QUARTERLY
Review
SUMMER 2005

European Outlook: Market Forces can "Liberate" Distressed Capital

No area of the global economy is immune from competitive forces and reasonable business principles in its capital markets, no matter its traditional way of "doing things." This is evident in both mature and nascent economies, in mega and modest-sized trading partners, and regardless of trading boundaries (i.e. tariffs and other means of protecting individual economies or labor issues).

Nowhere are these realities more apparent than in the capital markets of long-time juggernaut Germany and its Eastern neighbors Poland, the Czech Republic and Slovakia. Depending on the nation, issues to be tackled include combating resistance to evolving standards of accountability, transparency and liquidity, taxation, privatization, reforms in bankruptcy law and reorganization, and the role of foreign private equity.

Distressing News from Germany

German economic conditions remain tense with about 40 percent of companies showing signs of crisis with respect to strategic position, profits, or liquidity, according to Roland Berger Industry Tracking, 1Q 2005. Sectors on alert status include retail, technology, and aviation/aerospace. Interestingly, while more than EUR 160 bn of bank debt is now classified as "distressed capital," private equity and other forms of distressed debt continue to invest in these companies. This investment includes significant buyouts by non-German interests, aided by insolvency law reforms that move Germany closer to America's Chapter 11 framework.

The German market is also wrought with structural issues that include a shrinking and aging population, an economic structure where the government share is nearly half of the GDP (much greater than in the U.S.), not to mention benefits and labor rule burdens. On the positive side, in 2004, distressed asset disposals were primarily German real estate-backed debt. Going forward, we expect that a shift to commercial assets in Germany and Central Europe will emerge. Caveats with respect to trade balances, oil prices and lackluster domestic investment apply to any prospects for recovery in the German economy.

East of "Eden"

Poland, the Czech Republic and Slovakia—with a combined population of nearly 54 million—now belong to the European Union. Slovakia has displayed the most consistent GDP growth (as well as higher inflation) for the 2002 to 2004 period. In 2004, the gap was closed with 4.1 percent GDP growth in the Czech Republic (only a percentage point behind Slovakia's). Poland was in the middle with 4.5 percent GDP growth. Progress is also being made on the privatization front (especially in the Czech Republic and Slovakia), with the banking sector highly privatized in all three nations. Further, Poland is experiencing dynamic expansion of the capital market, especially IPOs on the Warsaw Stock Exchange. Disposal of the banking sector's distressed assets could give relief to the tightened credit policies and kick-off new lending.

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ANNOUNCEMENTS

BBK is proud to announce the following team additions:

Finance
James Connor, Principal
Ron Egan, Senior Director
Andrew Alley, Senior Consultant
Daphne Corry, Senior Consultant
Marcus Hudson, Senior Consultant
Douglas Murray, Consultant
Bruno Riccicuti, Consultant
Jim Clark, Consultant
Chaitanya Harimohan, Analyst

Operations
Alec Bedricky, Senior Director
Douglas Olander, Senior Director
Keith Updike, Senior Director
Lonnie Williams, Consultant

Marketing
Kathy Reaume, Database Coordinator

Administrative
Misty Evans, Executive Assistant
Anke Malkmus, Executive Assistant

IN THIS ISSUE

CASE STUDY:

Conquering Communication Barriers in Europe

COMMUNICATION IS MORE THAN JUST KNOWING THE LANGUAGE

The opportunity arose to work with a particular Tier One supplier in Europe; their client is a major European OEM.

Last spring they were experiencing problems with a metal fabrication supplier. The Tier Two had severe launch and quality problems, and the OEM's assembly lines were jeopardized. The Tier One tried sending in a production specialist and plant manager, but all attempts at assistance failed.

In April we got the call. BBK sent out a statistical problem solving team that included Mark Ripple, Jeff Kane and Rick Elliott. They boarded planes for a 30-day engagement in France.

Once there, our team took the initiative to find the right people to assist – people who knew the language and understood the issues. This was a key move because those relationships helped them through some difficult situations.

Management of the Tier Two was resistant to BBK involvement. Our team found the company was responding to Quality issues by adding inspections and pushing for daily shipments. Budgets were strained and costs were rising. 8D issues, (the 8 Disciplines of Problem Solving, see page 5), were largely ignored, resulting in an unhappy, demanding client who was making a troubled situation seem hopeless.

Our team helped the Tier Two look at their issues one at a time, focusing on the most achievable first. Two main programs were initiated. Jeff took one, Mark took the other and Rick coordinated the interface between the company and BBK.

Mark invested much of his time establishing a solid working relationship with the quality systems people from the Tier Two's partner companies in other countries. Different languages were not the only barrier to effective communication across the groups. Mark was able to find one common motivator that would get them to work together aggressively as a team - the potential for profits.

