Mergers, Acquisitions & Divestitures

- Mergers & Acquisitions
- Divestitures
- Valuation

Concept: Is a division or firm worth more within the company, or outside it?
John Deere Breakup

Consider a breakup of John Deere into two companies, JD Equipment and JD Financial Services

1. What is John Deere worth in the market?
2. Based on multiples, estimate the company's breakup value
3. Based on recent growth of revenues, estimate the present value of earnings
4. Does a breakup make sense?
5. What techniques could be used for the breakup?
## John Deere

### Financial Highlights

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Most Recent Quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-Oct</td>
<td>31-Jan-04</td>
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### Valuation Measures

<table>
<thead>
<tr>
<th>Measure</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Market Cap (trailing)</td>
<td>$18.04B</td>
</tr>
<tr>
<td>Enterprise Value (14-Apr-04)</td>
<td>28.11B</td>
</tr>
<tr>
<td>Trailing PE (trailing)</td>
<td>22.93</td>
</tr>
<tr>
<td>Forward PE (trailing)</td>
<td>14.51</td>
</tr>
<tr>
<td>PEG Ratio (trailing)</td>
<td>1.68</td>
</tr>
<tr>
<td>Price/Sales (trailing)</td>
<td>1.11</td>
</tr>
<tr>
<td>Price/Book (trailing)</td>
<td>4.70</td>
</tr>
<tr>
<td>Enterprise Value/Revenue (trailing)</td>
<td>1.73</td>
</tr>
<tr>
<td>Enterprise Value/EBITDA (trailing)</td>
<td>10.04</td>
</tr>
</tbody>
</table>

### Trading Information

<table>
<thead>
<tr>
<th>Stock Price History</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta</td>
<td>0.93</td>
</tr>
<tr>
<td>52-Week High</td>
<td>75.19B</td>
</tr>
<tr>
<td>52-Week Low</td>
<td>33.96</td>
</tr>
<tr>
<td>50-Day Moving Average</td>
<td>55.89</td>
</tr>
<tr>
<td>200-Day Moving Average</td>
<td>59.31</td>
</tr>
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### Share Statistics

<table>
<thead>
<tr>
<th>Average Volume (10-month)</th>
<th>1,779,227</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Volume (10 days)</td>
<td>1,604,000</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td>246,340M</td>
</tr>
<tr>
<td>Float</td>
<td>246,340M</td>
</tr>
<tr>
<td>% Held by insiders</td>
<td>0.14%</td>
</tr>
<tr>
<td>% Held by institutions</td>
<td>92.00%</td>
</tr>
<tr>
<td>Shares Short (as of 8-Mar-04)</td>
<td>1,600M</td>
</tr>
<tr>
<td>Daily Volume (as of 8-Mar-04)</td>
<td>N/A</td>
</tr>
<tr>
<td>Short Ratio (as of 8-Mar-04)</td>
<td>0.695</td>
</tr>
<tr>
<td>Short % of Float (as of 8-Mar-04)</td>
<td>0.76%</td>
</tr>
<tr>
<td>Shares Short (prior month)</td>
<td>2,186M</td>
</tr>
</tbody>
</table>

### Dividends & Splits

| Annual Dividend | 1.12 |
| Dividend Yield  | 1.54%|
| Dividend Date   | 3-Mar-04 |
John Deere Breakup

Consider a breakup of John Deere into two companies, JD Equipment and JD Financial Services
1. What is John Deere worth in the market?
2. Based on multiples, estimate the company's breakup value
3. Based on recent growth of revenues, estimate the present value of earnings
4. Does a breakup make sense?
4. What techniques could be used for the breakup?

