American Bankruptcy Institute

VALCON 2023

Capital Markets: A Voyage into the Unknown

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2023

Capital Markets Panel

VALCON

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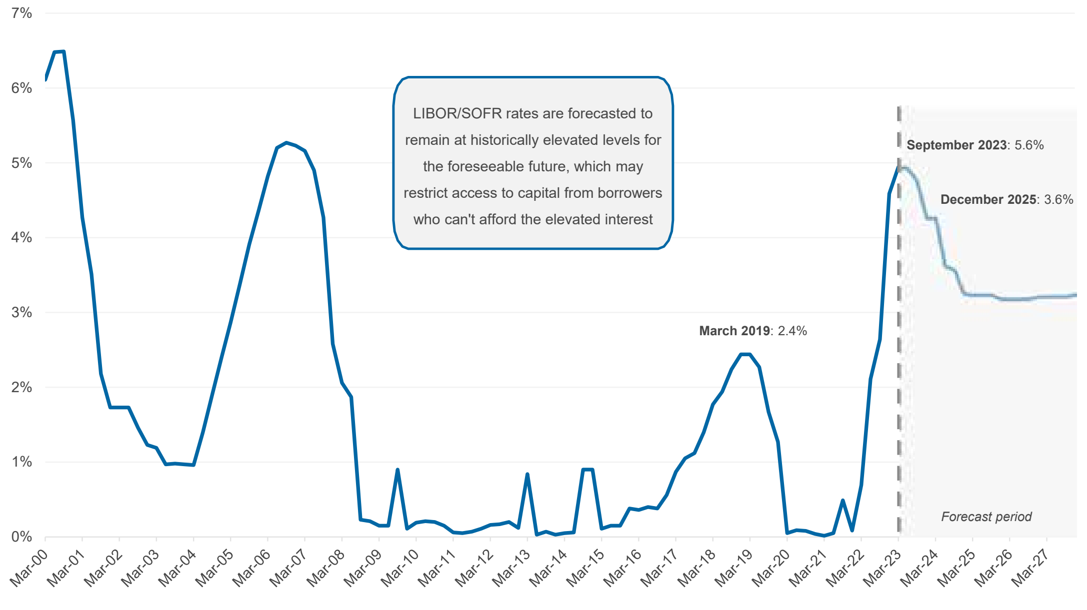
Historical and Forward Borrowing Rates

Increases in borrowing rates that began in early 2022 are expected to peak in late 2023 before decreasing back to the ~3.50% - 3.75% area

Historical and Forward 3-Month SOFR (2000 – 2027)



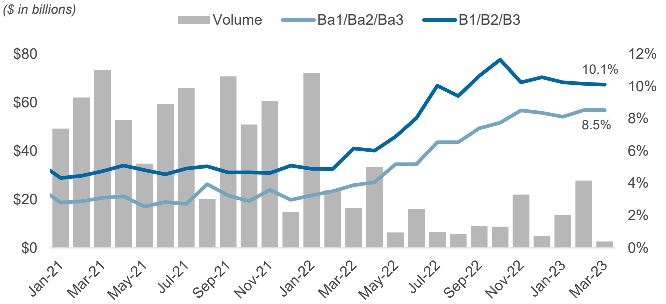
Sources: Bloomberg, Pensford
(1) As of 3/8/2023

U.S. Loan Market Update

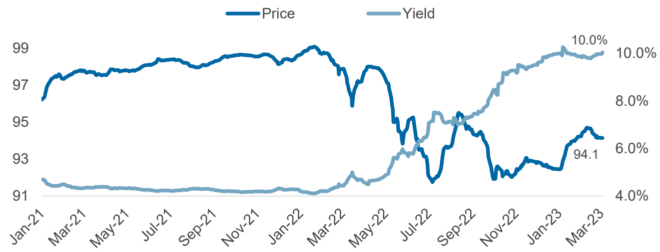
Issuances in the leveraged loan primary market have materially declined following strong issuance activity in 2021

