

Distressed Investing Report

Highlights from the 2010 TMA Distressed Investing Conference



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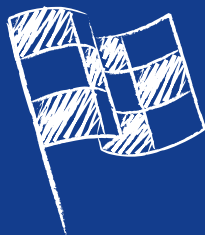
On behalf of the Turnaround Management Association (TMA), I am pleased to present highlights of the 2010 TMA Distressed Investing Conference. The fourth annual event took place January 27-29, 2010, at the Bellagio in Las Vegas.

TMA continues to look for new ways to add value to the Distressed Investing Conference and in 2010, the Turnaround Capital Forum was introduced to help facilitate partnerships between dealmakers and capital providers. Attendees also took advantage of other valuable networking opportunities throughout the conference. Whether meeting new business partners at receptions or visiting with colleagues during coffee breaks or meals, there was no shortage of opportunities for attendees to make connections that may lead to their next deal.

The conference also provided excellent educational content from some of the industry's most renowned experts. Leading off the conference, attendees explored an in-depth advanced case study detailing Circuit City's Chapter 11 filing and subsequent forced liquidation. They also received a glimpse into the future during a keynote session that provided a 2010 outlook and learned about many other key issues facing the distressed investing industry.

Learn more about the valuable insight provided at the conference by reading this Distressed Investing Report. Then be sure to visit turnaround.org to start making your plans to attend the 2011 TMA Distressed Investing Conference, January 26-28 at the Aria Resort in Las Vegas.

Linda M. Delgadillo, CAE, Executive Director
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Did Perfect Storm Cause Circuit City's Demise?

The worst economy in generations, collapsing sales, suppliers demanding more stringent credit terms, and nearly inaccessible capital markets—combined with changes to the U.S. Bankruptcy Code that limited debtor flexibility—pushed Circuit City into Chapter 11 in November 2008 and then into liquidation.

Several professionals who worked the case involving the nation's second-largest electronics retailer at the time discussed "Circuit City's Perfect Storm" at TMA's 2010 Distressed Investing Conference. The session was moderated by Professor Richard R. Morrison of Columbia Law School, who outlined the case in a session preceding the panel discussion.

Retailers generally try to avoid filing bankruptcy before the holiday season, which typically accounts for a large percentage of their annual sales. But its liquidity problems, along with wary vendors and lenders who refused to finance the build-up, prevented Circuit City from stocking up on inventory in anticipation of holidays, panelists said.

Gregg M. Galardi, a partner in the Corporate Restructuring practice of Skadden, Arps, Slate, Meagher & Flom LLP and lead attorney for Circuit City, said vendors have become "incredibly more sophisticated" in

anticipating issues that arise in bankruptcy. Already in September 2008, some vendors were expressing concern about their preference exposure in light of a possible bankruptcy filing. Circuit City's vendors also began tightening 30-day trade terms, he said.

Banks were also anxious about the outlook for the Christmas season and began cutting back on their commitments of capital. Galardi said it was "not inconsequential" that banks, reacting to dismal predictions for holiday spending in the fall of 2008, contracted their advance rates, exacerbating the liquidity problems many retailers, including Circuit City, already were facing.

"Should Circuit City have waited until after Christmas? There was no choice at that particular time. I would never recommend that you file in November if you could avoid it. But (Circuit City) should have had, on the week of November 10, \$1.6 billion of inventory ready and able to go out on Black Friday, two or three weeks later. They weren't in that position."

Robert J. Duffy, senior managing director with FTI Consulting, Inc., and leader of the firm's Northeast Region and retail practice, said the \$900 million difference between Circuit City's vendor payables and the \$1.6 billion



Robert J. Duffy of FTI Consulting, Inc., discusses events leading to the liquidation of Circuit City. Professor Edward R. Morrison of Columbia Law School (far left) moderated the session, which also included panelists Gregg M. Galardi of Skadden, Arps, Slate, Meagher & Flom LLP; Lawrence E. Klaff of GB Merchant Partners; and, right, Richard M. Pachulski of Pachulski Stang Ziehl & Jones LLP.



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in inventory it needed for the holiday season amounted to “a liquidity drain, a sucking out of the company’s cash flows.”

“What happened from early, mid-September to getting to the holiday season in early November (was) the company needed to get TVs, it needed to get many of its important products,” Duffy said. “But what would happen is, the vendors would say, ‘We’re not going to ship unless you pay down some of the amount that you owe.’ Really, we had to make hostage payments.”

Dropped in a Firestorm

In its Chapter 11 filing, Circuit City listed assets of \$3.1 billion and debt totaling \$3.25 billion. Among the claims filed in the case were \$650 million in total trade debt. Of that, as much as \$350 million were administrative priority claims for goods delivered within 20 days of the bankruptcy filing. The company also had \$64 million in underfunded pension obligations, according to the filing. Under amendments to the Bankruptcy Code enacted three years earlier, Circuit City had just 210 days to determine whether to assume or reject leases on its 602 stores.

Richard M. Pachulski, a partner with Pachulski Stang Ziehl & Jones LLP and the lead attorney for the creditors’ committee in the case, said that many of Circuit City’s suppliers felt their group was being asked to assume a essentially all of the risk associated with a proposed sale and restructuring of the retailer. He said the \$1.1 billion debtor-in-possession (DIP) loan supplied by a bank group included only \$50 million of new money but \$30 million in fees. The agreement also called for the banks to be repaid by the end of February.

“Circuit City was losing—some may disagree with this—\$100 million a month, and you were basically asking vendors to provide credit and to keep it alive and risk their unsecured distribution,” said Pachulski. “The creditors committee was dropped into a firestorm. We had a horrible DIP arrangement, where effectively, when you cut through it, you had \$50 million of additional availability for \$30 million in fees, which was outrageous. So we’re dealing with that, and we’re dealing with literally—within two or three weeks of being formed—whether the company should be liquidated or (should remain a) going concern, and there were a whole assortment of issues on that.”

Galardi said the continued tightening of credit terms by vendors discouraged potential buyers from seriously pursuing a potential deal. “Even with those companies that were coming in, kicking the tires, the constant message we received was, ‘What are the vendors going to do? Are the vendors going to give me, as a purchaser of this business, trade terms?’ The answer was no,” he said. “They kept saying no. So why would I buy a business in a market in November, December, and January, put the same debt load on it and the same no-vendor support?”

Lawrence E. Klaff, a principal and managing director with GB Merchant Partners, a Gordon Brothers Group Company, said Circuit City’s experience wasn’t unique among companies that received DIP loans during that period. He said that during that timeframe, appraisals dropped on inventories across a host of industries, including electronics, siphoning liquidity out of the market. Because liquidity is key to banks in structuring DIP loans, the tight credit conditions were reflected in the costs of Circuit City’s loan.

