Leverage Lending, Dividend Recaps, and Solvency Opinions

Jeff K. Davis, CFA

September 17, 2013

MERCER CAPITAL

“The pricing of credit is forever cyclical.”

Jim Grant

Grant’s Interest Rate Observer

THE WALL STREET JOURNAL.
WSJ.com

August 8, 2013, 1:58 PM ET

Small Companies Find Debt Markets Open Too

By Melvin Backman

Bond investors have gobbled up a slew of bond offerings by small-sized companies borrowing cash to pay dividends to their private equity owners.

THE WALL STREET JOURNAL.
WSJ.com

ECONOMY | Updated September 5, 2013, 9:38 p.m. ET

Financial Crisis Anniversary: For Corporations and Investors, Debt Makes a Comeback

FINANCIAL TIMES

December 20, 2012 8:33 pm

US dividend recaps rise

By Stephen Foley in New York

The pace of “dividend recaps”, debt-funded payments to the private equity owners of American companies, returned this year to levels seen before the financial crisis, thanks to the availability of cheap debt.

SECTION ONE

Leveraged Finance Metrics

Leverage Finance Themes

- Yield starved world
- Lenders are liquid and willing
- Rise of the institutional lender – YTD flows to loan funds $47B, $143B AUM; CLO issuance $53B YTD, ~$275B AUM
- "New" money loan demand soft due to moderate M&A, LBO activity and flattish corporate capital expenditures … ~67% refinancing vs. ~33% new money YTD
- Private equity (PE) firms are favoring dividend recaps given fewer M&A opportunities and lenders' willingness to fund

Leverage Finance Themes

» No “bright line” Street definition of a levered company

- Graham & Dodd – balance sheet focus (out);
  margin of safety timeless
- M&M – value of the asset is independent of capital structure
- Leverage varies by industry, but 4.0x EBITDA benchmark

» Bank Regulator Leveraged Lending Guidelines

- April 2001 guidance revised March 2013
- Banks determine what constitutes leverage loans
- EBITDA focus (cash flow to reduce debt ~50% over 5-7 years)
- Regulators monitoring covenant-lite and PIK-toggle structures

