AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Financial Statements

By James E. Fleet and Patrick J. Hughes

James E. Fleet
Phoenix Management Services; Chadds Ford, Pa.

Patrick J. Hughes
Phoenix Capital Resources; New York

Jim Fleet is a senior managing director and shareholder with Phoenix Management Services in Chadds Ford, Pa., where he focuses on turnaround, investment banking and M&A assignments. Patrick Hughes is a senior associate with Phoenix Capital Resources in New York and is a special-situations investment banking professional who advises middle-market clients in transition.

Who's on First, What's on Second: Capital Markets in Transition

For middle-market deal makers, 2013 has been notably slow. Today's historically low interest rates, coupled with the scarcity of deal flow, have increased competition among funding sources, spanning the entire capital structure. Given the extreme competition to deploy capital in a thin deal market, both lenders and investors are attempting to differentiate themselves, forcing many lenders to compete on structure, as opposed to pricing. Furthermore, with an abundance of debt capital in the market, private-equity firms are amplifying leverage levels to compete on headline valuations and boost internal rates of return.

Current market conditions are additionally provoking lenders and private-equity investors to underwrite new deals, within which risk and return are seemingly misaligned. For example, senior lenders are providing low-cost working-capital credit facilities and term loans at higher leverage multiples to companies that could not have borrowed as much so inexpensively just a few years ago. This has driven a wedge into the capital structure in many respects to the mezzanine or junior lenders, further diminishing the number of opportunities for those participants. As a result, mezzanine lenders are lowering their return benchmarks on new loans. Additionally, many have begun providing innovative products to compete with increasingly aggressive senior lenders, even though at times these products are directly at odds with the mezzanine lender mandate.

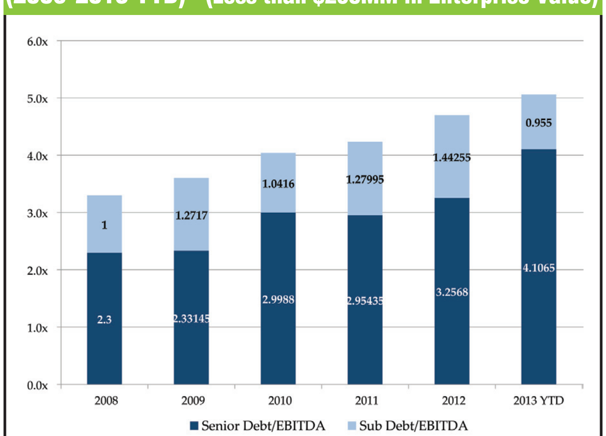
With debt capital abundant, private-equity firms' ability to pay premium valuations for new deals is as potent as ever. Yet they are also faced with the difficult choice of either putting money to work at premium valuations, taking on greater risk, or remaining patient and value-focused. At the same time, the private-equity fund managers are strongly incentivized by management fees and carried interest opportunities to put money to work for their limited partners. This situation is motivating them to compete on valuation to win new deals.

Clearly, today's artificially low interest rates are significantly impacting lending and investing practices, as illustrated in Chart 1, with interest rate suppression keeping rates at or below any historical points in the past century. As a result, market participants are responding in new ways. However, as middle-market companies lever-up on today's low rates, how will this play out when the inevitable happens and interest rates begin to rise, which we have begun to see in 10-year treasuries?

The "Domino Effect" on Market Participants

In a market where too many firms are competing for too few opportunities, the struggle to remain competitive can often seem like a war zone. Aggressive behavior on the part of senior lenders, mezzanine lenders and buyout shops in many ways

Chart 1: Acquisition Financing Trends: Leverage (2008-2013 YTD)[1] (Less than $250MM in Enterprise Value)



1 GF data, debt multiples for deals in which a financial sponsor was involved, as of June 30, 2013.

66 Canal Center Plaza, Suite 600 • Alexandria, VA 22314 • (703) 739-0800 • Fax (703) 739-1060 • www.abi.org

is akin to the attitudes that were commonplace leading up to the economic downturn in 2008. As lenders skirmish for positions on the lending ladder, however, it's apparent that more flexibility is essential.

In an effort to spur macroeconomic growth as a way out of the global recession of 2009, central banking policies have stabilized benchmark rates at historically low levels (*see* Chart 2). In fact, the three-month LIBOR has held at below 100bps for the last four years, making the cost of borrowing remarkably cheap for middle-market companies. While in recent years strong demand for company credit allowed banks to remain selective on structure, this demand has thinned for new loans in recent months. Banks stretching on structure to remain competitive for deal flow has triggered a domino effect throughout the lending market.

Early in the economic recovery, mezzanine lenders were able to actively deploy capital in order to fill the "structural gaps" left by senior lenders that remained conservative on debt levels. In the current market, however, stretch structures offered by senior lenders are allowing companies to avoid the punitive rates required by traditional sub-debt providers. As a result, traditional mezzanine lenders are challenged to underwrite new loans and to retain the existing loans in their portfolios.

