



# INSIGHT

## Guidelines for the Stalking Horse in a Bankruptcy Sale

*A successful stalking horse has significant advantages in a bankruptcy sale process.*

by William S. Hanneman

**B**ankruptcy once predominantly served as a safe haven for under-performing businesses to reorganize their affairs and financial obligations in a process that favored them regaining their financial footing. The generally creditor-friendly revisions to the bankruptcy code in 2005, coupled with the dearth of debtor-in-possession (“DIP”) financing in today’s troubled credit markets, have resulted in the sale of businesses (and assets) as the preferred exit strategy from Chapter 11.

The bursting of the real estate and finance bubbles unleashed “creative destruction,” in which all manner of inefficient or distressed corporate assets will be revalued and reshuffled to achieve greater economic efficiency. This restructuring process likely will accelerate over the next several years as the economy is reconfigured. Astute owners and managers familiar with the rudiments of Chapter 11 should be able to take advantage of significant opportunities to enhance their competitive position, further corporate strategy, and ultimately build value.

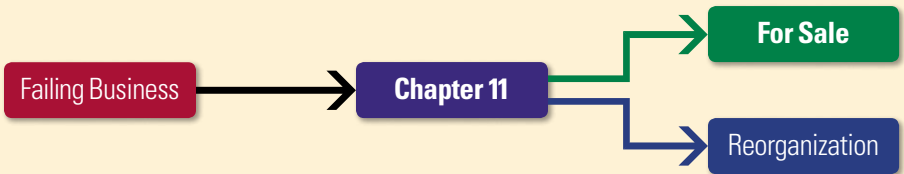
### BUYING ASSETS THROUGH CHAPTER 11

Section §363 of Chapter 11 of the bankruptcy code sets out procedures for the sale of tangible and intangible assets. A sale of assets pursuant to §363 can provide purchasers with a variety of benefits, as well as a number of challenges, particularly for the unfamiliar.

#### The Benefits

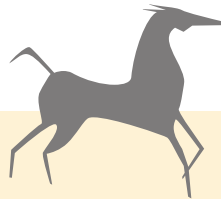
Assets acquired in a §363 sale are delivered free and clear of all liens, and are not subject to fraudulent transfer claims and/or contingent liabilities (e.g., successor liability and warranty claims). Moreover, upon court confirmation of a sale, the purchaser can be certain about the enforceability of the transaction documents, relief from the need to obtain consent to the assignment of certain contracts, a shortened Hart-Scott-Rodino Antitrust Act waiting period, and exemptions from state laws regarding bulk sales and stockholder approval.

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### The Challenges

Rules designed to assure that a public auction process provides the highest and best value for the assets are typically at the root of buyer apprehension. Contrary to a privately negotiated deal, in a §363 sale it is not possible to arrange exclusivity or lock-up provisions prior to the bankruptcy court’s final approval of the sale. The rules also tend to inject time limits into the sale process. And, of course, final court approval can depend on resolution of creditor objections. Success remains uncertain until the gavel falls.



### Stalking Horse Advantages

1. The opportunity to conduct thorough due diligence
2. More access to management, which can have a meaningful impact on the outcome
3. The ability to craft the terms of the purchase agreement in a manner that may discourage other bidders
4. Influence over the bidding procedures

### THE STALKING HORSE

The initial bidder with whom the debtor negotiates a purchase agreement is called the “stalking horse,” an old hunting euphemism referring to either a real horse or an animal-like screen, behind which a hunter would conceal himself to get closer to his prey. Don’t be misled by this term, because almost nothing will be concealed in a bankruptcy proceeding.

While a potential buyer’s initial reaction might be to wait to bid at the auction, when the prices and terms will be known with certainty, there are distinct advantages to being the stalking horse bidder that can greatly improve the likelihood of emerging as the successful buyer. The advantages are listed in the adjacent table.

