American Bankruptcy Institute

VALCON 2024

The Impact of a Higher-Interest-Rate Environment: A New Normal?

Pauline P. Chow, Moderator
Birch Lake Holdings, LP | Chicago

Christopher R. Donoho III
Hogan Lovells US LLP | New York

Steven J. Fleming
PwC | Wyckoff, N.J.

Craig A. Jacobson
B. Riley Advisory Services | New York

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Bankruptcy Implications of Today's Higher Interest Rate Environment

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The Rise of Interest Rates

Implications of Higher Rate Environment	
Increased Cost of Borrowing / Low Availability to Service Debt	• Companies that rely on debt to finance their operations will face higher interest expenses, which reduces profits and **Free Cash Flow.** • Reduced Free Cash Flow inhibits business's ability to service debt, as the rising costs have **no corresponding increase in revenues** • This in turn can lead to lower valuations as investors may be less willing to invest in a company that is facing challenges managing its debt.

Slower Growth / Low Ability to Invest in Growth	• When interest rates rise, companies often realize slower growth rates due to **the increased cost of capital** which often causes companies to scale back investment and growth plans to sure short-tern liabilities do not exceed projected income. Some examples include:
	  • Reduced hiring / layoffs
	  • Lower advertising / marketing spend
	  • Lower CAPEX / Investments / M&A

Reduced Customer Demand	• Consumers may be less likely to borrow money to purchase goods and services, as the cost of borrowing becomes more expensive • Depending on the business's industry, this can lead to **lower customer demands and sales**

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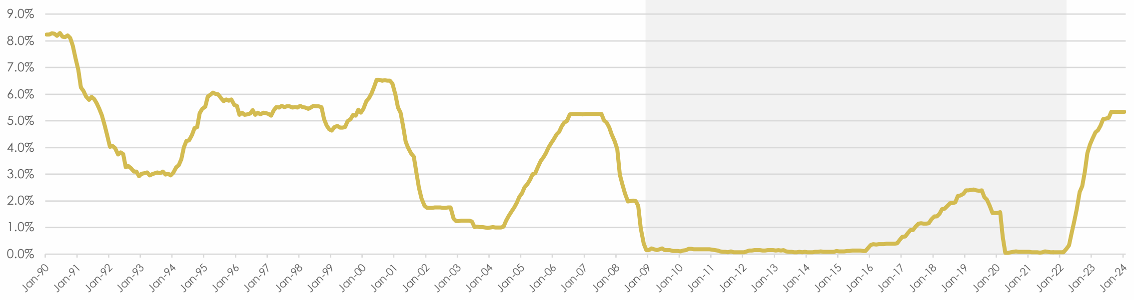
The Rise of Interest Rates

Drastic change after more than a decade of historically low rates

Money has been practically free for almost two decades. This has fueled investment which in turn drove growth and pushed up valuations

Effective Federal Funds Rate



Source: Federal Reserve Economic Data

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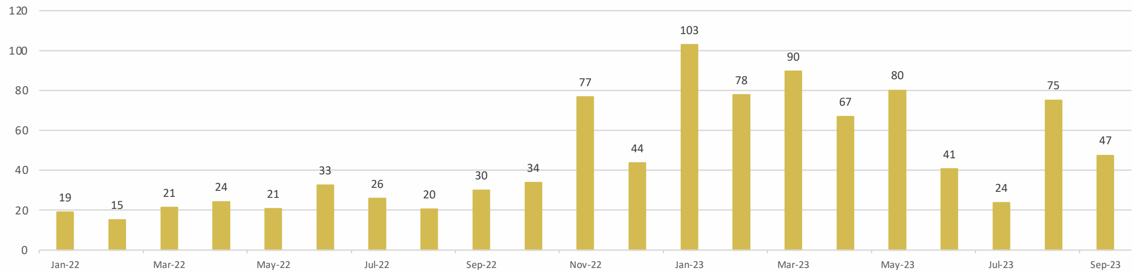
The Rise of Interest Rates

Increased Cost of Borrowing / Reduced Availability to Service Debt

Rising rates pressure a companies ability to service debt, which leads in some cases to cost-cutting initiatives (e.g. layoffs) to offset cash cost of higher rates

Job Cuts Announced by US-based Employers
(Units in thousands)



Source: Challenger, Grey and Christmas, Inc.