Consumer behavior changed so radically throughout the country in October and November 2008 that his firm, which had always been confident in the valuations it attached to products in such cases, suddenly found it difficult to accurately predict what consumers would do, Klaff said.

“We always thought we had an understanding of what the consumers’ reactions to products were, and that changed,” Klaff said.

Out of Time

Galardi said that despite the obstacles it faced, Circuit City believed that it might be able to sell the company if it had more time. He said the company was frustrated with what it perceived as the vendors’ view that Circuit City’s case would be a liquidation “from day one.” Duffy and Pachulski said, however, that some portion of the chain may have survived had the retailer tried to break up the company and sell it in pieces, particularly in the Northeast, rather than trying to find one buyer for the entire company.

“I think there were pieces of the business that could have generated significantly more money than they did liquidating,” Duffy said. “I think there was money left on the table by not pursuing different regions.” ■



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Hard Times Spawn Attractive Opportunities for Investors

The Great Recession underscored a painful maxim for the management teams of distressed companies: hope is not a strategy.

Faced with the credit crunch and dramatic decreases in asset values, many nonetheless clung to the hope that if they could just hold on a little longer or raise additional equity, conditions would improve and they could right themselves. It was a scenario with which panelists for the “Meet the Money” session at TMA’s 2010 Distressed Investing Conference in Las Vegas were all too familiar.

“Many management teams are often in denial, as we all know, and they wait and they wait...and rather than getting something done and bringing in capital, they simply wait too long,” said Jonathan Rosenthal, managing member with Saybrook Capital LLC and the panel’s moderator.

That strategy proved to be particularly inappropriate given how the capital markets seized up. The result for investors like Peter Spasov, a principal with Marlin Equity Partners LLC, and Gerald O’Brien, a senior director with CarVal Investors, has been a steady stream of increasingly attractive opportunities.

“We’re trying to take advantage of capital vacuums or orphaned assets for discontinued businesses, where there is something wrong at the parent company that’s forcing them to divest,” O’Brien said. “Historically, we would take on more-sticky situations that need improvement. But now the capital vacuum has been so pronounced that you don’t really need to take on a problem. You just take on a new investment opportunity.”

“The bar has been raised. You want to find better assets, especially with the opportunities that are out there,” Spasov agreed. “We’ve probably averaged about a deal per month for the last 12 to 16 months. We’ve seen a lot of deals.”

Two other panelists, Steve Hinrichs, a senior vice president, business development manager, and office manager for Bank of America Business Capital’s Pacific/Southwest region, and Jeanne Grasso of Wells Fargo Capital Finance, said asset-based lenders also had been busy. Hinrichs said that not only had his firm been involved in financing traditional asset-based lending (ABL) deals in 2009, but it also had refinanced “a decent amount” of traditional commercial bank loans after that funding source “for the most part, kind of shut down.”

Hinrichs said 2009 was his firm’s “busiest year ever,” topping 2008, which had been a record year to that point. He said, however, that although his firm likes to participate in large deals—“the bigger, the better”—few of those had materialized in the previous 18 months.

“It wouldn’t be uncommon in Jeanne’s world and our world to see a number of multi-hundred-million-dollar deals in a year, but that hasn’t been the case in the last 12 to 18 months,” Hinrichs said. “It’s just smaller deals, under \$100 million, getting done.”

Spasov said many deals his firm had participated in during the previous 12 to 18 months came from companies that were overleveraged and needed to shed assets to pay down debt or improve profitability to avoid tripping loan covenants. Others came from lenders who found



The “Meet the Money” panel included (from left) moderator Jonathan Rosenthal of Saybrook Capital LLC, Jeanne Grasso of Wells Fargo Capital Finance, Steve Hinrichs of Bank of America Business Capital, E. Gerald O’Brien II of CarVal Investors, and Peter Spasov of Marlin Equity Partners LLC.

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themselves owning businesses after borrowers defaulted on loans.

“What’s required these days is speed and certainty and also the operational know-how to go into these businesses and give people the confidence that you know how to fix businesses,” he said. “It’s not only the money. It’s also being creative and finding solutions to those types of problems.”

Although the panelists said that credit remained tight, all of them had seen signs that the crunch had begun to ease. In 2007, Rosenthal noted, middle market borrowers enjoyed leverage of 5.8 times earnings before interest, taxes, depreciation, and amortization (EBITDA). “Today, you’d be lucky to get two, 2.5 times leverage,” he added.

“But the glass is half-full,” O’Brien responded. “There is a market. It’s 2.5 times. There used to be no market.”

Grasso said ABL lenders stepped in to provide capital when other lenders began pulling back over the past few

years. She said the ABL market provided a source of stability in 2009, when it ABL comprised “a very significant portion of the leveraged loan market.”

“In the first of 2009, our deal flow consisted primarily of self-help amendments, amend-and-extends, and cash-flow conversions. There was also a spike in DIP financings early in 2009,” she explained. “Then in the second half of the year, when liquidity returned into the high yield market, we saw a surge in paired high yield/ABL financings. And today, there’s definitely a significant amount of activity related to refinancing, as issuers are trying to extend out and smooth their maturities.

“We are just now starting to see a pick-up in M&A activity, and certainly the stage appears to be set for a real ramp-up of M&A-related financings,” Grasso said. “With the return of liquidity in the marketplace and valuations seemingly on the rise, I think more of the opportunities will be growth- and M&A-related versus pure restructurings and covenant relief situations.”

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O'Brien said that although opportunities abound, investors have shifted focus in response to market changes, and they must be especially diligent in investigating potential investments. His firm invests globally in loan portfolios, corporate securities, real estate, and special opportunities. The firm historically has enjoyed a 30 percent "hit rate" on the deals it looked into, but O'Brien said that percentage dropped to about 20 percent in 2009.

In addition to good investment opportunities, there were a number of less attractive deals attempting to compete for capital.

"I'd say in 2009 the investment opportunities in corporate credit were unprecedented, but now in 2010, it's really, really tight. We're not interested in overly tight markets," he explained. "In real estate, how choosey are we going to be? Real choosey in real estate."