Given:
US Treasury 10-year: 4%
Market risk premium: 6%

<table>
<thead>
<tr>
<th></th>
<th>JD as is</th>
<th>JD Equipment</th>
<th>JD Financial Services</th>
<th>JD Financial Services</th>
<th>Break-up total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales, 2003</td>
<td>15824</td>
<td>13572</td>
<td>2252</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales, 2001</td>
<td>13382</td>
<td>11303</td>
<td>2079</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>973</td>
<td>643</td>
<td></td>
<td></td>
<td>330</td>
</tr>
<tr>
<td>Debt</td>
<td>23109</td>
<td>10313</td>
<td>12796</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BV of equity</td>
<td>6241</td>
<td>4002</td>
<td>2239</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beta</td>
<td>0.53</td>
<td>0.8</td>
<td>0.8</td>
<td>0.94</td>
<td>0.94</td>
</tr>
<tr>
<td>Mkt value</td>
<td>18,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>P/Earnings</td>
<td>18.5</td>
<td>30.8</td>
<td>30.8</td>
<td>17.7</td>
<td>17.7</td>
</tr>
<tr>
<td>P/Sales</td>
<td>1.1</td>
<td>0.6</td>
<td>0.6</td>
<td>5.3</td>
<td>5.3</td>
</tr>
<tr>
<td>Growth rate</td>
<td>5.7%</td>
<td>6.3%</td>
<td>2.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of Equity</td>
<td>7.2%</td>
<td>8.8%</td>
<td>8.8%</td>
<td>9.6%</td>
<td>9.6%</td>
</tr>
<tr>
<td>P/E value</td>
<td>19,804</td>
<td></td>
<td></td>
<td>5,841</td>
<td>25,645</td>
</tr>
<tr>
<td>P/S value</td>
<td>8,143</td>
<td></td>
<td></td>
<td>11,936</td>
<td>20,079</td>
</tr>
<tr>
<td>PV earnings</td>
<td>27,204</td>
<td></td>
<td></td>
<td>4,884</td>
<td>32,088</td>
</tr>
</tbody>
</table>
**Breaking Up**

- **Why**—The business may be worth more outside the company than within
- **How**—Sell to another company, or to the public, or give it to existing shareholders
- **Tax Aspects**—As a rule if you get paid in cash you realize a taxable gain; not otherwise
- **Effect on Shareholders**—The bigger the part sold off, the greater the percentage gain
Case Study: Pinault-Printemps-Redoute

- Why?
- How?
- Tax Aspects?
- Effect on Shareholders?

Breaking news: CNN reporter embedded with key Iraqi leaders says their WMDs are defective
Why Break Up?

- Pro-active
- Defensive
- Involuntary

Examples of each?
Why Break Up?

- Pro-active (GM tracking/selling DirectTV)
- Defensive (ABB selling ABB Cap Lease)
- Involuntary (ATT breakup, Enron)

Examples of each?
Why Break Up?

- Post-acquisition disposals
- Shift of core business or strategy
- Underperforming business or mistake
- Lack of fit, refocus on core business
- Avoid competing with customers
- Antitrust compliance
- Need for funds
- Market or litigation risk
The spin-off and related techniques have the advantage that they can be structured so as to be tax free (USA).

Tax Code Section 355 requirements:

- Both the parent company and the spun-off entity must be in business for at least 5 years.
- The subsidiary must be at least 80% owned by the parent.

Example: Marriott spin-off of Marriott International.
Breaking Up

- Tax-Free
  - Spin-Off
  - Split-Up
  - Tracking Stock
- Taxable
  - Divestiture
  - Equity Carve-Out
  - Split-Off IPO
  - Bust-Up
Tax-Free Breakups

- **Spin-offs**—pro-rata distribution by a company of all its shares in a subsidiary to all its own shareholders
- **Split-offs**—some parent-company shareholders receive the subsidiary's shares in return for their shares in the parent
- **Split-ups**—all of the parent company's subsidiaries are spun off and the parent company ceases to exist
- **Tracking Stock**—special stock issued as dividend: pays a dividend based on the performance of a wholly-owned division
Tracking Stock

