

Navigating in Today's Environment: The Directors' and Officers' Restructuring Guide 2010



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Building liquidity bridges through asset dispositions without bankruptcy

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In the face of a liquidity crisis, companies often look to asset sales as a way of generating short-term cash. A well-planned, well-orchestrated asset sale program can provide much-needed relief to a liquidity-starved entity. By contrast, a poorly planned, “knee-jerk” reaction often ends up cannibalizing the business and pushing the company into a downward spiral toward bankruptcy or liquidation. In the latter instance, companies are often forced to sell off their “crown jewel” assets at a discount to provide liquidity, leaving less-attractive assets behind.

Overview

Generally, companies looking to sell assets as part of a liquidity program have three sale alternatives to consider:

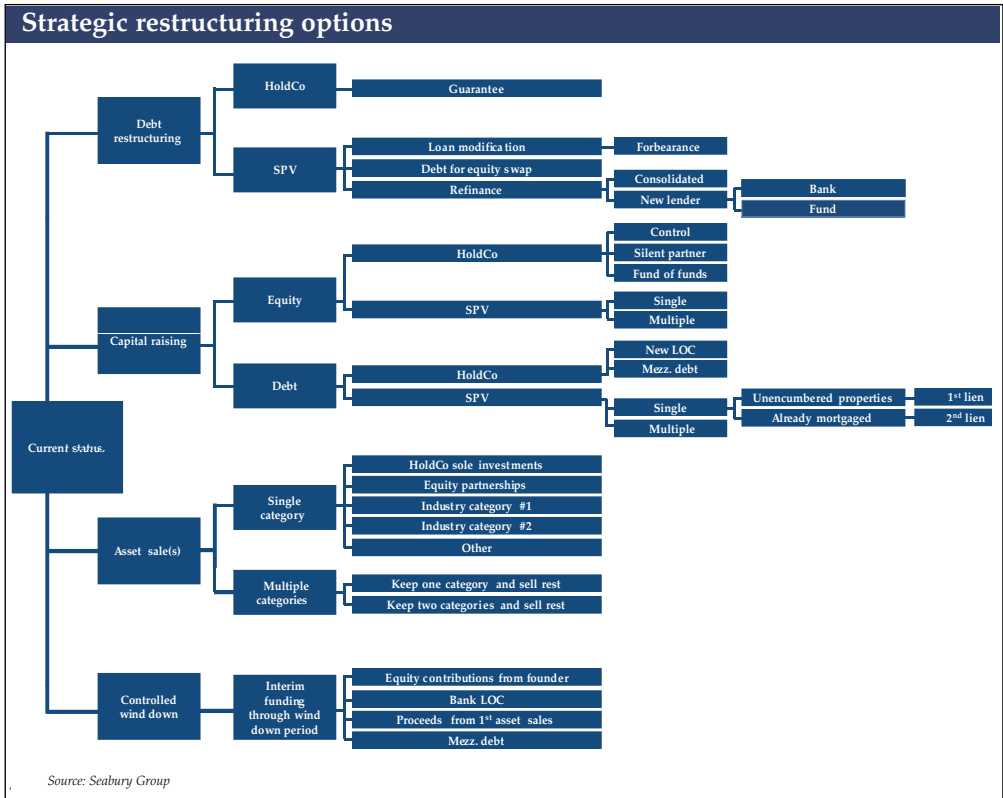
- Non-core assets or divisions.
- Core assets or divisions.
- All or substantially all of the business either through an asset sale or a controlling stake in the entity.

In determining which of these is most likely to satisfy the company’s requirements, it is vital to think of the future as well as the present. The most frequent mistake made by cash-starved enterprises is selling an asset at a discount, which can satisfy a short-term cash requirement but leave the company fundamentally unable to rehabilitate itself when it reaches the next liquidity hurdle. Sometimes “living to fight another day” is really just a stay of execution and it is important for any board of directors considering an asset sale to have undertaken a comprehensive analysis of the alternatives. Most companies are ill-prepared for performing such an analysis on their own and require both the skillset and objectivity of an outside investment banker or financial advisor.

