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Proactive private companies
Taking charge in today's economy

The economic downturn has challenged private companies' prospects for growth, as well as the way they manage their businesses and their balance sheets. Despite the obvious threats, though, this environment presents opportunities for healthy, proactive companies that can steady the ship and look ahead.

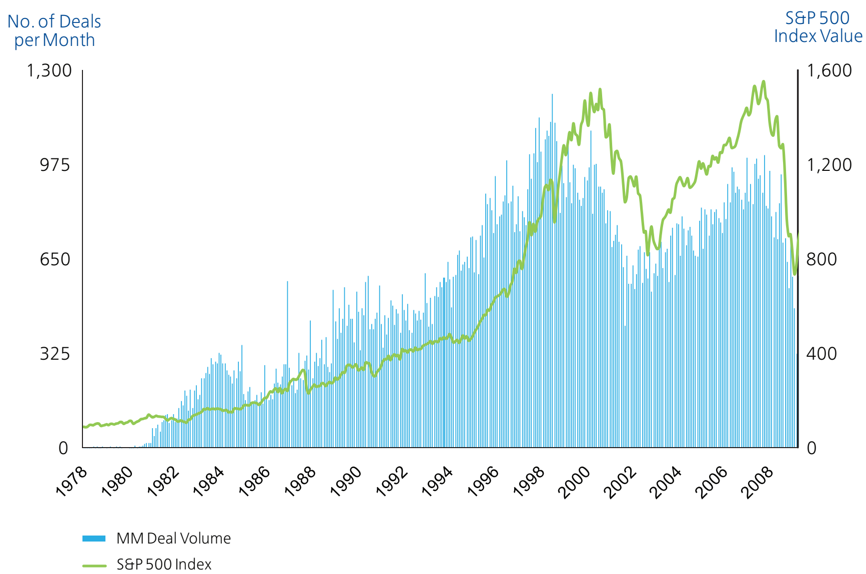
Deloitte hosted a Dbriefs webcast on March 31, 2009, to review the strategic alternatives available to private companies given today's economic concerns. Nearly 1,500 executives joined to review trends in middle-market merger and acquisition (M&A) activity and lending, to discuss strategies for dealing with underperforming and distressed situations, and to learn about strategic actions that private companies can take in this environment. Through responses to polling questions, participants shared their organizations' key concerns and reactions to market conditions.

The middle-market deal and lending environment

Business owners increasingly have viewed M&A transactions as a means to fuel growth and value, as evidenced by the tremendous run-up in volume of deals involving companies in the middle market (enterprise values less than $500 million) over the past 30 years. During that period, as illustrated in the exhibit, there have been only two notable dips: during the last recession near the beginning of this decade and again during 2008.

After a strong increase from 2001 to 2007, middle-market M&A volume began to drop sharply in 2008, according to Thomson Financial data. Middle-market deal volume for Q1 2009 was down 30 percent from Q1 2008 — the lowest quarterly level in more than nine years. While private equity buyers continue to look at many potential transactions, the lack of credit has made it more challenging to close deals. Middle-market deals that do proceed today often have a clear path for a sale to a strategic buyer. These trends have left sellers wondering whether this is, in fact, the right time to sell. Unless situations force the need to do so, many private company owners are sitting content on the sidelines — for now.

Monthly U.S. middle-market deal volume and S&P 500 index value



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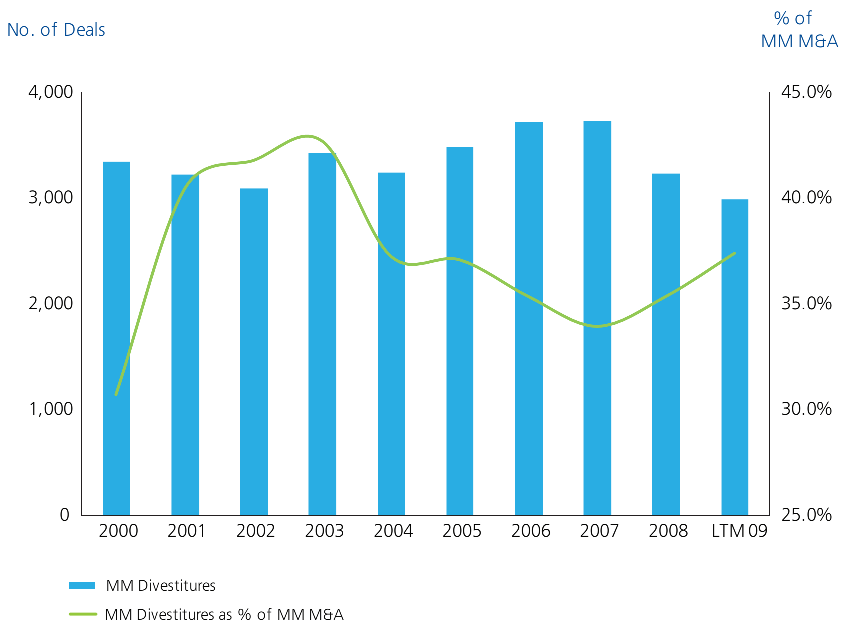
Cross-border transactions

