QUARTERLY
Review
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The Closing Plant: A Window of Opportunity

By Robert J. McCabe, Managing Director

For many firms, the first reaction is to sell the plant as soon as possible on an "as is, where is" basis, for the best available terms. Many "brownfield" development firms have sprung up to take advantage of this situation, purchasing older facilities at fire sale prices, remediating the site, and obtaining maximum value for the property. Every firm has to decide what's best for them–whether they want that profit or want someone else to have it. Hence, the question of decommissioning.

What is Decommissioning?

Historically, unneeded assets were just abandoned. Some examples are still around–the old Packard car plant in Detroit just celebrated its 50th anniversary of being idled! Then to preserve corporate images, the trend became demolishing plants at least to ground level. More recently, with increased government and societal pressures, formal decommissioning has become more common. This includes the entire scope from discontinuing production at a plant, through liquidating machinery and equipment, environmental site assessment, demolition, environmental remediation, along with development of property marketing plans to assure highest values. Decommissioning can include roughly 500 discrete tasks, best executed by a joint decommissioning project team which includes key personnel from the appropriate staffs and operations of the client firm to assure close coordination throughout the entire project.

Decommissioning Phases

Because closing plants is not a core expertise for any manufacturing or operating company, decommissioning support for your firm may begin at the time a decision is made to close a facility. Winding down operations is considered the first of six phases. This must be focused on the plans for building out production which need to be precise to ensure continued customer satisfaction. First, sufficient product banks must be determined, qualified new suppliers with capacity selected, tooling relocated, and quality at volume verified at the new supplier before existing operations can be dismantled.

Phase II is the actual closure of the plant and this must be integrated closely with the winding down of operations to minimize costs. How the equipment is left at the end of production by the operators and maintenance people including utility connections, can impact the plant closure costs, particularly the environment remediation expenses, as well as the value of the equipment in the next phase, the liquidation of the assets. A comprehensive environmental site assessment is completed early in this plant closure phase. This study serves as the basis for all the next phases of decommissioning and provides the tools to control subsequent demolition and remediation costs in Phase IV.

The liquidation of the operating assets is considered Phase III. The activity can actually begin with the offer to sell machinery, equipment, tooling and even raw material inventories to the new suppliers. Depending

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ANNOUNCEMENTS

BBK is proud to announce the following team additions:

Mark Bell, IT Manager - Detroit

Mark Hafeli, Analyst - Detroit

Yasmeen Hardy, Analyst - Detroit

Gloria Morse, Executive Assistant - Chicago

Yvette Richey, Data Coordinator - Detroit

Mac Rowland, Manager - Detroit

Guenther Stur, Director - Frankfurt

Sonya Xie, Executive Assistant - Shanghai

BBK is proud to announce the following team promotions:

Nancy Colah from Director to Senior Director

Phil Goy from Director to Senior Director

Michael Pizzorno from Manager to Director

Mark Schumacher from Manager to Director

IN THIS ISSUE

For more information on any of the articles shown here, please contact marketing@e-bbk.com.

CASE STUDY:

STOP THAT TRANSACTION!

By Jim Connor, Managing Director

Mergers and Acquisitions is an ever-changing market place. Today, transactions primarily stem from private equity funds with seemingly endless financial backing—good news for buyers. To that end, it is typical to see the money chasing too few transactions, which often creates a sense of urgency to secure and close a deal. That urgency can negatively influence important decisions that need to be made before moving forward.

Companies involved in M&A know all to well that sometimes—despite preliminary intent—transactions don't always make good business sense. Processes like due diligence are key to help evaluate the inherent risks and opportunities and to assist those executing the transactions understand and communicate both good and bad findings with honesty and integrity. Regardless of the findings, sugar coating is not an option!

A Recent Transaction

BBK was recently engaged to perform due diligence for a private equity fund functioning as a second lien lender in the transaction. In our view, the second lien was structured with favorable terms and conditions, and the collateral base was thin, even for a second lien lender.