Management members who had initially been resistant to BBK involvement began to cooperate. Our team studied the European systems and earned their trust. They showed them what their issues were and why BBK solutions made sense. This company was won over by communication and the presentation of solid data.

Mark says he lives for taking a look at charts and making the numbers come down. "We would pull out the charts and talk to the data all the time. The data was proof of progress." The ensuing progress was incredible and the Tier One extended our contract from one month to two.

From a numbers standpoint, the team worked on 10 major projects. In two months they were able to identify permanent corrective action in 6 out of 10. The team identified the root cause of the other 4 and left the Tier One with valuable suggestions and solutions.

At the end of April, defects were averaging 150 per day; our team drove them down to single digits by June. Reject rates dropped from 30% to less than 2% in some cases.

Product issues were identified and corrected, reworks were diminished, quality was improved, packaging changes helped prevent product damage and unnecessary inspections were eliminated. A number of 8D issues were also closed out, increasing customer satisfaction.

Much was learned, much was accomplished. Attitudes were changed, relationships built, problems solved, and processes improved. As we find with most of our engagments—both domestic and abroad—manufacturing is manufacturing, no matter where the location, and breaking through communication barriers is the most critical component of a successful outcome. ■

> *"Management members who had initially been resistant to BBK involvement began to cooperate. Our team studied the European systems and earned their trust."*

Contributions from Art Nelson, Director and Mark Ripple, Senior Consultant.

PRIVATE EQUITY

Key Factors to Evaluate Prospective Acquisitions

Customer base. *Diversity and insulation from market volatility are important. Look for companies with manufactured components that are not tied to one customer or even one product. Not only is the diversity of the customer base critical when acquiring a company, but there must also be a long-term plan to sustain and further diversify post-acquisition.*

Platforms. *Diversity is crucial here also. Can the target's products be used in a variety of settings? If components are used only for one product, any decline in that product's sales or fluctuations in the market could put you out of business.*

Products and product lines. *Are the target's products developed using proprietary technology or innovative techniques not readily available elsewhere? Do the products offer added value? Services that are not easily outsourced stand to fare better.*

Geography. *Companies, regardless of home country, must now be able to supply globally, either direct or via strategic alliances. If post-acquisition growth is predicated on becoming more global, private equity firms should enlist experienced operational resources to help achieve this capability.*

Intangibles. *Less quantifiable, more subjective factors that include history and length of existing and prospective contracts, relationships with industry leaders, quality and loyalty of labor force and management, sales and marketing, facility condition (if applicable) and over- or under-capacity.*

Familiarity with these critical success factors will help private equity firms select the correct asset-intensive industry companies to invest in and will also serve to guide longer-term operational improvement. Done right, contrarian investments can deliver both financially and operationally on their promise.

INDUSTRY OVERVIEW

Automotive Outlook: Supply Chain Risks & Rewards

These days the competitive waters for the automotive supplier industry are as choppy as ever. As most of us know, the supply chain is often being assaulted from all sides. First, customers continue to require price reductions, while asking suppliers to take on more design and engineering responsibility and overall risk. If a contract run isn't fulfilled or the product isn't successful in the market place, those transferred costs don't go away.

Second, suppliers face many of the same factors that seem to be harassing OEMs, including overcapacity, rising materials costs, high payroll costs and legacy obligations, i.e. health care, pensions and other post-employment benefits (OPEB). Domestic manufacturers, in particular, face both large legacy costs and decreasing market share, which compounds the pressures on suppliers that primarily serve domestic OEMs and Tier Ones.

Third, the global landscape moves as quickly for suppliers as it does OEMs. The very genius of modern manufacturing, with quick production cycles and the ability to bring a plant up to speed seemingly overnight, only encourages the transfer of OEM plants and their supplier satellite plants to the "next low-cost" geographic region.

The pressures will likely only grow, as there are more than 10,000 suppliers producing parts for fewer than 20 major car companies on a global basis. Still, the potential rewards are there, with average supplier content per vehicle at a healthy $11,000. This value should increase as OEMs continue to concentrate on assembly and marketing, and, in some cases, just supervision and marketing.

Maximizing Value

What's a supplier to do? At the strategic level, there are several key approaches. These include increasing content per vehicle with a systems approach; gaining "scale" with customers as a means of limiting competition; and developing a global presence in key components. Joint ventures, other forms of alliances, and mergers and acquisitions may play an important role on this strategic stage. Turning our binoculars the other way around, looking more closely, many suppliers are realizing bottom-line improvement through a disciplined value chain analysis or attack at specific components of the income statement.

