“Thirteen Week Cash Flow: What’s In a Number? The First 13 Weeks May Be Everything”

Moderator: Frank Mack
Panel: Carl Lane, Jim Macdonald, Dave Wirt, Ken Yager
Webinar Overview

TWCF in the Context of Turnarounds

TWCF Model Construction

Borrowing Base

Cash Collateral

Exit Strategy and Planning

Q and A
Thirteen Week Cash Flow Model Theory
The Turnaround Process

The CTP Body of Knowledge cites five stages to a turnaround:

- Management: “Leadership to develop the turnaround”
- Evaluation: “Diagnosing problems to evaluate viability”
- Emergency Action: “Control and conserve cash”
- Stabilization: “Restructure the business and operations”
- Return to Normal: “Institutionalize a change in the business”

In this context, the TWCF impacts the entire turnaround process:

- Management: Ownership of cash management and control
- Evaluation: Construction of the viable business model
- Emergency Action: Consideration of only the most critical needs
- Stabilization: Demonstrate result of corrective actions
- Return to Normal: Institute an additional management tool

The TWCF is more than a financial tool. It is a turnaround tool!
The turnaround of a company is based on enhancing its long-term viability.

Viability is a function of three measures:
- Liquidity, through the analysis of cash and working capital
- Solvency, which can be assessed by an I/S and B/S, and
- Positive cash flow, which can only be addressed by the TWCF.

Liquid Resources Depleted
- Low cash balance
- Limited / No Loan Availability
- Working capital deficiencies

Solvency Limits Reached
- Overleveraged Capital Structure
- Inability to meet debt obligations
- No unencumbered assets

Cash Flow Analysis
- How can more detail and visibility be provided?
- What immediate obligations can be addressed?
- How can the company be run differently?
- What can be done to conserve cash?
- How will the turnaround be financed?
- What factors can best catalyze a turnaround?

- How can the company best monitor performance?
TWCF: Comparative Analysis

How is a TWCF different than other financial forecasts?

It is cash (not accrual) based

• Evaluate “Revenue” and “Cash Flow from Operations”
  – Revenue is based on the contractual commitment of another party
  – Cash flow from Operations relies on working capital assumptions

• Note the accounting triggers for each
  – Income Statement: Revenue is recognized at the point of an agreement to purchase
  – Balance Sheet: A/R recognized at the point of shipment
  – GAAP Statement of Cash Flows: Cash Flow from Operations may fall into the same “accrual” traps if the working capital estimates are not forecast as observed

• Contrast to Cash Inflows in the TWCF
  – TWCF requires documentation of observed A/R payment terms
  – Cash is measured on the singular basis as when it is available for use
TWCF: Comparative Analysis

How is a TWCF different than other financial forecasts?

It offers specificity or disaggregation of activity:

• **Timing**
  – Generally performed at weekly (daily) intervals
  – Highlights specific peak cash needs
  – Implies sources or instances for negotiation

• **Line Items**
  – Delineation of line item activity from general account headings
  – Allows assessment of how critical/non-critical the obligation is
  – Signals if the amount is recurring or extraordinary

• **Business Unit / Product Line**
  – Segregation of segments or business units aids visibility
  – Evaluation of a core business becomes easier
  – Enables different strategies for different segments to be evaluated and monitored
TWCF: Comparative Analysis

How is a TWCF different than other financial forecasts?

• It is the only source for assessing and tracking short-term viability
  - Liquidity and Solvency Ratios are not performed on a cash basis
  - General financial statements do not “time” cash needs
  - TWCF models can best be adjusted for up-to-minute activity

• It is the ideal mechanism to individually track turnaround actions
  - TWCF can model and then be used to monitor specific actions
  - TWCF budget to actual variances can be very informative
  - TWCF often becomes or includes “vital signs” of the business

• It is periodically recast to reflect actual activity
  - Models are constantly updated with new actual information
  - Inherent timing differences can allow better management of cash flow and working capital
  - Performing weekly and cumulative budget to actual variances enables you to make real time adjustments.
How does the TWCF fit into the financial forecasting process?
TWCF as a Business Tool

An ideal TWCF considers the principal aspects of a business

• Customers
  - Who / what is / are the core business base?
  - Is the core customer / product base a source or use of cash?

• Production
  - What orders or lines are most critical?
  - Which activity best utilizes resources available to generate cash?

• Procurement
  - What vendors are most essential?
  - How are scarce cash resources best applied to purchasing activity?

• Cost Analysis
  - What costs are higher than expected?
  - Which outflows can be negotiated, deferred, or converted?
TWCF as a Business Tool

TWCF often allows visibility and execution of management

• Visibility Considerations
  – Which initiatives provide the most return?
  – What can be done to demonstrate management actions?
  – Over what time and constraints can gains be achieved?

• Execution Considerations
  – Best assessment of the effectiveness of the turnaround plan
  – Permits detailed evaluation of operating results
  – Indicates relative strengths and weaknesses of business renewal

• Ideally, the cash flow model goes beyond “reporting”, it “informs”.

