Leveraged Recapitalization

Cheap Debt + Reasonably Priced Equities + Possible Sunset on Favorable Dividend Tax Rate = Leveraged Recapitalization

- We believe that the increased leverage – due to leveraged recapitalization – offers multiple benefits to companies and their shareholders. A leveraged recapitalization (recap) is when a corporation (public or private) turns to the debt markets to issue bonds and uses the proceeds to buy back shares or distribute equity dividends to investors. The increased leverage results in higher value for all shareholders as it magnifies operating returns, and therefore can benefit an enterprise in the following ways: 1) improve future cash flows for re-investment in the company’s growth; 2) boost near term earnings growth & ROE; and 3) create new equity based incentives for management to improve operational performance.

- We believe that the ideal companies for such transactions operate in mature, non-cyclical industries, which have gone past their perceived valuation peak in the eyes of public investors. Therefore, we believe that firms operating in the energy, utility and industrial sectors make for the most suitable candidates for such transactions. Further, we believe that recaps are a very good source of funding for private companies with significant PP&E that can be borrowed against – 1) it acts as a source of diversification for owners that want to spread their risk; 2) provides a viable route for owners that want to exit the company, while allowing the remaining shareholders to maintain their respective holding; and 3) it improves access to capital through financial sponsors such as private equity firms.

- We believe that recaps are able to positively influence investor perception of growth opportunities for a company and the management’s potential to employ the assets efficiently. Firms that engaged in a leveraged recap in the second half of 1980’s – mainly to ward off hostile takeovers – were able to improve value for shareholders by improving efficiency which resulted in improved stock prices and valuation of the companies. Sealed Air Corporation (SEE) is an academic case study that we discuss, as they conducted a recap and from it were able to generate a higher return for investors.

- We believe that current market conditions – cheap debt, a healthy market appetite for debt, reasonably priced equity and a temporarily lowered dividend tax rate -- render this the perfect time to consider a leveraged recapitalization. The bond markets are liquid and demand is plentiful, even though interest rates are at anemic levels, due to investors looking for safe investments opportunities in highly volatile market. This provides a strong opportunity for both investment grade and high yield corporate bonds to find buyers -- swapping cheap debt capital out for equity. We believe that favorable bond market conditions, combined with fair equity valuations, and the risk of a sunset on favorable dividend and capital gains tax rates, make 2012 an attractive year to consider a leverage recapitalization.
Leveraged Recapitalization

What is Leveraged Recapitalization?

- A leveraged recapitalization (recap) is when a corporation (public or private) turns to the debt markets to issue bonds and uses the proceeds to buy back shares or distribute equity dividends to investors. While turning to debts markets may seem counterproductive, a company’s decision to repay debt, buy company stock, or reward investors from proceeds gained by debt instead of using earned profits may be driven by a number of incentives, both macroeconomic as well micro (internal company developments). One of the biggest macroeconomic drivers of such transactions are low interest rates on borrowing capital – such an economic environment makes debt cheaper than equity, thus making leveraged recapitalization a viable option for companies. At a micro level, the decision to opt for debt may also be driven by a company’s need to balance its leverage and improve its operational efficiency. Incorporating debt onto a balance sheet requires financial discipline even more rigorous than instituting a dividend because ongoing payments have to be made to debt holders consistently.

![Chart 1. Too Little Leverage vs. Too Much Leverage](image)

**Too Little Leverage**
- Waste of resources within the organization
- Inefficiency
- Too much scrap, capital expenditure
- R&D

**Too Much Leverage**
- Push to generate cash at expense of value
- Too little inventory
- Not enough credit for customers
- Skimping on capital expenditure & R&D

Sources: Scura Paley, Ian H. Giddy - Corporate Financial Restructuring

How and why should it be done?

- Leveraged recapitalization transactions can be carried out in two ways – 1) leveraged cashouts; & 2) leveraged share repurchases.
  - **Leveraged Cashouts (LCO):** In these transactions, companies pay a debt-financed special dividend to their shareholders. Additionally, existing shareholders also receive a “stub” – a stock certificate that represents ownership in the restructured company, and is publicly traded. As opposed to the existing stocks on the company, stub equity attracts long-term investors that are focused on the stub’s higher rate of return (read *cash-flow*) than on earning per share. LCO transactions also allow management team members to increase their and/or employees’ equity holdings instead of receiving the cash payout. The additional equity acts as an incentive to enhance productivity and improve performance, since new investors strongly favor linking rewards to performance.
Leveraged Share Repurchases (LSR): These involve the repurchase of a significant amount of its common stock by the company, in a transaction that is financed with bank and/or high-yield debt. As with LCOs, LSRs also replace outside equity with debt, thereby increasing the financial leverage of the firm. Once the company is able to improve its operating performance and earn a return on its operating assets greater than the after-tax cost of debt, LSRs lead to higher earnings per share since the number of outstanding shares reduces after the transaction.