Additionally, when looking to asset sales to create a liquidity bridge, the company should evaluate the form of consideration offered by potential buyers. Non-cash bids for assets, even if at a higher face value, may not be as attractive if the need for liquidity is immediate. Conversely, a bid for an asset that provides payment over time in the form of a seller note may provide liquidity at a point in the future when the cash burn of the company is higher or its ordinary income is lower due to the cyclical nature of the business. The decision matrix on the following page illustrates the analysis that the company, together with its financial advisor, should undertake as it considers the alternatives.

Sale of non-core assets or divisions

This is often the first option a company will investigate as it looks to generate cash. If an asset or operating division is not integral to the enterprise, selling it will not generally disrupt the core business or substantially impact the operating metrics. That said, it is also likely to generate the smallest amount



of liquidity. Often, these non-core assets are orphaned or capital starved and, as a rule, will yield a lower value in any sale process.

To maximize the value in an asset sale, it is fundamental that companies both (1) cast the net as wide as possible to potentially interested parties, and (2) run a robust, competitive process. Since the asset is non-core, concerns about strategic buyers are usually minimized and competition — involving financial as well as strategic parties — will create the best dynamic for achieving the highest possible price.

Case Study 1

A large public company (TVC) was a distributor of large-format televisions. It was the sole shareholder in a subsidiary, CVC — a distributor of cameras and camcorders throughout Asia, Europe, the United Kingdom and the United States. TVC had acquired CVC with a view to accessing its worldwide distribution channels, particularly in the UK and in Europe. As it turned out, TVC was never able to capture any synergies through CVC and could not

leverage those channels. TVC also had financial concerns of its own and, as a result, failed to focus on CVC and its capital needs.

CVC became an orphaned subsidiary, starved of capital and on the verge of insolvency. Although it had a good customer base and a recognizable trademark, it was forced into a program of recycling cash generated from sales to liberate product from its suppliers. TVC determined that CVC was non-core to its strategy going forward and elected to sell the subsidiary to generate much needed cash to service its senior debt.

Although the situation at CVC was bleak, the sale strategy was to market the company on a worldwide basis to both strategic and financial buyers. CVC’s intellectual property, especially its valuable trademark, formed the cornerstone of the marketing effort, which yielded six potential bidders: three strategic and three financial. The contest ultimately narrowed to three and the winning bidder was a strategic competitor that highly valued CVC’s intellectual property. As a result of this highly competitive process, the sale

generated several times the value originally expected for this orphaned, non-core asset.

Case Study 2

A large airline (Air Group) was organized as a holding company with three subsidiaries: (i) mainline airline operations; (ii) in-house maintenance and repair operations (MRO); and (iii) a regional airline that provided a feeder service to the mainline operations. By having the second of these in-house, Air Group was able to control maintenance expenses for its own operations. In addition, MRO was generating cash flows through contracts with third parties.

Due to deteriorating macroeconomic conditions and diminishing demand for air travel, especially in the high-yield sector of business travel, Air Group's airline operating performance began to suffer. Dwindling profits turned into operating losses and this put a substantial strain on the company's ability to sustain its existing capital structure, which was heavily debt-laden as a result of the expansionary strategy employed in prior years. Air Group did not have any further debt capacity to shore up liquidity. In addition, the capital markets drought eliminated the option of raising unsecured debt. Equity investor appetite was also non-existent, given the high likelihood of bankruptcy.

In response to these circumstances, Air Group decided to pursue a divestiture of its MRO division. Even though this would result in the company giving up control over its maintenance costs, which would likely increase if outsourced, Air Group viewed this as the only viable option for boosting liquidity. It worked with its investment banker to position the division for sale and attract both strategic and financial buyers.

The eventual sale to a financial buyer generated the cash needed to pay off near-term debt, and provided the liquidity bridge that was so important during the macroeconomic downturn.

