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M&A Advisor: Removing Stress from Distressed: Investing in Recovery Through Innovative M&A Activity

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Educational Materials

Value & Cents

BY DANIEL R. VAN VLEET

Bankruptcy and Business Valuation in the Current Environment

Even in the best of times, the valuation of a company involved in a bankruptcy can present its own set of challenges. In the current environment, those challenges have been magnified. COVID-19 has fundamentally altered the social, financial and economic fabric of our society. Stay-at-home orders, social distancing, high unemployment, remote business operations, civil disorder, urban flight and the classification of essential vs. non-essential businesses has impacted different sectors of the economy in material and disparate ways. As one might expect, these changes have also affected the way that business valuations are conducted.

The income and market approaches are business-valuation approaches that are often used in bankruptcy matters to determine solvency/insolvency and plan feasibility. Given the current environment, the mechanical application of these approaches might produce indications of value that lack credibility and reliability. This article will address valuation issues associated with the current environment and provide suggested modifications to the traditional application of business-valuation approaches.

Income Approach

The income approach is based on projections of financial performance and the cost of capital of a subject company. From these projections, estimates of expected cash flows are developed and converted into an indication of value using a discount rate based on an appropriate cost of capital. One of the primary components of the income approach is the projected financial performance of the subject company.

Projected Financial Performance

When preparing the projections for the subject company, an assessment should be made to determine whether the current environment conditions will impact the subject company on a temporary or more permanent basis. If temporary, the following issues should be addressed in the analysis:

- the length of time of the temporary period and the cash-flow requirements for the subject company to return to normalized financial and operational performance;
- new cost structure of the business during the temporary period related to regulatory issues, financial performance and operational changes;

- temporary cash-flow impact of existing obligations, government loans, stimulus payments, the Payroll Protection Plan, debtor-in-possession financing, cash infusions and other forms of support; and

- the impact of depreciation, capital expenditures and incremental working capital on the projected cash-flow performance during the temporary period.

If the impact on the subject company is more permanent in nature, the projections should still reflect these aforementioned issues. However, the analysis should also reflect the reality that there will be no return to normalized business operations. When this is the case, the “new normal” conditions are projected to continue for the foreseeable future.

In addition to these issues, the current environment has created significant new challenges that must be addressed when estimating the discount rate used in the income approach. The discount rate can have a material impact on a company’s valuation.

The Discount Rate

The discount rate is calculated based on the estimated costs of debt and equity capital for the subject company. The cost of equity capital is typically calculated by adding the market yield of U.S. Treasury securities to an equity risk premium derived from publicly traded companies. This calculation can become problematic when a “flight to quality” increases the demand for Treasuries during uncertain times. This increased demand can increase the price of Treasuries, which lowers their respective market yields. If an expert mechanically incorporates these lower Treasury market yields into a cost-of-equity-capital analysis in the current environment, the result can be a lower discount rate. This lower discount rate can imply that a company is less risky (and more valuable) than it was prior to the current environment.

When conducting valuations, experts should consider whether the current Treasury yield is the proper rate to use in the calculation of the cost of equity capital. It might be more appropriate to use a “normalized” or expected long-term Treasury yield if the valuation date occurs after mid-February 2020.

Yields on corporate debt are also changing due to the flight to quality. Accordingly, debt balances

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and interest rates reported on the financial statements of public companies may require further analysis. In addition, care should be exercised when estimating the components of debt and equity capital used in the calculation of the discount rate. Failure to do so could result in both an unreliable discount rate and indication of value.

In addition to the income approach, the market approach is a widely used business-valuation approach. The market approach is also susceptible to distortions attributable to the current environment.

Market Approach

The market approach is based on transactions involving the equity securities or business enterprises of publicly traded or privately held companies. When conducting the market approach, the expert will use market transactions to develop earnings multiples, which are then used to value the subject company.

Typically, the valuation methods used in the market approach are twofold: (1) merger-and-acquisition (M&A) method and (2) guideline-public-company (GPC) method. The current environment has had a substantial impact on the application of both of these methods for valuation dates occurring after mid-February 2020. Accordingly, modifications to the traditional application of these methods might be appropriate in order to conclude reliable indications of value.

