



cutting through complexity™

ADVISORY

Global Enterprise Institute

Middle market restructuring:
Early action can preserve
business value

kpmg.com





Contents

How we got here	2
Caught in the middle	2
Business changes are creating different challenges	4
What should middle market company leaders be doing?	5
Restructure before you “need to”	6
Time is of the essence; seek informed advice	7
KPMG can help	9
About KPMG Restructuring	9

Cash, the lifeblood of business, has been scarce for middle market companies since the recession began in 2007. Despite the recently improving economic outlook, lower asset values and poor forecasting continue to create challenges for management. Executives leading middle market companies need to take strategic, operational, and financial action if they are to pay down debt, obtain new credit, and drive new growth. There are several actions middle market companies should think about now, but cash management is key.

How we got here

How the economy got here is a matter of many missteps. For all, the next steps must focus on recovering from historical losses while moving forward and growing business—more easily said than done. The business climate is largely stalled despite bailouts and stimulus funding. In the credit markets, the economic recession has lowered the value of assets. Banks holding loans, which first perceived their interests in terms of enforcing rights and restructuring or through holding/ extending credits in hopes of an economic uplift, may have discouraged recovery more than helped. Consumers, anxious in a persistently poor job market, lack the confidence to spend.

Looming is a maturing debt figure some sources put at \$2.5 trillion between 2011 and 2014. According to *The New York Times*, 2012 will be the beginning of a “three-year period in which more than \$700 billion in risky, high-yield corporate debt begins to come due, “a surge that “some analysts fear could overload the debt markets”¹. Large sums also are coming due for global government debt, further complicating credit markets. Ireland, for instance, is in a period of financial turmoil due to aggressive lending and is currently being bailed out by other Eurozone countries. It is unclear how many other “shocks to the system” Eurozone countries can manage through internally.

\$2.5
trillion

Maturing debt figure between
2011 and 2014

Caught in the middle

Large businesses found access to cash during 2010, despite fluctuating debt markets. Many larger banks started to write down loans but not sell them, which allowed many large-cap companies to still tap and interact with the capital markets. Many middle market businesses were not as lucky. According to a Small Business Administration report released in February 2011, “lending to large businesses—measured by commercial loans of more than \$1 million—dropped by \$156.2 billion, or 8.9 percent, between 2009 and 2010”². While there are some recent signs of improvement, availability of debt remains low for middle market companies.

Middle market borrowers—buffeted by economic turbulence, a languishing credit environment, fierce competition for funding, strengthened credit risk policies by lenders, and depressed global and U.S. markets—continue to be squeezed. The realities are that life is different and requirements have changed. Companies are facing liquidity challenges. Credit is tight. Terms are less favorable. Some cash flow lenders are requiring companies to have EBITDA minimums as high as USD\$10 million to USD\$15 million and maintain unused availability under lines of credit, carving out significant pools of otherwise available cash or good collateral from borrowing base calculations.

The recession may have taught middle market companies to “work smarter and run leaner,” but to get back on track more is needed. Further, many of these companies were already extremely lean prior to the recession, making it hard to make further cuts. To achieve sustained growth once the economy turns, middle market business executives will have to concentrate on a core of financial and operational principles that drive superior performance at a strategic level and can be integrated into everyday business decision-making.

¹ “Corporate Debt Coming Due May Squeeze Credit,” *The New York Times*, March 15, 2010.

² “Banks slashed small business lending by \$43 billion,” CNNMoney.com, February 11, 2011.