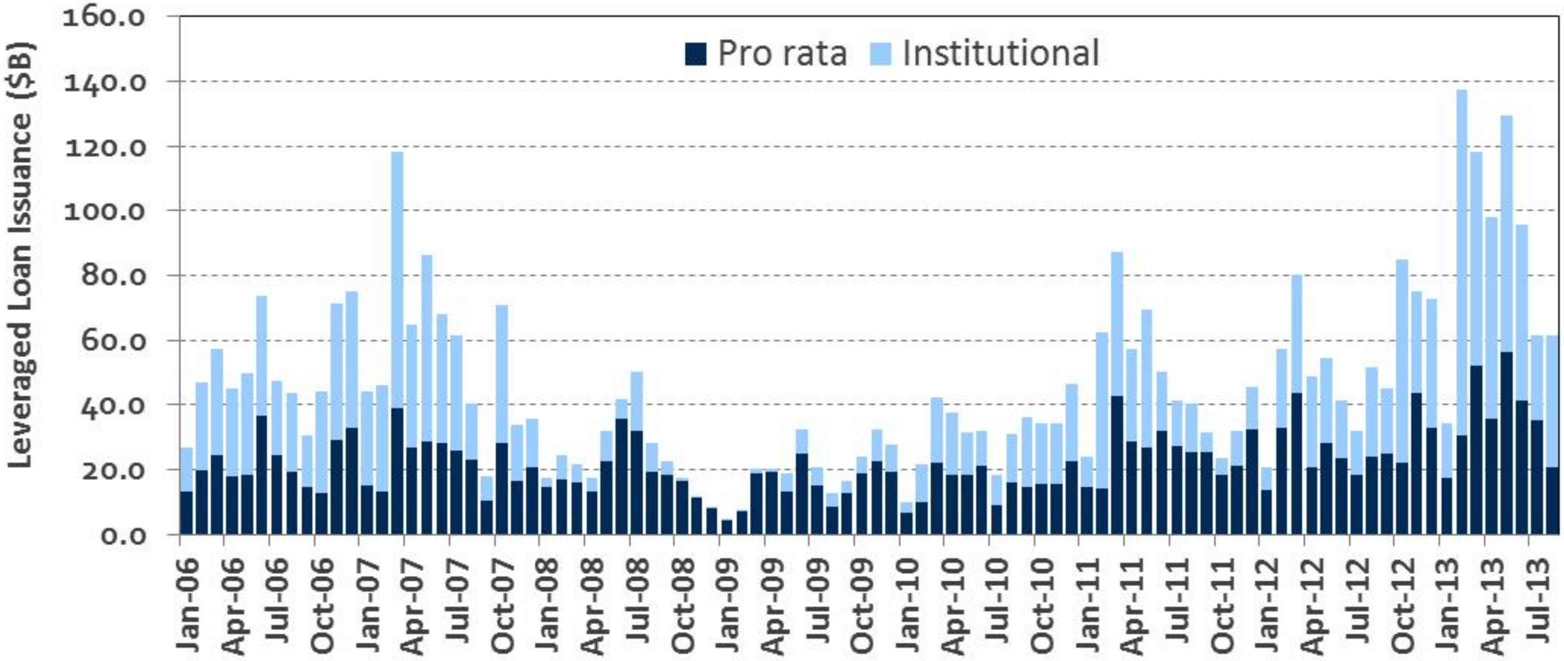
EBITDA Multiple

	LBO Debt / EBITDA		M&A Enterprise Value (Equity + Debt) / EBITDA						
	Middle Market	Broadly Syndicated	Industrials	Consumer	Healthcare	Tech	Energy	Deals < $100M	Deals $500-$1B
2007	5.5x	7.0x	na	na	na	na	na	na	na
2008	4.5x	5.5x	7.1x	8.3x	11.9x	11.0x	9.1x	6.2x	10.6x
2009	3.2x	4.8x	7.0x	8.3x	8.5x	8.4x	6.0x	6.9x	9.9x
2010	4.2x	5.6x	7.2x	8.5x	9.0x	9.6x	9.7x	7.7x	9.2x
2011	4.3x	5.7x	9.5x	8.7x	9.0x	9.5x	9.4x	8.3x	9.5x
2012	4.6x	5.8x	9.2x	7.7x	11.3x	8.3x	8.8x	7.1x	8.1x
2013	5.0x	6.0x	7.9x	8.3x	12.4x	7.4x	8.8x	nm	9.9x

- Average equity in MM LBOs of 43% YTD is higher than ~33% in ‘04-07
- Average equity in larger LBOs of 30% YTD approximates ‘04-07

Source: KeyBanc Capital Markets, NewStar Financial and Thomson Reuters; Debt multiples thru 1H13, M&A multiples thru 1Q13

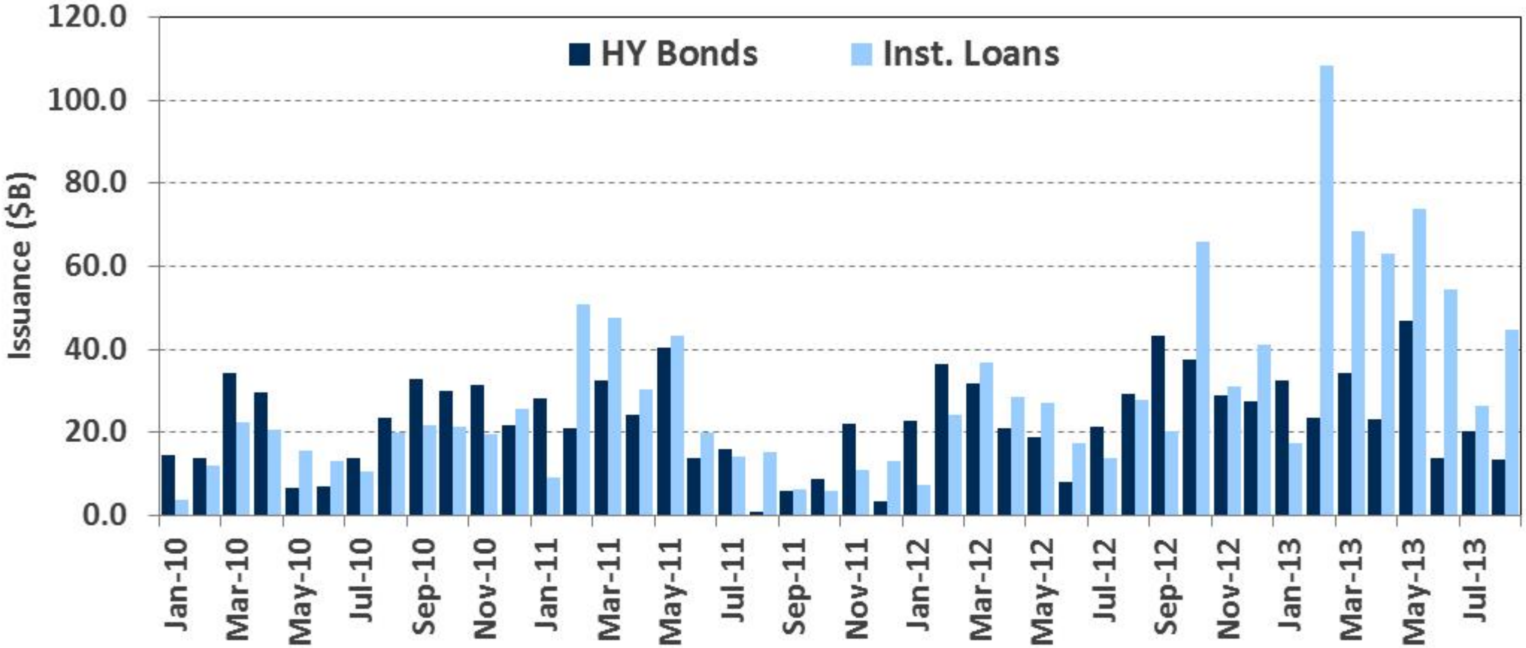
Leveraged Loan Issuance



- $61B of leveraged loan issuances in August; $736B YTD vs. $387B YTD last year
- 39% pro rata (bank syndicated) vs. 61% institutional distribution