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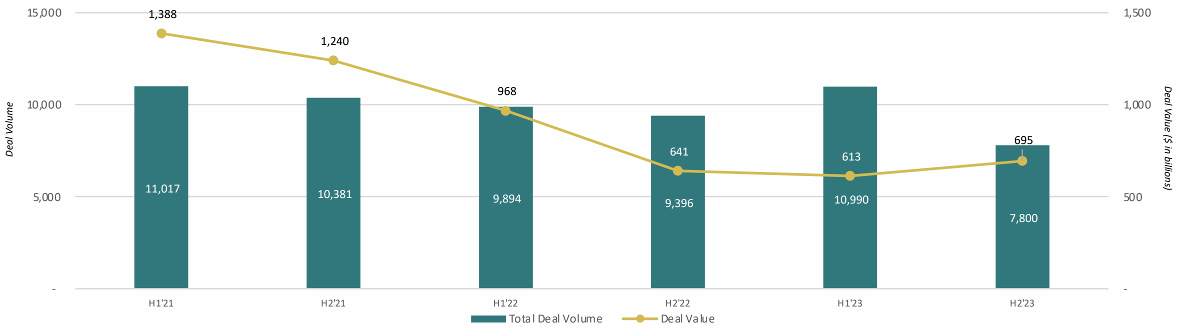
The Rise of Interest Rates

Slower Growth / Reduced Ability to Invest in Growth

A pull back in credit markets contributes to lower M&A market which in turn leads to slower growth prospects for companies

Americas Region M&A Deal Volumes and Values



Source: LSEG and PwC analysis

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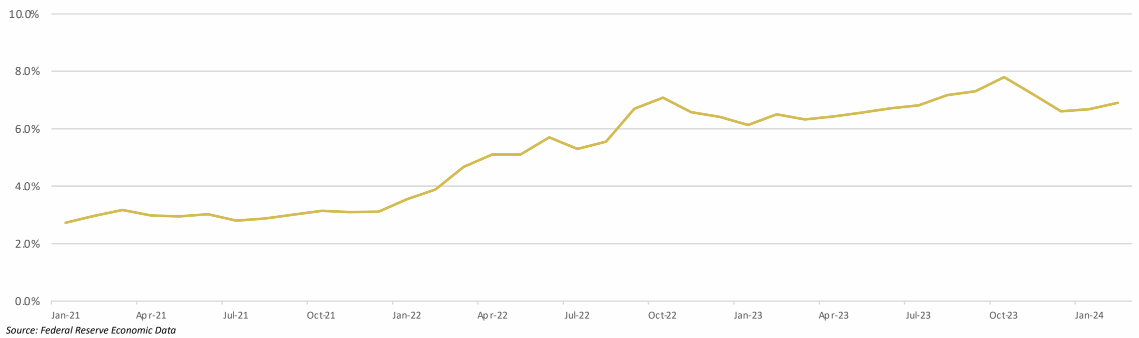
The Rise of Interest Rates

Reduced Customer Demand

Higher rates crowd out consumer demand, particularly for large purchases that typically require financing (i.e, real estate and automobiles)

30-Year Fixed Mortgage Average Rates



Source: Federal Reserve Economic Data

Higher interest rates have allocators rethinking risk exposure, dealmakers re-evaluating leverage and lenders tightening standards

10-year treasury real versus nominal rates (monthly series)

Source: FRED, Geography: U.S. (as of December 31, 2023)

Uptick in the quality of deals being funded

Dealmaking indicator

- As of December 31, 2023

Source: PitchBook, Geography: U.S.

