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Distress High in High-Tech Sectors

Consumer Electronics, Telecom Industries Most at Risk

by Dave Buzzell

When Karl Roberts and Michael Weyrich of AlixPartners began looking at the numbers collected from their global survey of the high-tech industry, they expected to find an industry that had emerged from the recession in decent shape and well positioned in the near term, with healthy balance sheets and good growth prospects. "What we found, instead," says Roberts, "were more companies than expected that are currently at risk of financial distress or in financial distress."

Roberts is head of AlixPartners' high-tech practice in North America and Weyrich is co-head of the firm's high-tech practice in Europe, Middle East, and Asia. Their findings, published in *AlixPartners Global High-Tech Industry Outlook*, are based on a

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Resnick Honored with Miller Award

Presentation at 2011 Distressed Investing Conference

by Julie Schaeffer

When the Turnaround and Restructuring group at the University of Chicago Graduate School of Business invited alumnus David Resnick to speak about changes in the restructuring industry at its 2009 annual conference, he paused.

"I never really thought of myself as having done it that long," he laughs.

Truth be told, Resnick is a veteran of the restructuring industry, with a rich history that spans almost 26 years and four notable firms, including Merrill Lynch & Co., Lazard Freres & Co., Peter J. Solomon Company, and now Rothschild Inc., where he is chairman of the firm's global financing advisory business.

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Distressed Assets, Fiduciary Duties

Board Responsibilities Change with Company's Health

by Julie Schaeffer

When a company is healthy, most boards of directors know their fiduciary duties regarding asset sales – but those duties change dramatically when the company is distressed, according to restructuring professionals.

"When a company is healthy, the board must consider its primary constituents, the company's shareholders, and maximize recovery for them," says Patrick Burns, an associate in Dinsmore & Shohl's business restructuring and reorganization group. "However, as a company slips toward insolvency, creditors of the corporation become the primary stakeholders concerned with maximizing value."

This, says Burns, has led to "substantial confusion and significant case law regarding

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compilation and analysis of financial data from over 1,200 high-tech companies. It is an industry that generated almost $5 trillion in revenues in 2010 and is a presence in nearly every business and household around the world.

The study divides the high-tech industry into nine key sectors: channel (distribution and retail), contract manufacturing, internet/digital media, computer hardware and electronic equipment, software, semiconductors, consumer electronics, telecom, and technology companies, which include corporations such as Apple that cut across several sectors. A comparison of the financial performance among these sectors, and the further delineation within each of those sectors by quartile of performance, produced some intriguing findings.

For example, the study found that top quartile performers generate 4.5 times as much EBITDA as a percent of revenue as the bottom 25 percent of performers. Of even more significance, those top quartile performers are reinvesting capital at a much higher rate than their low-achieving counterparts. Characterizing these findings as surprising, Roberts says, “My takeaway is that winners and losers are beginning to emerge. The winners are reinvesting and getting stronger over time and the losers are frankly losing their ability to compete.”

Weyrich adds that this finding is a possible harbinger of increased mergers and acquisitions in this industry. “For the winners, there is an increasingly attractive M&A opportunity in companies that are not doing well in the current environment.”

Speaking of winners and losers, some high-tech sectors are faring considerably better than others as measured by their Altman Z-score, a predictor of future financial condition. The financial stress in the consumer electronics and telecom sectors is particularly acute. Ninety percent of consumer electronics companies are either “at risk” or “high risk,” and 70 percent of telecom companies fall into one of these two upper-end risk categories.

Roberts believes that the high level of stress being experienced in the consumer electronics sector is a consequence of low product demand and increased competition. “Some very large companies have suffered from the economic downturn. Demand has not recovered, but the technological challenges remain. Most devices have a

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It’s no surprise, then, that Resnick has been honored with the 2011 Harvey R. Miller Outstanding Achievement Award for Service to the Restructuring Industry. The lessons he’s learned through his career make Resnick a natural choice – to everyone but him, perhaps. Humility, it seems, is also one of his strengths.