- Tracking stock, sometimes known as letter stock or alphabet stock, is a class of stock designed to reflect the value and track the performance of a part of the issuer's assets, usually a separate business or group of businesses. Claimed advantages:
  - preservation of the efficiencies of a single corporation
  - ability of the market to more accurately value the respective businesses of the issuer

- What does it really add?
Taxable Breakups

- **Divestitures**—the sale of a division of the company to a third party
- **Equity carve-outs**—some of a subsidiary’s shares are offered for sale to the general public
  - **Split-off IPOs**—a private company offers a part of the company to the public
- **Bust-ups**—voluntary liquidation of all of the company’s business
Shareholders of the selling firm seem to gain, depending on the fraction sold:

<table>
<thead>
<tr>
<th>% of firm sold</th>
<th>Announcement effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10%</td>
<td>0</td>
</tr>
<tr>
<td>10-50%</td>
<td>+2.5%</td>
</tr>
<tr>
<td>50%+</td>
<td>+8%</td>
</tr>
</tbody>
</table>
Divestitures Can Add Value

- Value of combined company
- Value of seller without sub + value of sub
  (Seller may gain from more managerial focus, lower WACC, less conglomerate discount)
- Value of sub – standalone value
- Value of sub – acquisition value to another company
## Break-up Computation

### Corporate Break-Up Calculation

<table>
<thead>
<tr>
<th></th>
<th>Combined</th>
<th>Seller alone</th>
<th>Spin-Off</th>
<th>Merger</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PPR with Finaref</td>
<td>PPR without Finaref</td>
<td>Finaref Standalone</td>
<td>Finaref with CA</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>€ 800</td>
<td>€ 500</td>
<td>€ 300</td>
<td>€ 330</td>
</tr>
<tr>
<td><strong>Tax rate</strong></td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Beta</strong></td>
<td>1.4</td>
<td>1</td>
<td>1.6</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Growth rate</strong></td>
<td>3.50%</td>
<td>2.50%</td>
<td>4%</td>
<td>4.50%</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>€ 8,000</td>
<td>€ 6,500</td>
<td>€ 3,000</td>
<td>€ 3,500</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>€ 7,000</td>
<td>€ 5,000</td>
<td>€ 2,000</td>
<td>€ 2,000</td>
</tr>
<tr>
<td><strong>Risk Free</strong></td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Mkt Risk Premium</strong></td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td><strong>Debt spread</strong></td>
<td>3%</td>
<td>2%</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td><strong>Re</strong></td>
<td>12.80%</td>
<td>10.00%</td>
<td>14.20%</td>
<td>14.20%</td>
</tr>
<tr>
<td><strong>Rd</strong></td>
<td>6.00%</td>
<td>5.00%</td>
<td>7.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td><strong>WACC</strong></td>
<td>8.51%</td>
<td>6.96%</td>
<td>10.20%</td>
<td>10.13%</td>
</tr>
<tr>
<td><strong>Enterprise PV</strong></td>
<td>€ 16,538</td>
<td>€ 11,500</td>
<td>€ 5,032</td>
<td>€ 6,128</td>
</tr>
<tr>
<td><strong>Equity PV</strong></td>
<td>€ 9,538</td>
<td>€ 6,500</td>
<td>€ 3,032</td>
<td>€ 4,128</td>
</tr>
<tr>
<td><strong>Additional Gains/losses</strong></td>
<td>€ 1,150</td>
<td>€ 0</td>
<td>–€ 1,400</td>
<td></td>
</tr>
<tr>
<td><strong>Choice</strong></td>
<td>€ 9,538</td>
<td>€ 10,682</td>
<td>€ 9,750</td>
<td></td>
</tr>
</tbody>
</table>

Source: breakup.xls
**Marriott**

**The Choice**
- the decision of whether to split Marriott Corp. into two companies--Marriott International and Host Marriott

**The Situation**
- decline in real estate values
- has a significant percentage of assets in hotels it had planned to sell
- difficult for Marriott to pursue growth strategies
- market price of the company had declined significantly
Marriott: Assignment

- Will this type of reorganization meaningfully improve the company?
- What are the different ways of effecting break-ups? In the Marriott case, are there reasonable alternative approaches?
- Draw up a spreadsheet comparing the before-and-after capital structure of Marriott and its proposed component parts.
- How are bondholders affected? How can they protect their interests?
- Make a recommendation, and justify it.
Marriott: Project Chariot

Marriott Corp.