Survival of the Fittest

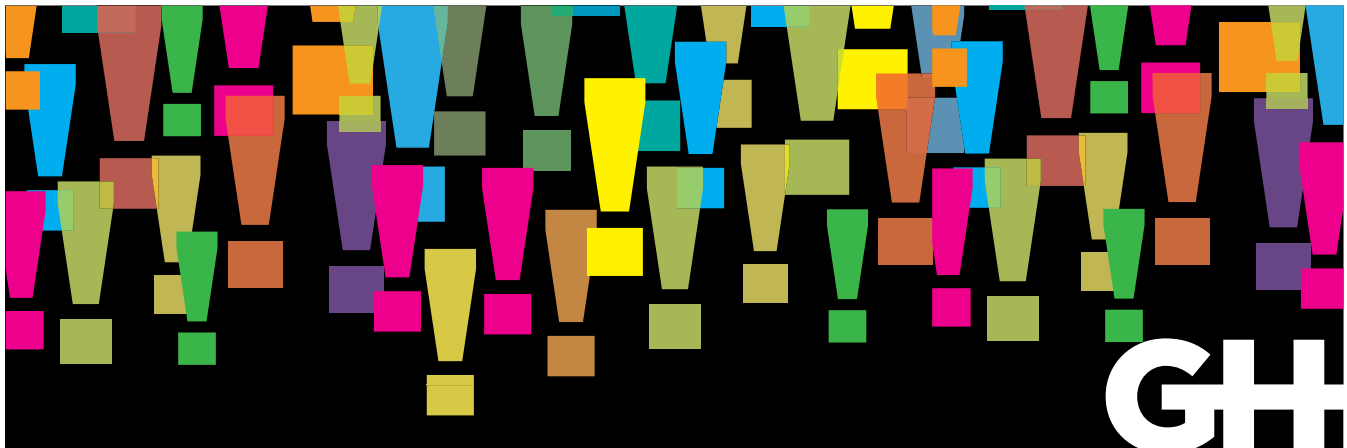
Rosenthal, O'Brien, and Spasov all said their firms attempt to screen potential deals quickly so that they

don't waste a lot of time on due diligence involving prospective investments that are unlikely to pan out. The recession has done its part as well by ensuring survival of the fittest.

"From my perspective, the people who have survived the credit crunch and have gone through what I call the credit crucible, if by hook or by crook they are still alive after this, it's a pretty good management team," O'Brien said. "The people who have survived and are now looking to do things with us have been vetted by Darwinian natural selection, if you will, so we're quite pleased. The deadwood has sort of fallen out, and so we're getting less noise and more quality."

Spasov said the environment looks good for dealmakers for some time to come.

"There's a little bit of shift in the market now, with capital markets coming back and a few other things," he said, "but I think we'll continue to be on the same page, I'd say, for the next three to five years." ■



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Even Banks Find Access to Capital Limited

Despite optimism in some quarters that the U.S. economy is on the road to recovery, Joseph S. Berry of Keefe, Bruyette & Woods sees continued tough days ahead for the U.S. banking industry.

The moderator of the “Where Are the Banks Going?” panel at TMA’s 2010 Distressed Investing Conference, Berry acknowledged that the U.S. had seen recent growth in its gross domestic product (GDP) and an uptick in home sales. But with unemployment expected to continue at 10 percent or more through 2011, consumer spending, the engine that has helped drive past economic recoveries, won’t be firing on all cylinders for quite some time, he said.

As bad as the situation has been in the banking sector, with well over 100 bank failures in 2009, it’s about to get even worse as the full impact of soured commercial real estate (CRE) and commercial and industrial (C&I) loans hits the industry, Berry predicted.

“I’m not here to tell you that you’re going to see the same level of loss in CRE and C&I that you did in construction because obviously there’s cash flow and there’s collateral. But because the concentration is so much higher for the industry as a whole, you don’t need the same level of losses to impact the same level of destruction of capital for the industry,” he said. “This is something that isn’t

going to be resolved overnight. It’s going to take time, and it’s going to cause a lot of bank failures.”

Banks have been besieged by plummeting home values that have left many borrowers underwater on their mortgages. With many borrowers losing their jobs and therefore their ability to repay outstanding loans, foreclosure rates have skyrocketed over the past few years.

Nevada experienced a 41 percent drop in home prices, while Florida saw a 30 percent drop, California sustained a 27 percent decline, and Maryland experienced a 14 percent decline. This led to double-digit or high-single-digit foreclosure rates and ultimately to the failure of many banks, Berry said. “If you superimpose that on where the bank failures have been, not surprisingly they fall right on top of each other.”

Bad loans have severely restrained the amount of capital banks have available for new loans. In addition, plummeting collateral values on loans that are generating cash flow have forced banks to reserve even more capital.

“I think the other element is that real estate was one of the profitability drivers in these commercial banks—smaller banks, regional banks,” said Tom Gordy, a senior managing director with Conway MacKenzie. “So you’re not only having problems, you’re also losing a profitable source of business that generates capital to do more lending.”



Joseph S. Berry of Keefe, Bruette & Woods discusses recent bank failures during “Where Are the Banks Going?” Panelists, seated, left to right, were Tom Gordy of CM&D Capital, Brad Amundsen of The Private Bank, Tim Kruse of the FDIC, and John E. Freechack of Barack Ferrazzano.

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Increased Scrutiny

John E. Freechack, a partner with Barack Ferrazzano and chairman of the firm's financial institutions group, said regulators have responded by being especially harsh in recent examinations. His firm represents about 250 banks across the country, most of them community and regional institutions. In some cases loans that passed muster in previous exams are being downgraded now, and regulators are much less likely to negotiate with bankers over potential problems, he said.

"Enforcement actions are being handed out like popcorn," Freechack said. "In the last 10 years, we've done two, three enforcement actions a year. In the last 18 months, we've done about 60 of them."

"I spent the last week with the FDIC on our annual checkup, and I will tell you it was the most rigorous checkup in my career," said Brad Amundsen of The Private Bank in Chicago.

Loans that were underwritten in 2005 or 2006 at a 75 or 85 percent loan-to-value ratio, collateral for which has sustained a 35 percent reduction in value, carry LTVs of 105 to 120 percent today, Berry said. In the hardest hit areas, those loans may now stand at 126 to 155 percent LTV ratios. To move those assets from their books, banks basically would have to write off the difference between the initial loan and today's LTV.

"That would wipe out their capital," Berry said. "It's one of the reasons that you're not seeing a lot of sales of distressed assets today."

For now, Amundsen said, bankers are trying to work with some of their borrowers rather than write off those loans. As long as a borrower is making payments on a loan, he said, his bank can look at amending and extending the agreement.

"We still have some leeway, even if you recognize that all the equity is gone and your loan is underwater," Amundsen said. "Where that's not the case are loans that have no cash flow, and those are the ones we are actively and selectively trying to dispose of."