Business changes are creating different challenges

Managing for survival in a recession is different from managing for growth in robust and thriving markets. Many business leaders have not previously seen an economic cycle such as the one we're in. Some may lack the depth of experience and skill sets needed to manage through it. All must adapt quickly to many new complexities. For instance:

- Bankruptcies, debt levels, and default rates have been at record levels but are improving. Companies with substantial amounts of debt could be at risk of bankruptcy and may want a strategy to fend off lenders with unclear or perhaps adversarial interests driven by factors outside of the borrower's control.
- The Dodd-Frank Act will affect all U.S. financial institutions, many non-U.S. financial institutions, and many nonfinancial companies, altering practices in banking, securities, derivatives, executive compensation, consumer protection, and corporate governance. Compliance with Dodd-Frank will require liaison with new and reconfigured regulatory entities, operational redesign, and attention to new rules as they are finalized. This creates a much more conservative lending base for middle market companies.
- FASB mark-to-market rules have changed, and bank valuations of loans and assets have been in flux. The FDIC chairman has spoken against mark-to-market valuations for long-term assets. These valuations affect the decisions of bank credit departments and may impact decisions around extension or content modification.
- FDIC-insured, small real estate loans from local banks have to be repaid. If the borrower can't pay and the bank can't take any more write-downs, the FDIC takes control of the bank and its assets. This often results in more assets on the market, lowering values and exacerbating a downward cycle.
- Many middle market companies forced to pursue bankruptcy may have to deal with jurisdictional issues that are a byproduct of the increasing globalization of lenders, suppliers and customers. Local laws, customs, and practices can affect the outcome of an insolvency case. Some jurisdictions will emphasize the interests of creditors; others will emphasize rescue and recovery.
- Meanwhile, the global supply chain is growing more complex due to market softness, reduction in available vendors, and fluctuations in currency. Global OEMs are applying increasing pressure on all participants in the supply chain and pushing down R&D and quality control responsibility.

Cash flow forecasting

- Identify the key cash flow drivers of the business.
- Get into the detail; increase the level of granularity.
- Analyze actual-to-forecast variances to identify trends and learn from previous mistakes.
- Standardize format and templates across portfolio entities/companies.
- Make people responsible for delivering individual line items in the cash flow (for example, the accounts receivable manager could be responsible for delivering the receipts line).
- Structure incentives to reward employees for incorporating cash flow forecasting.

What should middle market company leaders be doing?

First, be proactive. Your company has many options, and there is tremendous value to preserving them—but you must act early to do so. There is a correlation between how timely a company is in getting help and its results.

Key decisions require a realistic view of the company's short- and long-term cash needs. Assess your company's financial condition and liquidity position, its prospects, and value. Project downside scenarios in order to understand, in advance, the key trigger points or sensitivities for your business. Develop more robust and accurate forecasting capabilities, building this up internally within the functional areas that drive cash performance within the business. Use these insights to develop robust contingency plans.

Develop a cash management plan. Global economic conditions have affected companies across all industries. Companies are responding to the demands of banks and other stakeholders by focusing on working capital to release any available cash back to the business. Cash generation improvement programs typically focus on operating working capital, treasury, and capital expenditure, but improvements from indirect tax and duty, property, and pensions also may be able to unlock needed cash flow. Linking internal rewards, i.e., promotion and compensation, to cash management results is an important way to embed this discipline within business and make a cash

management plan/program more sustainable. Freeing cash on the balance sheets can provide evidence of good management to internal and external stakeholders, though there is of course a balance (think of Apple). Despite the increase in programs to improve performance, many companies appear to be leaving cash on the table.

Consider all corporate finance options. That may consist of improving liquidity through a recapitalization or refinancing of existing debt. The capital markets have improved significantly since the 2008–2010 recessionary period, and there is a renewed appetite by nonbank lenders and private equity investors to place funds. With the six-month LIBOR at about 45 bps, the cost of capital also has decreased significantly due to oversupply and the demand by investors for higher interest yields. The private equity sector also has recovered, and there is an appetite for the acquisition of select noncore corporate divestitures.

Restructuring leading practices

- Understand your company's liquidity position. Proactively manage working capital. Implement short-term, 13-week cash flow reporting on a receipts and disbursement basis.
- Create robust forecasts and understand the impact on liquidity from "stress case" sensitivities and scenarios, including fully developed contingency plans.
- Take a critical eye to cost containment and understand your company's fixed and variable cost structures.
- Know your bank. Open communication channels with your lenders and help them understand the key drivers of your business. Give your lender the information and time required to come to an informed decision without the pressure of racing to put out a fire.