M&A Method

M&A multiples are calculated by dividing the purchase price of the target company by its earnings. Prices paid in M&A transactions negotiated prior to mid-February 2020 likely do not reflect the impact of the current environment. In addition, the economic uncertainty, risk-aversion and tightening of corporate debt markets have reduced the flow of M&A transaction activity that would ordinarily serve as relevant data points for contemporaneous valuations.

If an expert is able to identify relevant M&A transactions, caution should be exercised when applying M&A multiples to the earnings of a subject company. Whether the earnings and purchase price of the target company are impacted by the current environment will be an important consideration in the analysis. Inconsistent measurements of the purchase price, earnings of the target company and earnings of the subject company may result in unreliable indications of value.

GPC Method

COVID-19 has had a substantial impact on public capital markets during 2020. From Feb. 19 to March 23, the major stock market indices experienced one of the most significant declines since the 1929 Great Depression. However, since March 23, these same capital markets have fully recovered and fueled speculation about a V-shape recovery.

GPC multiples are calculated by dividing the equity or enterprise values of public companies by their respective earnings. If these multiples are calculated based on stock prices occurring after mid-February 2020 and earnings that

do not reflect the current environment (*e.g.*, financial statements dated Dec. 31, 2019), the application of these multiples to the earnings of a subject company, which are affected by the current environment, might be problematic. Given these potential issues, it is appropriate to consider what modifications to the M&A and GPC methods are appropriate in order to properly address the disruptions associated with the current environment.

Modifications to the Market Approach

It appears that the conditions associated with the current environment were not fully reflected in the capital markets until mid-February 2020. Accordingly, in situations where the valuation date occurs before mid-February 2020, no modifications to the traditional application of the market approach may be necessary. However, when the valuation date occurs after mid-February 2020, experts may wish to consider the following alternative valuation methods.

Alternative M&A Method 1

If the purchase price and earnings of the target company reflect the current environment, it might be appropriate to calculate and apply these multiple(s) to the affected earnings of the subject company. This can occur when the M&A transaction occurs after mid-February 2020 and the reported earnings of the target company also reflect the impact of the current environment.

If the purchase price of the target company reflects the current environment (the “affected purchase price”) but its earnings do not (the “unaffected earnings”), the multiples derived from the transaction may not be appropriate to the earnings of a subject company affected by the current environment (the “affected earnings”). This can occur when the M&A transaction occurs after mid-February 2020, but the reported earnings of the target company are from an earlier, unaffected period (such as 2019). If this multiple is applied to the affected earnings of the subject company, the impact of the current environment might be double-counted, resulting in an unreliable indication of value. In order to correct this analysis, the following procedures may be appropriate: (1) Divide the affected purchase price of the target company by its unaffected earnings (this calculation will provide the “affected M&A multiples”); (2) the affected earnings of the subject company should then be adjusted to remove the impact of the current environment, resulting in its unaffected earnings; and (3) apply the affected M&A multiples to the unaffected earnings of the subject company to estimate the value of the subject company affected by the current environment (the “affected value”).

Alternative M&A Method 2

If the current environment has not affected the purchase price of the target company (the “unaffected purchase price”) and the unaffected earnings of the target company are used

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in the calculation of the multiples, the following procedures may be appropriate: (1) divide the unaffected purchase price by the unaffected earnings of the target company to calculate the “unaffected M&A multiples”; (2) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; (3) apply the unaffected M&A multiples to the unaffected earnings of the subject company to estimate the value of the subject company unaffected by the current environment (the “unaffected value”); and (4) conduct an income-approach analysis to estimate the value detriment attributable to the current environment for the subject company, which should provide an estimate of damages attributable to the current environment for a discrete time period, then subtract this damage estimate from the unaffected value of the subject company to estimate its affected value.

Alternative GPC Method 1

If the stock price and reported earnings of the public companies reflect the impact of the current environment (*i.e.*, after mid-February 2020), no modifications to the traditional application of the GPC method might be necessary. However, if the valuation date stock price reflects the impact of the current environment (the “affected stock price”), but the reported earnings used in the calculation of the GPC multiples are the unaffected earnings (*e.g.*, derived from Dec. 31, 2019, financial statements), the multiples derived from this analysis might not be appropriate for application to the affected earnings of the subject company.