We believe that the increased leverage – due to leveraged recapitalization – offers multiple benefits to companies and their shareholders (both existing and new). By undertaking a leveraged recapitalization, a firm can significantly increase its financial leverage and reduce its publicly traded equity. By increasing debt as opposed to equity, companies can avoid diluting the ownership of existing shareholders, and also reduce the chances that majority shareholders might attempt to shake up operations somehow. Further, the increased leverage also results in higher value for all shareholders as it magnifies operating returns, and therefore benefits in the following ways: 1) monetizing future cash flows and returning that money to shareholders to reinvest; 2) boosting the firm’s near term earnings growth rate and its return on equity; and 3) creating new equity based incentives for management. The tax shields associated with the interest expense of the additional debt used to finance the transactions are an additional source of value.

While the structure of leveraged recapitalization transactions is similar to that employed in leveraged buyouts (LBOs), we believe that recap transactions offer distinct benefits over LBOs. The key benefits include:

- Leveraged recapitalization transactions do not require public companies to go private again, thereby, helping them avoid legal and other associated challenges that accompany an LBO transaction. For public companies, this also means easier access to capital markets and funds, whereas private companies continue to be exempt from the SEC’s reporting requirements for public companies, which consumes time and monetary resources.
- Recaps have lower potential for costly disagreements among stockholders since shareholders are allowed to sell their holdings, if they disagree with corporate policies. On the other hand, the reduced marketability of nonpublic shares allows LBO investors to impose costs on managers by forcing them to hold poorly diversified and/or illiquid portfolios.

<table>
<thead>
<tr>
<th>Chart 2. Leveraged Recapitalizations (LRC) vs. Leveraged Buyouts (LBO) – Based on # Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Changes in Top Management</strong></td>
</tr>
<tr>
<td>LRCs</td>
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<td>Low prior mgmt equity LBOs</td>
</tr>
<tr>
<td>High prior mgmt equity LBOs</td>
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<tr>
<td><strong>Firm’s Status Post the Transaction</strong></td>
</tr>
<tr>
<td>Public</td>
</tr>
<tr>
<td>Acquired</td>
</tr>
<tr>
<td>Private</td>
</tr>
<tr>
<td>Liquidated</td>
</tr>
</tbody>
</table>

Sources: Scura Paley, Why firms engaged in a levered recapitalization rather than a levered buyout – analysis of sample of LRCs and LBOs from 1985 through 1989 done by Paul Halpern & Robert Kieschnick. Low prior managerial equity LBOs - management possessed less than 33% of the target firm’s equity prior to the buyout. High prior managerial equity LBOs - management possessed more than 33% of the target firm’s equity prior to the buyout.
Who should do it?

- We believe that the ideal companies for such transactions operate in mature, non-cyclical industries, with the method of recapitalization depending on perceived valuation. Leveraged recap transactions are most useful for well managed and profitable companies which operate in mature, slow growth, non-technology-based industries but are unable to boost their share prices because of the maturity of the industry and their own size. Further, recap investors prefer companies that have a history of steady and predictable cash flows that do not require substantial ongoing capital expenditures to remain competitive in the market, and have low levels of existing debt on their balance sheets. Therefore, we believe that firms operating in the energy, utility and industrial sectors make for the most suitable candidates for such transactions. LCOs and LSRs can both be structured to increase or decrease insiders’ equity ownership depending on perceived value and personal liquidity desires.

**Chart 3. Characteristics of a Good Leveraged Recapitalization Companies**

- Demonstrated history of positive cash flows
- Lack of pre existing bank debt
- Operating in mature, non-cyclical industries
- Evidence of a strong management team
- A defensible market position and well diversified customer base
- Ability to increase market share through acquisitions
- Realizable future growth plans
- Positive market dynamics

Sources: Scura Paley

**Chart 4. Sector-Level Forward 12-Month P/E Ratios – April 2012**

[Graph showing sector-level P/E ratios]