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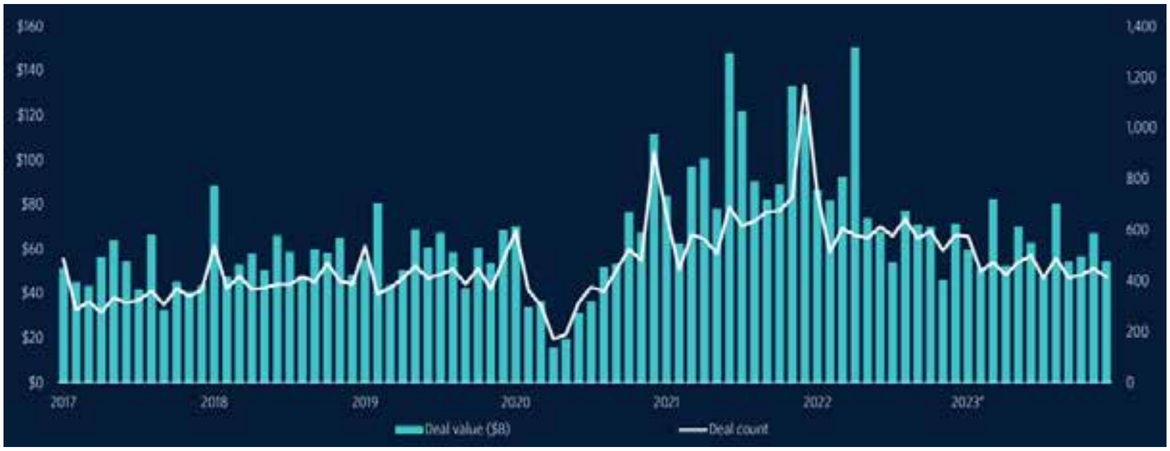
Buyout deal activity is comparable to pre-pandemic levels

Monthly buyout deal activity



- As of December 31, 2023

Source: PitchBook, Geography: U.S.

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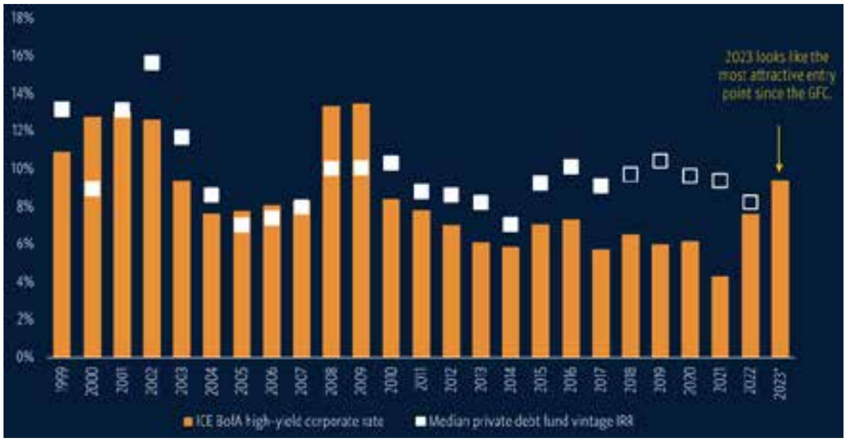
Higher interest rates have been advantageous to private debt funds

Average yields on select asset classes*



- As of December 31, 2023

** As of June 30, 2023

Source: FRED, PitchBook, Geography: U.S.

Note: Unfilled markers reflect vintages that have the majority of their returns unrealized.

Tighten bank lending means more opportunities for private credit

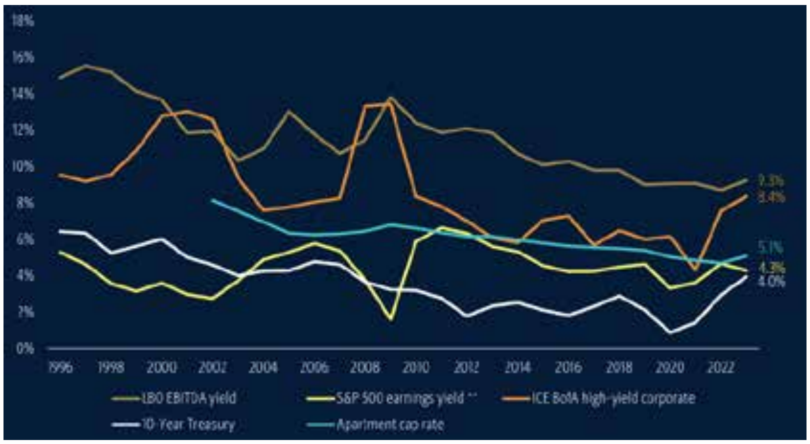
Net share of bank tightening standards on loans to small and medium-to-large firms

- As of December 31, 2023

Source: PitchBook, Senior Loan Officer Survey, Geography: U.S.