This is due to the fact that the multiples are calculated by dividing the affected stock price by the unaffected earnings of the GPC. If this multiple is then applied to the affected earnings of the subject company, the impact of the current environment might be double-counted, resulting in an unreliable indication of value. In order to correct this analysis, the following procedures may be appropriate: (1) divide the affected stock price by the unaffected earnings of the GPC to calculate the “affected GPC multiples”; (2) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; or (3) apply the affected GPC

multiples to the unaffected earnings of the subject company to estimate the affected value of the subject company.

Alternative GPC Method 2

An alternative to GPC Method 1 is conducted using the following procedures: (1) divide the GPC stock price unaffected by the current environment (the “unaffected stock price”) by the unaffected earnings of the GPC to calculate the “unaffected GPC multiples”; (2) in order to quantify the unaffected GPC multiples, it is necessary to identify a date for the unaffected stock price to use in the analysis (this date will likely be different than the valuation date because the stock price as of the valuation date presumably reflects the impact of the current environment; potential dates may include (a) the unaffected stock price date closest to the valuation date, (b) the date of the financial statements of the GPCs used in the calculation of multiples (under the assumption that the financial information is known or knowable); or (c) the first trading day after the financial statements are publicly disclosed by the SEC); (3) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; (4) apply the unaffected GPC multiples to the unaffected earnings of the subject company to estimate the unaffected value of the subject company; and (5) conduct an income approach to estimate the value detriment attributable to the current environment for the subject company, which should provide an estimate of damages attributable to the current environment for a discrete time period, then subtract this damage estimate from the unaffected value of the subject company to estimate its affected value.

Conclusion

The current environment is reshaping the valuation landscape. Accordingly, the mechanical application of traditional valuation methods may produce values that lack credibility and reliability. It is important for valuation experts and bankruptcy lawyers to consider whether modifications to traditional valuation methods are appropriate for any given engagement. If modifications are conducted, the expert should be prepared to provide supportable reasoning for those changes. **abi**

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Financial Statements

BY HARVE LIGHT

M&A Activity in Agriculture: Is It Time to Harvest?



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M&A activity in the U.S. has been strong for the last several years, especially in the middle market, and transaction multiples remain at record highs. Unfortunately, these multiples vary widely by sector, especially in agriculture. It has seen neither the volume nor the multiples that are evident in the rest of the market. Here is a look at several of the components (good and bad) that are affecting this market.

The U.S. Economy: A Historic Run

Since the Great Recession, the economy has been steady and improving. Home prices have recovered, and unemployment is under control and has declined to almost full employment. Interest rates have been at extremely low levels for an extended period, and gas prices have been relatively affordable. Major stock market indices, including the S&P and Dow Jones, have more than tripled since the Great Recession.

Exhibit 1 shows the huge U.S. historic domestic product growth rate. The gray bars indicate a recession,

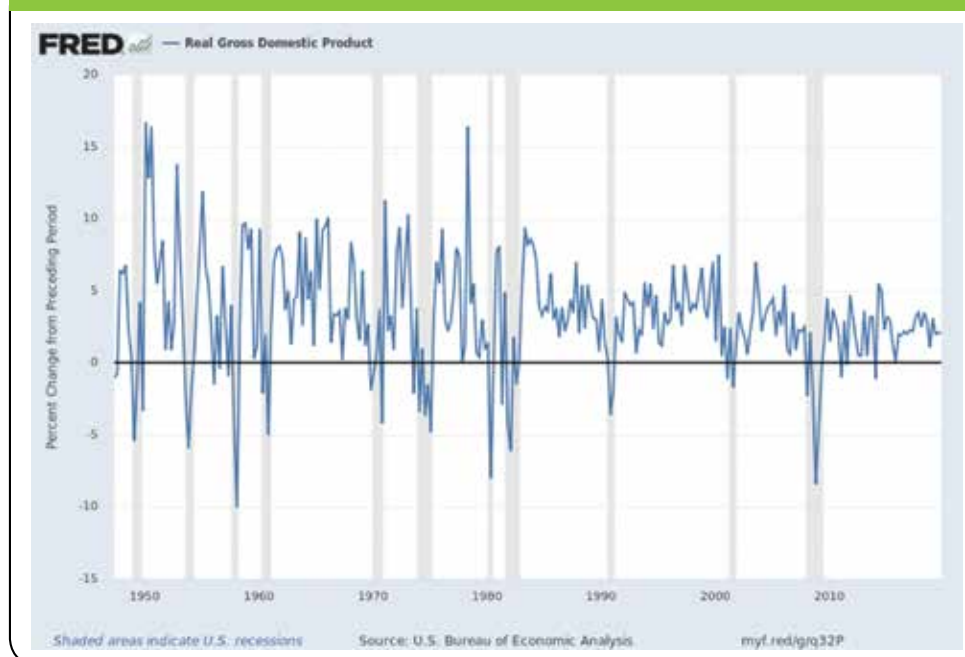
which is typically recognized as two quarters of negative gross domestic product (GDP) growth. (Recessions are officially declared in the U.S. by a committee of experts at the National Bureau of Economic Research.) We are well above the mean time between recessions for over the last 75 years. According to this survey of professional forecasters, the real GDP growth rate in the U.S. is likely to remain flat.

