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# Capital Infusion Transactions: A Private Equity Playbook

May 14, 2020

# Introductions



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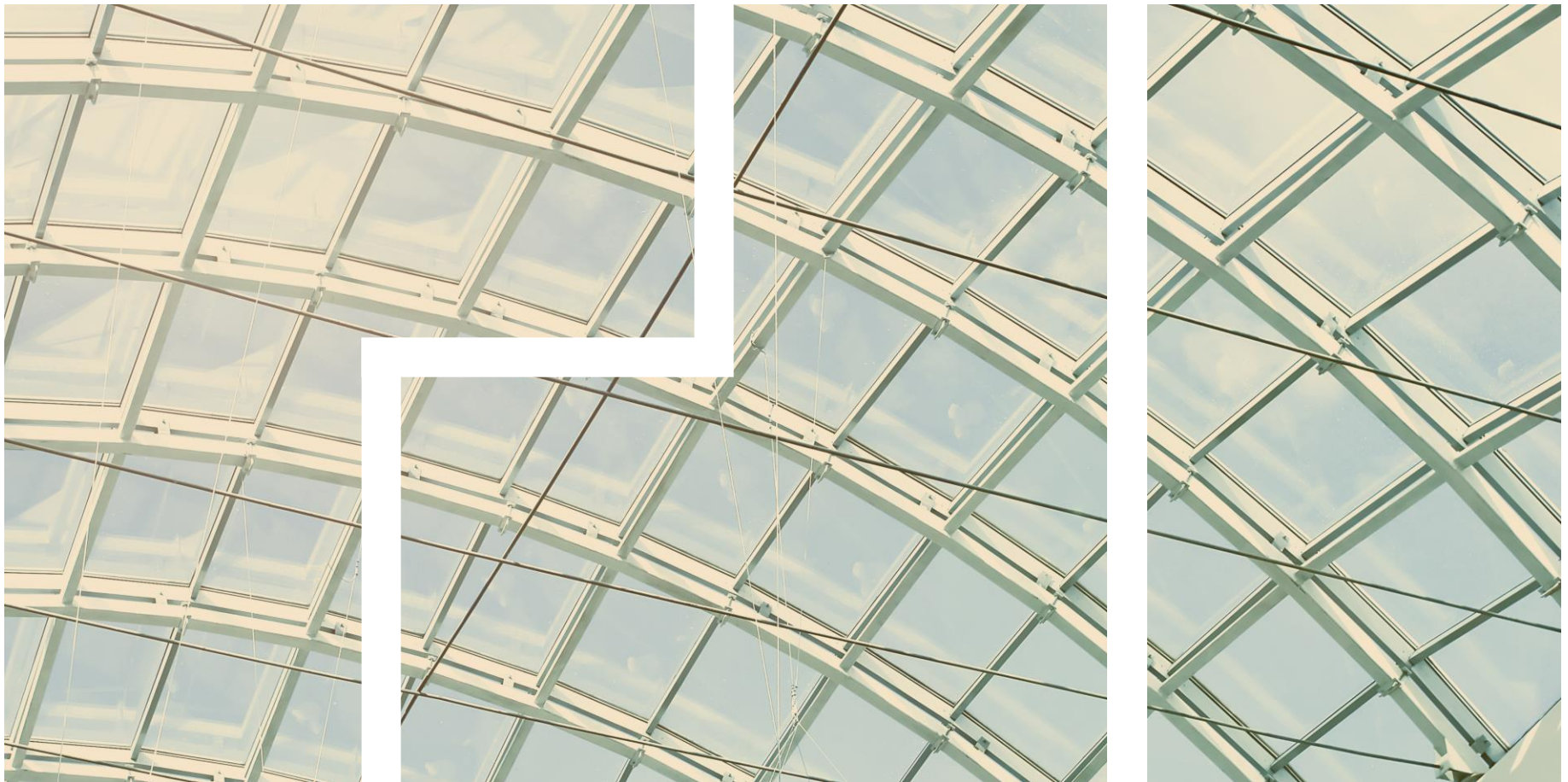
## Discussion Topics

## Capital Infusion Transactions

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# Current Market Conditions and COVID-19 Impact

## Section 1

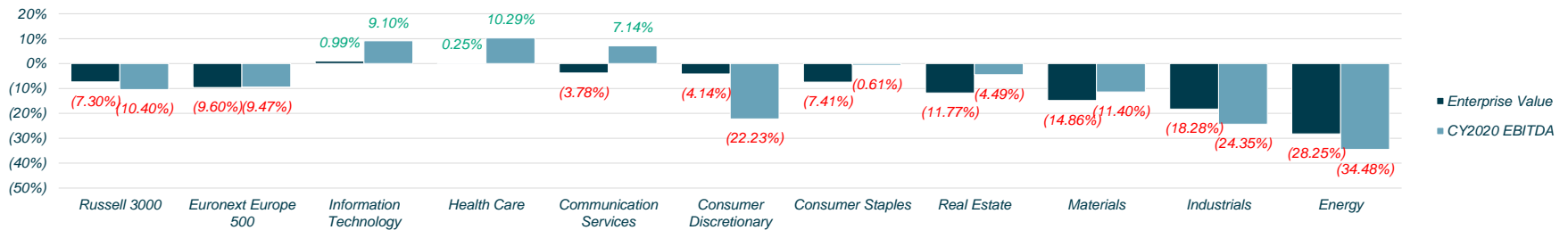


# COVID-19 Impact on Business Performance, Valuation and Leverage

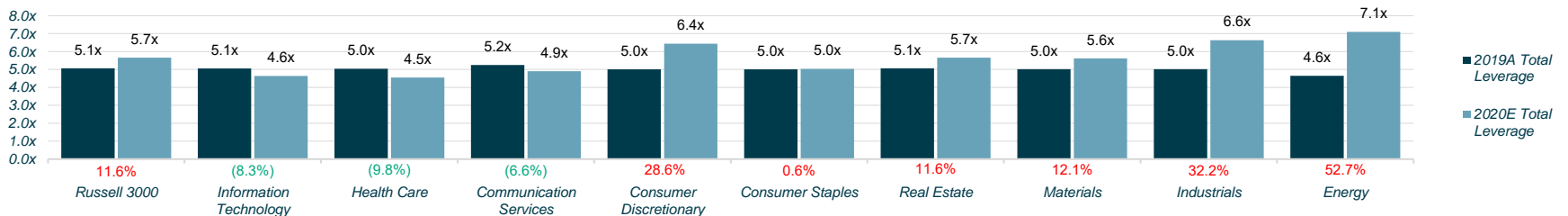
## 1. Primary COVID-19 Impacts on Business Performance

- Demand Disruption / Destruction
- Operations and Business Processes
- Strength and Continuity of Supply Chain
- Workforce / Workplace
- Finance
- Liquidity