With some underwriting latitude from their limited partners (LPs), these same lenders are turning to unitranche loans, blending down returns in order to compete with the increasingly aggressive senior lending community. In some situations, unitranche products are provided as a "partnership" with a bank asset-based lender whereby the product is offered to the borrower as a single capital source. In reality, the senior asset-based lender provides the senior debt capital portion and the mezzanine lender provides the higher-risk capital. To the borrower, it is a seamless transaction; to the respective capital participants, it is a necessity to compete in the current market.

Private-equity firms are following suit. The scarcity of deal flow relative to the supply of private capital raised for buyouts in the middle market has created an environment wherein private-equity firms are "paying up" for assets. This is perhaps best demonstrated by the thinning spread between multiples paid by strategic and financial purchasers in buyouts.

Historically, strategic purchasers have been able to comfortably outbid financial buyers, given the natural synergies and cost savings available to that group. With fierce competition for quality deals and an abundance of cheap debt capital, the spread between these two types of buyers has all but evaporated.

Blurred Lines

Significant changes in the roles of market participants in the current environment have manifested in a few notable ways:

- By stretching leverage and structure, senior lenders are absorbing more of the capital structure, rendering traditional mezzanine and sub-debt providers less relevant.
- Greater access to senior debt financing has increased private-equity firms' ability to pay, with debt capital funding a large percentage of the increased enterprise value.
- The thin deal market has led to "ginned-up" valuations in middle-market buyouts.
- To remain competitive, mezzanine lenders have cut current-pay interest rates and have attempted to blend up returns with higher transaction fees at close.
- Insurance companies and other nontraditional financing sources have also moved into second-lien and mezzanine slots where their required return on investment is higher than what senior loans will pay.

Outcomes of a Rising Rate Environment on Highly Leveraged Companies

In the current environment, interest rates can only stay flat or go up. The expectation is that as the broader economy improves during this recovery period, rates will indeed rise. When they do, highly levered middle-market companies, which are narrowly covering their fixed-charge coverage requirements (ability to service their debt) under the current low-interest-rate environment, will be at risk of default and breaking covenants.

Additionally, restructuring these loans will be significantly more challenging than during the post recession period from 2008-12. This is due to several factors:

- already-stretched leverage multiples;
- commingled structures between senior and junior capital;

Chart 2: Key U.S. Benchmark Rates[2] (2005-2013 YTD)

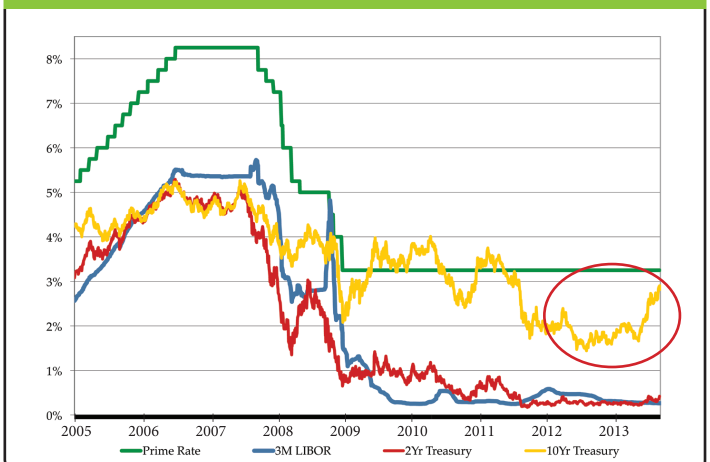
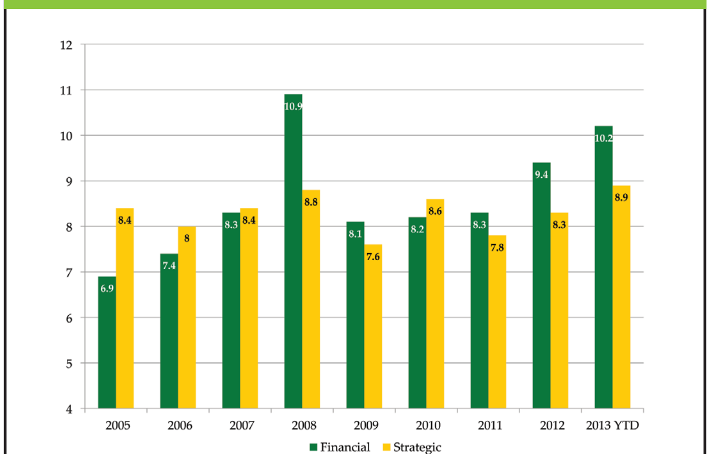


Chart 3: Financial vs. Strategic Multiples (2005-2013 YTD)[3]
Less than $2.5BB in Enterprise Value



2 *CapitalIQ*, daily benchmark rates and Treasury yields, as of Aug. 26, 2013.

