

Director Oversight of Emerging Opportunities

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With share prices and trading multiples significantly lower than last year's highs, talk of the economy turning around in the near term and the credit markets easing slowly, well-capitalized corporations are likely shifting their focus from stabilization and preservation back to future outlook and growth opportunities. The strategy to take advantage of the "30% or more off" sale is sound; however, finding true value in the current economic climate requires in-depth knowledge of the industry's landscape, coupled with a proactive approach that avoids competitive situations and minimizes potential damage to the target company.

The turmoil of the past year has resulted in and will continue to drive an increased number of opportunities including distressed mergers and acquisitions (M&As), value opportunities and joint venture possibilities that could be used to acquire companies, upgrade equipment, streamline costs, grow market share, enter new markets or expand product offerings.

As the number and complexity of opportunities increase, boards need to play an expanded role that supplements management with a broad base of differentiated expertise in distressed/value investing. Directors can also assist by identifying opportunities early through networking with directors of other boards and with professional advisors.

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How To Identify Potential Distressed Opportunities

In addition to traditional distressed M&A cases, i.e., companies sold through a court-governed process, market conditions have resulted in a broad range of distress circumstances including good companies in distressed industries, good companies with bad balance sheets and troubled companies that have not yet had to file under formal proceedings. By identifying situations early, that is, before an extreme liquidity



crisis or institution of creditor protection, intangible value can be preserved, inherently increasing the value proposition. The current economic crisis has helped to define easily identifiable “risk triggers” which buyers could use to proactively search for opportunities, including:

- companies that have been refinanced or acquired over the past 24 to 36 months and have high levels of debt;
- companies with syndicated debt in which a syndicate member needs to exit;
- diversified organizations where the company may be looking to generate liquidity by divesting operations that are not viewed as strategic priorities;
- companies looking to refinance where alternative capital structures such as preferred shares or convertible debentures are more tenable than they may have been in the past;
- companies operating in industries that are highly cyclical or very capital intensive;
- companies with a strong portfolio of intellectual property, such as proprietary technology or brands, where there may be an interest in monetizing some of this investment;
- companies with excessive exposure to fluctuating commodity pricing or foreign exchange rates; and
- publicly traded companies that have fallen out of favour with investors and consequently have a depressed share price.

Understanding the causes of a target’s distress better positions a buyer to assess the opportunity and maximize the end result. To do so requires management and the board to have a strong analytical framework to assess today’s economic climate and the target’s position therein. It also requires a solid understanding of the restructuring options under bankruptcy legislation and the options for structuring financial deals.

There are several approaches that could be used to gain control of a company or assets in a distressed situation. They include a simple asset purchase, familiar to most; “loan-to-own”, a strategy that is gathering momentum with a broader base of investors; and joint venture possibilities. Any of these approaches could be used as either an offensive strategy, to gain market share or diversify products

or as a defensive strategy to block a competitor from acquiring technology, brands or a desirable customer group. Which approach to use is completely dependant on the buyer’s motivations, seller’s needs and appetite for risk from both sides.

Opportunistic Strategies in Distressed Markets

Debt buybacks

Strong M&A markets over the past several years, fuelled significantly by the leveraged buyout model, have resulted in a large number of companies being choked by excessive debt service commitments or unable to roll maturing obligations. As reported by Standard & Poor’s *LCD LoanStats Weekly* at August 6, 2009, the leveraged loan default rate, by principal amount, was at 9.6 percent, up from 3.8 percent at the end of 2008. Further, the default rate for speculative grade issuers is forecast to continue to climb to 14.3 percent in the first quarter of 2010, before retreating slightly in the second quarter. Many market observers expect recovery rates to lenders on defaulted loans in the current circumstances to be less than the historical average of 60 percent.

To reduce risk and maintain required capital ratios, lenders are increasingly selling debt positions in the secondary market. Trading of debt in the secondary market usually is done at a discount, with lower pricing being indicative of higher risk. Currently, investment grade bonds trading in the secondary market are priced at a range of 83.78 for B-/B3 to 95.60 for BB-/Ba3. This compares to pricing at the end of 2008 of 50.66 to 74.56, for the respective ratings. Pricing for speculative grade bonds i.e., CCC+/Caa1, is currently trading at 59.13, up from 44.94 at December 31, 2008. The higher pricing is indicative of improving credit markets and lower perceived risk as government stimulus takes hold. As the economy strengthens, the window of opportunity will continue to contract as spreads narrow.

Assuming the credit agreement allows for it, debt paper can be acquired by the borrower or by a third party. For the borrower, buying back debt at a discount can be a cost-effective way to decrease leverage, reduce interest costs and/or avoid a covenant breach. If the company is heading for

default, buying debt enables the purchaser to step into the lender's position and regain control of the company.

A debt purchase by a third party would likely be motivated by the potential opportunity to gain control of the borrower with the intent of turning debt into equity at some point in the future. A recent example is Maguire Properties Inc., one of the largest office building owners in Southern California: Maguire struck a deal to turn over one of its buildings to LBA Realty, a real-estate company that bought its debt at a discount.

Debt buybacks are technical transactions with little opportunity for due diligence. They often take time to realize value and they have tax implications. While the benefits may be substantial, entering into such a transaction should be carefully considered by the board prior to a commitment.

Debtor in Possession (DIP) Lending

In previous downturns, finding a DIP lender to finance a restructuring or securing exit financing was rarely a concern. The tight credit conditions prevalent in this recession have limited the number of funders willing to incur the risk.

While the ultimate risk of failure of the debtor is high, funding the DIP provides the following benefits to the lender:

- **Super priority over other creditors** – An existing lender can provide the DIP loan as a defensive strategy to protect its pre-filing loans;
- **High returns** – Tight credit conditions and lower pricing in the secondary market are resulting in high-yield DIP loans; and
- **Control of the restructuring process** – A DIP loan provides an opportunity to control the direction of the process to potentially turn debt into equity as a “loan-to-own” strategy.

According to data provider Dealogic, distressed-debt deals in the U.S., in which creditors use their debt positions to seize ownership of troubled companies, are running close to double the pace of 2008. Some

140 of such deals with a value of \$84 billion have been struck during 2009, compared with 102 transactions valued at \$20 billion for all of last year across a broad range of industries.

Joint Ventures and Collaboration

With the recession reaching so deep, companies seem to be taking a softer stance, more willing to entertain opportunities to collaborate for mutual benefit and survival. Joint ventures (JVs) have successfully been part of the landscape in the on-line marketing, mining and heavy construction industries and, more recently, they have become a lifeline to the biotech industry as a means to fill the funding gap left by the tight credit and stalled IPO markets. JVs will play an increasingly important role in the global economy by enabling companies to remain focused on their core while increasing competitiveness, through partnerships or licensing arrangements that enable access to new growth markets, intellectual property or products.

Boards Need to be Vigilant Now

With the rate of decline slowing, liquidity improving and overall sentiment generally more positive than at the beginning of the year, the opening to take advantage of the “big sale” will begin to narrow. There is a limited window of opportunity for well-capitalized suitors to benefit from the economic downturn. With the restrictive timelines and deal complexities, boards should work with management to ensure opportunities are recognized and addressed as appropriate.

While opportunities may be tempting, distressed M&A situations require a comprehensive, disciplined and decisive approach, as the economy remains volatile and overall consensus is that the recovery will be soft.

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