Schulte Roth & Zabel

Distressed Investing M&A

A Schulte Roth & Zabel LLP report in association with mergermarket and Debtwire

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Foreword

Schulte Roth & Zabel is pleased to present Distressed Investing M&A, published in association with mergermarket and Debtwire. Based on a series of interviews with investment bankers, private equity practitioners and hedge fund investors in the US, this report examines the market for distressed assets at home and abroad.

Economic uncertainty brought on by the looming US "fiscal cliff" have placed companies in difficult situations where many are forced to sell assets and restructure operations and debt in order to avoid a court mandated sale further down the line. The value gained and time saved by selling assets prior to in-court restructuring and liquidation is signaled by the respondents' shift toward dealmaking early and out-of-court.

Outside of the US, the eurozone crisis and macroeconomic concerns in the emerging markets are having a similar effect. While some are waiting for a solution to the sovereign debt crisis, distressed investors are geared to take advantage of attractively-priced assets within the region. Hyperinflation remains a concern for the markets in Latin America and India, while economic growth has slowed in Brazil and China. Both are likely to create distressed opportunities over the next 12 months.

Respondents cite the energy sector as likely to be the most active for distressed M&A in the next year. Low natural gas prices in the US are hitting the bottom line and companies are feeling the strain. Additionally, inflation concerns in Asia may expose manufacturing companies, who respondents describe as "losing the battle" against prices.

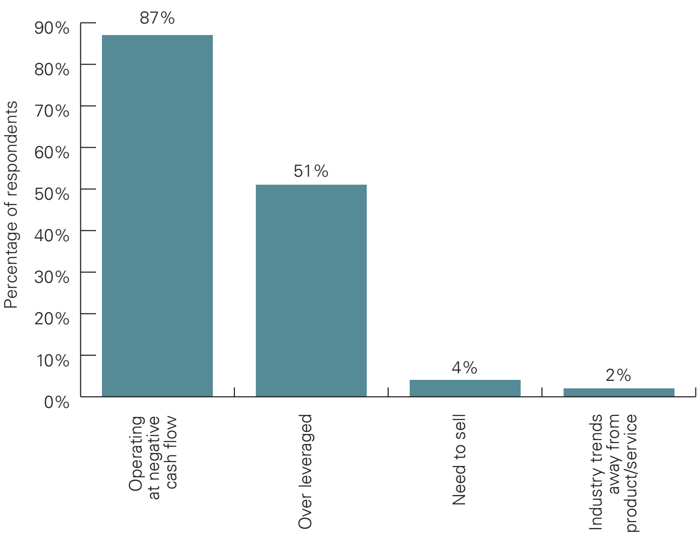
In addition to the above findings, this report provides insight into pricing, litigation, club deals, and various other issues concerning the distressed M&A community. We hope you find this study informative and useful, and as always we welcome your feedback.

Methodology

In the fourth quarter of 2012, Schulte Roth & Zabel commissioned mergermarket to interview investment bankers, private equity practitioners and hedge fund investors regarding their outlook for distressed M&A activity over the next year. All results are anonymous and presented in aggregate.

Analysis

How do you classify a distressed asset or company?

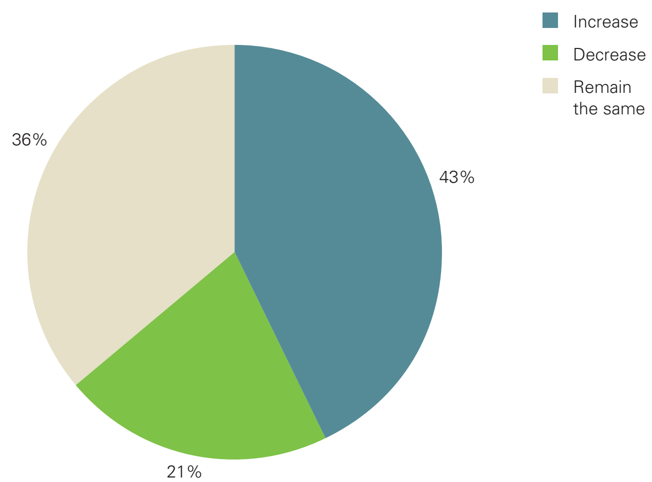


Respondents overwhelmingly use negative cash flow as their main indicator that a company or asset is distressed; 51% also use leverage signals. The two indicate a company is unable (or nearly unable) to make regular debt payments or refinance approaching maturities, which are highly likely to trigger distressed sales. This represents a change in opinion from the first edition of this report published in 2009 where leverage ratios were used more than cash flow.