- The elevated new issuance volume levels from 2021 began declining in 1Q22 as central banks indicated interest rates would be hiked in the face of increasing inflation
- Loans in 2022 were issued at a significantly higher cost of capital as issuance yields more than doubled from 2021
  - Recently, yields have leveled out at 8.5% and 10.1% for Ba1/Ba2/Ba3 and B1/B2/B3 loans, respectively
- Following an increase in central bank interest rates, yields for U.S. loan increased from ~4% in 2021 to ~10% in early 2023
- With declining market activity and an increasing cost of capital, companies are encountering an increasingly challenging financing market, with more detrimental implications for businesses with declining operating performance

New Issuance Volume & Yield



Average S&P/LSTA Index Price / Yield



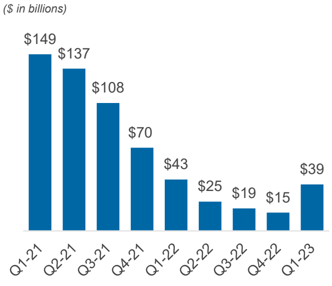
Sources: S&P LCD, LFI Weekly, Lipper Weekly

U.S. High Yield Market Update

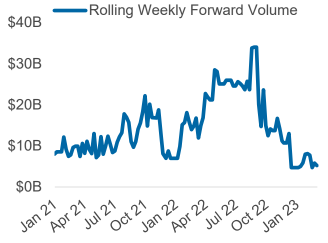
New issuances declined significantly through 2021 before bottoming in 4Q22 as yields peaked

- Within the U.S. high yield market, activity peaked in 1Q21, declining thereafter as companies successfully refinanced existing obligations
- Recent Central bank rate hikes have significantly elevated yields for high-yield issuances, with rates for CCC debt reaching ~17% in October 2022
- The high-yield bond market rebounded in the first six weeks of 2023, driven by term debt takeouts in the rising interest rate environment after historically low high-yield volume in 2022
  - However, the high-yield market has since gone quiet in the face of market headwinds faced by mixed signals about the state of the economy, inflation, jobs data and anticipated actions by the Federal Reserve
- Investors pulled $6.8 billion from U.S. high-yield retail funds for the week of February 22nd, 2023, which is the largest withdrawal in a single week since the Global Financial Crisis
- As investors consider the impact of various macroeconomic factors, the average bid on the HY Bond Index is ~88

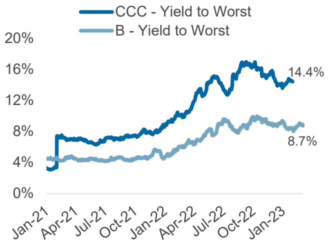
New Issuance Volume



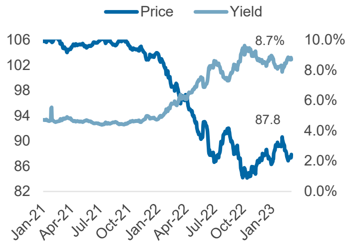
Pipeline



High Yield Pricing – CCC, B



Average HY Bond Index Price and Yield



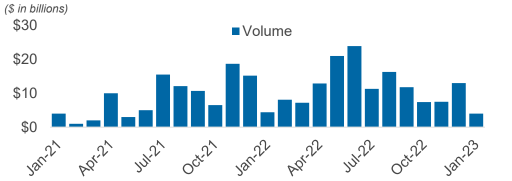
Sources: S&P LCD, LFI Weekly, Lipper Weekly

Direct Lending and Club Transactions

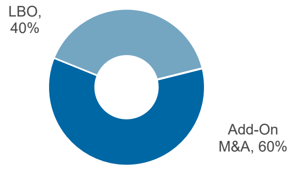
While more selective, lenders continue to look for opportunities to strategically deploy private capital in the direct lending market

