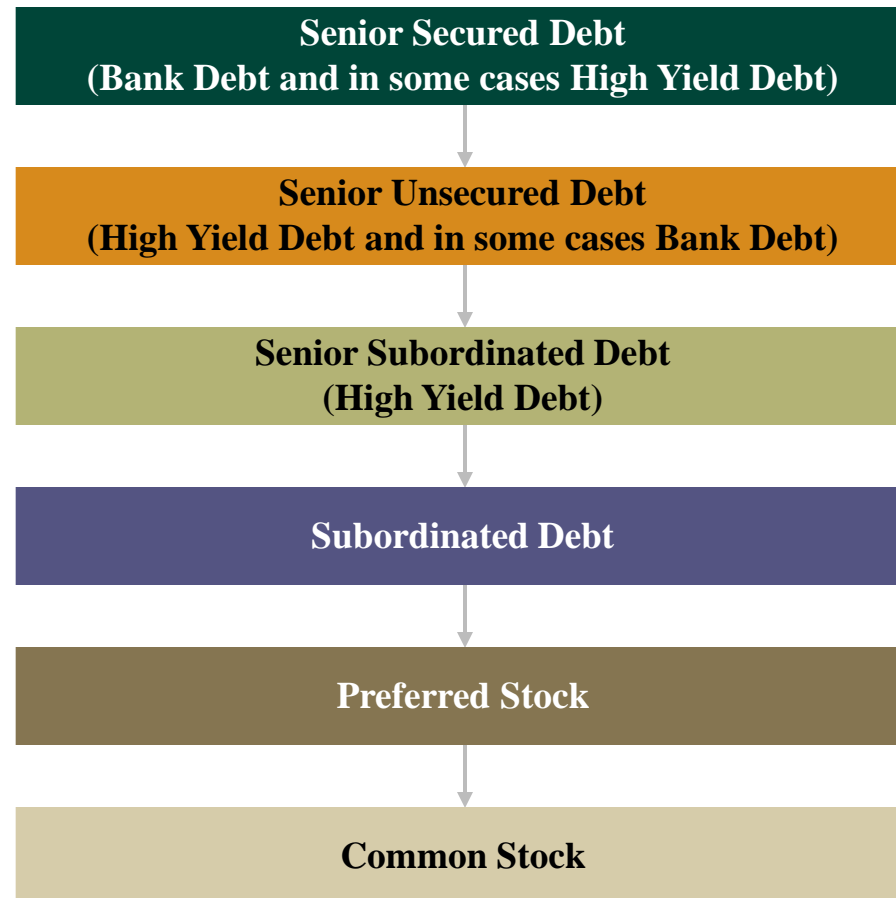

Credit Analysis Primer

Structural Classifications of Debt

Structural Classifications of Debt – Overview

The chart below delineates the general ranking of various financial instruments relative to each other



Structural Classifications of Debt

The credit quality of a debt instrument is determined by the “obligor” – the party obligated to repay the debt instrument – the financial strength of such legal entity, and the structure and terms of the instrument, itself

◆ Obligor

- To assess the credit quality of a debt instrument, one must first understand which entity is legally obligated to make payments pursuant to the instrument
 - Only legal entities (generally corporations, partnerships, or individuals) can be obligors under a debt instrument
 - Sometimes legal entities are referred to as “persons”
 - “Divisions” of a Company are not legal entities and consequently cannot be obligors
 - Sometimes there may be more than one obligor with respect to a debt instrument
 - Two legal entities might be joint and several obligors of the same debt instrument. In this case, each is obligated for the full amount of the debt obligation as if the other were not an obligor
 - Two legal entities might only be several obligors. In this case, the liability of each legal entity might be limited to a portion of the total obligation
 - One legal entity might be the “direct borrower” or “primary obligor” under the debt instrument while another legal entity might be the guarantor of the obligation of the primary obligor. In this case, the guarantor might be referred to as the “secondary obligor”. Note that only a legal entity may be a guarantor
 - One must read each debt instrument very carefully to ensure that we know specifically which legal entity is obligated to service it
-

Structural Classifications of Debt (cont'd)

The credit quality of a given debt instrument (obligation) of a specific legal entity is greatly affected by the “seniority” of the obligation

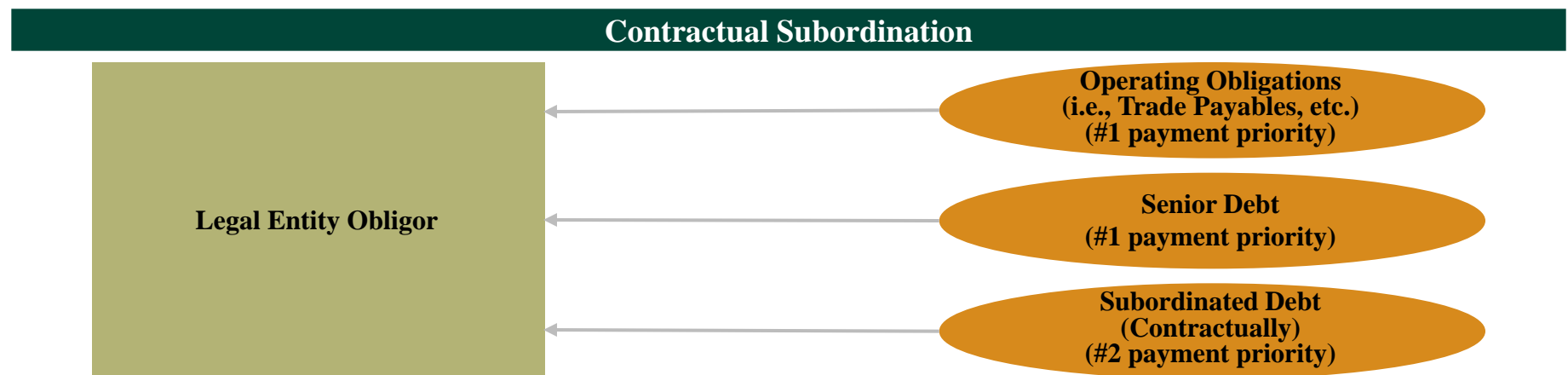
◆ Seniority

- “Seniority” refers to the precedence or preference in position of the claim of an obligor’s creditor relative to another claim or claims
 - Other things being equal, a senior claim is entitled to payment before a junior claim in the event that the obligor is unable to repay all of its obligations
 - An obligor that becomes financially distressed might not be able to meet all of its debt obligations, and as a result might seek protection from creditors pursuant to Chapter 11 of the US Bankruptcy Code
 - In that event, the Bankruptcy Court would generally recognize the senior creditor’s right to have its claim satisfied before the claim of a “junior” creditor can be satisfied
 - A debt instrument that is not senior is referred as “subordinated” (i.e., junior relative to the senior debt instrument)
 - Seniority may result from a “contractual” agreement or from certain “structural” considerations
-

Structural Classifications of Debt (cont'd)

Contractual seniority

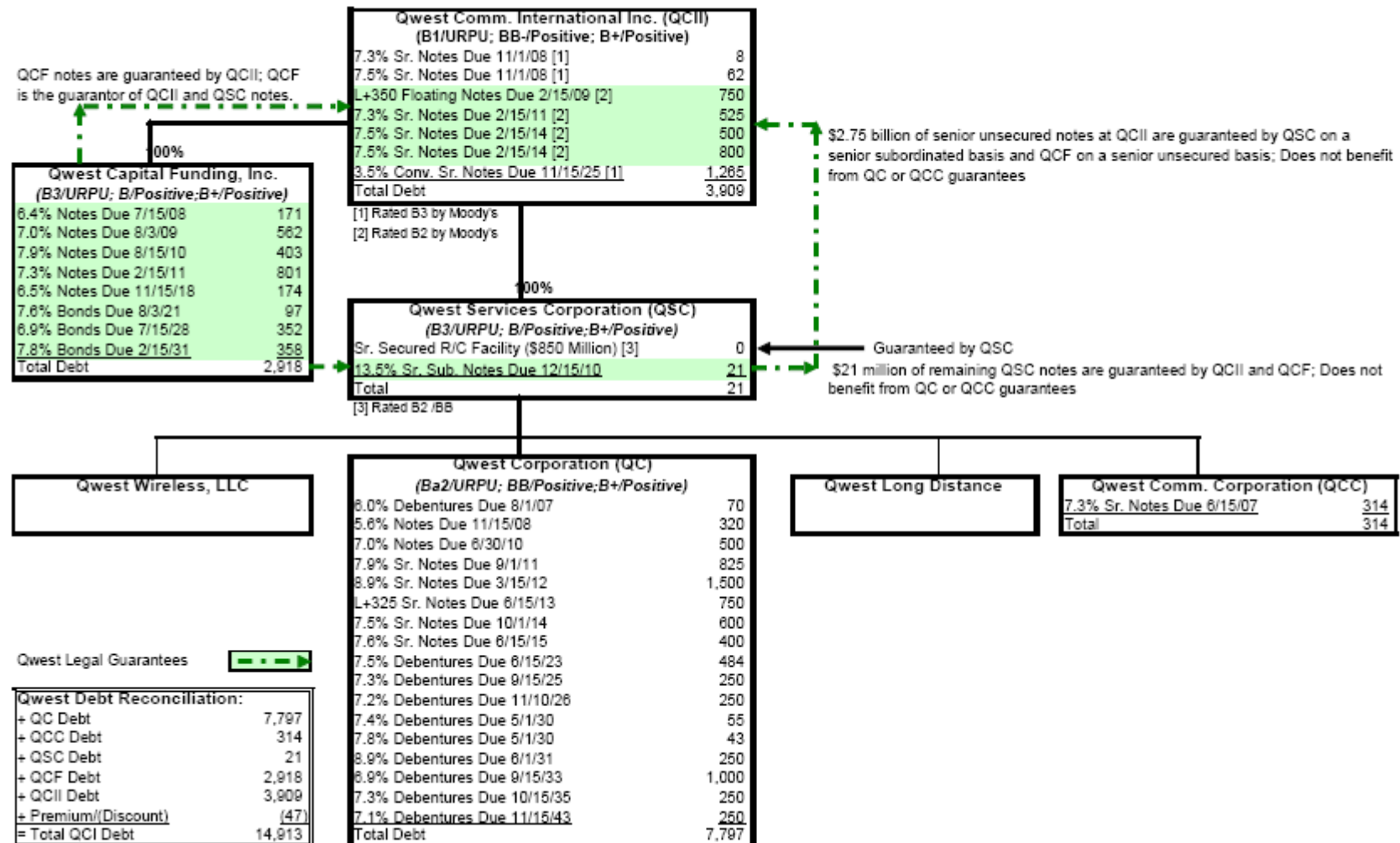
- ◆ The legal contract that sets forth the terms of the debt instrument specifically designates the obligation as a senior obligation
- ◆ The name of such legal contract is a function of the nature of the debt obligation. For example, bank loans have “credit agreements” and public bonds have “indentures” in which the seniority of the instrument is established
- ◆ Debt instruments that are contractually subordinated to senior debt instruments are made so pursuant to “subordination provisions” included in their related credit agreements or indentures
- ◆ Note that senior obligations generally rank pari passu (i.e., have the same ranking as) with other “general unsecured” obligations of a legal entity. For example, a senior obligation for borrowed money, other things being equal, generally ranks pari passu with trade payables of the same legal obligor
- ◆ Debt that is contractually subordinated is generally only subordinated to specific types of obligations of the same legal entity. For example, contractually subordinated debt is generally only subordinated to “debt for borrowed money” of the same obligor. Consequently, it generally ranks pari passu with trade payables of the same legal entity
- ◆ Contractual subordination provisions must be read very carefully to ascertain the specific implications for the credit quality of each debt obligation



Structural Classifications of Debt (cont'd)

Example of Capital Structure Complexities

Figure 6. Qwest Communications International Organization and Capital Structure, as of 30 Sep 06

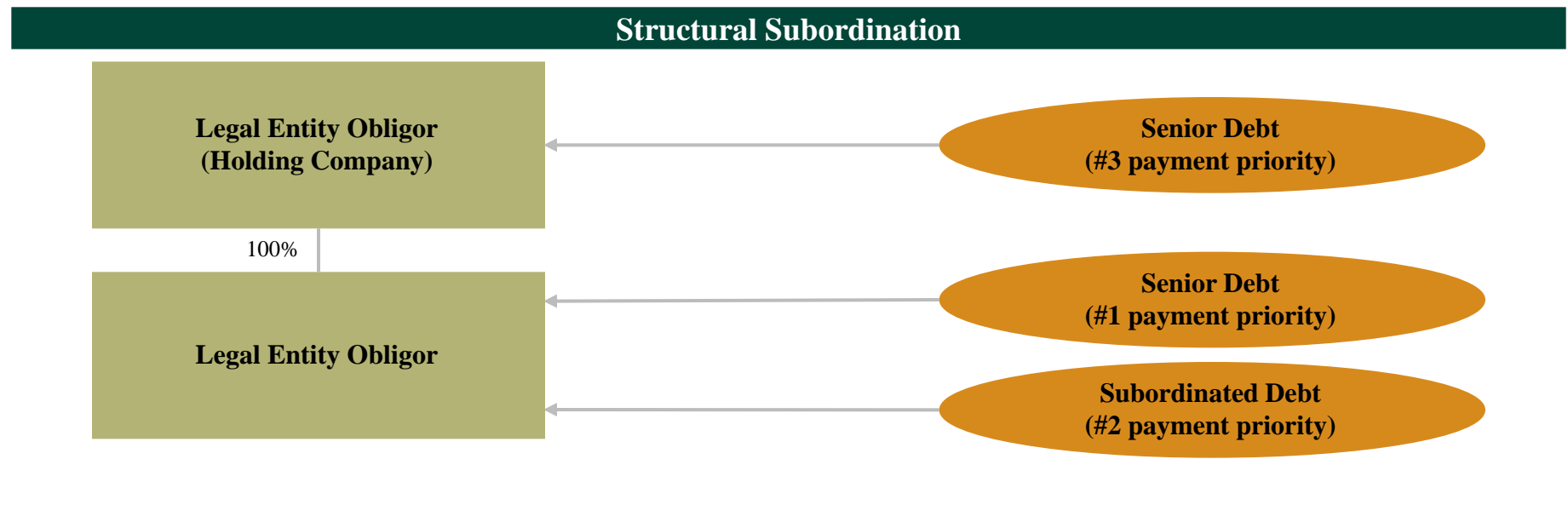


Source: Citigroup Investment Research and Company Reports

Structural Classifications of Debt (cont'd)

