated debt facilities. We were called in by the company’s private equity sponsor (“Old Equity”) to help negotiate with lenders on behalf of the private equity firm. Our challenge was how to affect a meaningful recovery for Old Equity. For starters, we needed to get Old Equity a meaningful seat at the table notwithstanding that Old Equity was way out of the money at that juncture. The situation was further complicated by the fact that Old Equity was not in a position to make a new capital contribution.

We were dealing with a situation where negotiating parties couldn’t be farther apart in their desired goals. To get the results we wanted, we knew we had to convince the lenders that our desired outcome was also in their best interests. We achieved this by laying out several alternative credible strategies (aka, the “sticks”) that, were we to implement them, would be even less beneficial to them. By applying some creative tactics, we were able to create a meaningful seat at the table for the sponsor.

We were thus thereafter able to help negotiate a transaction on behalf of Old Equity that included a 50 percent reduction in total debt from \$100 million to \$50 million. Old Equity received 5 percent outright of the reorganized Company’s equity and equity allocations to Old Equity once the banks receive a full recovery on their restructured \$50 million principal amount. Based on very achievable valuation levels, Old Equity could claw back to 34 percent of the Company’s equity. As a result of certain rights provided to the sponsor in the restructuring, it was able to reacquire a controlling equity stake within two years of closing at very advantageous pricing, positioning itself to reap the benefits of the Company’s strong performance.”

Risks and Ramifications Related to Fraud

For buyers, it's more important than ever to focus on identifying the potential financial and legal risks relating to fraudulent activities in any target they are considering. Additionally, as businesses become more global in terms of adding international suppliers and customers, investors need to be aware of the penalties related to cross-border targets. Under the Foreign Corrupt Practices Act (FCPA), which is enforced by the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), an acquiring company may be held liable for any prior unlawful payments made by the acquired company.⁸ Both the buyer and the acquired target will be held liable for their conduct.

One common misconception is that FCPA investigations are limited to large, publicly held companies trading stock on a U.S. Stock Exchange. In reality, any publicly held or private company of any size is potentially at risk for FCPA violations. Another misconception is that companies, not individuals, are prosecuted. In fact, corporate executives, officers, business partners and sales agents, as well as other key individuals such as board members, directors and shareholders can be prosecuted and face severe civil and criminal charges. In recent years, cases involving individuals made up more than 60 percent of the investigations.⁹

The potential for fraud is high in troubled companies, as they are often operating in an environment that is ripe for poor decisions. "You have to bear in mind, these are often activities borne out of desperation as the company is going through a downward spiral," said Thomas D. Hays, III, CTP, founding principal of turnaround management firm NHB Advisors, Inc., "You end up seeing a lot of good people doing a lot of bad things as they are trying to save the company and protect jobs."

According to Christopher L. Picone, President of turnaround advisory firm Picone Advisory Group, LLC, irregularities are occurring (or at least being discovered) more frequently these days. "We are seeing a higher occurrence of negligence/fraud in distress situations. These irregularities generally show up as failures to disclose certain items, overvaluations, undervaluations, the need to restate financial statements, etc.," he said, "In your due diligence process, you really have to look beyond the company's financial statements as they are presented to you, because you can't always depend on the integrity of the financial statements."

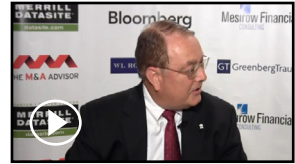
⁸ David S Krakoff, James T. Parkinson and Kristy L. Balsanek, "Foreign Corrupt Practices Act: FCPA Due Diligence in the Context of Mergers and Acquisitions," *Bloomberg Corporate Law Journal* (2009): 1.

⁹ "Foreign Corrupt Practices Act: Four Practical Steps to Minimizing FCPA Risk in Cross-Border M&A," Merrill Corporation.