## 2. Changes in Total Enterprise Value and CY2020 EBITDA Estimates (December 31, 2019 through May 7, 2020)



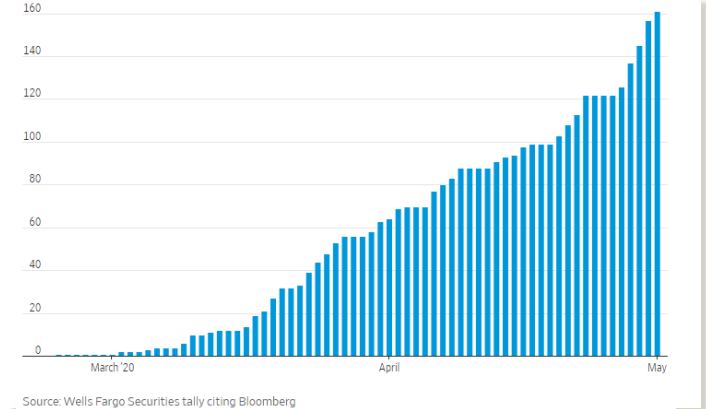
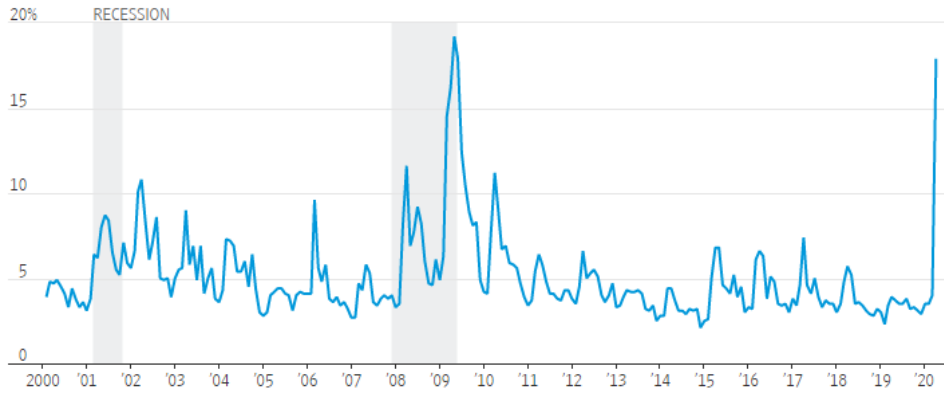
## 3. Using the Russell 3000 and its Industry Constituent Company Valuation and EBITDA Changes + Average PE Portfolio Leverage Profiles we illustrate pro forma leverage profiles for PE Owned Companies



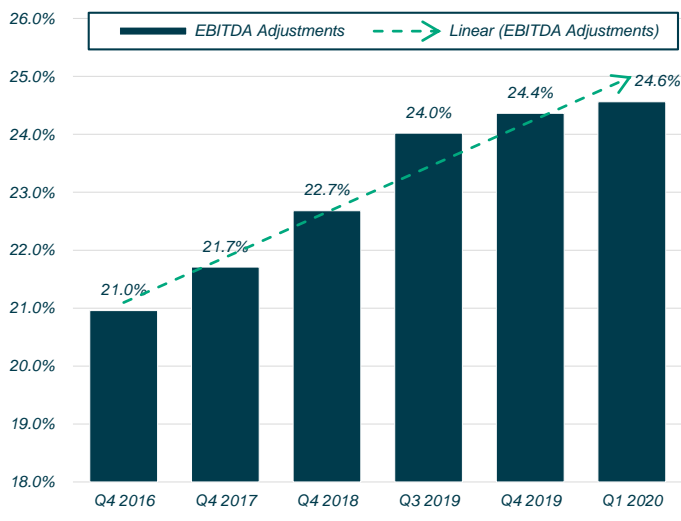
Source: Lincoln International Middle Market Database, S&P Capital IQ; Note: Industry-specific data sourced from consolidated Russell 3000 industry classifications

# Forecasting amid a pandemic is challenging

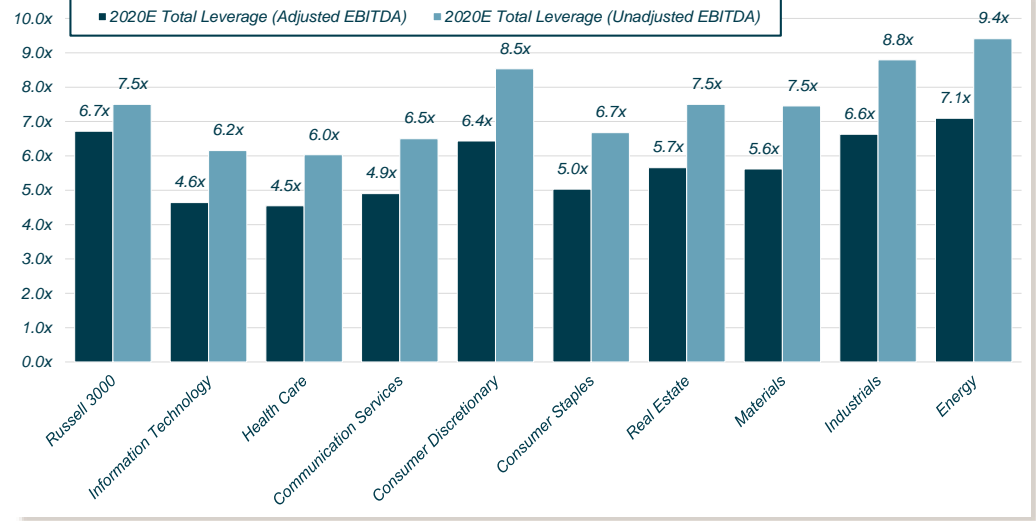
## 4) Wider Variance in S&P 500 Consensus Estimates and Withdrawn Earnings Guidance among S&P 500 Companies



## 5) EBITDA Adjustments as a % of Total EBITDA



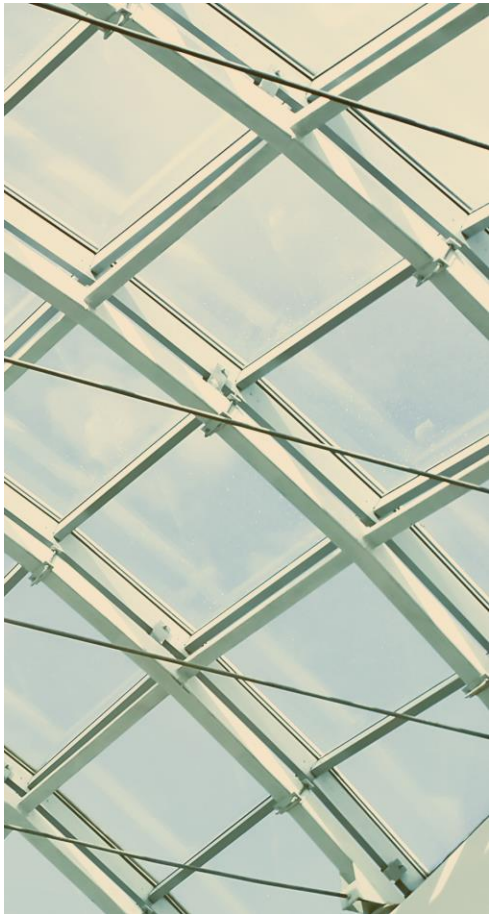
## 6) Illustrative 2020E Total Leverage Pre/Post EBITDA Adjustments