Marriott Intl.
- Intangibles
- Franchises
- Management Services
- Distribution Services
- Timeshares

Host Marriott Corp.
- Hotels
- Airport and Road Plazas
- Land
Marriott: Breaking Up

Breaking up

Tax-Free
- Spin-Off
- Split-Up
- Tracking Stock
- Divestiture

Taxable
- Equity Carve-Out
- Split-Off IPO
- Bust-Up
## Marriott: Financial Restructuring

<table>
<thead>
<tr>
<th></th>
<th>Marriott Corp.</th>
<th>Marriott Intl</th>
<th>Host Marriott</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>2732</td>
<td>378</td>
<td>2362</td>
</tr>
<tr>
<td>LYONs</td>
<td>228</td>
<td>205.2</td>
<td>22.8</td>
</tr>
<tr>
<td>Convertible preferred</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Shareholders' equity</td>
<td>585</td>
<td>524</td>
<td>61</td>
</tr>
<tr>
<td>Total long-term capital</td>
<td>3745</td>
<td>1107.2</td>
<td>2645.8</td>
</tr>
<tr>
<td>Long-term debt/Total</td>
<td>73%</td>
<td>34%</td>
<td>89%</td>
</tr>
</tbody>
</table>
# Marriott: Financial Restructuring

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</tr>
<tr>
<td>Total long-term capital</td>
<td>3749</td>
<td>1110.8</td>
<td>2646.2</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
<th>Percentage</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt/Total</td>
<td>73%</td>
<td>34%</td>
<td>89%</td>
</tr>
<tr>
<td>Long-term debt+/Total</td>
<td>84%</td>
<td>53%</td>
<td>98%</td>
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</table>

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Service Capacity</td>
<td>1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating profit</td>
<td>113</td>
<td></td>
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</tr>
<tr>
<td>+ depreciation</td>
<td>175</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>288</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>+Maturing debt</td>
<td>250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Refinancing</td>
<td>-250</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt Service</td>
<td>200</td>
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<tr>
<td>EBITDA/Debt Service</td>
<td>1.44</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: marriott.xls HMTMAR*
Bankruptcy and Reorganization

Prof. Ian Giddy
New York University
Understatement

"We built a good company ... with a bad balance sheet."

- **Barclay Knapp**, CEO of telecommunications firm NTL shortly before filing for bankruptcy. The company's debts totaled nearly $23.4 billion.
Corporate Financial Restructuring

Why Restructure?

- **Proactive**
  - *Example:* Sealed Air
  - Management acts to preserve or enhance shareholder value

- **Defensive**
  - *Example:* Loewen 1996
  - Management acts to protect company, stakeholders and management from change in control

- **Distress**
  - *Example:* Loewen 1999
  - Lenders and shareholders lose, but try to work out best way to minimize loss

"Management acts to preserve or enhance shareholder value"
Match the Solution to the Problem

Trouble!

The financing is bad
Reason
Raise equity, or Do debt/equity swap Or change debt mix
Remedy

Business mix is bad

Sell some businesses or assets to pay down debt

The company is bad

Change control or management through M&A
The New MCI

MCI's bankruptcy
By Matthew Barakat
Associated Press

McLEAN, Va. -- When WorldCom emerges from bankruptcy today, it hopes to make a fresh start, shedding $35 billion in debt, officially dropping the name tainted by an $11 billion accounting scandal and adopting its familiar MCI brand as its new moniker.

While the company's reduced debt load may provide it with a competitive advantage, MCI will still face significant challenges, experts say.