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TWCF Aids Accountability If Monitored

Monitoring cash flow performance enhances visibility...
- Cash inflows that fall below expectations of the turnaround plan
- Cash outflows that exceed expectations of the turnaround plan

...and allows Management/Advisor to query accountable parties as to the existence, merit or success of the business strategy

Cash Inflows
- Are customers failing to pay according to terms?
- Are higher than expected discounts being provided?
- Is there a deterioration in the customer base?
- Are competitive/pricing/position factors more influential than modeled?

Cash Outflows
- Are vendors accelerating payments (reduced terms, COD, deposits)?
- Are material or supplier costs increasing?
- Is a system of addressing vendor payments necessary/functioning?
- Is inventory being managed in the most cost effective manner?
- Are implemented cost reductions hitting the bottom line?
TWCF as a Turnaround Tool

TWCF integrates the “Who, “What” and “How” of the turnaround

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<th>Key Consideration:</th>
<th>Who?</th>
<th>What?</th>
<th>How?</th>
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<td>Is management part of the problem or the solution?</td>
<td>Are the key turnaround initiatives visible and clear?</td>
<td>Is the plan free of bias and externally supported?</td>
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<tr>
<th>Criteria or Basis of Evaluation:</th>
<th>Who?</th>
<th>What?</th>
<th>How?</th>
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</thead>
<tbody>
<tr>
<td>Capabilities, awareness and commitment of management</td>
<td>Weekly status, “flash” reports or key metrics</td>
<td>Singular/accepted model for all potential users</td>
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<td>Employing the capabilities of management and their understanding of the company’s systems and financial information to produce a clear and accurate cash flow model</td>
<td>Establishing the key success criteria to engineer</td>
<td>Modeling and remodeling of the TWCF to add clarity and remove any biases or preferences for vendors or customers and to vet interests or objections of external stakeholders.</td>
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<td>Accountable, engaged and motivated management team</td>
<td>Enterprise-wide focus on the action steps required to meet turnaround goals</td>
<td>Cooperative relationship with stakeholders and the establishment of credibility</td>
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Thirteen Week Cash Flow Model Construction
Cash Flow Model & Components

- TWCF is the standard distressed company forecast format.
- TWCF is typically a source and use of cash methodology.
- It tracks all cash activity to reconcile from an opening balance to the ending cash balance.
- Mirrors a “checkbook” and can reconcile to EBITDA.
- Offers a conservative outlook to other projections.
- Includes visibility as to the level and nature of expenses.
- Can be built to consider creditor positions / priority rules.
- Ignores or overcomes accruals and accounting factors.
- Yields insight as to who / what needs to be paid now?
- Roll forward of working capital accounts to a projected sale closing date allows for better construction of purchase price adjustments and related clarity into the actual net proceeds derived from a sale.
- Can be used to set DIP loan covenants.
- Gives lenders insight into projected exposure and can be used to convince them to continue funding through a sale or refinancing process.
- Focuses where/when the pressure points will be.
- Used as a tool to manage expenditures.
Cash Flow Construction

• The best model tracks the unique aspects of each company

• Simpler models may result in cases of simpler businesses
  – Homogeneous products
  – Singular product lines imply

• Complicated models may result from the following:
  – Seasonality of sales or cash receipts / disbursements
  – Extended or irregular procurement, cash conversion cycles
  – Unique customer payment terms
  – Unique vendor payment terms
  – Nature of competitive environment
  – Significant inter-company activity in accrual based financial data
  – Number of and differences within business units or product lines
Cash Flow Construction

In most cases, a TWCF plan is an organizational challenge

• Systems are often a weak link to addressing TWCF needs
  – Limited or less useful historic information impacts the plan process
  – Usually designed for financial reporting, not cash planning

• Management may present a challenge to a TWCF plan
  – Focus often on sales, operations and finance versus cash flow
  – Distracted by negotiations and discussions with constituencies
  – Often overly optimistic and unrealistic about potential future performance

• The turnaround advisor/role often catalyzes the TWCF plan
  – Source of experience and creativity to overcome system limitations
  – Authority to influence management to commit necessary resources
  – Leadership role in developing the plan with company personnel
  – Stewardship of process until the company can manage the model
  – Fresh and unbiased look at business facilitates more realistic assumptions
Beginning & Ending Cash Loop

Formats can be simple or complex and can focus on financial or operational considerations. A general format would include:

**Opening Cash Balance**

Add Cash Receipts:
- A/R Collections
- Other Operating Sources of Cash
- Other Non-operating Sources of Cash (Taxes, Rebates, Recoveries)

Subtract Cash Disbursements:
- Inventory Purchases
- Wages/Salaries/Commissions/Payroll Taxes/Bonus
- Advertising
- Rents and Leases
- Repairs & Capital Expenditures
- Utilities
- Insurance/Taxes
- Interest/Other Debt Service Payments
- Capital Expenditures
- Professionals
- Other Sales, General & Administrative Expenses
- Restructuring Expenses