“Harvey is someone with whom I worked early in my career, and from whom I have learned a great deal, but he is much more knowledgeable than me, so I was honored that he and those involved in selecting the nominee felt my contributions merit this recognition,” says Resnick.

Perhaps that humility stems from Resnick’s childhood in Baltimore, where his mother (a social worker) and father (who owned a dry cleaner and later helped run a local candy manufacturer) taught him the values that would guide him through his professional pursuits.

As is the case with most teenagers, however, Resnick was eager to spread his wings, and left Baltimore at 18 to attend Wesleyan University in Middletown, Connecticut. After obtaining a bachelor’s in European history with high honors, he found his way to the University of Chicago, where he received a master’s degree in business administration and a juris doctor.

As it turns out, law was not Resnick’s calling. “I always thought I would practice law, and I worked as summer associate at several law firms, but I wasn’t happy,” says Resnick. “Eventually I realized that it wasn’t the firm, it was me.”

More specifically, Resnick was interested in finance, as reflected by his first post-graduate job in the investment banking division of Merrill Lynch & Co. Initially a generalist, after two years he found his niche in the merchant banking/restructuring and mergers and acquisitions groups. His timing couldn’t have been better: It was 1987. The stock market had crashed and the high-yield debt market had come to a halt. “Merchant banking activity slowed dramatically, but many companies, including Merrill, had made a number of investments they needed to restructure,” says Resnick. “That’s how I found my way into the restructuring business.”

Resnick had a good run at Merrill Lynch, but by 1990, the economic environment had changed and business was slowing. Seeking a position with more stability, Resnick turned to Lazard, which was

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the fiduciary obligations of a board of directors when the economic conditions of a business falter and eventually deteriorate into insolvency and/or bankruptcy.”

The question is, to whom do directors owe fiduciary duties – and who may bring a claim against the board for alleged violations of their fiduciary obligations?

“Delaware case law indicates that, as a corporation approaches insolvency, the directors continue to have a fiduciary obligation to maximize the value of the enterprise,” says Paige Connelly, also an associate in Dinsmore & Shohl’s business restructuring and reorganization group. “Once the corporation is insolvent, the directors’ fiduciary obligations remain the same, but the beneficiary stakeholders become the creditors of the corporation.”

The Delaware Supreme Court clarified this issue in 2007 in *Gheewalla*, when it ruled that when a corporation is insolvent, that insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value,” and gives those creditors standing to make derivative claims against directors for breaches of fiduciary duties (although creditors may not bring direct claims against directors for breach of their fiduciary duties).

Thus, in evaluating asset sales of distressed companies, directors must understand where a company is in its lifecycle in order to be aware of their fiduciary obligations and potential pitfalls.

According to Burns and Connelly, one pitfall is directors not being informed when determining whether to approve a transaction prior to submitting the proposal to the corporation’s shareholders.

In determining whether directors are informed, the business judgment rule, which presumes directors made their decisions “on an informed basis, in good faith, and with the honest belief that the action was in the best interest of the corporation” usually applies, says Burns.

However, he continues, that presumption can be rebutted “if the plaintiff can show that the directors were self-interested, lacked independence, were grossly negligent in properly informing themselves of the details of the transaction, or that the transaction cannot be attributed to any rational business purpose.”

Another pitfall occurs when the directors seek hurried sale transactions, as was the

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product life cycle of six to nine months. If that investment cycle is not timed right or demand is softer than anticipated, it doesn't take many product cycles to put a company into real trouble."

The telecom sector is even more troubled, with more than one half of all global companies at "high risk" of financial distress. Roberts says the telecom companies' high stress level is largely due to their high debt loads. "Among the telecoms, a lot of capital is required to keep pace with technological change. In the cell phone universe, for example, cell phones have progressed from second generation to third generation, and now many regions are moving into fourth generation. Every time that technological crank is turned, companies have to upgrade the infrastructure that supports it. Telecom companies have a big appetite for capital, and have been borrowing heavily to meet it."