The bankruptcy process has allowed the company to slash its debt from $41 billion to about $6 billion when it emerges. That will shave $2.1 billion a year off interest payments for a company producing about $21 billion a year in revenue.

But MCI will be emerging into a telecommunications industry that is no less competitive than when WorldCom entered bankruptcy in July 2002. The company's biggest challenge will be to navigate the hypercompetitive pricing pressures in the industry, said Muayyad Al-Chalabi, managing director of telecommunications consulting and research firm RHK.

"The question is, can they reduce their costs enough to match the expected revenue decline?" Al-Chalabi said.

The problem is particularly acute for the company because its strength -- providing service to small and medium-size businesses -- is one of the most competitive segments in the industry.

WorldCom has already warned that it expects revenue to drop 10 percent to 12 percent in 2004, to about $21 billion. It has taken steps to reduce costs, especially through job cuts. Last month the company announced plans to lay off 4,000 workers at several call centers across the country, reducing its workforce to about 50,000 employees.

WorldCom employed 62,000 employees in 2002, before its accounting fraud was revealed and the company filed for the biggest bankruptcy in U.S. history.

Another challenge, Al-Chalabi said, is continuing to integrate the various companies WorldCom acquired during its buying spree in the 1990s. If the disparate companies have not effectively consolidated and coordinated operations, they will drag on the company's bottom line, Al-Chalabi said.

Also, like many companies emerging from bankruptcy, the bondholders who bought up WorldCom's debt at fire sale prices will wield significant influence.

The bondholders' primary interest is often to ensure that they are repaid for their investment as soon as possible, which might not be conducive to fostering a long-term vision at the company.

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The bondholders' primary interest is often to ensure that they are repaid for their investment as soon as possible, which might not be conducive to fostering a long-term vision at the company."

"I don't think there such a thing as a stigma from bankruptcy," Reisman said. "We still buy airline tickets from airlines in bankruptcy. I don't think their image with the consumer is blemished."

A WorldCom spokesman declined to comment on the issue Monday.

Overall, Reisman said he believes the company is well-positioned to compete as it emerges.

"They're going to be able to clear $35 billion in debt from their books when other companies that compete with them have not been able to do so," Reisman said. "They will be in a very strong, formidable position."

Reisman also discounted the notion that customers and clients will shy from the company because of its past.

Indeed, the company said it lost none of its top 100 customers during the bankruptcy process. And in January the U.S. government, which collectively is the company's biggest customer, lifted a six-month ban that had prohibited WorldCom from bidding for new government contracts.

The company still provides service to about 65 percent of the nation's Fortune 1000 companies.

"I don't think there such a thing as a stigma from bankruptcy," Reisman said. "We still buy airline tickets from airlines in bankruptcy. I don't think their image with the consumer is blemished."
Financially Distressed Firms

- Lose customers
- Get less favorable terms from suppliers
- Are forced to discount products
- Reduce new investment to below the optimal level

*Example: Hynix (Korea)*

Deaths-R-Us

- What is the debt worth? The equity?
- How much debt can the company afford to have?
- What kind of financial restructuring would you propose to the company's banks?
- Would you buy this company? For how much?
Deaths-R-Us Negotiating

Shareholders

- Restore value

Banks

- Create value

Develop proposal: Liquidation, sale or debt restructuring?
Deaths-R-Us Possibilities

- Debt/Equity swap
  50% debt-into-equity swap may be insufficient; leaves company little margin for error. May repeat

- Debt/Preferred exchange offer
  Lenders may demand controlling share; seniority of preferred may bring little value

- Debt extension
  Lenders would give immediate relief, but would demand changes that increase payback possibility

- Debt composition
  Lenders acknowledge they will not get back par; accept (say) 60% of face. But where is cash to pay 60%?

