RESTRUCTURING AND DISTRESS

2017

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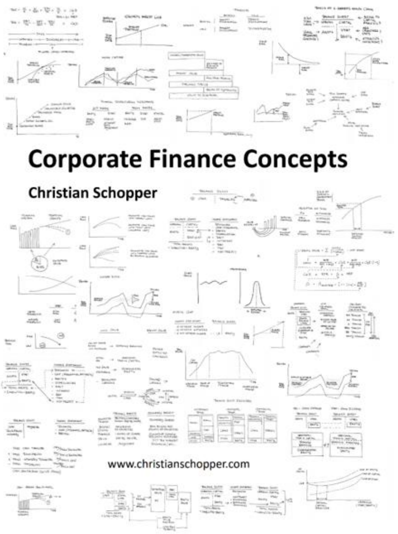

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Restructuring

Divestitures

Reasons for Divestitures

- The divested assets may have a **higher value to the buyer** of these assets
- Immediate **cash flow needs** of the divesting firm …
  - … and less value-driven
- **Re-focus** on core activities

Spin Off

Spin off

- A firm **separates out assets** or a division, and creates new shares with claims on this portion of the business
- **Current stockholders** in the firm **receive** these **shares** in proportion to their original holdings
- Russia
  - Luxsoft / IBS
  - Tower Business / Megafon

Differences to Divestiture

- **No cash** generated
- Spun off division usually becomes **independent entity** with existing management in place

Spin Off vs Split Off and Split Up

Spin off

- A firm **separates out assets** or a division, and creates new shares with claims on this portion of the business
- **Current stockholders** in the firm **receive** these **shares** in proportion to their original holdings

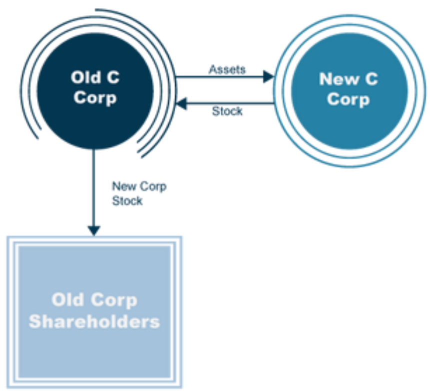
Split up

- Firm **splits** into different **business lines**
- **Current shareholders receive shares** in businesses in proportion to original ownership with **old firm ceasing to exist**

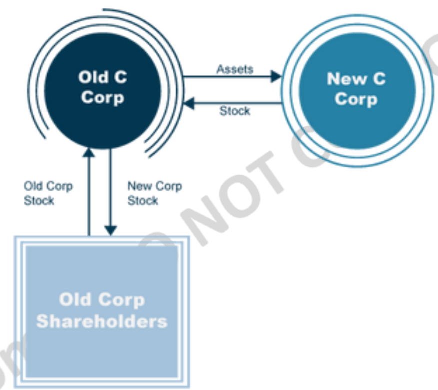
Split off

- Like in a spin off with new shares in a business line
- **Current stockholders given the option to exchange** their parent company stock for these new shares, which changes the proportional ownership in the new structure

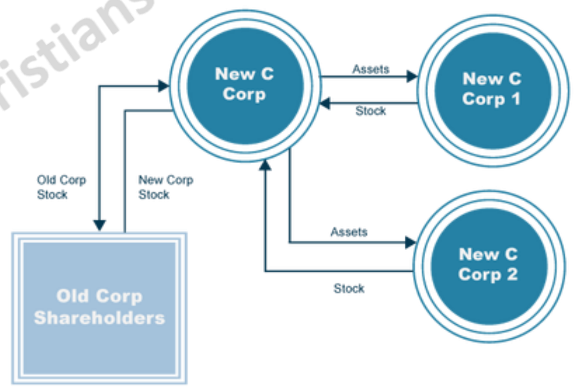
Spin Off vs Split Off and Split Up



Spin-Off



Split-Off



Split-Up

Reasons for Spin Offs

- Effective way of creating value, **when subsidiaries or divisions are less efficient or undervalued**
- Might allow the stockholders in the parent firm to save on **taxes**
- When **adverse developments** faced **by one portion of the business affect** the earnings and valuation of **other parts** of the business
- Create value when a **parent company is unable to invest or manage** its subsidiary businesses optimally because of regulatory constraints

Equity Carve Out (ECO)

Equity Carve Out

- A firm **separates out assets** or a division, **creates shares** with claims on these assets and **sell** them **to the public**
- **Raises cash**
- In general, the **parent company retains control** of the carved out unit
  - Though some equity carve outs are accompanied by spin offs or the issue of tracking stocks

Reasons for Equity Carve Outs

- ECOs **bring in cash** either **to** the **parent** company **or** the **subsidiary**
  - Usually, ECO of a division that has both **high growth** opportunities and significant **investment needs**
- Parent company usually retains **control** after the spin off
  - Hence, some of the operating improvements that follow after spin offs, that result from separation from the parent company, may not occur in equity carve out

Tracking Stock

- Issued by a parent company **tracking the performance of a division without having claim on its assets**

- **Revenues and expenses** of the division are **separated** from the parent company's financial statements and bound to the tracking stock

- **Investors receive dividends relating to the performance** of the division regardless of the performance of the overall business

Reasons for Using Tracking Stock

- The tracked division still gains substantially from its association with the parent company

- The **parent company** needs to **preserve control** of the tracked division
  - … because it supplies a product or service that is viewed as integral or irreplaceable to the parent

Choosing among the Alternatives

Common Objectives

- All highlight the **undervaluation**
- All might result in **additional information** being provided to markets on the operations of the separated units
- Firms that are interested in a **market estimate of the value** of different portions of the business will gain by using all of these actions

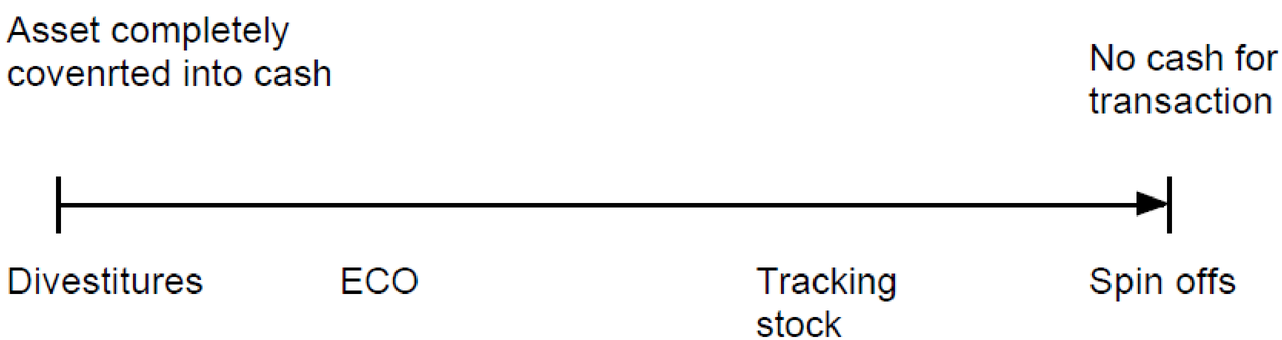
Key Differences

- Effect on **Cash**
- Effect on **Control**
- Effect on **Taxes**
- Effect on **Bondholders**

Key Differences among the Alternatives

Effect on Cash

- Divestitures, equity carve outs and tracking stock result in cash proceeds, whereas spin offs do not generate cash for the parent company



Key Differences among the Alternatives (cont´d)