Continuing Cash Crunch

Like many of their clients, banks are finding their access to additional capital is extremely limited.

"Private companies and small companies probably have the most limited access to capital that I've seen in 20 years," Berry said. "I don't know of anything that's going to alleviate that except for a complete lifting in the bank stock market. And obviously from what I've shown you, I don't think that's happening anytime soon, playing once again to my view that the wave of bank failures is going to be a lot larger than most people think."

Through mergers and other avenues of growth, mutual funds, hedge funds, and other sources of capital that banks have relied on in the past have grown so large that they no longer want to participate in deals involving less than \$20 million to \$25 million, Berry said. Freechack said that has made it particularly difficult for many of his clients to address some of their problems.

"There are a lot of smaller banks in the country that need a small amount of money—if \$4 million could be considered a small amount of money—to actually get going and to make things happen" Freechack said. "And if they're not selling that around the board table, it becomes very, very difficult to find someone who will be putting money into them."

Tim Kruse, a senior capital markets specialist in the Federal Deposit Insurance Corporation's (FDIC's) division of resolutions and receiverships, said a number of investors initially express interest in buying failing banks, but many of them back away when they learn about the regulatory obstacles they face.

"You can't just come in and say, 'I've got a wad of money, and I want to buy a bank.' You've got to show that you are in it for the long term and that you've got a team and that you've got a vision," Kruse said.

For private equity (PE) firms that might be interested in buying banks, "the hurdles are very, very, very high," he said. "Inside Washington, there's really just not a favorable view of PE. The thought is, we don't want to enrich people off this crisis."

Berry said the current political environment almost certainly guarantees that banks will face increased regulation as a result of their recent problems.

"I've never heard the level of bank bashing like I've heard recently," he said. "Banks are going to have to hold more capital and reserve a greater amount. And you're going to see reduced levels of real estate assets allowed on their books." ■

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Hoping for a Wave, Investors Were Hit with a Tsunami

Those who eagerly anticipated a new wave of corporate distress and bankruptcies got more than they bargained for when the surge arrived with the force of a tsunami, throwing millions out of work and forcing untold numbers of companies out of business. The recessionary wave that arrived at the end of 2008 led to plunging real estate values that left banks, businesses, and individuals underwater and many of them in default. Worse, according to panelists for “2010: A Real Estate Odyssey” at TMA’s Distressed Investing Conference, another tsunami is likely to strike the commercial real estate market very soon.

Matthew Bordwin, who moderated the panel, said he counts unemployment, consumer confidence, and retail sales as key drivers in the real estate market, and he doesn’t like what he sees on the horizon. Unemployment is predicted to remain high through 2011. Already, one in seven households that have mortgages is either behind in their payments or in foreclosure.

“That’s a pretty staggering statistic. If people can’t pay their mortgages, they’re not shopping. They’re losing jobs,” said Bordwin, a principal of KPMG LLP, managing director of KPMG Corporate Finance LLC, and a member of its U.S. real estate services team. “The retail marketplace has been battered in the last 18 months, and we expect it to continue to take a beating. Vacancy rates will continue to rise, and rents will continue to fall. There is nobody filling empty spaces in the retail world.”

Bordwin cited statistics from Real Capital Analytics that commercial real estate transactions last year totaled \$42 billion, down from \$136 billion in 2008, which was down from about \$490 billion the year before. In 2009, 140 banks failed compared to 25 in 2008, he said, and in January 2010, 416 banks with more than \$300 billion in assets were on the Federal Deposit Insurance Corporation’s “flag list.”

More ominous, however, is that \$1.4 trillion of real estate debt is coming due in the next five years, he said.

“Nobody knows what’s going to happen when this flood continues. We all hear, ‘Amend and extend. Amend and pretend,’ while nobody makes a decision. ‘We’ll just hold the line, and we’ll shuffle along and see what happens,’” Bordwin said. “That’s fine if nothing else was coming due, but now we’re going to have this huge tsunami of real estate debt coming due.”

Pursuing Opportunities

“People keep asking us if we’re seeing good opportunities, and we basically say, ‘We’re trying not to become an opportunity,’ which is the nature of the market today,” said Robert M. Caplin, a principal and executive vice president with Next Realty, whose firm invests in shopping centers and parking structures.

Neil Aaronson, CEO of Hilco Real Estate LLC, said he has no problem finding property that can be purchased at 30 or 40 percent of replacement value, or prices per square foot that are 30 percent of what they were two years ago.

“We get very excited about it,” he said, “but we then start thinking about the holding costs and carrying costs. Some of these are big industrial facilities that came out of the automotive bankruptcies, and you start really thinking about where is the demand? When am I going to be able to find an end user for this? How long am I going to have to carry it, and what are those costs? That’s really how our short-term investing philosophy has changed.”

Supply outpaces demand by “dramatic, dramatic margins,” Aaronson said, which accounts for the downward spiral in real estate prices. Although he continues to see deterioration in the commercial real estate market, Aaronson said the pace of the slide has slowed. Matt Schwab, a founding member and managing director of Karlin Real Estate, said there is cause for optimism by investors. He said his firm closed several deals recently and believes that now is the time to pursue more good opportunities.

“We may not be at the bottom, but we’re scraping along it,” Schwab said, “and if you look at it and start to look

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Matthew B. Schwab (second from right) of Karlin Real Estate sees 2010 as a good year for investors interested in distressed properties. Joining him on the panel were (from left) moderator Matthew Bordwin of KPMG Corporate Finance LLC, Neil Aaronson of Hilco Real Estate LLC, Nick Smith of Angelo Gordon & Co., and Robert M. Caplin of Next Realty.

at replacement cost and triangulate it around what lease rates are and historical cap rates, I feel pretty comfortable in the deals we're doing. We're buyers, and we're looking forward to having a good year."

Despite falling real estate values, panelists said bid/ask spreads remained wide. Nick Smith, a vice president of Angelo Gordon & Co. who focuses on sale/leaseback deals, said he routinely encounters businesses that quickly lose interest in such arrangements when they begin discussing figures with him. Instead, some companies are turning to the high-yield market to raise cash, "which is also a way to amend and pretend," he said.

"They're able to sort of kick that can out there a little bit," Smith said. "So when we look at a deal in the sale/leaseback space, we see a lot coming to us, but not quite yet."

Smith said that in underwriting a potential sale/leaseback deal, his firm assesses the location of the property and the real estate market in the area. Underwriters also gauge how "mission critical" a property is to the tenant's overall

operations. The firm also assesses whether a lease is likely to be affirmed if a tenant, in a worst-case scenario, were to file Chapter 11. Finally, underwriters look closely at the company to determine if it has "a reason to be there" and whether its functions are easily outsourced.

