DIVIDEND RECAPITALIZATION TRENDS

Seize Opportunity and Mitigate Risk Before the Window Closes

November 2017

ALVAREZ & MARSAL

Dividend recapitalizations can accelerate returns for equity investors. Current interest rates and loan terms make them especially attractive today, but that window of opportunity may be closing. Companies planning to pursue a dividend recap should act quickly, but only with the added confidence of having a solvency opinion.

CONTENTS

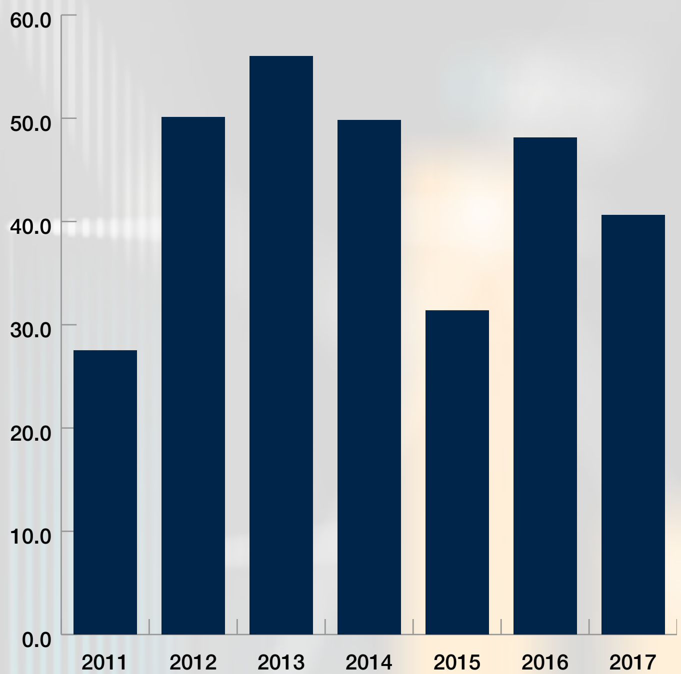
DIVIDEND RECAPS ON THE RISE

Dividend recapitalizations are once again on the rise. **This year's total leveraged loan volume related to dividend recap transactions is expected to surpass the post-financial crisis peak of $60 billion in 2013** (Exhibit 1). This latest uptick is fueled by a combination of historically low interest rates (Exhibit 2) – even in the high-yield market – and eager lenders seeking higher yields.

Dividend recaps give investors in private equity an opportunity to accelerate returns by creating liquidity through debt rather than the sale of equity. When interest rates are low and financing is easier to obtain, companies can generate cash while reducing their tax bill through interest deductions on any additional debt incurred to fund the dividend. They can also deliver tax-advantaged returns to investors in one strategic move. **The window of opportunity, however, may soon be closing as interest rates are expected to rise**, thereby increasing borrower expenses – including the cost of additional debt – and opening different prospects for lenders.

Exhibit 1

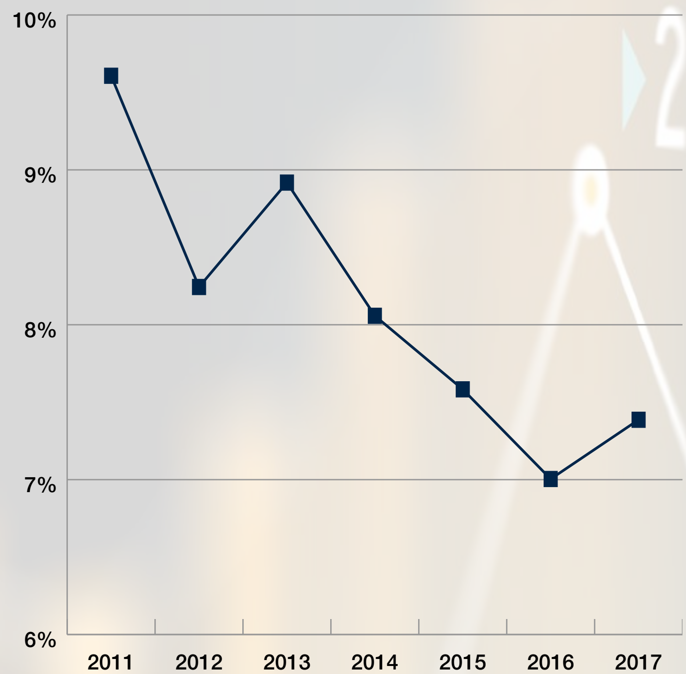
New/Refinancing* Leveraged Loan Volumes, 2011 – Q3 2017 ($Billions)