The first step is assessing a supplier's overall financial risk, as we examine the

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components that contribute to revenue. These include: diversity of customer base (Are we tied to one OEM or is risk spread?); platforms and programs supplied; products and product lines (Are we producing a commodity or specialized, high value product? How much of "content" is intellectual property or otherwise proprietary?); and geographic distribution (Which global regions are supplied?). The goal here is to reduce revenue stream volatility, understanding that the automotive industry is asset intensive and products generally have longer lead times to market than other consumer goods.

Next comes a vigorous attempt to reduce the cost of goods sold (COGS), thereby reducing cost stream volatility. This is a difficult, hard-digging area, but one that can pay large rewards because of the variability involved. We look at five basic categories that impact the cost of goods:

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Why is this Case There and Not Here?

B.N. Bahadur, BBK founder and CEO, along with guest speaker, James H.M. Sprayregen, Kirkland & Ellis in Chicago, and I. William Cohen, Pepper Hamilton in Detroit. (Photo by John Meiu, courtesy of the Detroit Legal News)

James H.M. Sprayregen of Kirkland & Ellis, LLP, Chicago, addressed BBK Educational Forum III at the Detroit Athletic Club on June 30, 2005. Mr. Sprayregen, counsel for the debtor-in-possession in high profile cases such as United Air Lines, Conseco and Collins & Aikman, discussed venue selection by asking, "Why is this case there instead of here?" His presentation of the practitioner's view followed the vigorous debate between Detroit's Chief Bankruptcy Judge Steven W. Rhodes and UCLA law professor Lynn LoPucki at the Federal Bar Association on May 9, 2005. Leading insolvency professionals from Detroit and Chicago attended to hear Mr. Sprayregen's analysis of the continuing controversy over venue selection in major Chapter 11 cases.

After a brief review of the current law of venue, "Jamie" Sprayregen presented the issues facing practitioners when meeting with clients to discuss where to file the case, reminding the audience that an attorney has a duty to explore every legal advantage that will help the client's case. As long as bankruptcy and appellate courts give divergent and conflicting decisions on important issues, practitioners must consider the advantages and disadvantages of particular venues in order to minimize risk and uncertainty. Legal issues in Chapter 11 include payments to "critical" vendors at the beginning of the case, retiree benefits, all asset sales, key employee retention agreements, classification of claims, discharge of environmental claims, DIP financing, severance pay provisions, use and misuse of extensions of the debtor's exclusive period to file a plan of reorganization, claims trading by third parties and protection of utility payments. A good lawyer wants to avoid the mistake of filing a Chapter 11 in a venue that limits the debtor's options if other, more favorable choices, are available.

Mr. Sprayregen concluded with comments about the opportunity Congress had to pass laws on venue in 2005 but for political reasons did not take action on the issue. ■

For a copy of Mr. Sprayregen's presentation, please contact marketing@e-bbk.com (reference BBK Educational Forum in the subject line) and include your contact information.

EUROPEAN OVERVIEW

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Market Forces can "Liberate" Distressed Capital

Labor rules and wage issues still bear close watching in both developed Germany and its neighbors. In 2004, Germany's labor costs were 27 EUR per hour, a marked contrast to Hungary, Poland, the Czech Republic and Slovakia, where 2004 wages ranged from 2.13 to 3.96 EUR per hour—a nine-fold factor, on average.

Insolvency Law Reform

In addition to tax legislation more favorable to businesses, Germany and its neighbors are developing bankruptcy laws that will make it easier to reorganize firms and provide employment relief where necessary.

The relatively new German Insolvency Statute (Insolvenzordnung) has been in effect since January, 1999. It provides for only one insolvency procedure, which may lead to either the reorganization or the liquidation of an insolvent enterprise. It allows for dismissal of employees once the insolvency process has formally commenced. Many or most of the transfer costs related to new employment, such as pension liabilities, will be covered by the public sector or a special Pension Insurance Fund created by German industry.

In Poland, a new bankruptcy and restructuring act in force since October 1, 2003, replaced two separate laws dating from the 1930s. In streamlining and modernizing the process, the new law provides better protection for creditors, while providing for two types of bankruptcy, liquidation or restructuring, based on the agreement between creditors and debtors (under the supervision of the court).

In the Czech Republic, a new bankruptcy and restructuring law is being drafted and is currently being considered by the government. If adopted, the new law would significantly strengthen creditors' rights and allow for Chapter 11-like reorganization proceedings. Along with the American Chamber of Commerce in the Czech Republic, Jan Kofol BBK Principal in Prague, and Ray Graves BBK Principal in Southfield, are advising Deputy Prime Minister Jahn in drafting the new bankruptcy law.