Like business, transactions increasingly are being driven across borders. Inbound acquisition activity, in particular, increased through the third quarter of 2008 before dropping somewhat in the aftermath of the Lehman Brothers news. Nevertheless, foreign buyers — particularly Asian buyers — will continue to look for access to the United States and likewise, U.S.-based Fortune 500 businesses are likely to pursue foreign targets as they try to grow their global platforms.

Divestitures

Middle-market divestiture activity has remained relatively stable across the decade. Although divestiture data for the past 12 months ending May 2009 indicates an eight percent decline from 2008 actual levels, the divestiture market tends to lag the overall health of the economy. Many of the deals taking place now are by sellers experiencing some form of distress, from high leverage to declining revenues. Traditional divestiture activity, however, stands idle as owners continue to digest their own situations and consider strategic moves. When all is said and done, actual 2009 divestiture activity likely will meet or exceed 2008 numbers.

U.S. middle-market divestitures



Availability of financing

The drop in issuances of new loans began in the large-cap (enterprise value greater than $1 billion) market, but over the course of the past year it has firmly hit the middle market. In fact, middle-market loan issuances have decreased in each of the last six quarters, and credit has returned to being a relationship game. Where middle-market companies formerly could call six lenders and obtain a very competitive price — even negotiating with banks to bring the price down — today many middle-market focused banks are unlikely to open new credit lines. Moreover, pricing spreads have increased, making new loans much more expensive with more financial covenants. Together, these trends have required companies to become more proactive in managing their current financial positions.

Middle-market capital structures

Purchase price multiples increased through 2007 and, like other market factors, were off somewhat in 2008, but not by as much as many observers expected. While the availability of credit will continue to put some downward pressure on deal value, a more significant trend is bank requirements for greater equity as a percentage of the purchase price — with a sharp increase in equity requirements in 2008 to between 40 percent and 50 percent of the transaction value versus 25 to 30 percent in 2007. This trend has continued in 2009 and is expected to continue as the credit markets remain cautious.

With deal activity off, credit tight, multiples contracting, and equity requirements going up, middle-market buyers and sellers face some critical challenges. But, it is also important to look at all of this bad news in the context of the past 30 years. Confidence and credit drive a buoyant M&A market. History suggests that once we move beyond today's challenges and regain some stability in the markets, deal volume should begin to tick upward again.

Market turmoil and heightening anxiety

The next 24 months will be very difficult for most businesses, particularly those that are highly leveraged. Corporate profits are declining, and debt covenants are being challenged for the first time in recent years. Transactions are taking place, but they often require more alternative financing structures such as seller financing or even earn-outs. In addition, deal size and valuations generally are decreasing in response to depressed equity values and tight credit markets. Policy actions by U.S. and overseas governments will be a market catalyst, but these steps will increase regulatory burdens for businesses. In short, this dynamic landscape requires private company owners to conduct proactive scenario and contingency planning around the length and magnitude of this recession. For some, this will mean considering a possibility that was inconceivable not so long ago: default or bankruptcy.

Standard & Poor's and Moody's Investors Services data presents a disturbing picture with respect to debt defaults and bankruptcies. Although it is difficult to gain visibility of privately held debt, defaults overall increased about fourfold from 2007 to 2008. Year-to-date through May 2009, defaults already have outpaced 2008 levels for the same period by more than fivefold and are expected to peak in 2010. Because defaults typically precede bankruptcy levels, the data suggest a significant rise in bankruptcy activity into 2011.