Data Sources: S&P Global Market Intelligence, Capital IQ
*Transactions include dividend recapitalizations.

Exhibit 2

Interest Rates for Unsecured Loans*, 2011 – Q3 2017

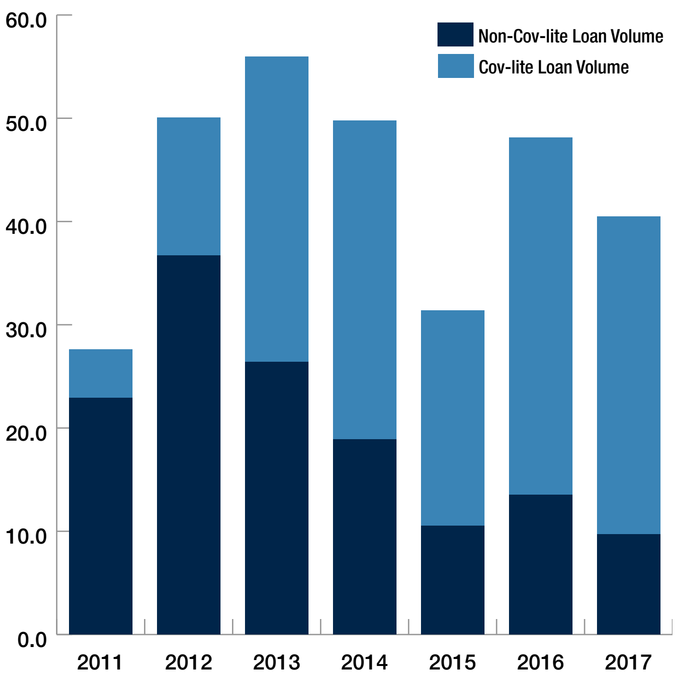


Data Sources: S&P Global Market Intelligence, Capital IQ
*Transactions include dividend recapitalizations.

Under current market conditions, lenders are chasing yield by issuing more covenant-lite (cov-lite) loans, which have fewer safeguards. Over the past six years, cov-lite loans have grown in popularity to comprise the bulk of leveraged dividend recap loan volume (Exhibit 3). **Already in 2017, cov-lite loans account for 74 percent of total leveraged dividend recap loan volume,** compared to only 27 percent just five years prior. Recent issues for B to B- rated firms that incorporate cov-lite financing include a first-lien term loan (average interest rate = L+325, 1% floor) and a second-lien term loan (average interest rate = L+650, 1% floor), both with 5-year maturities.

Exhibit 3

New/Refinancing* Cov-lite Loan Volume, 2011 – Q3 2017 ($Billions)



Data Sources: S&P Global Market Intelligence, Capital IQ
*Transactions include dividend recapitalizations.

The greater availability of cov-lite and other leveraged loans makes it easier for businesses to fund a dividend recap, but it also increases the overall risk for all parties, including lenders. If business owners, board members and lenders are fully informed about a company's solvency and pursue a dividend recap knowledgably, there can be great benefits for all. However, **understanding and mitigating risk is critical to avoid significant legal and financial consequences should there be a subsequent default.**

