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WHAT'S INSIDE

SEE P. 51 FOR DETAILS ON UPCOMING AIRA EVENTS:

11TH ANNUAL ENERGY SUMMIT & 22ND ANNUAL POR CONFERENCE

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Erratum: In AIRA Journal Vol. 36: No. 2 (2023), p. 57, John Ferretti's firm was incorrectly listed. His firm is correctly shown as M3 Partners, LP, on p. 41 of this issue.

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

It seems like it was yesterday that we celebrated the turn of the new year and here it is almost Labor Day. I find this leap through the year indicative of one thing. For the most part, our practice area of insolvency and restructuring is in the midst of an increasingly busy period. Last week, Andrew Nicholas and his team at William Blair & Company, L.L.C., released their report, *Specialty Consulting Quarterly: Second Quarter 2023*, which draws the conclusion that activity among industry participants supports the proposition that we are in the early stages of a long-overdue restructuring cycle. Nicholas concludes that demand for turnaround and restructuring services will continue to improve over the next several quarters.

Increased demand for services means increased need for professionals to provide those services. From my vantage point, I see the pickup as our member firms are hiring and those hires are seeking to enhance their professional qualifications by pursuing advanced training and CIRA and CDBV certifications. I am also seeing professionals who moved on to other endeavors returning to the turnaround and restructuring practice area.

Earlier this year, David Payne reported on AIRA joining the Bankruptcy Inclusion, Diversity, Equity and Accessibility Consortium (Bankruptcy IDEA Consortium), a consortium of twelve legal and financial professional organizations whose mission is to serve as a repository of opportunities and resources of the member organizations' efforts to promote and foster diversity in the insolvency field. Only in its second year, the Bankruptcy IDEA Consortium has made significant progress in advancing its mission. As Eve Karasik detailed in her August 2023 article in the *ABI Journal,* "ABI Strength in Diversity – The Bankruptcy IDEA Consortium,"[1] the key to the Consortium's mission is its website, bankruptcyidea.org. As it continues to be developed, the site is designed to host the opportunities and resources identified by the consortium members. These include employment listings, resumes, lists of speakers on DEI and accessibility topics, and a list of affinity organizations and related events among other resources.

As demand for services and professionals to provide those services picks up, bankruptcyidea.org provides an additional avenue to identify and hire the skilled and diverse individuals needed to meet these needs. Currently, the employment opportunities listed on the site tend toward legal professionals as the majority of the consortium members are legal organizations. As the financial oriented member organizations like AIRA and TMA spread the word, the site will become a place to find opportunities and individuals to meet the evolving needs, legal or financial.

So, what should the AIRA membership be doing? Share this note and the website address with your HR department. Post your staff needs and share your firm's efforts to increase inclusion, diversity, equity, and accessibility through bankruptcyidea.org. In case you forget it, our AIRA website lists the link on the lower right-hand corner of the home page under Helpful Links.

Before you turn the page, let me once again express my thanks to the teams whose efforts brought the membership another successful annual conference in June: The AIRA staff, Cheryl, Michele, and Mike; the annual conference chairs, Judge Scott Clarkson, Michelle Salazar-Rosenbloom, and Brad Sandler, and all of the planning committee members.

As you've come to expect, another informative and timely set of articles follows. Read, enjoy, learn.

Keep well. Jim Lukenda

1 *ABI Journal*, Vol. XLII, No. 8, August 2023.

A Letter from AIRA's Next President

DENISE LORENZO, CIRA
AlixPartners, LLP

AIRA's 39th Annual Bankruptcy and Restructuring Conference held in Newport Beach, CA in June 2023 was an immense success and the enthusiasm of the attendees helped make the time together productive and fun. I would like to thank the dynamic Planning Committee, Guest Speakers and Panelists for their valuable time, participation, and in-depth insights. The Organization has received positive feedback regarding the venue and conference overall. We hope to see you at one of our upcoming events where you will have the opportunity to meet and network with others in the industry and attend educational sessions:

- **The 11th Annual Energy Summit** will take place on September 13, 2023, in Dallas, TX.
- **97th Annual NCBJ – AIRA Breakfast Program** will take place on October 13, 2023, at the JW Marriott in Austin, TX.
- **22nd Annual Advanced Restructuring and POR Conference** will take place on November 13, 2023, at the Offices of CohnReznick, LLP, New York, NY.

On June 6-7 the AIRA Board of Directors held a one and one-half day strategic planning session with Louis Feldstein of Dynamic Change Solutions (DCS), our planning facilitator. The Board determined that the AIRA is best served in maintaining its focus on preserving and expanding the core values and services that AIRA offers in the restructuring community. The Board of Directors are proceeding to the next phase in the process to identify a business model that will enable the AIRA's foundational products to further develop and grow. We will continue to provide updates as we progress.

Thank you for all your continued support.

— Denise Lorenzo

Resident Scholar Column

JACK F. WILLIAMS, PHD, JD, CIRA, CDBV, CTP

Bankruptcy Busters

The role valuation plays in the law is fascinating. So much is predicated on the economic concept across so many areas, much has been written on the subject, and many voices have weighed in on its measure. Over time, the methods and ideas that underly practices used in the valuation profession have evolved, and many participants have contributed to that evolution through a dynamic and changing marketplace of ideas. Our humble area of the law and finance – bankruptcy, restructuring, and insolvency – has witnessed major contributions by our colleagues that have advanced the understanding on theory, method, and practice and aided in the resolution of many challenges as applied to the special species of valuation practice, that is, the valuation of distressed businesses.

The AIRA was the first to recognize the unique, multifaceted evolution of valuation approaches that affected the bankruptcy valuation environment. Its major contribution, the Standards for Distressed Business Valuation, continues to stand as an informative and integral guide to valuing businesses in distress. My role as AIRA Resident Scholar has led me to question, probe, and push my limits of understanding of the economic and legal concepts upon which valuations in dispute are predicated. My 35 years of study culminated in an article titled "Teaching Bankruptcy Valuation to Law Students and Other Unnatural Acts," published in the *Emory Bankruptcy Developments Journal*.[1]

In that article, I portray business valuation as both a fine art and a science, and a discipline born of thoughtful consideration of the appropriate drivers of value, their interconnectedness, the application of a rigorous methodology, and deliberate exercise in judgment. This characterization recognizes the dichotomy of the "science of objective measure" and established methodology, as against the fine art of applied "proficiency and judgment."[2] Both what is amenable to objective measure and what is not contribute to the composite portrait of the value of a debtor which we are required to draw.[3]

[1] Jack F. Williams, "Teaching Bankruptcy Valuation to Law Students and Other Unnatural Acts," *Emory Bankruptcy Developments Journal*, 39:1 (2023), 51-149, https://scholarlycommons.law.emory.edu/cgi/viewcontent.cgi?article=1225&context=ebdj.

[2] *See* Joseph Herman, "Medicine: The Science and the Art," *Journal of Medical Ethics: Medical Humanities*, 27:1 (June 2001), 42-46 (citations omitted); John Saunders, "The Practice of Clinical Medicine as an Art and as a Science," *Journal of Medical Ethics: Medical Humanities*, 26:1 (June 2000), 18, 20.