Source: Thomson Reuters Loan Market Monthly September 2013

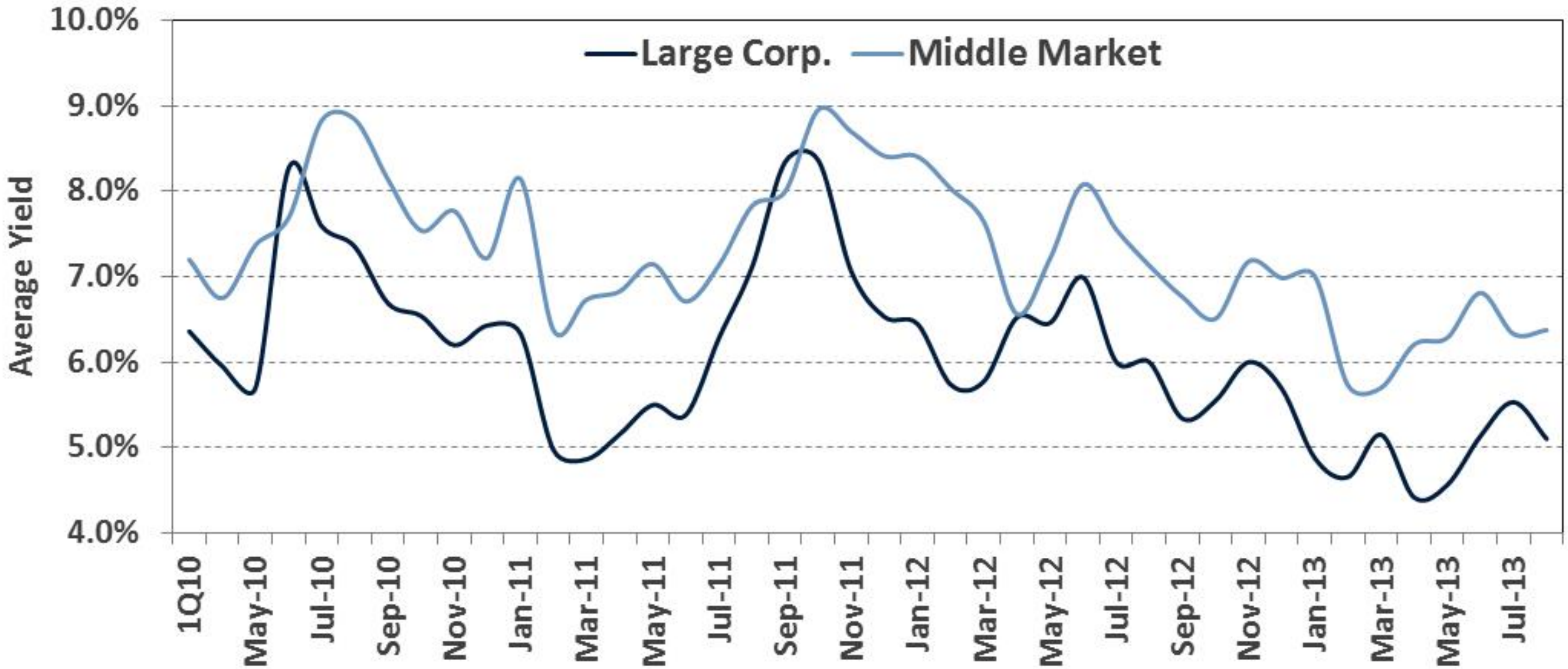
Leveraged Loan and HY Bond Issuance



- $456B YTD institutional loan issuance through August vs. $183B YTD last year
- $208B YTD high yield bond issuance vs. $189B YTD last year

Source: Thomson Reuters Loan Market Monthly September 2013

Primary Market Leveraged Loan Yields



- LIBOR-based pricing – demand has driven yields lower via tighter LIBOR margins
- Covenant-lite issuance $165B YTD vs. $35B last YTD

Source: Thomson Reuters Loan Market Monthly September 2013

Secondary Market Leveraged Loan Bids

- Average bid in August 99.2, up 150bps from August 2012
- 8% of loans are priced at 101 or higher vs. 39% in May before “taper” talk began

Source: Thomson Reuters Loan Market Monthly September 2013

SECTION TWO

Elements of Solvency Analysis

Solvency Opinion

- Issued when a financing transaction produces “high” leverage
- Does the company’s assets exceed its liabilities? Is it left with inadequate capital?
- Safe harbor aspect
- Officers can rely upon when providing solvency certificate
- May be required by lenders with solvency certificate

Fairness Opinion

- Issued for a significant transaction (M&A, buyback, spin-off, LBO, etc.)
- Safe harbor aspect
- Is the transaction fair to share-holders from a financial point of view?
- Pricing, terms, process
- FINRA 2290 re: disclosures

Elements of Solvency Analysis

» **Balance Sheet Test**: Does the fair value and present fair saleable value of the Company's total assets exceed total liabilities, including all contingent liabilities?