#### Expense Reimbursement

Fees and expenses that the stalking horse incurs for legal and financial advisers, due diligence, and other reasonable expenses related to the deal, are generally reimbursed if the stalking horse is outbid, so long as they do not amount to an unreasonable drain on the debtor’s estate. To qualify for reimbursement, the stalking horse should insist that its expenses are included as administrative expenses, the highest-priority creditor claim in bankruptcy.

#### Break-Up Fees

Break-up fees are a common protection offered to stalking horse bidders, but are controversial in many jurisdictions. Essentially, a

break-up fee is incremental compensation to induce the initial bidder to establish a “floor” for other potential bidders in an auction. However, approval requires the court to find that the break-up fee is “necessary to preserve the value of the estate,” which, outside of unique circumstances, can be a tall order.

#### **Bidding Procedures**

In order to be qualified to participate in the auction, other interested buyers will be required to deliver proof of financial capability and to submit a good faith deposit, conditions that the stalking horse already would have satisfied.

The auction procedures will specify an amount for any initial overbids and subsequent minimum bidding increments. Obviously, the stalking horse bidder will want the initial overbid to be substantially greater than its own offer, thereby creating a threshold that other bidders will be reluctant to overcome. The stalking horse bidder also will want to establish

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steep bidding increments to discourage competing bids and will want “matching rights” to minimize its costs to stay in the auction.

The stalking horse also has the opportunity to impose its form of asset purchase agreement, preferably in a manner that will not be easily adaptable by other bidders. For exam-

ple, the stalking horse will select which assets it wishes to acquire and/or which obligations it wants to assume, limit any subsequent bids for those same assets and obligations, and limit the form of alternative consideration (to the extent it is not all cash).

#### **CONCLUSION**

As we enter into a phase of rapid economic adjustment and restructuring, there will be significant opportunities for firms to meaningfully enhance their competitive positions by prudently acquiring distressed assets and businesses. Although the processes and procedures of a §363 bankruptcy sale can be a bit rigid and messy, competent legal and financial advisers can be invaluable guides during the process. As a result, strategic-minded business owners and investors should not turn away from attractive, albeit distressed, business assets, simply because they bear the taint of bankruptcy. ♦

## **An Industry Consolidated**

*Value and Synergy Through Realignment.*

by Mark D. Working

**V**alue is created by profitably satisfying customer needs with quality products and services. It is helpful to keep this principle in mind, as you digest the non-stop chatter in the business media regarding securities-market volatility, scarce credit, and the moribund state of private equity investment. During the six-month period beginning in the last quarter of 2008, Columbia Distributing and The Odom Corporation meaningfully consolidated the distribution of alcoholic beverages in the Pacific Northwest, with the goal of improving industry efficiency.

Until recently, Gold River Distributing, Mt. Hood Distributing, Columbia Distributing, Alaska Distributors, and The Odom Corporation each delivered beverages to overlapping territories and customers in Oregon, Washington, and Alaska. At the end of the consolidation, the five individual businesses had become two: Columbia Distributing (“CoHo”) and The Odom Corporation (“Odom”).

#### **THE IMPETUS**

The reason why this consolidation did not occur earlier can be attributed to the disparate personalities, rivalries, and strategies of the brands each firm managed. Miller distributors don’t handle Budweiser. Coke distributors won’t touch Pepsi. Similar alignments occur in the world of wines and spirits, making a more complicated labyrinth of supplier-distributor relationships than the casual observer could imagine.

Alcoholic beverage distribution is dominated by the major beer brands (Anheuser-Busch, Miller, and Coors) simply because of

the volume of these brands, relative to others. Distribution networks across the country have developed to service these individual brands, often times adding craft beers, wine, and spirits (in open states) to the distribution product mix.

Over the recent past, beverage brands have been undergoing a process of consolidation to obtain synergies in production, marketing, and administration. Early in 2008, Miller Brew-

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ing Company and Coors Brewing Company merged their operations, including the management of their distribution networks. Their conclusion was that market consolidation of Coors and Miller distributors would reduce costs throughout the system. Encouragement by Miller-Coors management opened up the possibility of strategic distribution system networks in specific markets across the country, including the Pacific Northwest.