A company that can't control its own labor costs because of a union is likely going to be penalized and may have to be restructured

Additionally, a Certified Turnaround Professional can detect areas of potential fraud and take steps to address the situation before the asset is put up for sale. While turnaround professionals are trained to evaluate operations to identify issues, noted Hays, sometimes they are also encountered in routine business. Regardless of the timing of the discovery, it has to be dealt with swiftly and decisively. In one situation, he noted:

“I had just taken over as CEO and was signing checks, when I came across a check for \$30,000 written to a company I didn't recognize. When I probed deeper into the matter, it ultimately turned out to be a kickback to the president of a vendor, funneled via check to his private company. This came to light at the very worst time, when we were trying to save this company. We immediately had to take steps to isolate the individual, do background work to make sure no other payments had gone out, and clean up the process before we could move ahead.”



Thomas D. Hays, III,
Founding Principal,
NHB Advisors, Inc.

Buyers would do well to augment their due diligence efforts with experts like Hays and Picone, who as certified turnaround experts are sensitive to identify red flags. Knowing the risks upfront can prevent tremendous legal and financial consequences downstream. “Financial irregularities tend to impact earnings,” Picone said, “If a purchase price has been set based on a multiple of EBITDA or another earnings-based formula, and financial irregularities are discovered that result in an overstatement of EBITDA or earnings, the buyer will potentially be paying too much.”

Complications Related to Labor Management Issues

Labor management issues are also becoming a growing challenge for companies dealing with tight margins and the rising cost of labor. Indeed, for Hostess Brands, failed negotiations between the company and its labor unions have been blamed for the company's bankruptcy filing. Companies and unions are at a crossroads in which the cost of maintaining traditional contracts and an employer's ability to support them are at odds. Businesses that cannot

bridge this growing gap face hard decisions that may include selling of assets, bankruptcy or the sale of the entire company.

“In today’s world, a company that can’t control its own labor costs because of a union is likely going to be penalized and may have to be restructured,” said Larry Lattig, President of advisory firm Mesirow Financial Consulting, “In dealing with that, you also have to realize that you have another party at the table. You don’t have just lenders, unsecured creditors, federal regulations or whatever caused your bankruptcy. What you really have is another agenda out there by people that are counting on your firm for their income.”



Larry Lattig, President,
Mesirow Financial Consulting, LLC

Lattig, however, has seen a major shift in the way labor issues are being worked out. “In negotiating with unions or discussing their bargaining agreement, one of the major changes I’ve seen is the reality that ‘we are going to have to make some concessions here and we’re going to have to figure this out before we get to court,’” he said.

Although labor management issues are often complicated, in some cases both parties’ objectives can be satisfactorily met. For example, according to Kaufman of the Gordian Group, in the case of the American Airlines bankruptcy, the Transport Workers Union (TWU) was able to build a better case for itself by taking an “out of the box” approach in negotiations. “We encouraged the union to negotiate with American on a new deal instead of letting it go to the judge to decide in an 1113 hearing whether their contract should be thrown out,” he said, “We also suggested the union should simultaneously negotiate with other potential acquirers, including US Air, to try and play them off each other and create a spirit of competition and try to elevate their status in the case maybe beyond where it by all rights should have been. That’s worked out really well for them.” Ultimately the airline and the union came to an agreement, jobs were retained, and the union has representation in what is now the largest airline in the world.

Joe Geraghty, senior managing director for advisory firm Conway MacKenzie, has seen negotiations take a positive direction when certain best practices are followed. “From our point of view, the union is a constituent and you need to negotiate with them on the front end,” Geraghty said, “From a best practices standpoint, you achieve the greatest success when you recognize them, of

Bidders must be mindful that they don't cross the line into collusion that keeps the price down

course, and get them into the process early. The second critical factor is to be able sit down with them and determine what the real essentials are.”

To work effectively with unions, Geraghty also recommends avoiding negotiations that lead off focusing on the price of labor. “If you start off by telling union they need a 20 percent reduction in price to remain viable – that’s not going to work,” he said, “I think the more practical and successful approach is to shift the focus from the price of labor to the volume of labor. For example, maybe you can modify collective bargaining agreement in areas such as work rules that don’t optimize productivity. If you have an interested buyer who is willing to work with the union and modify the collective bargaining agreement based on work volume instead of price, I think you can have some success.”