- Amid a slowdown in the syndicated loan and high-yield markets in 2022, the direct lending market has exhibited relative stability and, although recently more selective, continues to offer more competitive terms relative to the public markets, with sponsors seeking certainty to close in light of choppy market conditions
- In the direct market, LBO and add-on M&A has made up most of the deal flow in 4Q22, with similar deal flow continuing in January 2023
  - LBO's financed by direct lenders in YTD March 2023 outnumbered those financed in the broadly syndicated loan market by 61 to 4
- While the public markets remain volatile, direct lenders continue to deploy capital, but they have become more selective by reducing their hold levels while leverage levels are becoming tighter
  - Recent unitranche pricing has been in the ~S+675bps+ area with OID's in the middle market in the 2.5% - 3.0% range. Given lower deal volumes and competition to deploy capital, pricing has begun to tighten to the S+6.25 – 6.50% area for strong credits with OID's in the 2.0% - 2.5% range
- Unitranche volume surged to new heights over the past few years as the private credit market took increasing market share from the broadly syndicated market given their ability to provide large commitments, speed and flexibility. Direct Lenders provided multiple $1+ billion financings in 2021 & 2022
- Private credit defaults for 4Q22 were 2.06%, up from 1.56% in 3Q22[3]

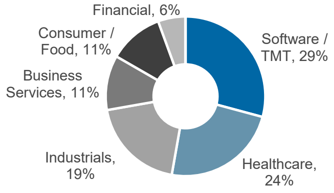
Direct Lending Volume



Use of Proceeds[1]



Industry Breakdown[2]

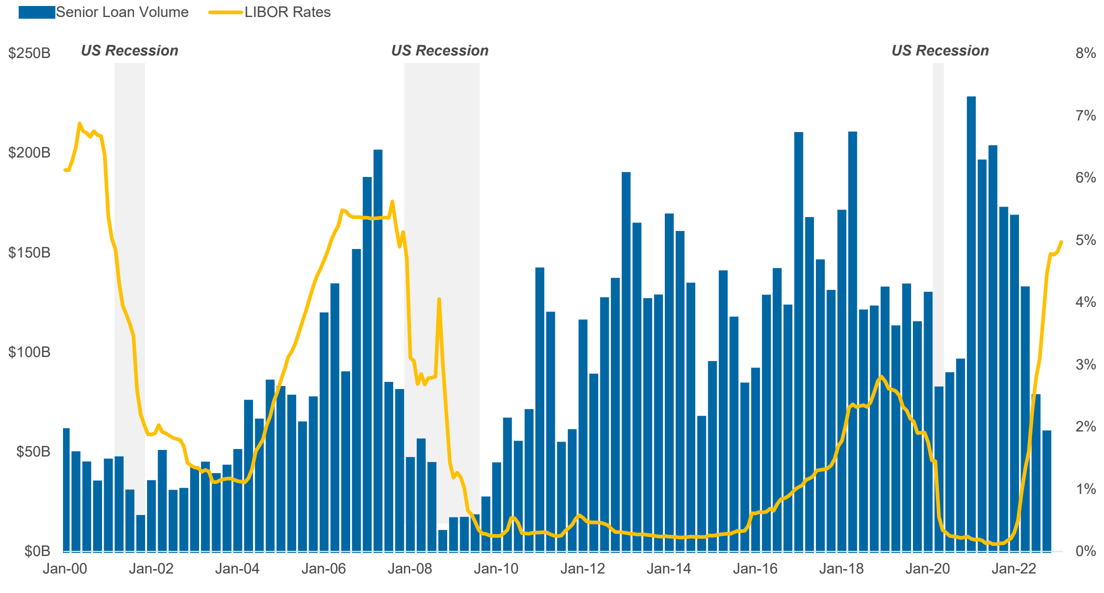


Source: DLD Weekly, LCD
(1) January 2023 volume by proceeds
(2) For the second half of 2022
(3) Proskauer Private Credit Index; defaults are defined as loans that have a payment, financial covenant or bankruptcy default; defaults also include credit agreements that were amended in anticipation of a default

