Finance and Restructuring *Spotlight*

Charting a New Course

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Selected Financing and Restructuring Transactions

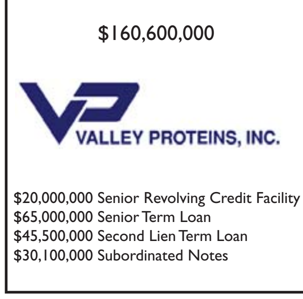
Manufacturing for the Housing Industry
Senior Financing

Interactive Entertainment
Cross-Border Financing

Apparel
Junior Capital Financing

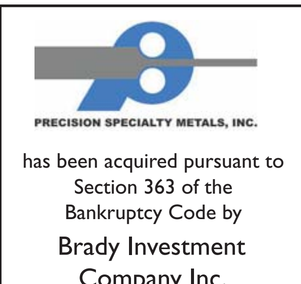
Construction Materials & Services
Financing

Restaurants
Junior Financing



Specialty Ingredients Producer
Restructuring

Optical Retailer
Financing



Metals
363 Sale

Telecommunications Equipment
Distressed Sale of Company

Specialty Tires
363 Sale

Specialty Tires
363 Sale

Specialty Ingredients Producer
Financing

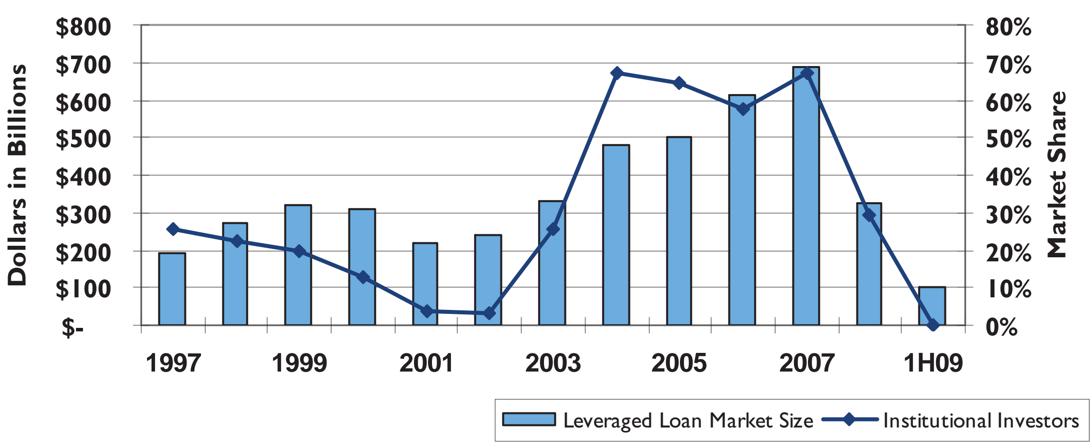
Charting a New Course

We are pleased to provide you with the initial installment of Finance and Restructuring Spotlight, a new publication from TM Capital Corp. Current market conditions make this a critical moment for issuers and potential issuers of middle market debt. The aftermath of the credit bubble has created a historic dislocation in the credit markets. The "rules of the game" are rapidly evolving and we believe that smart, honest and independent advice is critical to those considering financing and/or restructuring alternatives in today's environment. TM Capital's Finance and Restructuring Advisory Group brings to our clients the depth of experience and market reach critical to assuring optimal outcomes in this challenging environment.

The bull market that evolved into the current credit crunch began in the early part of this decade and precipitated a doubling of the size of the leveraged loan market. This report will explore how this growth was fueled by the emergence of institutional investment pools which, at the peak of the cycle, represented nearly 70% of all capital for new-issue leveraged loans. We believe there is a direct link between institutional investors' growth over the past decade and the severe dislocation experienced during the recent cycle reversal. We have observed that institutional investors behave differently, in meaningful ways, than do banks and, in fact, that not all institutional investors act alike. Thus, the presence of institutional investors in a capital structure complicates amendment and/or out-of-court restructuring processes, thereby increasing the difficulty of achieving success and, ultimately, increasing the risk of stumbling into bankruptcy court.