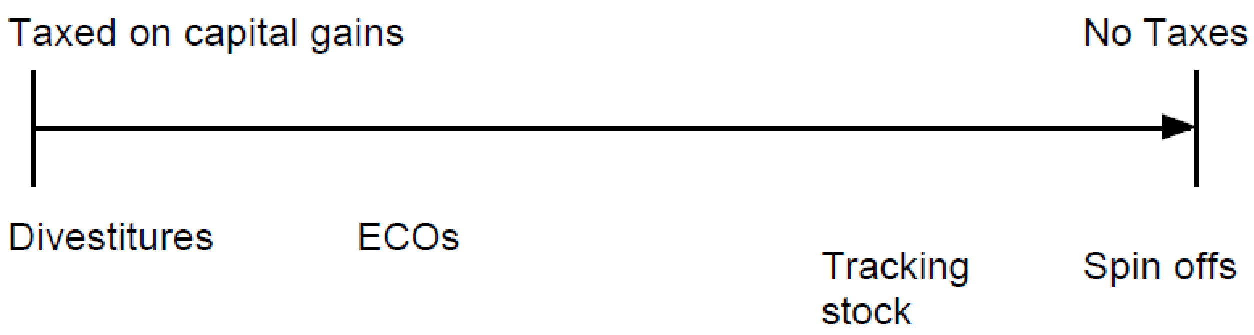
Effect on Control

- In a divestiture, the divesting company has no control over the assets once they are divested
- At the other extreme, when tracking stock is issued, the parent company usually retains complete control over the tracked unit, and stockholders in the unit get no voting right

Key Differences among the Alternatives (cont´d)

Effect on Taxes

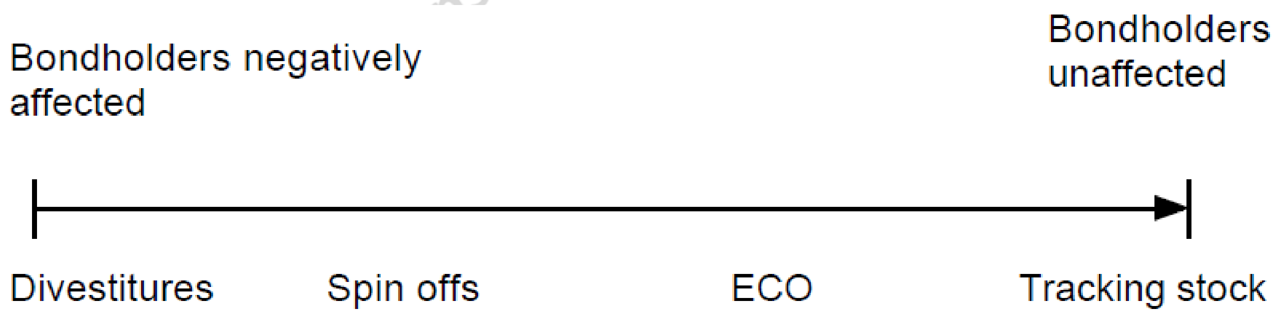
- Spin offs and tracking stock generally create no tax obligations for the stockholders of the parent company
- Divestitures, on the other hand, create a capital gain for the parent company, on which taxes are due



Key Differences among the Alternatives (cont´d)

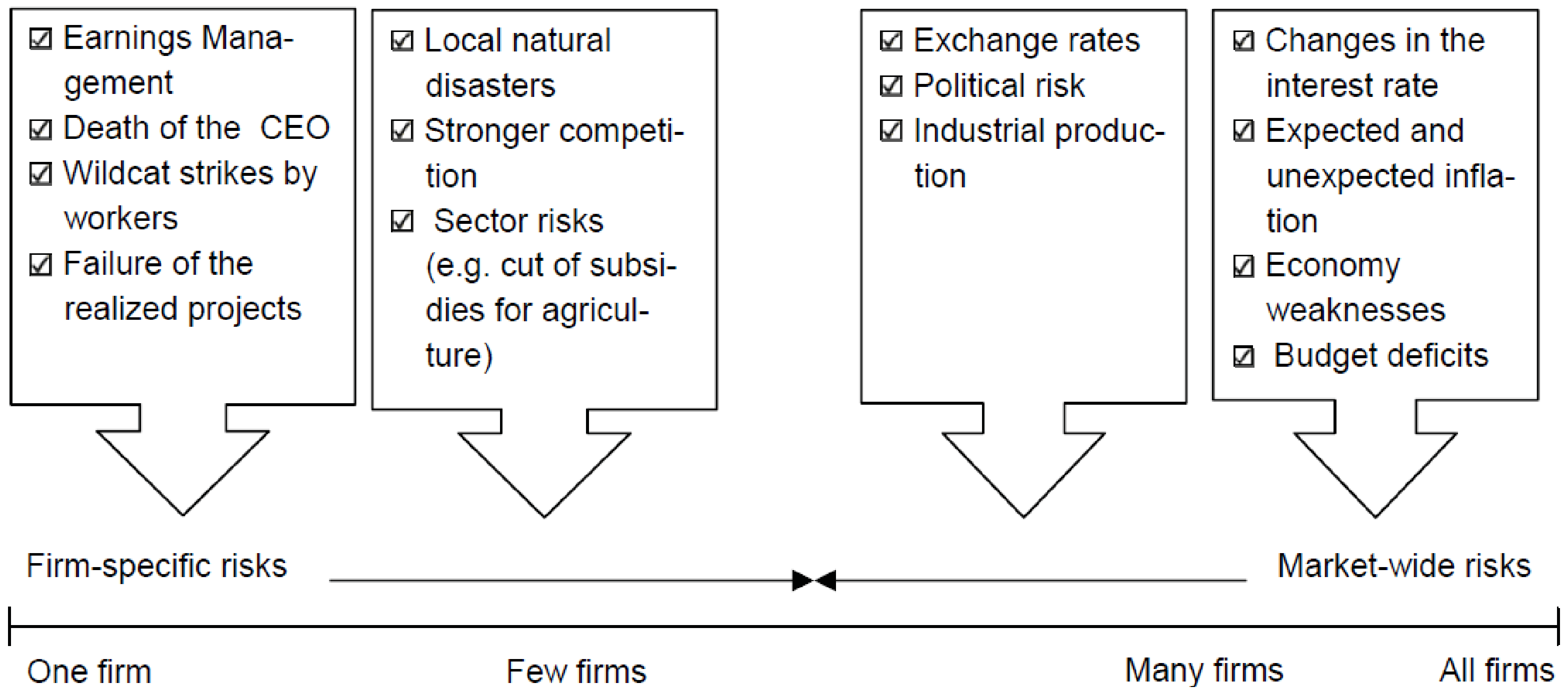
Effect on Bondholders

- The bondholders in the parent company have no claim on the assets that are divested
  - If the cash from the divestiture is paid out as a special dividend or used to buy back stock, the bondholders will be worse off
  - Bondholders can also be negatively affected by spin offs, since the parent company has only a minority interest in the spun off units



Distress

Selected Internal and External Risk Sources



Decline vs Distress

		Distress	
		Yes	No
Decline	Yes	• Cyclical decline in industry or market leading to higher financial and operating (systematic) risk	• Normal business cycle variation • Difficult to distinguish a normal downturn from a problematic one requiring restructuring
	No	• Profitable firm growing beyond sustainable growth rate leading to bankruptcy because of cash-flow problems	Healthy Company

Decline vs Distress – Can a Company Grow Too Fast?