- New equity issue with debt buyback
  Difficult to raise new equity except at a very low price -- possibly only option value

- Merger
  Although nominally less value for creditors, may be best they can get. Assumes merged value > going concern value

- Liquidation - voluntary
  Based on liquidation value > going concern value. Assumes firm is willing to negotiate liquidation

- Liquidation - bankruptcy
  Based on liquidation value > going concern value. Assumes firm is not willing to negotiate liquidation
When Default Threatens

- Out-of-court negotiated settlement
- Merger into another firm (which assumes or pays off debt)
- Formal legal proceedings (Ch 11 or Ch 7)
When Default Threatens, Value the Company

Highest Valuation of Company?

- Merged Value
- Going Concern Value
- Liquidation Value

Merged Value:
- Sale to Strategic Buyer
- Auction

Going Concern Value:
- Voluntary Reorganization
- Ch 11 Reorganization

Liquidation Value:
- Voluntary Liquidation
- Ch 7

Existing Management
New Management
Reorganization Processes

- **Out-of-court negotiated settlement**
  - Firm continues
    - Exchange: equity for debt
    - Extension: pay later
    - Composition: creditors agree to take less
  - Firm ceases to exist: assignee liquidates assets and distributes proceeds on a pro-rata basis

- **Merger into another firm (which assumes or pays off debt)**
  - Continues as subsidiary
  - Absorbed into other operations

- **Formal legal proceedings**
  - Firm continues: Ch 11, court supervises composition or modification of claims
  - Firm ceases to exist
    - Statutory assignment: assignee liquidates assets under formal legal procedures
    - Ch 7 liquidation: bankruptcy court supervises liquidation
Trouble in Paradise
Warnaco

 Warnaco sets bankruptcy plan
 Apparel firm expects to emerge from bankruptcy in early 2003; seeks new CEO, board members.
 October 1, 2002: 10:54 AM EDT

NEW YORK (Reuters) - Warnaco Group Inc., a maker of intimate apparel under the Warner's and Olga labels, said Tuesday it plans to emerge from bankruptcy protection in early 2003.

The company said a search committee has been formed and the executive search firm of Heidrick & Struggles has been engaged to identify internal and external candidates to succeed Tony Alvarez as president and CEO.

New York-based Warnaco said it filed a reorganization plan with the U.S. Bankruptcy Court for the Southern District of New York, and the plan has the full support of the company's pre-petition secured lenders and official committee of unsecured creditors. Warnaco filed for bankruptcy protection June 11, 2001.
Warnaco

Chapter 11 reorganization

June 11, 2001

Oct 1, 2002

2003?
Alternative

Chapter 7
liquidation

Making us all wish we were blind.
Warnaco?

Chapter 11 reorganization

Ch 7
Warnaco?

Chapter 11 reorganization
NEW YORK (AP) -- The Warnaco Group Inc., the maker of Calvin Klein underwear and Olga bras, emerged from Chapter 11 bankruptcy Tuesday, as scheduled.

The New York-based company said that in connection with its emergence from Chapter 11, it closed on a $275 million exit financing facility.

The company’s debt now totals approximately $247 million, including the initial $39 million draw; $201 million in second lien notes issued primarily to the company’s pre-petition lenders; and approximately $7 million of capital leases.

Debt was reduced to about $247 million through Feb. 4, from $2.2 billion on Jan. 4.
Chapter 11 (Reorganization)

1. Filing with bankruptcy court
2. Appointment of Debtor in Possession (or Court Trustee)
3. Operating under Chapter 11
4. Financing under Chapter 11
5. Develop reorganization plan and claimant classification
6. Acceptance of reorganization plan by creditors & owners (or cramdown)
7. Put plan into effect and pay expenses
Warnaco: Role of Vultures?

Chapter 11 reorganization

June 11, 2001

Oct 1, 2002

2003?