[3] *See, e.g., In re El Paso Pipeline Partners, L.P. Derivative Litig.*, No. 7141, 2015 WL 1815846, at *22 (Del. Ch. Apr. 20, 2015); *In re PTL Holdings LLC*, No. 11-12676, 2011 WL 5509031, at *5 (Bankr. D. Del. Nov. 10, 2011) ("[P]reparing financial projections for a large operating business is equal parts science and art."); *Chatz v. BearingPoint Inc. (In re Nanovation Techs., Inc.)*, 364 B.R. 308, 346 (Bankr. N.D. Ill. 2007) ("Valuation is as much an art as [a] science and there is room for a difference of opinion . . . .")

I want to explore the notion of bankruptcy valuation as a fine art through the lens of some of the intriguing discoveries that I made in my research and some of the great movies or TV shows that bring context and color to those discoveries. Here are 10 valuation artifacts and the movies that I hope bring them to life.

1. **The "OG" *Law and Order* Effect** (especially Seasons 5-7): Bankruptcy valuation disputes are driven by law and not by economics. More precisely, valuations in dispute draw from principles of remedies in most legal contexts and require a near seamless understanding of law and economics. As with remedies, we seek to place all parties in their rightful position, using legal principles to contextualize what that means and economic tools to explore that meaning. In bankruptcy, that means to address creditor harm usually through a substitute remedy and to prevent or disgorge unjust debtor or creditor enrichment. My thought experiment: think less about proving the value of a business and more about fashioning a remedy and recognize the dual roles of attorney and financial advisor.

2. **The *My Cousin Vinny* Effect**: Valuations in dispute are always contextual; they arise in real cases with real parties where facts matter and minor differences in facts may result in significant differences in consequences. There is nothing hypothetical about the parties and the dispute. Parties in interest are harmed, and there is the constant risk that the harm may go undercompensated or that a debtor or positionally strong creditor may be unjustly enriched. Facts lead the way.

3. **The *A Prairie Home Companion (Film)* Effect**: General valuation theory is predicated on healthy going concerns where no firm is in decline or in distress and estimates of value are always a function of stabilized future cash flows, moderate risk, and established growth. All firms are above average in this world. That is not our world.

4. **The *Back to the Future* Effect**: Valuations are forward looking and rest on the three irreducible pillars of finance theory: time value of money, diversification of risk, and rule of one price. We are always looking for the approach and inputs with the most predictive powers and, yet historical performance may matter … a lot.

5. **The *The General* Effect**: All valuation approaches require the exercise of judgment, either by an expert, a trier of fact, or both.

6. **The *Casablanca* Effect**: All valuation approaches and methods require assumptions, inputs, and other data. The choices with regard to assumptions, inputs, and data require us often to trade off degrees of reliability with relevance and degrees of transparency with opaqueness. Sometimes hard choices must be made.

7. **The *Twelve Angry Men* Effect**: Some assumptions and inputs are more prone to errors of competence, hindsight bias, or prejudice. These potential errors exist across all approaches and methods of valuation. Often, the only difference is the forum in which these assumptions and inputs are determined and associated errors are made. Often, what may appear to be errors of this type are not errors at all, but logical extensions of our competing points of view.

8. **The *Indiana Jones and the Last Crusade* Effect**: There has been a near-constant quest for the best estimate of the required return to equity in cost of capital calculations. In reported cases, estimates on the required rate of return (cost of equity) are most often based on the Capital Asset Pricing Model or CAPM. The CAPM is well recognized, and we continue our search.

9. **The *Apollo 13* Effect**: Experts do not take sides. Some humans do, even though they may try hard not to migrate to advocacy. We can usually witness this when an expert's valuation model contains all assumptions and inputs that point in one direction, the direction that tends to favor the client's position. It can happen, but life is seldom that simple. When objectivity yields to advocacy, especially in the estimate of risk, we have a problem.

10. **The *It's Complicated* Effect:** …Well, it is!

So, there you have it. Valuation through the eyes of film. And what is the takeaway here? Across my areas of study of bankruptcy, I have learned that no system is any better than the people who operate within it. We are blessed with an overabundance of good people, who do good work, and who are unafraid to put their shoulder to the plow. Through them, we have advanced our understanding of bankruptcy and finance. I have also learned that the bankruptcy institution and valuation practice are multiple systems that overlap when we address valuation issues in dispute. They bring with them their own social systems, and with their convergence, an additional system of systems inhabited by multiple professionals from multiple disciplines playing multiple roles. Each must operate effectively for the system to work. Our success, to the extent that we have achieved it, is a shared experience.

Let me know what you think! Appreciate you all.

NAVIGATING THE UNCERTAINTY AROUND COST OF CAPITAL AND VALUATION ASSUMPTIONS

Carla Nunes
Kroll

What a difference a year can make. In 2021, the S&P 500 Index increased by 27% while the NASDAQ Composite Index (a typical benchmark for tech stocks) gained 21%, in price terms. At the beginning of 2022, new record highs were reached by the S&P 500 as optimism about the recovery from the COVID-19 pandemic continued to fuel stock prices, despite some uncertainty on inflationary expectations.

A year later, the picture changed dramatically. The S&P 500 dropped 19% in 2022 (in price terms), entering "bear market" territory sometime during the year. The NASDAQ plunged, settling at a loss of 33% for the year, with many companies seeing their market value collapse by half or more. In fact, 2022 was the worst performance year for the S&P 500 since 2008, at the height of the global financial crisis.

The bleak performance for 2022 reflects volatile economic and geopolitical conditions. Since mid-January of last year, inflation continued to rise, reaching levels not seen in decades in some countries. To make matters worse, when Russia's war on Ukraine began in late February 2022, there was a sustained spike in energy and other commodity prices, which had a particularly negative impact in Europe. This added uncertainty to what was already a complex environment. For businesses operating in and across these economies, cost of capital and valuation assumptions were impacted, creating challenges for firms in terms of forecasting cash flows and assessing future risks.

How Did We Get Here?

In October 2022, inflation surged in many developed and emerging economies, hitting a record 25-year high of 10.6% in the eurozone.[1] Since then, inflation has slowly been coming down, standing at an estimated 6.1% at the time of writing (early June 2023). However, core inflation (excluding volatile energy and food prices) remains stubbornly high at an estimated 5.3%, far from the European Central Banks's (ECB) 2.0% target.[2]

In the U.S. and UK it is a similar story. The U.S. saw inflation surge to a 41-year high in June of 2022, which came down to 4.9% in April 2023,[3] still more than double the U.S. Federal Reserve's target of 2.0%. Moreover, the Personal Consumption Expenditures (PCE) Price Index, the Fed's preferred gauge for inflation, increased in April to 4.4%.[4] Likewise, the Core PCE index (i.e., excluding food and energy) accelerated to 4.7% in April, demonstrating the challenge the Fed is facing in bringing down inflation.

But How Did We Get Here?

The origins track back to COVID-19. Around the world, governments implemented stimulus packages to support their economies, similar in magnitude to fighting a world war. At the same time, central banks brought their policy interest rates to zero and launched unprecedented quantitative easing (QE) measures, creating an environment of easy and cheap access to credit.