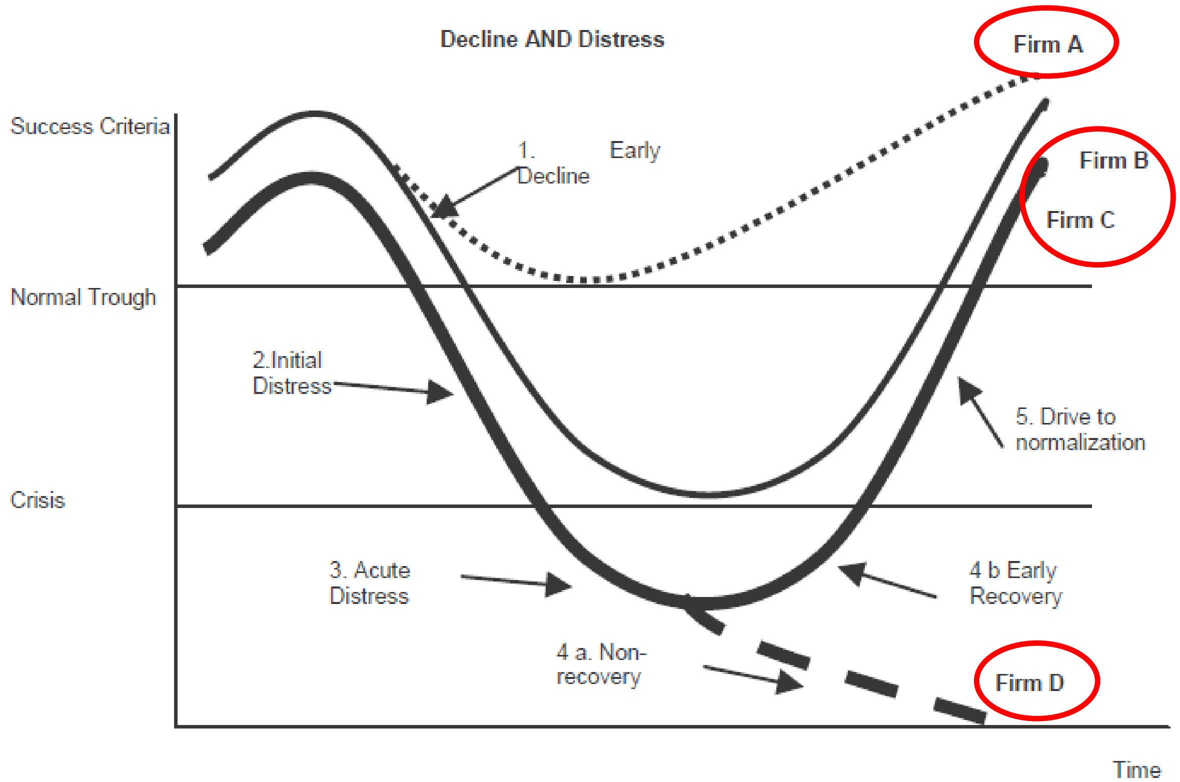
Yes, it can ….:

1. If true **operating costs** are not well understood and how they evolve as the business grows
   – Rapid growth frequently put margins under pressure as the company tries to keep customers happy with such services as faster fulfillment and generous payment terms

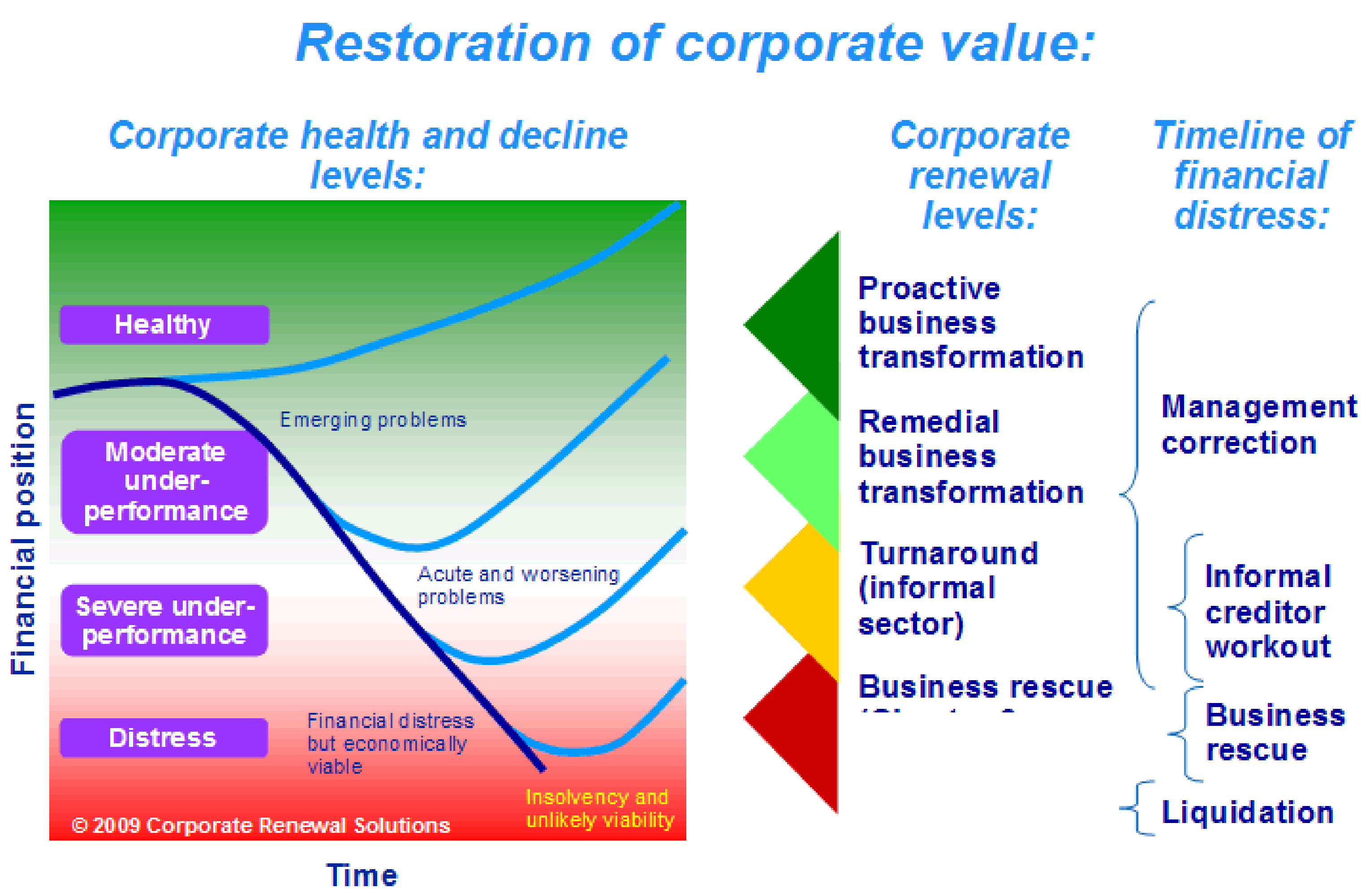
2. If **working capital needs** are underestimated
   – How much cash does the firm require to conduct day-to-day business?