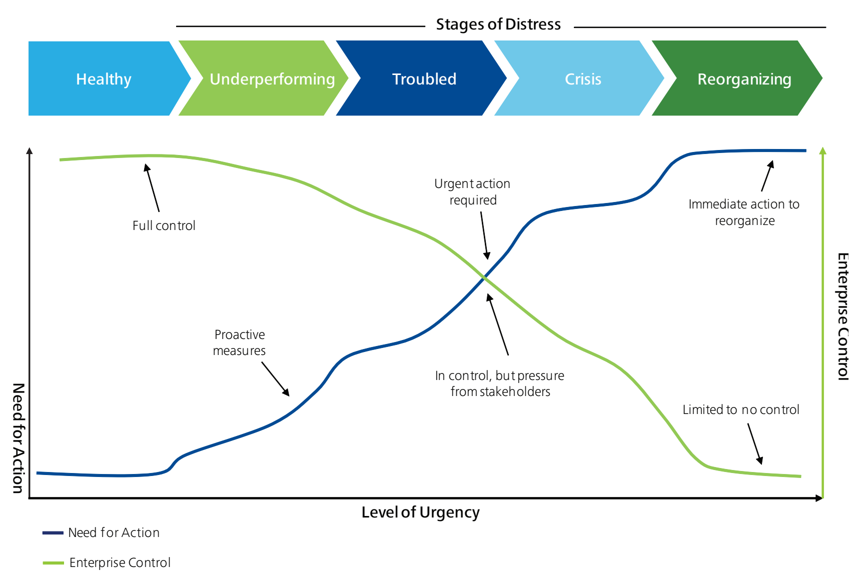
Companies that may be headed toward default or bankruptcy must arrange Debtor-in-Possession (DIP) financing. But, doing so in this environment has become very challenging and is prompting a greater level of distress for certain businesses. Not only is DIP financing more difficult to obtain, it often carries shorter terms than in the past; for example, six months versus the traditional 12 to 18 months. This is driving many of today's bankruptcies to find more immediate "solutions" than the 18-month period that companies are allowed to reorganize under the current bankruptcy code — that is, they are resorting to quicker sale processes, or Chapter 11-363 sales, rather than focusing on emergent scenarios.

Managing distress

There is no question that the current environment is causing distress for many private companies — whether it is in the form of customer demand, supplier viability, liquidity and cash flow concerns, talent retention, or worse. In this environment, owners and managers must make sure they are attuned to the signs of mounting distress and, more importantly, are prepared to respond.

A company's level of control and its need for action change inversely as its level of distress becomes more severe, as illustrated in the exhibit. There are clear signs and impacts as businesses progress through stages of distress. For example, inability to achieve budget or financial results, deteriorating margins, lagging sales, declining market share, working capital decreases, increased leverage, or insufficient cash flow from operations all can be signs that a company is moving from "underperforming" to "troubled." Companies in the later stages of distress will experience real signs of insolvency: technical insolvency, liquidity constraints, maximized leverage, constraints on supplier financing, limited to no access to capital, or true prepayment pressure.

As a company moves from one stage of distress to another, the actions required to maintain control over its future will change. Underperforming or troubled companies typically should focus on operational and financial initiatives that can help them improve performance. These might include tactical efforts to lean out operations, shift fixed costs to variable, simplify business models, generate and conserve cash, optimize working capital, or divest non-core operations through outsourcing or other methods. As troubled companies approach a crisis or reorganization mode, their strategic actions will shift — requiring negotiations with suppliers and creditors in an attempt to influence outcomes, development of bankruptcy contingency plans, or steps to secure DIP financing. Yet, as companies move closer to reorganization mode, their futures likely are going to be in the hands of their creditors.



Many private company executives understand the environment and key challenges, and they may recognize the warning signs of distress. The hard part, for many, is taking action to retain control and manage the challenges in front of them. Admitting distress is difficult, but denying it usually will drive an organization to deeper and deeper levels of difficulty.

Being proactive: The strategic alternatives

A realistic, objective assessment of the business is essential for executives in today's environment. Not only will this support management in forecasting adequately and adapting its business plan as the situation changes; it will help in revealing strategic actions that the company may take to manage its position and its future opportunities. Owners and managers should look at four areas in parallel.

Stabilizing and growing existing businesses

Today, banks expect companies to address — and exhaust — their internal operational issues before they ask for assistance, concessions, waivers, or amendments. This means that executives should look at all of the areas within their control:

- Shift fixed costs to variable through means such as outsourcing
- Increase variable pay components
- Prune existing operations
- Reduce material costs through sourcing
- Optimize working capital by extending payables, contracting receivables, decreasing the order cycle, and validating supply chain lifelines

Restructuring and refinancing

Internally, companies should take more aggressive steps to:

- Simplify their business model
- Shed unproductive R&D programs
- Optimize sales and marketing
- Tighten the alignment between operating plans and management incentives
- Generate or conserve cash by shutting down facilities, reducing headcount, and increasing the frequency of forecasting — perhaps even weekly

Private companies also should look at lender relationships and refinancing solutions — ideally, well in advance of debt maturity or any pending default. Existing lenders are the best source of capital in today's environment, but they do not like surprises. Constant communication is important.