Structural seniority

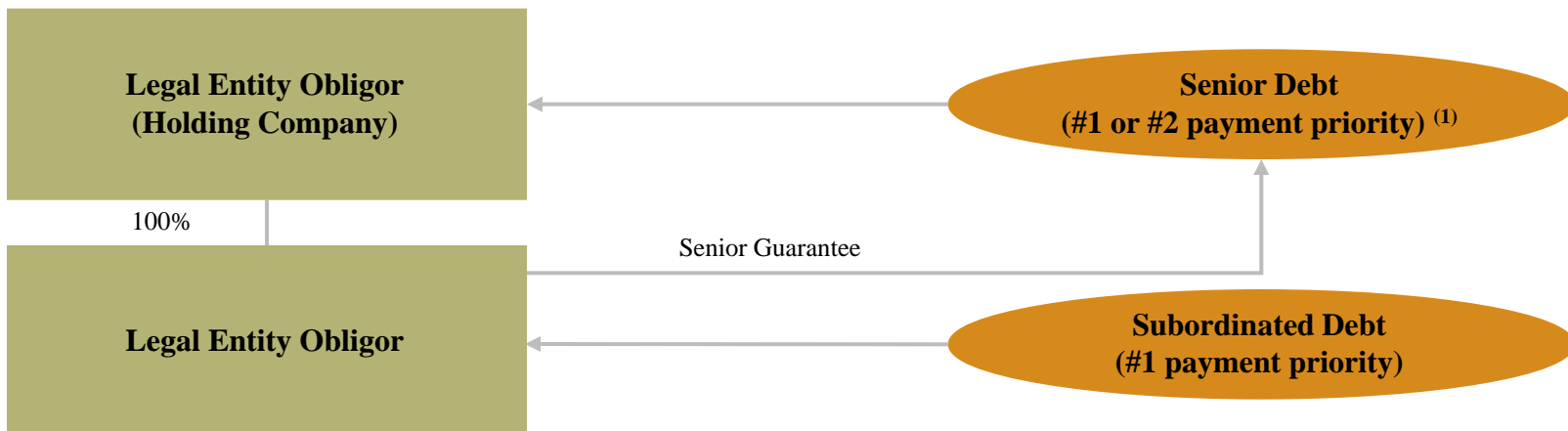
- ◆ The structural seniority of a debt obligation of one legal entity relative to another debt obligation of a different legal entity is established by virtue of the relationship between the different obligors, themselves, rather than as a result of the legal contracts underlying the debt instruments
- ◆ For example, generally, a debt obligation at a holding Company is structurally subordinated to a debt obligation of a subsidiary of the holding Company unless it is either guaranteed by the subsidiary or there is another obligation owed by the subsidiary to the holding Company
- ◆ Note that senior debt at a holding Company may in fact be structurally subordinated (or junior) to both senior and subordinated debt at a subsidiary of the holding Company



Structural Classifications of Debt (cont'd)

- ◆ An upstream senior guarantee by a subsidiary of the holding Company may “defeat” the structural subordination of the holding Company senior debt, thereby making the instruments pari passu to each other
- ◆ The seniority of an upstream guarantee will affect whether or not the structural subordination of senior debt at the holding Company is in fact defeated

Structural Subordination with a Senior Upstream Guarantee

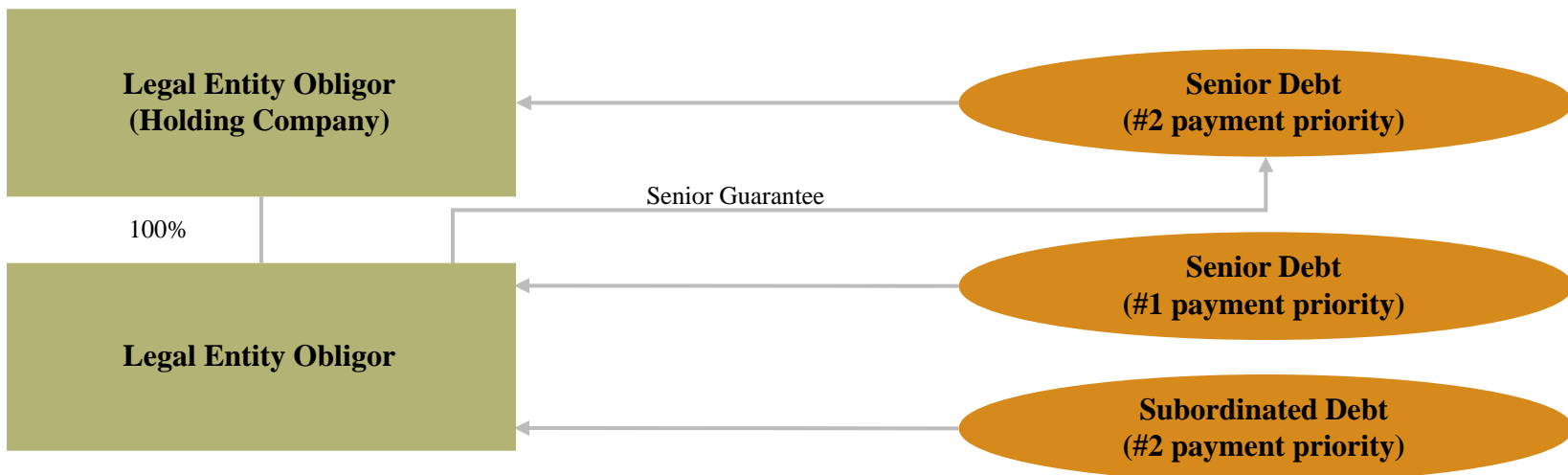


1. If the upstream guarantee is not senior, the holding company senior debt will have second payment priority in relation to the subordinated debt of the subsidiary.

Structural Classifications of Debt (cont'd)

- ◆ An upstream guarantee from a subsidiary of a holding Company that is subordinated to the senior debt of the subsidiary will not defeat the structural subordination of the senior holding Company debt relative to the senior debt of the subsidiary, but it will defeat the structural subordination of the senior holding Company debt to the subordinated debt of the subsidiary
- ◆ The senior debt of the holding Company would, in effect, rank pari passu with the subordinated debt of the subsidiary with respect to assets at the subsidiary

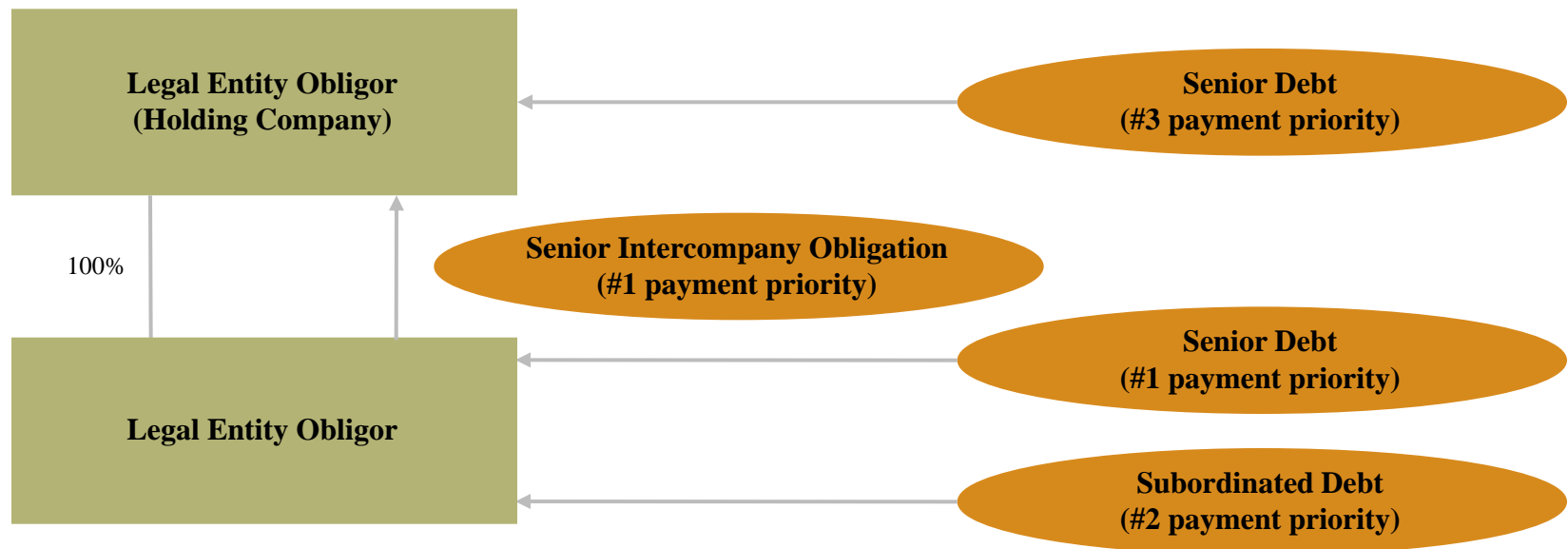
Structural Subordination with a Senior Upstream Guarantee



Structural Classifications of Debt (cont'd)

- ◆ Intercompany obligations between a holding Company and its subsidiary may also effect the structural subordination of senior debt at the holding Company relative to senior debt at the subsidiary
- ◆ A senior intercompany obligation from the subsidiary to the holding Company would rank equally with other senior obligations of the subsidiary and would effectively “dilute” the senior status of the senior subsidiary obligations relative to the senior, and otherwise structurally subordinated, obligations of the holding Company

Structural Subordination with a Senior Intercompany Obligation



Structural Classifications of Debt (cont'd)

The credit quality of a debt instrument is also affected by whether it is “secured” or “unsecured”

- ◆ A debt obligation is secured when a “security interest” is granted by the obligor in favor of the debtholder
 - A security interest is an interest in property or assets of the obligor that provides that such property may be foreclosed on or sold upon a default of the obligor (i.e., non-payment of principal or interest or violation of other covenants) in order to satisfy the associated obligation that is secured by such property
 - A security interest may be granted with respect to real property (generally through a mortgage) or personal property or fixtures (generally through a security agreement)
 - The underlying property that secures the obligations may be referred to as “security” or “collateral”
 - The security interest may be referred to as a pledge of, lien on or charge on the assets
- ◆ In practice, a secured creditor will not immediately seize the collateral and sell it to satisfy the underlying debt obligation in the event the Company defaults under the debt obligation
 - Rather, a Company faced with a default that is not likely to be waived by its creditors will file for protection from creditors, generally under Chapter 11 of the Bankruptcy Code
 - The borrower may be allowed to continue to operate as a “going concern” under Chapter 11 protection. Seizure of the borrower’s assets by the secured creditors is generally stayed, at least as long as certain tests can be met, while the Company seeks to reorganize its business and financial obligations
 - Nonetheless, a secured creditor is entitled to preferential rights in Chapter 11
 - The obligor is only allowed to continue to use the secured property in its business operations if after the filing for protection under Chapter 11 (the “postpetition”) it can demonstrate that the beneficiary of the security interest is adequately protected; (i.e., that the value of the collateral will not be impaired by continued use). If this cannot be demonstrated, the Bankruptcy may require additional collateral to be granted in favor of the beneficiary or allow the collateral to be sold
 - Generally, a secured claim may only be satisfied with cash, whereas unsecured claims may be satisfied in Chapter 11 with other non-cash forms of consideration, such as common stock of the reorganized Company
 - A secured creditor that is oversecured (i.e., the value of the collateral securing its claim is greater than the claim) is entitled to either accrue or perhaps even be paid postpetition interest on a current basis. Unsecured creditors generally are not entitled to postpetition interest, even on an accrued basis
 - Perhaps most importantly, no new lender is allowed to make a secured loan that is senior to the secured lender in Chapter 11 unless the “prepetition” secured lender is so oversecured that it would not be impaired by virtue of the new loan. Unsecured lenders, on the other hand, may be “primed” by a new lien imposed by a new lender that advances new funds postpetition to finance the Company while it is in Chapter 11

Structural Classifications of Debt (cont'd)

The credit quality of a secured obligation is affected by the nature of the underlying collateral

- ◆ An obligation is only secured by specifically pledged assets
- ◆ Collateral may be composed of “operating” assets (i.e., receivables, inventory, property, plant and equipment, intellectual property, etc.) or securities such as the common stock of a Company or its subsidiary(ies)
 - Knowing which specific assets are pledged and which are not is key to understanding how well secured a debt obligation is
- ◆ A secured obligation is secured only to the extent of the value of the underlying collateral
 - If the value of the collateral is less than the amount of the associated debt obligation, such secured debt is said to be “undersecured” and only possesses the benefits of secured debt to the extent it is secured
- ◆ Springing Liens and Springing Maturities are features that are becoming more prevalent particularly in distressed refinancings
 - Springing Lien: A lien on assets of a company that will arise on the occurrence of a specific event. For example, a loan agreement may include a springing lien that requires the borrower to pledge its assets to secure the loan if the borrower's credit rating falls below a specified level. The creation of a lien in the future to secure an antecedent debt creates a serious risk of being avoided as a preference in a bankruptcy proceeding
 - Springing Maturity: A condition in credit agreements or indentures that triggers (springs) the early maturity of the instrument should a trigger event occur. Generally, the trigger event is related to a refinancing where if the obligor fails to refinance junior debt by certain date, the senior debt maturity springs forward and becomes due. Very common feature in the most recent refinancing wave as companies have been able to refinance their bank debt with conditions that require their junior debt to also be refinanced by a certain date or risk accelerating the maturity of the bank debt. Recent deal include, Rotech, Michaels Stores and Rite Aid

Structural Classifications of Debt (cont'd)

Springing Maturity Examples


- ◆ Rite Aid: On August 9th issued \$650 million of 8.00% first lien secured notes due 2020 –replaced tranche 4 term loans due 2015 Extended maturities 5 years Annual interest savings of \$9.75 million
 - On August 19th amended revolving credit facility Extended maturity to 2015 (**springing maturity** in 2014 if term loans aren't refinanced or repaid) Improved borrowing rate and unused fee
 - Amended fixed charge coverage ratios and allows mandatory repurchase of 8.5% convertible notes
 - ◆ Michaels Stores: On November 5, 2009, Michaels Stores, Inc. (the “Company”) entered into a Fourth Amendment to Credit Agreement (the “Fourth Amendment”) to the Company’s \$2,400.0 million senior secured term loan facility with Deutsche Bank AG New York Branch, as administrative agent, and the other lenders party thereto (the “Term Loan Credit Facility”). The Fourth Amendment amends the Term Loan Credit Facility to allow for an extension of the maturity date for \$1,000.0 million of existing term loans (the “B-2 Term Loans”) to July 31, 2016. As a result of the Fourth Amendment, the applicable margins for the B-2 Term Loans under the Term Loan Credit Facility will be 3.50 % with respect to base rate borrowings and 4.50 % with respect to LIBOR borrowings. The B-2 Term Loans are subject to (i) a springing maturity date of July 31, 2014 unless either (x) the Company’s 10% Senior Notes due 2014 are refinanced 91 days prior to the maturity of such Senior Notes or (y) the Company can meet a leverage covenant of 3.25x; and (ii) a minimum increase in effective yield of 0.25% in connection with future extensions. Additionally, for the B-2 Term Loans one- and two-month LIBOR options have been eliminated.
-

Structural Classifications of Debt – Payment Priority

Rights of Absolute Priority

- ◆ The following table shows the general order of priority claims of an obligor's liabilities and equity