Loan Proceeds or (Payments) – *to be discussed in the next section*

**Ending Cash Balance**
# Beginning & Ending Cash Loop (example)

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<td>2,485</td>
<td>2,288</td>
<td>1,936</td>
<td>1,838</td>
<td>1,269</td>
<td>1,768</td>
<td>1,901</td>
<td>518</td>
<td>28,645</td>
</tr>
<tr>
<td><strong>Cash Source / (Use)</strong></td>
<td>(531)</td>
<td>1,058</td>
<td>(2,224)</td>
<td>(459)</td>
<td>(1,007)</td>
<td>(852)</td>
<td>1,192</td>
<td>(814)</td>
<td>977</td>
<td>(984)</td>
<td>1,564</td>
<td>(493)</td>
<td>2,401</td>
<td>1,423</td>
</tr>
<tr>
<td><strong>Ending Cash</strong></td>
<td>(586)</td>
<td>673</td>
<td>(651)</td>
<td>(1,000)</td>
<td>(2,007)</td>
<td>(2,859)</td>
<td>(1,367)</td>
<td>(2,215)</td>
<td>(1,239)</td>
<td>(2,223)</td>
<td>(2,859)</td>
<td>(852)</td>
<td>1,548</td>
<td>3,648</td>
</tr>
<tr>
<td><strong>DIP Balance</strong></td>
<td>(586)</td>
<td>673</td>
<td>(651)</td>
<td>(1,000)</td>
<td>(2,007)</td>
<td>(2,859)</td>
<td>(1,367)</td>
<td>(2,215)</td>
<td>(1,239)</td>
<td>(2,223)</td>
<td>(2,859)</td>
<td>(852)</td>
<td>1,548</td>
<td>3,648</td>
</tr>
</tbody>
</table>
Cash Receipts – Key Items

- In addition to the ordinary course items, other types of cash receipts may include:
  - Tax Refunds
  - Refinance Proceeds less Usage
  - Equity Contributions
  - Miscellaneous
  - Proceeds from Asset Sales
  - Sales of Excess Capital Assets
  - Rebates
  - Moving Excess Inventory-”Trash to Cash”

- Importance of Timing Cash Receipt
- Strategic Considerations
- Velocity in the cash conversion cycle
  - Impact of DSO Ratio (high and low)
  - Other variants to the cycle and their impact
Cash Receipts

Estimate Cash Receipts using A/R Rollforward

Steps Involved:
• Obtain Opening A/R Balance from A/R Aging

• Add Sales
  – Review prior year sales for the same period
  – Adjust for product launches, terminations, price changes, etc.

• Subtract Ending A/R Balance
  – Calculate Average Daily Sales
  – Calculate Days Sale Outstanding or DSO
    • Measures the time it takes to collect company’s receivable
    • Calculated as Avg. A/R divided by Sales multiplied by # of days
    • Be conservative: Adjust for customer concentration, unique payment terms, seasonality, past due balances, etc.
  – Multiply Average Daily Sales with DSO Ratio

• Arrive at Cash Receipt for the period
### A/R Rollforward Example:

<table>
<thead>
<tr>
<th>Week Ending</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
</tr>
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<tbody>
<tr>
<td>7-Oct-05</td>
<td>18,761</td>
<td>19,249</td>
<td>18,405</td>
<td>19,876</td>
<td>18,216</td>
<td>19,359</td>
<td>20,134</td>
<td>18,975</td>
<td>16,337</td>
<td>16,078</td>
<td>17,153</td>
<td>15,813</td>
<td>16,411</td>
</tr>
<tr>
<td>14-Oct-05</td>
<td>2,768</td>
<td>2,862</td>
<td>2,975</td>
<td>3,056</td>
<td>2,783</td>
<td>2,408</td>
<td>2,621</td>
<td>1,695</td>
<td>2,557</td>
<td>2,459</td>
<td>2,929</td>
<td>2,006</td>
<td>71</td>
</tr>
<tr>
<td>21-Oct-05</td>
<td>(2,280)</td>
<td>(3,707)</td>
<td>(1,503)</td>
<td>(2,246)</td>
<td>(1,640)</td>
<td>(1,633)</td>
<td>(3,780)</td>
<td>(1,088)</td>
<td>(2,815)</td>
<td>(1,385)</td>
<td>(3,632)</td>
<td>(1,408)</td>
<td>(2,949)</td>
</tr>
<tr>
<td>28-Oct-05</td>
<td>19,249</td>
<td>18,405</td>
<td>19,876</td>
<td>20,686</td>
<td>19,359</td>
<td>20,134</td>
<td>18,975</td>
<td>19,582</td>
<td>16,078</td>
<td>17,153</td>
<td>15,813</td>
<td>16,411</td>
<td>13,532</td>
</tr>
<tr>
<td>4-Nov-05</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2,470</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3,245</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4,190</td>
<td></td>
</tr>
<tr>
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<td>19,249</td>
<td>18,405</td>
<td>19,876</td>
<td>18,216</td>
<td>19,359</td>
<td>20,134</td>
<td>18,975</td>
<td>16,337</td>
<td>16,078</td>
<td>17,153</td>
<td>15,813</td>
<td>16,411</td>
<td>9,342</td>
</tr>
<tr>
<td>18-Nov-05</td>
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<td>409</td>
<td>425</td>
<td>437</td>
<td>398</td>
<td>344</td>
<td>374</td>
<td>242</td>
<td>365</td>
<td>351</td>
<td>327</td>
<td>287</td>
<td>10</td>
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<tr>
<td>25-Nov-05</td>
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<td>45.0</td>
<td>46.8</td>
<td>41.7</td>
<td>48.7</td>
<td>58.5</td>
<td>50.7</td>
<td>67.5</td>
<td>44.0</td>
<td>48.8</td>
<td>48.3</td>
<td>57.3</td>
<td>922.4</td>
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<td>2-Dec-05</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<td>-</td>
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<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>9-Dec-05</td>
<td>-</td>
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<td>16-Dec-05</td>
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</tr>
<tr>
<td>23-Dec-05</td>
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<td>-</td>
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<td>-</td>
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<td>-</td>
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</tr>
<tr>
<td>30-Dec-05</td>
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<td>-</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