3. If there is **too much obsession with income statements** as an index of health

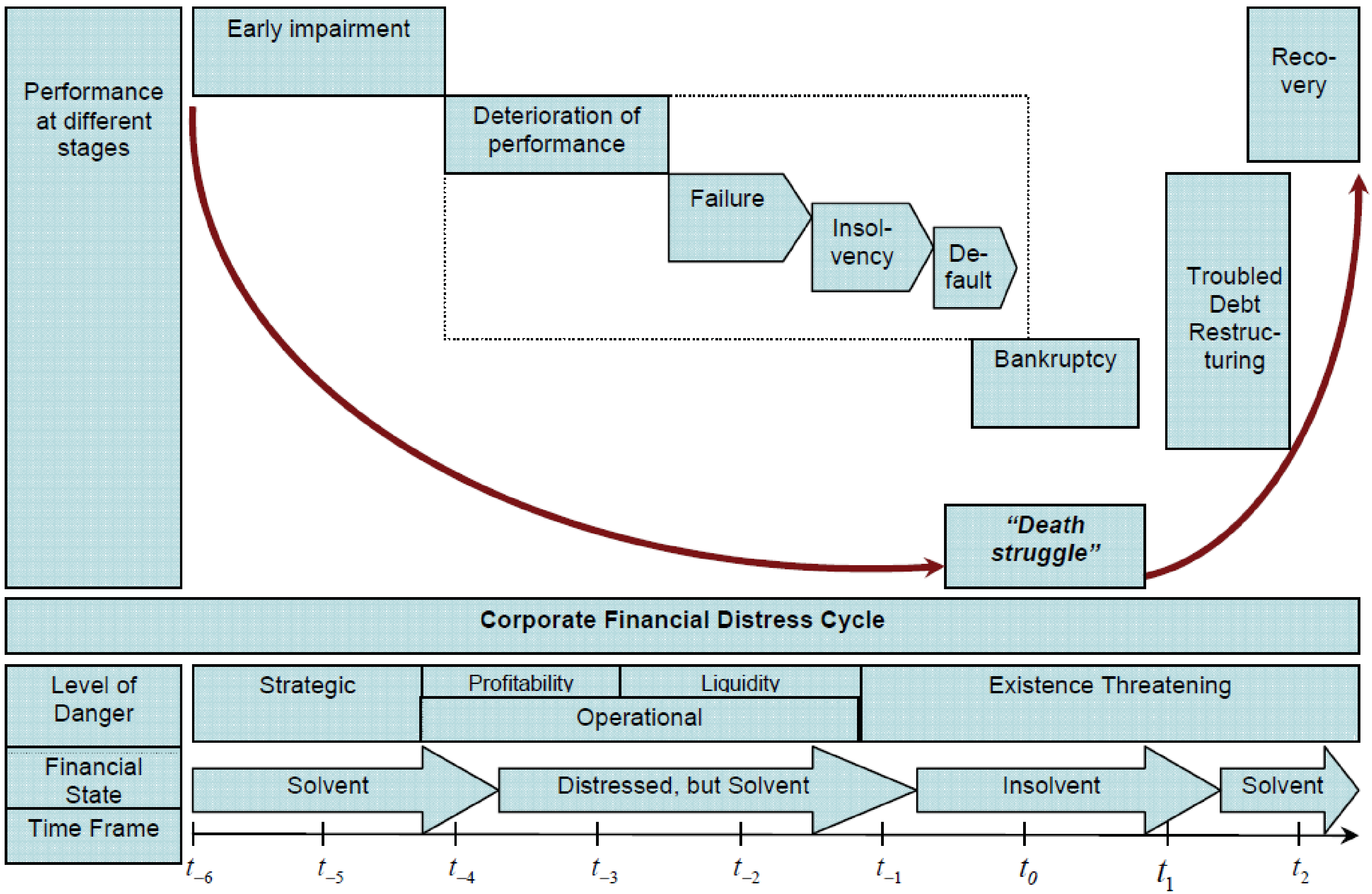
Decline vs Distress - Scenarios



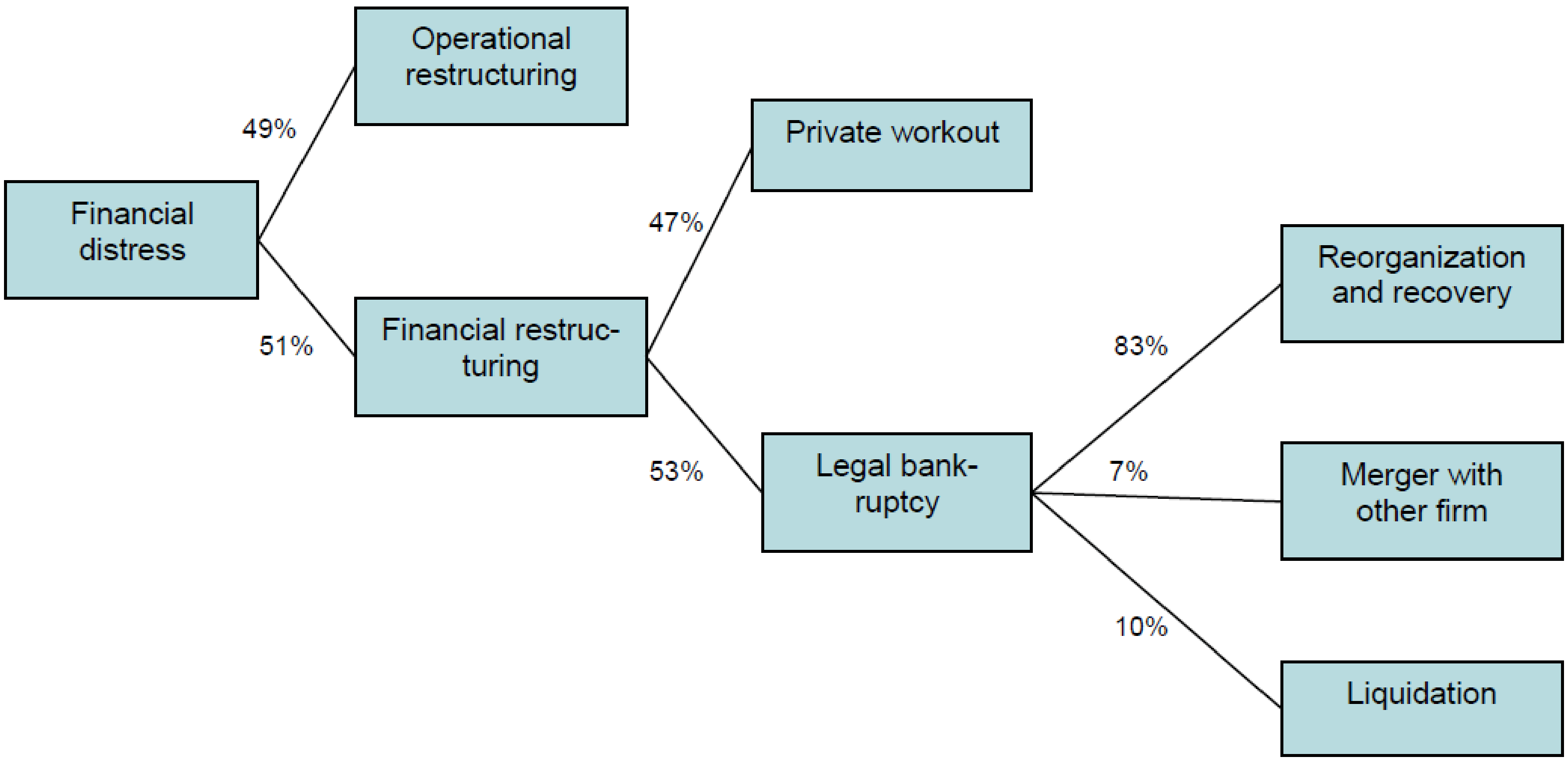
Decline vs Distress – Scenarios (cont´d)



Stages in Distress



Resolving Financial Distress and Success Rates



Appendix - U.S. Corporate Bankruptcy

U.S. Corporate Bankruptcy Procedures

- In the U.S., the traditional distressed opportunity typically arises when a company, **unable to service its debt**, files for **Chapter 7** (**liquidation**) or **Chapter 11** (**reorganization**) bankruptcy
  - Chapter 7 involves shutting a company's doors and parceling out its assets (or the liquidation value of such assets) to its creditors
  - **Chapter 11**, which recognizes the corporation as a going concern, gives the company **legal protection** from creditor actions to continue operating while working out a repayment plan, known as a **plan of reorganization** ("POR"), with a **committee of its major creditors**
  - The **POR describes how** creditors and shareholders are to be treated under the new business plan, and **claimants** in each class of creditors (per capital structure priority) **are entitled to review and vote on the plan**
  - Chapter 11 enables a debtor to **continue to operate** its business **while** it **reduces debt**, **eliminates unprofitable operations** and **renegotiates contracts** and/or leases
  - In effect, the Chapter 11 process seeks to preserve the value of the estate for the benefit of the stakeholders, although in **giving a priority to ongoing operations and the most senior creditors**, shareholders and junior creditors in the capital structure may be impaired or wiped out