- "Present fair saleable value" means the aggregate amount of consideration that would be expected in an arm's length transaction
- The "Balance Sheet Test" is applied whereby the value of the assets can be equated with the firm's "enterprise value" from which liabilities are subtracted
- Standard valuation methodology applied – pricing of publicly traded comps, M&A comps, DCF, etc.

Balance Sheet Test

Valuation Indications by Method ($000)	Low	Mid	High
Transaction Method		None	
Discounted Cash Flow (+/- 5% Point Estimate)	3,110,000		3,440,000
Industry M&A: EBITDA Capitalization @ 6.0x of LTM and 2014E	2,120,000		2,860,000
Industry M&A: EBITDA Capitalization @ 8.0x of LTM and 2014E	2,830,000		3,810,000
EBITDA Capitalization Guideline Companies (per Exhibit G)	2,300,000		3,050,000
Capitalized MLP Distributions (+/- 5% Point Estimate)	3,350,000		3,710,000
Concluded Range: Enterprise Value	**$2,742,000**	**to**	**$3,374,000**
Plus: Current Liabilities (ex-CMLTD)	150,000		150,000
Present Fair Salable value of Assets	**$2,892,000**		**$3,524,000**
Less: Liabilities (ex-Interest Bearing Debt)	(253,000)		(253,000)
Less: Post Transaction Interest Bearing Debt	(1,600,000)		(1,600,000)
Excess / (Deficiency) of Assets over Liabilities	**$1,039,000**		**$1,671,000**

Source: Mercer Capital

Elements of Solvency Analysis

» **Capital Surplus Test**: Does the fair value of the assets exceed the sum the liabilities and capital (pursuant to Section 154 of the Delaware General Corporation Law)?

» **Cash Flow Test**: Will the Company be able to pay its liabilities, including any identified contingent liabilities, as they become due or mature?

» **Capital Adequacy Test**: Does the Company have unreasonably small capital with which to operate, as such businesses are now conducted and will be conducted following the Transaction?

Cash Flow Test

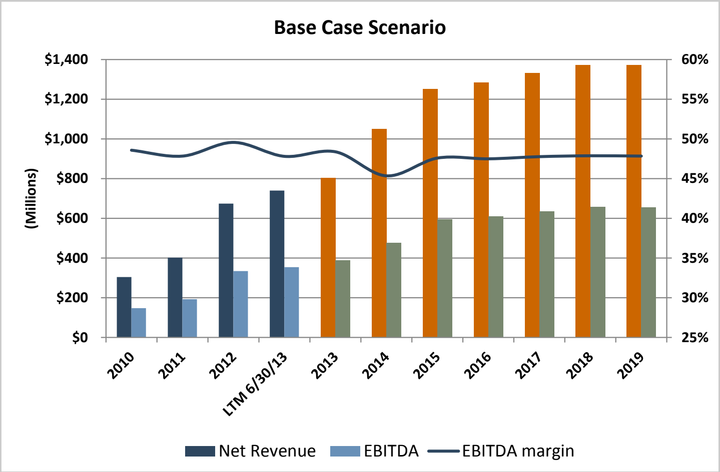
» We evaluate ability to pay debt as they come due via :

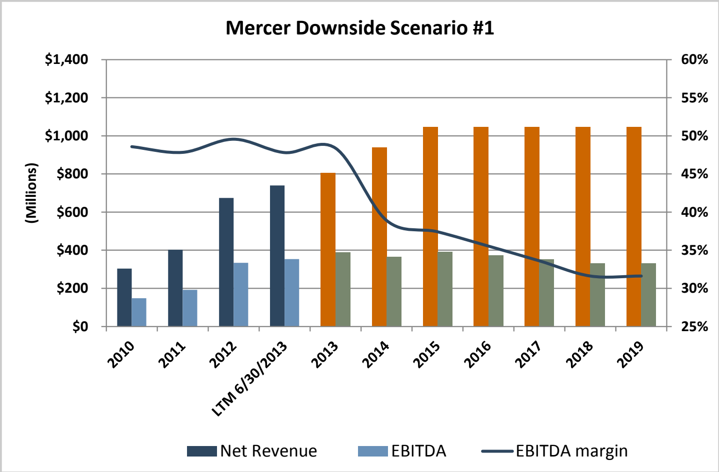
- **Projection Reasonableness**: How reasonable are management's assumptions regarding revenue growth, margins, cap-ex spending, etc. vis-à-vis history, industry conditions and consensus forecasts?
- **Revolver Capacity**: How dependent upon the revolver is the subject in the base case and alternative scenarios to plug cash shortfalls?
- **Covenant Violations**: Does the projected financial performance imply that the Company will violate covenants of the credit facilities?
- **Access to Capital**: Is it likely that the Company will be able to refinance projected debt at maturity and/or tap the bond market?
- **PE Support**: How likely will PE investors support if problems arise?

