

# Driving Through the Storm:

Capitalizing on Today's Auto Industry Climate



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## Driving Through the Storm:

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# Miller Buckfire & Co. Presentation

Presented by:  
**Durc A. Savini, Managing Director**

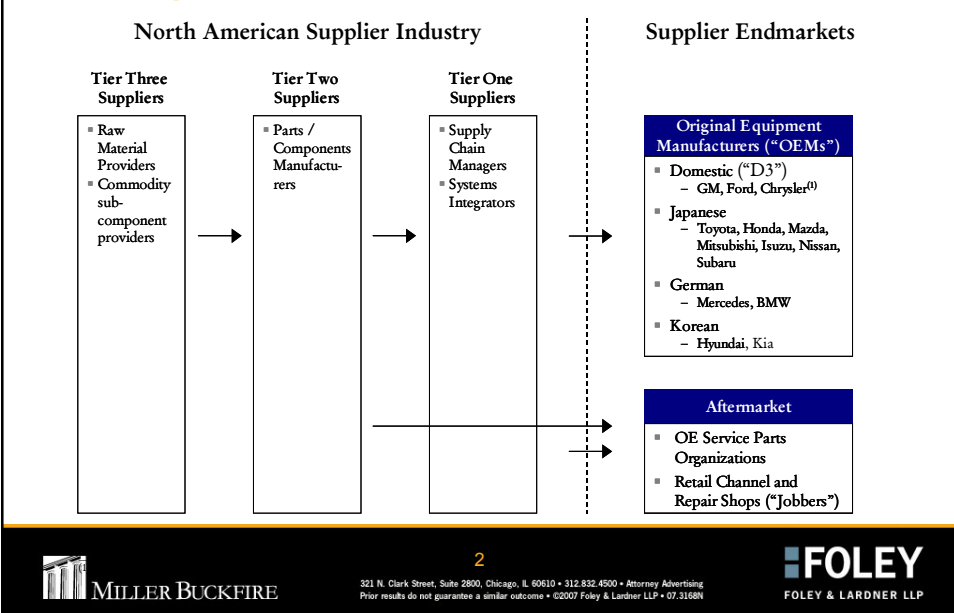
May 15, 2007



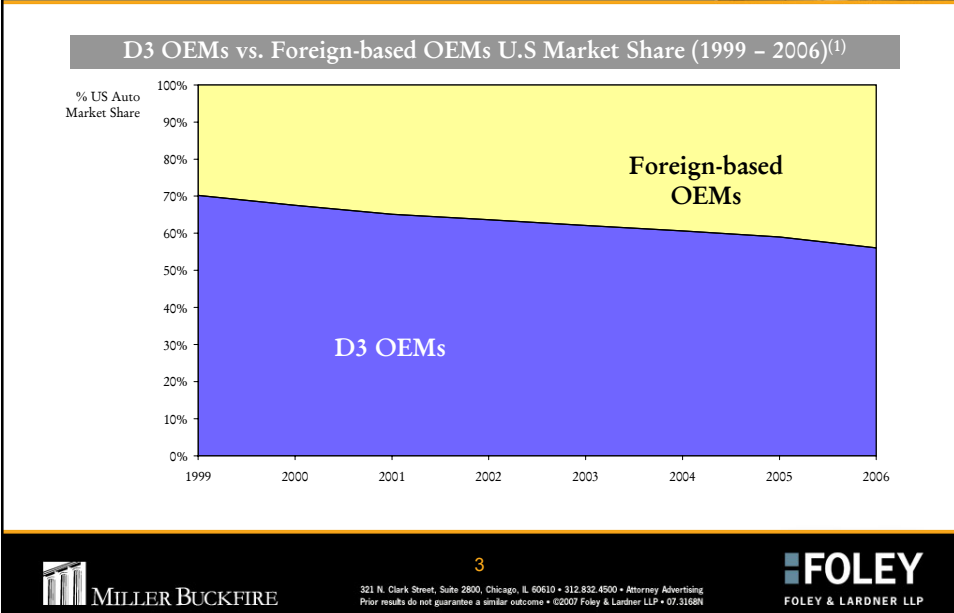
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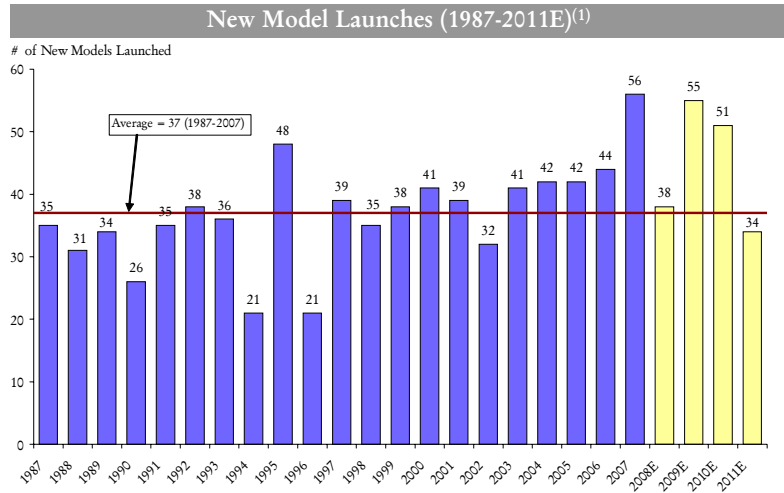
# Automotive Parts Supplier Industry Structure