Based on their experiences, both Lattig and Geraghty believe that some unions are becoming somewhat more pragmatic, with the focus in on maintaining jobs.

III. Creative Approaches to Winning the Deal

Today’s buyers are often competing with multiple bidders who are becoming more and more creative in their offers. “We’re seeing a lot of different and unique ideas to try to win the deal all because of the fact that there’s not much out there to buy,” said Peterman, “All of these trends that we’re seeing are really ways for distressed investors to try to figure out, ‘Where am I going to best put myself in a position to actually win that deal?’ Because there aren’t many deals out there and if they’re going to spend the time, they want to know they’ll come out with that deal.”



Nancy Peterman
Shareholder, Greenberg Traurig

Peterman went on to explain how creative the bidding became in a successful 363 sale, on which she was working on the company side: “We had four bidders show up for our auction – a stalking horse plus three. We had a strategic bidder that everyone was speculating was going to show up at that auction and it was kind of driving the private equity fund interest away. One

fund's approach was to offer benefits of intangible value: things like guaranteed jobs for the employees at one for six months and another plant for three months, and guaranteed contracts with critical vendors for three months. These were all sorts of things that the strategic bidder was not sophisticated enough to react to in the auction. The strategic bid was higher but we actually went with a lower value bid because of all these intangibles that were important to the company and the community. We got the judge to approve it.”

Other experts such as Albert Kass, Vice President of Corporate Restructuring at Kurtzman Carson Consultants, noted other trends. “We’re seeing a prevalence of 363 sale cases, the ‘GM model’ where you’re quickly taking the good piece of the company and selling it to some new entity, and the restructuring really comes out of the pot of money that’s after it,” he said, “For the investor, it’s really about getting that good piece sold and out of the restructuring as soon as possible.”

His firm is also seeing a fair amount of debtor in possession (DIP) financing that actually has dates itself included in the documentation. “In other words, it will specify that ‘by 30 days you have to have your plan on place and 60 days you have to have this done,’” he said, “Whether it’s an interest rate bump or they can pull the financing all together, it really makes for a fast-track Chapter 11. It gives the investors a little more surety as to what’s going to go on.”

Kass is also seeing a fair number of exchange offers with a pre-pack option, which is basically asking the debt holders to swap that for equity,” he said, “However, if you don’t get enough of that percentage up front, you’re also asking them to vote on a pre-packaged Chapter 11. Again, it gets everybody kind of moving towards the end even before you start the filing. We’re seeing a larger number of faster Chapter 11s.”

The Place for Consortiums

Buyers of distressed assets have also employed the power of consortium bidding to their advantage, a trend that dealmakers expect to continue. According to Steve Shimshak, Partner at law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP, “Over the last two years we have seen two very significant examples of consortium bidding in the sale of intellectual property, involving the sale of patents.” In effect, the group of bidders comes together and forms an entity that will acquire the assets. The risk, of course, that bidders must be mindful of is that they don’t cross the line into collusion that keeps the price down.

For restructuring activity to pick up in the U.S., the turning point will occur when the Federal Reserve Bank eventually raises interest rates

Shimshak has seen consortiums result in a win-win for both buyers and sellers. “For example, in the Nortel situation, Nortel knew who was going to be coming to that auction and was fully aware of the coalescence of the consortium,” he said, “They actually encouraged it, because they were going to have a complement of four bidders, each with the economic power to potentially win the auction.”



Steve Shimshak, Partner,
Paul, Weiss, Rifkind, Wharton &
Garrison LLP

He continued, “As it turned out, as the auction was ongoing, the bidding got to the level that two consortiums ended up being formed. Intel and Google combined with each other, and Apple and Rock Star combined with each other. It took the bidding to five times the level that had been in the original stalking horse bid. So one would say, ‘Risk of collusion? What risk?’ You ended up with a tremendous auction result.”

IV. The View Ahead – Summary

Deal flow may seem slow, but according to some of the industry’s most experienced experts, it is moving well, as it should be in a recovery. Most dealmakers expect activity levels in the U.S. and in Europe to remain sluggish for the foreseeable future. But this may be, as Bill Repko and other veterans of the restructuring industry point out, the result of a U.S. economic recovery in progress.

