

Valuation and Distressed Investment Strategies

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Emerging Valuation Issues in Bankruptcy and Beyond
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Valuation and Distressed Investment Strategies

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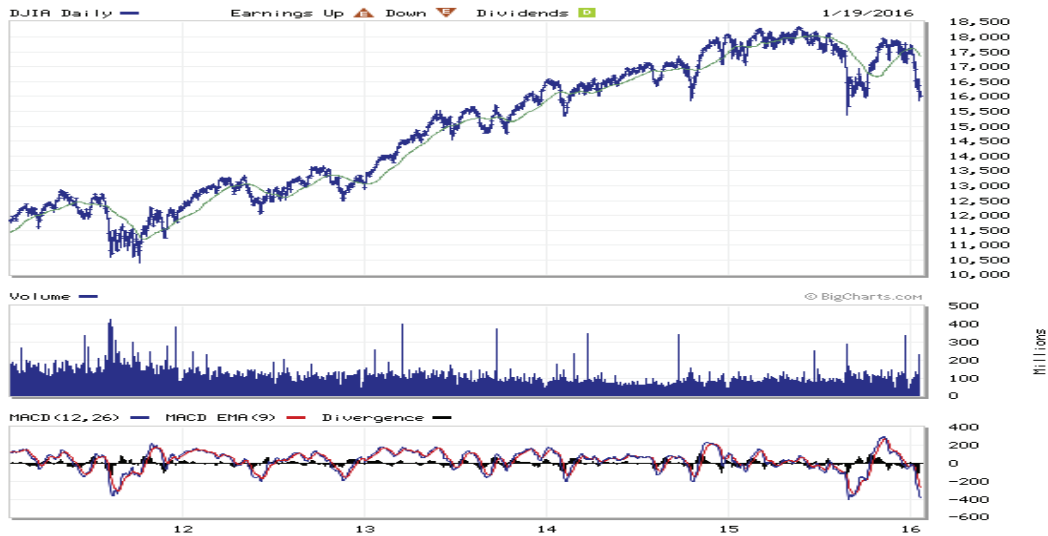
Roundtable Subjects

- 2016 Distressed Investment Outlook
- Valuations in the Context of Successful Distressed Investment Strategies
- Distressed Valuations – Cash Flow vs. Asset Based
- Evaluating Commodity Price Risks
- Impact of “Rich” Valuations on Distressed Investment Strategies
- The Opportunistic Activist Distressed Investor – Creating Value Through Advocacy



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Five Year Dow Jones Industrial Average





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Valuation in the Current Economic Climate

- The current economic climate places additional importance on the methodologies employed by experts when valuing companies or assets in a distressed or reorganization scenario
- Market volatility in recent years raises the question of whether the market is the appropriate mechanism to value a company (i.e., for example, whether a section 363 sale is more favorable than distributing equity in the reorganized company to creditors)
- Similarly, the multiples and comparable companies used by experts to value a company on a going concern basis will receive higher scrutiny
- Obviously, valuation is foundational in determining whether to execute on a potential opportunity



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Valuation Methodologies

- The Supreme Court has stated that the best indicator of value, whether valuing a particular asset or an entire business, is the actual sale price. See *Bank of America Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457 (1999) ("the best way to determine value is exposure to a market").
- Recent scholarly debate has focused on whether a sale provides sufficient value to the estate. See Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (363 sales undervalue companies when compared to reorganizations) and James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691 (2008) (responding to *Bankruptcy Fire Sales*).
- In many situations, multiple valuation methodologies are used to eliminate outliers and derive as accurate an estimate of values as possible given that valuation is an inexact science. See *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980); *Lippe v. Bainco Corp.*, 99 Fed.Appx. 274, 278 (2nd Cir. 2004).