Divesting non-core assets

During previous recessions, the best performing companies stuck to their strategies of pruning their businesses and disposing of non-core assets. Today's market, though, will produce little to no value for certain assets, forcing some companies to consider selling their "winners." Should this be necessary, owners will want to take steps to increase their chances of a controlled sale that produces benefits for all parties to the deal.

Pursuing acquisitions

Looking back, private equity groups saw some of their greatest returns on purchases coming out of the last recession. Similarly, current conditions may present healthy, proactive private companies with opportunities to position themselves favorably for the future. For organizations in the position to acquire, it is important to clarify the acquisition strategy and the types of targets that are attractive to the business, if available. Persistence and continued communication can be critical. Situations may change with respect to deals initiated but never consummated; targets that initially were not receptive to purchase now may be in a different position. Finally, it is important to recognize that a business acquired out of bankruptcy or a troubled situation is not necessarily a "tainted" asset. Many of today's troubled companies have sound businesses and strategies; they simply are too highly leveraged to avoid restructuring.

Take control of today's challenges

While these are very challenging times, well-prepared private companies with strategies in place for both today and tomorrow will find they have ample opportunities to drive future value. Owners and managers should be optimistic to the extent possible and not afraid to express that optimism and confidence to their constituencies. But, they also must be realistic with respect to market threats, cash flow, and liquidity — particularly over the next 12 to 24 months. Communication with lenders, vendors, customers, and employees is vital to maintaining continuing support for the business. So, too, is a proactive stance. Private companies that take control of their challenges, rather than letting the environment control them, will be the companies best positioned to weather the storm.

Webcast participants' views

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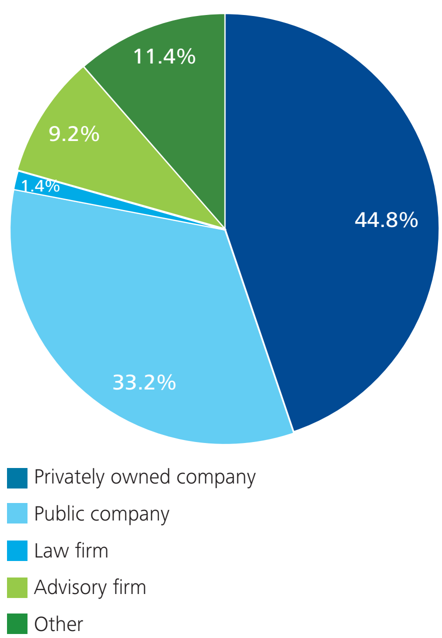
Nearly half of the 1,452 participants — 45 percent — represented privately owned companies, and another 11 percent represented law firms and other advisors to these organizations. Approximately a third of participants said they work for public companies, which face many of the same strategic challenges.

Tight credit markets are one of the key concerns for executives. Approximately 36 percent of webcast participants indicated that their organizations have maturing debt and/or external capital needs in the next six to 12 months. Given the current environment and expectations, these organizations must be proactive in working with current lenders to manage capital needs. With continued uncertainty in the market, even those with maturities beyond the next 12 months, 22 percent, still should be planning ahead.

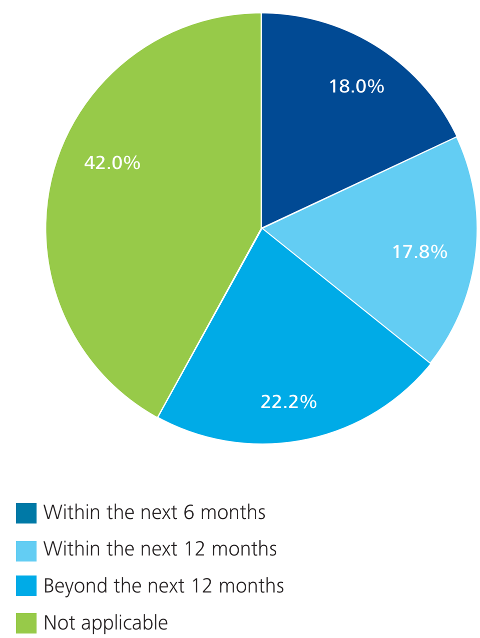
The economic crisis presents private company executives with a variety of competing challenges — both internal and external. Only eight percent of webcast participants said their organizations are still evaluating the environment and determining how to address their challenges; most are taking or have taken action. A majority of participants, 49 percent, indicated that their companies are focused internally on managing costs, liquidity, and capital. A far smaller

Which of the following best describes the company you work for?