"This change in opinion from the first report may reflect growing suspicion of whether accounting rules reflect reality. On the other hand, it is difficult to fake cash flow."

Kurt Rosell, Partner, Tax, Schulte Roth & Zabel

What do you expect will happen to the pricing of distressed assets and companies in the US over the next 12 months?

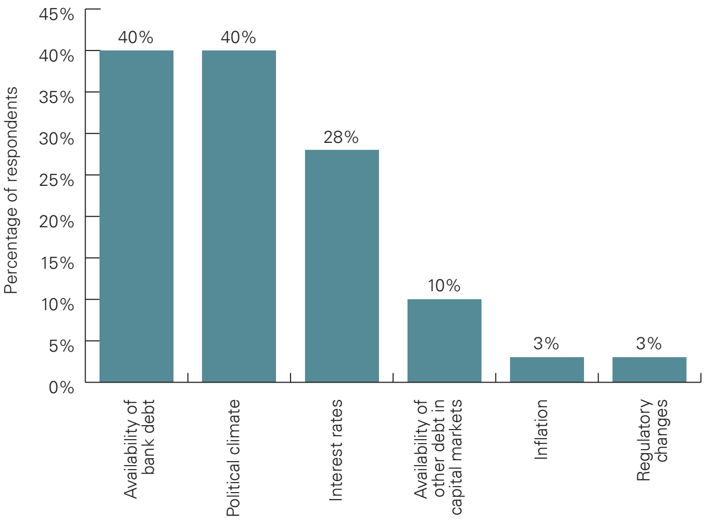


There is a divide between respondents' expectations for pricing of distressed assets and companies over the next 12 months. While 43% expect them to increase, 36% expect them to remain the same. The relatively split response is a far cry, however, from the pricing of 2008 through 2010 when distressed assets were selling at deeper discounts, and similar research showed as many as 90% predicting further decline. The markets and revenue have shown signs of stability and income-based asset valuations in the US appear to be improving, with increasing stability in the markets and in private sector revenues.

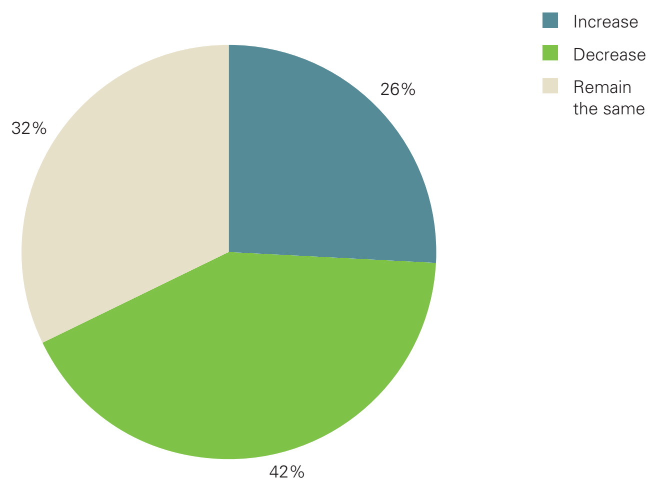
"The response reflects the existing tension in the market between the vast amount of capital that is still sitting in the sidelines waiting to be deployed (thus presenting potential upward pressure on prices) and the patience investors are showing evidencing concerns about the overall economy, the sluggish recovery, and the potential for another recession."

Adam Harris, Partner, Business Reorganization, Schulte Roth & Zabel

What factors do you expect will have the greatest impact on the pricing of distressed assets and companies in the US over the next 12 months?