"Food companies are great because you really can't send that stuff to China," he said. "We don't get a lot of our food manufactured there yet."

Caplin said that although grocery-anchored shopping centers were once highly valued by investors, they are "no longer that prize-type of retail investment" they have been historically. "And, as you said, those anchor spaces are leasing for less today than they were 10 or 15 years ago," he said. "Underwriting the value of those centers today is very difficult."

Caplin said his firm has been able to obtain loans, but only under much tighter terms than were routinely available in the past. Interest rates are higher, recourse rates are around 25 percent, and loan-to-value (LTV) ratios

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have fallen, he said. LTVs now hover in the 50 percent to 60 percent range, he added, and as a result, proceeds are much lower. Caplin said that in one refinancing his firm completed in December, for example, loan proceeds were \$18 million.

“Eighteen months ago, we probably would have got \$28 million in proceeds,” he said. “Getting to ‘yes’ has become very difficult, even with your existing lenders.”

And sometimes, Caplin added, it’s difficult even to get time with a bank to head off a potential problem, such as an anticipated Chapter 11 filing by a major tenant that could jeopardize an investor’s chances of paying his mortgage. Banks won’t assign such an account to a special servicer because servicers already are overwhelmed with other workouts.

“The special servicers are more than willing to work with you, but they’ve got a stack this big,” he said, “and if you’re a \$15 million to \$20 million loan and they’ve got a bunch of \$100 million loans they’re trying to work

out, you’re not going to get a lot of attention from them, which is pretty frustrating.”

Market Movement

Although panelists agreed that banks in 2009 were unwilling or unable to let go of troubled assets, they predicted that many of those would begin hitting the market this year, as banks move to write them off. “I imagine they were hoping something better would happen over the last 12 months, but it’s certainly deteriorated significantly,” Caplin said.

Schwab said, however, that opportunities were already available to those willing to do their homework and work their contacts at local and regional banks, which hold most commercial real estate debt.

“There is no better marketing than closing a deal,” Schwab said. “The condominium deal we did was actually a pain because there were three banks to negotiate with. The great thing was we had three sets of banks post-close (to whom) we could say, ‘What else you got?’” ■



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Fix It or Dump It—The Sooner, the Better

Conventional wisdom in the turnaround business is this: The sooner company problems are fixed, the better.

With one exception, that appeared to be the general thinking of the “Fix It or Dump It: That is the Question” panel moderated by William K. Snyder, CTP, at TMA’s 2010 Distressed Investing Conference earlier this year in Las Vegas.

or poorly from an operational standpoint and those that are poorly positioned strategically, but run well or poorly from an operational standpoint. Further evaluation entails the company’s level of distress and pressures from various creditors to move the company in one direction or another.

“You’ve got a company that’s really, really broken tactically, but strategically in the right place. How do you evaluate that?” Snyder asked.



Thomas R. Califano of DLA Piper LLP (US) says companies have fewer legal options the longer they wait to restructure, during a panel discussion with moderator William K. Snyder, CTP, of CRG Partners Group LLC, left, Carrienne J. Basler of AlixPartners and William R. Quinn of Versa Capital Management Inc.

Snyder, a managing partner of turnaround firm CRG Partners, was joined on the panel by Carrienne J. Basler, a managing director with AlixPartners; Thomas R. Califano, a bankruptcy lawyer and partner with DLA Piper LLP (US); and William R. Quinn, a principal with private-equity firm Versa Capital Management Inc. and the contrarian in the group with regard to how long a troubled company should languish.

At the start of an engagement, turnaround professionals assess whether forces affecting a troubled company are internal or external, and whether the fix should be strategic or tactical. As a backdrop, Snyder referred to a chart showing profiles of troubled companies by quadrant: those that are strategically well-positioned but run well

“Part of that goes back to the discussion of timing,” Basler said. “We all go in there, the turnaround professionals, and say, ‘What’s my cash position? Where am I going to get the financing to help me through if I need to fix this broken company? What’s my short-term fix? What’s my long-term fix? Can I get there?’”

Fixable Problems

Some private-equity firms view strategic positioning as a problem that can be fixed, especially if they’re aiming to take control of the company’s board. Companies with tactical problems are likewise attractive because those issues tend to be quantifiable. “Finally, we look at things that can be fixed that we can fix, but they’re going to add

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value to the enterprise,” Quinn said. “There are plenty of things that you can fix that don’t add value, and we don’t particularly want to focus on those.”

Pointing to the second quadrant of his chart, representing strategically well-positioned companies that are also well-run operationally, Snyder quipped: “Is that Sasquatch—it doesn’t exist?” Panelists seemed to agree that distressed companies whose troubles stem only from an upside-down balance sheet are far and few between.

Based on the distressed curve as a reference point, more companies are showing up in the lower half of the curve when options are dwindling and the company is moving dangerously close to running out of cash.

That’s an area that sits well with firms like Versa. “At the low point is where the alternative is us or a liquidator.

That’s a place where we’re very comfortable because the target typically has fewer options. Speed and certainty of a closing are more important than the last extra dollar in an auction,” Quinn said.

Driving companies to that edge are managers who are in denial about problems and lenders that enable them to remain that way through practices such as extending loan maturities to avoid losses. It’s a bad use of time for troubled companies.

“Just like you have more business options earlier on, you have more legal options earlier on—and a reorganization is a difficult thing to accomplish,” Califano said. “You need time. You need to have cash so you can work the process, work the constituencies...keep the company together.”

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“Even for lenders, by waiting until it gets to the end of that curve, they’re leaving value on the table and guys like him,” said Califano, motioning to Quinn, “are picking it up.”

Complicating matters are any number of stakeholders who may have any number of objectives—from the hedge fund that wants to own the company to banks that just want to get paid. With stakeholders at odds with one another, a U.S. Bankruptcy Code Section 363 sale sometimes is the only viable option.

“But if the only thing you can agree on is dump it, then that means whatever value that could have been accrued is just gone,” Snyder said.

Private-equity firms often seize on this “slippery slope” to gain control of a business. “If we end up with debt securities, oftentimes we have purchased them at a discount, and a likely outcome for us is that we are trading that piece of debt for a controlling piece of the equity. And there are plenty of debt holders that don’t want to be owners,” Quinn said. “We’re perfectly comfortable being owners. In fact, if we’re owners, you’re much more likely to be in the driver’s seat to drive the change that needs to happen in order to create value. “

Snyder asked about second-lien debt holders who realize they’re out of the money when a troubled company faces a sale. Califano offered a suggestion: “Open your checkbook.”