NYU's Altman Says U.S. Defaults to Climb

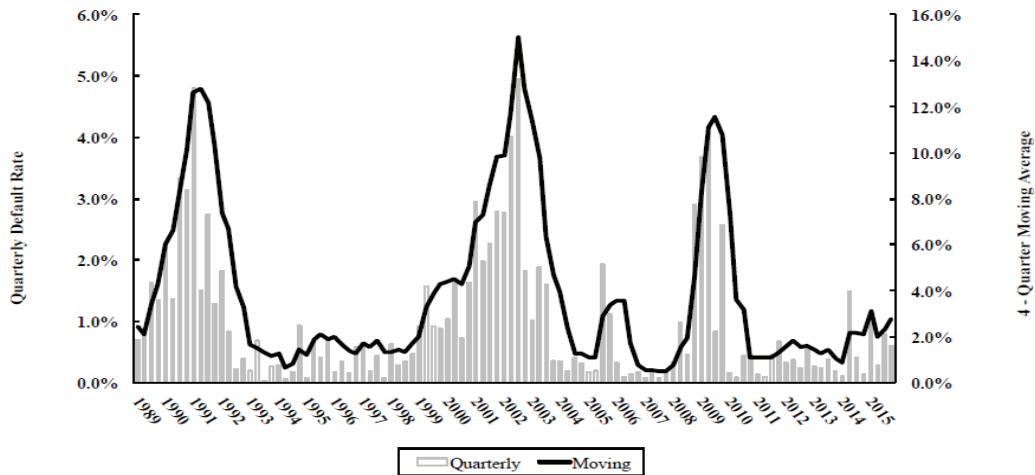
- "There is no question in my mind this year default rates will go beyond the average rates, maybe a lot more."
- "The high-yield markets have grown so big, you don't need to have a large default rate to have tons of debt in trouble."
- The default rate on high-yield bonds was 2.8 percent in 2015, compared with a weighted average of 3.7 percent, according to Altman. At a 2.8 percent rate, as much as \$45 billion of U.S. debt defaulted last year .
- Professor Altman expects Chapter 11 cases to rise in 2015 led by companies in energy, coal and metals and mining.



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Default Rate on High Yield Bonds



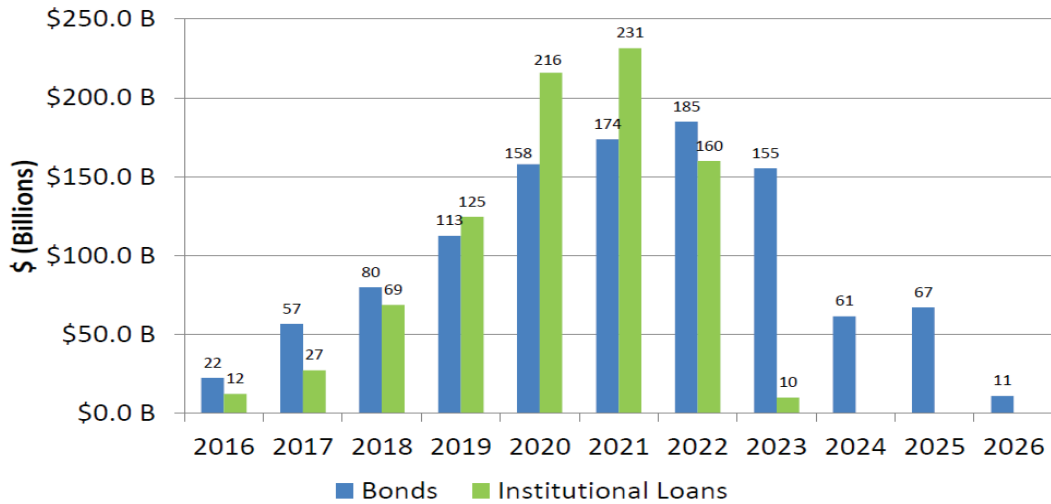
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Leveraged Debt Maturity Profile



Source: S&P Capital I.Q.