**Footnotes:**

[1] - DSO is calculated as Net Accounts Receivable Ending Balance divided by Average Daily Sales
Cash Disbursements – Key Items

• Many expenditures are based upon contractual obligations
  – Payroll and Payroll Taxes
  – Leases and Rent
  – Principal and Interest Payment
  – Workmen’s Compensation and other Insurance
  – Trust Accounts

• Other expenditures are estimated based on history and current knowledge
  – Repairs and Maintenance, as well as capital expenditures
  – Travel and Entertainment
  – Show and Sales Expense
  – Legal and Professional

• Some expenditures can be estimated based on sales volume, inventory turns, capital investments, etc.
  – Inventory Purchases
  – Machinery and Equipment Purchases

• Inventory purchases can be estimated two ways:
  1. Review of all purchase orders and purchase contracts
  2. Use a rollforward to schedule estimated payments
Cash Disbursements (cont.)

Estimate Inventory Purchases using Inventory Rollforward Steps Involved:

• Obtain opening inventory balance from inventory sub-ledger

• Review production forecast for current period along with margins
  – Be wary of a sales based forecast to model inventory purchases
  – Obtain backlog to support the use and replenishment of inventory

• Add required inventory purchases for large customers based on history and backlog of sales orders

• For other customers, add required inventory purchases using Inventory Turnover Ratio
  – Measures how often inventory turns over during the year
  – Calculated as Cost of Sales divided the average value of inventory
  – Very high vs. very low inventory turnover ratio: why does it matter?

• Subtract Current Period Cost of Sales
  – Adjust for product launches, terminations, vendor price changes, changes in product mix, freight and shipping costs, etc.

• Arrive at Ending Inventory Balance
### Cash Disbursements (cont.)