# D3 Market Share Decline Trend Continues



# Accelerating Rate of New Model Launches...

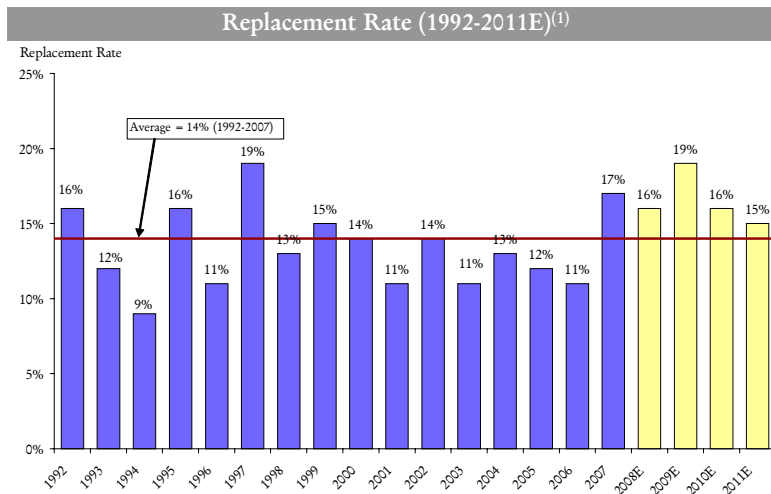


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# ...Will Result in Above Trend Annual Product Replacement in the Near Term

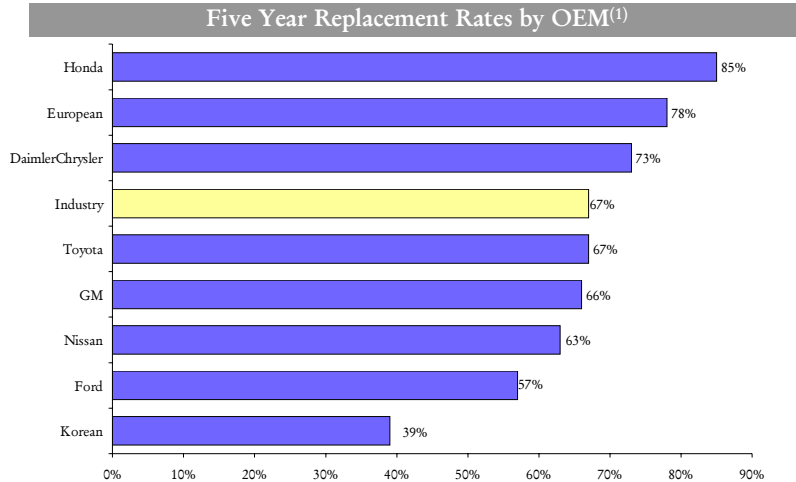


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## Cumulative Five Year Replacement Rates by OEM

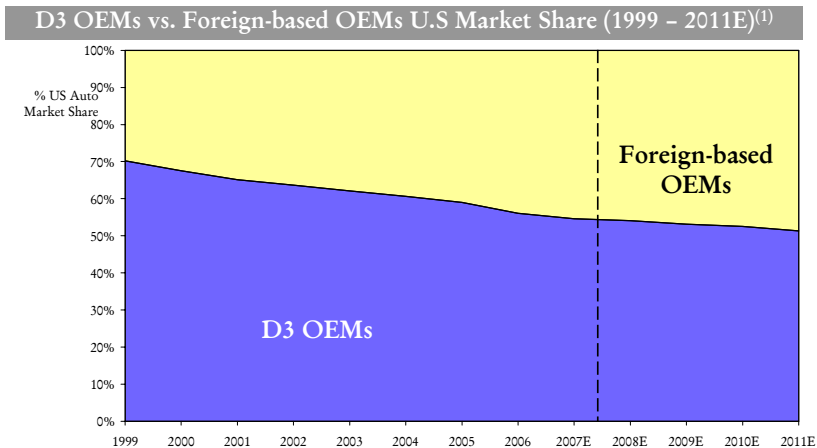


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## D3 Market Share Cession Expected to Continue, Albeit at a Declining Rate