Chapter 11

- Chapter 11 bankruptcy is a form of bankruptcy reorganization available to individuals, corporations and partnerships
  - It has no limits on the amount of debt
  - It is the **usual choice for large businesses** seeking to restructure their debt
- The **debtor** usually remains in possession of its assets, and **operates the business under the supervision of the court** and for the benefit of creditors
  - The debtor in possession is a **fiduciary for the creditors**
  - If the debtor's management is ineffective or less than honest, a **trustee may be appointed**
- A **creditors committee** is usually appointed by the U.S.Trustee from among the **20 largest, unsecured creditors** who are not insiders
  - The committee represents all of the creditors in providing oversight for the debtor's operations and a body with whom the debtor can negotiate an acceptable plan of reorganization
- A **Chapter 11 plan** is **confirmed only upon** the **affirmative votes of the creditors**, who are **divided** by the plan **into classes** based on the characteristics of their claims, and whose **votes** are a **function of the amount** of their claim against the debtor

Chapter 11 (cont´d)

- **If the debtor can't get the votes** to confirm a plan, the debtor can **attempt** to "**cram down**" a plan on creditors and get the plan confirmed despite creditor opposition, by meeting certain statutory tests
- Chapter 11 is probably the most flexible of all the chapters, and as such, it is the hardest to generalize about
  - Its flexibility makes it generally more expensive to the debtor

Automatic Stay

- **Halts actions by creditors**
  - Certain exceptions, to collect debts from debtor who declared bankruptcy
- **Stop pay to unsecured creditors**
- **Secured creditors cannot seize collateral**, but interest will accrue
- Hence …
  - Avoids asset grab
  - De facto prolongs maturities

DIP Financing

- **New** senior debt can be issued **even against existing covenants**
- New debt can even be senior to other administrative costs
- Hence …
  - Reduces debt overhang problem

Chapter 11 (cont´d)

Watch out for incentives on all sides

- Creditors
  - Race to the top
  - Don't want firm to go into Ch. 11
  - In Ch. 11, want you to liquidate inefficiently
- Shareholders
  - Stay out of Ch 11
  - In Ch 11, want ongoing firm
- Managers
  - Depends on what their position looks like

Chapter 11 is not first choice

- Almost all large, publicly traded firms **attempt to workout debt before entering Chapter 11**
- Why do firms attempt a workout?
  - Legal and professional **fees higher in Ch 11**
  - **Average length of Ch 11 is longer**, especially when workout included exchange offer
  - In workout, only deal with claims in default

Chapter 11 (cont´d)

Problems with Ch. 11

- **Legal/professional fees have priority** over other claims, so less incentive to get it done
- **Management by judges**
  - Major decisions: file application with court, notify creditors -- file complaints
  - Judges legal requirements
    - Claimholders must receive at least what they'd get in liquidation, company not in danger of going bankrupt again (near future)

Why would bondholders or lenders agree to workout?

- Chapter 11 is a **protection for the debtor** (called the debtor in possession, or **DIP**)
- Chapter 11 **can extract** an even **better** (worse for the creditor) **deal for** the **DIP** than you might get in workout

Chapter 11 (cont´d)

Advantages to DIP of Chapter 11

- **New issued debt higher priority** than pre-petition debt
- **Interest on pre-petition unsecured debt stops accruing**
- **Automatic stay from creditors**
- **Easier** to get **reorganization plan accepted** because of voting rules

Rights of Management in Ch 11

- **DIP** (debtor in possession) has **exclusive right to file first reorganization plan**
  - for 120 days
  - Typically extended, sometimes for years
- **Large management turnover** in both workouts and Ch 11's
  - Also, reputation issues

Chapter 11 (cont´d)

Hierarchy of Claims in Chapter 11

- Secured claims
- Superpriority claims (e.g., debtor-in-possession financing)
- Priority claims
  - Administrative expenses (including legal and professional fees incurred in the case)
  - Wages, salaries, or commissions
  - Employee benefit claims
  - Claims against facilities that store grain or fish produce
  - Consumer deposits
  - Alimony and child support
  - Tax claims
  - Unsecured claims based on commitment to a federal depository institution’s regulatory agency
- General unsecured claims
- Preferred stock
- Common stock

- DIP financing represents a major source of funding to bankrupt companies
- It is often lined up in advance so it can be accessed the moment a company files
- Because of their seniority, DIP lenders rarely fail to be fully repaid, and lending fees can be lucrative
- This market has attracted capital from both traditional lending institutions and, more recently, hedge funds and other investors

Chapter 11 (cont´d)

Why does firm go to Chapter 11?

- **In workout, have to get all participating creditors to agree**
- Bondholders have **incentive to free ride** on the settlement
  - Try to trap the free riders by making the exchanged bonds higher priority, shorter maturity
- Problem worse with public debt, more complex debt

Prepackaged bankruptcy

- Hybrid of workouts and Chapter 11's
  - **Firm files Chapter 11**
  - **But files reorganization plan at the same time** (agreed to with secured creditors informally beforehand)
  - Can hurry up the Ch 11 process
- Not a sure thing …

Chapter 11 (cont´d)

Exclusivity Period

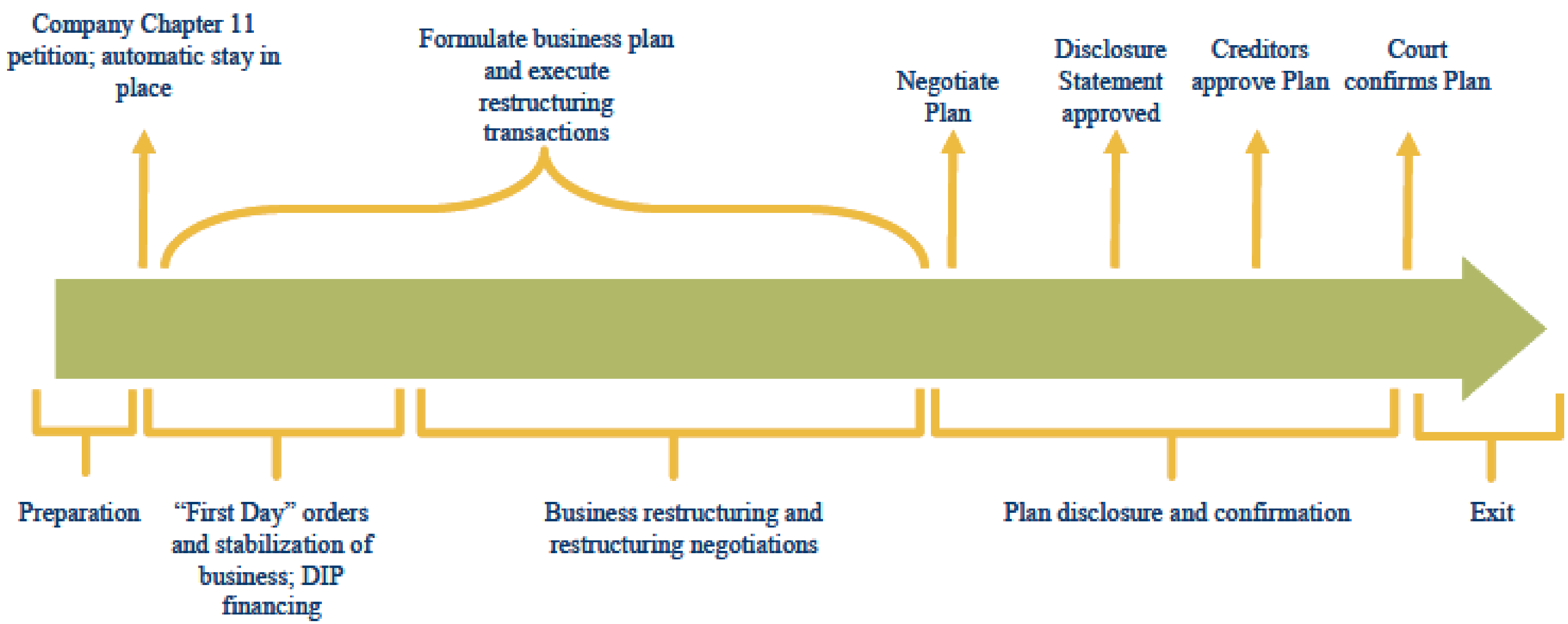
- **For 120 days only Mgmt / BoD can file a reorganisation plan**
- **Another 180 days** to get **approval**
- Judge can extend / reduce deadlines
- Then, other parties may propose alternative plans