This left consumers flush with cash, creating pent-up demand for goods; however, lockdowns left manufacturers and businesses struggling with global supply chain disruptions and labour shortages (e.g., China's zero-COVID policies which exacerbated worldwide supply chain problems). All these factors led to a disconnect between supply and demand, creating the perfect storm for inflation to surge.

At first, lockdowns left businesses unable to keep up with demand for consumer goods. When the economy reopened, inflation expanded to services as people were able to travel and go to restaurants, for example. But industries like hospitality and healthcare continued to struggle with staff shortages. All of this contributed to inflation within "services"—a much harder problem to tackle.

[1] Monthly inflation readings are calculated on a year-on-year basis. Source of underlying data: Eurostat database, series "HICP - monthly data (annual rate of change)," https://ec.europa.eu/eurostat/databrowser/view/prc_hicp_manr/default/table?lang=en. Accessed on June 1, 2023.

[2] In the eurozone, core inflation also excludes alcohol and tobacco prices. Source of underlying data: Eurostat database, series "Overall index excluding energy, food, alcohol and tobacco." Accessed on June 1, 2023.

[3] Source of underlying data: U.S. Bureau of Labor Statistics (BLS), series "All items in U.S. city average, all urban consumers, not seasonally adjusted," 12-Month Percent Change.

[4] Source of underlying data: U.S. Bureau of Economic Analysis (BEA).

The cost of other services such as rent and energy also skyrocketed, with the price of energy particularly deepening what many termed a "cost of living crisis." Dramatic rises in energy and agricultural commodity prices, triggered by Russia's war on Ukraine, placed renewed pressure on recovering global supply chains, contributing to the knock-on effect of significant inflation spikes in food and certain services across the world.

Inflationary pressures are no longer limited to volatile energy and food prices, creating the perfect breeding ground for "stagflation."

The Spectre of Stagflation

From the onset of the pandemic, monetary policies and fiscal spending played a role in surging inflation across the globe. In contrast, today, major central banks have embarked on an interest rate hiking cycle to tame stubbornly high inflation, which has reached levels not seen in 30 to 40 years in some countries.[5]

Amidst this perfect storm of inflationary pressures, major central banks, including the Fed, were forced to increase policy interest rates in 2022 at a much quicker pace than anticipated by investors. This has the potential to lead to a fall in the value of companies due to an increase in their cost of capital assumptions. In addition, it raises the risk of recession, a "double whammy" for business outlook.

In early 2023, economists have significantly downgraded real growth expectations, with several countries expected to experience a recession later in 2023 or in early 2024. In April 2023, the Conference Board estimated there is a 99% likelihood of a recession in the U.S. within the next 12 months, based on its probability model.[6] Meanwhile, a period of "stagflation"—where the economy experiences sluggish or no growth accompanied by high inflation—is still a realistic scenario for the UK and for some economies within the eurozone.

For example, according to recent data, Germany—Europe's largest economy—entered a technical recession in Q1 2023, after two consecutive quarters of negative real economic growth.[7] There was some optimism in early 2023 that a contraction could be avoided as an unseasonably warm winter in Europe contributed to lower energy prices. However, high overall prices continued to erode German consumer purchasing power. Inflation in Germany remained at an elevated level of 6.3% (estimated) in May and is expected to persist as a key challenge for the rest of the year.[8]

But What Does This Mean for Businesses?

Companies across the globe are now battling with higher cost of capital estimates, as they struggle to gauge how much money new investments need to generate to offset upfront costs and achieve profit, while also reflecting their potential risks.

In this highly volatile market, quantifying risk becomes significantly difficult. For example, if a company's earnings are volatile or cost of capital is higher, share prices (and valuations in general) may plummet. For investors and business leaders alike, dealing with this uncertainty is increasingly important.

Pressure on earnings may force companies to cut costs. For example, we have begun to see layoffs despite continued labour shortages[9] and unemployment rates are expected to rise, although projections are relatively tame compared to past recessionary periods. While cost-cutting initiatives often start with employee reductions, the next step is to cut back spending on big ticket items like advertising and IT.

From a cost of capital perspective, companies can expect an environment of higher interest rates and, as a result, a higher cost of capital. Even if a mild recession is in the cards and the Fed reduces policy interest rates in the latter half of the year, this will not reduce long-term interest rates to pre-pandemic levels.

Where Are We Now?

Stock markets began recovering in 2023 despite the Fed continuing its policy tightening. Nevertheless, the rapid increase in U.S. interest rates (10 times in a little over a year) has begun to cause anxiety in some pockets of the economy.[10] The housing sector is suffering from higher mortgage rates, while commercial real estate is still struggling with low office occupancy rates but is now facing higher funding rates.

The impact of credit tightening is also being felt in the banking sector, with some spillovers felt in global markets. It began in early March with the failure of Silicon Valley Bank (SVB). The bank's U.S. operations were seized by the FDIC, while its subsidiary, SVB UK, was bought by HSBC for the symbolic amount of £1.[11] Two days after taking control of SVB, the FDIC seized another institution, Signature Bank.[12] This was followed by Switzerland's largest bank, UBS, agreeing to take over its smaller rival Credit Suisse after ongoing negotiations with the country's central bank, Swiss National Bank (SNB). On March 19, the Fed, the Bank of England, the Bank of Japan, the ECB, and the SNB announced a coordinated action to enhance liquidity via standing U.S. dollar liquidity swap lines, in an attempt to ease strains in global funding conditions.[13]

In light of the banking turmoil, the Fed noted at its March meeting that recent developments were likely to result in tighter credit conditions for households and businesses while weighing on economic activity, hiring, and inflation, with the full extent of

[5] *Release: Global inflation: 1970 to 2022*, Figure 1, Office for National Statistics (ONS), November 22, 2022, https://www.gov.uk/government/statistics/global-inflation-1970-to-2022.

[6] "Probability of US Recession Remains Elevated," The Conference Board, April 12, 2023, https://www.conference-board.org/research/economy-strategy-finance-charts/CoW-Recession-Probability.

[7] "Gross domestic product: detailed economic performance results for the 1st quarter of 2023," Statistisches Bundesamt (Destatis), Press release No. 203 of 25 May 2023, https://www.destatis.de/EN/Press/2023/05/PE23_203_811.html.

[8] Monthly inflation readings are calculated on a year-on-year basis. Source of underlying data: Eurostat database, series "HICP - monthly data (annual rate of change)," https://ec.europa.eu/eurostat/databrowser/view/prc_hicp_manr/default/table?lang=en. Accessed on June 1, 2023.

[9] The U.S. unemployment rate reached a 54-year low of 3.4% in January and although it saw minor increases thereafter it reverted to 3.4% in April. Source: Bureau of Labor Statistics, Labor Force Statistics from the Current Population Survey, Series Id: LNS14000000. Accessed on June 1, 2023.

[10] See Federal Reserve, Policy Tools, Open Market Operations, https://www.federalreserve.gov/monetarypolicy/openmarket.htm.