#### **THE VALUE PROPOSITION**

In spite of dismal economic news, these mergers were not driven by business distress. Five successful firms were reconfigured to form two dominant players. The economic rationale for consolidation was more efficient utilization of distribution infrastructure. When the business owners and their advisors put their pencils down, the analysis confirmed that delivery fleet, warehouse, customer management, and accounting/IT infrastructure could best be leveraged at scale within a given geographic area. The conclusion was that two networks would represent the most efficient allocation of resources in this region.

In addition to the benefit of being a more important distributor to customers as a result of greater volume, the economic benefits were quite meaningful. As illustrated in the article, “Should Your Business Raise More Capital?” (*IN\$IGHT*, Spring 2009), the elimination of duplicate costs and improved utilization of joint assets resulted in a value in excess of that of the individual stand-alone firms. The term may be shopworn, but that is “synergy,” which is illustrated by the chart on the following page. The synergy value created was shared among the parties, with those shareholders that decided to sell receiving a premium value, while still leaving a meaningful benefit for those having the task of execution.

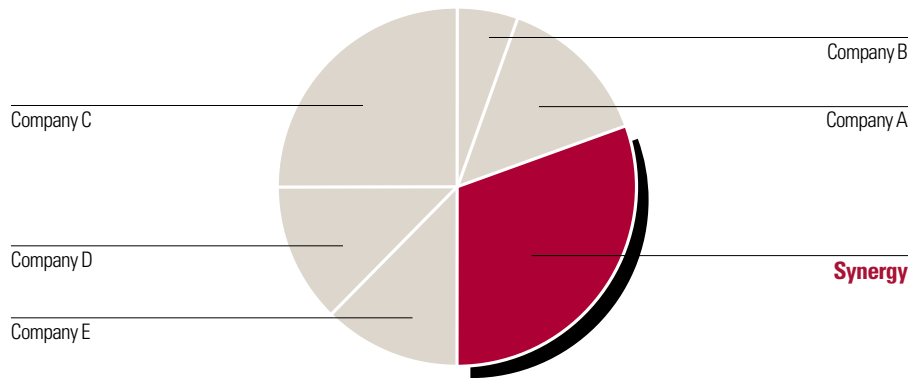
#### **THE DEVIL IS IN THE DETAILS**

This brief description of a seemingly straightforward business combination does little justice to the difficulty of the transactions or the complexity of the change to be accom-

plished by the respective CoHo and Odom teams. Prior to the transaction, each of the five individual companies possessed unique portfolios of compatible beer and wine brands, and spirits (in Alaska). As a result of the transactions, the supplier mix was not fully aligned, which required migration of certain suppliers to establish a new equilibrium. Columbia Distributing long ago had established a joint venture with a major national wine distributor, Young's Markets, to help with the alignment and retention of brands. As part of its consolidation, The Odom Corporation also formed a wine and spirits distribution joint venture with another national powerhouse, Southern Wine & Spirits.

Both Coho and Odom have challenges ahead to realize their respective value potentials. Greg Christiansen, CEO of Coho, says, "We merged four entities into one, each having its own distinct culture. Now, there needs to be one consistent culture. Achieving that will be important to realize the potential value of the merger." At Odom, the theme is similar, but with its own twist. John Odom, CEO, noted, "This transaction doubled the size of our business. At the same time, we added a partner in Southern Wine & Spirits. By working together and using best practices, we expect to realize substantial efficiencies from our expanded scale."

Allocation of Value



ATTRACTING CAPITAL IN A STALLED MARKET

The capital markets were in the worst straits of the last 20 years as these transactions were coming together. To suggest that this element of the deal was a snap would fly in the face of reality. Nevertheless, banks and investors were attracted to these situations because they exhibited compelling economics, predictable cash flows, and strong management.