- Committees for creditor clusters voice claims and negotiate

Voting Mechanism

- **Majority voting mechanism**
  - Classes grouped with similar claims
  - **2/3 in face value and 1/2 in holders in each class**
- Only groups who are impaired may vote
- Since the voting mechanism is based as of value, **interests differ**
  - Senior debtors want „under" valuation
  - Junior debtors want „over"valuation

Chapter 11 (cont´d)



Does Chapter 11 Really Work?

- Reports and studies indicate that about **10 to 15% of** Chapter 11 cases result in **successful** reorganizations
- **Most cases are dismissed** (often by agreement of the parties) or converted to Chapter 7 liquidations
- Dismissal or conversion of a Chapter 11 case requires **bankruptcy court approval**
- The bankruptcy court can dismiss or convert a Chapter 11 case for cause, including failure by the debtor to show that it can successfully reorganize

Does Chapter 11 Really Work? (cont´d)

The Longest-ever Chapter 11 Case

- W.R. Grace & Company, the construction products and special chemicals manufacturer, filed for chapter 11 in April **2001** to resolve its **asbestos liabilities**
  – Grace is the only large-cap debtor whose common shares were not de-listed after filing and continued to trade publicly on a national exchange (the New York Stock Exchange) through its entire chapter 11 case
- Grace's bankruptcy reached its conclusion in that its plan of reorganization was affirmed in January **2012**
- Although it took 11 years, the Grace bankruptcy **will result in payment of creditors in full, preservation of equity value, and set aside of funds in various trusts for resolution of asbestos personal injury and property damage claims**

Appendix - Investing in Distressed Assets

What is Distressed Debt?

- “Distressed debt” is generally classified as **debt trading with a yield to maturity of greater than 1000 basis points more than** the comparable underlying **treasury** security
  - Another commonly used criterion is debt that trades **below 80 cents on the dollar**
  - However, the distressed debt universe includes **many other types of securities** with different market prices, including defaulted fixed income instruments, stressed performing bonds, below-par bank loans, “busted” convertibles, credit default swaps, NPL portfolios, and post-restructuring equity, to name a few
- Distressed investing, sometimes pejoratively referred to as “**vulture investing**,” began to be recognized as a distinct investment style in the late 1980s/early 1990s with the problems with the US thrift industry …
  - … and collapse of the high yield debt market and **Drexel** Burnham Lambert in 1990
- The **Rothschild** dynasty – known for its **contrarian investing style** – is deemed the most famous institutionalized distressed investor in early financial market history
- Performance in distressed debt tends to be better during and after economic turnarounds when spreads tighten
  - This is when the profits from the successful restructuring can be reaped

Distressed Debt Investing

- One of the most common strategies for distressed debt investing is **buying securities at a distressed price** to what the investor believes is the net present value of the recovery …
  - … with the NPV assumed – logically – higher …

- Typically, investors focus on **high yield bonds and leveraged loans** (bank debt of non-investment grade companies) …
  - … but investors also will consider structured credit products (such as mortgage backed securities and CDOs), trade claims, leases, receivables, vendor financing, and other debt-like instruments.

- Within this typical strategy, there are generally two types of institutional investing sub-strategies:
  1. Passive
  2. Active

Distressed Debt Investing – Passive and Active

Passive Strategy

- More **trading oriented** and investment managers **do not receive non-public information**
  - They are **not engaged in the restructuring negotiations** and are not locked from selling their securities
  - The strategy tends to focus on larger companies with **liquid securities** with a shorter time frame to exit
  - Passive managers view the asset class from a cyclical standpoint and typically invest **opportunistically**
  - Passive managers can also make money by **shorting securities** they believe will decline in price

Distressed Debt Investing – Passive and Active (cont´d)

Active Strategy

- Active **non-control** investors are often **members of a creditor committee** but typically do not lead the restructuring
  – They will likely **receive non-public information** and, as such, be **restricted** from selling their securities until after the restructuring process is complete

- Active **control** managers will look to influence the process through a **blocking position** (size depends on the jurisdiction of the bankruptcy)
  – They also look to play an active role by taking a seat on the board of a company and **work closely with management**

Distressed Debt Investing – Non-Common Strategies

- **Debtor-in-Possession Financing** (DIP Financing) is a unique form of working capital provided to companies in Chapter 11
  - This form of working capital is **secured** and **usually more senior than all other securities**
  - It is often thought of as a **life line** provided to the company in dire need of capital
  - DIP financing **typically has a maturity of between 12-24 months** and allows the company to operate while restructuring its obligations
  - DIP financing is **often provided by investors who have exposure in other parts of the capital structure** and view the more senior lending as a way to increase the recovery value of their existing exposure
  - DIP lending has become quite common among **hedge funds and private equity funds** and not just banks

- **Rescue Financing** which is used to alleviate **working capital issues for a company that might otherwise have to file for Chapter 11**
  - Rescue financing can come in the form of secured lending and consist of equity and / or warrants

Distressed Debt Investing – Non-Common Strategies (cont´d)

- Another strategy employed by investors is a **short executed though credit default swaps** (CDS)
  - Credit default swaps are derivatives whose value increases/decreases inversely with the underlying security
  - For example, **if** an investor has a **bearish view** of a company and believes it may default, **purchasing a CDS contract** will reflect that change in value

- **Capital structure arbitrage** involves identifying **mis-priced securities in different areas of the capital structure** and taking advantage of the arbitrage opportunity
  - E.g.: **After analysis of recovery valuation**, discount rates (yields), asset coverage and a thorough understanding of all claimants within each class an investor may **buy senior** secured debt and **short** a security that ranks **lower** in the capital structure
    - Such a trade would profit if there is not enough to go around, that is to say either through liquidation or a restructuring the recovery on the senior instrument is significantly higher than the junior
  - Another capital arbitrage trade could include **buying unsecured bonds** and **shorting** the **equity** if the investor believes, for example, the common shareholders will get wiped out and there is something left over for bondholders

Distressed Debt Investing – Non-Common Strategies (cont´d)

- There has been an active market for investments in **NPL portfolios** of **defaulted bank loans** – typically mortgage, commercial, and consumer loans – since the early 1990s
  - Such portfolios usually are offered only after significant pressure by regulators for banks to clean up their balance sheets (or after a bank is actually intervened)
  - There have been active markets in the last 20 years in the US, China, Thailand, Germany, and Mexico
  - One of the impediments to NPL investing is that it requires active servicing in order to realize value, an administrative and people-intensive burden many investors are unwilling to take on. In the most recent debt crisis, **securitizations and CDOs** offered analogous opportunities to specialists willing and capable of doing the appropriate analysis and work through the underlying instruments

Strategic Investment Considerations

Phase	Equities	Credit	Description and Market Dynamic
1	↓	↑	Improving economy. Credit spreads tighten (i.e. credit markets rise) while equity markets still fall: Most interesting phase to be long distressed or credit risk in general as spreads quickly tighten. Balance sheets are being repaired and troubled companies restructured. In this situation credit outperforms equities.
2	↑	↑	Booming economy. Credit spreads continue to tighten while equity markets are rising: Everybody is happy and volatility across all asset classes is low or declining.
3	↑	↓	Softening economy. Credit spreads are rising (i.e. credit markets fall) while equity markets still rise: Late stage of the equity bull market as credit enters the emerging bear market. In this phase, corporate debt starts growing faster than profits and volatility is increasing.
4	↓	↓	Recession. Both equity and credit are in a bear market: This phase is bad for all risky asset classes. During this phase, investors can slowly build up exposure in the credit markets before phase 1 begins again. Entering the markets in this phase can yield the best future returns but requires patience as initial returns are often negative (J-curve effect).