Sources: Scura Paley, Factset
Further, the benefits of leveraged recapitalization are not limited to public companies only—we believe that recap is a useful source of funding and value creation for private companies and their owners as well. Mature private companies typically face the following issues—1) majority of the owner’s net worth is tied-up in only one asset, i.e., the company; 2) one or more owners want to retire, but there is no succession plan; 3) fellow shareholders have different personal objectives, such as reinvestment for growth; and 4) attracting growth capital is difficult and also results in dilution of owners’ equity. We believe that a recap, which can be effected in 60-90 days, is the ideal mode of raising funds for such companies, since it addresses all of the above concerns that a private company owner may have:

- It acts as a source of diversification for owners that want to spread their risk and generate liquidity for personal expenses.
- It provides a viable route for owners that want to exit the company, while allowing the remaining shareholders to maintain their respective holding, and provides the company with refinancing without a total sale of the company.
- Private companies can also choose to involve financial sponsors (e.g. private equity firms), when the debt issued by the company is not sufficient to meet its capital requirement. Financial sponsors that participate in such a transaction by purchasing existing or newly issued shares, bring in strategic expertise and access to funds required by the company. Sponsors not only contribute funds themselves, but also help the company raise more funds through their strong network in the banking and high yield communities.
- These deals are more flexible than LBOs, and sponsors usually defer to existing management for operational and strategic matters, even if they gain a majority share in the company. Also, some financial partners may allow the remaining management team members to gradually re-earn their equity shares based on the company’s performance. These factors act as a growth driver for the management to improve the performance of the company and take it to the next level, thus providing greater value to the business owner than if 100% of the company was sold initially.

Historical Evidence of Value Created by Leveraged Recapitalization

- Empirical evidence suggests that recaps are able to positively influence investor perception of growth opportunities for a company and the management’s potential to employ the assets efficiently. In the latter half of the 1980s, leveraged recapitalizations emerged as a popular tool deployed by U.S. companies to ward off potential hostile takeovers as the increased financial leverage obtained through a recap acted as a deterrent for corporates looking to acquire other companies. Management of incumbent organizations had to convince shareholders of their own recapitalization plans as opposed to the amount being offered by potential suitors. Empirical evidence published in the Journal of Financial Economics, demonstrates that Tobin’s q – which is the ratio between the market value and replacement value of a physical asset, is a measure of growth opportunities and the market’s assessment of management’s potential to efficiently deploy assets – went up from 1.05 before the transaction to 1.31 after the transactions. Further, these firms remained more highly levered three years after the recapitalization than before the recapitalization. We believe that this clearly signifies a rise in investor confidence in companies undergoing a recap and optimizing the company’s cost of capital.
Sealed Air Corporation (SEE) is one of the firms that successfully used leveraged recapitalization during the 1980s to increase value for shareholders. The stock of Sealed Air (SEE) – which is a provider of systems and solutions for packaging and food science, building care, hygiene, and food safety and security – was undervalued in 1989 as the company was generating free cash flow (>54Mn) in excess of what it could spend, thereby creating a doubt in investors’ minds about the company’s ability to successfully deploy that capital for growth purposes. SEE’s management then decided to purposefully use leveraged recapitalization as a watershed event, creating a crisis that disrupted the status quo and promoted internal change, which included establishing a new objective, changing compensation systems, and reorganizing manufacturing and capital budgeting processes. While the decision was initially met with substantial resistance (both internal & external), it eventually resulted in the rise of the company’s stock price and valuation, and SEE gradually lowered its debt to normal levels over the years. We believe that current macroeconomic environment also supports leveraged recaps and the companies that make use of this opportunity will emerge as long term winners.
Now is the Time to Perform a Leveraged Recapitalization

- Despite unprecedentedly low interest rates the demand for corporate debt remains near record levels. Global debt capital markets were robust in 1Q12 and remain very strong in 2Q12, albeit at a slightly reduced rate in April per our last Capital Markets Update. Most notable is the resurgence of the corporate bond market (investment grade + high yield corporate), which collectively is near historical record levels. According to Thomson Reuters, proceeds from the global debt capital market totaled $1.7Tn in 1Q12, up 69% Q/Q, and marginally up +0.2% Y/Y. Issuer demand is most heavily weighted towards the financial sector, especially European banks, refinancing to attain cheaper debt. New Finance (and the banks) accounted for ~50% of global bond issues as they issued bonds totaling $866Bn during 1Q12. Most significant growth came from the materials (+64% Y/Y) and energy (+46% Y/Y) sectors, primarily to fund plans for significant capital expenditure growth, refinance their existing debt and restructure the capital structure.