“People are talking about a return to the levels of excess that lead to the financial crisis, but I am not sure that is true,” said Bill Repko, “The statistics are pretty good – leverage is pretty reasonable, interest coverage is also pretty reasonable and we’re seeing the fundamental returns of solid investment vehicles like CLOs. There is a lot of activity; the rates are very attractive and people are rushing to do refis, but right now, I don’t see people making stupid loans.”

For restructuring activity to pick up in the U.S., the turning point will occur when the Federal Reserve Bank eventually raises interest rates. On the

European front, activity will be very limited until the banks holding most of the distressed assets begin to sell them off.

Nonetheless, the U.S. market will continue to gain the attention of investors at home and abroad as they seek investments for more aggressive growth. For distressed investors, the best practice seems to be to focus even more closely on fundamentals in researching, identifying and evaluating distressed targets. Equally important, buyers need to be well prepared to compete with multiple bidders and strike creative deals in order to secure their target.

DEAL NOTES

Outlook for Distressed Investing in Europe

Last year proved to be a slower year than predicted in terms of distressed M&A activity in the European Union, but opportunities may be on the horizon according to experts who have worked extensively in Europe. Part of the reason for low deal activity may be related to dealing with multiple bankruptcy processes in multiple countries.

As Dennis Shaughnessy, Chairman of global consulting firm FTI Consulting, noted, “Everything’s a little different in the European Union compared to the U.S. Of course, you’re dealing with multiple countries, but you’re also dealing with about ten banks that hold the bulk of the assets that are distressed.” He added, “The first steps they’ve been taking is to try to restructure in their own portfolios the character of the credits. Remember, most of these banks were founded as merchants banks, so they’re used to owning shares in the companies they lend to.”

Given these circumstances, it’s not surprising that these banks have tried to forestall the reality of accepting lower valuations to shed non-performing assets. However, Shaughnessy and other dealmakers see more opportunity for distressed investor in the coming year, based on changes that have taken place over that past 12 to 18 months.

Positive Changes in the Bankruptcy Process

Several EU countries have taken steps to modify their bankruptcy laws in ways that should somewhat simplify the process for distressed companies and buyers of their assets. According to Corinne Ball, Partner and Co-Head of the Global Business Restructuring and Reorganization Practice, for Jones Day, both Germany and the UK have made positive steps that should help to remove bottlenecks in the process. Ball, who spends half her time in in Europe, noted, “The good news is that the legal and advisory framework has changed a lot in the past 18 months and continues to change; it’s beginning to look more and more like Chapter 11.”



Corinne Ball
Partner, Jones Day

Changes in Germany in particular are already having an impact on activity. “Until last April, you couldn’t convert debt to equity. Trustees were appointed by courts. Now, trustees are selected by the creditors,” she said, “We’ve actually done our first pre-packaged, self-administration case in Germany; we were able to get an exterior case in and out in 60 days.” Ball also noted that her firm is seeing more Chapter 11 like moves in the UK, which has attracted companies from countries like Spain and Europe to complete their restructuring in in the UK.

U.S. Investors Getting a Warmer Welcome

Experts have also noted that the EU investing community is more open to U.S. and other foreign investment than in past years. Several factors have helped this change come about. From a purely financial perspective, the banks are looking to outside capital sources to fund restructurings. “Traditionally if you go back three, four, five years, the European banks were willing to do their own restructuring and fund their own issues,” said Scott Edwards, Managing Director of private equity firm Sun Capital Partners, “What we’re seeing now in the last year and looking forward is that due to the capital requirements being imposed on banks across the EU, they’re less willing to fund. Therein lies the opportunity.”

Another reason EU banks may be more amenable to outside sponsors is that it gives them an effective means to deal management issues, often a sensitive aspect of restructuring in European countries. “We just put together a \$4.5 billion deal involving two banks that held all the paper,” said Shaughnessy, “They were looking for another source of sponsor capital. Also, they didn’t want to get rid of the management – they were looking to the sponsor to come in and do that. There is a great reluctance on the part of European banks to try to move management out.”