<table>
<thead>
<tr>
<th>Week Ending</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
<th>13</th>
</tr>
</thead>
<tbody>
<tr>
<td>14-Oct-05</td>
<td>234</td>
<td>436</td>
<td>436</td>
<td>452</td>
<td>1,944</td>
<td>1,694</td>
<td>1,972</td>
<td>1,666</td>
<td>1,076</td>
<td>942</td>
<td>1,062</td>
<td>956</td>
<td>1,009</td>
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<tr>
<td>21-Oct-05</td>
<td>(2,294)</td>
<td>(1,720)</td>
<td>(2,124)</td>
<td>(1,876)</td>
<td>(2,200)</td>
<td>(1,653)</td>
<td>(1,739)</td>
<td>(1,189)</td>
<td>(1,552)</td>
<td>(1,746)</td>
<td>(1,402)</td>
<td>(1,169)</td>
<td>(98)</td>
</tr>
<tr>
<td>4-Nov-05</td>
<td>2,294</td>
<td>1,720</td>
<td>2,124</td>
<td>1,876</td>
<td>2,200</td>
<td>1,653</td>
<td>1,739</td>
<td>1,189</td>
<td>1,552</td>
<td>1,746</td>
<td>1,402</td>
<td>1,169</td>
<td>98</td>
</tr>
<tr>
<td>11-Nov-05</td>
<td>13.2</td>
<td>16.8</td>
<td>12.8</td>
<td>13.8</td>
<td>11.6</td>
<td>15.5</td>
<td>14.9</td>
<td>22.1</td>
<td>16.6</td>
<td>14.3</td>
<td>17.6</td>
<td>20.9</td>
<td>259.1</td>
</tr>
<tr>
<td>18-Nov-05</td>
<td>6,654</td>
<td>6,048</td>
<td>6,105</td>
<td>6,453</td>
<td>6,520</td>
<td>6,714</td>
<td>6,963</td>
<td>7,165</td>
<td>7,368</td>
<td>7,434</td>
<td>7,480</td>
<td>7,562</td>
<td>7,577</td>
</tr>
<tr>
<td>25-Nov-05</td>
<td>2,015</td>
<td>1,709</td>
<td>2,113</td>
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<td>1,799</td>
<td>1,642</td>
<td>1,728</td>
<td>1,178</td>
<td>1,541</td>
<td>1,463</td>
<td>1,391</td>
<td>1,158</td>
<td>87</td>
</tr>
<tr>
<td>2-Dec-05</td>
<td>(1,621)</td>
<td>(1,652)</td>
<td>(1,765)</td>
<td>(1,798)</td>
<td>(1,606)</td>
<td>(1,393)</td>
<td>(1,526)</td>
<td>(976)</td>
<td>(1,475)</td>
<td>(1,417)</td>
<td>(1,309)</td>
<td>(1,143)</td>
<td>(36)</td>
</tr>
<tr>
<td>9-Dec-05</td>
<td>6,048</td>
<td>6,105</td>
<td>6,453</td>
<td>6,520</td>
<td>6,714</td>
<td>6,963</td>
<td>7,165</td>
<td>7,368</td>
<td>7,434</td>
<td>7,480</td>
<td>7,562</td>
<td>7,577</td>
<td>7,628</td>
</tr>
<tr>
<td>16-Dec-05</td>
<td>13.9</td>
<td>14.1</td>
<td>14.2</td>
<td>14.3</td>
<td>12.4</td>
<td>10.4</td>
<td>11.1</td>
<td>6.9</td>
<td>10.3</td>
<td>9.9</td>
<td>9.0</td>
<td>7.8</td>
<td>0.2</td>
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</tbody>
</table>

**Footnotes:**

[2] - DPO is calculated as Accounts Payable Ending Balance divided by Average Daily Disbursements

[3] - Inventory Turnover Ratio is calculated as Weekly Cost of Goods Sold multiplied by 52 and divided by Inventory Ending Balance
Basis of Vendor Management

• Parallel with restructuring strategy
  – Chapter 11: Claim management
  – Out-of-court: Splitting old debt and new procurement
• Critical vs. non-critical vendors
• Staging of past due amounts
• Varying payment terms and conditions can range from
  – Nominal cash payments now...
  – ...Gain sharing later (conversion to long term debt or equity)
• Non working capital items:
  – Source of Information
  – Diligence to apply to cost estimates
  – Other qualitative considerations
Cash Flow Presentation

Beyond the actual forecast, the model should also include:

• History of at least one week of actual activity (same format)
• Reconciliation of variances from corresponding budget
  – Description / support of “timing” differences
  – Nature of differences unrelated to “timing”
  – Potential impact (if any) on remaining forecast period
• Underlying assumptions or narrative of methodology
  – Summary of modeled scenario, sensitivity or fact pattern
  – Cash conversion cycle: A/R aging vs. observed payment pattern
  – Segregation of vendor payments: new activity vs. past due amounts
  – Inclusion of all negotiated settlements, creditor accommodations
• Disclosure and basis of reforecast / methodology changes
• Footnotes for extraordinary or non-operating items
• Summary of new / revised methodologies or assumptions
• Borrowing base, if financed by an asset based lender
• Outlook and Request
Thirteen Week Cash Flow Borrowing Base Modeling
Borrowing Base Modeling: Purpose

Purpose of Borrowing Basis Analysis
• Summarizes the collateral underlying the credit facility
  – Types or Groups of Assets
  – Net, Loanable Values

• Calculates credit parameters
  – Implies the amount the loan cannot exceed
  – Also can indicate the level of cash available for paydowns

Borrowing Base Certificate
• Borrowing Base Certificate defined

• Requirement of Lender
  – To meet the collateral eligibility requirements specified
  – For compliance with terms of lending agreement (w/ or w/o over-advances)

• To use loan proceeds only for authorized purposes
  – Executive management (CFO) warrants use of funds
  – Summarizes loan agreement compliance

• For internal capital structure tracking
  – Under-secured creditor tracking
  – Impact of accommodation or access agreements
  – Modeling of “last-out” or other non-pari passu debt arrangements
Borrowing Base Modeling: Process

General Methodology
• Gross Asset balances listed first
• Adjustments to gross asset balances (including working capital rollforwards)
• Reserves, ineligibles, other special cases
• Net asset balance or “Eligible” account balance
• Advance rate
• “Availability” against net asset balance