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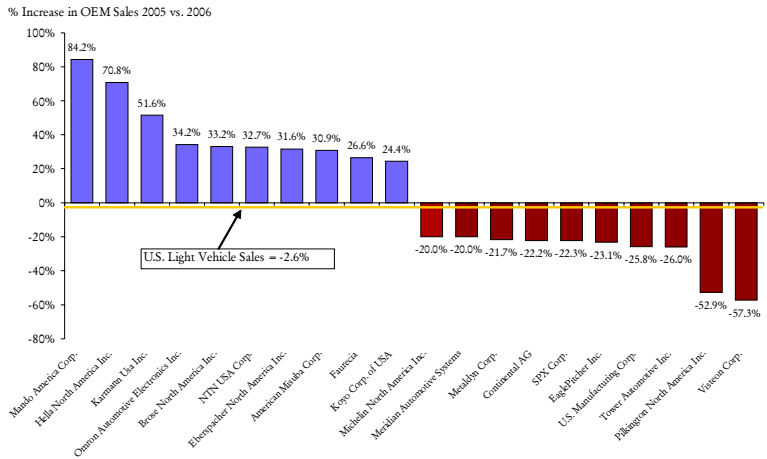
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## Relative Customer Exposure Determines “Haves and Have-Nots” Among Suppliers



US Light Vehicle Sales (% Change 2005 vs. 2006)<sup>(1)</sup>



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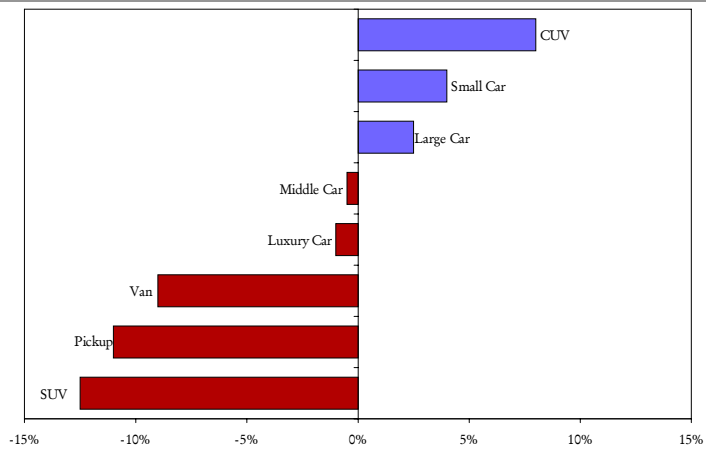
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## Vehicle Mix Moving in a Disadvantageous Direction. Secular or Cyclical?



% Shift in Mix (2005 vs. 2006)<sup>(1)</sup>



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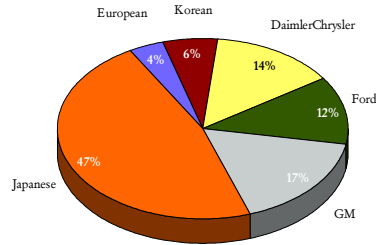
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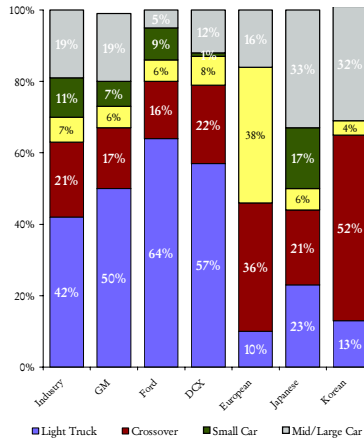
## D3 Making Move From Position of Relative Weakness in CUV Segment



CUV Segment Share<sup>(1)</sup>



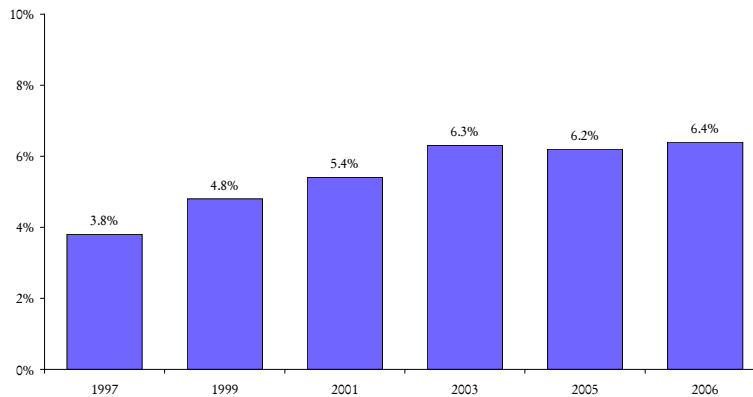
New Model Introductions by Segment<sup>(1)</sup>