The hunt for yield during the past decade saw rates compress generally

Average yields on select asset classes*



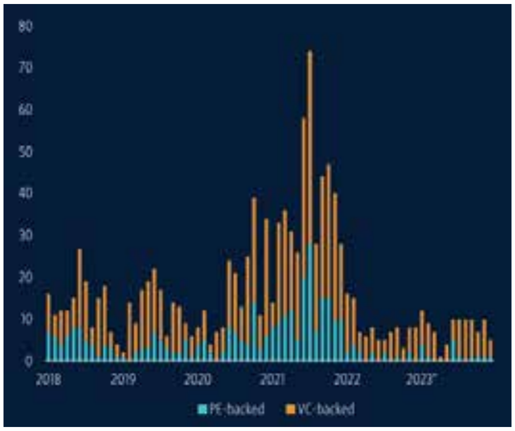
- As of December 31, 2023

** As of September 30, 2023

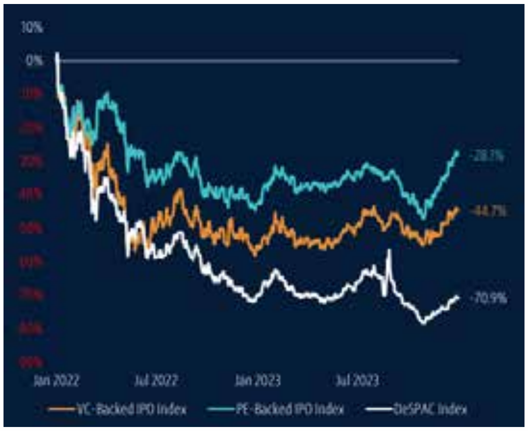
Source: PitchBook | LCD, FRED, Robert Schiller, National Multi-Family Housing Council, Geography: U.S.

IPOs levels indicate a lack luster exit environment

Monthly PE- and VC-backed public listing count



IPO and DeSPAC indexes return since the start of 2022*

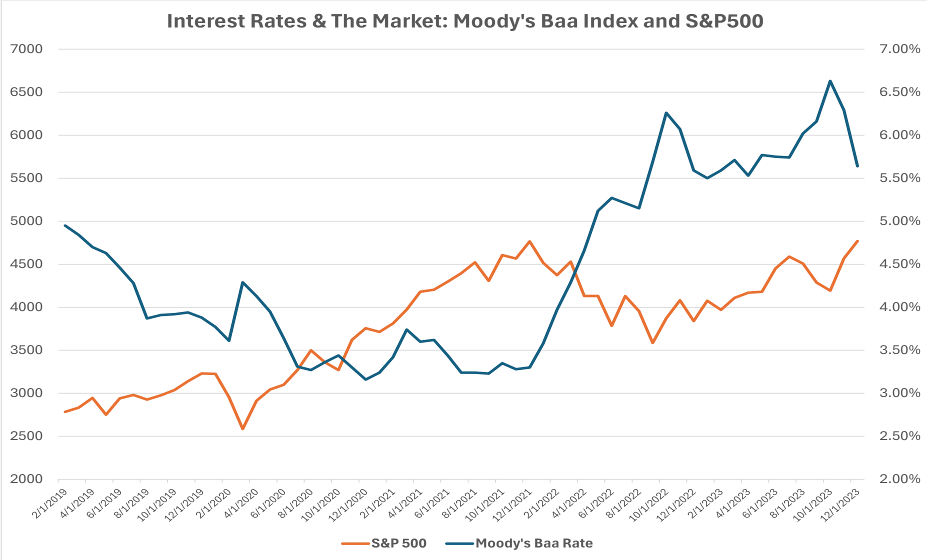


- As of December 31, 2023

Source: Morningstar, PitchBook, Geography: U.S.

How <u>should</u> higher interest rates impact value?

- The basic relationship is simple: when interest rates increase, value should generally decrease (with certain exceptions such as financial companies).
- Higher interest rates increase debt service costs, lowering cash flow to invested capital.
- Higher interest rates increase discount rates and the cost of capital, which lowers valuations assuming no changes in cash flows.
- Therefore, interest rates can have a double impact on valuation as calculated using DCF models.