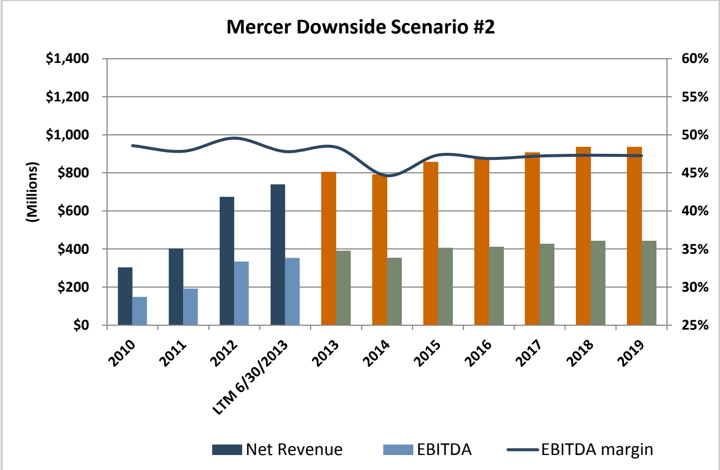
Capital Adequacy Test

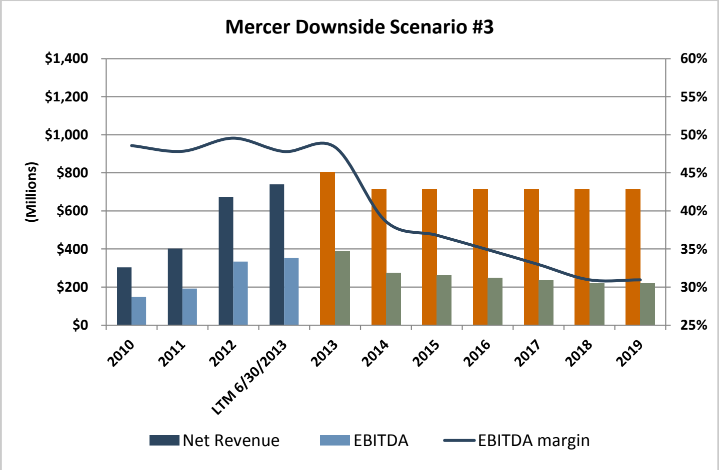
- No bright line for capital adequacy:
  - **Leverage**: How does the subject's post-transaction leverage compare with public and private comps?
  - **Sensitivity Analysis**: How likely is it that lending covenants will be violated (and by how much) when key cash flow drivers are subjected to negative variances?
  - **Rating Agencies**: How do rating agencies' views differ from those embedded in the base case? What opinion do the rating agencies have regarding increased leverage?
  - **Market Reaction**: If the subject has publicly traded debt or loans what is the market's reaction to a leverage transaction?