Restructure before you "need to"

A company sliding toward distress can take key steps to manage a potential crunch and minimize business risk:

- 1 Take control of the situation. Don't wait for the grim reaper to come knocking. Confront your issues head-on and develop plans to get your business back on track, either through operational improvements or through financial restructuring.
- 2 Proactively manage liquidity. Banks are less eager to fill funding gaps, so take a critical eye to cost containment and understand your company's fixed and variable cost structures. Implement short-term, 13-week cash flow reporting on a receipts-and-disbursement basis to provide visibility to all stakeholders. Identifying the appropriate source of capital for a distressed situation is critical.
- 3 Evaluate strategic alternatives. Is it the whole or just a part of your business that is the problem? Keep all your options open, regardless of how unpalatable some of them may seem and run with concurrent strategies. Ask yourself these questions:
 - Do I know what the problem is?
 - Can the problem be fixed and in what time frame?

- Can I sell or monetize the problem?
- Do I need to close down some or all aspects of our operations, either through a controlled wind down or through the protection of the bankruptcy code?

These decisions may feel difficult to make, but it is essential to separate emotions from hard, cold facts. The focus should be on what is best for the company overall, not just one aspect of it.

Improve communications with stakeholders. Increase your focus on transparency to balance competing interests among relevant stakeholders. Open communication channels with your lenders and help them understand the key drivers of your business. Problem situations with lenders often stem from poor or nonexistent communication, or a series of broken promises. In addition, as a loan moves into a workout situation, the characters and motivations change significantly. It's better to underpromise and overdeliver than the other way around. External help also can provide credibility and help repair broken lines of communication. Remember, some of your key stakeholders are your employees. Don't leave them in the dark.



Time is of the essence; seek informed advice

It is essential to understand the relationship between capital providers, cost of capital, and the company's degree of financial distress. Many middle market companies do not have the same level of access to capital markets as large-cap businesses, but there are numerous capital solutions available today for the right restructuring opportunities. Many investors have capital to deploy and are seeking attractive returns in a low-interest environment.

A fundamental strategy for ensuring the highest probability of a successful financial restructuring is the preservation of all options early in the process. This can be accomplished by pursuing multiple transaction options simultaneously (as compared to sequentially). These options would include negotiating a temporary forbearance with the current lender while pursuing a new equity infusion, refinancing or sale of the existing debt, or sale of noncore assets to raise capital to deleverage the company's balance sheet. If there is a strong business case for an increase in the company's future enterprise value, the existing lender could be open to a debt-for-equity conversion as part of a broader recapitalization.

Banks are less eager to fill funding gaps, so take a critical eye to cost containment and understand your company's fixed and variable cost structures. Implement short-term, 13-week cash flow reporting on a receipts-and-disbursement basis to provide visibility to all stakeholders.



The KPMG Global Enterprise Institute

The KPMG Global Enterprise Institute provides an open forum where business leaders can share knowledge, gain insights, and access thought leadership about key industry issues and emerging trends. Designed as both a virtual and a physical resource, the Institute offers industry professionals access to:

- Insights and education
- Tactical business knowledge focused on functional business issues
- A collaborative approach to research and problem solving
- A global community of middle market leaders.

For additional information or to register as a member of the Institute, please visit kpmgglobalenterpriseinstitute.com.

KPMG can help

KPMG LLP's Restructuring practice offers a broad network of experienced help and essential resources to companies experiencing financial stress. Working alongside lenders, stakeholders, and all levels of management, our professionals can assist in identifying, developing, and delivering restructuring actions that can provide real improvements to cash flow, profit and loss, and the balance sheet.

Coordinated network of services

KPMG's integrated network of service professionals delivers support to clients experiencing the wide range of challenges that may arise during a restructuring or turnaround. This unique network provides KPMG teams the flexibility to respond quickly and thoroughly to clients' changing needs. When needed, we leverage knowledgeable professionals from a complementary suite of services that includes our Transaction Services, KPMG Corporate Finance LLC, Real Estate Service LLP, Tax, Valuation, Forensic™, and Fresh Start Accounting practices. This specialization and integration combined with our turnaround specialists makes us well equipped to deliver efficient, quality service to clients. The process is smooth, because we provide a single point of service delivery, freeing our clients to focus on "running the business."

