

ts insights

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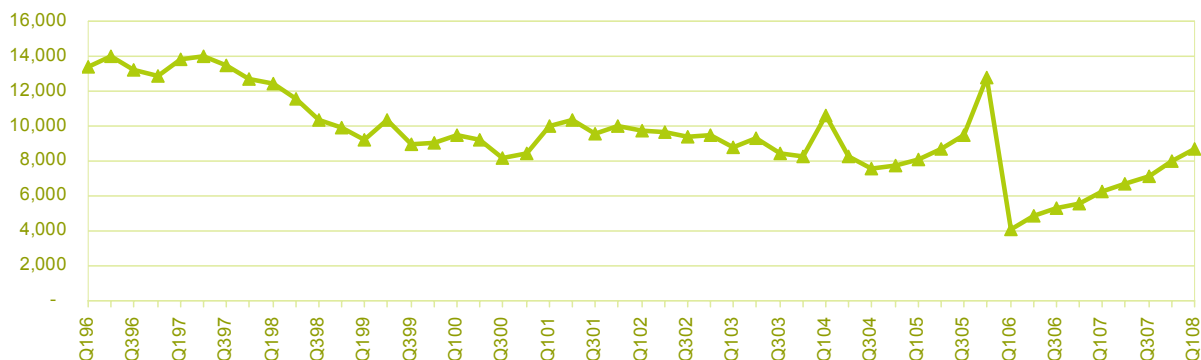
Investing in distressed: Not for all

TODAY'S MARKET: PANIC OR OPPORTUNITY?

From retail to consumer cyclical to restaurants to automotive to financial services, the number of business restructuring announcements has increased. Stock prices have plummeted. Margins are being squeezed. The signs are all around us: excess leverage, operating losses, weak management and strategy or operations not built for a downturn. Now may be the right time for investing in distressed. Seizing the opportunity are private equity firms that have raised new funds focusing on distressed investing. For example, Bayside Capital, an affiliate of H.I.G. Capital, recently closed its second distressed fund at \$3.0 billion and Apollo received \$2.3 billion from Calpers for distressed investments, while Centerbridge Capital Partners, L.P. was founded over a year ago to invest in both up and down cycles.

In the first nine months of 2008, we have witnessed a number of high profile retail and financial services bankruptcies. During the first quarter of 2008, US business bankruptcies were up 38.7 percent from the same period last year, and it was the highest quarterly filing since the fourth quarter of 2005 (*U.S. Courts*). Typically, reduced high yield issuances are a leading indicator of restructurings and bankruptcies. According to *Thomson Reuters*, for the first half of 2008, the number of US high yield corporate debt issuances decreased by 60.1 percent to 73 new issues totaling \$30.7 billion from 183 new issues aggregating \$95.0 billion. Moreover, high yield corporate default rates increased in the second quarter of 2008 to 2.4 percent from 1.8 percent in the first quarter (*Moody's Investors Service's July 8th report*). Several analysts feel this rate is artificially low given covenant light loans and could spike to six percent later in the year as such loans mature.

Quarterly US Business Bankruptcies



Source: uscourts.gov

There are several ways for astute investors to invest in distressed opportunities while helping to alleviate some of today's turmoil. Examples include: purchasing debts of distressed companies, providing financing to companies that lack bank options—perhaps utilizing a "loan-to-own" strategy, investing in private equity turnarounds and buying into section 363 (asset sale) bankruptcy pre-pack transactions to name a few. While these options offer significant opportunities for solid returns, the control positions offer higher rewards, albeit with potentially higher risks.