[11] For more details on SVB's U.S. operations, see: https://www.fdic.gov/news/press-releases/2023/pr23019.html. For more on the SVB UK acquisition, see: https://www.hsbc.com/news-and-media/media-releases/2023/hsbc-acquires-silicon-valley-bank-uk-limited.

[12] See https://www.fdic.gov/news/press-releases/2023/pr23018.html.

[13] See the Fed's related press release here: https://www.federalreserve.gov/newsevents/pressreleases/monetary20230319a.htm.

Continued from p.9

these effects being uncertain. However, the Fed reiterated that the banking system remained sound and resilient.[14] This did not lessen the pressure on U.S. regional bank stocks, culminating with First Republic Bank's being seized by regulators and subsequent sale to JP Morgan Chase in early May.[15] This was the second largest bank failure in the U.S., after Washington Mutual's collapse at the height of the 2008 global financial crisis.[16]

Throughout this mini-banking crisis, the Fed continued to raise rates. There is a disconnect between what markets are pricing and what Fed officials are saying will happen for the rest of the year. Markets seemed to be anticipating a rate cut as early as July;[17] meanwhile, the Fed appeared to pause its interest-rate hiking cycle at its May meeting, taking a wait-and-see approach. Although some Fed officials were still thinking another rate hike could be in the cards, this pause helped remove some uncertainty from financial markets.

At the end of May, the S&P 500 was up approximately 17% from its October 2022 low. Showing even greater recovery, the NASDAQ was up 27% from its December 2022 low and 25% from its local low in October. The S&P 500's improvement of 7–9% since the beginning of this year does not compensate for its overall 19% loss in 2022; however, it does reflect greater optimism by investors since the beginning of the year. Or, said another way, perhaps investors are less pessimistic compared to prevailing sentiment during 2022.

In 2023, the Volatility Index (VIX)—known informally as the "fear index"—has been consistently below its long-term average of around 20 (except for at the peak of the mini-banking crisis in March), implying a lower risk aversion. Corporate credit spreads (i.e., the difference in yields of junk-rated bonds and investment-grade bonds) remain low on a historical basis, even though underlying corporate debt yields have gone up significantly since early 2022.

While there is a good chance the U.S. economy will tip into recession later in 2023 or in early 2024, indicators suggest it would not be a deep or prolonged slump. Inflation is still far from the Fed's 2.0% target but is on a steadily downward path, while the global economy appears to have avoided the worst-case scenarios from the Russia-Ukraine conflict.

The one wrinkle here is the potential for another U.S. debt ceiling debacle, as happened in 2011 when acrimonious political wrangling over the debt ceiling led to S&P's downgrading the U.S. sovereign credit rating from AAA to AA+. The current situation resembles 2011 in some respects—back then, financial markets became significantly volatile and credit spreads spiked, with spillovers being felt in global financial markets. While a current U.S. default has been averted as Congress approved a bill to raise the debt limit, there could be residual ramifications from the polarized negotiation process between Democrats and Republicans. For one, Fitch Ratings placed its AAA rating for the U.S. on negative watch. Although Fitch acknowledged the U.S. government debt ratio of 112.5% of GDP at year-end 2022 was 12% above its 2019 pre-pandemic levels, it also pointed out this was much higher than the indebtedness of other AAA-rated countries (36.1% for the AAA median).[18] A U.S. sovereign credit rating downgrade could place further pressure on interest rates, with negative repercussions to corporate funding costs.

The Growing Spectre of Bankruptcy

Viewing the overall economic environment from the perspective of risk, projected cash flows are subject to the pressures of the current high inflation environment. Consumer demand is decreasing for some industries; for example, the decline in car purchases which shows there is less leeway for companies to increase prices going forward. Many businesses are struggling with stubbornly high inflation which is contributing to compressed margins. Ultimately, these and other factors could lead to more bankruptcies, especially in a "higher for longer" interest rate environment. Moody's and S&P expect default rates to rise between now and Q1 2024, as refinancing at higher rates and lower cash flows restrict the ability to make interest payments.[19] Additionally, compressed margins will make it harder to refinance existing loans.

Cost of capital is a function of both the cost of equity and the cost of debt. Given the current level of uncertainty, the equity risk premium remains high. Startup businesses planning to access liquidity via a near-term IPO have seen those prospects shattered. Meanwhile, corporate debt, which is typically priced as a spread over the risk-free rate, is also expected to command higher yields. Because of the recent mini-banking crisis, lending criteria has tightened, placing further upward pressure on the rates at which companies can borrow. Access to credit is more challenging, which—coupled with lower financial performance—is leading to defaults and debt restructuring activity.

The Outlook for Risk-Free Rates

When dealing with valuing investments or pricing deals, investors and corporations care about long-term cost of capital estimates. When considering risk-free rates (the building block of any cost of capital estimate), they do not rely on the policy rates that central banks set (which are short-term in nature), but rather on what would be the cost of financing debt and equity over the life of the investment. This means that 10- or 20-year government bond yields are more relevant as a proxy for the risk-free rate.

At the height of COVID-19, those yields were under pressure for safe-haven countries, due to a combination of investor flights to quality and central bank QE policies. Investors were trying to preserve capital and turned to the government bonds of

[14] Board of Governors of the Federal Reserve, "Federal Reserve issues FOMC statement," Press Release, March 22, 2023, https://www.federalreserve.gov/newsevents/pressreleases/monetary20230322a.htm.

[15] FDIC, "JPMorgan Chase Bank, National Association, Columbus, Ohio Assumes All the Deposits of First Republic Bank, San Francisco, California," Press Release, May 1, 2023, https://www.fdic.gov/news/press-releases/2023/pr23034.html.

[16] Ken Sweet, "First Republic Bank seized, sold in fire sale to JPMorgan," AP News, May 1, 2023, https://apnews.com/article/first-republic-bank-silicon-valley-fdic-5ab48702b7136d42f73ac13e0a20955d.

[17] CME FedWatch Tool, https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html, accessed June 1, 2023. Probabilities are based on 30-Day Fed Funds futures pricing data and change every trading day.

[18] "Fitch Places United States' 'AAA' on Rating Watch Negative," Fitch Ratings, May 24, 2023, https://www.fitchratings.com/research/sovereigns/fitch-places-united-states-aaa-on-rating-watch-negative-24-05-2023.

[19] See for example, S&P Global Ratings, "Default, Transition, and Recovery: The U.S. Leveraged Loan Default Rate Could Hit 2.5% By March 2024 Given Persistent Inflation and Higher Interest Rates," May 25, 2023.

countries that are considered relatively safe, including the U.S., Germany, and the UK. Additionally, unprecedented QE policies placed downward pressure on long-term interest rates.

Now, we face a situation in reverse. We are not only seeing the size of balance sheets decreasing (quantitative tightening), but also central banks raising policy rates much more quickly than before. Long-term interest rates for major economies are back to levels observed in the aftermath of the 2008-2009 global financial crisis. This is unlikely to change substantially by the end of 2023, as central banks will continue to raise policy interest rates through at least mid-2023, and keep them at those levels through the rest of the year.