Interest Rates & The Market: Moody's Baa Index and S&P500
7000
6500
6000
5500
5000
4500
4000
3500
3000
2500
2000
7.00%
6.50%
6.00%
5.50%
5.00%
4.50%
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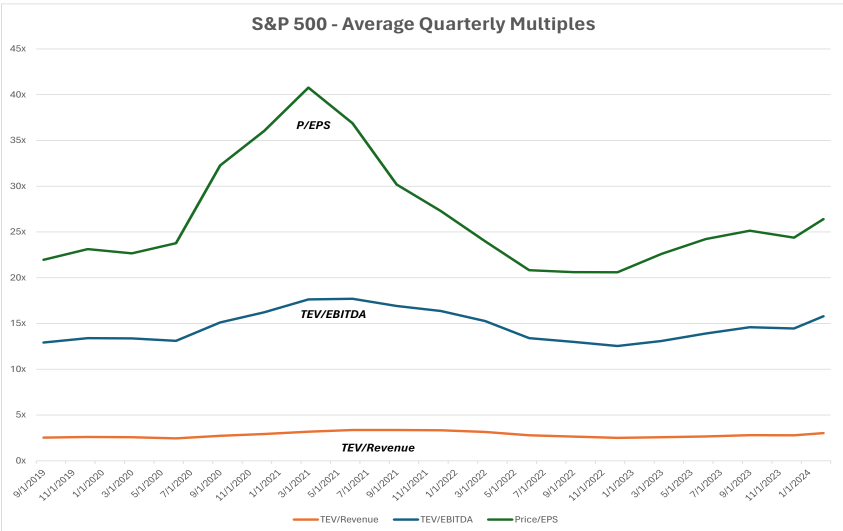
2.00%
S&P 500
Moody's Baa Rate


S&P 500 - Average Quarterly Multiples
P/EPS
TEV/EBITDA
TEV/Revenue
TEV/Revenue
TEV/EBITDA
Price/EPS

How have higher interest rates impacted value?

- When interest rates started rising in early 2022, the market reacted as expected and declined.

- This relationship changed significantly in 2023 – when interest rates began rising again, the market generally increased.

- We're now in a situation where while interest rates are elevated as compared to recent years, the market as at or near all-time highs.

- What other factors might explain this situation?

It's (always!) different this time:

- Interest rates have risen from historically low levels.
- Government stimulus before and after the pandemic has flooded the market with cash.
- FOMO – investors have a predilection to buy high rather than buy low.
- Prices can remain elevated – until they don't.
- AI – once again something is expected to change everything.
- Markets tend to rise in election years.
- Many investors expect rates to decrease.

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Alternative Restructurings

- During the pandemic, low interest rates led to more out-of-court restructurings, which remain an attractive alternative to bankruptcy for some companies.
- Companies took advantage of cheap financing and levered up their balance sheets – but now some cannot afford financing at current market interest rates.
- The climbing interest rates are thus encouraging restructurings.
- Unless financing sources are willing to extend maturities, companies are being forced to address the increased cost of capital.

The interest rate changes are in fact so dramatic that we are seeing a phenomenon not seen since 2005-2007 (the last time there were sustained rates enough higher than recent rates to make this worthwhile), in which even solvent borrowers can buy back their "money good" senior debt at its duration-impacted lower market price, <u>even if</u> the debt has contractual call protections.

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Increased Bankruptcy Filings

- The number of companies filing for chapter 11 and seeking bankruptcy protections has surged in response to economic headwinds.
- There are more commercial bankruptcies as interest rates continue to go up in efforts to bring down inflation. There are less sources of inexpensive credit.
- Bankruptcy becomes a solution to refinancing with high interest.
- The Bankruptcy Code provides the debtor with an exclusive period to file its own plan (which often gets extended by court order), placing the debtor in a position of power to strongarm its creditors into company-favorable restructuring terms.

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Addressing Capital Structures in Bankruptcy

1. Modifying Terms Under a Plan

Once a company is in bankruptcy, interest that comes due after the filing (referred to as post-petition interest) can be adjusted from the pre-bankruptcy rate under a plan of reorganization.

The plan of reorganization can address—and replace existing terms with better terms with respect to—ongoing payments to the company's existing creditors.