Deep industry knowledge

At the disposal of KPMG Restructuring teams is a vast global network of industry specialists that covers the breadth of markets in which our clients are involved. Our industry experience comprises Audit, Tax, and Advisory professionals who have the industry and specialist skill sets that enable a rapid response. Clients and targets see this as a key differentiator, because our teams avoid an "industry learning curve" and instead move quickly, bringing knowledge of that specific competitive environment, key trends, and relevant metrics. The ability to focus quickly on key industry-level issues enables our teams to get to the heart of a problem and implement change. We have experience in:

- Business Services
- Consumer Markets
- Energy and Natural Resources
- Financial Services
- Healthcare and Pharmaceuticals
- Industrial Markets
- Insurance
- Media and Marketing Services
- Real Estate Services
- Technology and Communications.

Global strength of service

Regardless of how far a company's borders extend, we provide extensive global reach and capabilities delivered with localized knowledge and resources. With more than 1,500 dedicated Restructuring professionals worldwide, KPMG International's global network of member firms operates in 146 countries and has more than 140,000 professionals working in member firms worldwide. Moreover, our member firms operate in developed markets as well as key emerging economies such as China and Hong Kong, Central and Eastern Europe, Russia, Latin America, and India. We understand the changing circumstances of our firm's clients and their markets as well as the challenges involved in dealing with complex, cross-border restructurings and insolvencies.

We help provide consistent, coordinated, and high-quality services based on:

- More than 30,000 Advisory professionals worldwide with advanced accounting, business advisory, and IT skills
- Extensive industry resources of one of the world's leading business advisory networks.

About KPMG Restructuring

KPMG Restructuring serves domestic and international clients globally to help provide stability, restore confidence, and improve performance and recovery in stressed and distressed situations. Our teams of dedicated restructuring partners and professionals from the KPMG International network of member firms have deep experience in performance improvement, turnarounds, insolvency, mergers and acquisitions, transaction structuring, tax, valuation, real estate, forensic investigations, and technical accounting services. KPMG's restructuring teams work globally with companies, lenders, and other stakeholders to assist clients in developing and evaluating business turnaround scenarios, improving cash and liquidity, assessing capital structuring alternatives, and enhancing recovery options out of court and in bankruptcy.

KPMGs global reach

1,500

**RESTRUCTURING PROFESSIONALS
WORLDWIDE**

For more information, contact:

KPMG Restructuring

Drew Koecher

U.S. Leader, Restructuring Services
212-954-3825
dkoecher@kpmg.com

Gregg Pritchard

212-954-6288
jgpritchard@kpmg.com

Tom Bibby

214-840-2479
tbibby@kpmg.com

Ben Gonzalez

212-872-7789
bengonzalez@kpmg.com

Tony Murphy

212-872-3835
anthonymurphy@kpmg.com

Kimberly Rodriguez

313-230-3176
kdrodriguez@kpmg.com

KPMG Corporate Finance LLC

Phil Isom

U.S. Leader, Corporate Finance
312-665-1911
pisom@kpmg.com

Rick Chance

949-885-5680
rchance@kpmg.com

Lou Frost

212-954-7480
lfrost@kpmg.com

kpmg.com

KPMG LLP, the audit, tax, and advisory firm (www.us.kpmg.com), is the U.S. member firm of KPMG International Cooperative ("KPMG International"). KPMG International's member firms have 140,000 professionals, including more than 7,900 partners, in 146 countries.

© 2011 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

KPMG Corporate Finance LLC, a Delaware limited liability company, is a member of FINRA and SIPC and is registered as a broker dealer with the SEC. KPMG Corporate Finance LLC is a subsidiary of KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. KPMG and the KPMG logo are registered trademarks of KPMG International. 23950NSS