According to Weyrich, the picture in Europe is even less attractive, with EBITDA of European telecoms having dropped 5 percentage points over the last four years. "Regulatory changes have caused roaming and data-use prices to fall substantially. At the same time, the European market is heavily saturated. People can only have so many cell phones. That puts pressure on profitability. A lot of capital is required to build 4G networks, increase capacity, and make other upgrades at a time when the financing market is very tight."

One result, observes Weyrich, is that, as the Western European markets have matured, capital has begun flowing elsewhere. "There has been a significant step up in investment in the Middle East and Africa by Western Europe players in the telecom space."

Regionally, companies based in Asia/the Pacific Rim account for 47.7 percent of global revenue generated by the high-tech companies. North American firms are next with a 30.5 percent share, followed by Europe at 16.2 percent. Roberts says this disparity, as well as the factors underlying it, were another interesting finding of the survey. "A lot of high-tech companies emerging over time have been based in Asia."

One reason, says Roberts, is that Asian companies are more accepting of lower overall profit margins. "We were quite surprised to find that Asian companies on average generate EBITDA of only one half the rate of North American and European companies. They are leveraging that willingness for lower margins to grow market share. As it turns out, the Asian companies are actually growing faster than companies based in North America and Europe."

More findings of this nature can be found in an abbreviated version of the study, available at http://www.alixpartners.com/en/WhatWeThink/HighTech/2011GlobalHighTechOutlook.aspx. ¤

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looking to build a restructuring business. "Lazard had a different culture because it was purely an advisory firm," says Resnick, who found the mentoring he obtained, in particular from David Supino, invaluable. "The senior people were much more hands-on because Lazard didn't do the same volume as a large investment bank, and I was given a tremendous amount of responsibility. It was sink or swim: They gave you the rope and you either pulled everything forward or hung yourself with it. That worked for me."

By 1996, the restructuring boom had waned, and Lazard was shifting its staff to mergers and acquisitions, which didn't work for Resnick, who preferred the complexity of restructuring and the fact that each project is different from the last. But when a headhunter called and said Peter J. Solomon Company (PJSC) was looking for someone to launch its restructuring group, Resnick knew taking the job would be a risk. "I didn't know if I had the skills to build a team and develop business on my own," he says,

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case in *Bridgeport Holdings v. Boyer.* There, a board of directors sought a hasty asset sale on the eve of a bankruptcy filing. In response, the Delaware Bankruptcy Court ruled that the directors breached their fiduciary duty by failing to inform themselves of all material information, by abdicating important decision-making authority to a restructuring professional, and by failing to sufficiently monitor the execution of the sale.

"*Bridgeport Holdings* is a warning to directors of companies suffering from deteriorating financial conditions," says Connelly. "The board of directors of a

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Calendar

Practising Law Institute
Nuts and Bolts of Corporate Bankruptcy 2011 Seminar
November 17-18, 2011
San Francisco, CA
Contact: www.pli.edu

ALI-ABA
Commercial Real Estate Defaults, Workouts, and Reorganizations
November 17-19, 2011
The Westin Casuarina
Las Vegas, NV
Contact: www.ali-aba.org

Beard Group
18th Annual Conference on Distressed Investing
November 28, 2011
The Helmsley Park Lane Hotel
New York, NY
Contact: (240) 629-3300

American Bankruptcy Institute
23rd Annual Winter Leadership Conference
December 1-3, 2011
La Quinta Resort & Club
La Quinta, CA
Contact: www.abiworld.org

VALCON 2012
February 22-25, 2012
Four Seasons Hotel
Las Vegas, NV
Contact: www.aira.org

National Association of Bankruptcy Trustees
2012 Spring Seminar
March 30-31, 2012
The Venetian/Palazzo
Las Vegas, NV
Contact: www.nabt.com

Turnaround Management Association
TMA 2012 Spring Conference
April 3-5, 2012
Grand Hyatt Atlanta
Atlanta, GA
Contact: www.turnaround.org

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we, as bankers, can contribute, but we're not going to have all the answers. We can advise our clients most effectively if we put a team together that includes the company's senior management, lawyers, and investment bankers, and we all work together."