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Vulture Investors

- These funds typically buy large blocks of debt (often across different seniority classes) in distressed firms in order to gain a seat at the bargaining table.
- As the term “vulture” implies, these investors have been viewed as “bondmailers” who seek only to delay and disrupt reorganizations in order to extract concessions from debtors.
- But by consolidating large blocks of debt, vulture investors facilitate restructurings by reducing the number of claimholders and aligning incentives across seniority classes.
- 3 largest players: Trust Company of the West, Fidelity Management and Research, and Apollo Investors.

Example: Trust Company of the West played a crucial role in facilitating the prepackaged bankruptcy of Kinder-Care Learning Centers by buying up most of that firm’s bank debt and subordinated debentures.
DIP Financing

- Who would throw money into a dying company?
- What protections must new lenders be offered? What incentives?
In March 2003, the Spiegel Group - which owns the famous Spiegel catalog, Eddie Bauer and Newport News, another direct-mail clothing business - filed for bankruptcy. The reason given was that the company had given credit to too many people, and some did not pay their credit card bills.

Despite the gloom, Spiegel announced that it had found $400 million of new financing. The Bank of America, which has already lent Spiegel $85 million (the fourth-biggest creditor, behind Commerzbank, Dresdner Kleinwort Wasserstein and DZ Bank), had agreed, with several other institutions, to extend another $400 million in "debtor in possession" financing; the spending of that money will be closely supervised by the bankruptcy judge.
Death Spiral Financing

Death spiral financing is a last resort method of raising money, used by desperate companies. Most of these stocks never recover.

Here’s how it works. Death spiral convertibles are privately held preferred stock or bonds that can be converted to common stock. An investor offers a struggling company cash in exchange for a percentage of the company, but in the event the stock loses value, the investor receives more shares, and a larger percentage of ownership in the company.

It’s bad news for the existing investors, because it means that their shares are diluted as the stock value falls. There is a large risk for the new investor (also known as a “vulture capitalist”), since if the value of the company falls to zero, his investment is lost.

Here’s an example: ABC Company accepts a $10 million investment in exchange for 25 per cent of the company. If the value of ABC’s shares rise, the investor keeps 25 per cent of the business and earns a return on his money. But if the stock falls to half its value, that means the value of the company is also halved. In order to keep to the terms of this kind of financing, new shares are handed over to the investor, and the percentage of his ownership rises. If the stock ever recovers, he'll still own a significant percentage of ABC Company.

Another risk for the company is that the investor may short sell the company's stock and try to push its price down. The lower the stock price drops, the more shares the investor will receive upon conversion.

This process is called a spiral because when the stock falls, the company is forced to issue more shares. That causes the existing shares to lose value, which can trigger further selling and more dilution.
Chapter 7 (Liquidation)

Priority in Liquidation

- Secured creditors (pledged assets’ value)
- Bankruptcy expenses & DIP financing
- Post-bankruptcy payables
- Wages
- Benefits
- Customer downpayments
- Taxes
- Underfunded pensions
- Unsecured creditors pro-rata
- Preferred
- Common
At Death’s Door: Loewen

Evaluate the choices facing the Loewen Group.

- What was the source of Loewen's problems? Were they financial or operational?
- What kind of financial restructuring would you propose to the company's banks?
- Will this offer a solution? What else might be necessary?
- What other restructuring can you suggest?
Loewen

- Nov 2, 1995: $500m damages
  - Mississippi
- Sep 17, 1996: SCI hostile offer
- Aug 6, 1998: Earnings down 56%
- Oct 8, 1998: Ray Loewen fired

![Bar chart showing assets and debt from 1989 to 1998](chart.png)
1996-1999

- Too much debt
- Too little death
1999: Debt Covenants Violated

- Banks waive defaults, or
- Banks renegotiate covenants, or
- File for bankruptcy
Trouble!

Reason

The financing is bad

Remedy

Raise equity, or Do debt/equity swap Or change debt mix

Business mix is bad

Sell some businesses or assets to pay down debt

The company is bad

Change control or management through M&A
On June 1, 1999 Loewen filed voluntary petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code and under the Canadian Companies' Creditors Arrangement Act.
Get a Job
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