Strategic Investment Considerations (cont´d)

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Appendix - Check-List for Distressed Firms

Company Prospects – Can It be Rehabilitated?

- Is the company's **business** viable?
  - Slower industry declines vs. sudden, non-recurring shocks
  - Nature of the enterprise (manufacturing, real estate, financial, transportation, conglomerate …)
- What is the company's **financial condition**
  - What are the company's **immediate** financial needs?
    - Near term maturities
    - Covenant defaults
    - Trade / general liquidity
  - What are the company's **long-term financial** fixes and does it have an **exit** strategy?

Company Prospects – Can It be Rehabilitated? (cont´d)

- What is the company's **financial condition (cont´d)**
  - How does the **complexity** of the company's **capital structure** affect its workout potential?
    - Secured vs. unsecured debt
    - Upcoming maturities
    - Existence and use of derivatives by and against the company
    - Structural and contractual priorities
    - Existence of cross-defaults (credit and operating agreements)
    - Differing yields
    - Number of issuances
    - Concentration of debt holders
    - Identity of debt holders (original, distress investors, government)
    - Existence and use of factoring or securitization facilities
  - What impact does the company's organizational structure have on its restructuring objectives?
    - Simple TopCo / HoldCo structure
    - Need for structural reorganization (*e.g.*, to address post-merger amalgamation with poorly integrated divisions, legal groups and accounting systems)
    - Existence of special purpose entities or bankruptcy remote entities that cannot be filed or easily restructured

Company Prospects – Can It be Rehabilitated? (cont´d)

- What is the company's **geographic blueprint**?
  - Location of center of main interests / headquarters
  - Nature of supply and distribution chain: number, concentration and location of critical vendors and customers
  - Where are physical assets situated?
  - Which country's legal regime governs
    - Operations
    - Sales
    - Minimal jurisdictional contacts

Identifying Restructuring Goals – What Needs to be Fixed?

- When to pursue an **out-of-court workout** versus a **formal filing** also depends on what the distressed company most needs to change
  - Is the business sound but the balance sheet overleveraged?
  - Does it require significant operational fixes, such as reducing over-capacity or streamlining production, that may require consolidation or asset divestiture?
  - Identifying both near-term and long-term restructuring goals – what must be fixed and what should be fixed – further informs the decision of when to file

- Areas to consider here include:
  - Balance sheet
  - Scope of operational fix: division / product specific vs. more enterprise-wide re-positioning
  - Existence of material litigation (commercial, environmental)
  - Existence of legacy pension and union liabilities

What Restructuring Tools Exist and Implementation

- Any restructuring effort requires an understanding of the company's restructuring **options**
  - What out-of-court platforms exist? How do they differ from court-supervised proceedings?
  - What are the benefits and drawbacks of the different approaches?

- Whether in or out of court, a successful corporate restructuring requires significant planning and effective negotiation
  - A distressed company and its investors often engage a restructuring team that includes key management personnel, legal and financial advisors, and crisis management professionals
  - The restructuring team will conduct extensive legal and financial due diligence, and assist the company with developing a sound business and restructuring plan. Planning and timing the out-of court workout entails numerous steps

Stakeholders: Understanding Dynamics and Leverage

- A successful out-of-court workout depends in large part on the company's universe of **stakeholders**, and their willingness to work with the company
  - A distressed company should identify key stakeholders: those entities necessary to deliver a confirmable plan

- **Lenders** (institutional/revolver lenders; hedge fund/term lenders)
  - Economics (are they original holders or distressed investors?)
  - Existence of potential lender liability actions
  - Intercreditor agreements
  - Lien priorities and asset allocations between and among lenders
  - Type of lending relationship (secured / unsecured, term, asset-based, factoring arrangement or securitization, etc.)
  - Necessity of collective action through a syndicated facility

Stakeholders: Understanding Dynamics and Leverage (cont´d)

- **Bondholders**
  - Economics (are they original holders or distressed investors?)
  - Location in the corporate structure (are they structurally senior or junior to other stakeholders? Do special corporate structures exist, such as a ULC or joint venture arrangement, that uniquely affect certain bond issues?)
  - Are any of the bonds guaranteed and by whom?
  - Existence of intercreditor agreements
  - Concentration of holders within an issue or across issues
  - Necessity of collective action to direct indenture trustee, otherwise, likelihood of concerted action (ad hoc groups)

Stakeholders: Understanding Dynamics and Leverage (cont´d)

- **General unsecured creditors**
  - The existence of potential avoidance actions against unsecured creditors, including preference actions against trade creditors, may affect their willingness to extend prepetition credit and negotiate more favorable commercial terms with a company during the prefiling period
  - Uncertainty (some creditors may prefer the certainty of chapter 11 treatment, including its creditor protections, over a less transparent out-of-court process)
  - The existence of a liquid market for trading bankruptcy claims may influence negotiating dynamics with trade creditors (a prepetition trade creditor may sell its claim leaving the company with an unknown third party as the economic stakeholder in a subsequent bankruptcy filing)

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Stakeholders: Understanding Dynamics and Leverage (cont´d)

- **Activist investors** seeking to influence change through acquisition of distressed debt (bank and bond debt) also affect the dynamics of corporate restructuring
  – Activist investors' efforts to obtain control in distressed situations may shape the role of management and ability of management to retain control over the company's future

- Finally, tax considerations will affect all stakeholders and must be considered

- Note on tactics:
  – In an informal workout, a company faces the risk that a group of creditors may file an involuntary petition against the company. Out-of-the money creditors, for example, who can expect little or no recoveries if the company contemplates (or is rumored to contemplate) a "**cramdown plan**," may feel they have nothing to lose by filing an involuntary petition …

Appendix - When business spin-offs spin out of control

Think! - Xerox

When shareholders decide a corporate separation is good for them creditors can feel that this is at their expense …

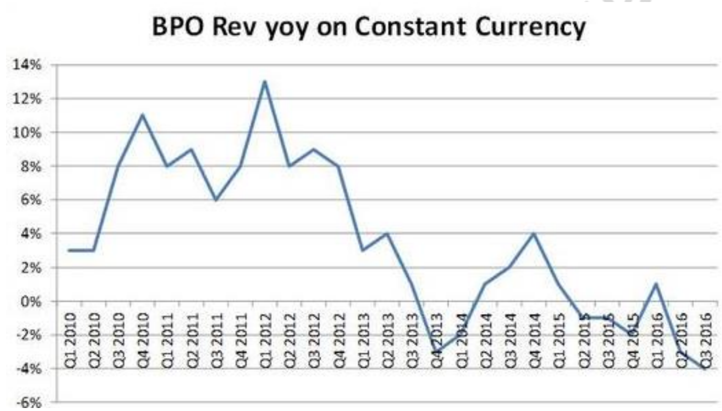
- In January 2016, Xerox announced it would split itself in two …
  - … after Carl Icahn took a 7 per cent stake in the copier business

- “”We are sending you this Information Statement in connection with the spin-off by Xerox Corporation, or “Xerox,” of its wholly owned subsidiary, Conduent Incorporated, or “Conduent.”
- To effect the spin-off, Xerox will distribute all of the shares of Conduent common stock on a pro rata basis to the holders of Xerox common stock
- We expect that the distribution of Conduent common stock will be tax-free to holders of Xerox common stock for U.S. federal income tax purposes, except for cash that shareholders receive in lieu of fractional shares.““

Xerox Acquisition of ACS

Vision: ACS shuffles lots of documents, both digital and paper, with 77,000 employees who process medical bills, student loan records, and credit card applications for other companies or government agencies. Xerox makes some of the most advanced equipment to automate document handling, plus has a global sales force and customer ties to the world's biggest companies. Bring them together, and they'll solve problems in new ways.