- A major demand driver has been liquidity injections by the European Central Bank (ECB) at ~1% rates. Global high yield corporate bonds reached $107Bn in 1Q12, with a major shift towards the American market. High yield markets were strong in 2010 and 1H11; however, weakened significantly in 2H11 with fears of a double-dip recession. With calming news coming from the global central banks that access to cheap liquidity would remain through 2014, demand for all corporate debt (including higher risk/yield paper) increased.

Surprisingly, low interest rates have had a minimal impact on demand for corporate debt.
We expect North American debt capital markets to experience tremendous fund flow growth through the balance of 2012. When analyzing aggregate numbers, 2011 was a great year for the U.S. bond market; however, it was the more traditional sectors and the larger companies that issued the vast majority of the paper. We believe that early trends in the Market’s appetite shifting in favor of riskier bonds will persist through the balance of 2012. To many investors’ dismay, Barclays Aggregate bond index returned 7.8% in 2011, led by the strong performance of the treasury bond returns which was 9.8% in 2011 as compared to 5.9% in 2010. The stronger than expected performance will attract incremental funds.

There are two primary trends that we see supporting an increasingly attractive Market appetite for corporate debt through 2012:

- **Fund Flows Remain Strongest into Bonds:** Although we are detecting a resurgence in fund flows towards equities, it is clear that this trend is not being funded from funds out of bonds. In fact, the fund flows into bonds remains stronger than funds into equities. Aggregate bond fund flows were $31.6 Tn in March 2012, +141% Y/Y, and we expect this high level of flows to continue through 2012. Reference the 3 month moving average comparison in the chart below.

- **As Sovereign Debtors Reduce New Issuances into the Market, Demand will Shift towards Corporate Issuances:** Although this trend has yet to become apparent on a global scale due to Europe, we believe that the U.S. debt capital markets are leading the transition from sovereign to corporate – a trend that we expect will strengthen in 2H12. We expect with less product being shown from the sovereign debtors that the Market’s consumption of corporate bonds could increase >100% H/H supporting record levels.

Investors maintain a high level of confidence in the bond market, thus making leverage cheap by any historic metric. This is an attractive opportunity for corporate owners to cash out of some of their equity by adding significant leverage to their capital structure without placing an undue burden on the enterprise.

**Chart 11.** U.S. Monthly Fund Flow (3 Month Moving Average)

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Sources: Scura Paley, ICI
Fixed rate debt might not be your only option, as cheap money is likely to remain available for the next several years. The Federal Reserves are committed to maintaining low rates, in large part to inflate the debt capital market. In its latest policy announcement, the Fed committed to keeping the short-term interest rates at near zero level through 2014, which has been maintained since 2008 (6 years). Although many experts question the validity of this promise, historical rates remained below 3% for over 20 years following the Great Depression to fund World War II. As the chart below illustrates, this comes at a price as the next 20 years witnessed the 10-year Treasury Notes rise to nearly 15%. Investment grade corporate bond yields are at a record low of ~3.4% and the 10 year swap rates are at ~4.4%, thus providing a very good opportunity. We would advise corporates requiring higher risk capital to at least consider variable rate opportunities as we expect capital costs to remain attractive for an extended period.
**Equity valuations are more reasonable than most pundits suggest.** Run-rate earnings and current prices suggest companies might be undervalued as compared to average valuations over the last 12 years; current P/E of 16x, vs. the 12 year average multiple of 21x. However, U.S. corporates are sitting on record levels of cash, and some might argue that with the Market trading at a cheaper P/FCF vs. P/E (an infrequent occurrence) that many corporates are under-investing in capital expenditures and employment growth. Under-investment is cyclical and limited, thus we believe a better valuation metric is current price to average earnings over the past 10 years. The chart below depicts this metric over the past 140 years to demonstrate that valuations are high by historical standards, currently at 22.2x P/E 10. In fact, current valuations suggest prices are in the most expensive quintile experienced over the past 140 years. So unless one can make the assertion that run-rate earnings are defensible and likely to continue growing on a multi-year trajectory, equities are at best fairly valued and at worst overvalued.

Investors have rewarded equities with attractive valuations based on a 10-year earn-out. We believe this provides an attractive opportunity for corporate owners to cash out some of their equity in one of many methods -- i.e. a one-time dividend.