“That’s the problem that you have when you’re at the end of the curve because now constituencies are out of the money,” Califano said. “They have a forum, which is the Bankruptcy Court. They’ve got a voice through the official committee, but there’s no value there. So their only play is...to make noise.”

Other Options

Quinn’s firm, Versa, has occasionally opted to use alternatives to the bankruptcy process to conduct transactions. Those include a business receivership, in which a court appointee takes over a debtor’s business, and an Article 9

foreclosure, in which a secured lender takes control of collateral after a borrower defaults.

“If you have a more basic capital structure, I have seen people doing an out-of-court restructuring of the debt or going straight to creditors and saying, ‘We’re in financial straits. We need to do a deal, and here is what I’m going to offer you,’” Basler said.

New provisions in the [Bankruptcy Abuse Prevention and Consumer Protection Act of 2005](#) regarding assumption of leases, 503(b)9 claims, and cash deposits for utilities create more hurdles for troubled companies. The rules rattle their confidence about whether they can exit Chapter 11 as a reorganized company.

“The overall issue is, nowadays because of the hurdles that you have in the law changes, you have to start earlier,” Califano said. “That requires you to do more work before you file, before you start that clock running.”

More judges have come to accept a Section 363 sale as an appropriate way to resolve a case, although panelists said that hasn’t always been the case. In a Section 363 sale, companies can be sold free of liens and claims, the process can move faster than a Chapter 11 reorganization plan, and the sale can proceed over creditor objections. A reorganization plan allows more flexibility in outcomes and attempts to achieve consensus among various constituent groups. Both have disadvantages.

Two court decisions have sparked questions about whether the Section 363 sale will remain a straightforward process. A 9th Circuit bankruptcy appellate panel held that Clear Channel could not sell its assets free and clear of a junior interest, and the U.S. Supreme Court ruled in the *Piccadilly Cafeterias* case that a transfer tax exemption allowed in the Bankruptcy Code applies only if a reorganization plan is filed at the time of the sale.

“This is a case that’s going to have more focus because I think...we’re looking at a wave for the next couple of years of commercial real estate failures,” Califano said. “Transfer taxes, especially in real estate cases, can be significant.” ■

Positive Signs Emerge in Some Industry Sectors

Business sectors are performing better than expected despite the fact that consumers aren't opening their wallets as exuberantly as they did before the financial crisis toppled the economy into recession.

To be sure, though, panelists who discussed "Industry Trends: Who Will Benefit From and Who Will Labor Under the Economic Recovery?" at TMA's 2010 Distressed Investing Conference in Las Vegas earlier this year said that certain sectors are likely to undergo significant transformation as a result of the downturn.

The panel, moderated by Ronald F. Greenspan, senior managing director and West region leader of FTI Consulting, Inc.'s Corporate Finance Practice, consisted of Frank A. Merola, managing director of the Recapitalization & Restructuring Group at Jefferies & Company, Inc.; Charles M. Moore, CTP, senior managing director with Conway MacKenzie, Inc.; and Kathleen Steele, managing director with Equity Group Investments.

Greenspan began with an overview of various sectors' performance in the debt markets, which turned out better over time than expected. Of 190 public company defaults, the lion's share—120—occurred in the first half of 2009, and 70 took place in the remaining six months of the year.

While Standard & Poor's (S&P) lumped about 85 percent of all U.S. speculative grade bonds—about \$400 billion in total debt, represented by 920 issues—under the distressed category in December 2008, it described only 15 percent of such bonds that way a year later. And while 12 out of 22 industries, including transportation, insurance, automotive, media, and retail, showed a stress level above 90 percent at the end of 2008, only two industries—homebuilding and banking—exceeded a 30 percent stress level a year later.

"In other words, despite what we are feeling out there... despite the high unemployment and low spending right now, the actual balance sheets and how these securities are trading indicate we are actually in a relatively healthy market situation," Greenspan said.

Equity markets seemed to bolster the notion that various sectors, as compared to a baseline S&P composite index, are looking up. Media, for example, experienced a 37.1 percent cumulative decline since January 2007 compared to the index, but an 18.2 percent cumulative decline since January 2008. "What that is telling us is that it's down, but the market has staged a remarkable recovery," Greenspan said.



Frank A. Merola, a managing director with Jefferies & Co., discusses how dampened consumer spending, overlapping markets, and overbuilt casinos are affecting the gaming industry. Joining him, from left, are Ronald F. Greenspan, a senior managing director with FTI Consulting, Inc.; Kathleen Steele, a managing director with Equity Group Investments; and Charles M. Moore, CTP, a senior managing director with Conway MacKenzie, Inc.

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Businesses that make up the capital goods sector, such as those focused on building products or construction and engineering, fared worse, with a steeper cumulative decline since January 2008 (31.4 percent) than since January 2007 (27.5 percent).

No Sector Unscathed

No sector remained unscathed from the downturn, particularly retail, whose fortunes are tied to flagging consumer confidence. “The savings rate has increased and a lot of that is driven by a fundamental change in perceived purchasing power,” Steele said. Consumers buy based on perceptions about their wealth, typically corresponding to owning a home or retirement account with increasing value. Those values plummeted in the recession, leading more consumers to spend less and save more.

“More recently what we’ve seen is the consumer really switching from being a net-worth consumer to a net-income consumer,” Steele said.

With spending consciousness abounding, value-based retailers, such as Burlington Coat Factory and T.J. Maxx, are likely to perform well in the short term. Over the long term, increasingly popular online retailers and retailers situated in prime locations and properties stand to do well.

“I think banks now, generally creditors, see a bottoming out of the losses. Retail no longer looks like the falling knife that it once did,” said Steele, referring to the surge in retail bankruptcies and liquidations in 2009.

Many retailers that accumulated too much debt have switched to survival mode by reducing inventory and buying less expensive inventory, cutting payroll, and not reinvesting in the business. Those changes could prove damaging when customers start spending again and find that a retailer has lost its luster.

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Retailers that skirted filing bankruptcy filing with the help of “covenant-lite” loans and other devices may face a reckoning when debt obligations mature in 2012 through 2014. “I think you’re going to start to see some acceptance of the fact that equity is underwater and (also) more bankruptcy filings,” Steele said.

Looking to the industrials sector, Moore seemed less sanguine about prospects for aerospace, automotive, and other businesses that support an intricate supply chain in which most component parts are single-sourced.

“There are just not the signs present that you would think need to be present to support a recovery in the manufacturing sector,” Moore said.