Case Study 3

A large international airline was faced with a deteriorating liquidity position and a credible threat of bankruptcy. In response, management embarked on a comprehensive restructuring plan, which had four central tenets: (i) Fly to Win; (ii) Fund the Future; (iii) Make Reliability a Reality; and (iv) Work Together. As part of Fund the Future, the airline concentrated on leveraging certain non-core assets. It closed a number of maintenance centers and outsourced long-term maintenance

contracts. It also sold five wide-body aircraft that were not considered core assets in the long-term restructuring plan. But perhaps the action with the most pronounced impact on its liquidity program was the company's agreement to sell its computer reservation system (CRS) platform to a leading strategic player in the space.

The airline transferred all its CRS assets and liabilities to the new owner and in exchange received consideration in cash and shares in the newly formed CRS entity. By making that sale, it avoided substantial near-term cash requirements for necessary investments in technology upgrades, lowered its own transaction processing costs, and added to its liquidity. The restructuring plan was a resounding success and resulted in the company posting the largest quarterly profit in its history.

Sale of core assets or divisions

The sale of core assets as a liquidity bridge is a struggle for any company. If an asset is central to operations, its sale may cannibalize the business and prevent further restructuring. On the other hand, if a valuable core asset can be hived off, that could make a big difference to liquidity and perhaps permit the company to acquire replacement assets in the future with a lower cost basis.

In many instances, a company with a strong aversion to bankruptcy (a family firm, for example) because of the reputational risk may elect to undertake the sale of a primary line of business to generate sufficient liquidity to pay creditors, either with or without a discount. The challenge in these instances is having the foresight to reshape the business going forward.

To determine which core asset or division is appropriate for this kind of sale, it is essential to determine the answers to several questions:

- How much liquidity will the sale raise?
- How much liquidity is necessary to satisfy the creditors and the needs of the company?
- Does the remaining business have sufficient debt capacity to support any shortfall?

This analysis should be run throughout the company to judge which assets will generate the optimal result. Ideally, this should be done dispassionately. Concerns about external factors, while relevant at the margins, may persuade the company to pursue a path that will not yield the best outcome and will frustrate its rehabilitation efforts.

Although it is still important to create a competitive dynamic and run a robust sale process, the importance of screening strategic buyers becomes a concern in sales of core assets. Because the company will continue to operate the remainder of its business after the transaction, disclosure of business practices and strategies must be judicious. Notwithstanding the need for liquidity, the company will have to make some judgment calls about allowing certain competitors into the process and what information should be disclosed to those prospective buyers. Electronic data rooms make the segregation of information easy, but it is important to be mindful of protecting the same information in management meetings and due diligence as potential buyers move through the process.

Case Study 4

A commercial real estate development company (RDC) was in the business of buying raw land, developing a project, leasing that project and selling out of the asset. It operated four disparate business lines: commercial office, commercial retail, industrial and multi-family units. Typically, RDC would secure a construction mortgage on each property and that would be satisfied upon the sale of the asset.

As a result of the meltdown in both the real estate and credit markets, RDC found itself with an approaching liquidity crisis. Certain construction mortgages would be coming due and the lack of available credit rendered them virtually incapable of being refinanced. Likewise, sales of the projects (many of which were not yet tenanted) would be at values considerably lower than projected. RDC recognized that a piecemeal approach would leave it with a significant cash shortfall.

Although each of the four divisions was core to the company's overall operations, RDC concluded that the sale of two (commercial office and commercial real estate) would yield the most liquidity both to pay down its existing bank debt and to leave it well capitalized to survive the balance of the downturn in the real estate market — as well as to position it for growth in the future.

In some cases, certain assets are so vital to the overall business that companies cannot afford to sell them to generate liquidity. Often, the only viable option is to enter into a sale and leaseback transaction whereby the company monetizes any existing equity it has in the asset but also preserves its ability to continue utilizing the asset for a predetermined time through a lease arrangement.

This approach to boosting liquidity is common in the aviation and real estate industries.