Implication of Working Capital Rollforwards
• Cash Inflows incorporate sales / A/R collections:
  – Sales discounts, commissions
  – A/R Conversion time
  – Bad debt expense
• Vendor payments may include inventory components and activity
  – Purchases, Production
  – Obsolescence, reserves, etc.
  – Typically incorporates A/P rollforwards as well
Borrowing Base Models: Inputs

Loan Agreement
- Establishes eligible collateral
- Defines adjustments to balances
- Sets the advance rate
- Impact of Intercreditor agreement

Indicative Term Sheets for Loan Agreements:

**Senior**
- Credit Limit: $13,000,000
- Advance Rate on Accounts Receivable (excluding ineligibles): 85.0%
- Single Customer and Aggregated Customer Concentration Caps: Varies
- Advance Rate on Eligible Inventory (or lower of 50% of Book Value): 50.0%
- Inventory Cap: $6,000,000

**2nd Lien**
- Additional availability on Accounts Receivable: 0%
  - Based on eligible Accounts receivable as per Senior Facility Loan documents
- Additional availability on Inventory: 5%
  - Based on eligible Inventory as per Senior Facility Loan Documents
**Borrowing Base Calculation**

**Loan Availability on Accounts Receivable**
- Beginning Balance (Accounts Receivable)
- Add New Sales (and New Debts)
- Less Collections, Discounts, Allowances, and other credits
- Less Ineligible accounts (discussed below)
- Multiply by set percentage of loan allowance on eligible accounts receivable
  
  Note the impact of each preceding factor to the “effective” advance rate

**Typical ineligible accounts (usually derived from loan agreement)**
- Foreign: any non-US entity sales
- Overdue: often, >90 Days
- Concentration: 30% Rule (can vary based on circumstances)
- Other: Unapplied, Unbilled or Disputed A/R, Taint/Cross-age (if 50% of acct is >90 then entire account is excluded)
<table>
<thead>
<tr>
<th>DIP Lenders</th>
<th>W/E</th>
<th>W/E</th>
<th>W/E</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>10/7</td>
<td>10/14</td>
<td>10/21</td>
</tr>
<tr>
<td>1. Accounts Receivable Total</td>
<td>$3,513</td>
<td>3,513</td>
<td>4,011</td>
</tr>
<tr>
<td>2. Add New Sales</td>
<td>2,768</td>
<td>2,768</td>
<td>2,862</td>
</tr>
<tr>
<td>3. Add Other Debits</td>
<td>Assume N/A</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4. Total Additions (Line 2 + Line 3)</td>
<td>2,768</td>
<td>2,768</td>
<td>2,862</td>
</tr>
<tr>
<td>5. Less Collections</td>
<td>2,270</td>
<td>3,230</td>
<td>1,503</td>
</tr>
<tr>
<td>6. Less Discounts, Allowances</td>
<td>Assume N/A</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>7. Less Other Credits, in</td>
<td>Assume N/A</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>8. Total Deductions (Line 5 + Line 6 + Line 7)</td>
<td>2,270</td>
<td>3,230</td>
<td>1,503</td>
</tr>
<tr>
<td>9. Accounts Receivable Balance For This Report</td>
<td>4,011</td>
<td>3,644</td>
<td>5,115</td>
</tr>
<tr>
<td>10. Less Ineligible Accounts (See Business Loan Agreement)</td>
<td>Assumed</td>
<td>675</td>
<td>685</td>
</tr>
<tr>
<td>Includes Foreign, Setoffs, Greater than 90 Day A/R, Cross Aging</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Total Eligible Accounts Receivable (Line 9 - Line 10)</td>
<td>3,336</td>
<td>2,959</td>
<td>4,400</td>
</tr>
<tr>
<td>12. Loan Availability On Accounts Receivable (Multiply Line 11 X 85 %)</td>
<td>85%</td>
<td>2,835</td>
<td>2,515</td>
</tr>
</tbody>
</table>
Borrowing Base Calculation

Loan Availability on Inventory

- Beginning Balance (Eligible A/R)
- Add Raw Materials, Work in Process, Finished Goods
- Multiply by set percentage of loan allowance on eligible inventory
- Use lessor of Inventory cap or calculated eligible inventory balance

Indicative Terms for Inventory eligibility

- Eligible Inventory:
  - 0% of obsolete Inventory (but less than 90 days)
  - 50-100% of Raw Materials
  - 0% of Work in Process
  - 100% of Finished Goods
- Ineligible Inventory:
  - All foreign inventory
  - All inventory greater than 90 days
# Borrowing Base Calculation

## Loan Availability on Inventory

(U.S. $ in 000's)