Sources: Lincoln International Middle Market Database, FactSet, BofA US Equity & Quant Strategy, Wall Street Journal, S&P Capital IQ

# Capital Market Observations

## Section 2



# Capital Markets Observations

*The Market is Open and Capital is Available, However...*

**1** | Determining Who is Open is Complex

**2** | Lenders are Facing Numerous Internal and External Challenges

**3** | The Balance of Power Has Shifted Back to the Lenders

**4** | Traditional Lenders are “Picking Their Spots”

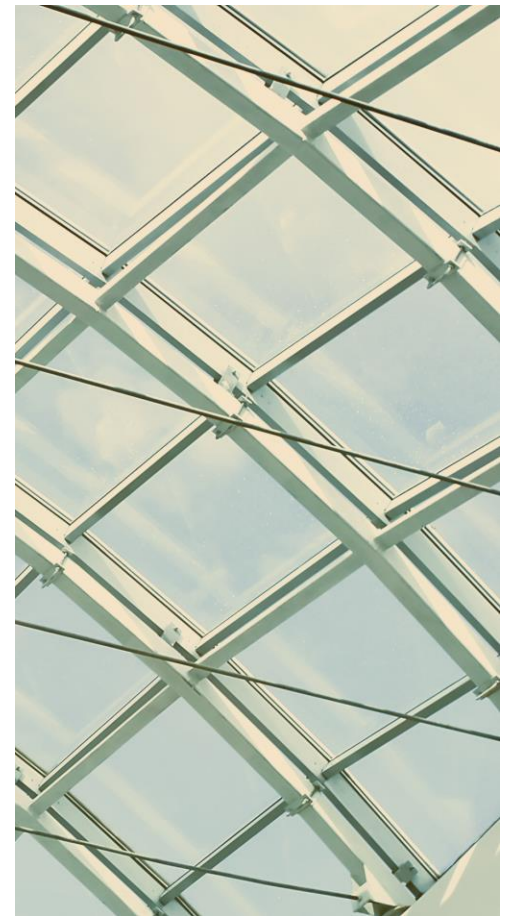
**5** | Where the Traditional Market Lacks Depth, Alternative Investors are Proliferating

**6** | Leverage is Down and Pricing is Up



# Third Party Capital Solutions

## Section 3



# Traditional Financing Market






*Over the last several weeks, Lincoln has priced four deals, generating substantial market insight*

In actively marketing these deals, Lincoln has interfaced with over 150 lenders across the below key buckets

Commercial Banks	Larger Private Debt Funds	Smaller Private Debt Funds	Mezzanine Funds
<ul style="list-style-type: none"> <li>▪ Generally faring well during the COVID-19 crisis and are open for business</li> <li>▪ However, currently distracted by federal CARES Act programs</li> <li>▪ Some anticipating significant transfers from commercial bank to ABL group</li> <li>▪ Particularly receptive to smaller cash flow deals, benefitting the lower middle market</li> <li>▪ ABL pricing is up significantly</li> </ul>	<ul style="list-style-type: none"> <li>▪ Remain focused on the relative value dislocation between the BSL market and the private debt market</li> <li>▪ Many are favoring liquid secondary loans in their hunt for yield</li> <li>▪ Those that remain active in the new issue market seek high yields from exceptionally clean credits</li> </ul>	<ul style="list-style-type: none"> <li>▪ Generally less active in the secondary market than their larger counterparts</li> <li>▪ Thus maintain greater focus on middle market new issues, but only for “pandemic-proof” businesses</li> <li>▪ Typically more relationship-oriented</li> </ul>	<ul style="list-style-type: none"> <li>▪ Do not utilize leverage and thus are well-positioned to weather the COVID-19 “storm”</li> <li>▪ Also taking an increasingly opportunistic approach, in parallel to other private debt funds</li> <li>▪ Have become more relevant in transactions that would have been all-senior prior to COVID</li> </ul>
<ul style="list-style-type: none"> <li>▪ Many of these private debt funds operate with leverage</li> <li>▪ Uncertainty associated with leverage lines could impact behavior and capacity to lend</li> </ul>			

# COVID-19 Impact on Key Terms

*Through hundreds of conversations with lenders in recent weeks, Lincoln has identified shifts across a range of key terms*

Terms	Illustrative Unitranche Deal	
	Pre-COVID	Post-COVID
 <b>Leverage</b>	6.0x total leverage	5.0x total leverage
 <b>Pricing</b>	L + 5.00% to 6.00%	L + 7.00% to 8.00%
 <b>OID</b>	1.50% to 2.00%	2.50% to 3.50%
 <b>Equity Cushion</b>	~30% to 40%	~40% to 50%
 <b>Prepayment Penalties</b>	102 / 101	*Substantially Higher*

For borrowers that require leverage beyond what can be achieved in the traditional market, there are a growing number of options in the alternative investor universe

# Filling the Gap

*For borrowers looking to access deeper leverage, two overlapping pockets of capital have emerged to “fill the gap” left by traditional financing providers*

## Structured Capital – Debt-Like Focus

- Credit opportunity funds that structure junior capital investments as debt-like securities
- Target a ~14% to ~18% IRR and a ~1.5x MOIC
- May or may not require warrants

## Structured Capital – Equity-Like Focus

- Growing subset of traditional private equity firms considering equity-like structured capital investments
- Target a ~16% to ~20% IRR and a ~1.5x to ~2.0x MOIC
- Capital typically in the form of preferred equity or minority equity
- If preferred equity, may include convertible option

