TRAVERS SMITH

Financial Turmoil Management

Equity Houses

October 2008

Risks

Investee Company Covenant Breaches

- Important to anticipate any issues with financial covenants as far in advance as possible.
- Facilities agreement should be reviewed to see whether it allows an equity cure and on what terms.
- If accounts prepared on an IFRS basis additional complication for end of year financial covenant test.
- Distressed lenders may lose customary reluctance to enforce on the basis of "technical" events of default so compliance with all undertakings is important.
- Market practice regarding "standstill" agreements, equity cures etc. is evolving but methods of dealing with breaches are being developed.
- Consider financial techniques available, for example, asset based lending and enhanced treasury operations.
- Keep creditors and other counterparties onside.

Investor Director Liabilities

- Investor directors need to manage conflicts of interest.
- Taking professional advice will reduce the risk of personal liability and/or disqualification for wrongful trading.
- Consideration of new companies legislation under Companies Act 2006 (effective 1 October 2008) is vital.

Investee Company at risk of Insolvency

- Equity Houses should identify potential crunch points and develop a plan to stay in control.
- Consider developing an insolvency contingency "Plan B".

No Debt for New Deals

- Banks are still willing to lend to "defensive" sectors at the "right" leverage.
- Clubs of banks necessary for medium to large deals.
- Alternative finance sources are becoming available.
- We are collating debt availability and terms and reviewing on a regular basis.

Investee Company's Working Capital Bank/JV Partner/Supplier is in trouble

- The insolvency of a counterparty could cause funding problems, as we have seen recently in relation to investee companies who have working capital finance from Icelandic banks.
- Any collapse of a joint venture or partner may be problematic. The ability to terminate a contract by reason of insolvency may not help where the investee company is dependent on continuity of supply or operation.

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Opportunities

Distressed M&A Deals (Outside Insolvency)

- Acquisitions may well be asset purchases rather than share purchases, because few, if any, warranties of any substance will be available. Due diligence and pricing are keys to success.
- The Seller may need bank waivers or standstills, and possibly new money, to enable the sales process to be completed.
- Control might be obtained in the first instance by buying the bank debt.

Distressed M&A Deals (Insolvent Vendor)

- A buyer will need to move quickly as the vendor may run out of time or money. A sale by an administrator or receiver may be unavoidable.
- "Pre-packaging" of the acquisition through an insolvency process may be needed to avoid challenge to the acquisition on the grounds of undervalue or preference.
- Due diligence should be aimed at identifying issues and negotiating the price and retentions accordingly.

P2P's, PIPES, Public Company Stakes

Public to Private (P2P)

- Attractive to Private Equity when public share price of a company is depressed and/or where an investor's expertise can be used to maximise an underperforming asset.
- Taking a company outside the restrictions of the Listing Rules/AIM Rules and IPC Guidelines can increase opportunities for growth and development.

PIPE (Private Investment in Public Equity)/Private Equity Stake

- Opportunity for listed companies to raise funds when equity market confidence is low and debt market unavailable.
- Attractive for Private Equity when public share price is depressed.
- Impact of Listing Rules/IPC Guidelines restrictions may be softened by current market conditions bringing institutional investors on-side and for distressed companies.
- Alternative investment structures available to avoid some regulatory restrictions (but regulation of publicly listed securities will impact on management of PIPE investment).
- Practical issues for investors such as limited due diligence may be less of a barrier in distressed company situations where the company is obliged to make more information publicly available.

Funding the Whole Deal

- Private Equity Fund documentation needs reviewing but will usually allow a fund to finance whole deal or provide junior debt. Careful consideration needs to be given to proportion of a fund being invested.
- In order to get the best chance of corporation tax deduction for interest on such debt careful structuring will be needed. HMRC's approach to such deals is currently unclear but we are monitoring their response.

Debt Purchases

- Can be an investment opportunity or way of de-leveraging an investee company.
- Facilities agreement needs to be reviewed for constraints on purchase of debt by investee company or Equity House.
- Banks may object to individual members of the syndicate being prepaid and/or to Equity House gaining voting rights on the debt and/or to investee company cash being used for debt buyback.
- Tax and accounting issues need careful consideration.
- Opportunities to buy debt at a substantial discount (e.g. from Icelandic banks) are emerging.

Vulture Funds

- Most existing Private Equity Funds can operate in the distressed arena without LP consent but there may be fund restrictions.
- Property Vulture Funds have become popular and there is LP appetite to invest in distressed situations. We believe, therefore, that new Corporate Vulture Funds will become a feature of the Private Equity scene.

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