The Current Economic Environment

When looking at valuations for any company, it is important to understand the current economic environment. If you look at where the U.S. economy is today, there are several factors that have differing effects upon valuations in the agriculture sector: GDP at 2.1 percent with an outlook of 2.1 percent (neutral); the unemployment rate at 3.3 percent and an outlook of 3.6 percent (negative); and the Fed Funds rate at 1.75 percent and an outlook of 1.75 percent (positive).

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Exhibit 1



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The unemployment rate is considered a negative factor because the agriculture industry is facing a labor supply shortfall. The Fed Fund's rate is a positive factor because low interest rates are supporting the high levels of debt that farms and agribusiness companies are currently carrying. In addition to these three factors, the value of the U.S. dollar is currently stable and is expected to remain so for the next year. This has a positive impact for the agribusiness industry in allowing it to continue to export. Unfortunately, there are several issues that are negatively affecting the U.S. agribusiness industry:

- African swine flu in China has wiped out nearly half of that country's pork production, which has resulted in weak feed demand;
- Weather in the U.S. has had a major impact, including the delays in corn and soybean planting that contributed to a roller-coaster for prices in 2019; and
- Geopolitics have had a negative effect on the industry because tariffs will continue, as a full trade deal is unlikely.

If tensions do not increase again, the U.S. economy should not fall into a recession — but that's a big "if." Overall, the U.S. economy is stable, and while it has had a historic run, some industries are surviving but not thriving. Several industries have raised concerns about the true overall health of the U.S. economy, including automotive, trucking, oil and gas, retail, health care, real estate and agriculture. A serious downturn in any one of these industries could push the U.S. economy into a recession. Many of these positive economic factors also have a negative impact on agribusiness valuations.

Agribusiness Headwinds

In addition to the economic environment, it is important to look at the headwinds that agribusinesses specifically are facing. This includes labor, global trade wars, technology needs and customer preferences.

First, minimum wage increases across the nation continue to place a heavy burden on company margins without providing the benefit of a stable workforce. The lack of a reliable workforce continues to strain many operations, as workers are hard to find despite higher wage rates. There is a bright spot in that proposed federal legislation might alleviate some of these labor issues. Unfortunately, timing and final terms remain unclear.

Second, trade wars on several fronts will increase the uncertainty around global demand for U.S. food products. Small wins will occur, but a comprehensive trade deal with China is unlikely to occur quickly. The impact of tariffs will be amplified by improvements in other global markets, reducing demand for U.S. products.

Third, technology is still a major headwind, and internet access to rural communities remains a significant issue. This lack of internet access hampers the ability of an agribusiness to implement technological solutions that will improve efficiency. New technologies are also needed as food safety requirements continue to expand. Traceability requirements to improve overall recall speed and success are increasing. Technology proto-

cols, specifically in blockchain, will require capital investment and changes to the way that data is collected.

Fourth, changing customer preferences continue to challenge growers and processors with a shift toward organic products. A new customer focus on sustainability will require additional investment, and product innovation will be required for smaller companies to survive.

In addition to these industry shifts, agribusinesses are facing significant issues at the company level. The biggest of these is input-vs.-output prices. Input prices have remained steady over the last several years, but commodity prices have steadily declined, as shown in Exhibit 2. The weaknesses are supported by three datapoints: farm income, farm debt and farm bankruptcies.

According to the U.S. Department of Agriculture, farm income is projected to reach \$88 billion this year. This is the highest level in several years, but it remains below the record set in 2013. Unfortunately, more than one-third of this income is from some sort of assistance or insurance payments.