3 *CapitalIQ*, Pitchbook Deal Multiples & Trends Report Median EBITDA multiples for U.S. transactions, as of June 30, 2013. Pitchbook 3Q 2013 Private Equity Breakdown as of June 30, 2013.

• the rising-interest-rate environment; and
• the inability of many middle-market companies to proportionately improve their EBITDA performance in the rising-interest-rate environment.

With the lack of available future tools to affect a restructuring, events of distress or default may be more event-driven or company-specific in a broadly healthy economy, and the situations will likely be more acute. In the same respect, unless lenders are able to foresee recapturing their original investments and achieving an acceptable ROI on any follow-on capital invested, there will be little incentive to further stretch debt structure or for equity to provide additional capital infusions. These dynamics will lead to lines of valuation being drawn on the battlefield, with each participant mindful of capturing their invested capital in a recovery scenario. Following is an example of a case study that demonstrates these principles:

Company A has $100 million in revenue and $10 million in EBITDA. In June 2013, it is acquired by private-equity firm ABC Capital for $100 million. ABC Capital borrows: 1.0x senior revolver ($10 million fully drawn) at 350bps; 3.5x senior term debt ($35 million) at 350bps, with a five-year amortization; 1.5x mezzanine ($10 million) at 11 percent; and 3 percent PIK, non-amortizing. With equity funding the balance of $45 million, the equity fund requires a 3.0x cash-on-cash return in five years to hit its target internal rate of return (IRR). The company's year one debt service requirement would be $9.7 million, which is just $300,000 below the $10 million of EBITDA generated at the time of purchase.

$0.35 million	Revolver Interest
$1.23 million	Senior Term Interest
$1.10 million	Mezzanine Interest
$7.00 million	Term Principal
$9.68 million	Total P&I year one

If company performance is flat and LIBOR rates rise 100bps, the company's fixed-charge requirements would jump to $10.2 million and the company would be unable to service the debt through its operating cash generated. More troubling is a scenario where earnings deteriorate (let's say by 20 percent); then the company would be $1.7 million behind on its fixed charge coverage ratio (FCCR) coverage in year one, without rates rising at all. Moreover, since the company is going to have to pay down more than $55 million in debt over the structured life of the investment, the company would have to double EBITDA at the sample multiple at the time of purchase for the private-equity firm to achieve a 3.0x cash-on-cash return.

While this might be an oversimplified example, it is still evident in the marketplace. As such, it is easy to see how a typical middle-market company that is over-levered in this environment might find itself in great difficulty quickly based on such aggressive structuring and investing practices.

Will this scenario lead to an increase in bankruptcies, a greater number of out-of-court settlements, or maybe something in between? It is prudent to examine some of the key possibilities:

• *Out-of-court restructuring.* In this situation, the various capital stakeholders are left to the valuation fight, with an acceptance of either: shortfall of recovery on loan principal for senior and/or mezzanine lenders; debt-to-equity conversions; or costly capital infusions with significant ownership dilution. Faced with the daunting outcomes of liquidations and the complexity and the costs of bankruptcy, capital participants are reluctant bedfellows in any attempt to either maximize recovery and/or provide the "hope" scenario of an acceptable ROI for investments down the road.
• *Bankruptcy.* In this scenario, the complexities of the balance sheets muddy the waters. Unitranche loans, stretch senior loan credit structures and mezzanine term loans (depending upon enterprise value for both recovery and obviously ROI) complicate the division of collateral recovery and/or proceeds in the event of a sale. Ultimately, it is not uncommon to see the "debt for equity" swap as a method in addressing the needs of the restructuring plan. Given an environment where interest rates are rising and capital structures are fully stretched, out-of-court negotiations may prove to be less effective than in recent years. The bankruptcy tool, while expensive, may return in popularity to resolve these issues with a gavel.
• *Liquidations.* With liquidation, the value of the collateral supporting the loans in question does not generally increase proportionately with business valuations. Given the circumstances of highly levered balance sheets, recoveries might often be short of the stretched senior loan balances. In the same respect, there is little left for the mezzanine lender typically, with the equity investor most certainly out of the game.

With the lack of available future tools to affect a restructuring, events of distress or default may be more event-driven or company-specific in a broadly healthy economy, and the situations will likely be more acute.

Looking Ahead

Current market conditions, most notably limited deal flow, low interest rates, an abundant supply of debt capital and motivated private-equity buyers, are inciting aggressive attitudes and deal structures similar to that of pre-recessionary levels. Whether the horizon is 12 or 24 months, or longer, the expectation is that benchmark interest rates are going to rise. With middle-market companies levering up in the inexpensive-debt environment with stretched deal structures, a day of reckoning is looming on the horizon.

The lessons learned by restructuring advisors over the last five years are deeply ingrained. However, the prospect of affecting reasonable restructurings for highly leveraged companies in a rising-benchmark-interest-rate environment appears daunting. abi

Reprinted with permission from the ABI Journal, Vol. XXXII, No. 11, December 2013.