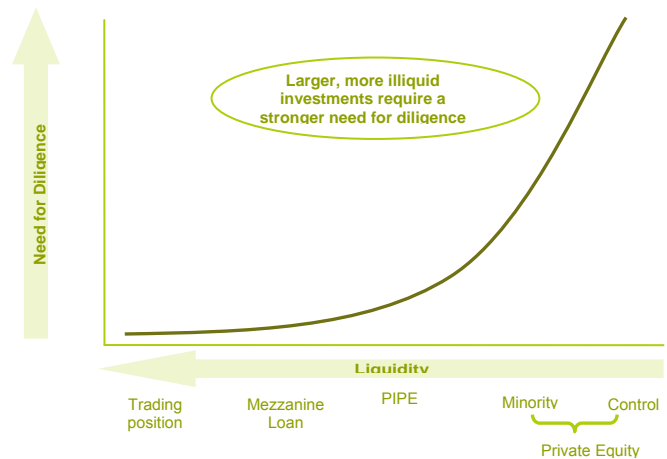
ONE CAN'T DABBLE IN DISTRESSED

When dealing with distressed, one cannot dabble. You are either in or out. Experienced players know the stakes are high and the level of return may hinge upon solving a multitude of a target's operational and strategic variables. Funding and liquidity constraints, financial reporting issues, high turnover and the lack of formal controls are often associated with distressed companies; therefore, interested players must have the proper turnaround talent, process and infrastructure to evaluate, plan and manage such investments. This is true even in section 363 bankruptcy pre-pack asset deals where acquirers are clear from most liabilities require thorough diligence. For example, when evaluating distressed deals in a bankruptcy, it is important to remember that in asset deals certain liabilities such as product liability and warranty can transfer to the buyer. Complexity also can arise from a human resources perspective, should the buyer wish to retain a majority of the seller's workforce or maintain the continuity of the business operations. In this situation, the buyer becomes a successor of the seller and is required to recognize the union and negotiate the terms of a new collective bargaining agreement.

Besides hidden liabilities, other bankruptcy specific matters include analysis of cure payments to the trade, stretched payables, and status of rejected contracts. With respect to distressed situations, important factors investors

need to consider include: liquidity, cash burn, supplier relations and terms, working capital management, customer relationships, debt covenants and ongoing concern issues, and subjective acceleration clauses in credit agreements.

DIFFERENT INVESTMENT STRUCTURES REQUIRE VARYING LEVELS OF DILIGENCE



As private equity firms make controlled illiquid investments, the greater the need for diligence to uncover hidden potentials and risks—especially when it comes to investing in distressed where the private equity acquirer takes control of the troubled company and restructures it. Thorough diligence may uncover additional liabilities, inefficiencies and potential opportunities which may influence the acquirer's turnaround plan.

As acquirers purchase controlling positions in targets or embark on a "loan-to-own" strategy, the more important it is for them to conduct a thorough diligence, which often yields surprises that need to be included in the turnaround plan. The teams and advisors conducting the diligence should have the requisite managerial, operational and industry skills to ascertain the quality of management, operations and company and industry specific positions in the business cycle. Understanding the operating and liquidity trends on a monthly basis is paramount in reviving the

troubled business. Experienced distressed investors conduct diligence that is as focused on identifying opportunities as it is on risks. By applying traditional "risk only" focused diligence to a distressed situation, inexperienced investors end up missing out on opportunities.

Seasoned investors seek out mismanaged companies with sound business strategy and/or unique offerings and identify hidden value through market analyses and operational improvement opportunities. In many instances, investors look for non-core assets that can provide liquidity and/or be managed more efficiently outside of the current ownership. Sometimes these are ancillary businesses that are part of a structure that is either too vertically or horizontally integrated. For example, a paper manufacturer may sell off its timberlands or a consumer goods company may sell off selected brands. Attaching a liquidation analysis to different assets gives investors a floor to value the business and thus, a speedy exit should a turnaround plan prove to be unsuccessful.

PRIVATE EQUITY OPPORTUNITY

Private equity buyers have an advantage over corporate buyers in a distressed environment; since, generally, it is more difficult for public companies to purchase distressed assets or companies due to investment constraints. This is particularly true given the funding, liquidity and financial reporting challenges associated with distressed companies. Often, distressed

companies have experienced significant turnover in the financial accounting group, no formal controls or have seen their control environment (hence Sarbanes-Oxley compliance) decline markedly. Given the challenges to restructure a distressed company, private equity acquirers can take the company private while a corporate buyer won't be able to do. This allows the private equity buyer to fix not only the operational, but also any reporting issues of the target away from public pressure.

Although, private equity deals are down significantly, private equity acquirers are still active. These acquirers are putting more equity in their deals, with the option to lever up later when economic conditions are better. Since "work-outs" typically require two years or more, this is not an issue for funds with five or ten year horizons. Although near term equity returns may not be like those of the immediate past, buying at or near the bottom should help returns in the longer term.

That being said, there are only a few private equity or hedge funds that have robust distressed investing platforms, and for them the future is bright in terms of reputation, deal flow and returns. In many cases, distressed investors began as traders and moved up the investment value chain—bridging the illiquidity risk into higher returns. Others should beware; as distressed investing is not for the faint of heart and solid due diligence is a prerequisite.

ts insights volume 5 no. 2 3

TS Insights provides strategic thinking on a wide range of issues that affect the deal community. **TS Insights** is a publication of the Transaction Services Group of PricewaterhouseCoopers, which includes over 1,200 professionals in 16 US cities. For more information on the topics discussed in this issue, contact **Curt Cornwell** at (646) 471-8791 or **Colin Wittmer** at (646) 471-3542.

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