The transaction involved a multi-million manufacturing company in the metals industry, for which BBK performed due diligence and operational reviews, as well as an intense evaluation of sales projections matching the target company's projections to our database. Based on our findings, we made an assessment of the target company's risks and opportunities and evaluated them in the context of the automotive industry. From there, we identified what was truly attainable and how any growth opportunities might be affected by the extremely competitive automotive environment.

In addition to assessments, key BBK operations professionals toured the plant facilities and reviewed the operational metrics and lean manufacturing techniques that were being employed. Our findings were typical; many companies state that they employ lean manufacturing techniques when in fact the techniques are more cosmetic than actual drivers within their culture. To be successful, lean practices have to be built from the ground up. This supplier was no exception––for example, certain operators did not completely understand the principles of the lean manufacturing process despite the fact that the charts and graphs were hanging throughout the facility. Understandably, this was a serious cause for concern given the aggressive productivity improvements and cost reductions the suppliers' management team touted would be a result of successfully employing the lean process.

We tallied the collective risks (and opportunities in some cases) on what we call the "BBK scorecard". Unfortunately, the scorecard indicated that should our client, the private equity fund, proceed with the transaction, it could prove disastrous within the very first year.

No stone left unturned, the qualitative due diligence process soon followed. We began by performing individual assessments of the management team. This review included the Chairman, CEO, CFO, Vice President of HR, Vice President of Technology, and the plant managers. We analyzed their backgrounds and industry experience and utilized our network of resources to get references. We critiqued each member of the team giving them an A through F rating. In our opinion, the intense analysis clearly indicated that the suppliers' team was sub par.

We passed these conclusions on to our client (acting in this case as a lender) and encouraged them to take a hard look at the pricing of this transaction given the incumbent risks, which BBK viewed as significant. At the end of the day, the supplier had a less than average management team charged with a task of implementing a difficult strategic plan with growth and cost reductions, coupled with a highly leveraged balance sheet—not a promising situation. However, the transaction was still "doable", and would all boil down to pricing. How could the firm price its investment to match the associated risks of the target company implementing this plan? With this question in mind, the firm went back to the target company with additional pricing options.

Meanwhile, the investment banker handling the transaction was able to secure a different private equity firm to provide the capital, mainly due to the highly competitive environment. To our knowledge, the second private equity firm did not perform any due diligence and was only provided with a brief report from other advisers within the main equity group in order to get the deal done. Unfortunately, the well intended firm may soon find they are in the midst of a rotten deal.

Due diligence should play a critical role in your transaction decision making process--knowing the facts can empower you to stop a potentially disastrous transaction, despite the sense of urgency prevalent in the market place.

Ultimately, by being proactive, our client prevented a potentially significant loss on a transaction and avoided the veritable toothache that sugar coating can cause. ■

THE AUTOMOTIVE AFTERMARKET

The "Other" Auto Industry

By Gary Kulesza, Managing Director and Louis R. Merz, Managing Director

Isn't the automotive aftermarket the same industry as the new car OEM (original equipment manufacturer) industry? No! The automotive aftermarket is a huge industry totaling $278.3 billion in retail, not including tires, lubricants or fuel sales. Typically the aftermarket begins servicing a vehicle after the new car service warranty has expired. The industry services the vehicles in the U.S. which now totals nearly 233 million. These vehicles average 9.4 years (the oldest on record) and are driven over 3 trillion miles annually.

Although the overall quality of vehicles produced today has improved, repairs continue to require more expensive and sophisticated parts and ever more highly trained service technicians. The industry has had steady growth over the past 5 years (2000-5.5%, 2001-3.9%, 2002-3.6%, 2003-3.4%, 2005 -5.0% and 2006-4.0% forecast). The aftermarket generates approximate 3.5% of total GDP of the US and employs over 4.5 million people.