## Contractual Price Downs Exacerbate Volume Challenges D3-exposed Suppliers Face



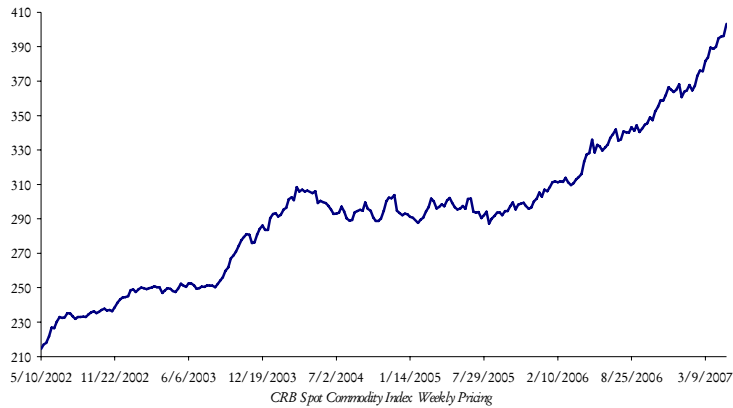
Annual Percentage Price Reductions Sought by OEMs<sup>(1)</sup>



## Unrecovered Commodity Cost Increases Effectively Become Incremental OEM Price Downs



Five Year CRB Spot Commodity Index History<sup>(1)</sup>



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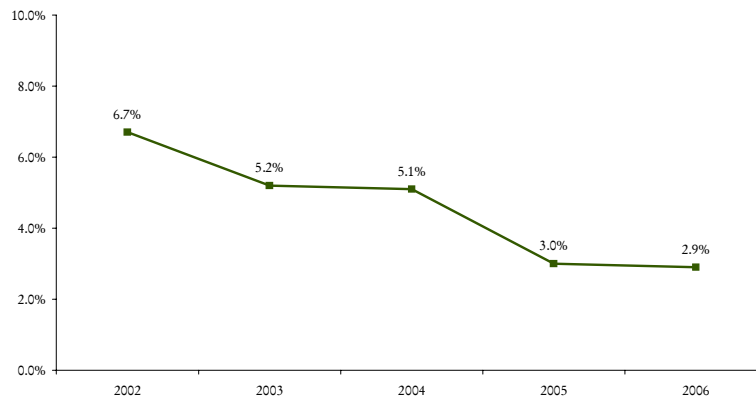
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## Cumulative Effect of Volume, Price, Commodity and Mix Challenges is Weakened Profit Margins for D3-Exposed Suppliers



EBIT Margin for OEM Suppliers<sup>(1)</sup>



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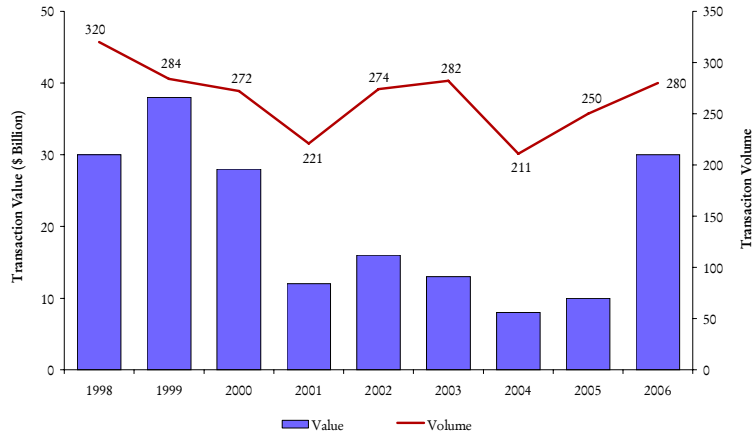
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## Consolidation Activity is on the Rise Again...



M&A Activity in the Automotive Supplier Sector 1998-2006



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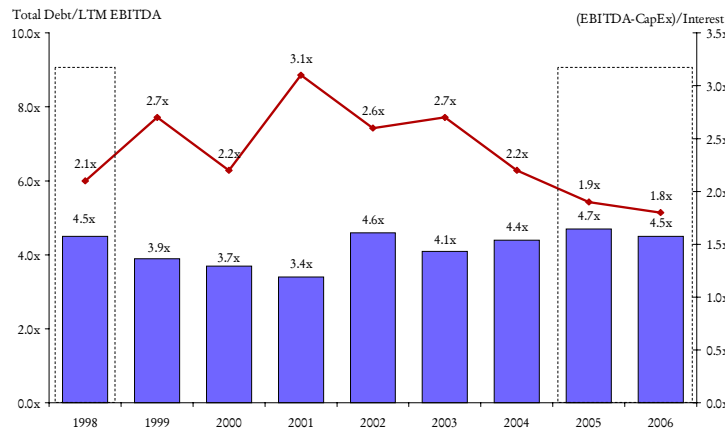
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## ...Perhaps Improved Industrial Logic Informing Current M&A Activity Will Support Leverage This Time