Source: Deloitte's Private Company Dbriefs webcast, "Proactive private companies: Taking charge in today's economy" held on March 31, 2009. Polling results presented herein are solely the thoughts and opinions of survey participants and are not necessarily representative of the total population of private companies.

Do you have debt maturing and/or external capital needs in the near term?



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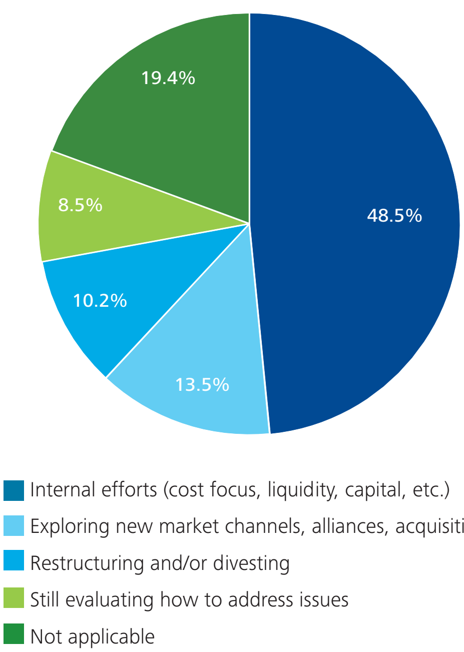
percentage, just 14 percent, said their organizations are looking externally at new market channels and alliances, or acquisitions. Indicative of the severity of this market, 10 percent said their organizations are facing restructuring and/or divestitures in response to the environment.

The current environment presents healthy, proactive private companies with opportunities to acquire organizations or assets that can enhance future growth and value. Only a quarter of participants, however, said their companies plan to take advantage of current conditions to pursue acquisitions within the next 12 months. Another nine percent said their organizations are seeking to increase operating scale. An equal number of participants — 33 percent —said their organizations are not pursuing acquisitions within the next 12 months due to concerns about the economic climate or their ability to obtain financing.

Deloitte, *CFO Magazine*, and Duke University recently surveyed business owners and chief financial officers about their greatest internal and external issues. While participants did not represent the middle market exclusively, most of their key concerns are applicable to private company executives. The key concerns respondents identified were:

- External
  - Consumer demand
  - Liquidity and access to credit needed to fuel the business
  - Impact of government regulation and/or programs
- Internal
  - Ability to attract and retain quality people; particularly, keeping people motivated and focused on the end game
  - Ability to predict the severity of conditions and to conduct scenario planning accordingly
  - Rising internal costs, particularly health care costs

Where are you focusing your efforts to address the impact of the current economic crisis on your business?



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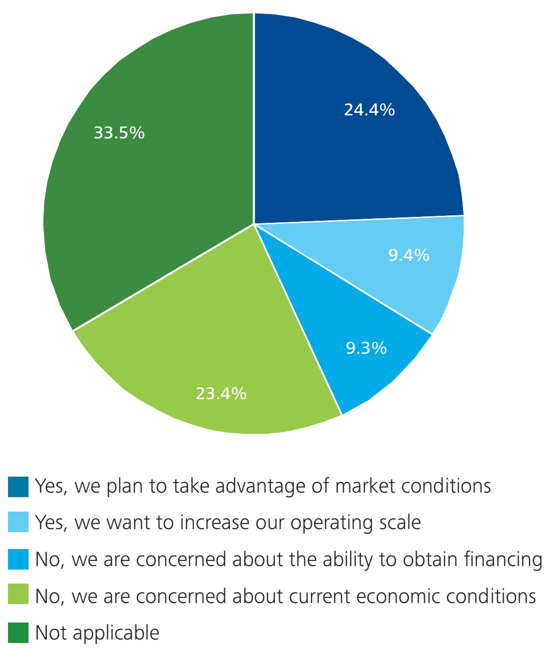
Are you likely to pursue any acquisitions in the next 12 months?



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