What do you expect will happen to the pricing of distressed assets and companies outside of the US over the next 12 months?



Availability of financing and the political climate will have the greatest influence on the valuations distressed companies receive, according to 40% of respondents. This year, distressed companies in the healthcare sector have seen stable valuations as the markets prepare for the enactment of the further stages of healthcare reform. With President Obama's re-election, the strength of distressed healthcare M&A is likely to hold.

Monetary policy such as the Fed's "quantitative easing" is not expected to impact the market for distressed M&A. Interest rates would potentially have the most influence, say over a quarter of respondents, while inflation and regulatory changes are not expected to play into pricing.

"The responses here are not surprising. The availability of financing and the price of that financing is a critical factor in determining the pricing of all assets and companies and this is even more pronounced in distressed acquisitions where you have the additional uncertainty of a turnaround. We have all witnessed that domestic and foreign political events and conflicts can have a material effect on the acquisition markets."

Fred Ragucci, Partner, Finance, Schulte Roth & Zabel

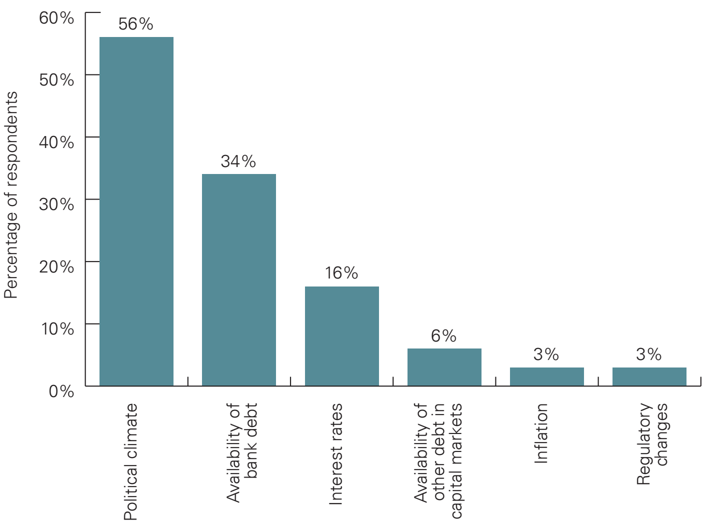
Overall pricing of distressed companies and assets are narrowly expected to decline throughout 2013, according to the 42% plurality of respondents. Corporate special situations-related investments are gaining momentum with alternative investment funds, but global investment banks are rapidly shying away as they lower the amount of risky investments in compliance with regulation.

"The expectation on pricing of distressed assets outside of the United States is consistent with the continued belief that European banks and other financial institutions will ultimately have to shed their balance sheets of non-performing or underperforming assets, thus creating opportunities for alternative investment funds. The question remains when, and whether, those banks and institutions will become more realistic on pricing."

Adam Harris, Partner, Business Reorganization, Schulte Roth & Zabel

Analysis

What factors do you expect will have the greatest impact on the pricing of distressed assets and companies outside of the US over the next 12 months?



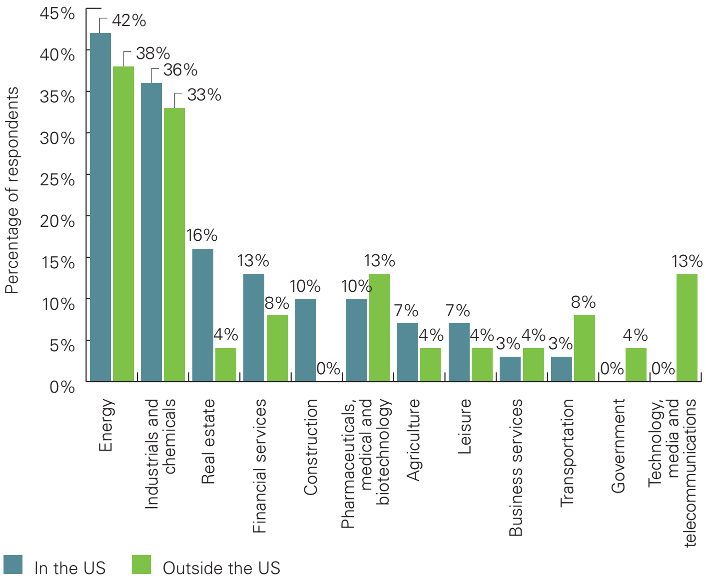
While M&A professionals across the globe paid close attention to the presidential election, the political climate outside of the US has greater importance in relation to companies in distress, according to over half of respondents. As conflict in the Middle East continues, the effect is felt around the world, especially in the energy sector. Similarly, the impact of the eurozone crisis is felt in the consumer and manufacturing sectors around the world, especially in the US.