Recent Lending Terms for Automotive Supplier Transactions (1998 - 2006)

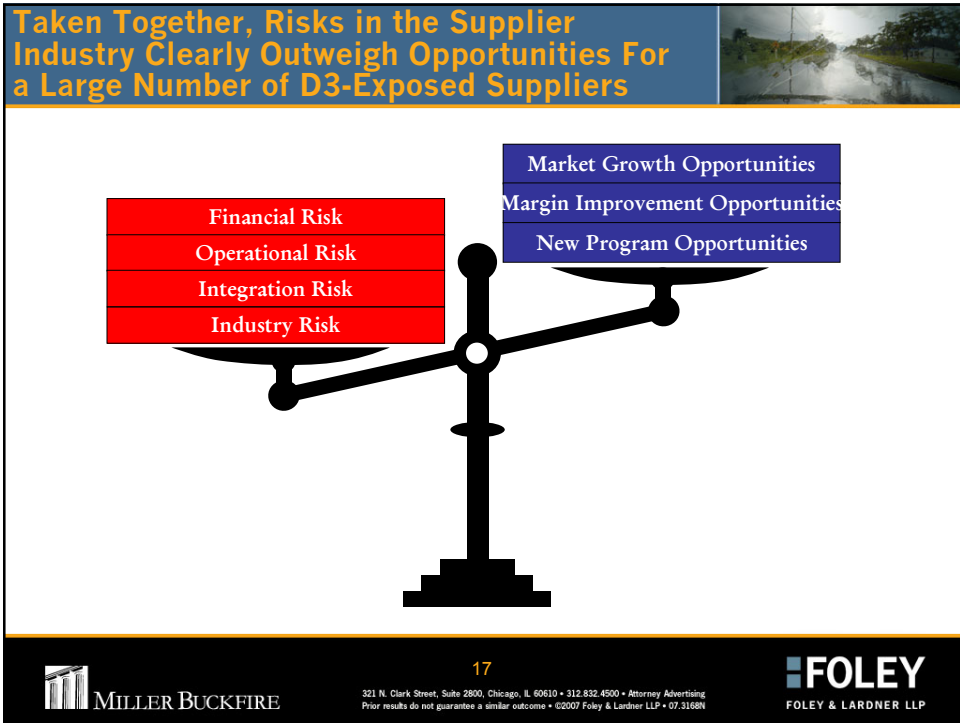
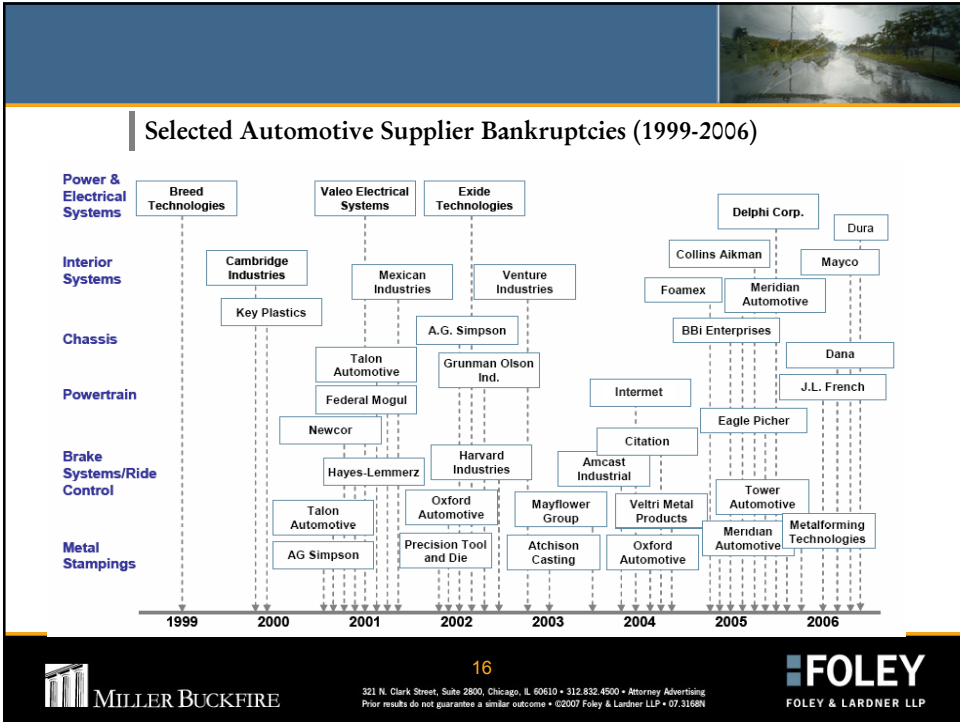