Historical Interest Rates and Capital Market Activity

Loan activity declines ahead of recessions and increases thereafter as interest rate cuts support financing activity

Historical 3-Month LIBOR and Senior Loan Volume ($ billions) (2000 – 2023)

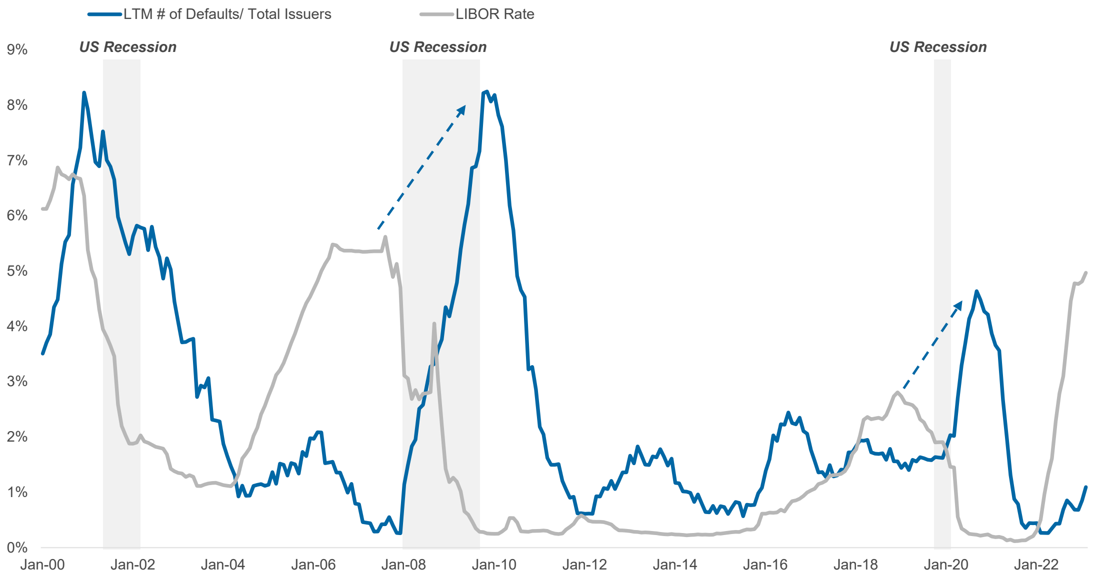


Sources: Pitchbook, CapIQ

Historical Interest and Default Rates

Rates hikes have historically preceded increases in the default rate and US recessions, leading to rate cuts thereafter

Historical 3-Month LIBOR and Loan Default Rates (2000 – 2023)

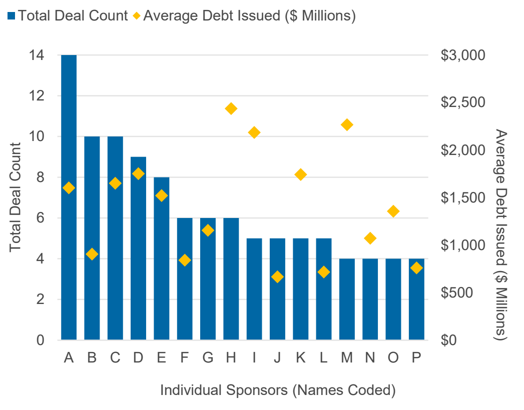


Sources: Pitchbook, CapIQ

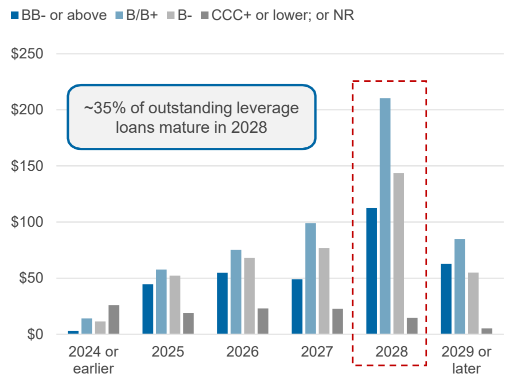
Near-Term Maturity Walls

Since 2021, sponsors have aggressively acquired businesses at elevated valuations, financing acquisitions with sub-investment grade credit and creating overleveraged portfolio companies that currently have significant refinancing risk