Overall, businesses in the industrials sector still have excess capacity, this despite the production uptick from the federal Cash for Clunkers program that paid incentives to auto buyers. High unemployment, regulatory uncertainty, and the potential for price increases for commodities such as oil and gas all point to rough months ahead for the industrials sector, at least in the short term.

Businesses looking to increase profits are setting their sights outside North America—to Brazil, Russia, India, and China.

“The Big Three automakers are no longer GM, Ford, and Chrysler. The Big Three automakers are GM, Toyota, and Volkswagen,” Moore said. “When you look at where those companies have their manufacturing plants, they’re heavily focused in those areas where the demand will occur.”

Credit poses another complication. The mid-market, \$100 million to \$200 million companies undergirding industrials-sector businesses, commonly rely on bank financing, and that remains elusive.

On the other hand, large companies have used bond and commercial paper markets to get financing. Merola mentioned a specialty chemicals company that could get bond financing but not an asset-based loan. “So we could get someone to advance \$400 million, but we couldn’t

get the \$40 million revolver,” Merola said. The company wound up creating a synthetic revolver, among the tactics being used more often.

Odds for Gaming Are Poor

The gaming industry faces some luckless prospects, too. For established casinos in A-list destinations, such as Las Vegas, a higher percentage of their earnings before interest, taxes, depreciation, and amortization (EBITDA) derives from activities consumers are shying away from—staying overnight, shopping, dining, and going to shows. When they do participate in those activities, they are shifting to lower price points, Merola said.

Resorts that reduce a \$350 per night room to \$99 may attract a customer less likely to gamble in a casino designed for mostly high rollers. And those casinos that added new towers and other additions aren’t seeing the uptick in business that fed those development projections. “You don’t have to look farther than Las Vegas to point to projects where people added towers and the additional casinos and the EBITDA is lower than when they were operating one tower or casino. A lot of those people would like to get their \$800 million back and try to think to do something else,” Merola said.

He expects some destination resorts to move away from a business model that depends on customers plunking down hundreds of dollars at a time each for lodging, dining, and Broadway-style entertainment. Instead, they will revert, at least in the short term, to the 1960s and 1970s practice of running each department in the property to break even and feed the casino.

The gaming facilities most likely to fare well in the short term are those situated in isolated locations where their nearest competitor is hundreds of miles away. Increasingly, that’s less of a possibility as gaming facilities continue to pop up all over the U.S. Before 1990, only Nevada, New Jersey, Iowa, and South Dakota allowed casino gambling. Since then, 30 more states have legalized casino gambling or have tribal casinos. As states struggle to find cash, those numbers may ramp up even further. ■

Expecting the Unexpected—Risks in Distressed Deals

An acquisition can appear as a beautiful package wrapped with rigorous due diligence and precise financial modeling, and still it can turn into a dud. Buyers should expect a greater number and variety of risks in acquisitions of distressed companies than in healthier ones, which was a theme of a panel session about transactions that went astray.

“Most acquisitions, I have found, get into trouble because of an insufficient understanding of the risk, and then implementation based on an inadequate understanding leads to problems,” said Howard Brod Brownstein, CTP, president of The Brownstein Corp. and moderator of “Deal Autopsy—Lessons Learned.”

Though various types of risks can bedevil an acquisition, underlying them all is financial risk since the *raison d’être* for the transaction is to make money. Lewis J. Schoenwetter, a managing director of private investment firm Bayside Capital and his then-team, thought they had accounted for the financial risk in a subprime auto deal. The transaction depended on securitization markets

behaving in a certain manner, an expectation backed up by analysis covering a decade.

“All the models proved out that 98 or 99 percent of the time, you would be able to securitize, or take the debt off the company’s balance sheet, and the financial risk was bounded,” Schoenwetter said of the deal from a decade ago. “That worked right up until the one percent of time that it didn’t work.”

James B. Shein, Ph.D., a professor of management and strategy at Northwestern University’s Kellogg School of Management, sits on boards of troubled companies. He recalled an acquisition in the early 1990s, the success of which depended on some unanticipated elements that became painfully significant.

Involved were an accelerator clause in a plant lease agreement, a component whose price was 55 percent of cost of goods sold, finished products sold at fixed prices, and a task list for an associated plant. The price of the key component doubled overnight, and the to-do list languished



Panelists Leon V. Komkov, Longroad Asset Management LLC, left, Lewis J. Schoenwetter, Bayside Capital, center, and John P. Tatum, Prophet Equity, listen to aspects of a well-crafted deal that turned dicey.

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with the previous owner, who confessed he didn't know how to do some tasks and couldn't bring himself to do others. While Shein's group sold the second plant at a profit, the investors lost their equity in the first.

"We took on financial risk and part of that financial risk was, we had not put sufficient reserves in the deal to allow for that kind of thing to happen," Shein said.

Beyond the Balance Sheet

A frequent problem crippling distressed acquisitions, which by nature are more unpredictable, is integration. Brownstein recalled a failed roll-up of two building manufacturers that made similar products and "followed 15 different accounting systems."

"They weren't getting the advantage of common buying. They weren't getting the advantage of common tooling," Brownstein said.

"It was just a mess."

One solution: send a member of the deal team to the target company for weeks or months to identify problems that could slip by typical due diligence. Shein once interviewed graveyard-shift workers, and Leon V. Komkov, founding member of special situations private-equity firm Longroad Asset Management LLC, went as far as to obtain a commercial driver's license. He wanted to validate how many drops per day drivers could make.