Ranking of all Corporate Obligations by Security and Seniority

Payment Priority	Ranking of Corporate Obligations
Highest	Taxes Owed
	Senior Secured Debt
	Senior Unsecured Debt
	Senior Subordinated Debt
	Subordinated Debt
	Preferred Stock
	Common Stock
Lowest	

Trade Payables and Other Unsecured Claims

Covenants

Covenants

The Basics of Reading Credit Agreements and Indentures

- ◆ When analyzing credit instruments, particularly leveraged loans and bonds, as well as distressed securities defined as either trading below 85% of par or 1000bp over Treasuries, it is imperative that you read the governing documents. Ultimately, the only thing that provides a claim to an issuer's cash flows is the contract governing the issuer - lender relationship
 - ◆ The document governing the relationship between the issuer (a/k/a debtor) and investors (creditors) is a credit agreement if it is bank debt or an indenture if it is a bond
 - Credit Agreement is managed by an agent who monitors compliance on behalf of investors and may often function as intermediary between debtor and creditors when negotiating out of court
 - Indenture is document that governs a bond offering and has an indenture trustee who monitors compliance on behalf of bondholders. Indenture trustee often serves on Official Committee of Unsecured Creditors to Represent bondholder interests
 - ◆ Credit agreements and indentures contain both “affirmative” covenants (actions a debtor must take to remain in compliance and “negative” covenants (what the debtor cannot do)
 - ◆ So where do you can you find these all important documents? The easiest way is if you have access to Bloomberg. If you only know the Equity Ticker then first look up the company by its equity ticker search under RELS and see what corporate bonds and bank loans the company has outstanding
 - In addition, you can use look up the corporate ticker by using F3 on Bloomberg and search for the corporate ticker and for loans use the TKL function to lookup loans by issuer. If you do not have access to Bloomberg, then you can look in the SEC filings. You have to know when loan or bond was issued however, because you need to search the nearest 10-Q or 10-K to the issue debt as it will be attached and listed as an exhibit
-

Covenants

The Basics of Reading Credit Agreements and Indentures

Key Sections of Credit Agreements and Indentures

- ◆ **Title page:** Here you'll find info such as the closing date of the loan, name of the borrower (legal entity), and the agent banks on the loan
 - ◆ **Table of Contents:** Lists where to find important sections of the document such as covenants, prepayments, defined terms and change-of-control (CoC) provisions
 - ◆ **Recitals:** This section will tell you, again, the date of closing as well as the borrower(s) and guarantor(s) of the facility. The names of the borrowers and guarantors are enormously important because they are the only entities that are required to pay you principal and interest. Sometime, the terms Borrower and Guarantor are listed without naming legal entities. Then, you'll have to consult the Defined Terms section of the agreement to see who the Borrower(s) and Guarantor(s) are. Understanding who the parties are is important because it is only those entities that you can look to recourse to for your repayment.
 - ◆ **Defined Terms:** This section is critical to understanding the rest of the documents. Every capitalized term in the document is usually defined in this section. These definitions explicitly layout specific meanings, formulations, and calculations that will govern the loan. This includes how to calculate covenants such as total leverage, permitted indebtedness, guarantees and the like
 - ◆ **Amount and Terms of the Credits:** This section includes such items as the amount of the facility as well as the amount of each tranche of the facility (so if a facility has a revolving credit and a term loan, it has 2 tranches). It will also include the amortization schedule of the facility, the amount of letters of credit that are permitted to be issued and a host of other items, many of which you really won't have to consider. However, two items that you will have to review have to do with prepayments: mandatory and voluntary
-

Covenants

The Basics of Reading Credit Agreements and Indentures

Key Sections of Credit Agreements and Indentures

- ◆ **Representations and Warranties:** These are a list of items that the Borrower and Guarantor state are true as of a certain date (items such as there are no material legal or environmental issues not previously disclosed to the lenders, etc.). Typically, you won't spend a lot of time here
 - ◆ **Conditions:** These are the conditions that allow the borrower to use the facility. There are usually two sets of conditions – conditions on the initial closing date and then each subsequent borrowing (for example, each revolving credit borrowing would be subject to meeting the conditions). The overriding principle here is that the borrower must be in compliance with the terms of the agreement each time it borrows. Again, not a place you'll likely spend a ton of time
 - ◆ **Events of Default:** Define what constitutes a violation under the issuer's credit agreement or indenture. Non-compliance with negative or affirmative covenants, for example, or failure to pay interest or principal are known as payment defaults. Other examples of events of default, known as technical default, are failure to deliver a covenant compliance certificate or failure to file timely financial statements. Pay close attention to the cure periods. For example, a failure to pay principal when due is an immediate event of default, but there may be a period of days where the company can make an interest payment after it was due and still be in compliance (interest is generally in a grace period for 30 days)
 - When there is a violation of a covenant, creditors look to the Agent Bank or the Indenture Trustee to send a notice of default. The issuer can cure the default or enter into a forbearance agreement while it negotiates a waiver for the violation
-

Covenants

Example of a Credit Agreement Summary– Simmons Bedding

Borrower.....Simmons Bedding
Agent..... Deutsche Bank
Description.....Term Loan and Revolving Credit Facilities
Date Issued.....May 25, 2006
Commitment.....\$465 million tranche D term loan; \$75 million revolving loan facility
Maturity.....Tranche D term Loan: December 19, 2011; revolving loan facility: December 19, 2009
Guarantors.....THL-SC Bedding Company ("Holdings") and Certain Subsidiary Guarantors
Interest Rate.....Term Loan:

Consolidated Senior Secured Leverage Ratio Eurodollar Loans Base Rate Loans

≥ 4.50x to 1.00x 2.25% 1.25%
≤ 4.50x to 1.00x 2.00% 1.00%

Revolving Credit Loans:

Consolidated Senior Secured Leverage Ratio Eurodollar Loans Base Rate Loans Commitment Fee

≥ 5.00x to 1.00x 2.50% 1.50% 0.500%
< 5.00x to 1.00x and ≥ 4.50x to 1.00x 2.25% 1.25% 0.500%
< 4.50x to 1.00x and ≥ 4.00x to 1.00x 2.00% 1.00% 0.375%
< 4.00x to 1.00x and ≥ 3.50x to 1.00x 1.75% 0.75% 0.375%
≤ 3.50x to 1.00x 1.50% 0.50% 0.375%

Interest Payment Dates.....Quarterly, 3/30, 6/30, 9/30, 12/30
Quarterly Repayments.....Required quarterly principal payments of \$1.23 million through December 31, 2010.
Required quarterly principal payments of \$117.16 million thereafter.
Optional Prepayment.....Any borrower may at any time prepay the loans made to it, in whole or in part without premium or penalty
Mandatory Prepayments.....(i) Asset sale and net insurance/condemnation proceeds unless such proceeds will be used to reinvest in non-current assets of the business within 365 days
(ii) 50% of proceeds from public equity issuances or private equity issuances greater than \$25 million through an investment bank, subject to certain exceptions Simmons Bedding Company
(iii) Issuance of additional indebtedness
(iv) 50% of Excess Cash Flow when the Leverage Ratio is 4.0x or less \$465 million tranche D term loan; \$75 million revolving loan facility

Covenants

Example of a Credit Agreement Summary – Simmons Bedding

<u>Date</u>	<u>Interest Coverage</u>	<u>Leverage Ratio</u>
12/29/2007	2.25x	5.00x
3/29/2008 to 12/31/2008	2.75x	4.50x
3/31/2009 and thereafter	3.00x	4.00x

Annual Capex Maximum.....\$30 million plus \$10 million with respect to one new production facility in the U.S.

Permitted Dividends.....Up to 50% of the aggregate net income from the Closing Date to the latest fiscal quarter, provided that the Leverage Ratio is less than 5.00x

Additional Indebtedness..... (i) Indebtedness of any loan party to any loan document
(ii) Indebtedness incurred to refinance, refund, replace or new any outstanding indebtedness provided that the principal amount does not exceed the amount being refinanced
(iii) Permitted Subordinated Indebtedness up to \$25 million per fiscal year
(iv) Capital leases up to \$20 million
(v) Indebtedness subordinate to Credit Facility, with no mandatory principal payments and due at least six months after the Term Loan maturity
(vi) Indebtedness to fund permitted acquisitions up to \$25 million
(vii) Indebtedness incurred by Holdings that is: (a) unsecured by the Company; (b) matures at least six months after the Term Loan; (c) requires no principal repayment for at least five years from issuance; and (d) Pro Forma Total Leverage Ratio and Leverage Ratio are less than 6.75x and 5.00x, respectively
(viii) Indebtedness incurred by Foreign Subsidiaries up to \$30 million
(v) Other indebtedness incurred by Holdings or any of its subsidiaries in an amount not to exceed \$40 million outstanding at one time

Equity Cure..... Up to \$20 million. Two cures permitted in any twelve month period and four cures permitted in total

Covenants

Overview of Covenants

What are Covenants?

- ◆ Covenants are agreements (promises) in bank credit agreements and bond indentures made by borrowers / issuers that are designed to assure debtholders that the creditworthiness of the borrower(s) / issuer(s) will remain satisfactory
- ◆ Every covenant package must be tailored to reflect the specific needs of the borrower / issuer and the specific risks perceived by the debtholders. HY and leveraged loans typically contain significant covenant packages, while investment grade debt generally only has a negative pledge (more recently CoC language has been included)

Why do we need Covenants?

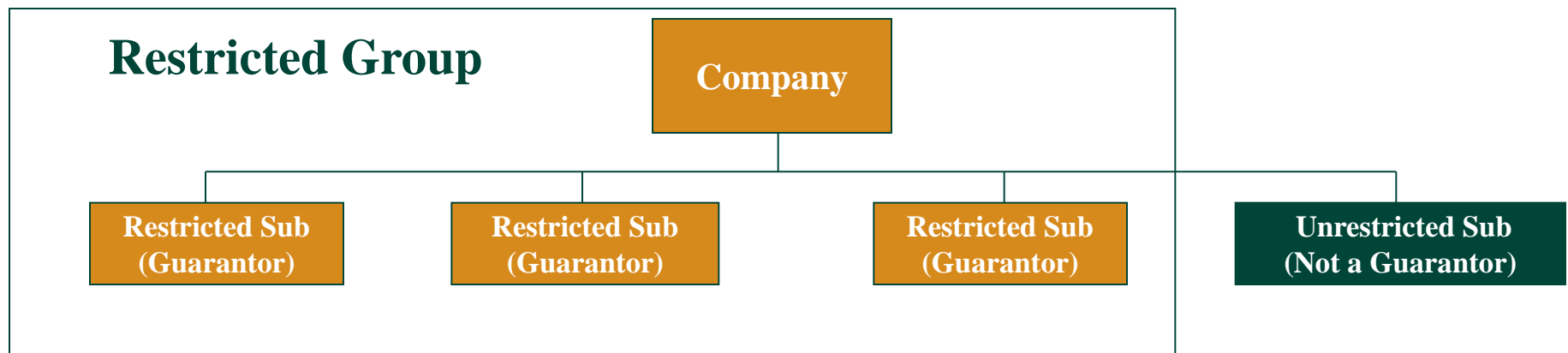
- ◆ Lenders need protections from equityholders who may have objectives that are inconsistent with the risk profile that lenders are willing to accept. For e.g., equityholders may want to
 - Add additional debt to fund internal growth or future acquisitions
 - Pay dividends
 - Make investments in joint ventures they do not control
 - Pay themselves consulting or management fees
 - ◆ Covenants protect lenders against a diminution in value of their investment through
 - Credit deterioration
 - Loss of “equity cushion”
 - Loss of control over assets
 - Loss of seniority position
 - ◆ Covenants potentially bring the borrower and lenders / bondholders “to the table” to restructure or refinance a troubled situation before it’s too late (i.e., bankruptcy)
 - ◆ Covenants increase the chance of capital gains for bondholders because they force the Company to
 - Deleverage (or, more accurately, limit the Company’s ability to re-leverage)
 - Reinvest earnings (the typical restricted payments covenant requires the Company to retain 50% of net income in the business and allows 50% to be dividended out to stockholders)
-

Covenants

Overview of Covenants

Who is subject to Covenants?

- ◆ The Company and its Restricted Subsidiaries are subject to the covenants, even if the Company is the only signatory to the bank credit agreement and / or bond indenture. Where the Company is the only signatory, each covenant begins with the phrase
 - “The Company will not and will not permit any of its Restricted Subsidiaries to...”
 - Bank lenders often do not distinguish between restricted and unrestricted subsidiaries (i.e., **all** subsidiaries are subject to the credit agreement’s covenants)
- ◆ Unrestricted Subsidiaries (where applicable) are not subject to any of the covenants
- ◆ The covenants place a firewall between the Company and its Restricted Subsidiaries, on the one hand, and the Unrestricted Subsidiaries on the other hand



Covenants

Overview of Covenants

How to read specific covenants:

- ◆ Generally, both bank credit agreements and bond indentures have the following three categories of covenants:
 - Reporting Covenants
 - Affirmative Covenants
 - Negative Covenants
 - ◆ Traditional bank credit agreements will also include one additional category of covenants
 - “Financial” or “Maintenance” Covenants
 - Maximum Leverage Ratio
 - Minimum Interest Coverage Ratio
 - ◆ To the extent of overlaps in covenants, bank covenants will almost always be more restrictive
 - This provides bank lenders an earlier “trip wire” to renegotiate with the Borrower and fix a problem before bringing bondholders to the table
 - Note that this is “almost” always—there are a few instances, particularly in covenant lite deals, where the opposite may be true
 - ◆ In contrast to traditional bank covenants, which keep the Borrower on a “short leash,” bond covenants are intentionally designed to give the Borrower much more latitude. This is because:
 - Lower in capital structure, bondholder accepts higher risk/return
 - Bonds trade freely and bondholders can be difficult to identify
 - Impractical to communicate with bondholders—to do an amendment you need to launch a consent solicitation; you can’t simply pick-up the phone to call your lenders
 - ◆ Bond covenants are looser because the indenture is “carved in stone” upon issuance and there is little chance to fine-tune the covenants over the 7-10-year life of the bonds
-

Types of Covenants

There are three types of covenants in credit agreements and bond indentures – Affirmative, Negative and Financial