This can include modifying interest rates, extending maturity dates, and limiting post-petition fees owed to such creditors. Therefore, bankruptcy provides additional flexibility for companies despite being in the higher interest rate environment.

2. Converting Debt to Equity

Another trend in bankruptcies to address capital structure is to convert debt to equity in order to reduce overall debt, particularly in situations where the company is not able to refinance out-of-court. A debt for equity swap can be effective: the creditor converts debt owed to it into equity in the reorganized company. The debt is then discharged, released or extinguished under the plan.

Lenders may provide debtor-in-possession ("DIP") financing with an option to convert their DIP loans into equity in lieu of cash repayment. These equity conversion features, which are becoming increasingly popular, may invite objections from parties in interest (particularly those that were not given an opportunity to participate) and challenges as to whether they were properly marketed and on fair terms. The commercial terms and methods of valuation are likely to be scrutinized.

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Addressing Capital Structures in Bankruptcy (cont)

3. Reinstatement/Cram Up

Undermarket interest rates have become valuable estate assets to protect in a proceeding – reminiscent of and economically akin to undermarket leases, long-term supply contracts or over market offtake contracts. These are not executory contracts, and so they cannot be assumed under the Bankruptcy Code. They can be reinstated, however. Reinstatement or "cram up" plans are therefore becoming more common.

In a reinstatement plan, the debtor continues using its pre-petition debt financing—maintaining the debt's maturity, interest rate, and other conditions in accordance with the pre-petition debt documents. The pre-petition terms are more favorable than what the debtor would be able to find in today's higher interest rate market.

Reinstatement involves the interplay of three different Bankruptcy Code sections:	
Section 1124(a)(2)	Permits the debtor to treat a creditor as unimpaired (and thus not entitled to vote on a plan) if the plan reinstates the loan's original maturity, interest, and other terms, provided the plan cures certain defaults and otherwise does not "alter the legal, equitable, or contractual rights" of that claim.
Section 365(b)(2)(D)	Provides that if the debtor proposes to assume an executory contract, it must cure all defaults, other than pre-bankruptcy defaults related to the financial condition of the debtor and other related circumstances (so-called "ipso facto" clauses), including penalties relating to the debtor's failure to perform any non-monetary obligations under the agreement.
Section 1123(d)	Provides that if the debtor's plan proposes to cure a default, "the amount necessary to cure [a] default [in a proposed plan] shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law."

Because a loan that is reinstated is not treated as impaired, holders of claims in that class are deemed to have accepted the plan and cannot vote to reject it. The policy underlying reinstatement is that where the debtor can cure past defaults and perform under the original terms of the loan, the lender receives the benefit of its bargain. Lenders are likely to fight back on cram up. There are recent lender-friendly decisions that require default interest and fees to also be reinstated under such a reinstatement plan.

Higher Discount Rates

Higher interest rates also means higher discount rates, which act like another asset for a troubled company, in that contingent liabilities like mass torts and pension liabilities actually come down because of their reduced present value calculation.

Where liabilities cloud the future of a business, a higher discount rate allows the possibility of transferring away those liabilities at a smaller price than would have been the case when interest rates were lower.

Changed Lender Behavior

These changes in interest rates also create incentives for creditors to change their behavior, and become more aggressive in their attempts to cause a higher interest rate to replace the existing low rate one.

As a result, we can expect to see and are already seeing more “bad-ish” faith (refusing waivers and cures customarily allowed even if not strictly obligatory) default declarations and accelerations by money-good lenders looking to either see the contract rate move up to a market rate, or alternatively get repaid on the debt at par and then reinvest at the market rate.

Faculty

Pauline P. Chow is a managing director and principal with Birch Lake Associates, LLC in Chicago and is responsible for deal-sourcing and execution. She specializes in working with founder-led businesses to develop strategies for value-creation, sustainable growth and social impact. Ms. Chow has more than two decades of experience with corporate restructurings and is accomplished in capital-raising, M&A and recapitalizations. Previously, she supported the partnership at Skadden, Arps, Slate, Meagher & Flom LLP in strategic corporate intelligence and winning new engagements. In 2023, Ms. Chow was selected for inclusion in the Women In Secured Finance issue of *The Secured Lender* for exemplifying excellence and distinguishing herself in the industry. She is active in the women-led investment community as a member of Private Equity Women Investor Network (PEWIN), Women's Association of Venture & Equity (WAVE) and Women Investment Professionals (WIP). Ms. Chow received her B.A. in political science from the University of Illinois at Urbana-Champaign and studied at American University Washington, D.C., and The London School of Economics and Political Science.