As one investment banker explains: “There is a great deal of change afoot in several key markets. One feels the eurozone is heading for a significant political shift in one or two member countries, which may well reap some great opportunity for sharp-eyed investors.”

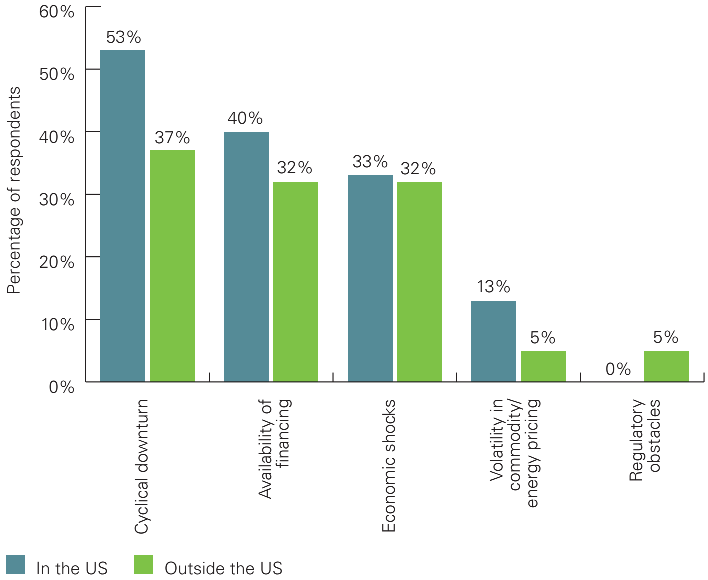
“We are all monitoring the eurozone, but I believe there is opportunity in the GCC (Gulf Cooperation Council) region as well.”

Managing director, US investment bank

In which sector(s) do you expect to see the best opportunities for distressed M&A in the US and outside?



What factors will contribute to the distressed opportunities in the chosen sector(s)?



Energy and industrials and chemicals are the top two sectors respondents identify as offering the best opportunities for distressed acquisitions both within and outside the US. The fall of natural gas prices has put strain on the American oil and gas sector providing prime opportunities for larger strategic and financial buyers who can bear the brunt of what is most likely a transitory weak revenue stream.

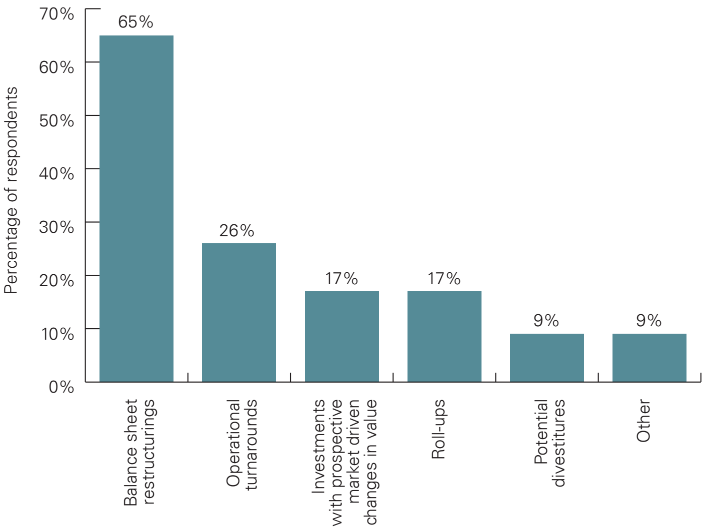
Since the height of the US economic downturn, the real estate sector comes in as a distant third choice in the US among investors with 16% of respondents (it was the top sector in the 2009 edition of this report). Recent indicators show recovery in home buying, though the growth in 2002-2006 will not be matched for the foreseeable future.