## Relevant Situations



Accessing deeper leverage for acquisitions



Tougher refinancings



Companies with less predictable financial performance

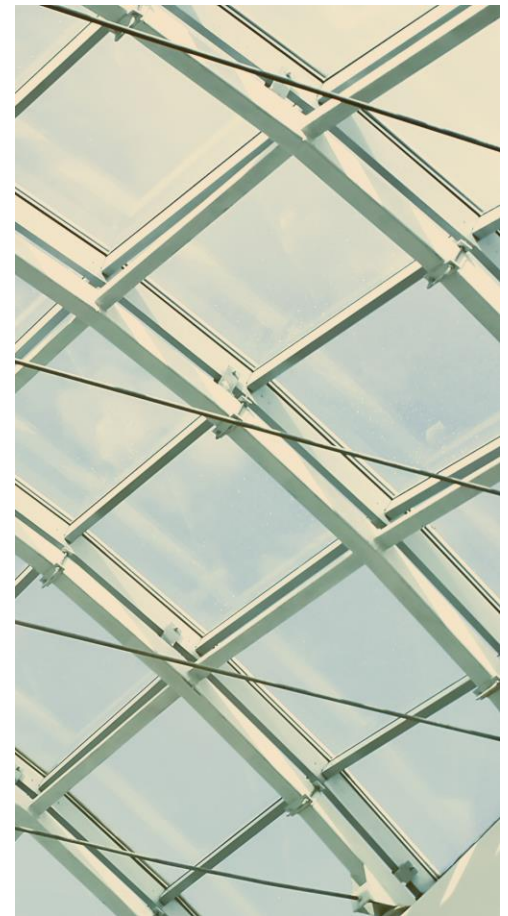
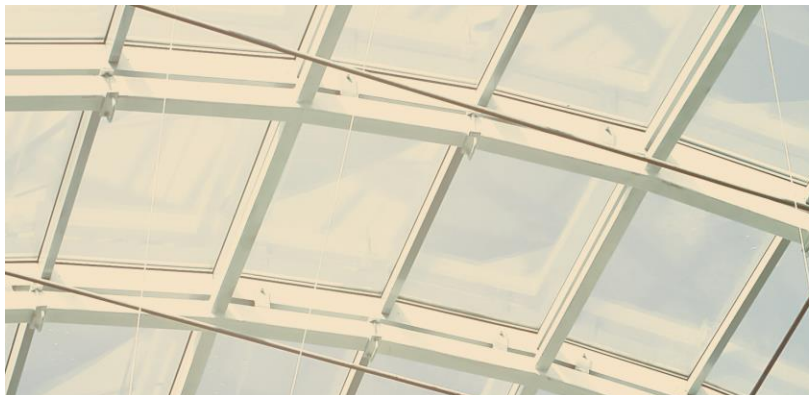


Near-term liquidity needs

The economic fallout from COVID-19 has accelerated market appetite for structured capital alternatives, which are being offered by a continually expanding investor base

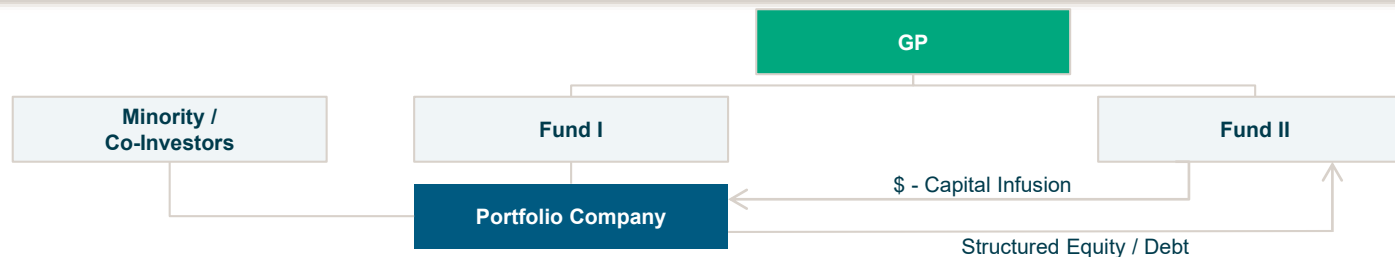
# Affiliate Party Capital Solutions

## Section 4



# Affiliate Party Capital Infusion Process

- As an alternative to a third-party funded capital infusion, portfolio companies may choose to raise capital from their private equity sponsor
  - Advantages include the avoidance of new stakeholders, the lack of information asymmetry, speed to close, ability to put capital to work in a challenging environment, and lower transaction costs
  - Drawbacks and challenges related to a cross-fund transaction include inherent conflicts of interest, dilution to the predecessor fund, potential misalignment of incentives, and exposure to regulatory scrutiny