Another issue we will highlight is a looming maturities bubble which, we believe, is also directly linked to the growth (and now decline) of institutional investor capital. Much as the institutions provided the marginal capital that drove leveraged loan market growth, the outflow of that capital has left fewer dollars available to refinance the loans created during the bull cycle.

Finally, we will discuss two emerging restructuring related strategies. The first, amend-to-extend exchanges, are being used by certain issuers as a way to push out maturities without fully refinancing their senior capital structures. The second, Chapter 11 "cram-ups", are being used by debtors seeking to preserve attractive first lien capital upon exit from Chapter 11.



Source: Credit Suisse and S&P LCD

Institutional Investors and Their Impact on the Market

The leveraged loan market nearly tripled in size over the past ten years and roughly doubled during the past five years. Much of this growth was fueled by the emergence of institutional investment pools (predominantly CLOs or Collateralized Loan Obligations), which grew to represent nearly 70% of all new issue capital at the peak.

CLOs are structured vehicles that invest in loan assets with the goal of arbitraging the spreads between the loans (e.g. collateral) they own and the liabilities (e.g. rated debt tranches) they issue. CLO structures are highly leveraged, with $10-$12 of debt issued for every $1 of equity. Moreover, this $10-$12 of debt is low cost and LIBOR-based, typically carrying spreads of L+45bps – L+60bps.

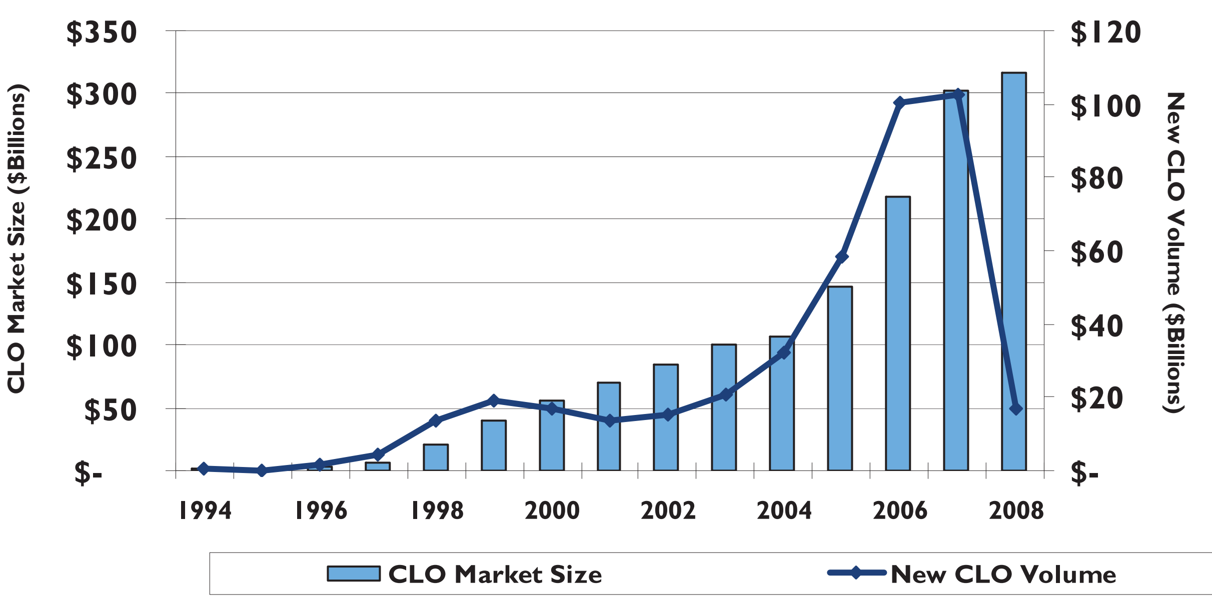
The importance of CLOs to the unprecedented expansion of the leveraged credit markets cannot be overstated. While CLOs barely existed ten years ago, at their peak they represented approximately a third of the leveraged loan market. The creation of all this leveraged liquidity allowed for small companies to enjoy unprecedented access to inexpensive capital and drove the bull market for loans that peaked in 2006/2007 and collapsed in the fourth quarter of 2008 following the failure of Lehman Brothers.

The table below shows the growth of the CLO market both in terms of annual new issue volume and total market size.