LBOs Since 2021 | Non-Investment Grade Credits



Leveraged Loan Maturity Wall | $ Billions



- Since 2021, sponsors have initiated 219 leveraged buyouts with sub-investment grade credit
- The average issuance amount per transaction was ~$600 million, with transactions weighted towards tech, services, manufacturing and healthcare sectors

- The amount of leveraged loan issuances maturing in the next couple of years is more than any other comparable period in the history of the Morningstar LSTA US Leveraged Loan Index
- Maturities before the end of 2024 are dominated by Software & Services, which makes up 29% of the maturing debt

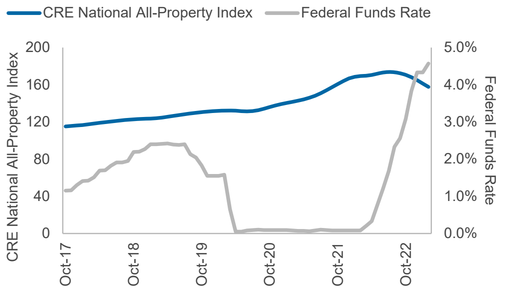
Source: LCD

Commercial Real Estate Prices Are Falling

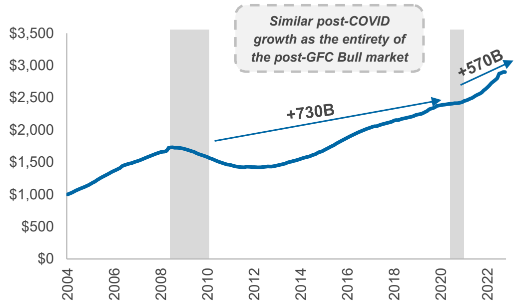
Commentary

- CRE prices have experienced pressure over the past 12 months as rates have risen and default risks have elevated
  - While underlying property prices have fallen somewhat, equity and debt returns have fallen dramatically
- Fueled by dovish monetary policy from central banks, CRE debt has risen substantially in the wake of the COVID pandemic
  - The consequential increase in leverage is expected to add to financial distress if prices continue to fall

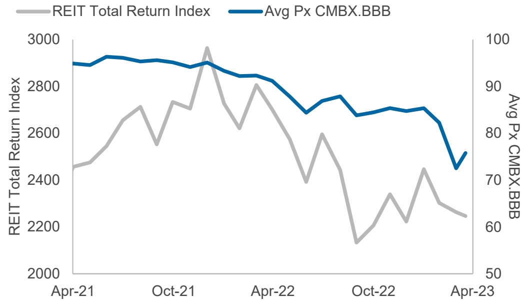
CRE National All-Property Index & Fed Funds Rate



Commercial Real Estate Loans | $ Billions



REIT & BBB CMBX Prices

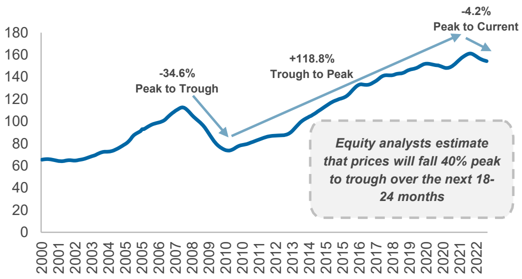


Office Real Estate Prices Are Uniquely Vulnerable

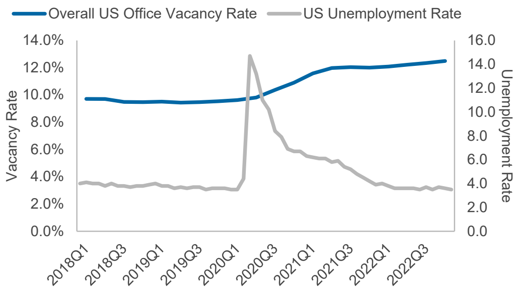
Commentary

- The outlook for office CRE prices is particularly grim given unfavorable macro headwinds
  - While there are vast regional differences, work-from-home and hybrid work trends have resulted in substantial increases in vacancy rates for US office space despite unemployment being near record lows
- In clear need of re-pricing, the real estate market has seen poor equity and debt returns for office REITs and CMBS securities as well as implied cap rates