There are thousands of companies in the aftermarket (no significant OEM influence). These include:

- Manufacturers – *this will include the full spectrum of parts manufactures for both foreign and domestic vehicles (truck and auto)*
- Warehouse Distributors (WD's) – *this includes a number of major players (NAPA, CARQUEST, Alliance, Pronto, Parts Plus, Federated, etc.)*
- Service Centers - *this group includes companies such as Firestone, Goodyear, Sears, Midas, Meineke Car Care Center, etc.*
- Retailers – *this group includes such company's as Auto Zone (3,600 stores), Advance Auto (2,500 stores), CSK (1,200 stores), O'Reilly's (1,100 stores), and Pep Boys (900 stores)*

As vehicles are a necessity for the average person and the cost to purchase a new vehicle continues to increase, car owners are keeping their vehicles longer and repairing them rather than purchase new ones. This, coupled with the complexities of today's vehicles and a continued shift from DIY (do-it-yourself) to DIFM (do-it-for-me), has given the aftermarket industry a strong recession resistance.

What then, are the challenges facing the automotive aftermarket industry? According to Lou Merz, having served as a senior level executive for multi-billion dollar automotive components and aftermarket manufacturers since 1963, as well as being past Chairman of the Automotive Aftermarket Industry Association, "The aftermarket, while not challenged like its original equipment 'cousin' is facing cost, consolidation and global sourcing issues". The cost and global sourcing issues have become ever more important as the number of parts (SKU's or stock keeping units) required by the industry to service the vehicles on the road has increased from approximately 100,000 to over 300,000 to date. The number of SKU's is expected to continue to increase as the result of the useful service life of today's vehicles and the introduction of new Chinese automobile brands in the next several years.

Unlike the OEM industry which is going through some significant restructuring, the aftermarket is going through an evolution. This evolution will require changes at all levels of the industry. The true winners will be those companies that embrace the necessary changes. ■

The data reflected in this article comes from the AAIA (Automotive Aftermarket Industry Association) Factbook 2006/2007 16th addition.

NEW HIRE SPOTLIGHT

Louis R. Merz

Lou brings 40 years of experience in the automotive industry to BBK, having served as a senior level executive for multi-billion dollar automotive components and aftermarket manufacturers since 1963. Most recently, he led a successful automotive aftermarket consultancy, Aftermarket Growth Concepts, which served an impressive client roster in a variety of capacities including strategic business plan development, new business development, training and sales management, and operations advisory.

"We are pleased to announce that Lou Merz, a well-respected and long-time auto aftermarket senior level executive, has joined forces with BBK to launch a focused aftermarket initiative", said Bill Wexler, BBK's New York based Managing Director and Group Lead for its Corporate Advisory Group. "This exciting new effort will combine Lou's extensive industry experience with BBK's 28+ years of auto industry experience and its integrated, international advisory services platform, to form one of the most comprehensive aftermarket advisory resources available. The automotive aftermarket industry is going through a significant evolution and the addition of Lou gives BBK a unique positioning to assist our clients in this industry."

Lou received his Masters of Business Administration and his Bachelor of Science in Industrial Engineering from Washington University in St. Louis. Lou served as Chairman of the Automotive Aftermarket Industry Association in 2002-2003 and was the President of Automotive Sales Council in 2003.

Contact Lou at 312.795.1105 or lmerz@e-bbk.com.

CHINA UPDATE

Trends in Consolidation

By James Feldkamp, Director

In the late 1990s the aviation industry in China was in a state of disarray, with national and regional carriers engaged in a price war, fighting for market share at the expense of profits. In 1996, the Civil Aviation Administration of China (CAAC) suspended approval for new airlines and two years later, in 1998, stepped in and imposed price controls and began to formally consider how to consolidate the industry.

At the time, China's airline industry faced three major problems: i) overcapacity, ii) lack of profits and high debt, and iii) a poor safety record. The overcapacity stemmed from the 1980s when the CAAC, in an attempt to encourage competition, allowed individual cities and provinces to establish their own carriers. This resulted in 31 carriers: 10 airlines controlled by the CAAC – comprising 80 percent of the passenger volume – and 21 local and provincial airlines. Lack of coordination between carriers, and route networks motivated by political interests instead of profits, resulted in duplication of routes and substantial overcapacity. Passenger load factors for the China airline industry was between 58-61 percent from 1999 to 2001. In comparison, US passenger load factors during the same period averaged over 71 percent.

