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VIEWPOINT

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- Tips for Troubled Companies: Ten Things Every Officer and Director Should Know
- M&A Strategies in a Down Market

WHY THIS MATTERS:

Commercial bankruptcy filings increased by 54% in 2008 and are expected to increase still further in 2009. Chances are that in 2009 your business will be affected by a commercial bankruptcy – whether the insolvent business is your own, or that of a competitor, vendor, or customer.

If your business (or a key supplier's business) is financially distressed, beware of the potential for a hostile takeover. Increasingly, banks are selling troubled loans at a discount, and in some cases, the buyer of that loan may be the borrower's biggest competitor.

An opportunity to acquire a distressed competitor, supplier or other business at an attractive price may be in your Company's future, but if your management team isn't prepared to move quickly, you may miss out.

DISTRESSED M&A, DISTRESSED DEBT, AND THE RETURN OF THE HOSTILE TAKEOVER

By Jamie Grant and Don Richards

Like virtually every other sector of the worldwide economy, the transaction sector has been impacted significantly by the current financial crisis. Frozen credit markets, declining corporate profits and overleveraged borrowers are converging to make 2009 one of the more challenging deal environments in memory. November 2008 saw the lowest number of transactions close since September 2001, and the trend has been downhill from there.

Given the current deal environment, distressed transactions, hostile takeovers and bankruptcy sales will represent a growing share of 2009 transactions. According to FactSet, hostile offers have already accounted for 47% of the public-market M&A deals announced this year, compared with 24% in all of 2008 and just 7% back in 2004. Being aware of current trends in distressed investing and knowing how to navigate the unfamiliar waters of creditor disputes and the bankruptcy courts will be valuable for any firm looking to complete a transaction in the coming year. In this Viewpoint, we examine a variety of popular strategies including "loan-to-own", "buy-your-own", pre-packaged bankruptcies, secured-party sales and private hostile takeovers.

WHAT EXACTLY IS "DISTRESSED M&A"?

There are many reasons for the stockholders of a business to consider a merger, sale, or leveraged buyout. However, when a business is over-leveraged, insolvent, or bankrupt, the motivation to sell is one of necessity. Cash is the lifeblood of companies in financial distress, and therefore the distressed company's life expectancy is tied directly to the amount of cash available to continue operations. As such, "distressed M&A" is all about

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how long the distressed business has to complete a deal. If the business is burning $1 million per month and has access to $2 million in cash, the company probably has just two months in which to raise additional capital or sell. A buyer or investor that can complete a cash transaction quickly should be able to negotiate an attractive price in exchange for the liquidity it is offering to the stakeholders.

In the case of Envisionet, a call center operation that Mirus sold out of bankruptcy, Microdyne Corporation made an attractive all-cash offer that was conditioned on a standard due diligence period. However, Envisionet was burning cash and didn't have time to wait for a buyer to complete an in-depth review. As a consequence, Microdyne revised the offer, reducing the up-front cash by half while agreeing to close within days. Envisionet accepted the lower offer with a higher certainty of close.

DISTRESSED DEBT

The current market for distressed debt, now over $1 trillion, includes high-yield (junk) bonds, distressed and defaulted bank loans, mortgage-backed securities, and other debt instruments that trade in the secondary market. For middle-market companies, the term "distressed debt" generally connotes one or both of the following: (1) the borrower is in default (or would be in default if the loan document included traditional maintenance covenants); and/or (2) the lender (or lenders) wants out of the loan.

In most situations, the "distress" is a result of declining earnings or significant asset impairment. For example, if a business borrowed $30 million on the basis of $15 million in earnings, and those earnings are now $5 million, that loan would be distressed. Likewise, if the borrower's collateral were a $10 million office building which is now vacant, and the appraised value of the building had declined to $5 million, that loan might be distressed.

The market for distressed debt, once reserved for large "rated" loans and corporate bonds, has matured significantly over the past 10-15 years, and it is now possible for lenders to unload relatively small loans, provided that they are prepared to accept a discount off the face value. One recent transaction for a middle market loan involved a $32 million senior secured note for a services firm with declining revenue and earnings. Because the firm's primary asset (receivables) was tied to the continuing operations of the business, the loan, which was in default, was acquired at a steep discount (15% of face value).

POPULAR STRATEGIES FOR TAKING ADVANTAGE OF FINANCIAL DISTRESS

For savvy investors with capital to deploy, there are a variety of opportunities to profit from the acquisition of distressed debt, including "loan-to-own", "buy-your-own", and the hostile takeover. Alternatively, if time allows, the same objectives can be accomplished with significantly less exposure to third-party litigation. Some popular strategies include:

LOAN-TO-OWN

The loan-to-own strategy involves purchasing some or all of the outstanding debt of a borrower at a discount, then negotiating with the borrower to restructure and convert the debt into a controlling equity position. This can be done with the consent of existing shareholders, or forced through a foreclosure or bankruptcy proceeding.

Dozens of distressed debt funds have been joined in recent months by traditional private equity and mezzanine investors in the pursuit of attractive investment returns using this strategy, which was pioneered by Apollo Management, Oaktree Capital and Cerberus. Large sponsors such as Carlyle Group, Goldman Sachs and Blackstone Group have recently raised substantial distressed debt funds. While this is not a new model for investment, the entry of traditional buy-out firms – many of which are unaccustomed to turnarounds - is a meaningful development in response to an unprecedented wave of corporate defaults. U.S. private equity firms, anticipating the current economic downturn, set fundraising records in 2007 and 2008, raising over $100 billion for more than 50 new funds aimed at acquiring distressed companies and/or their debt.