Winners and Losers

While economic recession is a real risk, central banks may need to hold interest rates at a much higher level than pre-pandemic until inflation is brought under control. Some financial institutions may benefit from higher rates, if their earnings stem primarily from a spread between the interest rates they charge on loans versus what they pay on deposits. However, there are negative headwinds to deal with: recessions are typically accompanied by a rise in bad debts, which hurts banks' bottom lines. We could see consumers defaulting on their car loans or home mortgages, for example, or businesses being forced to restructure their debt or file for bankruptcy protection.

Non-financial corporations with high brand recognition have been successful at passing on higher prices to their customers, thereby maintaining or improving margins; but this is not the case across the board and many companies are struggling. Moreover, borrowing costs make financing the purchase of another company more expensive. We have already seen a significant drop in reported M&A activity and financing day-to-day operations has become more expensive. Consequently, businesses may further decrease or delay planned M&A investments or capital expenditures, such as building new plants or opening new stores. High risk-free rates will have a significant impact on those decisions. The higher interest rate environment will thus continue to weigh negatively on economic activity.

All this uncertainty also contributes to a higher equity (or market) risk premium—the additional return that investors require to induce them to invest in equities rather than government securities considered free of default risk. While investors have become more optimistic recently (compared to 2022), in recessionary environments the earnings volatility of businesses rises, which increases the risk of investing in the equity of those companies.

Long-term Inflation Expectations

Global financial markets are still trying to ascertain if central banks will manage a soft landing while attempting to get inflation under control. Amidst this highly uncertain environment, costs of capital inputs have risen substantially relative to the beginning of 2022 and are again approaching levels observed just after the 2008-2009 global financial crisis.

The challenge will be whether central banks are able to get inflation back to their target level (typically around 2.0% for major developed economies) in a speedy fashion. If history is of any guidance, we should recall that the 1970s and 1980s were periods of central bank policy mistakes, when many countries had to deal with painful double-digit interest rates as the process of bringing down inflation turned into a protracted affair.

The danger right now is that market participants are starting to incorporate higher inflation expectations into long-term decisions. Economists call this a de-anchoring of inflation expectations. Certainly, we have seen long-term inflation expectations for the U.S. rise significantly since the height of the pandemic. Back in June 2020, Kroll's analysis found that consensus expectations for long-term inflation (5 to 10 years out) in the U.S. stood at 2.0%. Fast forward to October 2022, those expectations rose to 2.9%, subsequently coming back down to 2.4% in May 2023.[20]

While these may not seem like big swings, in economic terms the rise is quite significant. The U.S. grappled with subdued inflation for much of the period following the global financial crisis, all the way through the height of the pandemic. The fear back then was that the developed world would enter a deflationary spiral akin to what Japan struggled with for two decades. During this period the Fed tried with little success to bring inflation up to its 2.0% target.

A major objective of global central banks is to ensure price stability, which has now been compromised. We are seeing a pendulum swing as central banks attempt to recover some of their credibility and achieve their main mission. To lose the fight against inflation has negative reverberations on the stability and functioning of global financial markets.

In that context, the aggressive monetary policy stand is understandable. However, this has a direct bearing on long-term risk-free rates and cost of capital estimates. Businesses may have to deal with an environment of higher cost of capital for the foreseeable future.

Note: Statements and rate references in this article were accurate at the time of writing.

[20] *See* Kroll's Cost of Capital Infographics, https://www.kroll.com/en/cost-of-capital/cost-of-capital-infographics.

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MODIFIED INTERCOMPANY DEBT: IS IT STILL RECOGNIZED AS DEBT?

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In the context of multinational companies using intercompany debt instruments to fund domestic subsidiaries, the economic crisis has created insolvency issues and liquidity concerns that have prompted companies to consider modifying these instruments. These modifications, however, raise the potential application of section 385 and the regulations thereunder issued in 2016, which can potentially reclassify debt as equity for U.S. tax purposes, and carry significant tax implications.

Furthermore, it is crucial to consider the impact of modifying intercompany debt instruments for bankruptcies and restructurings. The potential reclassification of debt as equity for U.S. tax purposes can significantly affect the outcome of bankruptcy proceedings.[1] Such recharacterizations could alter the priority of claims, impact the distribution of assets, and potentially complicate the debt restructuring process in bankruptcy. As a result, careful compliance and risk management become even more essential in navigating bankruptcy and restructurings involving intercompany debt instruments.

Below, we will shed light on the risks of modifying intercompany debt instruments and the potential application of section 385. The case study presented reflects how debt restructuring and cross-border intercompany funding can lead to the reclassification of debt as equity for U.S. tax purposes.

Background

Section 385[2] provides broad authority to Treasury to issue regulations to determine whether an interest in a corporation is treated as stock or indebtedness. In April of 2016, Treasury ultimately used this authority to issue regulations[3] that govern how certain debt instruments are treated for tax purposes when they are issued by a U.S. corporation to a related party. While the regulations were originally intended to prevent excessive borrowing by related parties in cross-border transactions, they also broadly apply to debt issued by U.S. corporations to a related parties, regardless of whether the related party is domestic or foreign.[4] These regulations apply when "covered debt instruments," generally defined as certain[5] debt instruments issued after April 4, 2016, by certain[6] "covered members," are issued to a member of the "expanded group."[7]

The general rule[8] ("General Rule") reclassifies a covered debt instrument as stock, in the following three transactions:

- If the note is distributed, generally from a U.S. issuer to a foreign related party;
- If the note is issued in exchange for "expanded group stock" (such as a section 304 cross-chain sale), other than in an "exempt exchange"; or
- If the note is issued in an exchange for property in an asset reorganization, to the extent that an expanded group shareholder receives the debt instrument with respect to its stock in the transferor corporation.

The regulations also apply to debt instruments issued in exchange for property that is treated as "funding" any of the three transactions described above, regardless of when issued (the "Funding Rule"). Another rule further expands application to covered debt instruments issued by a "funded member"[9] during the period ("Per Se Period") beginning 36 months before and ending 36 months after, the date of certain distributions or acquisitions ("Per Se Funding Rule").[10] Said differently, if a debt instrument is issued by a U.S. corporation to a related party, and then that related party makes a distribution within the Per Se Period, the debt instrument is subject to recharacterization.

For purposes of section 385, when a covered debt instrument is deemed exchanged for a modified covered debt instrument, the modified covered debt instrument is treated as issued on the original issue date of the covered debt instrument. If, however, the modifications include the substitution of an obligor, the addition or deletion of a co-obligor, or the material deferral of scheduled payments due, then the modified covered debt instrument[11] is treated as issued on the date of the deemed exchange (i.e., the date of the modification).[12] Notably, a material deferral of scheduled payments is generally understood to be a deferral of at least one payment outside of a "safe-harbor period."[13]

In determining which amounts of a covered debt instrument are subject to recharacterization, there are various exclusions, exceptions, and reductions available.[14] The aggregate amount of any distributions or acquisitions made by a covered member is reduced by the covered member's expanded group earnings account ("E&P Reduction").[15] This E&P Reduction does not apply to distributions or acquisitions that were made by a predecessor

[1] *See for example, United States v. Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976); *United States v. Stewart (In re Indian Lake Estates, Inc.)*, 448 F.2d 574 (5th Cir. 1971).