- ◆ **Affirmative Covenants** – These covenants require that the obligor of the debt must do certain specific things. Examples of Affirmative Covenants are (i) Financial reporting requirements; (ii) Maintenance of corporate existence; (iii) Payment of taxes; (iv) Maintenance of properties and insurance; and (v) Compliance with laws
 - ◆ **Negative Covenants** – These covenants require that the obligor of the debt must refrain from doing certain specific things. Examples of Negative Covenants are (i) Limitations on indebtedness; (ii) Restrictions on liens; (iii) Payment restrictions affecting the borrower and its subsidiaries; (iv) Restrictions on the sale of assets; (v) Restrictions on mergers and consolidations
 - ◆ **Financial Covenants** – There are two types of Financial Covenants – Maintenance and Incurrence. Maintenance Financial Covenants are included in bank credit agreements and Incurrence Financial Covenants are included in bond indentures. Examples of Financial Covenants are (i) Maximum senior and total leverage; (ii) Minimum interest coverage; (iii) Minimum fixed charge coverage; and (iv) Minimum net worth
 - Maintenance Financial Covenants (Bank)
 - Borrowers must remain in compliance with these types of covenants throughout the term of a credit agreement
 - These covenants are generally tested on a quarterly basis
 - Failure to comply with these covenants represents an event of default and a waiver / amendment to the credit agreement is required from the debtholders
 - Incurrence Financial Covenants (Bond)
 - Issuers may not perform certain activities, i.e. incurring additional debt or making acquisitions, unless these covenants are met
 - The issuer is not in default if it is not complying with the tests included in its incurrence covenants (assuming it is not engaging in the prohibited activity, such as incurring additional debt); rather, such covenants only limit its prospective actions
-

Affirmative Covenants

The following list describes some of the most common Affirmative Covenants contained in bank credit agreements and bond indentures

Financial Reporting Requirements

- ◆ In a bank credit agreement, debtholders want to ensure that the borrower provides periodic financial reports, including (in some cases) certain non-public information
- ◆ In a bond indenture, debtholders want to ensure that the issuer files the required disclosure documents regularly with the SEC
- ◆ Much of the time debtholders rely on the Company's public reporting for updates on its operating performance and financial position

Maintenance of Corporate Existence

- ◆ Debtholders want to ensure that if a Company becomes involved in acquisition transactions, it remains the surviving entity and that it complies with all laws and filing requirements

Payment of Taxes

- ◆ Debtholders want to ensure that a Company pays all of its obligations to various taxing authorities as required on a timely basis

Maintenance of Properties and Insurance

- ◆ Debtholders want to ensure that a Company satisfactorily maintains its assets in good working condition to support ongoing business operations
- ◆ In addition, issuers are required to maintain customary insurance policies to protect against damage to their assets and operations in certain events

Compliance with Laws

- ◆ Debtholders want to ensure that a Company remains in compliance with the laws within the jurisdictions in which it operates

Negative Covenants

The following list describes some of the most common Negative Covenants that are contained in bank credit agreements and bond indentures

Additional Indebtedness

- ◆ Debtholders want to restrict the Company's ability to incur additional debt, e.g.,
 - Other senior debt (secured or unsecured)
 - Other subordinated debt
 - Debt acquired with acquisitions
 - Guarantees of the debt of other companies or unrestricted subsidiaries (i.e., non-guarantor subsidiaries)
 - Assumed debt of a subsidiary that becomes a party to the indenture or credit agreement
 - Capital lease obligations
 - Vendor debt

Restricted Payments

- ◆ Debtholders want to restrict a Company's ability to do the following
 - Make investments in other companies (including unrestricted subsidiaries)
 - Pay dividends or make other cash distributions
 - Redeem junior securities (debt or equity)
 - Eliminate an existing subsidiary from being a party to the indenture or credit agreement (i.e., re-designating a restricted subsidiary to an unrestricted subsidiary)

Change of Control

- ◆ A change of control typically occurs when a majority of a Company's voting stock is purchased by another entity or when a majority of a Company's board is replaced
- ◆ Protects debtholders from a potential deterioration in creditworthiness that may arise as a result of a change in control
- ◆ In a bank credit agreement, a change of control is an event of default that allows the debtholders to demand immediate repayment of all outstanding loans
- ◆ Typically, a bond indenture requires a Company to make an offer to repurchase the notes (at a predetermined price, usually 101%) in connection with a change of control, but a change of control is not itself an event of default

Asset Sale Proceeds

- ◆ When assets above a specific threshold are sold, the debtholders want the Company to use the proceeds either to reinvest in its business or to repay debt. They do not want the Company to apply the money to uses that may weaken the creditworthiness of the obligor, like paying a dividend to shareholders or giving an excessive bonus to the CEO

Negative Covenants

Acquisitions

- ◆ Intended to control the magnitude of future acquisition activity since acquisitions may result in a deterioration in creditworthiness and may increase the risks associated with integrating acquired operations
- ◆ Debt instruments often place limitations on (i) the size of permitted acquisitions; (ii) the amount of an acquisition that can be financed by debt; (iii) the amount of the target's debt that can be assumed (bank debt only); and (iv) the pro forma financial profile of the consolidated Company

Additional Liens

- ◆ A lien is a first claim on an asset that affords substantial rights to the lien holder in a bankruptcy. These rights include assurances that a Company cannot permit other creditors to have a direct lien on pledged assets ahead of the first lien holder, and that the lien holder has a priority claim on the proceeds from the sale of the secured assets ahead of all other creditors
- ◆ A "negative pledge" or other limitation on additional liens prevents the Company from granting liens on its assets to other creditors, thereby ensuring that the value of the assets to existing debtholders is not impaired by virtue of a lien benefiting others. A negative pledge is generally required by both secured and unsecured debtholders

Sale / Leasebacks

- ◆ In a sale / leaseback transaction a Company sells an asset, like a factory, to a finance Company and then simultaneously leases it back under a long-term operating lease (on or off balance sheet)
- ◆ Intended to limit off balance sheet obligations and to protect the collateral value of physical assets owned by the Company

Transactions with Affiliates

- ◆ Debtholders want to restrict the Company's ability to enter into transactions with affiliates that may not be fair to the Company or its various stakeholders, e.g.,
 - Loans and other payments to officers, directors, etc.
 - Contracts with companies owned or controlled by officers, directors, etc.
 - Transactions above a specific value typically require Board approval and / or a Fairness Opinion

Lines of Business

- ◆ Debtholders provide capital in part because they believe management has expertise in running the Company in a specific business, like building materials. They do not want that management team expanding into a totally unrelated line of business, like the production of Hollywood action movies
- ◆ Intended to restrict a Company's business activities to its existing areas of expertise

Financial Covenants

The following list describes some of the most common financial Covenants that are contained in bank credit agreements and bond indentures

Maintenance Financial Covenants (Bank)

- ◆ Total Debt/EBITDA
- ◆ Senior Debt/EBITDA
- ◆ Interest Coverage Ratio⁽¹⁾
- ◆ Fixed Charge Coverage Ratio⁽²⁾
- ◆ Total Debt/Total Capitalization
- ◆ Limitation on Capital Expenditures

Incurrence Financial Covenants (Bond)

- ◆ Total Debt/EBITDA
- ◆ Fixed Charge Coverage Ratio⁽³⁾
- ◆ Net Worth

1. Generally defined as EBITDA divided by interest expense.

2. Definitions vary depending on the specifics of the bank financing (Generally defined as EBITDA divided by interest expense and dividend or preferred; occasional includes a reduction for capital expenditures).

3. Generally defined as EBITDA divided by the sum of interest expense plus preferred dividends.

Typical Bank Covenants (Maintenance)

Though Maintenance Covenants seemingly reduce flexibility of the Company, they align the bank group's incentives with those of the Company

In most cases in which companies seek covenant relief, bank group will work with Company to approve amendments

- ◆ Credit agreements are subject to maintenance financial covenants
 - Borrowers must remain in compliance with these types of covenants throughout the term of a credit agreement
 - These covenants are generally tested on a quarterly basis
 - Failure to comply with these covenants represents an event of default and a waiver / amendment to the credit agreement is required from the debtholders
- ◆ Maintenance Financial Covenants include
 - Total Debt/EBITDA
 - Senior Debt/EBITDA
 - Interest Coverage⁽¹⁾ or Fixed Charge Coverage⁽²⁾ Ratio
 - Total Debt/Total Capitalization
 - Limitation on Capital Expenditures

1. Generally defined as EBITDA divided by interest expense.

2. Definitions vary depending on the specifics of the bank financing. Generally defined as EBITDA minus capital expenditures, divided by interest expense.

Typical High Yield Covenants (Incurrence)

- ◆ **Limitation of Incurrence of Indebtedness** – The basic High Yield Debt Covenant is designed to maintain a minimum level of financial health by restricting the incurrence of a significant amount of additional debt unless the cashflow can support it. Debt incurrence test is usually a minimum of 2.0x Fixed Charge Coverage Ratio (note this is **much** less restrictive than both bank and debt private placement covenants)
 - Credit facilities
 - Capital lease obligations
 - Refinancing of existing indebtedness
 - General basket
 - ◆ **Limitation on Restricted Payments** – Limits the Issuer from making investments and payments to holders of junior capital – restricted payments would include dividends, principal prepayments on subordinated debt, redemption of capital stock, and certain investments with carve-outs or exceptions including
 - Basket that grows based on 50% of net income (or reduced by 100% of net loss)
 - Basket increases from equity contributions
 - General basket
 - ◆ **Limitation on Asset Sales** – Limits the sale of the Issuer’s assets not in the ordinary course of business, unless done under certain guidelines including (i) the percentage of proceeds received in cash; (ii) sale for fair market value of the asset; (iii) specified application of proceeds
-

Typical High Yield Covenants (Incurrence)

- ◆ **Limitation on Liens** – Limits the Issuer from incurring liens on its assets (i.e., incurring secured indebtedness), with a pre-specified carveout amount and certain exceptions, including
 - Existing liens at the time of issuance
 - Liens incurred in connection with credit facilities
 - Liens to secure performance obligations, taxes, statutory obligations, etc.
 - Liens used in refinancing any of the above
 - In the Tribune LBO negative pledge in investment grade bonds did not limit subsidiary guarantees, thus large amounts of bank debt were layered at the OpCo level massively priming the bonds which had no CoC
 - In the TXU LBO a “negative pledge” in the investment-grade bonds’ indenture was written to include only “capital stock” (but not assets) of subsidiaries, which allowed the company to secure huge amounts of new debt at its subsidiaries. Furthermore, a lack of subsidiary guarantees in the investment-grade indenture allowed the company to place structurally senior guaranteed debt at the parent level as well
 - ◆ **Limitation on Transactions with Affiliates** – Puts guidelines on transactions with affiliates
 - Must be arms-length
 - Thresholds that require board or fairness opinion
 - ◆ **Change of Control Put** – at 101%
 - ◆ **Limitations on Mergers, Consolidations and Sale of Assets**
 - Must be able to incur at least \$1 of additional debt
 - Net worth test
 - ◆ **Other Covenants** – Include limitations on business activities, limitations effecting restricted subsidiaries, as well as various information reporting requirements
-

Restricted and Unrestricted Subsidiaries

In drafting a bank credit agreement or bond indenture, the borrower / issuer and the debtholders can negotiate what subsidiaries of the Company will be bound by the bank credit agreement or bond indenture

- ◆ Generally, the restrictions in debt instruments (i.e., covenants) apply only to subsidiaries of a Company that are designated as “Restricted Subsidiaries”
 - At the time that a Company issues debt, it lets the debtholders know which of its subsidiaries will be subject to the credit agreement or indenture (“Restricted Subsidiaries”), and which of its subsidiaries will not. Essentially, the Company is designating the parts of the Company that will be responsible for fulfilling the obligations under the credit agreement or indenture
 - All other subsidiaries are designated as “Unrestricted Subsidiaries”. Unrestricted Subsidiaries may do anything they wish, regardless of any restrictions placed on the Company by the credit agreement or indenture, because those restrictions only apply to Restricted Subsidiaries, and the debtholders have effectively been put on notice to assume that the Unrestricted Subsidiaries will not be available to help repay the debt
 - ◆ After the debt is issued, the Company may, if it wishes, change the designation of a subsidiary from Restricted to Unrestricted or vice versa. However, upon changing the designation of any subsidiary, all the covenants must continue to be satisfied
 - ◆ Earnings of unrestricted subsidiaries will not be included for purposes of the financial tests under the financing documentation
 - ◆ Making a Restricted Subsidiary into an Unrestricted Subsidiary
 - This involves taking a subsidiary that has been subject to all of the restrictions in the credit agreement or indenture, and making it not subject to those restrictions anymore
 - To debtholders, this generally represents an extraction of value from the original borrower
 - When the Company chooses to do this, the value of the subsidiary is treated as a Restricted Payment at the time the subsidiary is redesignated as an Unrestricted Subsidiary. The limitation on making restricted payments must be satisfied before the redesignation can be done. The borrower must demonstrate compliance with the financial covenants in the bank credit agreement and bond indenture
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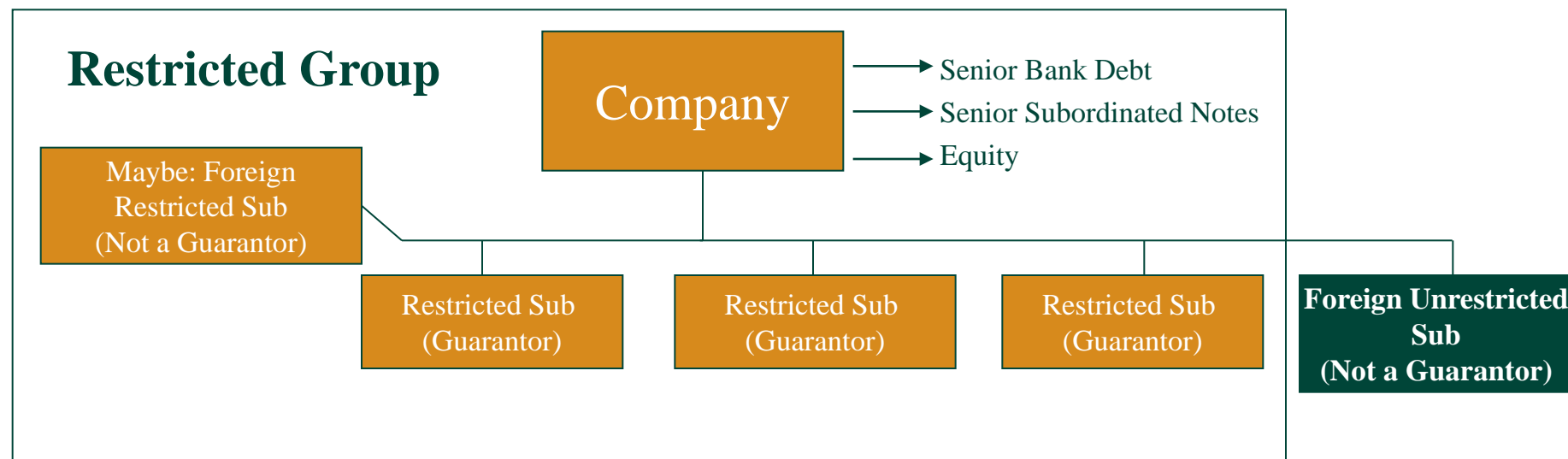
Restricted and Unrestricted Subsidiaries (cont'd)

- ◆ Making an Unrestricted Subsidiary into a Restricted Subsidiary
 - This involves taking a subsidiary that has not been subject to any of the restrictions in the bank credit agreement or bond indenture, and making it subject to those restrictions
 - From the debtholders' perspective, this is generally positive, because it generally involves transferring positive net value to a place that directly supports the credit and that is subject to the restrictions that are designed to protect such value for the benefit of the debtholders. Obviously, if such subsidiary had negative net value, by virtue of its debt or other obligations relative to its asset value, this would be adverse to bondholders
 - When the redesignation of a Restricted Subsidiary takes place, any debt of the subsidiary to be assumed must pass the limitations on additional indebtedness, and the obligor must demonstrate compliance with the financial covenants in the bank credit agreement and / or bond indenture
 - ◆ A restricted payment covenant typically restricts an issuer's ability to make distributions, whether in the form of cash, assets or securities, to shareholders, to redeem subordinated debt, repurchase equity or provide dividends. Such a covenant also constrains an issuer's ability to make "restricted investments." These are investments in "unrestricted subsidiaries" that is, subsidiaries not subject to the indenture covenants – as well as other investments that are not "permitted investments," such as joint ventures and minority investments
 - ◆ The provision should also allow a further limit, in addition to the debt covenant, on the degree to which shareholders can use indebtedness of the issuer to finance distributions to shareholders in leveraged recapitalizations or buyouts
-

Restricted and Unrestricted Subsidiaries (cont'd)

In dealing with restricted and unrestricted subsidiaries, who is liable for payments?