Distressed investors will be monitoring the US economy and the eurozone closely for indicators on attractive sectors over the next 12 months.

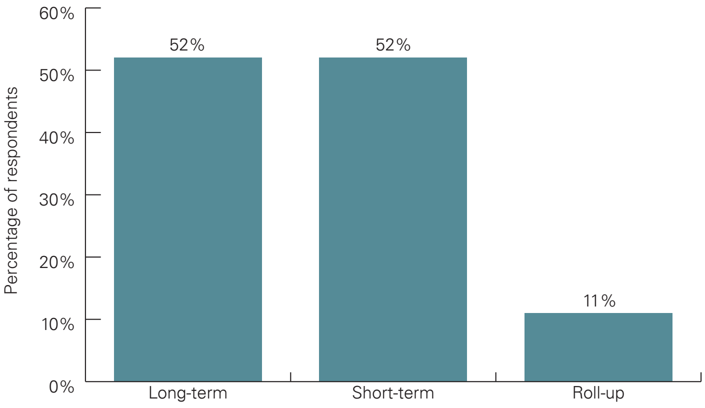
A managing director at an investment bank who chose industrials and chemicals in Asia-Pacific explains: "Manufacturing companies are losing a battle with inflation and will need assistance in the face of stern challenges in what has been, until now, unprecedented growth."

Analysis

Which type of distressed opportunities are you targeting?



What type of strategy do you employ for your targeted distressed assets and companies?



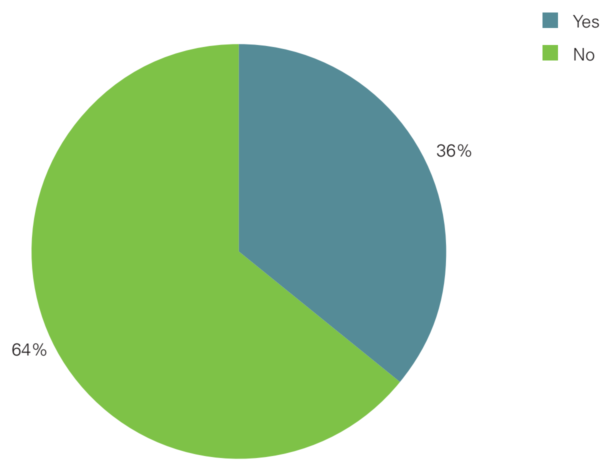
Balance sheet restructurings are the top targets for acquirers of distressed companies, according to the 65% majority of respondents. These situations are sought for both long- and short-term distressed M&A strategies. As distressed companies struggle to improve financial health, non-core assets will be on the selling block and investors will look to take advantage.

As one private equity director explains: "With the economic downturn as the key driver, you need to think long-term and be patient for the right market conditions to return."

31% of overall potential M&A targets are expected to be distressed.

On average, respondents hold investments for 2-3 years.

Have you participated in any distress for control transactions as part of a broader investor group (known as a "club deal")?



"The even split between respondents long-term and short-term investment horizons is reflective of the mix of both private equity and hedge fund investors seeking returns in special situations. However, investors with the most time horizon flexibility continue to be best positioned to take advantage of the wide range of investment opportunities and to withstand the markets twists and turns."