Christopher R. Donoho, III is a partner with Hogan Lovells US LLP in New York and a key member of the firm's global Restructuring and Special Situations team, which works on many of the most important bankruptcy situations around the globe. From 2015-19, he was the administrative partner for the New York office. Mr. Donoho previously served as the global head of the firm's Restructuring and Special Situations team, but continues in a leadership role in the U.S. He focuses on protecting the rights of creditors in restructurings, frequently on behalf of investment funds. He also has experience representing companies facing distress, leading them through workouts or chapter 11 restructurings in jurisdictions across the U.S. Mr. Donoho is frequently called into situations that involve multinational companies and complicated cross-border disputes, drawing on the resources of his colleagues and Hogan Lovells around the world. He is a member of INSOL, the American College of Investment Counsel and the Turnaround Management Association. Mr. Donoho received his A.B. from Brown University in 1991 and his J.D. from Vanderbilt University in 1994.

Steven J. Fleming, CIRA, CDBV, CTP is a principal in the New York office of PwC LLP and the U.S. leader of the firm's Business Recovery Services practice (BRS), as well as a member of its Deals leadership team. He has more than 23 years of business advisory experience with PwC, during which he has been assigned to the firm's London, New York and Dubai offices. He was previously a leader in the firm's Middle East & North Africa (MENA) transaction advisory practice, where he led strategy, M&A, valuation and restructuring mandates across the MENA region. Mr. Fleming has provided financial advisory services to many local and international clients, spanning the whole deal spectrum from devising acquisition/disposal strategies to performing valuations and due diligence, business reviews, and negotiating with potential investors. He has represented both debtors and creditors in high-profile restructurings, and he has experience serving as a CRO in connection with chapter 11 cases. In addition, he has been qualified as an expert witness with respect to valuation, DIP financing, § 363 transactions and other bankruptcy-related matters. Mr. Fleming has experience in assisting distressed companies in the development of *pro forma* financial statements, the preparation and analysis of business plans and strategic alternatives, the analysis of cash-flow and working-capital management, the identification of liquidity-enhancing activities, including the execution of cost-savings initiatives, and the identification and prosecution of avoidance actions, including preferences and fraudulent transfers. He is a member of the Association of Insolvency & Restructuring Advisors and serves on its board of directors. He is also a member of the Turnaround Management Association's International Restructuring Committee, ABI and INSOL International. Mr. Fleming is a regular speaker at domestic and international industry conferences, including for TMA, AIRA, ABI, M&A Advisor and others. He received the M&A Advisor's 40 under 40 award in 2013. Mr. Fleming received his B.S. in finance from Lehigh University and his M.B.A. from Columbia Business School.

Craig A. Jacobson is a managing director with B. Riley Advisory Services in New York and has 30 years of experience in valuation, litigation support services and transactions consulting. Prior to joining B. Riley in 2014, he was a principal at a regional CPA firm providing valuation and litigation support services, and prior to that, he held a senior position with Willamette Management Associates. Mr. Jacobson began his career at a boutique investment banking and consulting firm, where he provided valuations, mergers and acquisitions, and litigation support services. His experience includes performing valuations for financial reporting, tax and corporate planning purposes; investment banking services including mergers, acquisitions and fairness opinions; pre-Initial Public Offering services, including valuations and assistance in the preparation of SEC filings; intellectual property valuation and litigation support services, including irreparable harm calculations; calculating economic damages, including lost profits and lost enterprise value; dissenting shareholder litigation and transactions; change-in-control disputes; failed real estate developments; and failed mergers and acquisitions litigation. Mr. Jacobson has testified as to his findings in deposition, arbitration, mediations and in court. He frequently writes and lectures on topics including fairness opinions, solvency opinions, intellectual property valuation and infringement damages, and valuation. Mr. Jacobson received his B.S. in economics and computer science from the State University of New York at Albany and his M.B.A. in finance from New York University's Stern School of Business.