LESSONS FOR OTHERS

Business owners should continually contemplate how their businesses can be more

successful in the future. Especially in light of reduced demand for products and services in many industries, a drive toward greater efficiency will move to the fore because of the compelling economics. And, that might mean aligning and consolidating operations with other entities that bring something to the value equation. Despite the tightened credit markets, combinations that improve business performance will attract capital. Concentrate on value creation; capital will follow. ♦

# Mezzanine Debt—An Alternative in Tight Credit Markets

Where can creditworthy businesses turn for capital?

by Michael T. Newsome

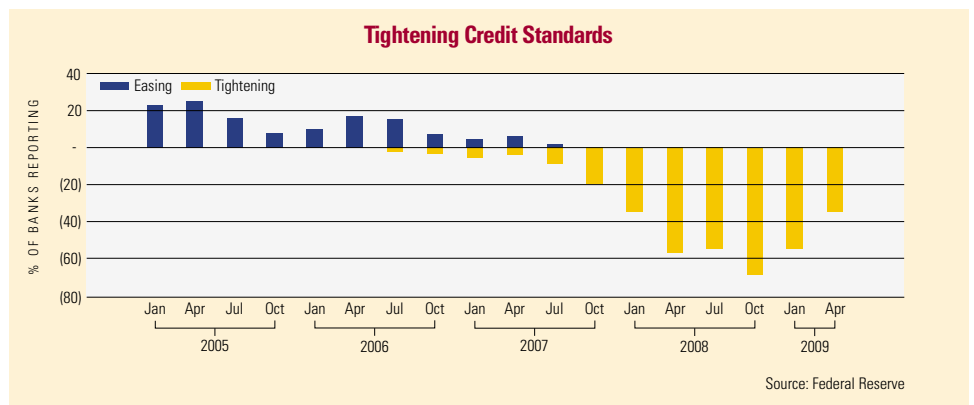
Many of us have seen clear evidence that banks have curtailed business lending. Bankers argue otherwise, that credit remains available, albeit more expensive, for those that are "qualified." Most CFOs or corporate treasurers are feeling the impact of tight money and would testify that credit is much more difficult to obtain today than in recent years. The banks, themselves, substantiate this view. The Fed's latest quarterly survey of lending practices shows that bank chief credit officers uniformly reported either tightening or unchanged underwriting standards.

So, in the absence of accommodative senior lenders, where can a creditworthy business turn for capital?

THE MEZZANINE ALTERNATIVE

Traditionally, mezzanine has been a junior-priority, cash-flow-predicated, bullet loan, geared toward privately held companies with specific event-driven financing requirements. The combination of a term commitment, minimal amortization, and compensation structure provides an incentive for investor patience and flexibility in support of the company's business objectives.

Mezzanine is a source of intermediate



"bridge" financing for a company in transition. It is used to fortify the balance sheet against the prospect of prolonged economic softness, fund business acquisitions that strengthen competitive position and create value, or fund the purchase of interests of minority shareholders. The transactions described in the companion article, "An Industry Consolidated," are prime examples of situations where mezzanine can be effectively employed.

Mezzanine capital is typically employed by middle-market companies (revenue of \$20MM

to \$500MM) to fill financing shortfalls due to bank-imposed constraints concerning collateral advance rates or cash flow coverage ratios (the ratio of debt to cash flow). These two variables, which are key determinants of senior-debt capacity, tend to move up and down, depending on the appetite of bankers for new business, and are certainly at a low-ebb these days.

The most suitable mezzanine candidates are mature businesses with stable or growing margins, defensible market positions, well-defined

**Mezzanine Debt** *continued from p.3*

strategies, and experienced management. Mezzanine is particularly suited to service industry or asset-light situations, where credit capacity is constrained by the lack of collateral support. However, it is not a high-risk capital source that will step up to fund a turnaround when senior lenders balk.