Overall, especially in Germany, concern can yield way to optimism with continued tax and labor reforms, in addition to laws and experience in more varied forms of revitalizing or reorganizing distressed assets or companies. These developments will make Germany and its neighbors more competitive on the global stage, provide existing ownership with better exit strategies, and encourage domestic investment.

For more information, contact Jan Kofol, Principal, located in Prague at 420.224.900.044, 800.BBK.0030 or jkofol@e-bbk.com.

LETTER FROM BBK

Facing the Storm Most of Us Fear

All of us are profoundly shocked and saddened by the horrific impact of Hurricane Katrina on Louisiana, Alabama and Mississippi. Disasters of this magnitude are unthinkable before they happen; it is difficult to imagine that our worst nightmares may come true. Further, we may rationalize the situation, using the popular credo, "If it ain't broke..." , so oftentimes, we learn to live with risk, tuck it away and hope for the best. Unfortunately, as discovered with so many natural and man-made disasters alike, the natural inclination to avoid fearing the worst can inhibit proactive measures, sometimes having catastrophic affects. That said, when disaster does strike, it often brings the best out in us, and we rise to the occasion, doing whatever it takes to make it through and better the situation. Later, after the smoke of tragedy has cleared and the road to recovery has begun, inevitably the question becomes, could something have been done differently?

At BBK, we often find this to be the question that haunts many of our clients after a crisis has arisen. While there is no comparison to the tremendous loss and suffering from Katrina or other recent natural disasters, the failure or dissolution of a business can be an astounding loss, affecting hundreds or even thousands of people. Too often, we have witnessed first hand the heartfelt emotions of those who have endured such a loss. Now the good news—the tide may be turning. More and more we are receiving calls from company owners, boards of directors, lenders and other vested parties, looking for guidance *before* crisis strikes. They are investing in proactive measures to protect their futures, as well as the futures of those they impact.

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Given the very natural and human instinct to avoid fearing the worst and to hope for the best, company leaders who take the initiative to prevent a down slide or crisis are to be commended. We are honored to be able to work with these successful decision makers and move their companies or interests forward, by partnering and helping fortify their infrastructures in the face of upheavals in the global marketplace.

In the face of tragedy, maybe there is a lesson for us all. While we cannot possibly protect ourselves from every potential disaster or live in constant fear, perhaps we can focus more on things we can do to mitigate risk, no matter how arduous or uncomfortable those actions may be. For at the end of the day, like the old truism says, "an ounce of prevention is worth a pound of cure."

William G. Diehl
Principal, COO & Automotive Advisory Group Lead

WHAT'S NEW

BBK Ratings

BBK is proud to announce the rollout of its new and improved BBK Ratings website, www.BBKRatings.com.

The new site features:

- Enhanced user interface
  - More user-friendly
  - Easier to navigate
- Better information
  - Benefits
  - Client/report samples
  - Comprehensive services
- Improved functionality
  - Online data submission
  - Manage reports/users
  - Purchase reports
  - Sign up online

BBK Ratings is an affordable, web-based tool that helps you determine if a business you depend upon today – or may depend upon tomorrow– is at full strength or has unseen weaknesses. Currently used by several industry leaders, Ratings now covers companies in North America, Europe and Asia, and an ever-widening scope of industries.

Take a moment to check out the new BBKRatings.com. For additional information, contact:

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The 8 Disciplines of Problem Solving

1. Create a cross-functional team
2. Clearly state the problem or concern
3. Identify containment actions
4. Identify the root cause
5. Verify the root cause
6. Implement corrective actions
7. Implement preventative actions
8. Congratulate your Team

Automotive Outlook: Supply Chain Risks & Rewards

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- Suppliers and sourcing
- Raw materials management
- Labor and engineering changes
- Overhead flexibility
- Geographic, logistics and freight

Specific methodologies are available within the COGS area to realize gains. Examples include Launch Readiness programs; hedging and other strategies to stabilize and reduce materials costs; or Inventory Control and JIT programs.

Digging deeper, we attack the second main "write-off" from gross revenue, that being operating expenses. Once again, we examine five broad categories, with the goal of reducing dependency on volume programs. These categories are manufacturing footprint; R&D and propriety of technology; SG&A, which reflects customer relationships; best use of information technology; and control of bad debts through better analysis of customer credit worthiness and other loss control systems.

These efforts are accompanied by a rigorous balance sheet analysis of assets and liabilities, addressing such issues as working capital, depreciation (on and off balance sheet financing), interest and principal requirements, leverage risks and future sources of capital.

The task ahead for suppliers—both strategically and operationally—is not easy, but it is manageable. Working within disciplined frameworks like the value chain approach just described,

today's best suppliers are reducing costs and overall revenue stream volatility, and improving net income. In doing so, they are directing their best "assets" in the best places, which also positions them for future growth and profitability. ■

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