David Karp, Partner, Distressed Debt & Claims Trading, Schulte Roth & Zabel

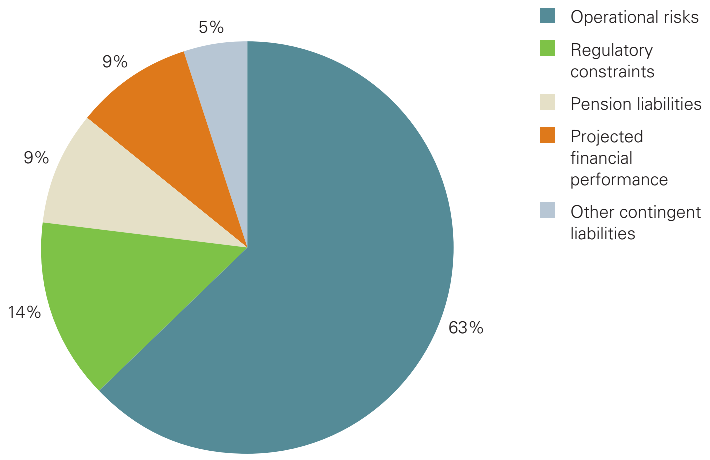
Over a third of respondents have been among a group of investors who have completed club deals, which primarily were formed before the investment. All respondents who report issues with corporate governance were the most difficult to address. These consortium acquisitions have seen recent popularity in the global energy sector as natural gas prices have remained flat. An 86% majority of respondents say the groups form prior to the investment.

"Investors are right to focus on governance as a key issue in club deals. There may be differences in operational strategies, investment horizons and return expectations that need to be resolved. These issues can become particularly acute when investors in distressed securities find the need to form an ad-hoc consortium to push through a plan of reorganization and manage the restructured company."

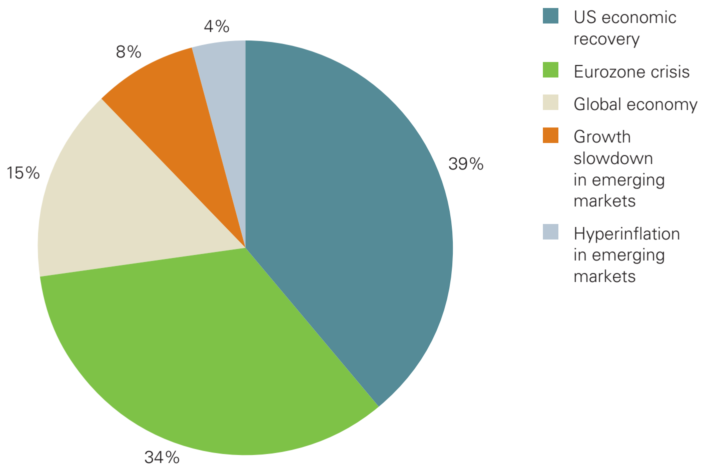
Stuart Freedman, Partner, Mergers & Acquisitions, Schulte Roth & Zabel

Analysis

Which factor will have the biggest impact on your decisions to invest or not invest in distressed assets and companies?



Which current economic issue will have the biggest impact on your distressed M&A decision-making over the next 12 months?



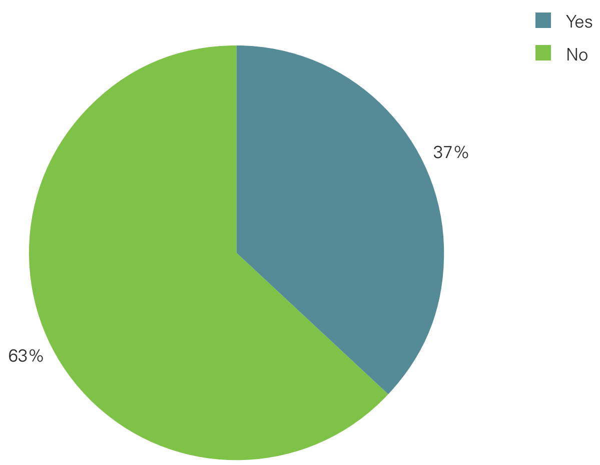
The operational risks of a company in distress have the biggest impact in deciding whether or not to acquire, according to the 63% majority. Respondents note the growing impact operational risks can have on future capital expenditure demand and the potential of catastrophic events on operating performance, market capitalization, and corporate reputation. These types of risks and deficiencies must be priced into the sale, respondents add.