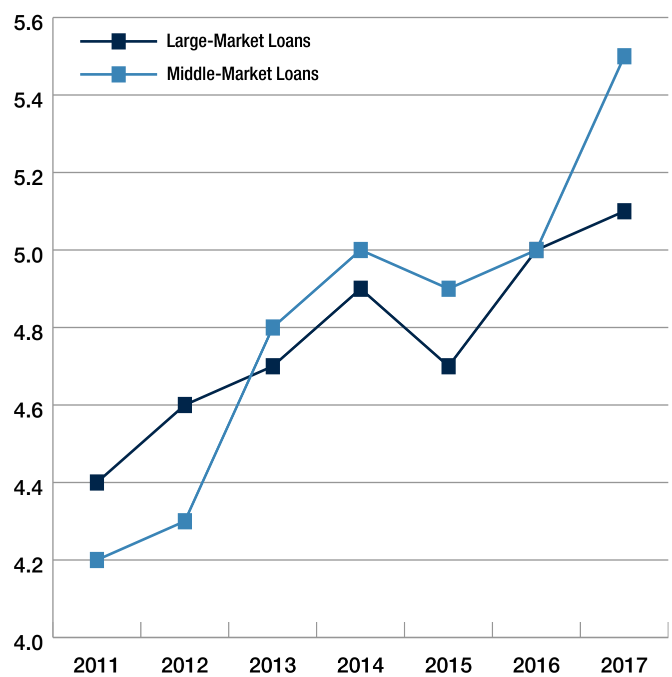
RISKS OF DIVIDEND RECAPITALIZATION

Dividend recapitalizations involve risk because a company incurs debt without receiving reasonably equivalent value. The transaction increases a company's debt service obligations while reducing financial flexibility, particularly in a downturn. If, at the time of the transaction and as a result thereof, the business is solvent and has access to sufficient capital to conduct its business and service its debt, there should be no issue. If it cannot meet these requirements, the financial and legal consequences could be significant and lead to unintended results.

Companies – particularly middle-market firms – are taking on an extremely high volume of debt compared to previous years (Exhibit 4). Since 2015, the average debt/EBITDA for middle-market loans has increased 0.6 turns of leverage. If companies are incurring this level of debt to pay dividends, it is especially critical for managers and board members to understand all potential risks.

Exhibit 4

Debt/EBITDA for Middle-* and Large-Market Loans, 2011 – Q3 2017



Data Sources: S&P Global Market Intelligence, Capital IQ
*Companies with EBITDA of $50 million or less.

If a company that implements a dividend recapitalization strategy is later required to restructure in or out of bankruptcy due to unmanageable debt or other business problems, **individual legal and financial consequences are certain**. Possible repercussions include the following:

- Under federal or state laws, the transaction could be determined to have been a constructive or intentional fraudulent conveyance
- Management and individual board members could be held responsible as participants in a constructive or intentional fraudulent conveyance
- Lenders could face severe repercussions, including disgorgement or loss of their collateral
- Investors could be required to return dividends, even years after receiving those funds

For a constructive fraudulent conveyance claim to succeed, a court must find that a company – either knowingly or through ignorance – was insolvent at the time or because of the transaction, or that the company failed other tests related to future capital needs and accessibility.

Fortunately, **there are steps management and board members can take to obtain assurance in acquiring full knowledge of their company's solvency** before pursuing a dividend recap.

MITIGATING DIVIDEND RECAP RISK

The primary candidates for dividend recapitalizations are companies that are backed by investors who are seeking a current return on investment. For companies in this category, there are two things managers and board members can do to mitigate risk before pursuing a dividend recap:

1. Objectively assess whether the company can support the new or incremental debt from a business and financial perspective
2. Obtain a third-party solvency opinion from an experienced, independent provider

To gauge whether a company is a good candidate for dividend recapitalization, consider the interests of its primary owners and the overall strength of the firm. If the primary business owners have significant wealth concentrated within the business and intend to maintain full ownership for the mid- to long-term, a dividend recapitalization may be a good option for generating liquidity. Furthermore, the overall financial and operational strength of the company must be considered as well. Look for:

- Total debt to EBITDA that is below average for the peer group
- Adjusted EBITDA capable of generating sustainable cash flow
- Strong track record of debt service and access to capital
- Demonstrated ability to weather economic and operational downturns
- Strong market positioning
- Experienced leadership

While this assessment is a good starting point, **the most important step to mitigating risk is obtaining a solvency opinion from an experienced, independent provider**. Legal counsel will typically recommend obtaining a solvency opinion to demonstrate a sufficient level of business capital and adequate cash flow to service total debt for the foreseeable future. In some cases, a solvency opinion from an independent provider may be a condition to consummating the transaction.