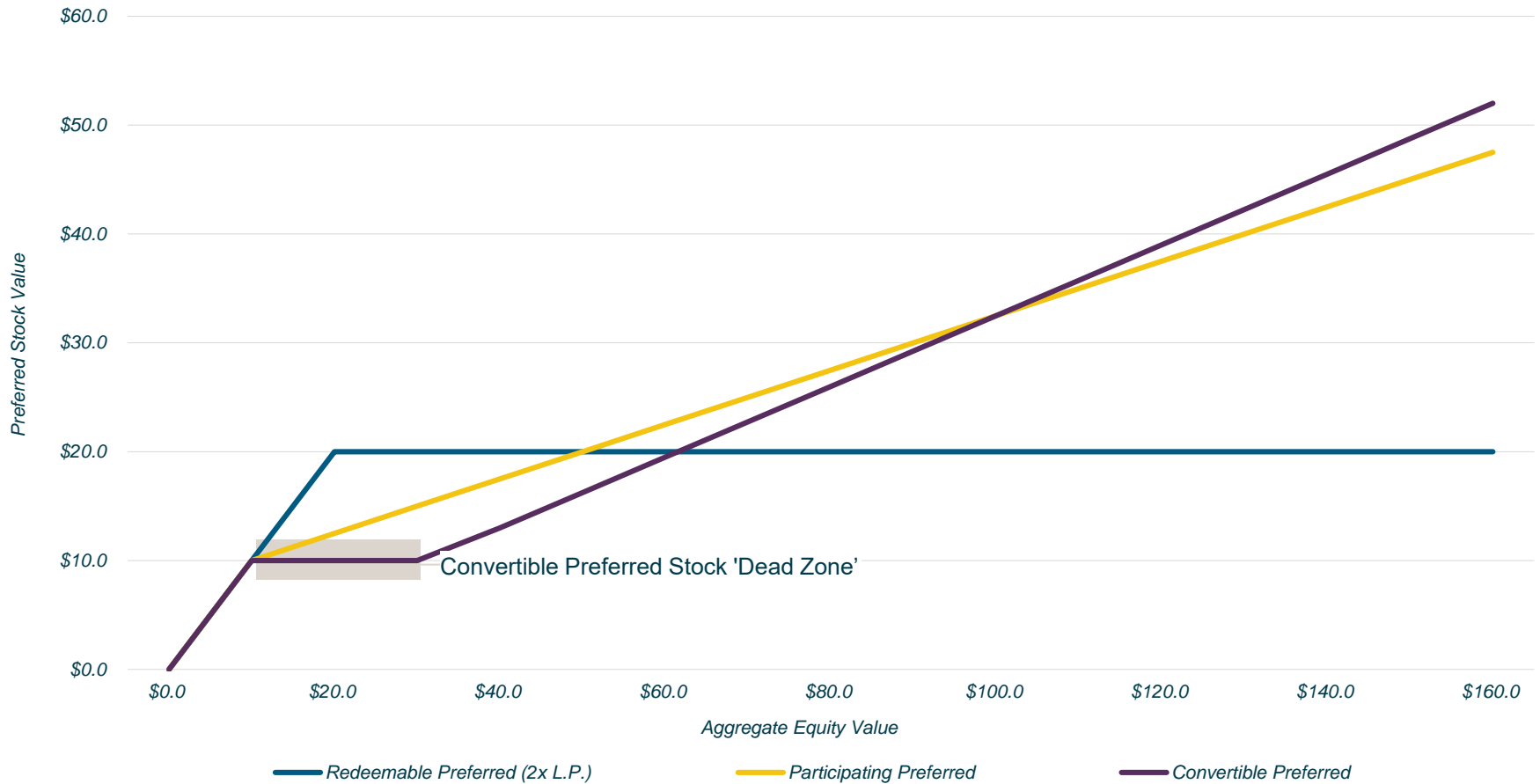


Communication with LPs	Structure Transaction	Fairness Opinion from Independent Financial Advisor
<ul style="list-style-type: none"> <li>Conflict waiver</li> <li>Transparency on rationale and situation</li> <li>Discuss process, including intent to involve an independent financial advisor (if any)</li> </ul>	<ul style="list-style-type: none"> <li>Determine quantum of capital required</li> <li>Select type of security and issuance mechanism (i.e. rights offering)</li> <li>Establish material economic deal terms that are fair to both funds:                             <ul style="list-style-type: none"> <li>Consider whether separate deal teams negotiating for each fund (rare)</li> <li>Based on GP analysis</li> <li>Input from Independent Financial Advisor</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>For the benefit of the GP as fiduciary and LPAC/LPs</li> <li>Mitigation of conflict of interest</li> <li>Engagement by GP on behalf of Funds/LPACs</li> <li>Often addresses fairness to both Funds (or Company)</li> <li>Delivered to GP/LPACs prior to signing</li> </ul>

# Form of Capital Considerations

	Security	Key Terms	Key Considerations
	<b>Participating Preferred Stock</b>	<ul style="list-style-type: none"> <li>Dividend Rate</li> <li>Accreting / Cash Pay</li> <li>Participation Rate</li> <li>Liquidation Preference (Typically 1.0x)</li> </ul>	<ul style="list-style-type: none"> <li>Downside protection</li> <li>Deleveraging transaction</li> <li>Favorable alignment of incentives</li> <li>Equity/hybrid treatment from creditors</li> <li>Capitalization table complexity</li> </ul>
	<b>Convertible Preferred Stock</b>	<ul style="list-style-type: none"> <li>Dividend Rate</li> <li>Accreting / Cash Pay</li> <li>Conversion Price</li> <li>Liquidation Preference (1.0x, 1.5x, 2.0x)</li> </ul>	<ul style="list-style-type: none"> <li>Downside protection</li> <li>Deleveraging transaction</li> <li>Payoff profile can result in less favorable alignment with common</li> <li>Equity/hybrid treatment from creditors</li> <li>Capitalization table complexity</li> </ul>
	<b>Redeemable Preferred Stock</b>	<ul style="list-style-type: none"> <li>Dividend Rate</li> <li>Voting Rights</li> <li>Call Protection</li> <li>Type (Cumulative, Exchangeable, Perpetual)</li> <li>Liquidation Preference (1.0x, 2.0x, 3.0x)</li> </ul>	<ul style="list-style-type: none"> <li>Downside protection</li> <li>Higher dividend versus a hybrid security</li> <li>Fixed return may make investor decision making easier</li> <li>Preferred return overhang may weigh on common value at exit</li> <li>Less aligned with common</li> <li>More debt-like treatment from creditors</li> </ul>
	<b>Subordinated Debt</b> or <b>Subordinated Debt + Detachable Warrants</b> or <b>Convertible Bonds</b>	<ul style="list-style-type: none"> <li>Unsecured and Subordinate</li> <li>Intercreditor Agreements</li> <li>OID</li> <li>Coupon</li> <li>Cash pay vs. PIK</li> <li>% of fully diluted ownership through warrants</li> </ul>	<ul style="list-style-type: none"> <li>Potentially more tax efficient</li> <li>Potential to credit bid in a Chapter 11 reorganization if they have an existing lien</li> <li>Ability to detach equity upside from fixed income</li> <li>Solvency impact of newly issued subordinated debt</li> <li>Governance complications due to sponsor owning equity and debt securities in same company</li> </ul>