- ◆ The Company, as the Borrower under the credit facilities or issuer of the bonds, is liable; Guarantors are also liable
 - Most common U.S. structure has all domestic Restricted Subsidiaries as Guarantors as follows:



- ◆ Foreign Restricted Subsidiaries are not usually guarantors because of tax issue known as the “deemed dividend” problem
 - May want to limit transfers of assets to non-guarantor subsidiaries even if they are restricted subsidiaries, particularly if foreign or less than wholly owned
 - Banks can take a pledge of 100% of the non-voting stock, and 66 2/3% of the voting stock, of foreign subsidiaries without causing a “deemed dividend”, but can take no pledges of assets owned by those foreign subsidiaries
- ◆ “Holding Company” bonds are typically not guaranteed by any subsidiaries`

Differences Between First and Second Lien Debt

Frequent Terms Sought From First Lien Holders in Inter-Creditor Agreement

Typical Terms Required From First Lien Creditors:

- ◆ Second lien lenders waive:
 - Right to challenge validity, enforceability or priority of first liens
 - Right to object to requests by first lien lenders for adequate protection payments or liens
 - ◆ Second lien lenders consent to:
 - Debtor's use of cash collateral supported by first lien lenders.
 - ◆ Second lien lenders may retain rights to:
 - Object to ancillary agreements or arrangements materially prejudicial to their interests
 - Seek adequate protection in the form of second liens on any additional collateral granted to first lien lenders.
 - DIP financing approved or provided by first lien lenders (subject to negotiated parameters, including those referred to below)
 - Separate Liens. First lien debt and second lien debt should not be secured by the same liens; separate liens should secure first and second lien debt
-

Differences Between First and Second Lien Debt

Frequent Terms Sought By Second Lien Holders in Inter-Creditor Agreement

Critical Rights Second Lien Lenders Should Demand:

- ◆ Second lien debt should not be subordinated in right of payment
 - ◆ Second lien lenders should retain right to vote claims in bankruptcy [Sometimes: “in accordance with the inter-creditor agreement”; or “not inconsistent with the inter-creditor agreement”; or “not in violation of the inter-creditor agreement”]
 - ◆ Second lien lenders should have right to purchase first lien debt, at par.
 - ◆ Remedy standstill applicable to second lien lenders should apply to collateral enforcement actions only
 - ◆ If first lien lenders are granted adequate protection in the form of replacement liens, second lien lenders should be permitted to request same, provided the replacement liens are subordinated
 - ◆ Second lien debt should be governed by a separate second lien credit agreement, with covenants and events of default that operate independently of covenants and events of default in first lien credit agreement
-

Differences Between First and Second Lien Debt

Credit Agreement Negotiating Points

Critical Issues When Negotiating Credit Agreements:

- ◆ Parameters for advance consent by second lien lenders to DIP financing approved or provided by first lien lenders
 - Cap on DIP financing
 - a. How much is enough?
 - b. How is cap calculated? Examples:
 - (i) First lien debt cap, minus outstanding First lien debt on petition date; or
 - (ii) First lien debt on petition date plus unutilized revolving credit facility on petition date
 - (iii) Specific cap unrelated to unutilized first lien cap.
 - c. Should roll-up of first lien debt be permitted? Why does it matter?
 - ◆ DIP financing does not require (i) confirmation of (or “milestones” requiring progress toward) a particular plan of reorganization, or (ii) asset sales prior to an event of default under the DIP financing documents
 - ◆ DIP financing is on “commercially reasonable terms” (what does that mean?)
 - ◆ Second lien lenders retain rights to:
 - Propose a competing DIP financing. What if agreement is silent on this issue?
 - Object to ancillary documents that are materially prejudicial to their interests
 - Assert any objection to the DIP financing available to an unsecured creditor
-

Differences Between First and Second Lien Debt

Credit Agreement Negotiating Points

- ◆ Extremely important because second lien debt generally is not subordinated in right of payment
 - ◆ Examples of Alternatives: Waterfall applies to proceeds of collateral received:
 - From collateral enforcement actions (classic; narrow).
 - In connection with disposition or collection of collateral after exercise of remedies (broader; may or not be collateral remedies)
 - After acceleration, certain events of default, or any event of default (progressively broader; isn't this debt subordination?)
 - ◆ Effect of full cash dominion structure in which all cash collections are applied to prepay first lien debt and all cash expenditures are proceeds of first lien loans.
 - ◆ Post-petition release of liens:
 - Second lien lenders agree not to object to disposition of collateral, under Section 363 of the Bankruptcy Code, free of second liens, if required first lien lenders have consented to disposition, so long as second lien attaches to proceeds of disposition; or:
 - Second lien lenders do not give any advance consent to 363 sales or agree to release their liens in connection with such sales
-

Differences Between First and Second Lien Debt

Credit Agreement Negotiating Points

Application of collateral proceeds waterfall:

- ◆ DIP financing. Some first lien lenders want:
 - a. To be able to “roll-up” first lien debt into DIP financing
 - b. No competing DIP financing proposed by second lien lenders
- ◆ Application of collateral proceeds waterfall. Some first lien lenders want waterfall to apply more broadly
- ◆ Agreement by second lien lenders to release liens. Some first lien lenders want to be able to do “consensual foreclosures”, working with the borrower, prior to the bankruptcy
- ◆ Second lien lenders are generally resisting the efforts by first lien lenders to “push back” in the areas described above

Areas where some second lien lenders are pushing back:

- ◆ Areas where some second lien lenders have concluded that market norms don’t make sense and are seeking outcomes more favorable to second lien lenders include:
 - Advance consent to a 363 sale approved by first lien lenders
 - Blanket consent in advance to use of cash collateral supported by first lien lenders
-

Covenant Survey

Performing a Covenant Analysis

What is Covenant Survey?

- ◆ A covenant study examines the credit agreements and indentures of comparable companies to compare affirmative, negative and financial covenants
 - Since covenants vary greatly from transaction to transaction and since they can be quite complex, careful review of the specific credit agreement and indenture(s) (together with any amendments or waivers to these agreements) may be necessary to accurately understand them. Special attention must be paid to the definitions in each document. Moreover, similar covenants in different credit agreements and indentures may be actually quite different, so careful separate review of each is important

When will I use a Covenant Study?

- ◆ To establish parameters regarding the typical types and levels of covenants for a particular type of debt instrument, a specific industry, or a given level of credit worthiness
- ◆ To facilitate negotiations with a client regarding affirmative, negative and financial covenants in a proposed bank credit agreement or bond indenture

Where can I get the information to compete a Covenant Study?

- ◆ Summary terms and covenants of a bank deal
 - Credit Agreements, Loan Connector, Loan Capital Markets, InterLinks
 - ◆ Summary terms and covenants of a bond deal
 - High Yield Comps, High Yield Database, Prospectus, Indentures (BIS), High Yield Capital Markets
-

Covenant Survey of Comparable Issuers – Example 1

Covenants

Performing a Covenant Analysis

Company	Interline Brands	Wesco Distribution	Park-Ohio	Airgas
Issue Principal Amount (\$ in mm) Coupon At Issue Rating Current Rating Maturity Date Issue Date	Senior Subordinated Notes \$200.0 11.500% Caa1/B- B3/B 5/15/2011 10/28/2003	Senior Subordinated Notes \$125.0 7.500% B2/B B2/B 10/15/2017 9/22/2005	Senior Subordinated Notes \$210.0 8.375% Caa1/CCC+ Caa1/CCC+ 11/15/2014 3/30/2005	Senior Subordinated Notes \$150.0 6.250% Ba2/B+ Ba2/BB- 7/15/2014 3/3/2004
Limitations on Indebtedness	<p>*Incurrence based on Company's Consolidated Leverage Ratio < 4.50x before 6/24/04; < 4.25x between 6/24/04 and 7/1/05; and < 4.00x after 7/1/05</p> <p>Key Baskets:</p> <p>*Incurrence of Revolver, provided debt amount does not exceed greater of \$65 million and 50% of book value of inventory of the Company</p> <p>*Incurrence of Term Loan Facility, provided outstanding amount does not exceed \$140 million less the sum of all principal payments made with respect to such indebtedness</p> <p>*The Notes or Exchange Notes</p> <p>*Existing Indebtedness</p> <p>*Existing Indebtedness that was acquired by the Company, provided that Consolidated Leverage Ratio < 5.00x before 6/24/04; < 4.75x between 6/24/04 and 7/1/05; and < 4.50x after 7/1/05.</p> <p>*Incurrence to finance the purchase, lease, construction or improvement of property or equipment and any Refinancing Indebtedness not to exceed \$7.5 million</p> <p>*Incurrence by Foreign Subs not to exceed \$15 million</p> <p>*Other indebtedness not to exceed \$15 million</p>	<p>*Incurrence based on Company's Consolidated Coverage Ratio < 2.00x</p> <p>Key Baskets:</p> <p>*Incurrence of Bank Debt not to exceed the greater of the borrowing base and \$350 million</p> <p>*Indebtedness of the Company owed to and held by any Wholly Owned Subsidiary or Indebtedness of a Restricted Subsidiary owed to and held by the Company or any Wholly Owned Subsidiary</p> <p>*Indebtedness represented by the Notes and the Exchange Notes</p> <p>*Indebtedness of a Restricted Subsidiary incurred and outstanding on or prior to the date on which Restricted Subsidiary was acquired by the Company; provided, however, if amount exceeds \$50 million, that on the date that such Restricted Subsidiary is acquired by the Company, the Company would have been able to incur \$1.00 of additional indebtedness</p> <p>*Indebtedness in respect of performance bonds, bankers' acceptances, letters of credit and surety or appeal bonds</p> <p>*Incurrence to finance, purchase, lease or improvement of property or equipment, in each case incurred no more than 180 days after such purchase, lease or improvement; provided, however, that outstanding amount not exceed greater of \$50.0 million and 7% of Adjusted Consolidated Assets</p> <p>*Incurrence in connection with acquisition of a Related Business and any Refinancing Indebtedness, shall not exceed \$75 million at any one time</p> <p>*Attributable debt incurred by the Company in respect of Sale/Leaseback shall not exceed \$75 million</p> <p>*Other indebtedness not to exceed \$75 million</p>	<p>*Incurrence based on Company's Consolidated Coverage Ratio < 2.00x</p> <p>Key Baskets:</p> <p>*Incurrence by Park-Ohio and Guarantor of additional Indebtedness and letters of credit under Credit Facilities in an aggregate principal amount not to exceed the greater of \$185 million or the amount of the Borrowing Base as of the date of such incurrence, in each case, less the aggregate amount of all Net Proceeds of Asset Sales</p> <p>*Incurrence by Park-Ohio and its Restricted Subsidiaries of the Existing Indebtedness</p> <p>*Incurrence represented by the notes and related Note Guarantees to be issued on the date of the indenture and the exchange notes and the related Note Guarantees to be issued pursuant to the registration rights agreement.</p> <p>*Incurrence represented by Capital Lease Obligations, mortgage financing, or purchase money obligations. Incurred for any part of purchase price of design, construction, improvement does not exceed 7.5% of Park-Ohio's Consolidated Tangible Assets</p> <p>*Incurrence used to renew, refund, refinance, replace, defease, or discharge any Indebtedness</p> <p>*Incurrence of intercompany debt</p> <p>*Incurrence of hedging obligations in ordinary course of business</p> <p>*Incurrence related to workers' compensation claims, BA, performance and surety bonds in ordinary course of business</p> <p>*Incurrence of foreign subs not to exceed \$15 million</p> <p>*Additional indebtedness not to exceed \$40mm</p>	<p>*Incurrence based on Company's Consolidated Coverage Ratio < 2.00x</p> <p>Key Baskets:</p> <p>*Incurrence by Airgas and Guarantor of additional Indebtedness and letters of credit under Credit Facilities in an aggregate principal amount not to exceed the greater of \$600 million or the amount of the Borrowing Base as of the date of such incurrence, in each case, less the aggregate amount of all Net Proceeds of Asset Sales</p> <p>*Incurrence by Airgas of existing Indebtedness</p> <p>*Incurrence represented by the notes and the related Subsidiary Guarantees</p> <p>*Incurrence represented by Capital Lease Obligations, mortgage financings or purchase money obligations, in each case, not to exceed the greater of \$40 million or 3% of Consolidated Net Tangible Assets.</p> <p>*Incurrence of Permitted Refinancing in exchange for net proceeds used to refund, replace, refinance</p> <p>*Incurrence of Airgas or Restricted Sub indebtedness owing to Airgas</p> <p>*Incurrence of Hedging Obligations</p> <p>*Incurrence related to bid, performance and surety bonds in ordinary course of business</p> <p>*Indebtedness arising from honoring by financial institution of an instrument drawn against insufficient funds in ordinary course of business</p> <p>*Additional indebtedness not to exceed \$40mm</p>