One recent loan-to-own transaction was the acquisition of Portola Packaging, a manufacturer of plastic closures, bottles, and equipment for food, beverage, and cosmetics. Wayzata Investment Partners acquired the company's senior notes at a discount in the secondary market, and then funded a debtor-in-possession financing to allow Portola to restructure under Chapter 11. The bankruptcy restructuring plan involved the conversion of Wayzata's debt into equity and a refinancing that included $66 million of new senior debt and a restructured second lien facility. Portola then emerged from bankruptcy with a strong balance sheet.

BUY-YOUR-OWN

One variation on the loan-to-own strategy is for a deep-pocketed investor with an equity interest in a portfolio company to buy back the issuer's debt at a discount. For private equity investors, this "buy-your-own" debt transaction offers the dual benefit of de-leveraging the business while at the same time boosting the internal rate of return on the investment. Also popular for companies recently acquired in a leveraged buy-out is for the former business owner to

repurchase the very debt that was used to provide the buy-out capital. In one recent example, a business owner with $20 million in after-tax proceeds from the sale of her business was able to buy the company's $12 million secured note for just $5 million, putting her in a position to take back her company and still hold onto the bulk of the sale proceeds.

HOSTILE TAKEOVERS

Hostile takeovers are back, both in the public markets and in privately held businesses. The traditional "hostile" would be that of a public stock company being acquired without the board of directors' consent. Such hostile takeover bids have accounted for 47% of the M&A deals for public stock companies so far in 2009. In the private market, hostile takeovers are also becoming more common as a result of troubled loans being traded in the secondary market. If a lender wants out of a loan and has the right to sell the note or liquidate the assets in a foreclosure sale, the lender can generally sell its note (or the company's assets) to the highest bidder.

In January 2009, the Mirus Special Situations Group marketed the senior secured debt of ONSITE3, a provider of electronic evidence solutions for law firms, to a variety of the company's competitors as well as several distressed debt funds. Given their in-depth understanding of the market and of ONSITE3's business, the "strategic" buyers had the advantage of being able to move quickly without traditional due diligence. After an expedited but competitive bid process, the secured debt was acquired by Integreon, a global provider of electronic discovery services. Following the acquisition of the debt, Integreon then agreed to provide debtor-in-possession financing to ONSITE3, which filed for Chapter 11 in February.

A bankruptcy filing in the ONSITE3 situation, as was the case in the Portola/Wayzata situation described earlier in this piece, provides the new note holder with several attractive options: (1) "credit-bid" the face value of the debt, and acquire the assets for an actual cost that is equal to the discount paid for the debt; or, (2) if a new bidder emerges and pays more, take the profit and walk away.

"PRE-PACKAGED" BANKRUPTCIES AND OUT-OF-COURT REORGANIZATIONS

Under the scenarios outlined above where the note is sold and the assets are taken by the senior creditor, the other stakeholders (equity holders, subordinated and unsecured creditors) will likely be left with little or no payout. As such, the junior stakeholders will often file legal actions in opposition to such plans. This potential for litigation is one of the key risks an investor or acquirer must understand and try to minimize when considering a loan-to-own strategy.

In part to minimize the threat of third-party litigation, buyers of distressed debt will often use a bankruptcy reorganization as a vehicle for acquiring the business assets, as in the ONSITE3 and Portola transactions. However, while a bankruptcy can eliminate most litigation, going into a bankruptcy proceeding without a pre-arranged plan of reorganization that provides a dividend for the junior creditors can lead to long drawn-out fights in the bankruptcy court – all at the debtor's expense.

The concept of a "pre-packaged" bankruptcy (often discussed, but seldom accomplished) is to pre-negotiate settlements with most if not all creditors prior to filing the voluntary petition. This can be done in the context of selling the business rather than selling the note. For example, in the case of Maxnet Technologies, Mirus assisted the buyer with negotiating settlements (averaging approximately 20 cents-on-the-dollar) to the trade claimants, who were only too happy to get paid in cash from a new buyer that would allow Maxnet to get back on its feet. The settlement process was so successful that no bankruptcy filing was required, but the threat of bankruptcy provided the debtor and the buyer with the leverage to settle the claims at a reasonable cost.

CONCLUSION

Given the current economic climate and the significant amounts of leverage currently in the market, it is no wonder that default rates are predicted to rise to levels not seen since the 1930's. The downturn in financial performance coupled with high debt loads is creating an environment where distressed M&A and other special situations are becoming more and more common. In a certain number of these situations, one of the strategies discussed herein could present an investor or acquirer with a winning hand. Understanding both the risks and rewards of each option is key to its successful implementation. Seeking the advice of legal, financial and transaction experts with experience in insolvencies and special situations will certainly increase the likelihood of a successful outcome.

Jamie Grant *is a partner at Mirus Capital Advisors, Inc. Founded in 1987, Mirus Capital Advisors is a middle-market investment bank that specializes in merger advisory, capital-raising services, fairness opinions and valuations to entrepreneurs, corporations and professional investors. By combining a proven process, industry and transactional expertise, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Our affiliate Mirus Securities, Inc. is a registered broker-dealer and FINRA/SIPC member. Additional information about the firm is available on our website* **www.merger.com.**