The overall economic conditions in the first half of 2011 have been in a word, abysmal. Growth in the second quarter was worse than expected and recent revisions to the first quarter growth rate show that the economy came very close to contracting. Second quarter output increased by 1.3% and the first quarter was adjusted downward to just 0.4% from the previously reported 1.9%. Consumer spending advanced an anemic 0.1% in the second quarter which was the weakest quarter since the recession ended two years ago. Although consumer confidence increased slightly from June to July and is up from the recession lows, it has not materially changed since the latter half of 2009. The growth forecast for the U.S. economy is a bit more optimistic but by no means rosy. The popular view is that the U.S. economy will grow around 2% for the remainder of 2011 and through 2012, but there are a number of risks that could negatively impact an already fragile economy as these forecasts are likely to be revised downwards.

Recent events including the debt ceiling debate in Washington, S&P’s first ever credit rating downgrade of the U.S. and the plunge in the stock market have done nothing but exacerbate the existing overall nervousness. The outlook is not any brighter as the real estate market shows virtually no signs of recovery despite historically low interest rates, the current unemployment rate is just over 9% and projected to be almost 10% by the beginning of 2012 and average gasoline prices are estimated to remain above $3.50 per gallon into next year. The capper to our collective psychological fragility will be the continued political wrangling in Washington as a committee of 12 lawmakers, six from each party, have been tasked with identifying $1.5 trillion in budget cuts over the next 10 years by the end of November—a process that is not likely to instill confidence in U.S. consumers or the markets.

As for the state of the restructuring and capital markets, the second quarter of 2011 was mostly a continuation of the trends seen in the first quarter, namely:

- The 2012 liquidity wall crumbled further;
- Lenders continued the amend-to-extend (A-to-E) strategy;
- Default rates continued to fall further to record lows;
- Average leverage multiples on middle market loans continued to creep upward and covenant-lite loans are starting to make a return;
- Pricing and rates on middle market loans continued to ease;
- Financial buyers are sitting on tremendous amounts of cash; and
- The required equity contributions to LBOs are coming down.
There were changes in direction in certain trends from the first quarter in the lending market including:

- Overall loan volume decreased as inflows to loan mutual funds decreased while the supply of new money deals rallied;
- Overall LBO volume remained flat;
- The second lien loan market volume was up over three times.

**The Maturity Wall Comes Crumbling Down**

It is a foregone conclusion that the 2012 maturity wall is now not even a bump in the road. The 2012 maturity wall peaked near the end of 2009 at approximately $95 billion and has steadily eroded since. The total 2012 maturities now stand at about $20 billion after pay downs or extensions of approximately $40 billion and $50 billion in the first and second quarters, respectively. As seen below, the maturity wall has been pushed to 2014, when total maturities are now approaching $180 billion.

Of the $50 billion in second quarter activity, A-to-E activity accounted for approximately one-half which was an increase of about three times over first quarter’s activity. Lenders are expected to continue their A-to-E approach into the near future, and why wouldn’t they? In many situations, there is only one direction for borrowers’ financial performance to go: up. A-to-E is a relatively quick and inexpensive approach for lenders to give borrowers more time to rebound. It also typically avoids a long and costly foreclosure process that ultimately does not result in adequate recoveries, especially in situations involving real estate.

Although less than the fourth quarter of 2010 and first quarter of this year, total pay downs by borrowers of just over $20 billion accounted for approximately 40% of the total reduction in maturities in the second quarter. This compares to total pay downs of approximately $30 billion in the fourth quarter of last year and first quarter of this year. This level of pay downs is a sign of continued improvement in borrowers’ profitability and their focus on the deleveraging of their balance sheets.
Default Rates Continue To Plummet

Default rates continue to be driven lower by borrowers’ improving EBITDA and liquidity performance as well as the aforementioned A-to-E activity. As of the end of June, the lagging 12-month loan default rate was less than 1% by principal amount which is unchanged from May when the lagging loan default rate hit a 40 month low.

EBITDA growth percentage was again in the double digits for all S&P/LSTA issuers, which serves as a proxy for the middle market. The consensus among analysts is that the EBITDA growth will continue in the low to mid teens through next year. We believe these trends are driven by several factors. First, most management teams have been very effective in right-sizing cost structures, were able to survive the downturn and are now realizing the fruits of their labor, even in a very weak economy. Second, many of the weaker borrowers have simply gone away and are no longer part of the sample. Third, it is much easier to attain double digit growth coming off of a very low comparison period. The question now is can management teams grow the top line in a very tough economic environment because for many, that is the only path to survival.
Lenders Are Starting To Loosen Their Underwriting Belts

A return to more lenient underwriting standards combined with a more competitive lending market continued in the second quarter as leverage multiples increased from 4.1x to 4.5x EBITDA from the first to second quarter. The biggest increase in leverage ratios has been seen in the first lien lenders where the ratio has increased from 2.6x in 2009 to over 3.7x in the second quarter.

The same trend has been seen in middle market LBO loans where the leverage ratio has increased from 3.3x EBITDA in 2009 to 4.4x in the second quarter. Again, first lien lenders have materially increased their leverage ratios from just over 2.5x in 2009 to 3.8x in the second quarter.

Source: LCD Leveraged Lending Review

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Source: LCD Leveraged Lending Review
Covenant-lite loan activity has also seen an increase in volume to levels not seen since 2007. Covenant-lite loans accounted for 31% of the total institutional loan volume in the second quarter and 26.8% year to date which is higher than the previous high of 25% set in 2007. However, the market is expected to cool as pricing incentives are beginning to be demanded by the market, but memories are short. It will be interesting to see if that holds true.