As the airlines were funded by 'soft' loans from provincial or national banks, growing market share was more important than making profits. Despite tremendous sustained industry growth (average 17 percent annual growth between 1978 and 2000) the 10 CAAC-controlled airlines reported a combined RMB6bn loss in 1998. By this time, the same 10 CAAC airlines had accumulated debts of RMB112.6bn ($13.6bn). Hu Angang, Chinese Academy of Sciences Director of the Centre for China Study, stated that "debt ratios of above 80 percent are common for the China airlines". This compares to debt ratios for US airlines which ranged from 47 percent in 1997 to 58 percent in 2001.

In mid-2000 the CAAC revealed its consolidation plan. Tearing a page from the playbook used for previous State-Owned Enterprise (SOE) consolidations (i.e., telecom and energy) it announced that it would consolidate the large players and let the remaining small players fend for themselves. Three airline conglomerates would be created from the ten CAAC-controlled carriers. Each conglomerate would have as sets of approximately US$6bn and a fleet of around 200 planes. Two of the airlines were publicly traded at the time, China Eastern Airlines and China Southern Airlines, while the third, Air China, planned to list following the consolidation as a way to offset the additional debt burden.

From the time the plan was announced, the process took several years to transfer the assets and liabilities to the conglomerates and complete the consolidation. For the two airlines that were publicly traded at the time of consolidation, they required approval from their respective Board of Directors to acquire the merging airlines. Although the costing of revenue generating and marketable assets was relatively straightforward, the challenge was costing non-core assets and liabilities including staff pensions and medical expenses; a situation similar in many ways to the challenges currently facing North American automakers. Overall the consolidation was a success, with China's airline industry making a profit of RMB8.7bn ($1.37bn) in 2003, equal to the total profit earned during the previous 10 years.

How can the lessons of China's airline industry consolidation be applied to the auto industry? Currently there are 120 companies in China manufacturing entire vehicles, a number nearly unchanged for more than a decade. Production volumes of many of these manufacturers are unsustainably low, with several companies no longer producing any vehicles at all. However, under China's current bankruptcy law, there is either no mechanism for insolvent companies to go out of existence, or, for certain SOEs for which the current regulation applies, they must wait for government approval to proceed through bankruptcy.

Over the past three years, as new entrants, both domestic and foreign, have entered the market and capacity has increased, profits have declined substantially, causing concern currently of overcapacity. According to the National Bureau of Statistics, profits in the China auto industry declined 38.4 percent in 2005 to $2.2bn, after sliding 18.4 percent in

2004. Average sales margins were 4 percent in 2005, compared to 6.85 percent in 2004 and 9.11 percent in 2003.

Consolidation in the auto industry will likely take place within the next 5-7 years. Hopefully a new bankruptcy law, which has been discussed for several years, will be put into place and used as an orderly exit mechanism for many companies that are currently insolvent, rather than simply combining their assets with other companies to form larger, healthier organizations. Similar to the airline industry, a handful of large automotive conglomerates will emerge; with talk already of the Chinese "Big 3". Regulation and industrial barriers will likely rise, preventing new market entrants. In the end, competition among remaining players will increase. The profitable mid-sized manufacturers will likely be left to fend for themselves. ■

- Excerpted from Financier Worldwide, Asia Pacific Restructuring & Insolvency Review 2006

LETTER FROM BBK

Challenges for the Expert Witness

The turnaround manager engaged as an expert witness in a bankruptcy proceeding faces higher standards and new challenges to his or her credentials, testimony, opinions and conclusions. Bankruptcy courts have followed the lead of the U.S. Supreme Court and the Federal Rules of Evidence (FRE) in requiring clear, verifiable and definite qualifications prior to qualifying a witness as an expert. The development of case law and judicial "gate keeping" is weeding out witnesses and testimony whose only qualifications may have been years in the insolvency field or participation in packaging the debtor's assets for a sale under 11 USC Section 363.