A solvency opinion involves a provider applying multiple tests that are required by U.S. bankruptcy law to determine if a company has the assets needed not only to satisfy its current and proposed debt obligations but also to provide some level of comfort in the event of an unexpected downturn. In performing its analysis, the procedures involved and used by the provider are not only process but also substance. Recent court cases emphasize the importance of these procedures.

In addition to other tests, the provider's analysis should include:

- A review of the company's projections and underlying assumptions
- A review of its stated and contingent liabilities, including maturities
- Stress testing of company projections under a downside scenario
- Review of the company's future capital needs and resources

Only upon satisfying these and other analytical reviews and procedures can a solvency opinion be issued.

While a solvency opinion cannot guarantee a business will avoid future distress or provide insurance to protect managers and board members, it can provide them information and a degree of assurance needed to make a knowledgeable and responsible decision regarding a dividend recapitalization. If a solvency opinion supports a dividend recap as a liquidity option, it can provide evidentiary support from liability to managers and board members in the event of a future bankruptcy or restructuring. In short, a relatively small investment in a solvency opinion upfront can help companies avoid much higher legal and advisory costs down the road.

CHOOSING A SOLVENCY OPINION PROVIDER

Solvency opinions for dividend recapitalization require extensive experience with that type of transaction, knowledge of U.S. bankruptcy law and applicable state law as well as an understanding of the industry in which the company operates. Additionally, because of the short timeframes in which solvency opinions are typically needed for dividend recaps, they require a team with enough resources to assemble quickly and dedicate their full attention to making a thorough assessment.

Alvarez & Marsal's Valuation Services practice has deep valuation expertise with a specialization in dividend recapitalization. Practice leaders have also provided solvency opinions for some of the largest leveraged buy-outs in history, including a multi-billion-dollar LBO for a transaction processing firm. With more than 50 offices and more than 3,000 professionals around the globe, A&M has expertise across industries and borders and the capability to respond quickly to any solvency opinion or valuation need.

Manage risk while managing returns.
Get a solvency opinion from A&M.

RELATED A&M INSIGHTS

[CASE STUDY: Part 1: Caesars' Liquidity and Solvency (February 2017)]

This is the first of a four-part series highlighting some of the key issues and findings of the Examiners report on Caesars Entertainment Operating Company, which filed for bankruptcy protection in January 2015.

[The 2013 Resurgence of the Dividend Recapitalization (November 2013)]

Anticipated changes in the U.S. tax code led to what many thought would be a short-lived spike in dividend recapitalizations in late 2012. Instead, dividend recapitalization activity surged again.

ABOUT THE AUTHORS

KIMBERLY RUSSELL
MANAGING DIRECTOR, VALUATION SERVICES
krussell@alvarezandmarsal.com
+1 212 763 1614

With more than 20 years of experience in valuation services, Ms. Russell has provided numerous solvency and other transaction-related opinions for classic mergers and acquisitions, leveraged buy-outs, dividend recapitalizations, stock repurchases and related party transactions. She has also provided solvency-related analyses in the context of bankruptcy proceedings and litigation support as well as some of the largest leveraged buy-outs in history.

COREY BLEIL
MANAGING DIRECTOR, VALUATION SERVICES
cbleil@alvarezandmarsal.com
+1 212 763 1884

Mr. Bleil has more than 15 years of experience providing financial advisory services in mergers and acquisitions, corporate finance and valuation across a broad range of industries including healthcare, industrial services, manufacturing and consumer. He has advised clients on transactions totaling over $10 billion in aggregate value and has extensive experience providing fairness opinions regarding change of control and related party transactions.

LEADERSHIP.
PROBLEM SOLVING.
VALUE CREATION.

Follow us on:

ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to make change and achieve results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services.

With over 3000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

When action matters, find us at: **www.alvarezandmarsal.com**

ALVAREZ & MARSAL