Covenant Survey of Comparable Issuers – Example 1

Performing a Covenant Analysis

Company	Interline Brands	Wesco Distribution	Park-Ohio	Airgas
<p>Limitations on Restricted Payments</p>	<p>*RP Capacity will be based upon the sum of (a) 50% of the Consolidated Net Income; (b) 100% of aggregate net cash proceeds of equity issuance and 100% of FMV of property or assets and 100% of any cash capital contribution received; (c) amount by which Indebtedness is reduced on balance sheet upon conversion or exchange provided amount does not exceed net cash proceeds received from sale of such indebtedness; (d) amount equal to sum of net reduction in Investments and the portion of FMV of the net assets of such Unrestricted Sub at the time such Unrestricted Sub is designated Restricted Sub, provided that foregoing amount shall not exceed amount of Investments previously made</p> <p>*Compliant with \$1 debt test</p> <p><u>Key Baskets:</u></p> <p>*Restricted Payment made out of Net Cash Proceeds of the substantially concurrent sale of Capital Stock of the Company</p> <p>*Any purchase, repurchase, redemption, defeasance, satisfaction, discharge or other acquisition or retirement for value of Subordinated Obligations of the Company or any Subsidiary Guarantor made by exchange for Subordinated Obligations</p> <p>*Dividends paid within 60 days after the date of declaration</p> <p>*So long as no event of default has occurred and is continuing, the repurchase or other acquisition of shares of Capital Stock of the Company from employees, former employees, directors and former directors</p> <p>*Payment of dividends on Disqualified Stock</p> <p>*Restricted Payment made with Net Available Cash from Assets</p> <p>*Repurchase of Capital Stock deemed to occur upon exercise of stock options if such Capital Stock represents a portion of the exercise price of such options</p> <p>*Payment of intercompany subordinated Indebtedness</p> <p>*Restricted Payment in amount taken together with all Restricted Payments does not exceed \$10 million</p>	<p>*RP Capacity will be based upon the sum of (a) 50% of Consolidated Net Income; (b) the aggregate Net Cash Proceeds or FMV of assets or property received by the Company as a contribution to its equity capital or as an inter-company advance from International or its Subsidiaries from the issue or sale of its Capital Stock; (c) the amount by which Indebtedness is reduced on the balance sheet; (d) the amount equal to the net reduction in Investments resulting from (i) payment of dividends, (ii) sale or liquidation for cash of such Investment or (iii) the redesignation of Unrestricted Subsidiaries as Restricted Subsidiaries; (e) amount of any dividends or distributions paid; (f) less the amount equal to the sum of the amount of Net Cash Proceeds from the initial Equity Offering by International plus the amount of net proceeds from the issuance of the Debentures contributed as equity capital</p> <p>*Compliant with \$1.00 debt test</p> <p><u>Key Baskets:</u></p> <p>*Any Restricted Payment made by exchange for, or out of the net proceeds of the substantially concurrent sale of, Capital Stock of the Company</p> <p>*Any purchase, repurchase, redemption, defeasance or other acquisition or retirement for value of Subordinated Obligations of the Company made by exchange for Indebtedness</p> <p>*Any purchase or redemption of Subordinated Obligations of the Company from Net Available Cash</p> <p>*Dividends paid within 60 days after the date of declaration</p> <p>*Any Restricted Payment made for repurchase, redemption or other acquisition or retirement for value of any Capital Stock of International, the Company or any of their respective Subsidiaries held by any employee, former employee, director, former director, provided does not exceed \$5 million in any calendar year and \$20 million in aggregate</p> <p>*Payment of dividends</p> <p>*Repurchase of Capital Stock deemed to occur upon exercise of stock options if such Capital Stock represents a portion of the</p> <p>*Other Restricted Payments not to exceed \$30 million since June</p>	<p>*RP Capacity will be based upon the sum of (a) 50% of the Consolidated Net Income plus (b) the aggregate Net Cash Proceeds received plus (c) amount of debt that is reduced on balance sheet upon conversion or exchange plus (d) an amount equal to (i) FMV of Investments or (ii) portion of FMV of the net assets of an Unrestricted Subsidiary plus (e) 50% of any dividends received plus (f) \$20 million.</p> <p>*Compliant with \$1.00 debt test</p> <p><u>Key Baskets:</u></p> <p>*Payment of any dividend or consummation of any irrevocable redemption within 60 days after the date of declaration of the dividend or giving of the redemption notice.</p> <p>*The making of any RP in exchange for Equity Interests of Park-Ohio or from the substantially concurrent contribution of common equity capital to Park-Ohio</p> <p>*The repurchase, redemption, defeasance or other acquisition or retirement for value of Indebtedness in exchange for Permitted Refinancing Indebtedness.</p> <p>*Repurchase, redemption, or other acquisition or retirement for value of any Equity Interests pursuant to any equity subscription, stock option, shareholders' agreement or similar agreement; provided such amount not exceed \$2.0 million in any twelve month period, with unused amounts being carried over to succeeding twelve months, not to exceed \$4.0 million.</p> <p>*Repurchase of Equity Interests deemed to occur upon exercise of convertible securities</p> <p>*Permitted payment to Parent</p> <p>*Payment made with respect to extinguishment of fractional shares not to exceed \$0.5 million</p> <p>*Purchase or acquisition of Equity Interests of Park-Ohio in open market purchases, pursuant to any benefit plan in the ordinary course of business not to exceed \$2.5 million in any calendar year</p> <p>*Retirement of preferred stock not to exceed 250K</p>	<p>*RP Capacity will be based upon the sum of (a) 50% of the Consolidated Net Income plus (b) 100% of the aggregate Net Cash Proceeds received plus (c) to extent Restricted Investment made after July 30, 2001 is sold for cash or liquidated, the lesser of such cash and the amount of such Restricted Investment plus 50% of cash received plus (d) to extent designated Unrestricted Sub, the lesser of FMV of Investment and FMV on date designated as Unrestricted Sub</p> <p>*Compliant with \$1.00 debt test</p> <p><u>Key Baskets:</u></p> <p>*Payment of any dividend or consummation of any irrevocable redemption within 60 days after the date of declaration of the dividend or giving of the redemption notice.</p> <p>*The making of any RP in exchange for Equity Interests of Park-Ohio or from the substantially concurrent contribution of common equity capital to Airgas</p> <p>*The repurchase, redemption, defeasance or other acquisition of Subordinated Indebtedness with net cash proceeds from incurrence of Permitted Refinancing Indebtedness</p> <p>*Payment of a dividend by Restricted Sub to holders of Equity Interest</p> <p>*Repurchase, redemption, or other acquisition or retirement for value of any Equity Interests not exceed \$7.5 million in any fiscal year with unused amounts being carried over to succeeding two fiscal years</p> <p>*Purchase of fractional shares out of stock dividends</p> <p>*RP not to exceed \$40 million under this clause plus an amount equal to cash pursuant to the previous clauses, plus amount of such restricted payment</p>

Covenant Survey of Comparable Issuers – Example 1

Covenants

Company	Interline Brands	Wesco Distribution	Park-Ohio	Airgas																																																																
Limitations on Sale of Assets	<p>*The Company must receive consideration at the time of such Asset Sale at least equal to FMV</p> <p>*At least 75% of consideration received in form of cash</p> <p>*An amount equal to 100% of the Net Available Cash from such Asset Disposition is applied by the Company: first, to the extent the Company elects, to repay, prepay, redeem or purchase Senior Indebtedness; second, to acquire Additional Assets; third, to make an offer to the holders of the Notes to purchase Notes; fourth, for any purpose not prohibited by the terms of the Indenture. Applies when Net Available Cash exceeds \$10.0 million</p> <p>*In event of Asset Disposition that requires purchase of Notes, Company will purchase Notes tendered at a purchase price of 100% of their principal amount, without premium, plus accrued but unpaid interest</p>	<p>*The Company must receive consideration at the time of such Asset Sale at least equal to FMV</p> <p>*At least 75% of consideration received in form of cash</p> <p>*An amount equal to 100% of the Net Available Cash from such Asset Disposition is applied by the Company: first, to the extent the Company elects, to repay, prepay, redeem or purchase Senior Indebtedness; second, to acquire Additional Assets; third, to make an offer to the holders of the Notes to purchase Notes; fourth, for any purpose not prohibited by the terms of the Indenture. Applies when Net Available Cash exceeds \$20.0 million</p> <p>*In event of Asset Disposition that requires purchase of Notes, Company will purchase Notes tendered at a purchase price of 100% of their principal amount plus accrued and unpaid interest</p>	<p>*The Company must receive consideration at the time of such Asset Sale at least equal to FMV</p> <p>*At least 75% of consideration received in form of cash</p> <p>*All net Available Proceeds, less any amounts invested within 365 days are applied to permanent repayment of Senior Debt; second, to acquire all or substantially all of the assets of another Permitted business; third, to make a capital expenditure; fourth, to acquire other assets not classified as current assets under GAAP and that are useful in a Permitted Business; fifth, a combination of the previous permitted clauses.</p> <p>*The offer price in any Asset Sale Offer will be equal to 100% of the principal amount plus accrued and unpaid interest and Liquidated Damages, if any, will be payable in cash. If any Excess Proceeds remain, Park-Ohio may use those Excess Proceeds for any purpose not otherwise prohibited.</p>	<p>*The Company must receive consideration at the time of such Asset Sale at least equal to FMV</p> <p>*At least 75% of consideration received in form of cash</p> <p>*All net Available Proceeds, less any amounts invested within 365 days are applied to permanent repayment of Senior Debt; second, to acquire all or substantially all of the assets of another Permitted business; third, to make a capital expenditure; fourth, to acquire other assets and that are useful in a Permitted Business</p> <p>*When aggregate amount of Excess Proceeds exceeds \$25 million, Airgas will make an offer to holders of notes to purchase the notes. The offer price will be equal to 100% of the principal amount plus accrued interest</p>																																																																
Permitted Liens	<p>*"Lien" means any mortgage, pledge, security interest, encumbrance, lien or charge of any kind (including any</p>	<p>*Liens on Indebtedness under the Credit Agreement or other Credit Facilities</p> <p>*Liens in favor of the Company or its Wholly Owned Restricted Subsidiaries</p> <p>*Liens on property of a Person at the time such Person becomes a Restricted Subsidiary</p> <p>*Liens of the Company securing Indebtedness of the Company</p> <p>*Liens on property existing at time of acquisition by the Company</p> <p>*Liens incurred to secure the performance of tenders, bids, leases, statutory obligations, surety or appeal bonds, government contracts, performance and return of money bonds or other obligations of alike</p> <p>*Liens existing on the Closing Date and any additional Liens created under the terms</p> <p>*Liens incurred in the ordinary course of business with respect to obligations that do not exceed \$20 million</p> <p>*Liens incurred in the ordinary course of business in connection with workers' compensation</p> <p>*Liens on accounts receivable</p> <p>*Liens refinancing indebtedness to extent such liens do not cover any property of the Company not previously subjected to Liens</p> <p>*Liens on pledges of capital stock of any Unrestricted Subsidiary</p>	<p>*Liens on assets securing Senior Debt</p> <p>*Liens in favor of Park-Ohio or Guarantors</p> <p>*Liens on property of a Person existing at the time such Person is merged with or into or consolidated with Park-Ohio</p> <p>*Liens on property existing at the time of acquisition of the property by Park-Ohio</p> <p>*Securing performance of statutory obligations, surety or appeal bonds, or other obligations</p> <p>*Liens existing on date of indenture</p> <p>*Liens for taxes, assessments or governmental charges or claims</p> <p>*Liens imposed by law</p> <p>*Liens created for benefit of the notes</p> <p>*Liens secured IRB</p> <p>*Liens securing Hedging Obligations</p> <p>*Ordinary course of business not exceeding \$3mm</p>	<p>*Liens securing indebtedness that is pari with the notes, the notes are secured on an equal and ratable basis with the Indebtedness so secured until the time such indebtedness is no longer secured by a lien</p> <p>*If such lien secures indebtedness which is subordinate to the notes, any such Lien shall be subordinated to a Lien granted to the holders of the notes in the same extent as such subordinated indebtedness is subordinated to the notes</p>																																																																
Notes / Other	<p>*Optional Redemption - not before 5/15/2007</p> <p>*Not required to make any Mandatory Repayment on Notes</p> <p>*Change of Control - 101%</p>	<p>*Optional Redemption - Prior to 10/15/08, redeem up to 35% at redemption price of 107.5%, provided at least 65% still outstanding. Redeemable in whole or in part at any time after 10/15/10 at declining redemption prices</p> <p>*Change of Control - 101%</p>	<p>*Optional Redemption - Prior to 11/15/07, redeem up to 40% of notes issued, provided at least 60% remains outstanding.</p> <p>*Change of Control - 101%</p>	<p>*Optional Redemption - Prior to 7/15/07, redeem up to 35% of notes issued, provided at least 65% remains outstanding. Prior to 7/15/09, may redeem at 100% of principal amount plus make whole premium</p> <p>*Change of Control - 101%</p>																																																																
Capitalization	<table border="1"> <thead> <tr> <th></th> <th>6/27/2003</th> </tr> </thead> <tbody> <tr> <td>Cash and Cash Equivalents</td> <td>\$0.0</td> </tr> <tr> <td>Pari Passu Debt</td> <td>140.0</td> </tr> <tr> <td>Notes Offered</td> <td>200.0</td> </tr> <tr> <td>Total Debt</td> <td>\$340.0</td> </tr> <tr> <td>Preferred Stock</td> <td>\$354.3</td> </tr> <tr> <td>Equity</td> <td>(248.5)</td> </tr> <tr> <td>Total Capitalization</td> <td>\$446.3</td> </tr> </tbody> </table>		6/27/2003	Cash and Cash Equivalents	\$0.0	Pari Passu Debt	140.0	Notes Offered	200.0	Total Debt	\$340.0	Preferred Stock	\$354.3	Equity	(248.5)	Total Capitalization	\$446.3	<table border="1"> <thead> <tr> <th></th> <th>9/22/2005</th> </tr> </thead> <tbody> <tr> <td>Cash and Cash Equivalents</td> <td>\$15.0</td> </tr> <tr> <td>Pari Passu Debt</td> <td>394.4</td> </tr> <tr> <td>Notes Offered</td> <td>150.0</td> </tr> <tr> <td>Total Debt</td> <td>\$544.4</td> </tr> <tr> <td>Preferred Stock</td> <td>-</td> </tr> <tr> <td>Equity</td> <td>402.8</td> </tr> <tr> <td>Total Capitalization</td> <td>947.2</td> </tr> </tbody> </table>		9/22/2005	Cash and Cash Equivalents	\$15.0	Pari Passu Debt	394.4	Notes Offered	150.0	Total Debt	\$544.4	Preferred Stock	-	Equity	402.8	Total Capitalization	947.2	<table border="1"> <thead> <tr> <th></th> <th>9/30/2004</th> </tr> </thead> <tbody> <tr> <td>Cash and Cash Equivalents</td> <td>\$6.0</td> </tr> <tr> <td>Pari Passu Debt</td> <td>137.4</td> </tr> <tr> <td>Notes Offered</td> <td>210.0</td> </tr> <tr> <td>Total Debt</td> <td>\$347.4</td> </tr> <tr> <td>Preferred Stock</td> <td>-</td> </tr> <tr> <td>Equity</td> <td>70.8</td> </tr> <tr> <td>Total Capitalization</td> <td>418.1</td> </tr> </tbody> </table>		9/30/2004	Cash and Cash Equivalents	\$6.0	Pari Passu Debt	137.4	Notes Offered	210.0	Total Debt	\$347.4	Preferred Stock	-	Equity	70.8	Total Capitalization	418.1	<table border="1"> <thead> <tr> <th></th> <th>12/31/2003</th> </tr> </thead> <tbody> <tr> <td>Cash and Cash Equivalents</td> <td>\$0.0</td> </tr> <tr> <td>Pari Passu Debt</td> <td>565.2</td> </tr> <tr> <td>Notes Offered</td> <td>150.0</td> </tr> <tr> <td>Total Debt</td> <td>\$715.2</td> </tr> <tr> <td>Preferred Stock</td> <td>-</td> </tr> <tr> <td>Equity</td> <td>666.9</td> </tr> <tr> <td>Total Capitalization</td> <td>1382.1</td> </tr> </tbody> </table>		12/31/2003	Cash and Cash Equivalents	\$0.0	Pari Passu Debt	565.2	Notes Offered	150.0	Total Debt	\$715.2	Preferred Stock	-	Equity	666.9	Total Capitalization	1382.1
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Covenant Survey of Comparable Issuers – Example 2