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## Investment Success Factors in Supplier Restructurings



- Be skeptical of market valuations as an indicator of intrinsic value (e.g., Meridian, Tower, C&A)
- Be selective when screening for targets. Overcapacity will eventually mean some suppliers won't come out the other side (e.g., C&A, Oxford, Harvard)
- Don't underestimate probability of a bankruptcy filing even when its counter-indicated by the circumstances
- Make sure you're interested in being an owner regardless of your entry point in the capital structure
- Rely on Debtwire to your detriment



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## Investors Should Favor Supplier Distressed Investment Opportunities that Offer:



- Narrower vs. broader product range
- Vertical vs. horizontal acquisition history
- Competitive strategy emphasizing proprietary technology vs. product innovation
- Tier 1 vs. OEM customer exposure
- Consolidation-driven turnaround plan vs. volume-driven or customer-driven turnaround plan
- Low union labor exposure
- Untapped growth investment opportunities



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## Foley & Lardner LLP Presentation

**Presented by:**  
**Pat Daugherty, Foley & Lardner LLP**  
**Judy O'Neill, Foley & Lardner LLP**  
**Sal Barbatano, Foley & Lardner LLP**

May 15, 2007



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## Foley & Lardner Overview



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## Foley's Automotive Industry and Restructuring Capabilities



- Foley's Automotive Industry Team (AIT) represents companies throughout the automotive supply chain, with an emphasis on representing Tier 1 suppliers
- More than 50 attorneys practice in Foley's Business Reorganizations Practice Group, including in New York, Delaware, Detroit and other jurisdictions
- Foley is the only national law firm with a Detroit Office and dedicated Automotive Industry Team, with deep knowledge of supply chain contracts and how to deal with troubled customers/suppliers



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## Foley's Automotive Industry Chapter 11 Experience



- Foley & Lardner attorneys have had significant involvement in the following Chapter 11 cases in the automotive industry:
  - Tower Automotive
  - Meridian Automotive Systems
  - BBi Enterprises
  - Collins & Aikman
  - Pilot Industries
  - Venture
  - Oxford Automotive
  - Intermet Corporation
  - Key Plastics
  - Amcast Industrial
  - Delphi
  - JL French
  - Dana Corporation
  - Dura Automotive




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## Automotive Supply Chain and Contracting Overview



**The Contract**

- Blanket Purchase Orders
- Releases
- LTA
- Cost Downs


**The Product**

- Sole Sourced
- Just In Time
- Tooling
- Platform
- Re-Sourcing
- Capacity
  - Supplier
  - Product


**Timing**

- Shutdown
- Changeover
- New Awards

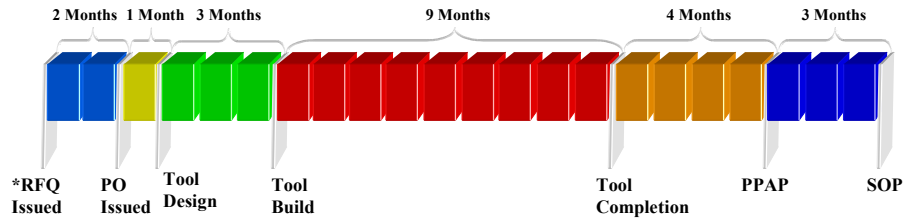
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## Timeline for New Auto Business Average Time from Quote to Full Production 18 – 30 Months



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## Current Contracting Practices



- RFQ's
- Quotations
- Purchase Orders
- "Battle of the Forms"



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## Current Contracting Practices



- What is the contract?
  - T's & C's: conflicting terms and the "Battle of the Forms"
  - Termination date is important: fixed or indefinite?
  - Emails and conduct impacts what constitutes the "contract" (course of dealing and course of performance)
- Directed supply
- Hostage situations
- Trends: Long Term Agreements?



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## Common Issues in Automotive Restructurings



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## Common Issues in Automotive Restructurings



- Customer Influence – Short Term
  - New business hold
  - Resourcing
  - Setoffs and recoupment
  - A/R remittances slow down



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## Common Issues in Automotive Restructurings



- Importance of Contract Issues in Restructurings and Acquisitions
  - Impact of contracts and contract terms on:
    - Ability to stop shipment in transit
    - Terminate contract
    - Demand and obtain adequate assurance of performance
    - Bankruptcy Rights
      - Performance in the Gap Period:
        - » Bankruptcy law requires the non-debtor party to perform in the gap period



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## Common Issues in Automotive Restructurings



- Assumption or Rejection of Executory Contracts
  - If contract is executory, the contract must be assumed or rejected at least by confirmation of the plan
  - Assumption requires cure of all monetary defaults, including pre-petition defaults
  - Suppliers need to be aware of leverage that may enable pre-confirmation assumption or rejection
- Acquisitions
  - Suppliers may have leverage if contract is not assigned



