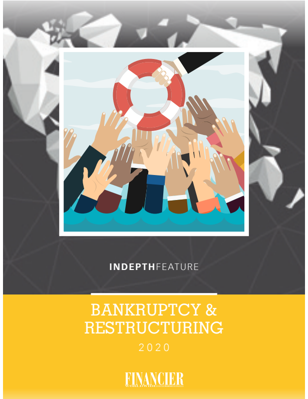

KUGMAN PARTNERS
RESTORING STABILITY. CREATING FUTURES.

Published by Financier Worldwide Ltd

INDEPTH FEATURE Reprint June 2020

BANKRUPTCY & RESTRUCTURING

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in bankruptcy & restructuring.

UNITED STATES

Kugman Partners

Respondents

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Q. Reflecting on the last 12-18 months, how would you characterise the US in terms of failing businesses and bankruptcy filings?

A: In the time period preceding the COVID-19 pandemic, the US economy was characterised by continued growth. Following the summer of 2019, the US economy entered its 10th year of expansion, the longest on record. As a result, bankruptcy filings continued their over 60 percent decline from 2009, the height of the Great Recession. Segments of the economy were, however, experiencing challenges, called 'micro recessions' by the US Federal Reserve. In 2019, agriculture, energy and retail experienced micro recessions, resulting in significant increases in bankruptcies in each segment year over year. The reasons varied, including tariffs, oil prices and technology, respectively. With COVID-19, the expectation is that the economy will enter a recession, the only question being how deep and how long, with a significant increase in business failures across the entire economic landscape. One estimate shows bankruptcy filings increasing nearly threefold by year end.

Q. Could you outline the primary macroeconomic trends currently affecting businesses? Are any particular sectors demonstrating structural weaknesses, resulting in distress?

A: In 2019, the US economy grew an estimated 2.3 percent, inflation was low, and the unemployment rate remained at historic low levels, finishing the year at 3.5 percent, all trends positively impacting the economic climate. The US government's ongoing trade war with China, however, had a material impact on manufacturers that relied on China as part of their supply chain. The impact varied by manufacturer and was largely dependent on the ability to pass along price increases. The automobile, technology and agriculture industries were those most affected. A non-macroeconomic trend, but one that is, however, affecting businesses, is climate change. The US continues to see companies reducing their carbon footprints, eliminating waste from their supply chains and focusing on the triple bottom line. Green private equity

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firms, debt funds and banking initiatives continue to push this societal agenda forward. Of the four primary economic sectors – agriculture, manufacturing, retail and services, brick and mortar retail and technology, specifically those companies employing software as a service (SaaS) models, are the ones that appear to be suffering structural weaknesses. In retail, the decline of brick and mortar is the result of the continued disintermediation from online retailing that has taken place over the last decade. 2019 saw retail bankruptcies in everything from sporting goods to furniture. Most recently, this also included luxury goods, as Neiman Marcus filed for bankruptcy. In technology, the proliferation of companies delivering SaaS has pressured customers to ruthlessly discriminate when considering software purchases.

Q. Have any recent restructuring trends or cases in the US captured your attention in particular?

A: Several high-profile bankruptcies highlighted an otherwise average year in 2019 and all are notable for the varied factors affecting companies in today's business environment. PG&E, the largest public utility in California, filed at the beginning of the year to shield itself from litigation associated with fatal forest fires for which it was responsible. Purdue Pharmaceuticals filed last summer as the result of lawsuits associated with the opioid epidemic. Sears filed again as strategic and operating missteps proved costly in the unforgiving retail environment. Taking a step back, 23,000 other US companies declared bankruptcy in 2019. And then there were the umpteen others that were distressed but able to take advantage of non-bankruptcy strategies. Sales under Article 9 of the Uniform Commercial Code is an example. These sales allow companies to avoid the cost and delays of the US bankruptcy court system, while often returning greater proceeds to creditors than otherwise would have been possible.

Q. How easy is it to renegotiate existing debt in the current market? Is there funding available to support distressed companies and finance restructurings?

A: Pre-COVID-19, the financial markets were flooded with liquidity. This was the culmination of the long gradual recovery from the Great Recession as well as the resultant increase in patient 'amend and extend' capital. As an example of the flood of liquidity, many PE firms expanded into debt markets and now play up and down the balance sheet. Liquidity drove pricing down and loosened structures significantly for both lenders and investors. And this liquidity was available for stressed, distressed and non-distressed companies. Post COVID-19, there is still liquidity available. Many lenders and investors had deployable cash on their balance sheets when the pandemic hit. But this cash will be deployed more opportunistically and perhaps more cautiously going forward, and only after portfolio assessments identify the cash needs of existing investments. Debt funds and PE firms are moving quickly in their portfolio assessments.

"Many lenders and investors had deployable cash on their balance sheets when the pandemic hit. But this cash will be deployed more opportunistically and perhaps more cautiously going forward."

Q. What trends are you seeing in the market's appetite to purchase troubled assets? How would you describe recent distressed M&A activity?

A: When considering the purchase of troubled assets, there are two categories:

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the purchase of troubled debt and the purchase of the troubled assets themselves. In both cases, despite recent trends, the fundamentals have stayed the same. The quality of the assets, the level of stress within the industry vertical, and the value of the assets within a purchaser's platform still drive market appetite. Pre-COVID-19, there was liquidity available for troubled assets if there was a fit along these three criteria. In many cases, the liquidity pushed realisations beyond what would be seen in a typical market and in what would be considered a very active market. Going forward, we expect realisations to fall as the level of scrutiny outweighs opportunistic purchases. We also expect to see a return to the post-2008 days when debt holders set up desks to sell their troubled notes.

Q. Could you outline some of the personal risks facing D&Os of a company that nears insolvency or enters bankruptcy in the US?

A: Regardless of region, we would argue that the same basic principles apply. In particular, the business judgment rule requires directors of a corporation to maintain a genuine interest in the affairs of the corporation which has been entrusted to its care. If directors faithfully execute their fiduciary responsibility of 'good faith, loyalty and due care', this dramatically lessens the potential for personal risk. More specifically, employee and tax issues are two areas we are acutely focused on as they carry personal risk for directors and officers (D&Os) in the US.

Q. How do you expect restructuring and bankruptcy activity in the US to unfold for the remainder of this year, and beyond?

A: We expect it to be a busy and demanding market. COVID-19 will have far-reaching and lasting impacts on the US economy. Given that at vaccine will not be available until 2021, the economic tail for this pandemic could be up to 24 months long. We expect the pace of restructuring and bankruptcy activity to slowly pick up in Q2 of this year, accelerate through the remainder of the year, and continue well into 2021. The immediacy of the impact can be divided into two groups: those companies for whom revenues fell immediately and those for whom they

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did not. For profit healthcare companies, for example, fall into the former group, as patient volume for many dropped dramatically in the initial weeks. The other group will include companies for which the impact was less pronounced, but which do not have unlimited borrowing capacity or will not be able to maintain covenant compliance when financial reporting requirements begin. For both groups, if 'amend and extend' is not a viable strategy this time around, their options may become more limited. ❑

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KUGMAN PARTNERS is a corporate advisory firm that specialises in restoring stability to middle-market companies. The firm provides financial and operational consulting aimed at the development of initiatives that improve performance and increase stakeholder value. Kugman Partners' comprehensive personalised solutions include capital investment, credit solutions and profit enhancement services. The firm is committed to improving its clients' financial position through innovative solutions grounded in solid strategy and unparalleled experience.

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