[2] All section references are to the Internal Revenue Code of 1986, as amended, or to underlying regulations.

[3] *See generally*, Treas. Reg. Sec. 1.385-3; there are numerous important defined terms within these regulations and while this article refers to a few of them, readers should be aware that some definitions have been simplified herein for readability.

[4] *See* 81 FR 20912.

[5] Debt instruments that are not a qualified dealer debt instrument (as defined in paragraph Treas. Reg. Sec. 1.385-3(g)(3)(ii)) or an excluded statutory or regulatory debt instrument (as defined in paragraph (g)(3)(iii)).

[6] Domestic members that are not an excepted regulated financial company (as defined in Treas. Reg. Sec. 1.385-3(g)(3)(iv)) or a regulated insurance company (as defined in paragraph (g)(3)(v)).

[7] Generally, a group of corporations connected by 80% common ownership.

[8] Treas. Reg. Sec. 1.385-3(b)(2).

[9] A covered member that makes a distribution or acquisition under the Funding Rule.

[10] Treas. Reg. Sec. 1.385-3(b)(3)(iii)(A).

[11] *See generally*, Treas. Reg. Sec. 1.1001-3.

[12] Treas. Reg. Sec. 1.385-3(b)(3)(iii)(E).

[13] Treas. Reg. Sec. 1.1001-3(e)(3)(ii); The safe harbor period is either: five years for debt instruments with an original term of at least ten years, or 50% of the term of debt instruments with an original term of less than ten years.

[14] Note: for the limited illustrative purposes of this article, only the E&P Reduction and Threshold Exception are discussed.

[15] Treas. Reg. Sec. 1.385-3(c)(3)(i)(A).

Exhibit 1: Original Structure

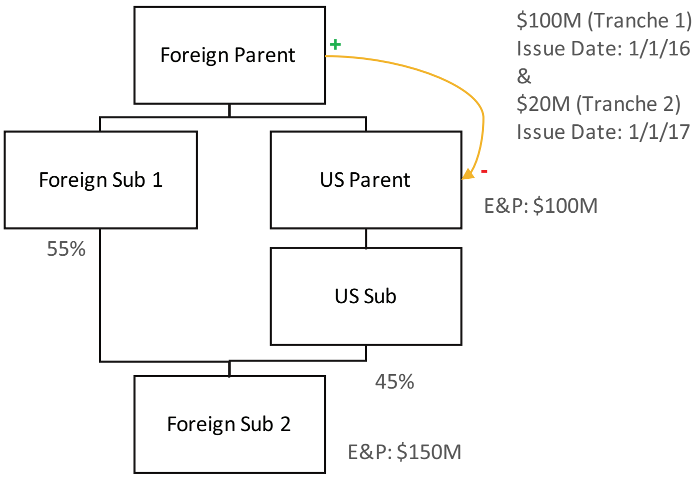
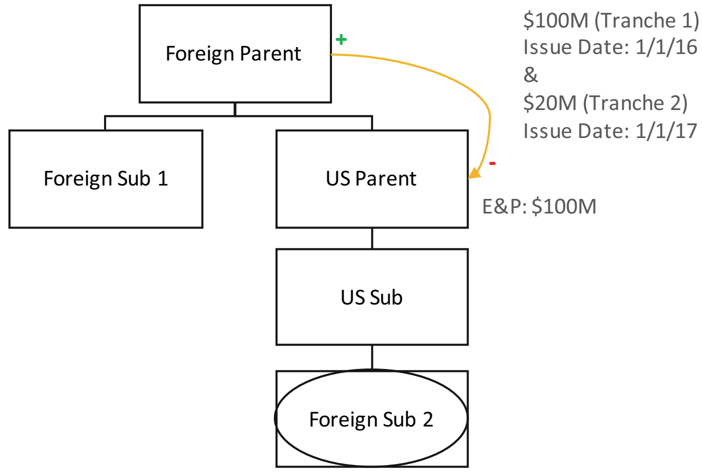


Exhibit 2: Redemption Transaction



of the covered member.[16] There is also an exception that applies to the first $50M[17] of covered debt instruments issued by members of the issuer's expanded group, meaning that first $50M is not subject to recharacterization (the "Threshold Exception").[18]

Case Study

The following case study analyzes a series of transactions that illustrate the application of the rules described above.

Facts

Original Structure

Prior to the effective date of the regulations, a foreign parent corporation (Foreign Parent) wholly owned another foreign corporation (Foreign Sub 1) and a U.S. corporation (US Parent). US Parent filed a consolidated return with its wholly owned domestic subsidiary (US Sub). Foreign Sub 1 owned 55% of a foreign corporation (Foreign Sub 2). US Sub owned the remaining 45% of Foreign Sub 2 (all entities collectively are referred to as the "Group").

Prior to the effective date of the Regulations, debt existed between US Parent, as the issuer, and Foreign Parent, as the holder, and consisted of two tranches of bona fide debt. Whether there is a non-tax business purpose for the lending or distributions is irrelevant for section 385 purposes and is thus not discussed here.

Tranche 1 has a principal amount of $100M and was issued by US Parent to Foreign Parent on January 1, 2016, for cash, with a maturity date of January 1, 2021. Tranche 2 has a principal amount of $20M and was issued by US Parent to Foreign Parent for cash on January 1, 2017, with a maturity date of January 1, 2022. US Parent has $100M of earnings and profits (E&P) and Foreign Sub 2 has $150M of E&P. See Exhibit 1.

US Parent deducts the associated interest expense in the U.S. and Foreign Parent recognizes interest income in the relevant foreign tax jurisdiction. As Tranche 1 was issued prior to the effective date of the Regulations, it was respected as debt for U.S. federal income tax purposes.

Redemption Transaction

On January 1, 2018, Foreign Sub 2 distributed $150M to Foreign Sub 1 in complete redemption of its stock. Immediately after, Foreign Sub 2 made a check-the-box election to be treated as disregarded for U.S. federal income tax purposes (collectively, the Redemption Transaction). See Exhibit 2.

Debt Restructuring

On January 1, 2019, US Parent and Foreign Parent restructured the two tranches of debt into a single debt instrument (Restructured Debt) with a principal amount of $120M and a maturity date of January 1, 2026. See Exhibit 3.

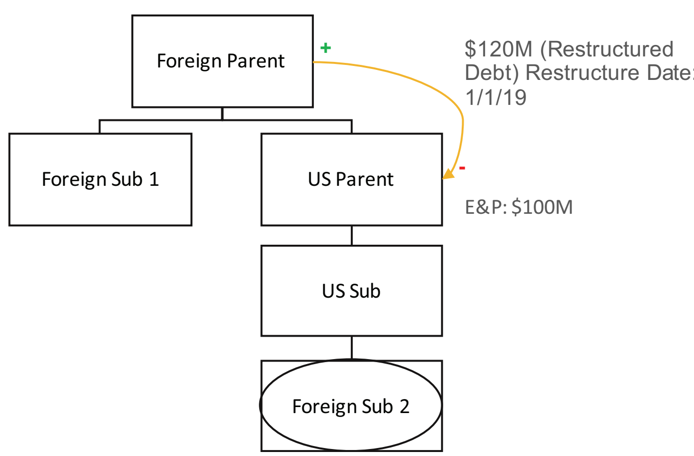
Analysis

Original Structure

As of December 31, 2017, prior to the Redemption Transaction, the Group had $20M of "covered debt instruments" as Tranche 2 was issued after April 4, 2016. At this point, there is no reclassification of any debt into stock.