Sale of all or substantially all of the business

This, again, is a bitter pill to swallow. The sale of all or substantially all of a business, either through an asset sale or a controlling stake in the entity, is often a last-resort strategy in creating a liquidity bridge to avoid bankruptcy. Indeed, in many instances, a company will seek to raise debt or equity capital and the process often morphs into this type of transaction.

When an enterprise elects to go down this route in the first instance, it is often because either (i) it has some interest that it is looking to protect (management, jobs, company reputation) and it believes this can be served through the sale; or (ii) it believes that no other alternative is workable as it seeks to avoid bankruptcy because of an external reason such as expense or delay.

In order to create maximum liquidity through the sale of substantially all of the business, it is again important to run a thorough and competitive process. As in the previous situations, casting the net wide and creating competition will serve to keep values high. In addition, if the company is under stress and absolutely must transact because of a lack of liquidity, it is critical to get the "story" right the first time. Crafting a compelling marketing piece is fundamental in attracting bids. Sophisticated financial buyers may be able to visualize the prospect represented by the transaction, but sophisticated strategic buyers may reject the proposed deal if they only see the stress and not the long-term opportunity.

Timing is also vital. When liquidity pressures loom, a company often attempts to compress the process, but remember that there is an inverse relationship between speed and value. You need to allow sufficient time for the process to yield the maximum number of bidders — and therefore the highest possible offer — and in over-emphasizing speed, you may sacrifice value because some bidders will opt out if they feel they cannot work to the schedule required. Getting the timing right is critical to achieving the goal of generating sufficient liquidity to avoid bankruptcy.

As with a core asset sale, it also important to be judicious about disclosure. Eliminating strategic bidders from the process is not advisable since, as a rule, they will generally pay more. That said, if the successful bidder turns out to be a financial buyer, it will ultimately compete against those same

strategic parties. So you must be circumspect about the type and amount of information that is disclosed and at what points in the process.

Case Study 5

A family-owned, middle-market distributor of construction materials to local, regional and national homebuilders, FSI was a company whose business had been brought low by the collapse of the US housing market. In addition, its line of credit had matured and the lender would not extend new credit because the company was too heavily exposed to housing.

FSI did not want to file for bankruptcy primarily because it wanted to: (i) avoid a loss of control over the process; (ii) avoid the expense associated with a Chapter 11; and (iii) avoid reputational risk in an industry dependent upon supplier/customer relationships. It elected to sell a controlling stake in its business in an effort to maintain jobs and the company's reputation, and, if possible, allow the family to retain a minority stake. Notwithstanding that, FSI faced an enormous and immediate liquidity crisis. Its senior lender had accelerated its loan and could commence sweeping the lock box, effectively leaving FSI without enough cash to operate the business.

FSI, together with its investment banker, formulated a process for a sale of the business. It worked out a schedule that it believed would generate sufficient liquidity for the bank within a reasonable time. It ran a competitive process in which several financial buyers and a select few strategic parties were introduced to the opportunity. Five financial buyers submitted indications of interest. Several of those insisted on a Chapter 11 proceeding to "cleanse" the assets.

By maintaining the competitive dynamic throughout the entire process, FSI was able to achieve nearly all of its goals. The winning bidder was an investor who let the family retain 25 per cent of the business, the banks received more than two-thirds of their principal while reinstating the balance, the employees kept their jobs and the company and family reputation was untarnished. All trade creditors were paid in full. Now, properly capitalized, the company is poised for growth and has been able to take advantage of some interesting opportunities because the market remains distressed.

Conclusion

The sale of assets has long been a mechanism for a company under liquidity stress to avoid a bankruptcy filing. It can, if properly executed, be a

means to achieving a good result without the wholesale destruction of the company. There are, however, numerous critical analyses that must be undertaken and we stress that the involvement and advice of a qualified investment banker or financial advisor is critical to the success of any process. This, after all, has to be a bridge to liquidity — not a bridge to nowhere.