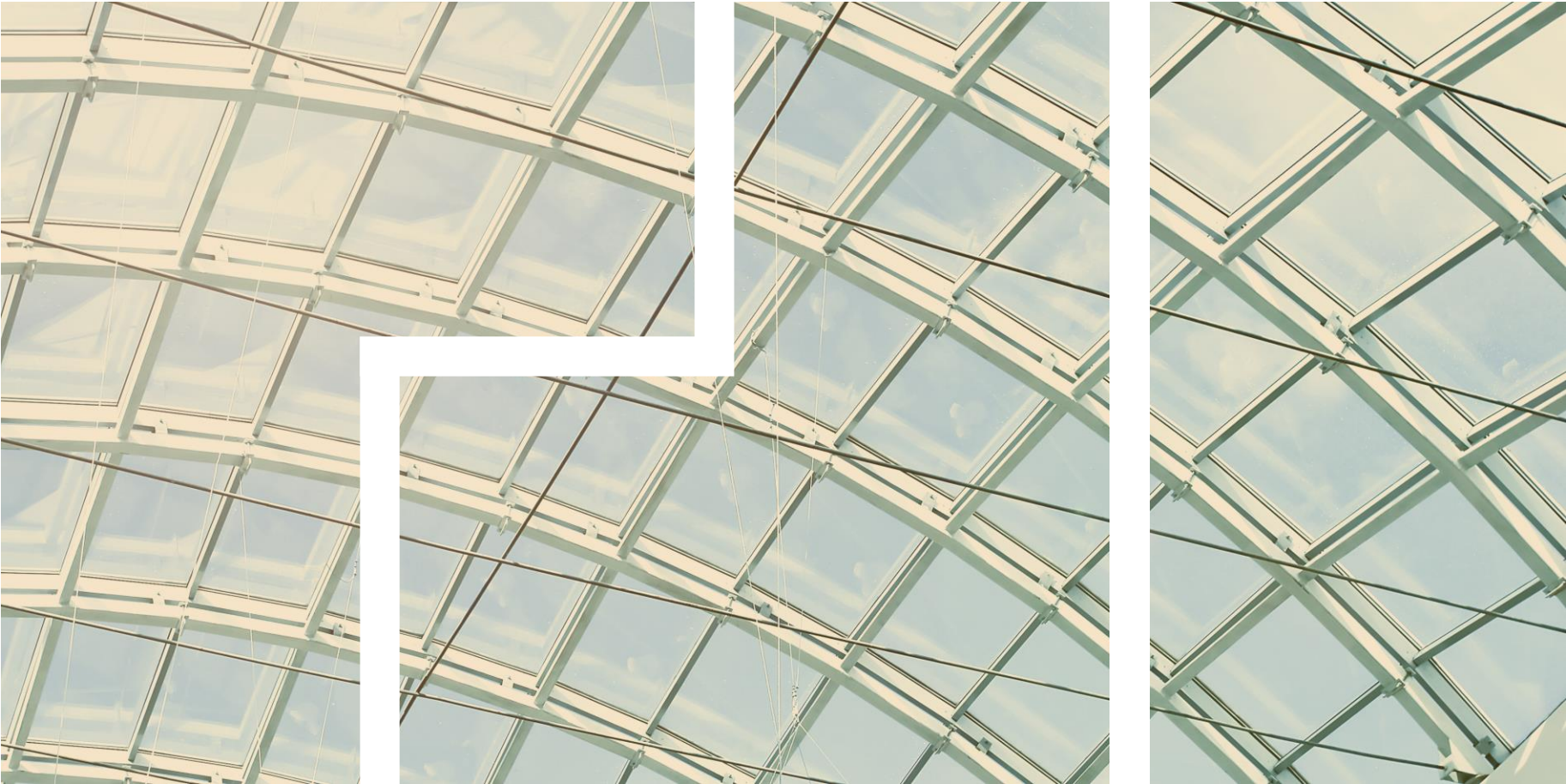
# Illustrative Payoff Diagram





# Corporate Governance Considerations

## Section 5



# Fiduciary Duties – General Overview

- Generally similar for both general partners and directors of a corporation
- Partnership agreements often waive these duties but include other contractual protective provisions instead
- RIAs have regulatory duties as well
  - General antifraud rule
- Duty of Care
- Duty of Loyalty
- Duty to Disclose / Duty of Candor

# Duty of Care – Process and Considerations

- **Directors/partners are required to carry out their responsibilities in good faith and in a manner they reasonably believe is in the corporation's/partnership's best interest**
- **When discharging duties must use the same prudence and care a reasonable person in like circumstances would use (“reasonably prudent person” standard)**
- **In considering a transaction, directors must:**
  - Do “homework” – request and review all material information reasonably available
  - Understand the terms of the transaction and the various transaction documents
  - Seek out and rely upon advice from management and outside experts (financial advisors, attorneys, accountants, etc.) as appropriate
  - Devote adequate time, consideration and deliberation to the matter
- **To fulfill the duty of care, directors must:**
  - Hold regular meetings and keep accurate minutes of such meetings
  - Discuss issues and business decisions collectively prior to taking action
  - Employ the necessary experts (financial advisors, attorneys, accountants, etc.) when required

# Duty of Loyalty – Interested Transactions

- **Directors/partners are required to act in what they believe to be the best interests of the corporation/partnership, and must not act in their own interests or in the interests of another person or organization**
- **Directors must avoid self-dealing and usurping corporate opportunities**
- **There is no prohibition on interested transactions, but in pursuing one the Board should consider:**
  - Disclosing that the transaction is an interested transaction
  - Seeking approval of the transaction by disinterested directors or stockholders
  - Having a “special” or “independent” Board committee consider the transaction and advise the Board as to whether it is fair to the corporation

# Duty to Disclose – Communication and Candor

- **Duty is implicated when the GP/Board seeks partner or shareholder action or approval**
- **When making disclosures:**
  - The Board must “disclose fully and fairly all material information within the board’s control”
  - Participating parties should make full disclosures regarding potential benefits and reasonably known risks of a particular action
- **Individual directors/partners have a duty of candor to the board/partnership, which requires the disclosure of information known to a director/partner that is relevant to the board’s/partnership’s decision making process**

# Distressed Companies

- Duties may extend to creditors as well as stockholders
- Directors may find tension between desire to “swing for the fences” (to increase shareholder value) and to reduce spending (to protect creditor value)
- Disclosure/R&W claims by new investors

# Key Practical Considerations

- **Determining value and Supporting documentation**
  - Effect of non-economic terms, such as voting/control rights
  - Affiliate transaction covenants in debt agreements
- **Negotiation process with minority holders**
  - Charter and fund documents
  - Separate legal and financial advisors?
  - Who has the right to approve?
- **Considering alternatives that may be more beneficial**
  - Does a process with third parties need to be run?

## Key Practical Considerations (continued)

- **Participation rights**

- Preemptive rights in governing documents
- Rights offerings to all investors

- **Fund conflicts**

- Policies, governing documents and regulatory compliance
- Information and personnel barriers
- Is second fund lead investor or just participating?

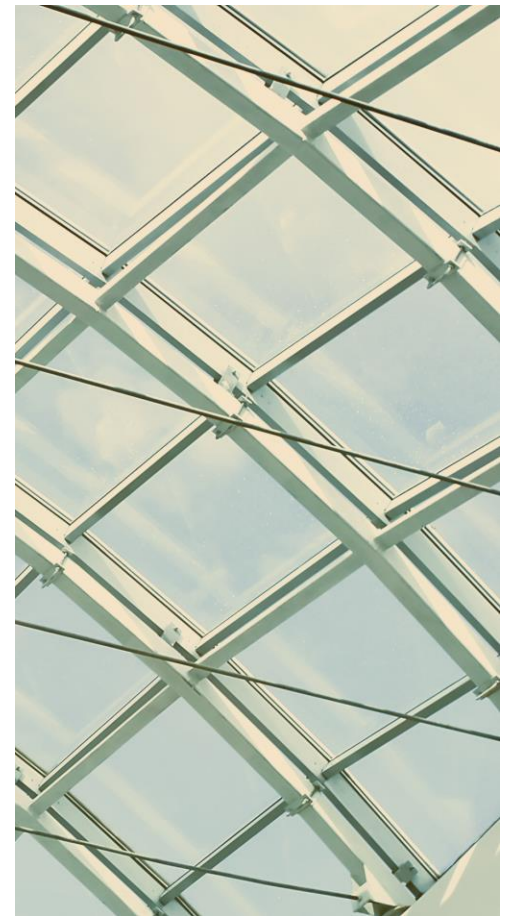
- **Disclosing, managing, and approving conflicts**

- Recusal of interested directors
- Minority stockholders
- Limited partners
- Fairness opinion from independent investment bank



# Fairness & Valuation Considerations

## Section 6



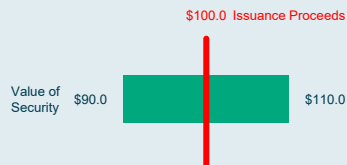
# Fairness & Valuation Considerations – Analytical Framework

## Illustrative Fairness Analysis for Capital Infusion Transactions (bifurcated approach)

1

### “Give” / “Gets” from Perspective of Issuer

- Value of New Security vs. Proceeds to Company
- “Mid-Point Deal” Preferable for Cross-Fund Transaction



2

### New Security Material Economic Terms

- Convertible Preferred Stock
  - ✓ 5% Dividend
  - ✓ \$100 million par value
  - ✓ 1.0x Liquidation Preference
  - ✓ Converts into 25% of fully-diluted common

3

### Determine Pre-Money TEV and Equity Value

- Income Approach
  - ✓ Discounted Cash Flow Analysis
- Market Approach
  - ✓ Selected Public Companies Analysis
  - ✓ M&A Transactions Analysis