To that end, he utilizes skills he learned from two mentors, one being Nate Thorne, with whom Resnick worked at Merrill Lynch. "He's one of those people who didn't have any constraints in regard to approaching a problem," says Resnick. "He always pushed the envelope in terms of finding solutions, and that's what you have to do to be successful in restructuring."

Resnick also acknowledges the impact Lazard's Supino had on his approach. "Restructuring is a business where there's not enough value for everyone," he says. "As a result, a lot of people in the business are known for screaming and yelling and banging fists on the table. David, in contrast, was calm in the midst of difficult situations. He knew if you really want to find a solution, you focus on bringing people together, laying out all their arguments, doing thorough analysis, and looking for a common thread."

Both of those skills, says Resnick, have served him well. "I've learned to have a lot of patience. You're much more effective if you develop relationships, listen to other people's ideas, and put yourself in their shoes than if you come in and say, 'Here's the answer I've come up with.'"

If the past is any indication, Resnick will certainly continue in that vein because the restructuring industry – as he told University of Chicago students in 2009 – is still active. "We've kept business despite the fact that the big wave of restructurings ended. The work is different from what our group did two years ago when we were handling many big cases, like Delphi, LyondellBassell, Trident Resources, Chrysler, and GM. Mid-cap companies are the ones in trouble now because they don't have access to the capital markets, so they lack liquidity. But there will always be companies that face balance sheet challenges." ¤

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distressed company should seek assistance from restructuring professionals in a timely manner, and the directors should oversee the actions of such professionals throughout the due diligence and sales process, rather than relinquish all authority to them."

Connelly also urges directors to consider all creditor constituencies, including senior secured lenders, subordinate secured lenders, and general unsecured creditors – however difficult it may be.

"In most instances, the interests of these parties will vary, especially when a debtor is pursuing a sale of assets that is unlikely to pay the creditors in full, and often will leave the more junior creditors without any recoveries at all," she notes. "As a result, a sales process that begins prior to the filing of a bankruptcy petition may be subject to objections filed by junior creditors that are likely to receive minimal distributions, or be completely frozen out of any recovery from the sale proceeds."

To counteract potential objections, Connelly says it is important to ensure that proper steps are taken in establishing the sales process, marketing the assets, and entering into an asset purchase agreement so the court will be satisfied that the directors understood and properly satisfied their fiduciary obligations.

According to Burns, directors should start by establishing the sales process, which likely involves naming a special committee to evaluate possible exit opportunities, including bids for assets of the company. "Because management may be supportive of one buyer, and the board may be affiliated with potential bidders, the board should initially name a special committee consisting of independent directors (or, in some instances, a sole director)," says Burns. "This committee should have clearly defined duties, including evaluating bids for assets and other potential exit proposals, negotiating on behalf of the debtors, and approving all actions with respect to a transaction."

Next, says Burns, the directors should market the assets. Typically, this will be handled by a financial advisor or investment banker, and result in a form asset purchase agreement wherein the counterparty will agree to make a stalking-horse bid that includes provisions that require the assets to be sold pursuant to Section 363 of the Bankruptcy Code and include a timeline for the sale to occur," says Burns. "In return, the debtor should seek a lock-up agreement wherein the buyer agrees to support an open auction process and not disturb the sale if it is not the best bid as determined by the debtor."

Finally, says Burns, with a stalking horse bidder in place, the debtor should file a motion to establish a bidding and auction process. This process should be long enough to fully market the property and allow enough time for interested buyers to perform appropriate due diligence.

At the conclusion of the auction, the debtor will seek court approval to close the transaction with the highest or best bid at the auction. ¤

In the Next Issue…

- *Special Report: Sources of DIP Financing*
- *Special Report: Outstanding Restructuring Lawyers – 2011*
- *Research Report: Who's Who in NewPage Corporation*

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