Covenants

Company	Interline Brands		Wesco Distribution	Park-Ohio	Airgas
LTM Revenue	\$880.1		\$4,695.7	\$964.2	\$2,829.6
EBITDA	98.30		268.61	74.62	398.50
% Margin	11.17%		5.72%	7.74%	14.08%
Current Rating	B3/B		B2/B	Caa1/CCC+	Ba2/BB-
	Existing Subordinated Notes	Proposed	Wesco Distribution	Park-Ohio	Airgas
Optional Redemption					
Make-whole Premium:	None	T + 50	None	None	T + 50
Indebtedness					
Ratio Test:	4.00:1.00 (lvg test)	2.00:1.00 (cvg test)	2.00:1.00 (cvg test)	2.00:1.00 (cvg test)	2.00:1.00 (cvg test)
Incurred under Credit Facility:	R/C: Greater of "The RC Amount" and 50% of Book Value of inventory TL: Not to exceed "The Term Loan Amount" less sum of all principal payments	Not to exceed \$350 million or Borrowing Base	Not to exceed the greater of \$350 million or borrowing base	Not to exceed the greater of \$185 million or borrowing base	Not to exceed the greater of \$600 million or borrowing base
Indebtedness for Capital Leases:	\$7.5 million	Greater of \$15.0 million of 5.0% of Consolidated Tangible Assets	N/M	7.5% of Consolidated Tangible Assets	Greater of: \$40 million or 3.0% of Consolidated Tangible Assets
Foreign Subsidiary Debt:	\$15.0 million	\$15.0 million	N/M	\$15.0 million	N/M
General Basket:	\$15.0 million	\$35.0 million	\$75.0 million	\$40.0 million	\$40.0 million
Restricted Payments					
Definition:	Back dated to give credit for equity offerings	Back dated to give credit for equity offerings	Back dated to give credit for equity offerings	Back dated to give credit for equity offerings	Back dated to give credit for equity offerings
Acquisition of Capital Stock from employees, directors, etc.:	\$2.5 million per annum \$7.0 million in total	\$2.5 million per annum \$7.0 million in total	\$5.0 million per annum \$20.0 million in total	\$2.0 million per annum \$4.0 million in total	N/M N/M
General Basket:	\$10.0 million	\$25.0 million	\$30.0 million	N/M	\$40.0 million
Event of Default:					
Cross acceleration:	\$12.5 million	\$12.5 million	\$35.0 million	\$10.0 million	\$30.0 million
Judgement default:	\$12.5 million	\$12.5 million	\$35.0 million	\$10.0 million	\$30.0 million
Asset Disposition:					
Recognition threshold:	\$1.0 million	\$5.0 million	\$5.0 million	\$5.0 million	\$5.0 million
Permitted Investments:					
JV Basket:	\$7.0 million	\$10.0 million	\$10.0 million	\$10.0 million	\$25.0 million

Financial Distress and Insolvency

Absolute Priority

- ◆ Under the Bankruptcy Code, each “class” of creditor has a specific ranking in terms of their recovery. Theoretically, each “class” is paid in full before the next class receives any recovery (absolute priority rule). In practice, as we have seen most notably in Chrysler and GM the rules of absolute priority are often violated
 - ◆ Administrative claims
 - Expenses for lawyers, bankers, accountants, etc.
 - Debtor-in-possession
 - Employee wages (earned but not paid) up to \$4,600 per employee
 - Post-petition accounts payable and accrued expenses
 - ◆ Priority claims
 - Taxes owed to state or federal entities
 - Secured claims (Only to the extent of the value of the collateral)
 - Pension Claims
 - ◆ Unsecured claims
 - Pre-petition trade and other claims
 - Unsecured debt (includes trust preferred)
 - Deficiency claims (undersecured lenders)
 - Claims arising from rejection of leases
 - Contingent claims (lawsuits)
 - ◆ Equity interests
 - Preferred stock
 - Common stock
-

Financial Distress and Insolvency

Bankruptcy Timeline

STAGE 1: BANKRUPTCY FILING AND KEY INITIAL ISSUES			
DEBTOR FILES VOLUNTARY PETITION	FIRST DAY ORDERS AND OTHER MATTERS	FORMATION OF CREDITORS COMMITTEE	REPORTING REQUIREMENTS
<ul style="list-style-type: none">• Automatic Stay• Business operates in the normal course	<ul style="list-style-type: none">• Use of cash collateral• Interim use of DIP• Retention of professionals• Ability to pay wages• Maintenance of bank accounts	<ul style="list-style-type: none">• US Trustee appoints creditors committee• Advisors (legal and financial) appointed	<ul style="list-style-type: none">• Statement of schedules• Schedule of executory contacts• Periodic reporting

Financial Distress and Insolvency

Bankruptcy Timeline

STAGE 2: DUE DILIGENCE AND NEGOTIATION OF TERMS OF REORGANIZATION			
DEVELOPMENT OF CHAPTER 11 PLAN OF REORGANIZATION	CLAIMS PROCESS	EXECUTORY CONTRACTS	DUE DILIGENCE AND MONITORING
<ul style="list-style-type: none"> • Debtor has 120 days exclusive right from the petition plus approved extensions to file proposed plan • Plan classifies claims and interests and specifies their treatment • Plan terms guided by valuation, debt capacity and creditor rights and positions (seniority of claims, secured vs. unsecured, etc.) 	<ul style="list-style-type: none"> • Deadline established for filings of claims ("Bar Date") • Proof of claims filed by creditors • Debtors/Creditors/Court resolve claims issues 	<ul style="list-style-type: none"> • Decisions on rejection or assumption of leases and executory contracts 	<ul style="list-style-type: none"> • Creditors Committee and other parties-in-interest conduct due diligence on company • Investigation and monitoring of operations • Negotiation of plan of reorganization terms

Financial Distress and Insolvency

Bankruptcy Timeline

STAGE 3: CONFIRMATION REORGANIZATION PLAN & EXIT FROM BANKRUPTCY	
FILING OF PLAN OF REORGANIZATION AND DISCLOSURE STATEMENT	CONFIRMATION AND CONSUMPTION OF PLAN OF REORGANIZATION
<ul style="list-style-type: none">• Filing of Plan and Disclosure Statement with court• Hearing in court on adequacy of disclosure (with 25 days notice to creditors); upon approval of Disclosure• Upon approval of Disclosure Statement, mailing of plan, Disclosure Statement and voting ballots to parties-in-interest (minimum 25 days voting period)	<ul style="list-style-type: none">• Hearing on confirmation court hearing on objections to plan and consideration of confirmation of plan• Plan must be approved by 50% in number and 2/3 in amount by each voting class of creditor• Plan must meet "best interests" test and be deemed "feasible" on a post reorganization basis• After bankruptcy case is fully administered, court enters a final decree closing case

Case Studies

Sandridge Incurrence Analysis

Setting up Distressed Exchange

Sandridge Energy Issues \$1.25bn of 8.75% 2nd lien Notes in May 2015

- ◆ The transaction was designed to boost liquidity to get through the bottom of the Oil price cycle
- ◆ In conjunction with the transaction the company's RBL was reduced from \$1bn to \$500mm (undrawn)
- ◆ The 2nd lien indenture allowed for the issuance of at least another \$250mm of 2nd lien debt as well as junior secured debt

July 2015 Oil prices break below \$50, Sandridge in high cost Mid Continent Play 2nd liens trade into the mid 70s

- ◆ Announces the retention of Lazard as Restructuring advisor
- ◆ Appears to be setting up distressed exchange

What is Sandridge's Debt Capacity and What can realistically be incurred given current trading levels

- ◆ With the 2nd lien debt trading in the mid 70s issuing new 2nd lien or junior debt is not feasible given current yields
 - ◆ However, 2nd lien debt cap at \$1.75bn provided that amounts in excess of \$1.5bn reduce the RBL by 25% of such debt making \$250mm the effective cap given excess would reduce the RBL (however could go up to \$500mm)
 - ◆ \$75mm carveout lien basket up to \$50mm could be 1st lien the remainder 2nd or 3rd lien
 - ◆ Junior (3rd lien) debt can be incurred subject to 1.1x ACNTA test (Estimated capacity of \$1.78bn)
 - ◆ Also Incurrence of additional debt would be limited by 2.25x Fixed Charge Coverage Ratio to incur additional ratio debt. Given these constraints Sandridge appears to be setting up a distressed exchange. LTM EBITDA of \$832mm and LTM Interest Expense of \$245mm leaving approximately \$125mm in additional interest expense
 - ◆ Given that much of Sandridge's unsecured debt is trading in the 30s, Sandridge could offer the unsecured debt the option to swap into a component of the remaining \$250mm 2nd lien basket (pro rata) and the rest in third lien. All at a large discount to par. The 2nd lien option would probably used as carrot for early tenders
-

Sandridge Incurrence Analysis

Case study

Priming Transaction

Is a new 1st Lien Priming Transaction Possible

- ◆ The credit facilities debt basket in the 2nd lien indenture permits the incurrence of debt up to the greater of (i) \$950 million, (ii) the borrowing base for debt incurred under a senior credit facility or (iii) 30% of modified ACNTA (≈\$1bn) . However, the borrowing base calculation allows for significantly more capacity assuming a lender would be comfortable with the underlying collateral value

The Relevant Borrowing Base Definition:

- ◆ *The maximum amount in United States dollars determined or re-determined by the lenders under the Senior Credit Facility as the aggregate lending value to be ascribed to the Oil and Gas Properties of the Company Senior Credit Facility.... exceed 65% of the discounted future net revenue before state or federal income taxes from Proved Reserves of the Company and its Restricted Subsidiaries calculated using Modified ACNTA Prices (after giving effect to commodity derivatives contracts in effect as of the date of determination) but otherwise calculated in accordance with SEC guidelines, as estimated in the most recent Reserve Report after giving effect to exploration and production activities, acquisitions, dispositions and production since the date of such Reserve Report in the same manner as would be given in calculating Modified ACNTA*
- ◆ Using the 65% ACTNA calculation could allow for the issuance of up to \$2bn of 1st lien debt. While traditional bank RBL lenders would unlikely be comfortable with this level of loan to collateral value. However, a large distressed lender seeing an opportunity to possibly loan-to-own or at least sit in the drivers seat of any restructuring may find such a transaction attractive, despite what would likely be an under collateralized loan if oil prices remain where they are currently

Gulfmark Energy

Case study

Debt Capacity Analysis

Gulfmark Provides Marine Transportation Services to Offshore Oil&Gas Rigs and Has been hit hard by Oil decline

- ◆ GLF has a Multi currency revolver: \$200mm \$60mm drawn (Note: Covenant that they must maintain \$50mm of liquidity so true availability is \$90mm)
 - ◆ NOK 600mm US\$80mm Revolver
 - ◆ \$59mm of cash
 - ◆ Total Liquidity $\$140+80+59-50=\229mm
 - ◆ The 6.375% notes trading at 74 have a credit facility cap = max \$350mm or 25% CTA whichever is greater. CTA appears to be about \$1.7bn which would allow them up top \$425mm of secured debt. There is an additional carveout basket for \$30mm.
 - ◆ Assuming the US and NOK facilities account for \$280mm of the cap, then there is approximately \$145mm of secured debt capacity. We believe the \$30mm additional carveout could not be secured, but could be subsidiary debt.
 - ◆ The \$145mm would have to be issued as 2nd lien debt on the unencumbered assets. However, assuming a 12% interest rate on this debt and existing \$35mm that would put interest expense at \$52mm.
 - ◆ The revolver covenant is 1x coverage for 2016 and stepping up to 1.25x in June 2017, 1.5x Dec 2017, 2x in 2018 and 3x thereafter. This may limit the ability to issue additional debt. Under no circumstance could a use of proceeds be the purchase of stock or unsecured debt
 - ◆ While consensus EBITDA for 2015 is \$50mm our recent discussions with those in the market have indicated that North Sea pricing was much worse than street analysts were assuming and that EBITDA may be \$30-40 and 0 in 16
 - ◆ Regardless of whether EBITDA is between \$25-\$50mm, the interest coverage ratio on the revolver makes the issuance of additional debt very difficult without a very credible EBITDA bridge to demonstrate they can remain within covenants
-

Caesars Case Study

When LBO's Go bad

Genesis of Caesars

- ◆ In 2006 Apollo and TPG engaged in a \$30bn leveraged buyout of Harrah's Casino
- ◆ Approximately \$20bn of debt was raised with an additional \$4bn of pre LBO debt being rolled
- ◆ The majority of the debt was raised at CEOC the operating company while the sponsors equity was at the holding company CEC

The 2008 Credit Crisis

- ◆ The credit crisis impacts the business of Caesars and the company begins to be weighed down by excessive debt
- ◆ The company's operating performance declines and the debt begins to trade down

2010 Sponsors Begin Transferring Assets (Asset Stripping)

- ◆ In 2010 the sponsors begin transferring assets from CEOC to non-guarantor subs as well as parent Guarantor for what creditors allege to be less than reasonably equivalent value
- ◆ Allege they are non-arms length transactions with inherent conflicts of interest
- ◆ No third party market test

Culminates in the 2014 Removal of Parent Guaranty after Valuable assets have been transferred to Parent

- ◆ Differing groups of 1st and 2nd lien creditors attempt to file lawsuits for what they regard as violations of the indenture, fraudulent transfers. 2nd lien creditors attempt to file involuntary bankruptcy.
-