4

### Value New Security - Fixed Income Portion

- Determine Market Yield (~15% - 20%)
- Determine Value of Convertible Preferred Stock (Excluding Conversion Option)
- Apply market yield to expected cash flow assuming no conversion
  - ✓ (~\$60 - \$70 million)

$$\text{PV Factor} = \frac{1}{(1+r)^n}$$

5

### Value New Security – Conversion Option Portion

- Determine Value of Conversion Option (Black-Scholes or other Option Pricing Model)
  - ✓ (~\$30 - \$40 million)

Note: Other hybrid security valuation methods including binomial lattice and Monte Carlo may be employed depending on the circumstance

6

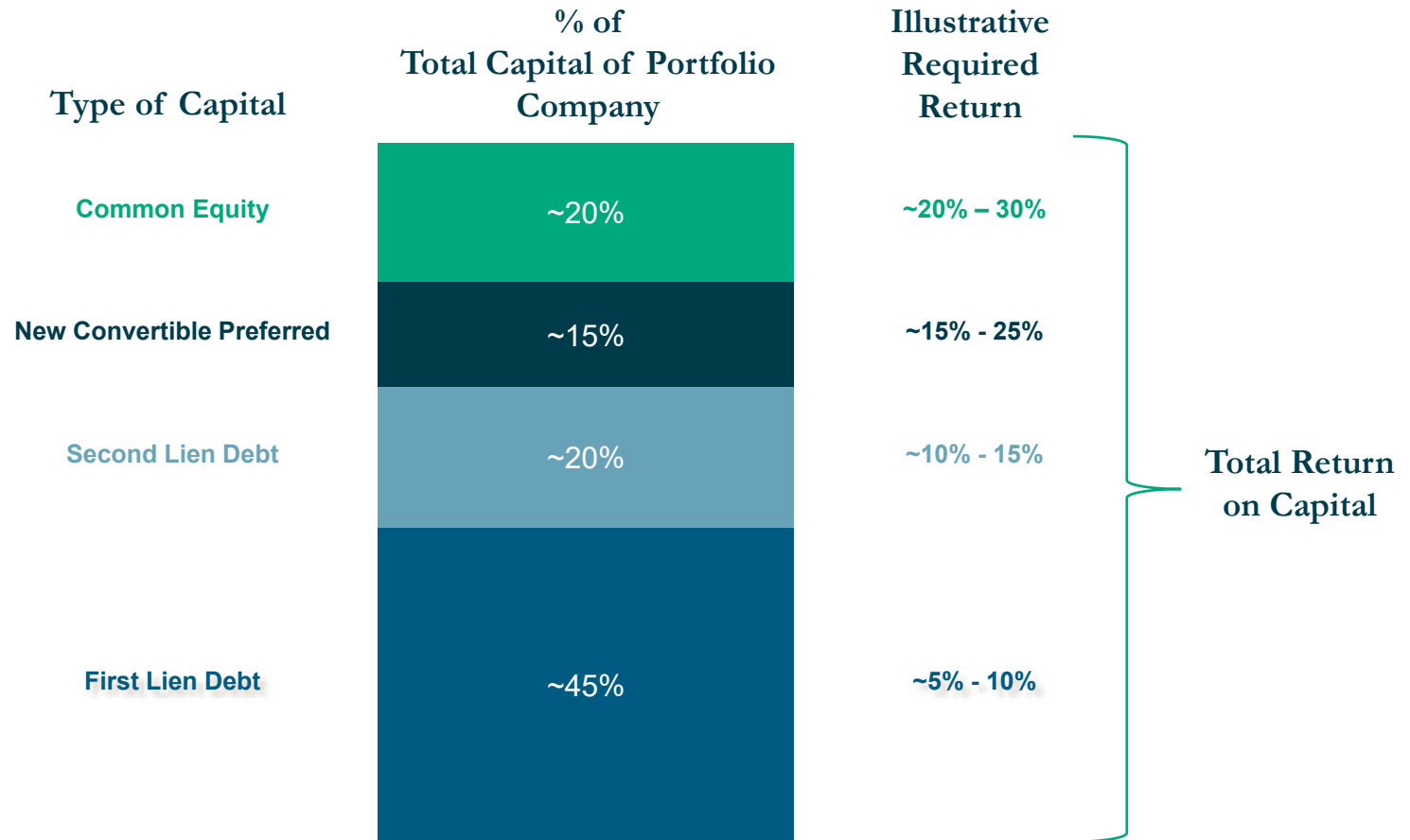
### Value New Security (continued)

- Total Value of Convertible Preferred Stock
  - ✓ Preferred (excl. Option): ~\$60 - \$70 million
  - ✓ Conversion Option: ~\$30 - \$40 million
  - ✓ Total: ~\$90 - \$110 million
- ✓ Proceeds to Company: \$100 million

*It is also important to understand the expected total yield on the security using an expected case forecast*

# Fairness & Valuation Considerations – Returns Analysis

The required return on new capital in an infusion transaction needs to correspond to its preference and attachment points in the capital stack



# Valuation Methodologies – Considerations amid pandemic

## Income Approach

### Discounted Cash Flow Analysis:

- Reliability of Management Projections
  - Duration of pandemic impact and shape of expected recovery curve
  - Return of demand for products and services
  - Multiple Scenarios (possibly probability weighted)
  - Deep dive on operating costs (labor, rent, vendors)
  - Net working capital (renormalization of A/R, inventory, A/P)
- Potentially lower long-term growth rates

### Discount Rate:

- CAPM - Risk free rate, beta, equity risk premium
- Higher risk and corresponding required returns (Debt and Equity)
- Target capital structure

## Market Approach

### Selected Public Companies Analysis:

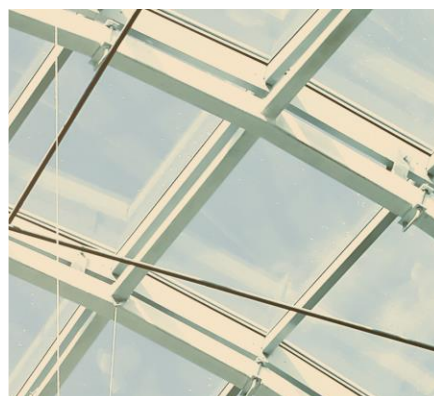
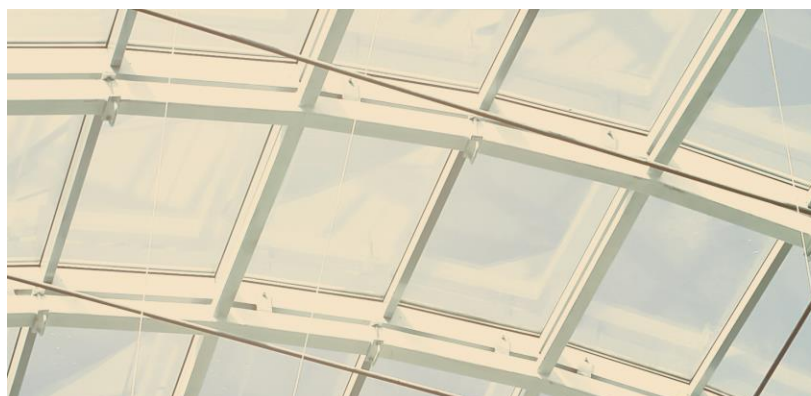
- Public Market:
  - Consider absolute declines in public company enterprise values and corresponding multiples
- Need to be mindful in use of LTM vs 2020E, NTM, NTM+1 financial metrics such as EBITDA
- Key is to have consistently COVID impacted (or adjusted) financial metrics (i.e. EBITDAC) for both comps and subject company
- Public company Financial Statistics:
  - Analyze financial performance/strength leading into and expected during pandemic
  - May consider market value of debt in calculating TEV