The world's various economic issues have thrown many curveballs into investors' decision-making, but the US economy stands out as the most important for the 39% plurality; 34% say the eurozone will have the most significant impact. While the slowdown of China's rapid growth and Latin American countries like Brazil and Argentina on hyperinflation watch have hurt companies, the market for distressed companies does not match the volume of the US and Europe.

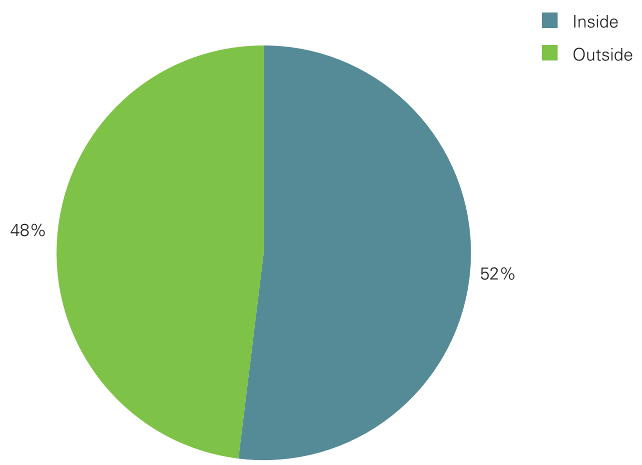
"The concerns shown by the respondents are consistent with the drivers of the overall sluggishness of the M&A market in the 2nd half of 2012 – confidence and stability are drivers of M&A activity generally, and may be of particular concern with respect to distressed M&A because such companies have less room for error in their financial condition and results of operations."

David Rosewater, Partner, Mergers & Acquisitions, Schulte Roth & Zabel

Do you invest in distressed assets or companies where litigation outcomes may play a significant role in the overall recovery?



Over the next 12 months, do you expect more distressed M&A to occur inside or outside of bankruptcy?



Companies where litigation can play a significant role in the long-term performance are targeted by 37% of respondents. These types of companies are often evaluated by the investor's legal team on a case-by-case basis. In regards to Latin America, one respondent advises: "When investing outside the US, understanding the bankruptcy code is extremely important. In some countries, it favors the shareholders over the creditors, and this causes serious problems in recovery."

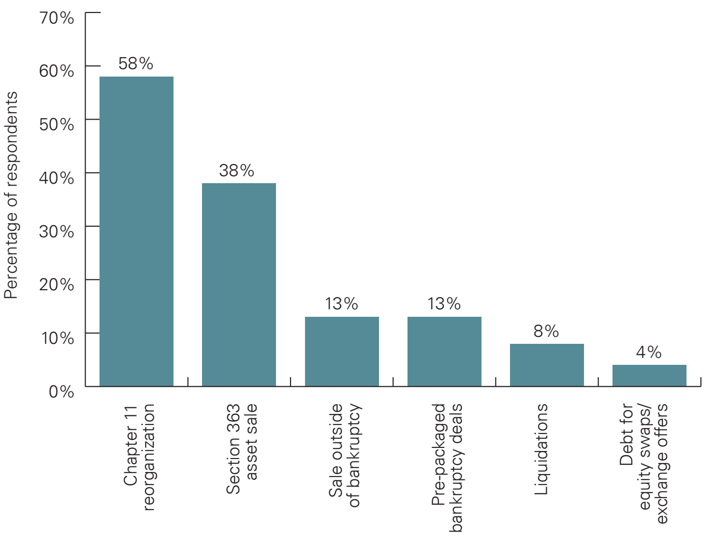
Respondents are virtually split on the primary source for distressed M&A in 2013 with just over half (52%) expecting more deals to come from inside bankruptcy, rather than outside. According to Debtwire data, 2012 is on pace to see 80 distressed exchanges; roughly 63% are expected to take place in court. This represents the growth of out-of-court restructuring, which is noted to be a significantly shorter process, though typically dependent on the company's capital structure or financial performance.

"Given the advantages of out-of-court transactions – lower cost, quicker – it is not surprising to see such transactions continuing on the rise. However, the need to obtain consensus among creditors (because of the typical inability to bind objecting parties) will always limit the ability to achieve goals out-of-court in many situations, especially as "empty creditor" issues involving credit default swap positions rise in frequency."