Farm debt is expected to finish up 2019 at record levels of nearly \$415 billion. Of this amount, \$255 billion is related to real estate and \$160 billion is related to non-real estate debt. Also concerning are the average loan maturities, which are at an all-time high. Most troubling are the maturities for operating expense loans at 11.5 months. Non-real estate loans are also getting bigger, as banks made more than \$800 million in new non-real estate farm loans in the second quarter of 2019 alone. Loans greater than \$1 million were a significant contributor.

Farm bankruptcies are on the uptick, and chapter 12 cases are increasing at a rapid rate. For the 12 months ending Sept. 30, 2019, there were 580 filings, up 24 percent from the previous year. This will be an interesting trend to watch with the recent increase in allowed debt limits. Lenders now have to take a harder look at whether giving up a significant amount of control for the capital gains exclusion will be worth it.

Exhibit 2: NAV-Invesco DB Agriculture Fund



These factors are being offset by the low-interest-rate environment. It is critical that companies do what they can to improve balance sheets before rates begin to rise again.

How Much Gas Is Left in the Tank?

The effective Fed Funds interest rate had been steadily increasing from 2016-19, which is a good sign for economic growth. In July 2019, it peaked at 2.4 percent, its highest level since March 2008. The Federal Reserve began to take actions with several rate cuts, as it started to see some weakness in the economy. The current interest rate level is expected to remain steady throughout 2020, barring any external impacts. Exhibit 3 shows the 10-year Treasury constant maturity minus two-year Treasury constant maturity. It is a good indicator of economic health.

The yield spread is the difference between the long-term 10-year and short-term two-year interest rates. The curve has flattened, which usually indicates an impending slowdown. Short-term yields equaled long-term yields in August 2019, but a widely expected inversion scenario was averted. An inverted-yield scenario is a strong signal of a possible recession, as the yields are driven by inflationary pressures and high asset prices. The impacts of President Donald Trump's tax cuts and fiscal stimulus are likely to fade by the next presidential election in 2020. The outcome of trade wars with key U.S. economic partners and surging budget deficits are now negatively impacting the spread. It has remained at or near

the zero mark, but we will need to see where it goes given the expected short-term impact of COVID-19. It is improbable that the economy will slip into a recession because pent up demand will bring the economy roaring back.

In the interim, producers and processors face very different challenges from the rest of the economy. They are seeing small demand losses but major shifts in product mix as retailers become the dominant customers. These companies are now managing the demand shift and logistical challenges related to inputs and deliveries. On the bright side, workers are collecting overtime in many instances. These companies should be able to weather the storm better than others.

Where Is Private Equity?

One of the common questions asked regarding agriculture industry M&A activity is this: "Where is private equity?" Over the last several years, private-equity firms have had record fundraising levels. Deal flow has been extremely high, and the number of exits has been very low. Transaction multiples have maintained almost 12x over the past three years. However, almost two-thirds of private-equity transactions are add-ons to existing platforms.

There are a limited number of firms that are investing in agriculture, primarily in processors and ancillary service

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Exhibit 3



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providers. These are niche players with very specific investment criteria. New players might emerge given the level of capital that has been raised and put to work. Given the level of distress in the industry, however, business owners should be mindful that if the negative trends continue, distressed investors will enter the market with the intent of buying at extremely low prices.

Why hasn't private equity taken a larger interest in the agriculture industry? The fundamental reason is the industry's inability to generate the required investment returns. Returns are negatively impacted by commodity price risk, potential recall exposure and lack of exit strategies (the most significant reason). The existing large companies that dominate the agriculture space generate significant cash flow and have no reason to take investment risks on new technologies and applications, which hampers innovation and access to capital. There does appear to be some hope on the horizon, as companies like Microsoft, Google and IBM are starting to make startup investments in the space. This should lead to potential exit strategies for venture capital and other startup companies down the road, as these heavyweights become more invested and the large existing players realize that they need to keep up.

Current M&A Trends

There are three key trends that are dominating M&A activity within the agriculture space: strategic buyer domination, macroeconomic factors, and labor and benefits. Strategic buyers comprised 90 percent of the deals that have closed. Nearly 70 percent of the transactions that have recently taken place have been between private companies. Macroeconomic factors negatively affecting M&A include uncertainty around U.S. trade policies, which are expected to continue and put downward pressure on multiples. This pressure will be com-

pounded by improvements in other global markets, which are causing shifts in global supply. These improvements in global supply are pushing commodity prices down, as evidenced in the earlier commodity price chart.