Scenario Analysis - Net Revenue, EBITDA & Margin



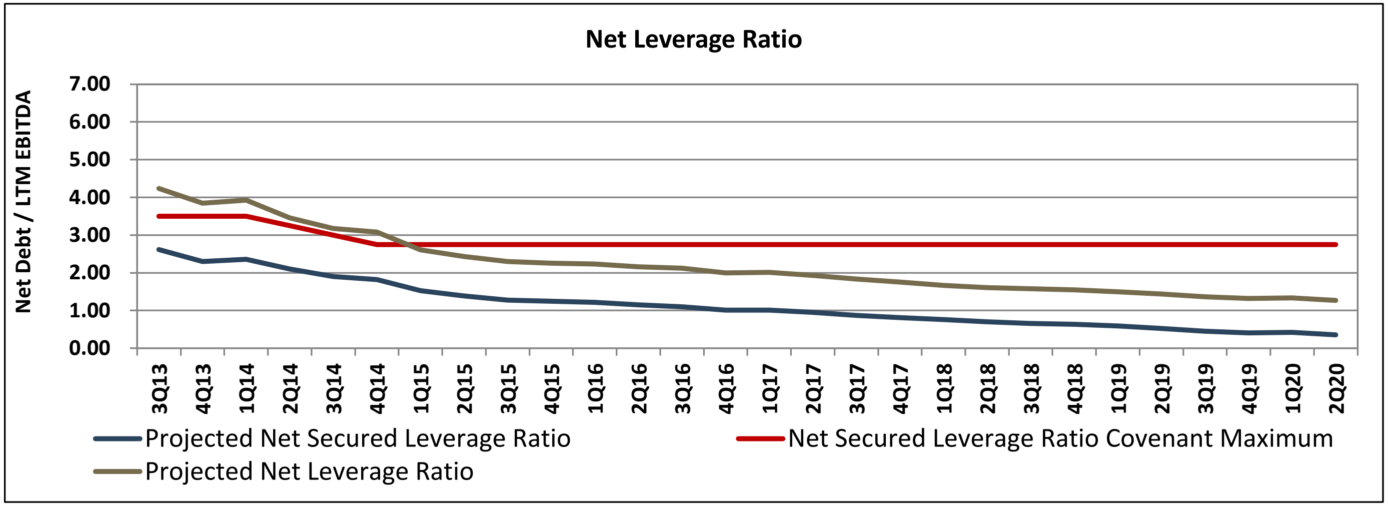


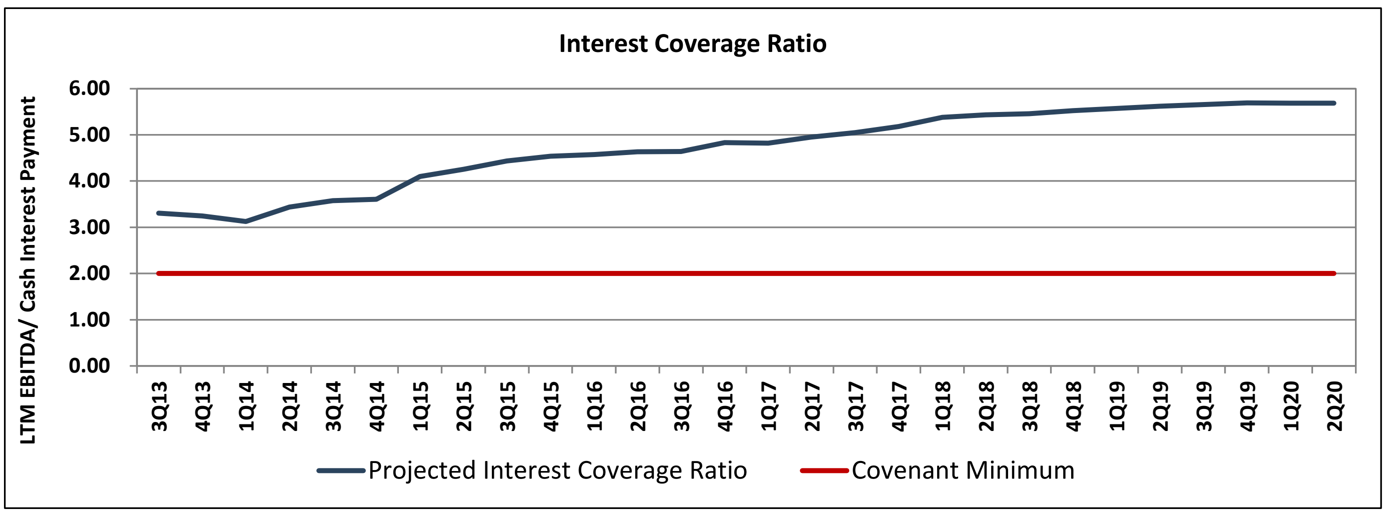




Source: Base line management projections, alternative scenarios per Mercer Capital