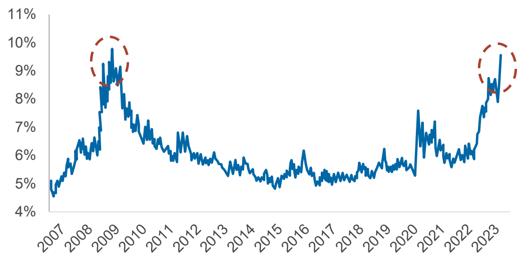
CRE Office Index



US Office Vacancy Rate & Unemployment



Office REIT Implied Cap Rate



What Happens to These Companies if Unable to Refinance?

If unable to refinance, sponsors will likely be required to undertake actions that will negatively impact equity returns (at best)

Alternatives

1. High-cost debt replacing low-cost debt
2. Equity oriented junior capital replacing low-cost debt
3. Low-cost debt refinancing requiring sponsor equity injections
4. Debt restructuring or turnover of business to secured lenders

Potential Outcomes

- ***Capital structure restructuring***
- ***Equity returns are diminished***

Sponsors will likely evaluate liability management alternatives to better prepare for debt maturities unable to be regular-way refinanced. Various strategies include, but are not limited to:

- Discount debt purchases
- Assets drop downs and re-leveraging
- Up-tier transactions at discounted prices

Further Discussion Topics

With a tightening of traditional sources of capital in the current market, what are some potential alternatives that companies should be exploring right now?

- Equity-linked securities, such as convertible preferred equity or convertible debt
- Tapping unencumbered value or unrestricted subsidiaries
- Mezzanine loans / preferred equity
- Corporate partnerships
- Government grants and loans

What are some of the legal pitfalls that struggling companies may need to be aware of when raising funds?

- Restrictive covenants / default provisions that may inhibit a company's ability to operate efficiently during difficult times and / or capitalize on future growth opportunities

What are some potential pitfalls with raising capital from financial sponsors, PE investors, credit funds, or from stockholders, including directors / officers?

- Highly structured or complex securities, including preferred stock, warrants, first-lien debt and debt-like instruments
- Can result in change of control issues, SEC approval hurdles, and equity holder approval requirements

What pitfalls should a trustee look out for if taking on a fiduciary role in a capital market transaction?

- Creditworthiness of the issuer and underwriter
- Ensuring compliance with legal and regulatory requirements

Faculty

Michelle A. Dreyer is managing director of CSC Global Financial Markets in Wilmington, Del. She oversees Independent Director and Restructuring, including bankruptcy remote entity independent directors, distressed directors, litigation and liquidating trustees, successor indenture trustees, disbursing agent services, § 363 escrows, and loan administration agents. Ms. Dreyer serves as an independent director for both bankruptcy remote entities and nonbankruptcy remote entities, and in this capacity has participated in many complex distress matters, including General Growth Properties, Sears Holding Corp. and Medley LLC. Previously, she served in a variety of roles for CSC's business, including administrative manager for special-purpose vehicles and trust administrator. Ms. Dreyer is a member of ABI and the International Women's Insolvency & Restructuring Confederation (IWIRC). She received her B.S. in finance with honors from Kent State University and her J.D. *cum laude* from Taft Law School.