Bradley H. Kerkhoff



- In 2010, Xerox had acquired a successful technology outsourcing company, Affiliated Computer Services (ACS), for $6.4bn in cash and stock.
  - ACS was founded by Texan Darwin Deason, …
  - … who made a fortune mastering the dull back-office functions banks and companies need to survive
  - But performance was below expectations

- Xerox's goal — now dashed — was to bundle multiple corporate services and sell the package to big companies

Think! – Xerox (cont´d)

The Conduent Spin-Off

- The impending spin-off unwinds the ACS deal
- The outsourcing unit will be listed as a new enterprise called Conduent that will have annual revenue of about $7bn
  - … leaving $10bn at Xerox
- As for Xerox creditors, Conduent will, as is common practice at spun-off companies, borrow $2.4bn and send most of the cash raised back up to Xerox, which will use the funds to pay down its existing debt

As filed with the Securities and Exchange Commission on June 30, 2016

File No.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10

GENERAL FORM FOR REGISTRATION OF SECURITIES
PURSUANT TO SECTION 12(b) OR 12(g)
OF THE SECURITIES EXCHANGE ACT OF 1934

Conduent Incorporated
(Exact name of registrant as specified in its charter)

New York (State or Other Jurisdiction of Incorporation or Organization)	81-2983623 (I.R.S. Employer Identification Number)
P.O. Box 4505, 45 Glover Avenue Norwalk, Connecticut (Address of Principal Executive Offices)	06856 (Zip Code)

Registrant's telephone number, including area code:
(203) 968-3000

Securities to be registered pursuant to Section 12(b) of the Act:

Title of Each Class to be so Registered	Name of Each Exchange on Which Each Class is to be Registered
Common Stock, par value $1.00	

Securities to be registered pursuant to Section 12(g) of the Act:
None.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Securities Exchange Act of 1934.

Large accelerated filer	☐	Accelerated filer	☐
Non-accelerated filer	☒ (Do not check if a smaller reporting company)	Smaller reporting company	☐

Think! – Xerox (cont´d)

CONDUENT

Who We Are Today

Leader in business process services delivering seamless, mission-critical interactions for businesses, governments and their constituents globally

~$6.6B[1] Revenue driven by long-term annuity contracts	~$630MM[1] Pro Forma Adjusted EBITDA
86% Annual contract renewal rate	~94K Teammates globally
~$260B Market opportunity	~6% Annual market growth

Note: Revenue, Pro Forma Adjusted EBITDA and renewal rate reflect LTM Q3'16; teammate count as of September 30, 2016. Please refer to Appendix for Adjusted EBITDA and Adjusted Revenue reconciliations
Market size and growth rate Source: Xerox Internal Data; NelsonHall 2015 BPO Global BPO Market Forecast, v1.1
[1]Revenue and Pro Forma Adjusted EBITDA exclude the impact of Health Enterprise (HE) strategy change which resulted in a $116MM reduction in revenues and a pre-tax charge of $389MM recorded in Q3'15

5

Think! – Xerox (cont´d)

According to his October court filing, the legal provisions of the preferred stock make "clear that he only agreed to sell the fruits of his life's work [ACS] in exchange for a guaranteed, substantial stake in the combined company on terms that would preclude Xerox from marooning his investment in a company separated from [Conduent]"

Comes in ACS Founder, Mr Deason, again …

- While owning 6 per cent of Xerox common stock, Mr Deason also happens to be a Xerox **creditor**
- He owns $300m of **convertible preferred stock** which he received for his super-voting ACS shares in the 2010 acquisition
- In the upcoming spin-off, **Xerox had planned to keep Mr Deason's preferred stock at Xerox with no participation in Conduent**
- But after months of negotiation Mr **Deason** sued to stop the Xerox separation, **believing** the terms of **his preferred stock entitled him to a stake in Conduent**
- Mr Deason **estimated** that the **value loss** to him from deprivation of a Conduent stake could be as high as $200m

Think! – Xerox (cont´d)

The Settlement

- After initially calling Mr Deason's position "meritless", Xerox settled in just three weeks
- It chose to swap Mr Deason's $300m of preferred shares for $120m and $180m of preferred shares at Conduent and Xerox, respectively
- Given Xerox's $16bn enterprise value, a lengthy scuffle over a $300m security seemed unproductive for the company

Think! – Xerox (cont´d)

Legal Reasoning

- Mr Deason argued that the preferred stock documentation dictated that in a company reorganisation he should be able to participate in whatever new entity was created
  - Common shareholders received shares in the new company
  - The preferred stock could be converted into common shares and thus were similarly entitled

- Xerox countered that the Conduent spin-off constituted not a reorganisation but a "small distribution"

- Mr Deason's convertible shares should simply have the Xerox conversion price adjusted down to reflect the loss of Conduent's earnings

Think! – Xerox (cont´d)

The Issue of Hybrids

- The duties of company boards are to shareholders
- Creditors' primary protection is in the legal documents describing their securities
- Mr Deason's convertible preferred stock left him in the position of being both a creditor and a de facto shareholder
- As a shareholder, he felt entitled to a stake in the new company …
- … but as a creditor, he was just as worried about how a weak, standalone Xerox could support his preferred dividend

Think! – Xerox (cont´d)

The Issue of Hybrids (cont´d)

- Such potential abuse of creditors and others incidental to shareholders is a continuing theme in spin-offs
  - In perhaps the most notorious instance, oil driller Kerr-McGee separated its chemicals unit to form Tronox in 2004
  - But after allegations of environmental damage, Tronox collapsed, leaving Kerr-McGee and its new owner Anadarko to pay out $5bn in damages
  - More recently, the spin-off controversy has centred on their tax-free feature
  - Yahoo notably abandoned its Alibaba spin over tax liability concerns

- In 2015, there were $177bn worth of US spin-offs, up from just $17bn in 2010

In the News WSJ

16 April 2018 - **Xerox Board Ordered CEO to Stop Negotiating With Fuji; Instead, He Raced to a Deal, Lawsuit Alleges**

- Xerox board told Chief Executive Jeff Jacobson in November to stop negotiations with Fujifilm because it was considering firing him, a newly amended lawsuit alleges
- Instead, the suit says, the executive raced to strike a complex deal that would leave him in charge, and cede control of the American icon to the Japanese company, a move that has been criticized by two of Xerox's biggest investors
- Though Xerox's board ultimately stuck with Mr. Jacobson after his performance improved and signed off on the deal he negotiated, communications disclosed Sunday in a lawsuit filed by billionaire investor Darwin Deason allege the CEO negotiated to sell the company—and keep his own job—while pushing the acquirer to help him avoid being ousted under pressure by Carl Icahn, his biggest investor
- Xerox's chairman, Robert Keegan, said Sunday Mr. Jacobson was "fully authorized to engage in discussions with Fujifilm"

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