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## Common Issues in Automotive Restructurings



- Accommodation and Access Agreements
  - What are they?
    - Typically between customers, suppliers and secured lenders, these agreements are designed to provide continuity of supply and protection of the secured lenders' collateral base
    - The access agreement permits the customer, under limited circumstances, to access the supplier's plant to produce parts pending transfer of the contract and/or facility to a healthier supplier



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## Common Issues in Automotive Restructurings



- Accommodation and Access Agreements (cont.)
  - The accommodation agreement provides accommodations that solidify the lenders' collateral base through protections on inventory and receivables and commitments to continue sourcing of existing parts to the troubled supplier
  - Often provide for waiver of the right of setoff as to consequential damages
  - May provide for loans or financial accommodations
- Why are they used?
- Key Provisions



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## Common Issues in Automotive Restructurings



- Critical Vendor Status
  - “Essential or “critical” suppliers
    - Cardinal principal of bankruptcy is that similarly situated creditors receive equal treatment
    - Certain creditors (usually trade) can be deemed “critical” in bankruptcy proceedings if they are”
      - Irreplaceable
      - Crucial to continued operation and successful reorganization
      - Can be used as a means to obtain unsecured credit



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## Common Issues in Automotive Restructurings



- Critical Vendor Status (cont.)
  - Auto industry gives support to critical vendor arrangements
    - Customers may not have alternative markets for the goods they are purchasing
    - An inability to replace that supplier (owing to the high cost associated with moving tooling from one supplier to another and the attendant time delay)
    - Extremely thin profit margins (where the collapse of even one customer may mean economic ruin for many suppliers)
    - Tooling vendors often considered critical vendors
    - Lien issues (possessory and by filing)



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## Common Issues in Automotive Restructurings



- Impact of revisions to code on acquisition in bankruptcy
  - Section 503(b)(9) of the Bankruptcy Code – Administrative claim for goods sold to the debtor in the ordinary course of business in the 20 days preceding the bankruptcy
  - Expanded time period for reclamation rights



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## Common Issues in Automotive Restructurings



- Customer influence – long term
  - Customer expectations of restructured supplier
    - Competent management with automotive experience
    - Sound capital structure able to survive cyclical nature of industry
    - Long term owners with stable ownership.



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## Labor Agreement Issues in Bankruptcy Cases



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## Labor Issues in Bankruptcy



- Bankruptcy Code § 1113
- Rejection of Collective Bargaining Agreements (“CBAs”)
  - Rejection of a CBA may be necessary to terminate a pension plan if the Union refuses to drop a contract bar
  - Aggressive approach may be appropriate if the Union “holds hostage” the pension plan termination issue as leverage in negotiations
  - To reject a CBA, the debtor must meet strict procedural requirements and show that its proposed modifications to the CBA are “necessary to permit the reorganization of the debtor”



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## Labor Issues in Bankruptcy



- Courts Have Divergent Interpretations of How “Necessary” the CBA Changes Need To Be
  - Third Circuit – “But for” test – debtor may propose only those modifications necessary to avoid liquidation
  - Second Circuit – Less stringent test – whether changes “will enable the debtor to complete the reorganization process successfully” because rejection will result in a greater chance for reorganization than if the CBA remains in force
  - If Debtor is Selling its Assets – In a liquidating chapter 11 case where a sale of assets is proposed, the debtor only must show modifications are “necessary to confirmation of the plan”



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## Pension Issues in Bankruptcy Cases

## Pension Issues in Bankruptcy



- Pensions
  - Bankruptcy Code § 1114
  - Role of Pension Benefit Guaranty Corporation (the “PBGC”)
    - A governmental “insurance company” that oversees Title IV of ERISA
    - Roles in chapter 11 cases include overseeing plan termination process, recovering premiums and filing claims
    - Take a very active role in chapter 11 cases, particularly automotive restructurings
    - In many cases will sit on the Official Committee of Unsecured Creditors

## Pension Issues in Bankruptcy



- Recurring problem of underfunded pension plans
  - Funding must always be sufficient to cover an “accumulated funding deficiency”
  - Very onerous on companies to fund deficits
  - ERISA does not allow over-funding in good times
  - “Anti-cutback” rule in Internal Revenue Code prevents employers from decreasing or delaying certain benefits
  - Many employers stuck with pension plans they cannot possibly fund



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## Pension Issues in Bankruptcy



- Tools Bankruptcy Provides to Deal with Pension Issues
  - Distress Termination
  - Rejection of Collective Bargaining Agreements
  - Potential Suspension of Contributions
  - Limiting PBGC Claims



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## Pension Issues in Bankruptcy