### Selected M&A Transactions Analysis:

- Less meaningful as recent M&A activity has ground to a halt
- Historical multiples are more challenging to apply in the current environment

Q&A

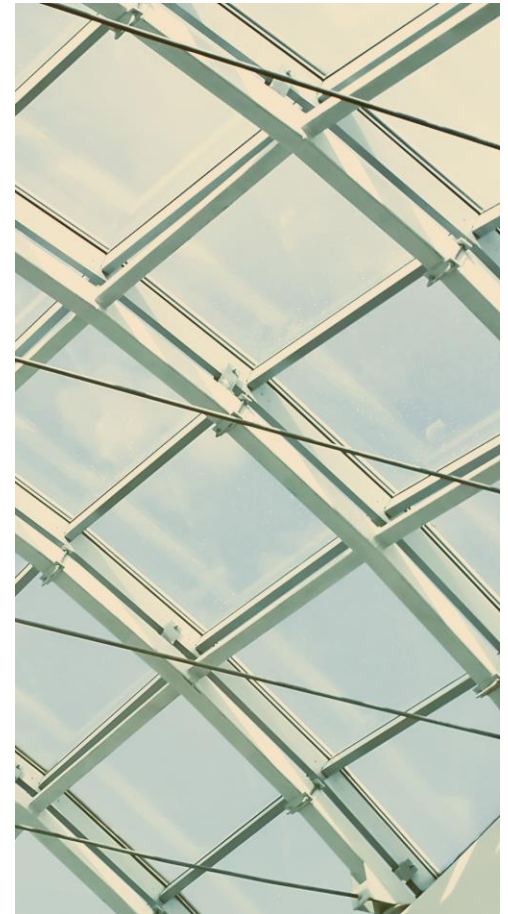
Section 7



**Any Questions?**

# Professional Biographies

## Section 8



# Professional Biographies



**Chris Gregory**

Managing Director



I enhance my clients' decision making and governance processes by providing independent and objective financial advice in a highly responsive manner.

Chris is a Managing Director in the New York office of Lincoln International and as a member of the firm's Valuations & Opinions Group, leads the Fairness and Solvency Opinion Practice. He has over 15 years of experience in advising companies and their boards in the areas of corporate finance, valuation and transaction fairness and solvency. Prior to joining Lincoln International, Chris was a Managing Director in Duff & Phelps' Transaction Opinions Practice which he joined in 2005.

Chris specializes in providing financial and valuation advice to corporate boards and private equity GPs and the execution of transaction opinions and board advisory valuations. He has executed over 175 fairness and/or solvency opinions in a variety of public and private company transactions, including take-privates, leveraged buyouts, asset sales, reverse mergers, tender offers, related-party transactions, spin-offs, capital raises, recapitalizations, and ESOP transactions. Chris has extensive experience providing fairness opinions and valuation advice in both GP-led secondary fund recapitalizations and other secondary transactions.

Chris holds a Master of Business Administration (with honors) in finance and accounting from the University of Chicago Booth School of Business. He also earned a Bachelor of Science in chemical engineering from the University of Illinois at Urbana-Champaign and practiced as an engineer with UOP, Nalco-Exxon, and Citgo Petroleum Corporation. Chris holds the Series 7 and Series 63 certifications. He is also a member of the American Society of Appraisers and the Association for Corporate Growth.



# Professional Biographies



**Alex Stevenson**

Managing Director



We attempt to pursue a consensual resolution to complex challenges while maintaining effective advocacy for our clients' interests.

For 22 years, Alex has advised companies, creditors and other stakeholders in varied distressed and special situations involving approximately \$80 billion of financial obligations. He has comprehensive experience in special situations driven by overall economic conditions, capital market trends, sector disruptions or situation-specific factors such as poor management, customer loss and commodity prices. He drives consensual resolution of these complex issues for his clients. In addition, Alex leverages extensive lender relationships to deliver strategic, bespoke financing alternatives for clients requiring structured or specialized financing solutions.

Alex has been instrumental in establishing and building Lincoln's relationships in the restructuring market both nationally and locally, and successfully raised both debt and equity capital to complete restructuring and other transactions. He has advised on distressed M&A, amendments, waivers, debt for equity conversions, plans of reorganization and other financial restructuring transactions and has extensive experience executing transactions through the Chapter 11 process.

His has represented public and private companies, hedge funds, lender groups, ad hoc committees, official committees and buyers of distressed assets. Selected clients have included Vince, Hobbico, Kraco, AT Cross, Katy Industries, Dream Center Foundation, Vestis Retail Group, Eastern Outfitters, Hancock Fabrics, Constar, Insight Imaging, LandSource, Fleetwood Industries, Nurseryman's Exchange, Fuddruckers, FullerBrush, Gateway Container Leasing Corporation, Winn Dixie Stores, Byucksan Corporation, Flow International and Pillowtex.

Alex is a member of the Turnaround Management Association and American Bankruptcy Institute. He is a frequent speaker on restructuring and Chapter 11 topics.

Prior to joining Lincoln, Alex led the restructuring and special situations practice of FocalPoint Securities. Previously, he was a senior member of the restructuring practice at Ernst & Young Corporate Finance.

Alex holds a Bachelor of Arts from Michigan State University where he graduated cum laude.

# Professional Biographies



## Steven Stokdyk

Partner and Former Global Co-Chair of the Firm's Public Company Representation Practice, Latham & Watkins

Steven Stokdyk, a leading corporate lawyer, advises companies, principal investors, and investment banks on their most complex securities, finance, acquisition, and governance matters. He is the former Global Co-Chair of the firm's Public Company Representation Practice and Local Chair of the Corporate Department.

Mr. Stokdyk has extensive experience with strategic transactions, including:

- Mergers and acquisitions (M&A)
- Initial public offerings (IPOs)
- High-yield, convertible, and secured debt offerings
- Recapitalizations
- Private equity and debt investments

He also regularly advises public and private clients on corporate governance and structure, as well as securities law compliance.

Mr. Stokdyk draws on nearly three decades of experience representing clients in a wide range of industries, including technology, financial institutions, healthcare, gaming, and real estate.