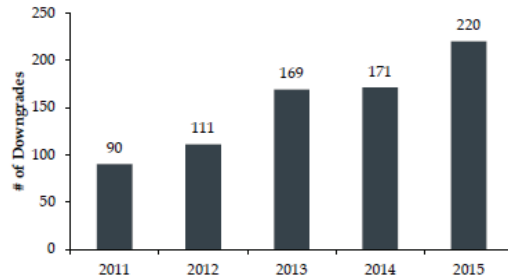
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Stress in the High Yield Markets

HIGH YIELD INDICES



HIGH YIELD DOWNGRADES



FREE CASH FLOW (\$ IN MM)

- Yields on high yield has increased by approximately 740 bps over the last year
- 2015 rating downgrades have outpaced ratings downgrades each year since 2011
- Fund flows had their second consecutive negative year with \$6.0bn in outflows versus 2014's \$7.2bn in outflows as investors fled commodity and retail related names and the Fed's first rate hike since 2006 exacerbated investors concern in highly leveraged credits

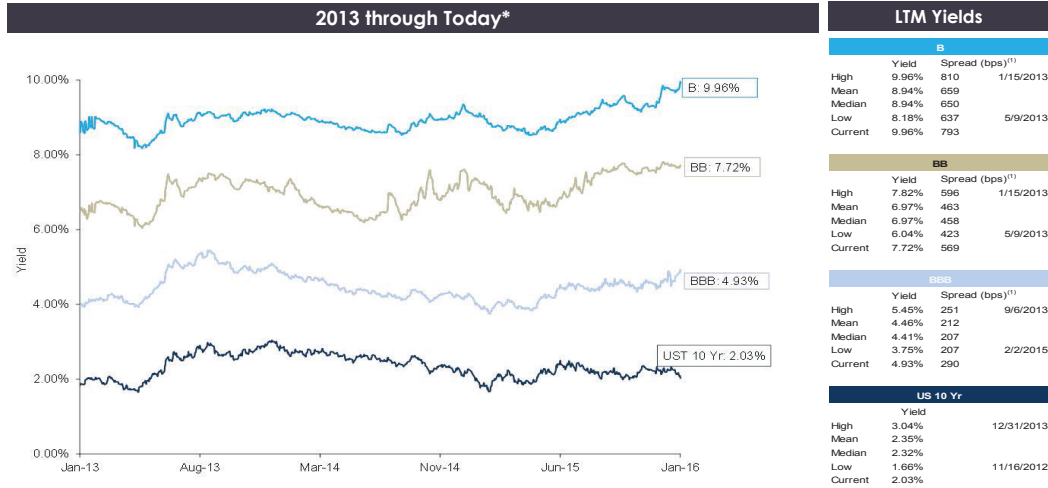




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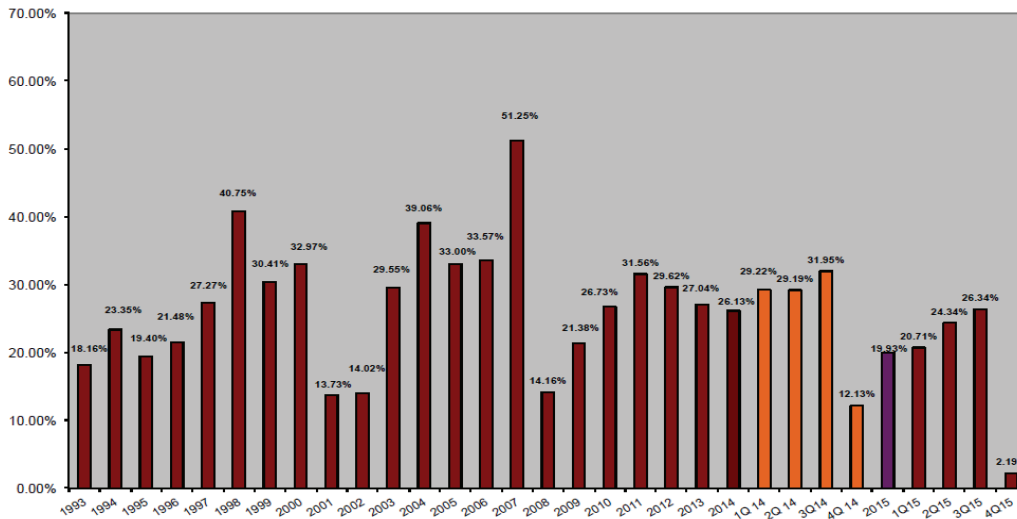
US Credit Markets Overview – January 2016