Daubert v. Merrell Dow Pharmaceuticals was the culmination of years of litigation over the misuse of scientific expert witnesses and prompted changes in both the court rules and judicial attitudes. Target defendants, primarily health care professionals and manufacturers of consumer products, had bemoaned the use of "junk science" to fix liability in personal injury litigation. With the Daubert decision, critics of expert witnesses won a major victory that had eluded them in the legislative arena. Today experts are required to:

- Show the testing of a scientific hypothesis
- Demonstrate the known or potential error rate
- Provide verification of the methodology through peer review and publication
- Establish that the methodology is generally accepted within the relevant community

But did Daubert apply to non-scientific experts, such as witnesses offering testimony on securities valuations, commercial transactions or the probable success of a debtor's proposed plan of reorganization under Chapter 11? In Kumho Tire v. Carmichael, the Supreme Court extended the Daubert standards to non-scientific experts. FRE 702 (2000) was written to codify these standards for all experts. Thus, experts in any field must be able to show:

- Qualification as an expert by knowledge, skill, experience training or education
- Testimony based upon sufficient facts or data
- Testimony based upon reliable principles and methods
- Application of reliable principles and methods to the facts of the case in court

"If a reputable organization conducts peer review or certification, it's time to get back in the classroom."

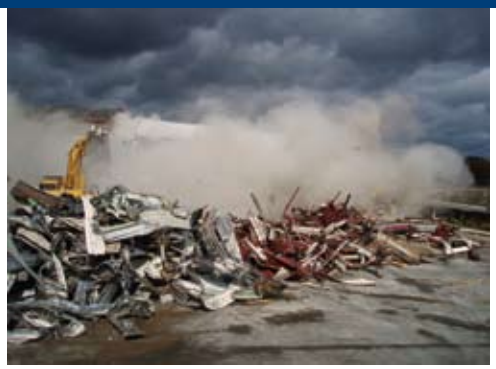
For example, a 20 year veteran of many bankruptcy proceedings was proposed as an expert in business valuation. During the multi-day hearing on the objection to this attorney's qualifications, the Judge took an active role in the examination of witnesses and found that, in fact, the attorney was not qualified as an expert because he:

- Lacked peer-granted certifications as an expert in business valuations
- Did not employ the same "intellectual rigor" in his analysis that would be used by an expert in the field of business valuations
- Showed a discernable measure of negligence in applying certain methodologies

This attorney's well known record as an accountant and liquidating trustee in Chicago was not enough to pass the new tests. It's a warning for us all. Insolvency professionals and turnaround managers who may be called as expert witnesses are advised to review existing credentials and update them. If a reputable organization conducts peer review or certification, it's time to get back in the classroom. Regular publication of articles in professional journals is a real asset as the failure to publish may weaken credibility. The bottom line-there are growing ways to address today's challenges for the expert witness. The rest is up to us.

Ray Reynolds Graves, ret. Bankruptcy Judge
Managing Director

THE CLOSING PLANT...*CONTINUED FROM PAGE 1*



on the size of the plant, a multi-staged auction should be considered with a pre-auction sale if the nature of the equipment is very specialized. A very important element of this phase is the strict supervision of the removal of the equipment.

Phase IV, the development of detailed work statements, starts with a rigorous pre-qualification process for the bidding demolition companies. Then the environmental site assessment report serves as the basis for the detailed work plans which provide the foundation for the requests for quotation (RFQ's) to the qualified firms. We recommend meetings with the bidders for clarification after the bids are received.

Phase V is the actual contract negotiations with several of the most competitive bidders. We also believe that the contracts be as detailed as feasible to minimize any unforeseen additional work which can be very costly in the construction or "destruction" industry! It is very important to negotiate with the demolition and remediation contractors aggressively and most importantly from a very strong, knowledgeable and experienced base. This contract serves as the blueprint for all the subsequent work leading to the preparation of the site for sale and is very important to the overall success of the decommissioning project.

Phase VI, the final phase, involves development of a future land use plan which serves as the basis for creating a marketing plan, retaining a commercial real estate firm and, depending on the extent of the acreage, an urban planning consulting firm to maximize the revenue from the sale of the property.

The Choice

Every situation is unique. If you're involved in a plant closing, know your options. If you decide to walk away, you could be leaving money on the table for a developer. Is that always the case? Maybe or maybe not. One thing is for certain, understanding the decommissioning process can empower you to weigh your firm's risks and benefits accurately and decide what's best for your firm. Don't miss the opportunity to realize the full asset value of a plant closing. ■

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