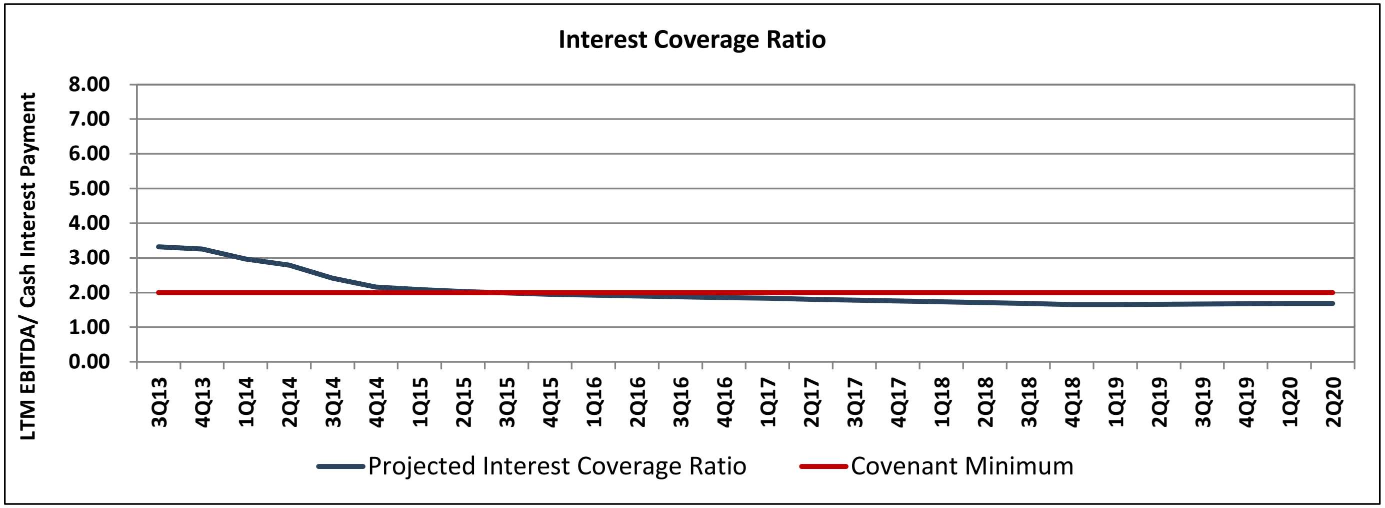
Base Case

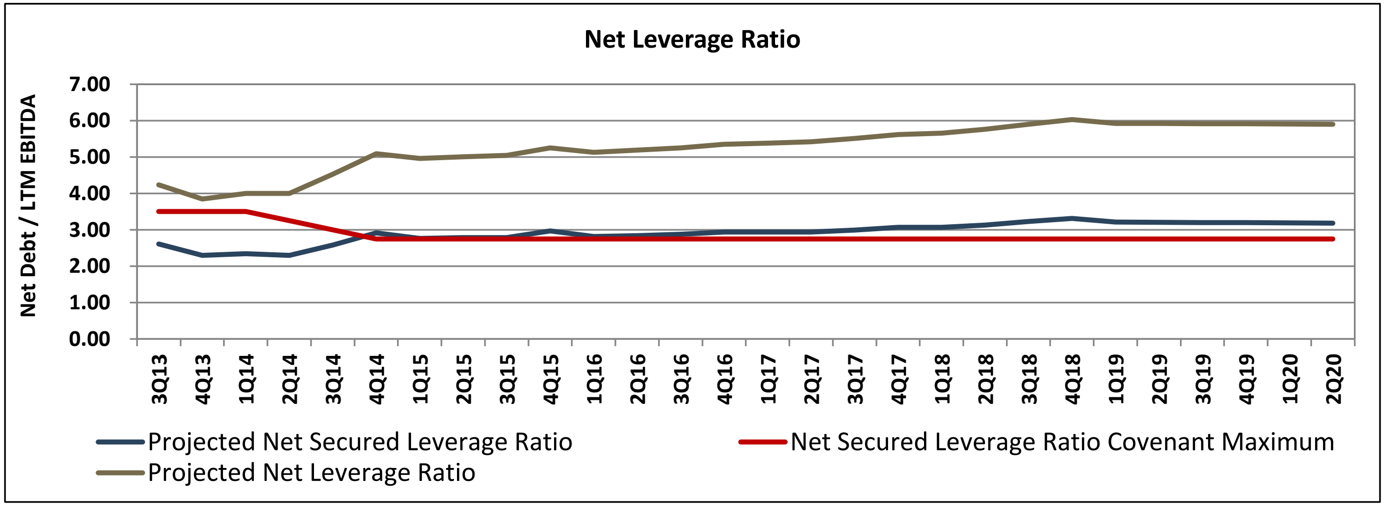




Source: Mercer Capital

Downside Scenario #3





Source: Mercer Capital

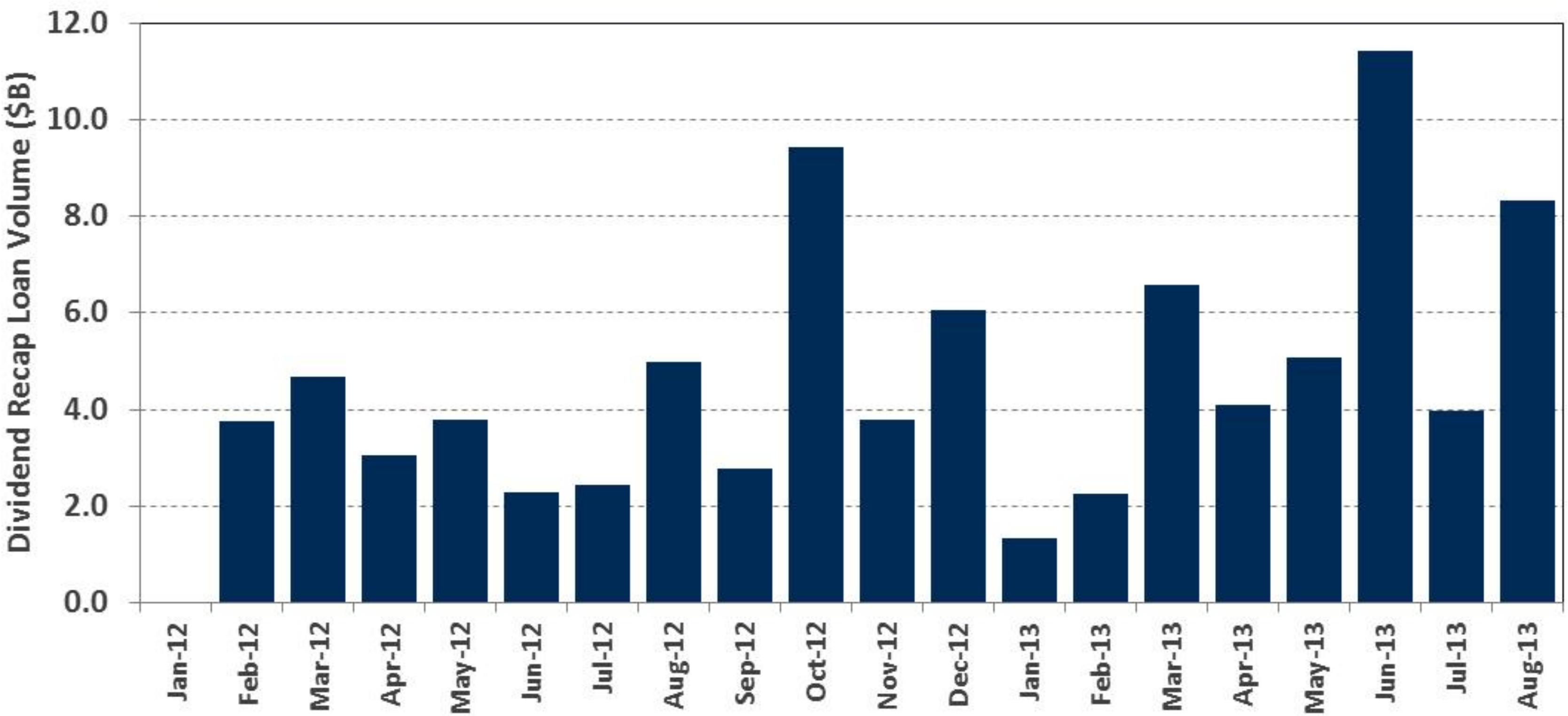
SECTION THREE

Dividend Recaps

Dividend Recaps

- Large dividend funded via assumption of debt
- Equity holders may pursue when there is no desire to sell or IPO or market conditions are not favorable to do so
- Concept of short-duration equity
- Distributions do not hurt PE’s fund raising efforts
- Existing bond holders view dividend recaps as a dirty phrase
- Equity holders may view dividend recaps as unlocking value

Dividend Recap Loan Volume



- $45B YTD through August vs. $25B YTD last year

Source: Thomson Reuters Loan Market Monthly September 2013

Subject	As of 6/30/2013	Adjustments	Pro Forma 6/30/2013
Cash	50,000	(25,000)	25,000
Accounts Receivable	123,500		123,500
Inventories	114,500		114,500
Other Current Assets	29,500		29,500
Net Fixed Assets	1,575,000		1,575,000
Other Assets	26,500		26,500
TOTAL ASSETS	**$1,919,000**	**($25,000)**	**$1,894,000**
Accounts Payable	103,500		103,500
Other Current (ex-CMLTD)	255,500		255,500
Revolving Credit Facility	275,000	0	275,000
Term Loan B	0	300,000	300,000
Project Financing	125,000		125,000
Capital Leases	52,500		52,500
Total Senior Secured Debt	452,500		752,500
9.25% Sr. Notes due 2019	582,500	(582,500)	0
6.75% Sr. Notes due 2021	0	557,500	557,500
Total Senior Unsecured Debt	582,500		557,500
Total Debt	**1,035,000**		**1,310,000**
Total Liabilities	1,394,000	275,000	1,669,000
Equity	**525,000**	**(300,000)**	**225,000**
TOTAL LIABILITIES & EQUITY	$1,919,000	($25,000)	$1,894,000

Sources	
$500M Revolver / Drawn	275,000
Term Loan B	300,000
6.75% Unsecured Notes	557,500
Excess Cash	25,000
	$1,157,500

Uses	
Existing Drawn Revolver	275,000
Tender for 9.25% Notes	582,500
Shareholders' Dividend	300,000
	$1,157,500

	6/30/2013	Pro Forma
Total Debt / EBITDA	3.8x	5.0x