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New Issues Rated B- or Below (\$ Issuance)

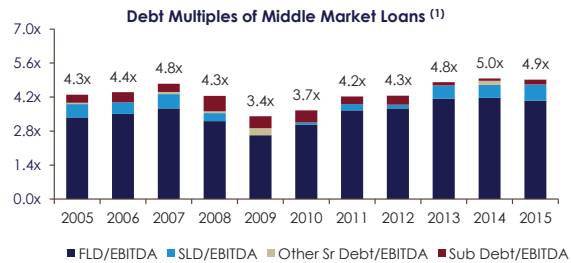
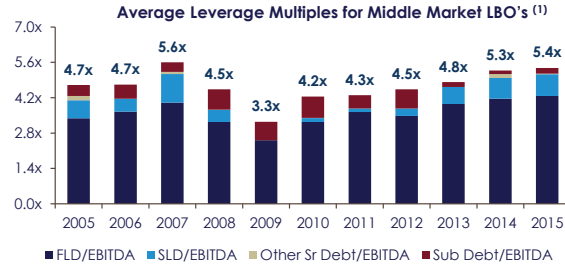




Middle Market Credit Conditions – January 2016

Commentary

- The credit markets continue to support high leverage levels, and middle market liquidity conditions remain competitive
 - However, there have been some significant regulatory, market, and “flight to quality” concerns in the greater debt capital markets
 - Credit downgrades far outnumber upgrades, default rates are on the rise, yields for lower quality credits (sub “BB”) are rising, and there is clear retreat from high risk assets in the larger high yield and traded markets
 - As the market becomes more risk sensitive, there is likely to be an expectation for investor scrutiny, especially for cyclical or “storied” situations
 - There is significant and growing interest in “structured” equity products to supplement financings that are equity light
- High-yield bond prices have significantly dropped in the past few days, especially those of risky and distressed companies
 - Some higher quality bonds were also negatively impacted, but they were isolated to particular credit challenges (e.g., commodity-linked firms)



⁽¹⁾ Source: KPMG LLP from Standards & Poor | Leveraged Commentary & Data



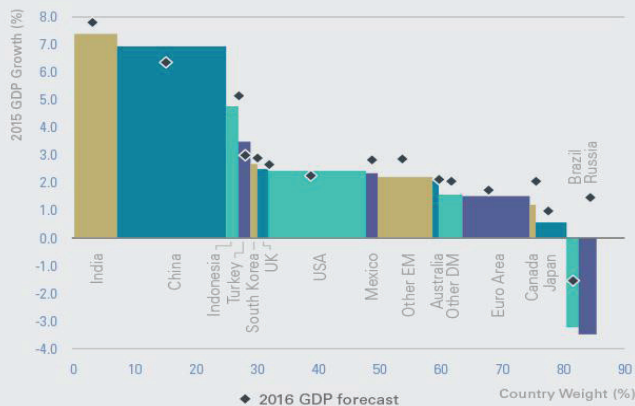
Goldman Sachs 2016 Investment Outlook

1

Global growth: More stable than it looks

- GDP growth will grind higher to 3.5% from 3.2% as recovery from crisis continues
- Growth will come from rebounds in hard-hit emerging markets and small improvements in Europe, Japan
- Labor markets will continue march toward full employment in economies such as the US, UK

STABILIZING ECONOMIES TO DRIVE GLOBAL GROWTH IN 2016



Source: Goldman Sachs Global Investment Research.





Goldman Sachs 2016 Investment Outlook

2

US inflation: Less downside risk than is priced

- Headline inflation will rise across developed markets, bringing core inflation closer to target
- Less labor slack and recovering oil prices will reduce deflation premiums in US rates, inflation
- Emerging market central banks will face a trickier balancing act between inflation, growth

OPTION-IMPLIED PROBABILITY OF 'LOWFLATION' REMAINS AT AN UNLIKELY HIGH



Source: Bloomberg, Goldman Sachs Global Investment Research.