**Continued Strong Market For Sellers**

The biggest beneficiaries of the current market environment are business owners willing to sell. The marketplace is currently flush with financial and strategic buyers who have the capital and the desire to make acquisitions. M&A activity in terms of the number of transactions, aggregate deal values and notional value of loans have all been generally picking up in recent quarters. Q4 of 2010 had the most transactions and highest total deal values with Q1 of 2011 coming in a close second. Both of these quarters greatly exceeded anything seen since before the financial crisis. In terms of loan volumes of M&A transactions, if the second half of 2011 continues at the same pace as we saw in the first half, 2011 M&A loan volume will have its most active year since 2007. What is driving the rapid growth of the M&A market? Arguments can be made for several underlying factors—strengthening credit markets, better enterprise valuations for businesses which motivate owners to sell and PE funds that have tremendous amounts of capital that need to be invested. Additionally, there is a large overhang of aged private equity portfolio companies that are also expected to be coming to market in the near future.
The financial crisis caused the collapse of many businesses and institutions, but those that did survive proved to be solid business models and were led by strong management teams that were able to navigate through incredibly difficult economic times. Private equity firms have always been willing to pay premiums for investments in stable and well-managed companies. This in combination with the amount of dry powder within the PE industry are major drivers in the increase in M&A transactions closed and higher valuations. Virtually every industry has seen an increase in total enterprise value to EBITDA from 2010 to Q1 of 2011. We believe the large amounts of capital chasing a fewer number of quality companies is a major driver in the increase in valuations. More simply, the demand for quality deals in the middle market is outpacing the supply.

Private Equity Dry Powder

![Private Equity Dry Powder](source: LCD Leveraged Lending Review)

Another contributing factor to the rapid growth of the M&A market is the strengthening of the credit markets where money is cheap, pricing is aggressive, underwriting standards are starting to loosen and the required equity contributions are coming down. The cost of leveraged loans has continued easing as Q2 saw another decrease in the average discounted spread of leveraged loans. This has been an ongoing trend in the middle market since 2009 and is expected to continue into the near future. It is becoming increasingly cheaper and easier for companies and buyers to access capital as lending criteria and underwriting standards continue to relax. In addition, 2011 Q2 also saw a slide in the average equity contributions of PE transactions. This has also been an ongoing trend since 2009 but is still a far cry from the lowest equity contribution levels that dipped below 30% just before the financial crisis.

TEV/EBITDA by Industry

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Source: GF Data Resources

Average Discounted Spread of Leveraged Loans

![Average Discounted Spread of Leveraged Loans](source: LCD Leveraged Lending Review)

Average Equity Contributions by PE Firms

![Average Equity Contributions by PE Firms](source: LCD Leveraged Lending Review)
There has also been an increase in new issue leveraged loans—Q1 and Q2 of 2011 have been the two most active quarters by a wide margin in the past two years. U.S. dollar denominated new-issue loan volume was $141B in Q1 of 2011 and $116B in Q2, volumes that greatly exceed anything seen since Q3 of 2007. It should not be difficult for quality sellers to find buyers with access to capital. The overall market conditions are very strong for sellers. We have seen the increase in activity in our own pipeline and expect to see a continued increase in M&A activity throughout the rest of this year and into 2012.

FASB Accounting Standards Update For Troubled Debt Restructurings

The recent accounting standards update by FASB (ASU 2011-2), which became effective as of Q3 2011, requires financial institutions to report re-default rates on non-residential loans. The update is a direct effect of the economic downturn where the volume of debt restructured by creditors has increased dramatically, much of which is attributable to the A-to-E activity. The concern by many stakeholders was if additional guidance or clarification was needed to determine if a creditor had granted a concession and whether a debtor was experiencing financial difficulties in order to determine if the restructuring meets the definition of a troubled debt restructuring (TDR).

A TDR, as defined by FASB Subtopic 310-40, is a restructuring in which a bank, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to the borrower that it would not otherwise consider and that the debtor is experiencing financial difficulties. The restructuring of a loan or other debt instrument may include, but is not necessarily limited to:

1. The transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan;
2. A modification of the loan terms, such as a reduction of the stated interest rate, principal, or accrued interest or an extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk; or
3. A combination of the above.

So what exactly is a “concession?” FASB defines it as:

1. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that circumstance, a creditor should consider all aspects of the restructuring in determining
whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.

2. A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below the market interest rate for new debt with similar risk characteristics. In such situations, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.

3. A restructuring that results in a delay in payment that is insignificant is not a concession. However, an entity should consider various factors in assessing whether a restructuring resulting in a delay in payment is insignificant. The amendments include examples illustrating the assessment of whether a restructuring results in a delay in payment that is insignificant.

FASB further states that a creditor may deem a debtor to be experiencing financial difficulty even when the loan is not in default. The creditor should evaluate whether it is probable that the debtor would be in default in the foreseeable future had the modification not been made.

While all lenders are generally in favor of transparent loan loss reporting, it appears that most lenders are in disagreement with the proposal. The recurring issues with the update observed from lenders are that:

- The update will be very difficult to implement operationally;
- It will not provide more useful and transparent information to financial statement users because most loans that meet the definition of a TDR have already been identified as impaired and are currently reported as non-accrual loans and, therefore, there would be no material impact to the allowance for loan losses;
- Market interest rates are not always transparent and are dependent upon business cycles, certain instances of illiquidity in particular markets, special terms, the nature of collateral and even the form and substance of guarantees; and
- It will eliminate industry practices and standards developed over many years by regulators.

Many lenders believe the TDR distinction should be eliminated entirely. The update does lower the bar in defining a troubled loan and removes some of the subjectivity able to be applied by lenders. Therefore, theoretically, it should cause an increase in the loan loss reserves for some lenders. Whether it results in lenders taking a more proactive approach in resolving these troubled credits remains to be seen.
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