Dividends have been a tax efficient way for corporates to distribute earnings to owners; however the potential for a sunset on current tax cuts are being considered. The Bush administration, in 2003, announced a cut in dividend tax rates, thereby excluding the dividend income from the definition of ordinary income and collecting 15% tax on the dividend payout. This was aimed at reducing the effect of double taxation on dividend payouts and sent a positive signal to the market, inducing firms to pay more dividends and reward their shareholders. As a result the dividend payout which remained in range of $25Bn during the period 1998-2002, suddenly increased to $33Bn by 2005. This tax holiday is scheduled to expire in 2012.

We believe that equity capital investment and formation will be adversely impacted as the dividend tax cut period comes to an end in 2012. With the sunset of existing dividend and capital gain tax structure in 2012, President Obama plans to collect >$200Bn over the next
10 years in the form of additional taxes, by allowing dividend income to be taxed as ordinary income for high-income individuals, and simultaneously increasing the income tax rate for high-earning individuals to 39.6% from the current 35%. The proposal will allow the dividend tax cut to expire for high-income shareholders, thus individuals earning >$200K and households earning >$250K will be taxed at 39.6% on dividend income as against existing rate of 15%. With the sunset of existing tax structure in 2012, new tax rates applicable in 2013 for high-income group individuals include:

1) top federal tax on dividends will increase from 15% to 39.6%,
2) federal tax on long-term capital gains will increase from 15% to 20% and
3) an additional 3.8% Medicare tax will be introduced.

As a result, the integrated dividend tax will increase from current level of 50.8% to 68.6% in 2013 and integrated capital gains tax will increase from 50.8% to 56.7% for the high-income group. Overall, we believe that these significant changes in tax structure will have a negative impact both at company and economy level as they:

1) discourage capital formation and investment particulary in the corporate sector,
2) promote debt funding, and
3) discourages dividend announcement, thus adversely impact corporate governance of companies.

However, we see a near term opportunity arising in 2012 because of these proposed changes, as the current low interest rate regime provides an opportunity for corporates to replace high cost equity capital with low cost debt capital through leveraged recapitalization.

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### Chart 15. Impact of Dividend Tax Sunset On Integrated Dividend & Capital Gains Tax

<table>
<thead>
<tr>
<th></th>
<th>2011 Law</th>
<th>2013 Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal-state corporate income tax rate</td>
<td>39.2%</td>
<td>39.2%</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top federal dividend tax rate</td>
<td>15.0%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Medicare tax</td>
<td>0.0%</td>
<td>3.8%</td>
</tr>
<tr>
<td>State dividend tax rate (includes fed. deductibility)</td>
<td>4.0%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Federal-state dividend tax rate</td>
<td>19.0%</td>
<td>48.3%</td>
</tr>
<tr>
<td><strong>Integrated dividend tax rate</strong></td>
<td>50.8%</td>
<td>68.6%</td>
</tr>
<tr>
<td><strong>Capital gains</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Top federal long-term capital gains tax rate</td>
<td>15.0%</td>
<td>20.0%</td>
</tr>
<tr>
<td>Medicare tax</td>
<td>0.0%</td>
<td>3.8%</td>
</tr>
<tr>
<td>State cap. gains tax rate (includes fed. deductibility)</td>
<td>4.0%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Federal-state long-term capital gains tax rate</td>
<td>19.0%</td>
<td>28.7%</td>
</tr>
<tr>
<td><strong>Integrated long-term capital gains tax rate</strong></td>
<td>50.8%</td>
<td>56.7%</td>
</tr>
</tbody>
</table>

Sources: Scura Paley, E&Y
### Chart 16. Why 2012 is the right time for Leveraged Recaps? – At Individual Owner Level

<table>
<thead>
<tr>
<th></th>
<th>Existing Scenario</th>
<th>Lev Recap 2012</th>
<th>Lev Recap 2013 (if Sunset)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Valuation</td>
<td>$100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Debt/Equity Ratio</td>
<td>0.2</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Equity</td>
<td>20</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Equity Dilution from Leveraged Recapitalization</td>
<td>30</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Incremental Debt to be Distributed as Dividend</td>
<td>30</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Dividend Tax Rate</td>
<td>15%</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>Post Tax Dividend Income</td>
<td>$25.5</td>
<td>$18.0</td>
<td></td>
</tr>
<tr>
<td>Loss Due to Incremental Tax</td>
<td></td>
<td></td>
<td>-29%</td>
</tr>
</tbody>
</table>

Sources: Scura Paley

**Bottom-line:** Cheap debt + a market that has an appetite for your company to add leverage + favorably priced equities market + a favorable dividend tax rate that could potentially sunset at the end of this year suggest now is the perfect time to consider a leveraged recapitalization to allow owners to withdraw significant equity ownership positions.
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