Based on the ownership, US Parent is a "covered member" and the Group is an "expanded group" with each entity being a member. Interest payments are made by US Parent to Foreign Parent, which are deductible in the U.S. and included as income in the foreign country.

Exhibit 3: Debt Restructuring



[16] Treas. Reg. Sec. 1.385-3(c)(3)(iii).
[17] That is, the aggregate adjusted issue price of the debts.
[18] Treas. Reg. Sec. 1.385-3(c)(4).

Continued from p.13

Redemption Transaction

The wide net of the Per Se Funding Rule likely treats the distribution of $150M in redemption of Foreign Sub 2's stock, as having been funded by US Parent with the covered debt instrument.

Mechanically, the Per Se Funding Rule applies because the covered debt instrument was issued within 36 months of the distribution, and Foreign Sub 2 made the distribution within 36 months of US Parent becoming the successor. Therefore, US Parent is treated as having funded the distribution in part by the $20M Tranche 2.

The $100M Tranche 1, even though issued within 36 months, is not a covered debt instrument because it was issued prior to April 4, 2016.

Through the application of the Per Se Funding Rule, Tranche 2 is potentially subject to the application of the recharacterization rules under Treas. Reg. Sec. 1.368-3. However, as discussed above, the first $50M is not subject to recharacterization and as such Tranche 2 will not be treated as stock by way of 385.

Debt Restructuring

Assuming the two tranches were combined, and the term extended via modifications of the original debt instruments, this would likely represent a significant modification for purposes of Treas. Reg. Sec. 1.1001-3. The extended term would constitute a "material deferral" in that the term is extended beyond the safe harbor period discussed above.[19] Since there was a "material deferral," Treas. Reg. Sec. 1.385-3(b)(3)(iii)(E)(2) treats the Restructured Debt as having been reissued on the date of the modification (i.e., January 1, 2019).

Therefore, the Restructured Debt is treated as having been issued within 36 months of the Redemption Transaction and is now subject to reclassification under the Per Se Funding Rule.

The aggregate adjusted issue price of the covered debt instruments held by all the members of the expanded group is $120M. However, under Treas. Reg. Sec. 1.385-3(c)(4), the first $50M is excluded from recharacterization. Therefore, as a result of the deemed reissuance, $70M of the Restructured Debt is treated as stock for U.S. federal tax purposes.

As mentioned above, utilizing the E&P Reduction, the aggregate amount of any distributions or acquisitions made by a covered member is generally reduced by the covered member's expanded group earnings account. In this instance, US Parent has $100M in its expanded group earnings account. However, since the distribution was made prior to Foreign Sub 2's joining of the U.S. consolidated group, that amount is unavailable to offset any amount of the distribution.

Conclusion

As a result of the Redemption Transaction and the Debt Restructuring, $70M of the outstanding Restructured Debt amount is treated as stock for U.S. federal tax purposes. One result is that interest payments that relate to the reclassified $70M are no longer deductible as interest expense for U.S. federal tax purposes.

Additionally, since payments made under the reclassified amount are treated as distributions on stock (and potentially dividends) for U.S. federal tax purposes, there may be withholding tax consequences that were not present prior to recharacterization. Moreover, since the recharacterization is solely for U.S. federal tax purposes, Foreign Parent will continue to have interest income in its home country without any offsetting interest expense in the U.S.

In terms of alleviating the disconformity between interest income and interest expense, the simplest solution, from a U.S. federal tax perspective, is likely a capitalization of the reclassified debt obligation into the US Parent. For U.S. federal tax purposes, this capitalization would potentially be a tax-deferred recapitalization transaction. However, for foreign purposes, the contribution would be treated as a contribution of the note receivable into the US Parent, thus tying out the interest disconformity. As demonstrated in the case study, practitioners need to be cautious when restructuring debt, particularly in the international context as a seemingly simple modification of an intercompany debt instrument could have major tax consequences.

Additionally, as mentioned above, this recharacterization can disrupt the priority of claims, complicate asset distribution, and pose challenges in the debt restructuring process. Therefore, companies need to exercise caution and implement effective risk management strategies when modifying intercompany debt instruments, particularly in the context of bankruptcy and restructurings. By doing so, they can navigate these complex scenarios while minimizing potential pitfalls and maximizing their chances of successful financial outcomes.

[19] In this case, the original term of both instruments was 5 years, and combined the term is extended by at least 4 years. The safe harbor in this case is 50% of 5 years, therefore 2.5 years.

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THE BRAVE NEW WORLD OF SOVEREIGN DEBT RESTRUCTURING: THE CHINA CONUNDRUM AND OTHER CHALLENGES[1]

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The past few years have not been kind ones generally for emerging economies and developing countries around the globe. These economies were hard hit by the economic fallout from the two external shocks without precedent in recent history, namely the once-in-a-century COVID-19 pandemic and then the Ukraine war, the first major ground war in Europe in 75 years. Apart from a relatively strong economic recovery in 2021 in which these economies grew by nearly 7% (according to the International Monetary Fund (IMF)), these economies experienced less-than-stellar growth in 2022 in the range of 3.4% to 4% according to the World Bank and the IMF, respectively, and much improved results are not expected for either 2023 or 2024.

Perhaps more troubling is that slow growth for the emerging and developing economies is expected to continue over the remainder of the 2020s. In fact, the World Bank recently published a report indicating that these economies may experience an average growth rate of 4% over the 2020s compared to an average growth rate of 6% in the period 2010-2020, and the report suggested that that the actual growth rate for the 2020s could even turn out to be lower in the event of a global recession or global financial crisis. Some commentators are even raising the specter of a "lost decade" in the 2020s for emerging economies and developing countries, something that the countries of Latin America experienced in the sovereign debt crisis of the 1980s.

Current Sovereign Debt Landscape for Emerging Economies and Developing Countries

Sluggish growth, however, is not the only problem facing these economies. Many of these economies are now suffering from a broad array of economic ills, including high inflation (especially with respect to food and energy costs), depreciating currencies, widening balance of payment deficits, dwindling foreign exchange reserves, and shortages of critical commodities and supplies.

The economic travails of these emerging and developing economies are only likely to continue to get worse if global interest rates remain at relatively high levels and/or if, as some predict, the global economy slips into a worldwide recession in the coming months. Furthermore, China's slower-than-expected post-pandemic economic recovery may well have a dampening effect on the global economy in general and the emerging economies and developing countries in particular.

Against this backdrop, it is perhaps therefore not surprising that many emerging economies and developing countries are currently experiencing sovereign debt distress or are at risk of experiencing such distress in the coming months. Many of these economies incurred substantial new debt during the pandemic on top of what were already historically high debt levels that existed pre-pandemic. (The IMF considers a country to be in debt distress when, particularly as a result of an unsustainable debt burden, "a country is unable to fulfill its financial obligations and debt restructuring is required.")