Caesars Case Study

Case study

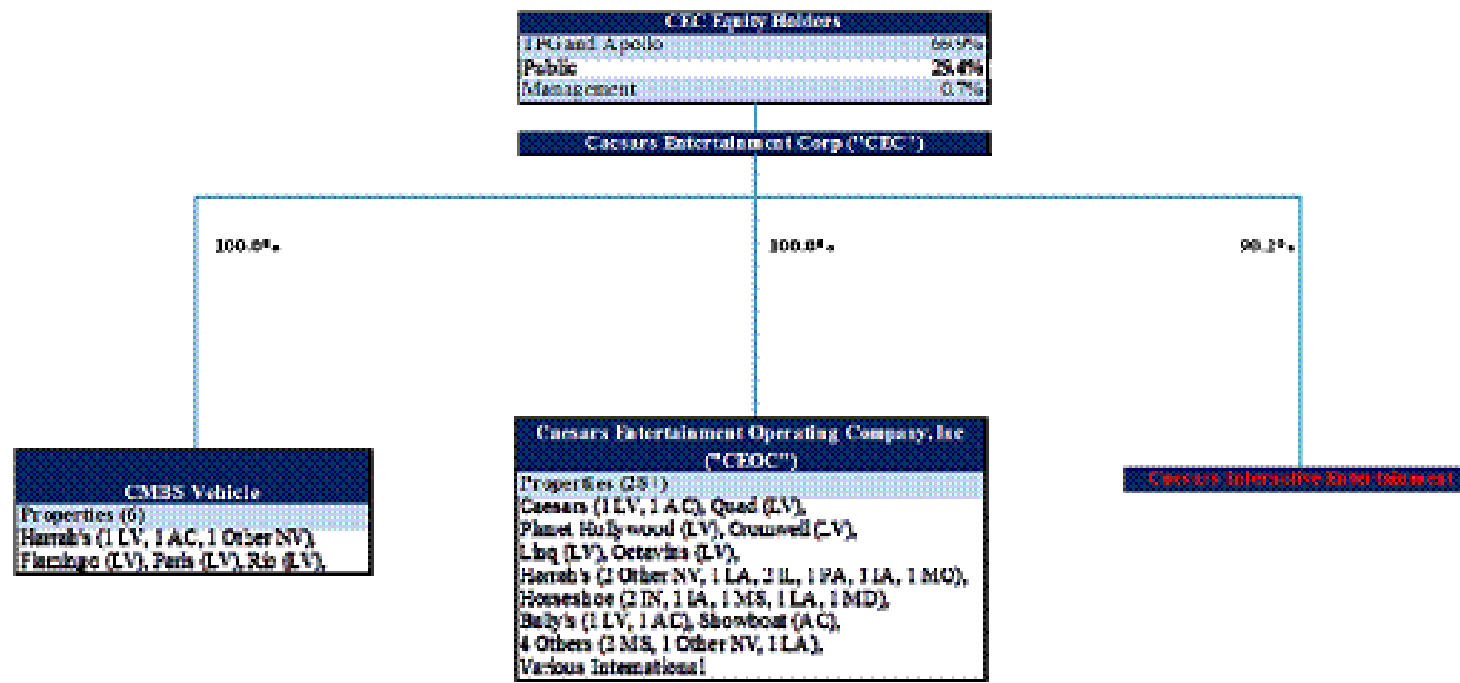
Capital Structure Detail

CEOC Detailed Capital Structure					Credit Metrics		
(\$ in millions)	Face Value	Maturity	Interest		Debt / EBITDA	EBITDA / Interest	EBITDA / (CapEx + Int.)
			%	\$			
Term Loan B-4	\$377	10/31/16	L+8.50%	\$40			
Term Loan B-5	938	01/28/18	L+5.75%	60			
Term Loan B-6	2,299	01/28/18	L+6.75%	170			
Term Loan B-7	1,750	01/28/18	L+7.50%	142			
Total Bank Debt	\$5,364			\$411	5.2x	2.5x	1.6x
First Lien Notes	2,095	06/01/17	11.25%	236			
First Lien Notes	1,250	02/15/20	8.50%	106			
First Lien Notes (Aug. & Dec. 2012)	1,500	02/15/20	9.00%	135			
First Lien Notes (Feb. 2013)	1,500	02/15/20	9.00%	135			
Total Senior Secured Debt	\$11,709			\$1,023	11.4x	1.0x	0.8x
Second Priority Notes	—	12/15/15	10.00%	—			
Second Priority Notes	4,502	12/15/18	10.00%	450			
Second Priority Notes	750	04/15/18	12.75%	96			
Total Secured Debt	\$16,961			\$1,569	16.5x	0.7x	0.6x
Guaranteed Senior Notes (Cash)	479	02/01/16	10.75%	52			
Guaranteed Senior Notes (Toggle)	16	02/01/18	11.50%	2			
Total Contractually Senior Debt	\$17,456			\$1,623	17.0x	0.6x	0.6x
Senior Notes ⁽¹⁾	297	06/01/16	6.50%	19			
Senior Notes ⁽¹⁾	234	10/01/17	5.75%	13			
Clark County Bonds	47	06/01/37	5.30%	2			
Capital Lease / Other Misc	62	12/31/16	6.00%	4			
Chester Downs Notes	330	02/01/20	9.25%	31			
Total CEOC Debt	\$18,425			\$1,692	17.9x	0.6x	0.5x
					16.4x		

Note: Source Blackstone Lender Presentation
September 2014

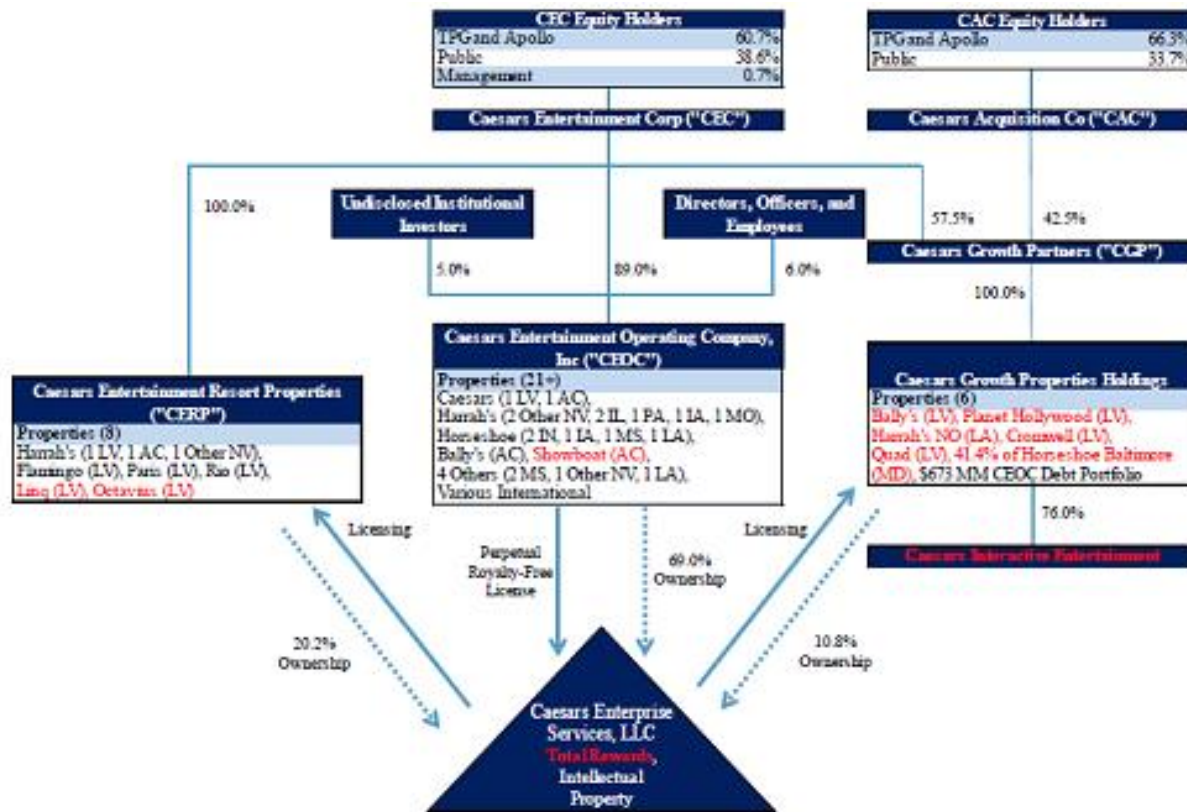
Caesars Case Study

Corporate Structure Pre Asset Transfers



Caesars Case Study

Corporate Structure Post Asset Transfers



Caesars Case Study

Alleged Asset Stripping

Genesis of Caesars

- ◆ 2011 transferred interactive gaming operations to CEC, for virtually no consideration which was later valued at almost \$800mm by CEC 2 years later base on sale of 10% stake to Rock Gaming and \$225mm of potential earnings form social mobile gaming
 - ◆ 2012 moving additional assets to two affiliates Caesars Entertainment Resort Properties, LLC (“Resort Properties”), a wholly owned subsidiary of CEC, and Caesars Growth Partners, LLC (“Growth Partners”), an entity controlled by the Sponsors and which is 58% owned by CEC. Neither of which are liable for CEOC debt
 - ◆ In 2013 transferred 2 Las Vegas properties, Over \$750mm had been invested yet CEOC got \$600mm. (Self dealing, inadequate consideration) then Planet Hollywood and Baltimore casino including 50% of CEOC management fees from those properties
 - ◆ March 2014 sold 4 of CEOCs most valuable properties to CEC as well as the Total Rewards Loyalty program to Caesars Growth Partners
 - ◆ New Caesars Growth Partners and Resorts , then CEOC left with less valuable assets and the bulk of the debt
 - ◆ Allege that CEOC was insolvent at time of transfer (Fraudulent transfer), transfers did not have adequate consideration, reasonably equivalent, value
 - ◆ Not market tested to third parties, insider, non-arms length transactions. Violated fiduciary duties
 - ◆ May 2014, stripped parent guaranty from CEOCs debt, through the sale of 5% of equity in CEC. Most controversial the sale was to a group of new B7 1st Lien TL holders. A transaction also which purported to release the parent guarantee from CEOC debt except for the B7 TL. Playing creditor classes off each other is an effective strategy in negotiations
-

Caesars Case Study

Creditor Causes of Action

Were these transactions permitted under the indentures?

- ◆ Creditors argued that CEOC had been insolvent from at least 2012 citing large losses and negative book equity 10K for the year ended December 31, 2013, CEC had operating losses of \$2.235 billion, total losses of \$2.948 billion, and negative shareholders' equity of \$3.122 billion.
 - ◆ Prior to a bankruptcy the courts generally do not rule on solvency issues and Fraudulent Transfers. The courts tend to favor issuers (company) and defer to their business judgment.
 - ◆ It is not until bankruptcy that many of these issues get litigated. Tribune, Lyondell, SemGroup litigation still ongoing 7 years later
 - ◆ Recent Marblegate ruling on TIA could be favorable on asset stripping case
 - ◆ Breach of Fiduciary Duties
 - ◆ Creditors generally considered creatures of contract and therefore officer/directors do not owe them any duties other than those spelled out in indenture/credit agreement. Although, still can be an effective tool in negotiations.
 - ◆ The transfer of Assets for less than market value is the stronger argument
 - ◆ The release of the guaranty is the most controversial in that it hinges on what creditors allege to be a sham equity transaction that was purchased by lenders who were participating in new B7 TL deal and would keep guaranty while purporting to release remaining CEOC guaranty.
 - ◆ How was CEOC able to continue for so long without tripping covenants?
 - ◆ The indentures allowed for the addback of pro forma cost savings as well various other addbacks
 - ◆ While the cost savings were never realized, they could be continually be projected in order to comply with covenants
-

Caesars Case Study

Creditors Allege Valuable Assets Transferred for far less than Market Value

Figure M: Defendants' Looting of CEO's Valuable Operating Assets

Date of Transfer	Asset Transferred	Conservative Estimated Equity Value	Equity Value Attributed	Equity Valuation Shortfall – \$	Equity Valuation Shortfall – %
August 2010	Trademarks	\$45MM	None	\$45MM	100%
2011 – 2013	Caesars Interactive Entertainment <i>Online gaming business</i>	\$635MM	Likely none	\$635MM	100%
October 2013	Linq / Octavius <i>Two Las Vegas properties</i>	\$942MM	\$134MM	\$808MM	86%
October 2013	Planet Hollywood	\$633MM	\$134MM	\$499MM	79%
October 2013	Horseshoe Baltimore	\$236MM	\$80MM	\$156MM	66%
May 2014	Cromwell, Quad and Bally's <i>Three Las Vegas properties</i>	\$1.6BN	\$1.4BN	\$213MM	13%
May 2014	Harrah's New Orleans	\$855MM	\$660MM	\$195MM	23%
May 2014	Total Rewards	\$1.0BN	None	\$1.0BN	100%
TOTAL		\$5.9BN	\$2.4BN	\$3.6BN	60%

Caesars Case Study

The Guaranty Release

Was the Parent Guaranty Permitted Under the Indentures?

- ◆ After transferring valuable assets to Caesars Growth Partners and Caesars Resorts controlled by the parent, if the parent guaranty remained then ultimately there would be no benefit to the sponsors from these transactions. Hence, the move to release the parent guaranty of the CEOC debt.
- ◆ On May 5, 2014 through the sale of 68.1 shares of CEOC's common stock for a total of \$6.15 million (the equity investment and release together, the "First CEC Guarantee Release Transfer").¹⁵¹ The sale price implied that CEOC's total equity was worth \$123 million, when in fact the equity was clearly worth zero given CEOC's \$19 billion debt load. It has been publicly reported that the purchasers of CEOC's equity included the lenders of the New B7 Term Loan, releasing the CEC Guarantee as to \$14.2 billion in CEOC's debt, while keeping the CEC Guarantee in place as to the New B7 Term Loan
- ◆ Section 12.02(c) in turn provides, in part, that the CEC Guarantee: *shall terminate and be of no further force or effect and the Parent Guarantor shall be deemed to be released from all obligations under this Article XII upon: (i) the Issuer ceasing to be a Wholly Owned Subsidiary of Caesars Entertainment; (ii) the Issuer's transfer of all or substantially all of its assets to, or merger with, an entity that is not a Wholly Owned Subsidiary of Caesars Entertainment in accordance with Section 5.01 and such transferee entity assumes the Issuer's obligations under this Indenture; and (iii) the Issuer's exercise of its legal defeasance option or covenant defeasance option under Article VIII or if the Issuer's obligations under this Indenture are discharged in accordance with the terms of this Indenture*
- ◆ Does the word "And: require all 3 to occur to release guaranty. CEC argues it really means or and therefore satisfied criteria for release of liens

Other Cases for Further Study

Additional Examples

The last several years have provided several high profile examples of contentious creditor issues:

- ◆ Make whole cases:
 - Chemtura (favorable/ global settlement)
 - Calpine I (favorable)
 - Calpine II (unfavorable not tied to acceleration)
 - School Specialty (favorable highly tailored document)
 - American Airlines (unfavorable not tied to acceleration)
 - Momentive Performance Materials (unfavorable cram up take back note)

 - ◆ Post Petition Interest (solvent debtor):
 - WAMU (Federal Judgment Rate vs Contract Rate – Unfavorable)
 - General Growth Properties (reinstated received default contract rate – Favorable)
 - Dvorkin Holdings (unfavorable judgment rate, debtor was insolvent at time of filing, later solvent)
 - Energy Futures Holdings (unfavorable on appeal)

 - ◆ Reinstatement/Cramup:
 - Charter Communications (reinstated, kept same interest rate)
 - DBSD (reinstated, lower interest rate)
 - Young Broadcasting (denied reinstatement)

 - ◆ Marblegate Asset Management v. Education Management Corp (Trust Indenture Act/Asset Stripping)
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