David Rosewater, Partner, Mergers & Acquisitions, Schulte Roth & Zabel

Analysis

Which will be the most common distressed M&A transaction type?



Chapter 11 reorganizations are expected to be the top distressed M&A transaction type with 58% of the response, followed by Section 363 asset sales. The reliance of debtors on Section 363 sales as a substitute for the more traditional Chapter 11 reorganization process has remained strong, according to respondents. Once thought to be "a thing of the past," Chapter 11 is still providing opportunities for distressed investors. As one respondent explains: "Kodak's sale of its patent portfolio has been going on for much of 2012, and is essential in order to obtain financing to bring it out of bankruptcy."

"363 sales are also an extremely useful tool for acquirors. In a 363 sale, intercreditor fights to divide up the spoils are generally left to another day, and transactions can get consummated quickly. Plans of reorganization are more suited to larger companies with more complex capital structures, particularly where it is going to be difficult or unattractive to replace existing financing."

Stuart Freedman, Partner, Mergers & Acquisitions, Schulte Roth & Zabel

DISTRESSED INVESTING

COMES IN ALL SHAPES AND SIZES

Representative distressed investing transactions include:

ICBC Broadcast Holdings, Inc. Acquisition	PRECISION PARTNERS Foreclosure on Equity Interests	Speymill plc Acquisition and Debt Restructuring	DRI Corporation Acquisition
phoenix technologies Debt Restructuring	WaMu Exit Financing	The Great ATLANTIC & PACIFIC Tea Company Acquisition	REAL MEX RESTAURANTS Acquisition
CHEF SOLUTIONS Debt Financing	LOCAL insight MEDIA Exit Financing	deb Acquisition	INNKEEPERS USA Acquisition
DIGITAL DOMAIN Reorganization and Auction	Fiddler's Creek A RETURN TO NAPLES Reorganization	STORMCAT ENERGY CORPORATION Exit Financing	ORLEANS Building Trust Since 1918. Reorganization
Angiotech Redefining Success Debt Financing	Brunschwig & Fils Acquisition	RIVIERA CASINO & HOTEL Reorganization and Acquisition	Caritas CARITAS CHRISTI HEALTH CARE Acquisition

Schulte Roth & Zabel

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Schulte Roth & Zabel's Distressed Investing Group is unique in its ability to meet the complex needs of its clients in every phase of distressed investing, creating business-savvy solutions by strategically blending expertise from our business reorganization, finance, investment management, mergers & acquisitions, real estate, tax and other practice areas. Our superior knowledge of the investment management industry and experience developing and implementing the structures and products that a distressed investor analyzes results in substantial synergies and gives us an insider's edge.

When it comes to providing sound advice and trusted counsel on all aspects of distressed investing, sophisticated clients rely on us for all aspects of their interests in a wide range of contexts. We advise on, and have extensive experience with, out-of-court transactions, navigating bankruptcies (including bankruptcy acquisitions, debt restructurings, loan-to-own strategies and debtor-in-possession and exit financings), distressed real estate, capital structure analysis and trading issues.

Structuring or restructuring a deal may also require collaboration by our clients with one or more other parties who have aligned interests in order to achieve their investment objectives. We regularly advise consortiums and syndicates in joint investments, whether those investments are structured as club deals or the group acts together as an informal, ad hoc committee, or otherwise. We are experienced in defining, negotiating and navigating those working relationships and managing the complex governance and tax issues that arise.

SRZ has the experience and expertise to provide clients with comprehensive representation and advice in all manners of large and complex distressed situations across a wide range of industries and opportunities.

Schulte Roth & Zabel is a premier multidisciplinary law firm focused on delivering sophisticated, leading-edge advice to its clients, which include prominent financial institutions, corporations and investors. We strive to build and maintain long-term relationships with our clients by emphasizing client service, and with expertise in a broad array of practice areas, we provide comprehensive advice to achieve our clients' objectives.

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mergermarket

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