Goldman Sachs 2016 Investment Outlook

3

Monetary policy: Divergence in developed markets

- The Fed tightening cycle will go further than markets expect
- The ECB and BoJ will remain dovish even as the US tightens
- Central bank divergence will drive the US dollar higher

US RECOVERY OUTPERFORMS, LEADING TO MONETARY POLICY DIVERGENCE



Source: Haver Analytics, Goldman Sachs Global Investment Research.





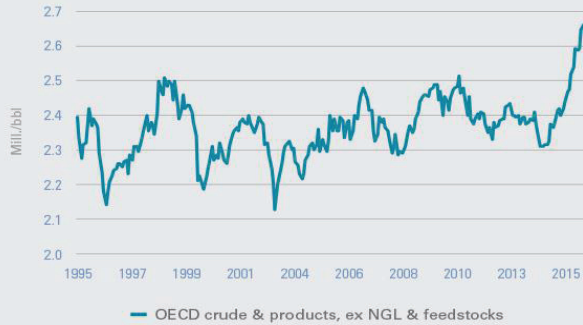
Goldman Sachs 2016 Investment Outlook

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Oil prices: Near-term downside risk, year-end upside

- Near-term risks for oil tilt to the downside as inventories approach storage capacity
- Our base case is that oil does not breach storage limits and WTI ends year higher at \$52/bbl
- The risk that oil surprises to the downside is among the top risks for 2016

RIISING OIL INVENTORIES CREATE RISK OF BREACHING STORAGE CAPACITY



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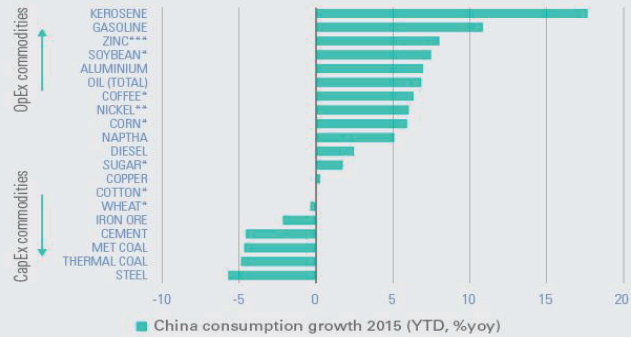
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Relative value in commodities: OpEx over CapEx

- Commodity prices will remain "lower for longer"
- "CapEx" commodities such as steel will be hit hardest by China's rebalancing
- "OpEx" commodities such as oil will see better demand

CAPEX COMMODITIES BEAR THE BRUNT OF CHINA'S REBALANCING



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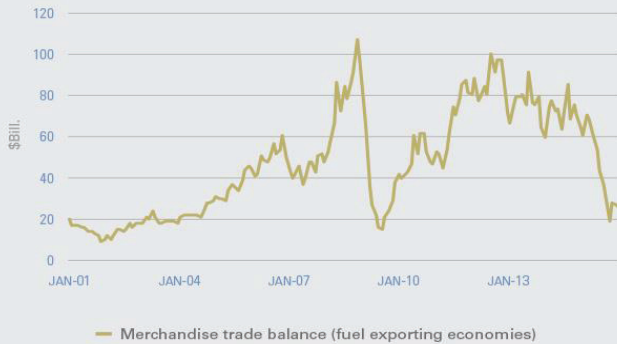
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Global saving glut: In reverse

- “Lower for longer” commodity prices will reallocate income from savers to consumers
- This will drain one of the main contributors to the “global savings glut”
- The shrinking glut will become more visible as global consumption and investment pick up

REVERSE GLUT ALREADY VISIBLE IN DECLINE IN PETRODOLLAR SAVINGS



Source: IMF, Haver Analytics.