Institutional investors, which also include leveraged vehicles such as hedge funds and business development companies (BDCs), differ from banks in the way they construct, finance, mark-to-market and manage their portfolios. Not surprisingly, in workout scenarios, these investors' behavior tends to differ from that of traditional bank lenders. Thus, in troubled situations, the landscape for middle market debtors has changed as their lenders have changed.

Because these institutional investors come in so many shapes and sizes, it is not unusual to find that different institutional investors have conflicting constraints and/or motivations. For example, some institutional investors may have pressures or constraints driven by the credit facilities they use to finance their portfolios. In many cases CLOs are less likely to be focused on paydowns than are hedge funds, particularly those facing redemptions. On the other hand, while those hedge funds with locked-in capital may welcome equity in workouts, CLOs typically prefer to keep their debt claims. Different lenders often disagree dramatically on the value of a loan. For example, we have been involved in cases where certain lenders have their positions marked-to-market at 50% of par while others have the same position marked at 5% of par, which signals diametrically different views of the direction and potential outcomes of a restructuring. These are a few of the many areas in which different lenders may have varying agendas in a workout situation. One other important reality about institutional transactions is that, unlike the traditional bank, institutional transactions are broadly distributed, which further complicates the task of structuring and negotiating

Growth in the CLO Market



Source: Credit Suisse

amendments. Today, more than ever, we believe it is critical for issuers (and lenders) facing capital structure challenges to retain advisors, early in the process, who understand the unique motivations of different players and how to navigate in today's turbulent waters.

Market Conditions Today: the Looming Maturities Bubble

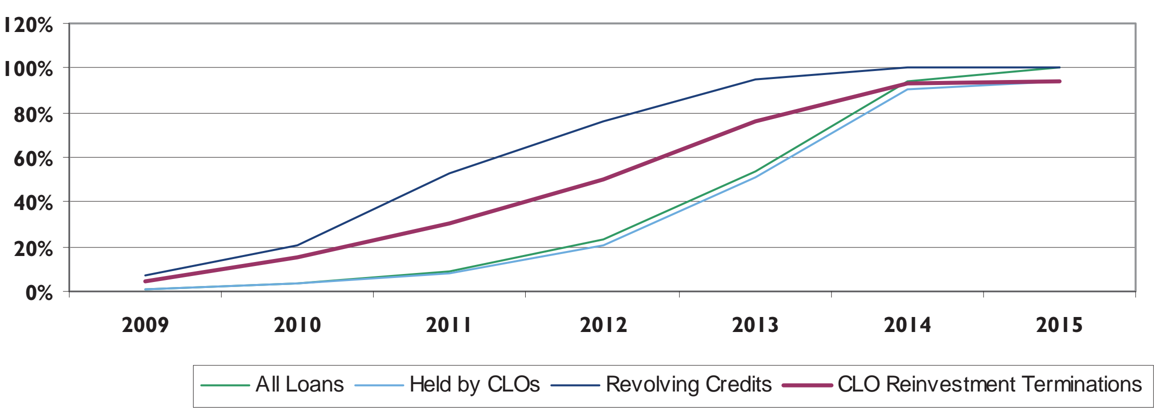
As we discussed above, the bursting of the credit bubble and the resulting capital drain away from institutional investors has left a gaping hole in the leveraged loan market. Until recently, new issue capacity had effectively dried up, yet approximately 60% of leveraged loan issuers will face revolving credit line maturities before the end of 2011.

It is unclear from where (or if) the capital to refinance these loans will emerge. One virtual certainty is that capital to refinance the $316 billion of loans held by CLOs will not be fully provided by those same CLOs. Recall that CLOs are structured vehicles that issues significant amounts of debt to finance their portfolios. As CLOs near the maturity dates of their liabilities, their ability to reinvest in new assets is curtailed. Over 50% of CLOs will cease reinvesting before the end of 2012. Simply put, many of the CLOs that exist today will simply not be around to invest, or "roll into", refinancings of their portfolio credits.