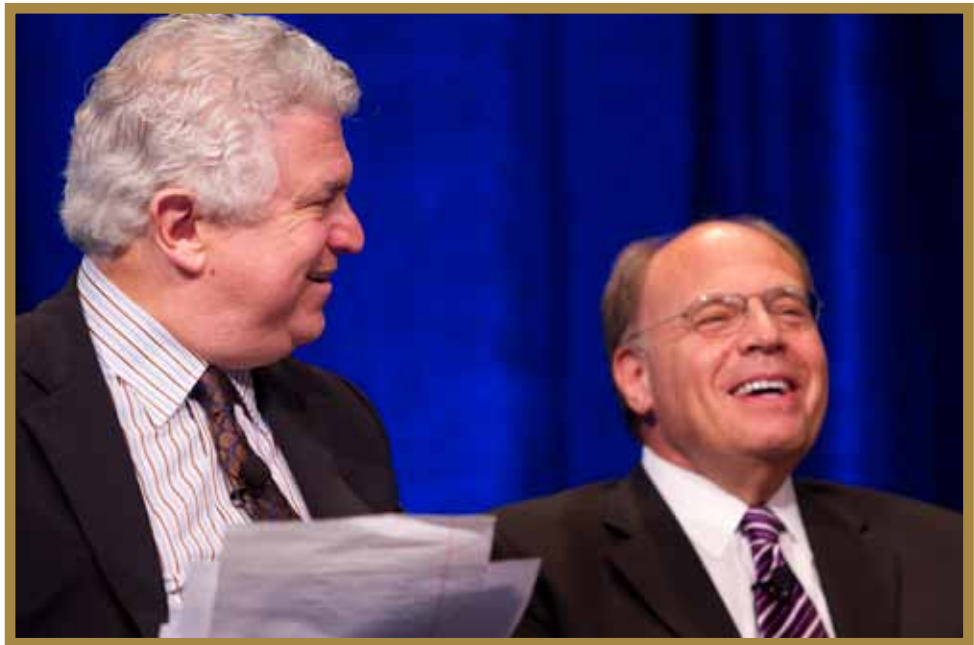
"When all is said and done, yeah my guys were lazier than they should be and weren't working as hard," said Komkov, who overcame union resistance and rode as a passenger. "But the truth is, when you're sitting at a desk saying, 'You drive a truck. You pull a hose. You pull the pump. It's not that hard.' Yeah, it actually is. There are complexities that you don't get to see if you're sitting in an office looking at a balance sheet, instead of driving with a guy in a heating oil truck."

Telltale Signs of Trouble

John P. Tatum, a vice president at private-equity firm Prophet Equity, recalled an investment in a retail gift card company foiled by the discovery of a year's worth or more of overstated inventory accounts. Rehashing things seven months after closing, team members acknowledged that they suppressed doubts about the CFO who had angled to keep his job.

"In transactions, you're always having to make judgments about people...about risk," Tatum said. "It's good to actually be listening to your instincts in some ways."

Schoenwetter's tack for mitigating accounting risks is to track cash, which he said includes determining all of the



Howard Brod Brownstein, CTP, The Brownstein Corp. and moderator of "Deal Autopsy—Lessons Learned," shares a laugh with James B. Shein, Ph.D., Northwestern University Kellogg School of Management, during a light moment on the panel.

different places in the balance sheet and income statement where earnings have not translated into cash.

"Had people done that in Enron, had people done that in some of these more spectacular blowups, the answers would have been more clear very early on—immediately," Schoenwetter said.

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Deals that involve distressed companies require extra scrutiny of such items as recent audits, projections and their assumptions, and historical sales figures.

“Are those sales profitable sales? How do you know?” Brownstein asked rhetorically. “With due respect to our colleagues in the accounting profession, it may really take a turnaround professional to go in and do a risk assessment for you, in addition to accounting due diligence, so that you really understand what the value of those numbers is going forward.”

Changing Markets

Dealmakers also should be wary of market risk, which takes into account customer relationships; market share by customer, segment, and product and service; growth opportunities; and competitor behavior since the company's decline. Shein provided an example of a marriage between two companies that each controlled 25 percent

of the market for plastic bags, each with about \$30 million in earnings before interest, taxes, depreciation, and amortization (EBITDA).

At worst, the deal architects figured on \$70 million EBITDA from the combined companies. Instead, they made \$30 million EBITDA. Why? The combination pushed a major customer into the arms of Chinese suppliers who offered to absorb transportation costs. The company wound up in a prepackaged bankruptcy because the \$30 million EBITDA could not pay for debt used to merge the two, Shein said.

“It kind of gets back to a big overarching which is, when all is said and done, pricing of the investment,” Komkov said. “You’ve got to buy right.”

And that’s what Komkov’s team appeared to have done when they paid \$9 million for a bank’s \$45 million stake in a textile plant. Then things went wrong. A key

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customer opted to use a different source. A change in Canadian law freed the company's locked market. Key customers followed fired management out the door.

The plant was turned into warehouse space. Although the investors got back financially to where they started, Komkov said it took years and half the team to accomplish that.

Things that need to happen for the deal to be successful fall under the category of execution risk. In the building manufacturers' case, the company emerged from bankruptcy with a healthy stock of orders, Brownstein said. The only problem was that it had not yet ordered the steel, which had since doubled in price.

"We were looking at going back into bankruptcy without the ink even being dry on our confirmation order," Brownstein said.

The company negotiated with its customers and persuaded them to put up more money for their orders. Brownstein's argument? "I'm a turnaround guy, and here is my bankruptcy analysis of this company if we go to a Chapter 22. This row of zeroes is you."

Organizational Risk

Execution risks also can topple grand plans. Tatum recalled a management team's attempt to turn a product reseller into a services business. "Obviously, selling product—and being able to do that well and do it profitably—is a very different thing than selling services," Tatum said. "Really try and understand why it is that the company is going to be able to get from A to B. Obviously, just doing what you are doing better probably is a little bit easier."

When physician and dental practice management organizations (PPMs and DPMs) were all the rage in the late 1990s, it took missed earnings and an analyst's return on investment capital study to reveal that doctors and dentists were working less than they had before professional managers started running consolidated offices. "The multiples came off dramatically to reset the expected return on the investment," Schoenwetter said.

Panelists dispensed nuggets of experiential wisdom with regard to organizational risk. Investors who decide to augment or replace management should do so sooner rather than later. Some suggested offering short-term and long-term incentives, including multiyear agreements with rewards tied to the ultimate exit.

At least one panelist, however, flatly opposed giving bonuses if a distressed company is losing money, no matter how hard the management team worked to try to prevent that. If the CEO of the distressed business asks about compensation before talking about how to fix the business, he or she should be let go, several panelists said.

Komkov called that "a golden insight," but Brownstein seemed to take exception. "Leon, isn't his maximum leverage with you before he has gotten you out of that pickle?" Brownstein asked.

Komkov replied that based on his experience in buying nuts and bolts manufacturers, it's rare to find an irreplaceable management team member. "There's another guy who can run this little stamping plant, I promise you. And if you come in with the attitude like that, you can negotiate well with management," he said.

The group espoused hiring good advisers who have been in the trenches with distressed businesses and good lawyers who can guide dealmakers through the briar patch of risks. Even with the best efforts, some issues, such as unfunded pension plan liability, are formidable.

As the recession left millions of union workers jobless and pitched the stock market downward, pension plans to which those workers contributed suffered heavy losses. But somebody still pays.

Komkov referred to a company that pre-recession had zero pension plan liability. "As of last week, the pension plan liability is \$56 million," Komkov said.

The liability, Brownstein added, pierces the corporate veil to reach owners. ■

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