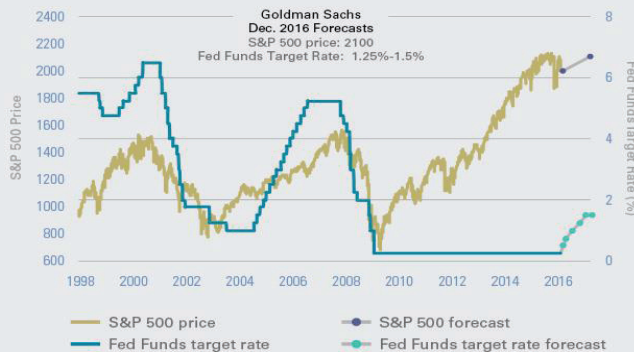
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US equity upside: Limited by the ‘Yellen call’

- US stocks have limited upside in 2016 as earnings rise and P/E multiples contract
- Concern that good economic news will bring more Fed tightening also will hang over stocks
- This perceived “Yellen call” (after Fed Chair Janet Yellen) may cap rallies in risk sentiment

S&P 500 FORECAST TEMPERED BY SHIFT TO FED TIGHTENING



Source: Compustat, Federal Reserve, Goldman Sachs Global Investment Research.





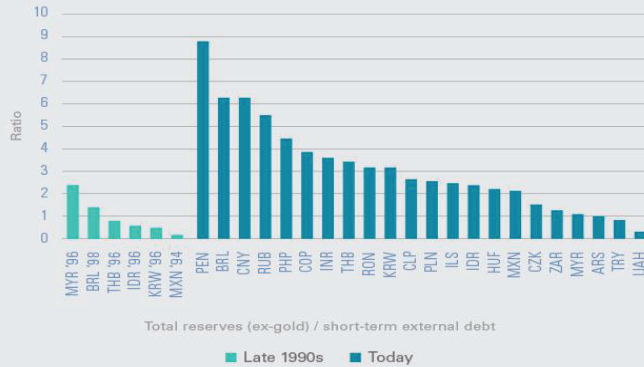
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EM risk: Slowdown, not meltdown

- Emerging markets are better positioned than in previous crises to weather slower growth
- Countries with currencies pegged to the dollar are most at risk of difficult adjustments
- Reserve buffers and less reliance on hard currency debt will help EMs manage rebalancing

EM RESERVES IN FAR BETTER SHAPE THAN IN THE LATE 1990S



Source: IMF, Haver Analytics, Goldman Sachs Global Investment Research.



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Market liquidity: The 'new normal' is less

- The loss of liquidity in fixed-income markets is likely to persist
- There is little sign of regulatory remedies to address issue
- Shift to "agency" model from "principal" trading will continue

CORPORATE BOND TRADING VOLUME DECLINES



Source: SIFMA, FINRA TRACE, Goldman Sachs Global Investment Research.



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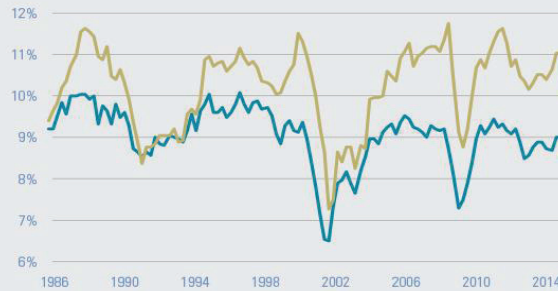
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Corporate earnings: Only a temporary loss of mojo

- Fears over falling returns on assets will prove overdone as firming GDP growth helps revenue
- Assuming margins are maintained, there is ample room for renewed growth in revenue, earnings
- There is little evidence rising cost inefficiencies or declining pricing power are starting to weigh on earnings

LOWER RETURNS ON ASSETS REFLECT WEAK REVENUES, NOT MARGINS



Calculated as median ROA for nonfinancial firms in each quarter:
 — S&P 500x (excludes energy, metals and mining sectors) — S&P 500

Source: Compustat, Goldman Sachs Global Investment Research.



Goldman Sachs 2016 Investment Outlook

2016: Global Growth Edges Up

Goldman Sachs global and regional GDP forecasts for 2016

% change YOY	2015	2016
World	3.2	3.5
Developed Markets	2.0	2.0
Emerging Markets	4.4	4.9

Source: Goldman Sachs Global Investment Research.