EBITDA / Interest Expense	5.6x	4.0x
LTM EBITDA	$275,000	$260,000
LTM Interest Expense	49,163	65,500

Source: Company reports and the August 2013 Lenders' Information Memorandum

Dividend Recaps for Smaller Companies

Pros

- Diversification of personal net worth
- Convert “paper” equity (and uncertain future terminal value) to cash today
- Borrowing rates modest
- Valuations have recovered +/- to pre-crisis level
- Premium on achieving op efficiencies

Cons

- Debt may be an anvil over management’s head
- Cash flow diverted to debt service not available for additional cap-ex, M&A
- Increased bankruptcy risk if business turns down
- Lenders may have a say in how business is managed

SECTION FOUR

Mercer Capital

About Mercer Capital

Overview

- Business valuation and financial advisory firm, founded in 1982
- 40 employees (employee-owned)
- 300+ annual engagements
- Financial services—ranging from banks to private equity—accounts for ~40% of annual engagements
- Average EBITDA for non-financial service client ~$10 million
- ~80% of engagements relate to equity valuation, 20% debt, mezzanine capital or other
- Clients include private businesses, public companies, banks, specialty finance companies, hedge funds, BDCs, REITs, family offices, high net worth individuals, law and other professional firms

Mercer Capital Services

- **Valuation**
  - Tax compliance
  - Employee Stock Ownership Plan valuation
  - Corporate valuation services
- **Transaction Advisory Services**
  - Fairness and solvency opinions
  - M&A and investment banking services
  - Buy-sell agreements and private company transactions
- **Financial Reporting**
  - Purchase price allocation
  - Impairment testing services
  - Alternative investment portfolio valuation services
- **Litigation Support**
  - Expert testimony
  - Business damages
  - Shareholder disputes
  - Divorce

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