<table>
<thead>
<tr>
<th></th>
<th>W/E</th>
<th>W/E</th>
<th>W/E</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10/7</td>
<td>10/14</td>
<td>10/21</td>
</tr>
<tr>
<td>12. Loan Availability On Accounts Receivable (Multiply Line 11 X 85 %)</td>
<td>85%</td>
<td>2,835</td>
<td>2,515</td>
</tr>
<tr>
<td>13. Raw Materials</td>
<td>Assume N/A</td>
<td>5,897</td>
<td>5,897</td>
</tr>
<tr>
<td>14. Work In Process</td>
<td>Assume N/A</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>15. Finished Goods (Less goods turned obsolete)</td>
<td>Ineligible</td>
<td>664</td>
<td>654</td>
</tr>
<tr>
<td>16. Total Inventory (Line 13 + Line 14 + Line 15)</td>
<td></td>
<td>5,233</td>
<td>5,243</td>
</tr>
<tr>
<td>17. Eligible Inventory (Multiply Line 16 X 50 %)</td>
<td>50%</td>
<td>2,617</td>
<td>2,622</td>
</tr>
<tr>
<td>18. Inventory Cap</td>
<td>$ 6,000</td>
<td>6,000</td>
<td>6,000</td>
</tr>
<tr>
<td>19. Loan Availability On Inventory (Lesser Of Line 17 Or 18)</td>
<td></td>
<td>2,617</td>
<td>2,622</td>
</tr>
<tr>
<td>20. Additional Availability</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>21. Borrowing Base For This Report (Line 12 + Line 19 + Line 20)</td>
<td></td>
<td>5,452</td>
<td>5,137</td>
</tr>
<tr>
<td>22. Credit Limit</td>
<td>$ 13,000</td>
<td>13,000</td>
<td>13,000</td>
</tr>
</tbody>
</table>
Borrowing Base Calculation

Second Lien Availability

- Variable from transaction to transaction, subject to terms of loan agreement
- Actual second lien advance rates follow Senior Debt methodology
  - Incremental availability on A/R, Inventory
- Equipment or fixed asset advance rates are off of net orderly liquidation value of M & E and fair market value of real estate
- Intellectual Property (i.e. trade names, brands) – generally on market value
- Enterprise Value – on the basis of an agreed value of the overall business
Borrowing Base Analysis

Calculate total availability

Reconcile to cash flow requirements
• If excessive availability exists, consider paydown on the line
• If ample availability exists, model the draw against the line
• If no availability exists, evaluate what payments to defer
• Usually, this is performed in one consolidated step

Evaluate and address model outcomes
• Can the terms and conditions of the facility be met?
• What timing issues exist and how can they be addressed?
• Where are the risks or sensitivities of the model?
• How much value is being derived from each lender tranche?
The Cash Collateral Order
Implementation of the 13-Week Cash Flow in Chapter 11
DIP Financing v. Cash Collateral

Benefits of Chapter 11
- The Automatic Stay
- New Liens
- Tying up loose ends
- Assets can be sold free and clear of liens, claims and encumbrances
- Ability to reject contracts

Authorization
- 11 U.S.C. § 364 authorizes DIP financing
- 11 U.S.C. § 363 authorizes the use of cash collateral

Purpose
- Post-petition funding of operations

Differences
- DIP Financing involves obtaining new credit to fund post-petition operations
- The use of cash collateral involves use of cash or cash equivalents to fund post-petition operations

Realities
DIP Financing

- Section 364 of the Code
- Unsecured credit in the ordinary course
- Unsecured credit outside the ordinary course
- Superpriority credit
- Secured credit
Cash Collateral

What is “cash collateral?” (11 U.S.C. § 363)

Cash collateral means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of the Code...
The Cash Collateral Order

• What is it?

• What is in it?
  – Provisions limiting challenges to pre-petition liens
  – Provisions granting replacement liens
  – Provisions granting superpriority claims
  – Provisions lifting the automatic stay
  – Provisions regarding the “carve-out”
  – Provisions barring third party financing
  – Provisions granting liens on avoidance actions
  – Provisions incorporating the 13 week cash flow/budget
  – What do the Local Rules say about it?
The 13 Week Cash Flow/Budget

- How much is going?
- What is it going to?
- When is it going?
- Where is it going?
- Why is it going?
- How much is needed?
- How long is it needed for?
- When is it projected to be paid back?
Specific Line Items

• Salaries
• Legal & Professional
• Utilities
• Miscellaneous
• Inventory Purchases
• Taxes
• Insurances
Thirteen Week Cash Flow
Sale of Company in Bankruptcy
Transaction & Exit

• An entity in bankruptcy can exit the process through:
  – Confirmation of a plan;
  – Chapter 11 or Chapter 7 liquidation;
  – A sale of some or substantially all assets through a Section 363 Sale;
  – A dismissal.

• For a number of reasons, a Section 363 sale may be the best alternative to exit bankruptcy.

• Note – Confirmation of a plan may provide greater protection to the buyer than a 363 sale.

• The TWCF is an important tool for tracking the operations of a business to an exit.
Transaction & Exit: Key Business Issues

Valuation
• Which is likely to yield the highest return to the estate;
  – Going Concern: with what cash level will it restructure/emerge?
  – Break-up: what is the cash burn of the business in a break-up?
  – Liquidation: how will the estate wind-down? What will the conversion strategy be?