Part of their reticence may be due to business reasons and cultural reasons, but it may also be due to legal restrictions. “In some EU countries, the banks are prohibited from interfering with management and appearing to be in control,” said Rene-Pierre Azria, President and CEO of advisory firm Tegriss Advisors, “That’s why the banks have generally moved completely on the side of being passive until the companies have no way other than filing for what used to be bankruptcy, and more and more now, thank goodness, is something akin to our insolvency proceedings here in the U.S.”

Best Practices for Distressed Investors

While dealmakers Ball and Shaughnessy see opportunity for distressed investors in Europe, they also warn investors to do their research before they enter the market. “Many distressed investors this past year were burned terribly because they did not understand that in the UK, the insolvency practitioner (IP) is the arbitrator of good taste – the judge, jury and the executioner,” said Ball, “So even if you thought you bought the Fulcrum security, in an English situation there is no valuation of hearing; there’s very little notice; you don’t know what the testing is for a sale. Inexperienced U.S. investors did not do well in British insolvencies because they kept thinking they would have an opportunity for valuation or new money or bidding. It just doesn’t work that way.”

Edwards noted that his firm, Sun Capital, has had some successful investments in the UK by buying right before administration.¹⁰ By investing the time to understand how distress and bankruptcies are handled by each country, they’ve been able to identify and win viable targets.

10. As a legal concept, administration is a procedure under the insolvency laws of a number of common law jurisdictions. It functions as a rescue mechanism for insolvent entities and allows them to carry on running their business. The process – an alternative to liquidation – is often known as going into administration. A company in administration is operated by the administrator (as interim chief executive) on behalf of the creditors as a going concern while options are sought short of liquidation. These options include recapitalising the business, selling the business to new owners, or demerging it into elements that can be sold and closing the remainder. Administration differs from receivership in that it is usually carried out by a judicial authority, whereas receivership is called in by the bank or creditors involved. http://en.wikipedia.org/wiki/Administration_%28law%29

Seek Advice – or Strong Partners

Expert dealmakers also advise any U.S. investor new to the EU distressed M&A market to avoid going it alone. One strategy is to engage a U.S. advisory firm with “feet on the ground” in the target’s country. Another is to partner with a European company that has the expertise necessary and investment objectives that are in alignment. When dealing with EU distress opportunities, investors need to understand each country’s unique operating rules and their relationship with the other EU countries. A European partner can be extremely helpful in dealing with these nuances. “Europe is a essentially a club,” noted Shaughnessy, “The interdependence, the codependency is so extreme that I do not think the countries can afford their self-interest to go too far from each other.” This should be kept in mind, combined with the fact that, ten major banks hold most of the distressed assets.

Focus on Tier I and Tier II Opportunities

Another piece of advice for EU distressed investors is not to focus on the large or high profile opportunities. In cases where the brand has global recognition, such as Peugeot, the government is likely to have a very definite opinion in the company’s future. Instead, more amenable deals may be found in the Tier I or Tier II suppliers who support such national brands. “I would drop my sights to the suppliers because it’s getting easier to negotiate those deals,” said Shaughnessy, “Also, this group is not finding a willing lending group via the usual channels, so outside liquidity is going to be able to cut a pretty good deal.”

Be Patient

While deal experts are see positive change in the way that restructuring and bankruptcies are being handled by countries in the EU, they are also quick to remind investors to be patient. As noted by Corinne Ball and Rene-Pierre Azria, European countries are making positive changes in their bankruptcy and restructuring procedures, which are being influenced by U.S. distress practitioners. Eventually, they hope to see the emerging policies align more closely with U.S. bankruptcy processes. But the changes won’t take place overnight. In the meantime, smart investors are doing their research to identify good opportunities and strong partners.