% change YOY	2015	2016
USA	2.4	2.2
JAPAN	0.6	1.0
EURO AREA	1.5	1.7
Germany	1.5	1.7
France	1.2	1.4
Italy	0.8	1.6
Spain	3.1	2.5
UK	2.5	2.7
CHINA	6.9	6.4
INDIA*	7.4	7.8
RUSSIA	-3.5	1.5
BRAZIL	-3.2	-1.6

* Fiscal year basis, 2014 is India FY15 (Q2 2014 - Q1 2015).





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Capital Markets Perspective

- The likelihood of closing any lending transaction (including rescue financings, DIP financings and Exit Financings) is an essential factor for borrowers to consider when seeking capital – and the rules have changed
- Leverage lending guidelines established in 2013 by the OCC and FDIC and which are applicable to banks and bank holding companies impact the ability of banks and most large investment banks to provide leveraged loans to borrowers -- these guidelines are applicable to all transactions -- whether they are best efforts or underwritten, whether the bank will take a hold position or not
- It will be very difficult for any lender to know whether a leveraged deal can be completed unless the part of the bank that has approval for such issues, typically credit and compliance, will approve it



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Capital Markets Perspective

- This new credit approval paradigm is opening up the doors for many non-bank lenders to act as an alternative source of capital in leveraged and distressed transactions
- Increasingly, we expect to see large alternative asset managers trying to fill the vacuum created by commercial and investment bankers being either unable or unwilling to finance difficult leveraged transaction
- However, given the size of the balance sheets of these alternative managers, no single lender will likely be able to take on multi-billion loan, which means borrowers are going to need to 'club up' those deals if banks will not participate



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An Investor's Perspective

- We spend considerable time analyzing the aggregate leverage of a business – financial leverage, operating leverage (exposure to cyclicality) and industrial leverage (exposure to increased competition, regulatory pressure or secular decline)
- The goal is to minimize the risk of permanent capital loss – high aggregate leverage increases the risk of a restructuring
- Low valuation coupled with moderate aggregate leverage increases margin of safety
- Oftentimes dislocation events/overhangs result in depressed valuations -- bankruptcy filings and other types of distressed restructurings are good examples of dislocation events



An Investor's Perspective

- The complexity of the bankruptcy process also often creates additional valuation discount – being able to successfully navigate such a process can result in value creation
- Being able to invest in both equity and credit is essential -- we first estimate the enterprise value of a business and then factor in how that value is and could be distributed across the capital structure under a variety of scenarios -- in some cases distressed debt offers the most attractive risk/reward
- In other cases, understanding a company's actual restructuring risk introduced by its debt structure (covenants, etc) can result in the determination that significant value should accrue to the common equity (i.e., often the equity market overestimates true default risk and over-discounts equity values as a result)





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An Investor's Perspective

- Restructuring is generally cyclical – identifying good businesses going through bankruptcy proceedings can result in outsized returns
- The drivers of those returns can be generated through:
 - a successful financial restructuring;
 - a successful operational restructuring;
 - further business optimization and intelligent capital allocation



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Future Outlook and Observations

- Debt and equity markets are volatile – and will remain so
- Energy and other commodity prices are affecting many markets and transactions – and will continue to do
- Liquidity constraints in the leveraged and high yield markets are affecting some M&A transactions and impacting restructurings – although liquidity constraints are less evident in the lower middle market
- Disruption creates value -- ugly disputes by parties with little economics at stake are continuing – genuine need exists to generate value from each other if not available from the business enterprise – mostly intercreditor with company and other stakeholders as bystanders



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Future Outlook and Observations

- In chapter 11 cases, expedited sale processes are accelerating as “in the money” stakeholders indicate little interest in cost, delay, uncertainty and external event risks associated with traditional reorganization cases – as the markets have reset to these new norms, more bidders are showing up at auctions and competing for control
- Escalating intercreditor disputes are leading to more “first impression” judicial decisions – but new decisions are being “priced into the system”
- Chapter 11 venue disputes are escalating particularly in energy cases where employees and unsecured creditors believe they will fare better in an oil and gas state
- Cashless transactions are more prevalent with very little cash to creditors or value distribution