Timing: Best captured in the TWCF
• Does the Company have the resources and time to execute?
  – Impact of DIP
  – Ongoing Business activity
  – Creditor treatment

Alternative Strategies: Is there enough cash?
• Confirmation of a Plan of Reorganization
• §363 Sale
• Conversion to Chapter 7
• Dismissal

Probability of success under each scenario
• The cash flows should provide a starting point for this analysis.
Transaction & Exit: Key Legal Issues

To confirm a §363 sale, the court must find:

• A sound business purpose
• Accurate and reasonable notice of the sale was provided;
• The price paid is “highest and best,” i.e., fair and reasonable;
• The sale was made in good faith and in the best interests of the estate.

Confirmation of a plan requires higher standard (1129(a))
Mechanics of a §363 Sale

Similar to a controlled auction

“Stalking horse” bidder establishes floor valuation and terms and conditions for sale.
  • Generally includes break-up fee and expense reimbursement to “Stalking horse.”
  • May also including minimum topping bid and bid increments.
Advantage of §363 to Buyer

• The Stalking Horse has the following advantages over the competition:
  – More control over the process and ability to dictate the terms of the deal, through drafting the asset purchase agreement;
  – More time for due diligence;
  – More time to obtain financing;
  – Expense reimbursement, minimum topping bid, minimum bid increments, and breakup fees provide the stalking horse with an economic advantage;
    • Note break-up fees, etc may be reduced or eliminated by the court.

• Executory contracts can be transferred notwithstanding anti-assignment clause, although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 disallows certain executory contracts from being transferred.

• Assets are purchased “free and clear” of most liabilities

• Upon receipt, the Stalking Horse bid should be integrated into the TWCF
  – Escrow Deposits
  – Expense Reimbursements
  – Disclosure of Potential Break-Up Fees
Advantage of §363 to Seller

• Speed and certainty of recovery

• The Stalking Horse should stimulate interest from other bidders and or establish a floor

• The process may limit director and officer liability related to the sale

• The process may also limit exposure of breaches of reps and warranties

• Most situations rely on the TWCF as a premise on which to pursue the sale process:
  – Costs of transaction marketing
  – Professional Expenses
  – Due diligence preparation
  – Gives the buyer and seller an estimate of the working capital account balances at the projected closing date
Additional Considerations in the Sale Process

Seller Considerations

• Re-trade – buyer may assert that value has diminished between bid and close
  – Working capital adjustments
  – Impairment of assets
  – Other Material Adverse Changes (“MAC”)

• Timing and value of payouts can influence “best transaction”
  – TWCF is a good tool for value and the best tool for timing issues
Additional Considerations in the Sale Process

Buyer Considerations

• Deal Costs
  – Attorney fees and professional fees may be greater than in a traditional auction.
  – Earnest Money Deposits—preferably in cash to prove *bona fides* of offer.
  – Cash is King: Having easy access to cash and/or financing makes bid more attractive.

• Tax Consequences
  – Built-in gains tax if asset basis post acquisition is less than the fair market value (i.e. discounted inventory).
  – Limitations on net operating loss utilization

• Other
  – Competition
    • Debt for equity swaps
    • Distressed debt buyers may have an advantage in the process through an ability to credit bid (face value of distressed debt)

Each deal cost, tax element or any other disbursement related to sale can be integrated into the TWCF model.
Cash Flows as a Proxy For Valuation

3 General Alternatives

• Capitalization
  – Price to EBITDA, Price to Book Value, etc.
  – TWCF can provide guidance to EBTIDA value

• Discounted Cash Flows
  – “Normalized” cash flows and terminal value discounted at the appropriate rate
    • Normalized means post bankruptcy, including expected growth
    • TWCF can serve as a starting point to build cash flows
  – Discount rate can use weighted average cost of capital or cost of equity

• Book Value
  – Price to net book value
  – Liquidation value
    • TWCF can assist in calculating the net liquidation value
Liquidation Analysis

Assumptions relating to assets and liabilities are made to determine the potential recovery by different classes of creditors

• Assets
  – Cash & Equivalents (generally 100%)
  – Tangible Assets
    • PP&E
    • Real Estate
    • Other
      • Accounts Receivable and Inventory
  – Intangible Assets

• Claims
  – Super priority, Administrative & Priority, Secured, Unsecured
  – Equity
  – Bondholders

• Waterfall will dictate the recovery by class

Note – expenses (operating, legal, maintenance, CAPEX) should be considered in determining the net to be distributed and might best be modeled in a TWCF format when executed.
Waterfall Analysis

The general concept of the waterfall analysis is to determine the allocation of the sale proceeds between the various classes of creditors in accordance with the priority rules.

Note: purchase price adjustments may have a significant impact on the allocation.

Note: The creditor’s committee, even if it is out of the money, may assert whatever leverage it can to obtain a portion of the sale proceeds that would otherwise go to senior creditors.
Questions?