- Distress Termination
  - A voluntary distress termination requires approval by the PBGC and the Bankruptcy Court
  - The Plan Administrator must give the PBGC and participants 60 days written notice
  - Termination cannot violate the terms of a collective bargaining agreement unless the agreement is rejected as part of the termination
    - Company may try to get the Union to drop a contract bar through negotiations
    - Important strategic call of the company on whether to integrate, or bifurcate, the distress termination and section 1113 process



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## Pension Issues in Bankruptcy



- Legal Standard for Distress Termination
  - Financial Necessity Test – Whether the debtor can confirm any plan of reorganization absent termination of its pension plan or plans
  - Necessary does not mean necessary to a particular preferred plan—it must be necessary to any confirmable plan
  - Requires review of the debtor's cash flow, opportunities for debt capital and extent of its pension obligations
  - If the debtor has multiple plans, the court will likely analyze them in the aggregate rather than on a plan-by-plan basis



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## Pension Issues in Bankruptcy



- Potential Suspension of Contributions
  - The debtor often attempts to suspend minimum funding contributions while in bankruptcy
  - Can be an interim first step prior to the distress termination process



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## Pension Issues in Bankruptcy



- Limiting PBGC Claims
  - PBGC generally has claims against all estates in multi-debtor case due to joint and several liability of all members of the plan sponsor's "control group" (generally meaning all entities 80% or more commonly owned)
  - PBGC also has a claim for any missed funding contributions and insurance premiums
  - PBGC may oppose substantive consolidation in order to enhance its recoveries



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## Pension Issues in Bankruptcy



- Calculation of Claim – Dispute Over Discount Rate
  - PBGC’s unfunded benefits claim must be discounted to present value
  - Until 2003, courts had consistently applied the “prudent investor rate” to present value the PBGC’s claims—the rate achieved by a prudent investor over the long term while preserving capital and minimizing risk
  - CSC Industries decision by the Sixth Circuit is one of the leading decisions on this issue
  - In 2003, the US Airways case rejected the “prudent investor rate” and accepted the PBGC’s use of ERISA’s valuation regulation as an interest rate, which results in a much lower rate
  - PBGC has used the US Airways decision as settlement leverage in courts not governed by current authority



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## Pension Issues in Bankruptcy



- Priority of PBGC Claims
  - PBGC may attempt to obtain administrative expense or priority tax status for its unfunded benefit claims
  - Most courts have limited administrative expense status to unfunded benefits attributable to post-petition labor
  - Priority claim theories have fared poorly as well in recent years
  - In some cases, PBGC may have a perfected secured lien due to collateral posted by the debtor as security for missed contributions or the perfection of a lien pre-petition



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## Pension Issues in Bankruptcy



- Impact of possible substantive consolidation
- Liquidity shortfalls to fund plans
- Customer influence – long term
  - Customer expectations of restructured supplier
    - Competent Management with automotive experience
    - Sound Capital Structure able to survive cyclical nature of industry
    - Long term owners with stable ownership



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## Driving Through the Storm: Capitalizing on Today's Auto Industry Climate



# Distressed Investment Opportunities and Investment Considerations



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## Investment Opportunities



- Targets of Opportunity
  - Companies that can be deleveraged and restructured
  - Spin-offs of non-core but otherwise healthy operations of larger suppliers
  - Second lien debt issues
  - Recognizing When a Company is Troubled
    - Late and delayed payments
    - Increasing receivables
    - Decreasing market share
    - Dun & Bradstreet reports
    - Changes in key management positions
    - Lengthening of credit terms
    - Delays in payment of dividends or payments on funded debt



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## Investment Opportunities



- Early warning signs of financial distress may include:
  - Supplier requests for price increases, early payments, accelerated payment terms, or customer financing
  - Late deliveries or negative changes in product quality
  - Failure to update information technology systems
  - Failure to effectuate cost reductions or to address volume reduction during economic downturns
  - Delinquent taxes
  - Deteriorating accounts receivable and accounts payable
  - Restatement of or delays in issuing audited financial statements, or a change in audit firms
  - Changes in key management positions



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## Investment Opportunities



- Vehicles for Acquisition
  - Section 363 Sales
  - Acquisition of Claims/Conversion to Equity
  - Plan of Reorganization



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## Investment Considerations



- Customer relationships
  - Strength
  - Diversity
  - Opportunities to expand offerings
  - Ability to restructure existing contracts
  - Reliance on supplier as sole source



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## Investment Considerations



- Platform analysis and book of business
  - Strength of platforms they are supplying
  - Runoff versus new awards
  - Current bidding scorecard
- Product offerings
  - Market leader or also-ran
  - Commodity versus value-add
  - Product design and R&D capabilities
  - Industry capacity to absorb company's product offerings



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## Investment Considerations



- Other considerations
  - Facilities and equipment
  - Labor and unions
  - Operational and management differentiators



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## Questions & Answers



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