CONTRIBUTOR BIOGRAPHIES





Rene-Pierre Azria is the President and Chief Executive Officer at Tegriss Advisors. Mr. Azria launched Tegriss LLC in January 2008. Prior to founding Tegriss, Mr. Azria was a Global Partner with Rothschild worldwide and headed the Telecom practice of Rothschild in the United States. Prior to joining Rothschild in 1996, Mr. Azria had founded Blackstone Indosuez in 1987 and managed it until 1996, and was during that period of time President of Financière Indosuez Inc. in New York. Prior to joining Banque Indosuez in New York in 1985, Mr. Azria had started his banking career with the bank in Tokyo, Japan in 1981. During over 30 years in Corporate Finance in North America, Asia, and Europe, Mr. Azria has enjoyed extensive advisory experience, generally in transactions of large size and a high degree of complexity. Mr. Azria is a generalist banker and speaks several languages. Mr. Azria holds an M.Sc. degree (magna cum laude) from Ecole des Hautes Etudes Commerciales (France), a Bachelor of Mathematics from University of Paris-Jussieu and an International Management Degree from London Business School and the Stern Graduate School of New York University.



Corinne Ball is a Partner and Co-Head of the Global Business Restructuring and Reorganization Practice at Jones Day. Corinne Ball has 30 years of experience in business finance and restructuring, with a focus on complex corporate reorganizations and distressed acquisitions, both court-supervised and extra judicial, including matters involving multijurisdictional and cross-border enterprises. She is co-head of the New York Office's Business Restructuring & Reorganization Practice. Corinne led a team of attorneys representing Chrysler LLC in connection with its successful chapter 11 reorganization, which won the Investment Dealers' Digest Deal of the Year award for 2009. She also led a team of attorneys in the successful restructuring of Dana Corp., which emerged from bankruptcy in 2008, and has orchestrated many other complex reorganizations involving companies such as Axcelis Technologies, Kaiser Aluminum, Oceans Casino Cruise Lines, Tarragon, and The Williams Communications Companies. In addition, she has counseled lenders and bondholders in the ABFS, Comdisco, Excite@Home, Exide SA, GST Communications, Iridium, Loews, NorthPoint Communications, Telergy, VARIG Airlines, and Worldcom restructurings, among others. Corinne also has advised on loans, acquisitions, and workouts involving professional sports franchises, including the Charlotte Bobcats, the Detroit Redwings, the Minnesota Wild, the New Jersey Devils, and the Phoenix Coyotes. Corinne leads the Firm's distressed M&A efforts and is the featured "Distress M&A" columnist for the New York Law Journal. Corinne won the Turnaround Management Association's "International Turnaround Company of the Year" Award and was named "Dealmaker of the Year" by The American Lawyer and one of "The Decade's Most Influential Lawyers" by The National Law Journal. She is a director of the American College of Bankruptcy and the American Bankruptcy Institute.



Kathryn A. (Katie) Coleman is a Partner in Hughes, Hubbard & Reed's New York office, is a member of the Corporate Reorganization Group, and has over 25 years' experience representing companies restructuring their financial affairs, both in and out of court. Ms. Coleman has advised clients on, and litigated at the trial and appellate levels, the significant legal issues inherent in modern restructuring and financial practice, including contested plan confirmation, prepackaged plans, credit bidding, exclusivity, use of cash, debtor-in-possession financing, valuation, adequate protection of security interests, and cash collateral usage. Ms. Coleman frequently speaks on bankruptcy law and distressed investing, participating in programs sponsored by Practising Law Institute, the American Bankruptcy Institute, California Continuing Education of the Bar, the American Bar Association, the Pacific Bankruptcy Law Institute, the Western Mountains Bankruptcy Law Institute, and the Norton Bankruptcy Litigation Institute. Ms. Coleman graduated magna cum laude from Pomona College. She earned her J.D. from U.C. Berkeley's Boalt Hall School of Law.



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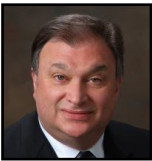
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Merrill DataSite is a secure virtual data room (VDR) solution that optimizes the due diligence process by providing a highly efficient and secure method for sharing key business information between multiple parties. Merrill DataSite provides unlimited access for users worldwide, as well as real-time activity reports, site-wide search at the document level, enhanced communications through the Q&A feature and superior project management service - all of which help reduce transaction time and expense. Merrill DataSite's multilingual support staff is available from anywhere in the world, 24/7, and can have your VDR up and running with thousands of pages loaded within 24 hours or less.

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