The recent rally in the leveraged loan market has certainly helped. Loan market activity is currently being driven by a combination of declining default rates and increased liquidity. Default rates are down from just under 14% in the first half of the year to about 7% since July. In addition, the market has generated about $65 billion of cash in 2009 – nearly $11 billion of which has been generated since Labor Day alone. The bulk of this liquidity represents proceeds from repayments associated with issuances of high-yield bonds. Even with the approximately $30 billion of new issue activity during 2009 (about $11 billion of which took place in September alone), the market has a very long way to go to solve the maturity bubble described above. In our view, a refinancing crunch over the next few years still seems likely. In today's environment, issuers of leveraged debt are well-served to proactively review their financing options on an ongoing basis to take advantage of narrow windows of opportunity.

Debtors and creditors continue to push the envelope in an effort to avert disaster or increase their relative recoveries. Below we discuss two currently unfolding developments. The first, amend-to-extend transactions, are being pursued by healthier issuers seeking to term out their existing loans without engaging in refinancings (which, in any case would be more expensive and, in most cases, not possible in today's market). The second, Chapter 11 "cram-ups" (combined with reinstatements), are currently being tested in the courts and involve a strategy in which junior lenders attempt to take control of a bankrupt company's reorganization plan while freezing senior creditors in place by asserting that they are "unimpaired."

Cumulative Loan Maturities
vs.
Cumulative CLO Reinvestment Termination Dates



Source: S&P LCD and Barclays

Amend-to-Extend Exchanges

There continues to be significant uncertainty regarding the ability of the institutional loan market to refinance the extraordinary amount of paper issued at the peak of the cycle. Some issuers have turned to the high yield market, issuing senior unsecured notes to pay down first lien debt. This strategy has the advantage of trading out of shorter-dated bank debt and replacing it with non-amortizing longer-term money. However, it is an alternative only available to very large and liquid issuers and is costly from a yield-to-maturity perspective.

Other issuers are engaging in amend-to-extend exchanges as a way to term out at least a portion of their first lien debt by exchanging shorter maturity loans for higher spread, longer dated loans. These transactions, as the name implies, involve a two-step process. In the first step, the required lenders (typically 50.1% in principal amount) approve an amendment allowing for the creation of a longer dated, pari passu, tranche of loans. Typically, the amendment will stipulate a minimum and maximum amount of debt that can be exchanged as well as a specified spread for the new loans. Upon approval by the required lenders, lenders who vote in favor of the amendment exchange existing loans for the new tranche of loans. Those who vote against do not exchange and the original tranche (albeit at a reduced size) remains outstanding.

Amend-to-extend exchanges are attractive to both issuers and lenders. For borrowers, they provide an opportunity to term out a portion of their bank debt at levels well below the cost of refinancing the whole tranche (if such a refinancing is even possible in this market). For holders, they create a positive mark-to-market event because of the enhanced pricing of the newly created tranche.

Completed Amend-to-Extend Transactions

	With Covenant Relief	Without Covenent Relief	Total
Number of Deals	6	19	25
Average Spread Increase	180	173	174
Average Extended Spread (bps to Libor)	383	395	392
Average Fee (bps)	52.5	11.67	26.25
Percent with Libor Floor	50%	21%	28%
Average Libor Floor	2.33%	2.25%	2.29%
Average Extension Period (years)	1.92	2.24	2.17

Source: S&P LCD

The amend-to-extend transaction is a new development. The first was executed in early 2009 by Dutch telecom operator UPC and, since that transaction, 24 other issuers have followed suit. Above is a summary of all amend-to-extend transactions completed through August.

Chapter 11 "Cram-ups"

Junior lenders are accustomed to being the fulcrum security in bankruptcies, meaning they expect to have their debt converted into a controlling equity stake. In the current environment, senior lenders are increasingly arguing that they are impaired (by virtue of declines in the value of pledged collateral) and therefore hold the fulcrum security, giving them the lead role in the resulting restructuring. In such cases, the senior lenders in alliance with the debtor's sponsor/management can squeeze the junior lenders. They do this by proposing restructuring plans that leave a portion of the senior debt in place while converting the rest into a sizable equity stake (and leaving attractive equity "promotes" available for the management and, in some cases, the sponsor) and imposing the plan on the junior creditors over their objections. The imposition of a plan or reorganization upon a dissenting class of impaired creditors (in this case, the junior lenders) is called a "cram-down", and is governed by Section 1129 of the Bankruptcy Code.[1]

Junior lenders often have limited options to challenge cram-down plans due, among other factors, to the terms of their intercreditor agreements. In order to protect themselves in situations in which the senior lenders' claims are arguably covered, junior lenders can use the "cram-down" provisions to their own advantage by employing the "cram-up" strategy, whereby the junior creditors turn the tables and impose a plan on the senior creditors.