Finally, labor and benefit issues will continue to put significant pressure on margins. Many agriculture-heavy states have minimum wage increases that will be implemented over the next two to three years, although these minimum wage hikes are having little to no effect on labor supply for agriculture companies. In addition, employers continue to pay significantly higher health care costs, as seen over the last decade. The average cost of employer health care coverage offered to workers rose to nearly \$20,000 a year for a family plan. All these issues are having a negative effect on transaction multiples.

What Does This Mean for Transaction Multiples?

As shown in Exhibit 4, agriculture companies have generated returns below those of the major market indices. Publicly traded agriculture companies are trading at an EV to EBITDA multiple of 13.6x, which is in the middle of the pack. To adjust for the typical agriculture transaction, there are several factors that must be considered, such as a smaller company size, fewer growth opportunities, fewer cost-savings opportunities and smaller management teams (see Exhibit 5). The conclusion is that a company performing to industry standards can expect a transaction multiple of six to nine times EBITDA.

Conclusion

Over the next two to five years, we can expect that low- to mid-market companies will become sellers, and that the anticipated headwinds will cause entrepreneurs and sponsors to sell while they can. The high debt levels and increased labor costs will continue to cause distress and lower valuations. Larger companies will be strategic and opportunistic buyers, and more focus will be placed on operating profits in order to sustain and increase margins. Technology will drive strategic acquisitions. Finally, disruption and distress will drive opportunistic acquisitions.

Disruptions to the economy have very different effects on transaction timing and trading multiples. In today's market, the

Exhibit 4: S&P 500 EV to EBITDA Ratio by Sector

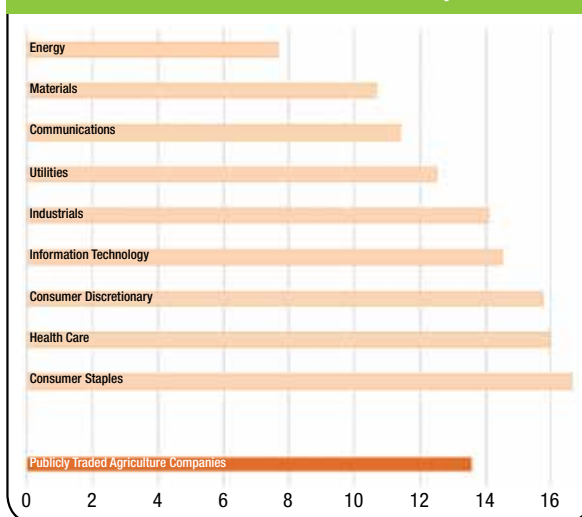


Exhibit 5

Publicly Traded Company Multiple	13.6	
Deductions:		
Smaller Company Size	3.0	2.0
Fewer Growth Opportunities	2.0	1.0
Cost-Savings Opportunities	2.0	1.0
<u>Management</u>	<u>0.5</u>	<u>0.5</u>
Middle-Market Company Multiple	6.1	9.1

time to close a transaction will likely be longer due to market uncertainty and the disruptions caused by the novel coronavirus in early 2020. This will have negative effects on equipment suppliers and service providers with moderate to weak financial health. These companies are more likely to see a decline in revenue and profitability as purchases are delayed, which will drive the opportunistic acquisitions at lower multiples.

Conversely, current events will have a positive effect on producers and processors due to a short-term increase in demand for food products as more people stay home. This will lead to higher short-term profitability, but the effects of this event will not last. Of greater concern are issues like the continuing water rationing in California, which will have lasting effects on crop production. This is an industry that remembers the drought of 2014 and its lasting effects on commodity pricing.

Regardless of whether an owner is an active seller, it is important to have a sale price in mind, as an unsolicited offer could come at any time. Once the price has been established, owners will need to take a hard look at the validity of that price. Owners tend to overestimate a company's value, but in reviewing the valuation, management teams can look for specific areas to target to increase the overall value of the company. By doing so, there would be no surprises at the start of a transaction. And that leads to a better overall process that maximizes potential value. **abi**

Editor's Note: *For a prediction of what the COVID-19 situation might bring, please visit abi-org.s3.amazonaws.com/Newsroom/The_Coronavirus_and_Its_Likely_Impact_on_the_Bankruptcy_World.pdf.*

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