Adam L. Dunayer is a managing director in Houlihan Lokey's Financial Restructuring Group in Dallas, where he leads the firm's regional financial restructuring and distressed-company M&A efforts. He has nearly 20 years of experience consummating transactions and providing strategic advice to companies and creditors in connection with in- and out-of-court financial restructurings, mergers, acquisitions and dispositions. He also has experience raising debt and equity capital in public and private markets. Mr. Dunayer's experience spans such industries as consumer products, food, health care, building products, energy, general industrial, telecom and technology. His recent engagements include Quicksilver Resources (company), TNT Crane (secured creditors), Chuck E. Cheese (secured creditors), Alert 360 (company), Pilgrim's Pride (equity committee), Jack Cooper (company), Taco Bueno (company), Dental One (company), Pioneer Energy Services (company) and Parker Drilling (creditors). He speaks frequently on trends and issues in restructuring, distressed M&A and other topics, and has testified as an expert witness on a variety of bankruptcy and restructuring issues. Before joining Houlihan Lokey, Mr. Dunayer was a managing director with Bear, Stearns & Co. and was an executive vice president and chief financial officer with Miller Industries, where he also served as president of the company's largest subsidiary. He is a member of ABI and the Turnaround Management Association, and is registered with FINRA as a General Securities Principal (Series 7, 24 and 63). Mr. Dunayer received his B.B.A. from the University of Texas at Austin.

Jamie L. Edmonson is a partner with Robinson & Cole LLP in Wilmington, Del., and a member of its Bankruptcy + Reorganizations Group. She also spends significant time in the firm's Los Angeles office. Ms. Edmonson has more than two decades of experience representing public and nonpublic debtor corporations, secured and unsecured creditors, official committees, trustees and asset-purchasers in bankruptcy and restructuring matters. Her practice is focused on guiding clients through commercial bankruptcy cases, restructurings, creditors' rights issues, insolvencies and liquidations, in which she represents a wide range of clients, including debtors, creditor and equity statutory committees, lenders, asset-purchasers, landlords and lessees. In addition to her bankruptcy work, she works in the areas of finance, real estate, energy and corporate law. Ms. Edmonson regularly serves as Delaware and lead counsel in large chapter 11 filings and has experience in all aspects of the chapter 11 restructuring process involving many industries, including information technology, retail, food, energy, construction, real estate, telecommunications and manufacturing. She was elected to the 2017

Global Network of Women Committee for the Turnaround Management Association, and her *pro bono* work includes serving as a judge for the National Appellate Advocacy Competition (NAAC) for the American Bar Association and joining efforts with the Lawyers' Committee for Civil Rights to serve as a nonpartisan poll monitor on Election Day 2018 and 2020. Before joining Robinson+Cole, Ms. Edmonson was the managing partner of the Wilmington office for an AmLaw 100 firm. She also utilized her finance background as a managing director with a nationally renowned financial advisory firm for several years. Ms. Edmonson received her B.S./B.A. from American University and her J.D. from Loyola Law School Los Angeles.

Peter R. Morrison is a partner with Squire Patton Boggs in Cleveland and has a broad and versatile corporate, litigation and finance practice built on extensive experience representing and counseling clients in the corporate insolvency, distressed lending and investing, restructuring and bankruptcy contexts, including in complex chapter 11 cases nationwide. His clients include debtors, creditors' committees, and secured and unsecured creditors in reorganizations and liquidations. He also represents receivers and secured creditors in receiverships and foreclosure proceedings. Ms. Morrison has significant bankruptcy litigation experience focused on dischargeability contests, declaratory judgment actions, director and officer liability suits, and the prosecution and defense of avoidance actions. His insolvency and restructuring practice is bolstered by his banking and debt-finance experience, which has included the negotiation, documentation and management of secured and unsecured loan transactions, including securitizations, syndicated credit facilities, unitranche facilities, split collateral pool transactions and bridge financings. Mr. Morrison received his B.A. in 2004 from the University of Wisconsin - Madison and his J.D. *cum laude* in 2009 from Case Western Reserve University, where he was a member of the Order of the Barristers and executive notes editor of the *Health Matrix - Journal of Law-Medicine*.