**TYPICAL STRUCTURE**

Mezzanine investments are typically structured as 5- to 7-year term notes. Providers tend to fall into one of two camps. The first views the capital as an extension of debt, relying on covenants, yield, and second-lien positions. The second sees the capital as more akin to minority equity, where greater emphasis is placed on the value to be created by the business plan. The structural flexibility of mezzanine provides the opportunity to tailor the capital to fit specific circumstances. Of course, as the structure moves from debt toward equity, risk/return requirements increase for the lender/investor, which are earned through some combination of the components in the adjacent table.

Required returns vary based on the degree of financial leverage, the size of the company and its market position, the stability of its cash flow, and competition among lenders to provide capital.

**WHY MEZZANINE?**

Owners of privately held businesses are attracted to mezzanine for several reasons:

- Flexibility and patience—bullet loan with little or no amortization, coupled with less-restrictive covenants focused on maintaining cash flow and limiting financial leverage.
- Control—less invasive than private equity, lenders require far less shareholder dilution and often observe board meetings, but have no voting rights.
- Cost—tax deductibility of interest expense makes mezzanine much less costly than equity.

For owners of closely held businesses, the idea of parting with some amount of ownership can be a major deterrent to raising junior capital. Nevertheless, mezzanine investors are not long-term shareholders bent on control. Warrants are simply a method to tie the lender's return to the incremental value that their capital helped to create. In the final analysis, with target annual yields of 16% to 22%, this is expensive money. To make sense, it must be matched with investment opportunities that offer even higher returns.

**CURRENT MARKET**

Up until mid-2007, mezzanine lenders (primarily banks, insurance companies, and dedicated limited partnerships funded by institutional investors) have been the odd-men-out of buyout finance. Aggressive senior and second-lien credit structures, where total leverage (senior and junior debt) frequently topped five (if not six) times EBITDA,

COMPENSATION	DESCRIPTION	MARKET RANGE
Cash Interest	Fixed or floating rate interest, payable quarterly or semiannually	12% to 14% p.a.
Deferred Interest	Accrued, but deferred, interest known as payment-in-kind (PIK) notes	3% to 6% p.a.
Equity	No-cost warrants or conversion rights with sufficient prospective value under an "expected case" business plan to achieve a target all-in return over the life of the investment	Varies to achieve target return
All-In Rate of Return	Total target return on a per annum basis	15% to 22% p.a.
Call Protection	Sliding prepayment fee designed to keep the capital in place for at least several years	5% falling to 0% by the end of the 3rd or 4th year

squeezed mezzanine out of many opportunities.

The market has since come full circle, as senior lenders are hiding in the weeds and leverage (in all of its forms) is way out of vogue. Mezzanine capital remains available and competitive. In 2008, 16 funds reportedly raised \$20.2 billion of mezzanine capital. This is a

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126% increase over the \$8.9 billion raised in the prior year. As senior credit has dried up, mezzanine is an increasingly attractive way to fill the gap for firms with the appropriate credit profile and return prospects.

In spite of the availability of capital and the urge to put it to work, today's lenders are

highly selective. Issuance activity has been weaker than expected. In part, this is due to lender reticence to take on any new situation where performance has not clearly stabilized. For prospective mezzanine borrowers, the chief implication is the necessity for presenting a well-articulated business strategy and plan that demonstrate relative stability in the face of continuing economic softness.

**THE OPPORTUNITY**

It is interesting to note that in the past 90 days, activity has jumped in the investment-grade and high-yield bonds markets, as a growing wave of issuers has arranged more than \$60 billion in new long-term funding. A number of issuers, including Microsoft and Berkshire Hathaway, have raised capital, even though they already have substantial cash or credit lines on hand. So, what do public company CFOs see that private-company managers do not? The message is one we have been preaching for some time, that in a tight credit market, access to capital can be a powerful competitive advantage. Mezzanine capital is one of few sources currently available to private companies to build the liquidity necessary to take advantage of opportunities that are likely to emerge during this down cycle. ♦

**ABOUT ZACHARY SCOTT**

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to [ZacharyScott.com](http://ZacharyScott.com).

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