As in a cram-down, a critical element in the success of a cram-up strategy is the cooperation of the debtor and/or majority equity holders. In addition, the cram-up plan must comply with the absolute priority rule, which prohibits junior creditors (or equity interests) from receiving payments before more senior creditors are paid in full. One way to overcome the absolute priority rule is to argue that the senior debt is not impaired and ask the court to "reinstate" it. Under Section 1124 of the Bankruptcy Code, if a debtor cures all non-bankruptcy related defaults under a debt instrument and maintains the contractual rights of the lenders, a reorganized company can reinstate the debt on its original terms. Reinstatement does not require the consent of the holders of the reinstated debt – as they are NOT deemed to be part of an impaired class. Instead, the debtor must show that its plan of reorganization will not violate the terms of the reinstated debt and is likely to allow the debtor to remain in compliance following the exit from bankruptcy. Reinstatement is gaining attention today because of the attractive terms of senior loans put in place during the credit bubble. These loans tend to have low interest rates, loose (or non-existent) financial covenants and favorable negative covenant packages and therefore are seen by many debtors as a prized asset of the estate.

[1] Confirmation of a Plan of Reorganization requires, among other things, an affirmative vote by each impaired class (two-thirds in amount and one-half in number of voting creditors or interest holders). However, a plan can be approved over the objection of a dissenting class of creditors provided that another impaired class of creditors has voted to accept the Plan.

Reinstatement arguments have rarely been litigated, and therefore there is little case law in this area. However, the reinstatement strategy has been employed in both the Spectrum Brands and Charter Communications bankruptcy cases.

- Spectrum went to trial in June of this year. In that case, the first lien lenders argued that confirmation of the plan of reorganization would create at least four separate defaults (current or pending) under the terms of the credit agreement. While the bulk of the case was argued in court, the litigants settled prior to the conclusion of the trial. In that case, a TM professional served as the expert witness on behalf of the agent for the first lien lenders.

- Charter, which went to trial after Spectrum, was successful in reinstating roughly $11.8 billion of secured debt, consisting of approximately $8.5 billion of 1st lien credit facilities and $3.3 billion of 2nd lien loans. Based on press reports, we believe the Charter case centered solely on the question of whether the debt for equity swap would constitute a “change of control” under the terms of the credit agreement (a similar argument was made in the Spectrum case). Based on Charter’s success, we expect to see more reinstatement cases going forward.

Conclusion

The markets are continuing to work through the indigestion caused by the excess from the peak of the cycle. The same forces that allowed for the creation of abundant and inexpensive capital are now causing extreme dislocation in the credit markets. Restructurings have become more complex and the “rules of the game” are continually being rewritten. We expect that the next few years will see a continuation of the current high levels of financial restructuring, driven by a combination of weakening balance sheets, looming maturities and shrinking liquidity in the marketplace.

As the market has evolved, so too have the dynamics of restructurings and workouts. In today’s world, outcomes are often largely dependent upon the individual agendas of the various constituents in each creditor class. Expert advice, including knowledge of particular motivations of the individual players, has never been more critical than it is in today’s environment.

TM Capital has been delivering expert financing and restructuring advisory services for over two decades. Our Finance and Restructuring Advisory Group professionals have worked on some of the most complex assignments in the middle market and have completed hundreds of successful transactions around the world. Areas of expertise include advisory services for public and private companies in section 363 sales, workout tactics, exchange offers, debt and equity capital raises, fairness and solvency opinions and expert testimony. We look forward to learning more about your business, on a confidential basis, and stand ready to help you achieve your strategic and financial goals

For more information about TM Capital and the firm’s Finance and Restructuring Advisory Group, please contact Rob Grien at 212-809-1434 (rgrien@tmcapital.com) or Jerome Romano at 781-320-3200, ext. 219 (jromano@tmcapital.com)

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