By the reckoning of the IMF, as of January 2023, 60% of low-income countries were either in debt distress (15% of low-income countries) or at high risk of debt distress (45% of low-income countries), and the IMF indicated that this 60% figure was double the corresponding percentage in 2015. In addition, as of late 2022, according to a Bloomberg index of 72 emerging economies, at least 15 emerging economies had debt trading at distressed debt levels (i.e., 1000 basis points over US Treasuries).

Debt servicing costs, particularly in view of the currently prevailing higher interest rate environment and the marked depreciation of local currencies (which affects the cost of servicing hard currency-denominated debt), are eating up an ever-increasing percentage of government revenues in many developing countries. This is possibly nowhere more evident than in the countries of Africa, especially those of sub-Saharan Africa. For African countries as a whole, 17% of government revenues are spent on debt servicing costs which is the highest level since 1999, according to a report in *The Economist*. As a general matter, external debt servicing costs for sub-Saharan countries are expected to rise 50% from 2019 to 2026, according to a December 2022 article in *Bloomberg*.

At a very concrete level, this means that debt servicing costs in a number of countries are eclipsing the amount of government revenues that can be devoted to government expenditures on health, education, and other social services—i.e., expenditures intended to meet the basic human needs of the local populations. As noted recently in *The Economist*, "In 2010 the average sub-Saharan country spent 70% more on health per person (US$38) than on external debt (US$22). By 2020 spending on debt service was 30% higher."

The China Conundrum

In terms of the international financial community's reaction to this situation, the good news is that the issue of sovereign

[1] Note: This article originally appeared in *International Insolvency & Restructuring Report 2023/24* (IIRR) and is reprinted with the kind permission of IIRR's publisher, Capital Markets Intelligence Ltd. (https://www.capital-markets-intelligence.com). Unless otherwise specifically noted, this article speaks of developments only as of mid-May 2023 and does not address any subsequent developments.

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debt distress in the emerging and developing economies is now receiving the high-level attention it deserves. Thus, this issue was front and center at the recent annual spring meetings of the World Bank and the IMF.

However, the bad news is that the issue does not lend itself to easy or straightforward solutions that are palatable to both sovereign debtors and their creditors (whether such creditors are, for example, international financial institutions such as the World Bank and the IMF, private sector creditors such as bondholders or commercial banks, or bilateral creditors/national governments). Moreover, the issue appears to have become subject to geopolitical tensions between the US and the West, on the one hand, and China, on the other hand.

There are several ongoing high-profile situations of sovereign default and sovereign debt restructuring discussions, including among others Zambia and Sri Lanka, and yet after extended periods of time, sovereign debt restructuring deals have not been reached between the respective sovereigns and their creditors. To take but one example, Zambia defaulted on its sovereign debt over two-and-a-half years ago (and thereby became the first sub-Saharan nation to do so in recent years), and it still has not reached a restructuring deal with its creditors.

[UPDATE: In late June, Zambia finally reached a deal with its principal bilateral creditors, including members of the Paris Club of industrialized countries and other non-Paris Club creditors, particularly China which reportedly holds one-third of Zambia's outstanding external debt. According to press reports, the deal apparently involves rescheduling Zambia's debt repayments over a twenty-year period, with a three-year grace period on principal payments, and a clause requiring Zambia to obtain similar treatment from its private sector creditors. The deal enabled Zambia to receive a second tranche of funding from the IMF under a previously agreed arrangement that Zambia had entered into with the IMF. Notwithstanding the deal with its bilateral creditors, Zambia has yet to come to an agreement on a restructuring with its foreign bondholders (who hold both local and foreign currency-denominated debt) or other private sector creditor constituencies such as commercial banks.]

Zambia, which is estimated to have an external debt burden of approximately US$20bn, has a very diverse creditor body, including bondholders (both foreign and local), bilateral/national government creditors (other than China), Chinese lenders, multilateral institutions, and banks. But Chinese lenders have far and away the largest official exposure, estimated to be approximately US$6bn or just under one-third of Zambia's overall external indebtedness.

China is an actor in so many of the current wave of sovereign debt restructuring situations because it is the largest official bilateral creditor to emerging economies and developing countries taken as a whole, with much of the Chinese lending in the last decade having been connected to China's Belt and Road Initiative.

Other non-Chinese creditor constituencies have the following exposures to Zambia, according to a recent report in the *Financial Times*: international development banks (US$2.7bn), various Western governments (US$1.3bn), banks (US$1.6bn), local currency-denominated bonds held by foreigners (US$3.3bn), and international dollar-denominated bonds (US$3.3bn).

Criticisms from the Western International Financial Community

In the lead-up to and during and after the recent IMF-World Bank spring meetings, China came in for unusually harsh criticism from US Treasury Secretary Janet Yellen, outgoing World Bank president David Malpass, and IMF Managing Director Kristalina Georgieva, all of whom asserted that China was a major, if not the primary, obstacle holding back progress in these sovereign debt restructuring situations.

As Treasury Secretary Yellen said in a speech in late April, "China's participation is essential to meaningful debt relief, but for too long it has not moved in a comprehensive and timely manner. It has served as a *roadblock to necessary action*" (emphasis added). For her part, IMF Managing Director Kristalina Georgieva said in early April, "China has been very slow to recognize that multilateral debt restructuring requires China to *play by the rules* that are already established" (emphasis added). World Bank President David Malpass has criticized China for "asking lots of questions in the creditors' committees," seemingly suggesting that China is simply looking for a way to slow down, if not stall, debt restructuring discussions.

The US Treasury, the IMF, and the World Bank, as well as Western creditors and Western governments generally, criticize China's role in these debt restructuring situations on several grounds. (For ease of reference, I will use the term "Western international financial community" to describe collectively all of these parties.) First and perhaps most importantly, they maintain that China is unwilling to consider debt forgiveness (aka "haircuts") which they believe must be an indispensable element of any overall sovereign debt restructuring solution for the countries in question.

They also believe that many of the countries in question are facing debt burdens that are manifestly unsustainable and that these countries therefore require debt forgiveness as opposed to merely loan rescheduling (which has been China's traditional approach to sovereign debt restructuring). The Western international financial community believes that loan rescheduling is a grossly inadequate response in light of the degree of debt distress currently facing many sovereigns.

Second, Western creditors, whether private creditors (such as bondholders) or bilateral creditors, do not wish to forgive debt if that means essentially that the debt they have forgiven could then effectively be used by the relevant sovereign to continue servicing the debt of Chinese creditors. Furthermore, it seems that the IMF as well would be reluctant to lend into a situation where such IMF loans could be used to service the unrestructured debt of Chinese creditors.

Third, the Western international financial community points out that China does not like to engage in multi-creditor restructurings and instead prefers to work out bilateral restructurings between itself and the sovereign. They believe China does not wish to share information with other creditors as is often the case in many multi-creditor restructuring situations and that China instead prefers to handle these restructurings on an opaque basis.

Indeed, China's initial lending to the countries in question is often shrouded in secrecy and confidentiality so that basic information about the loans (including the size of the loans, the interest rate on the loans, the maturity structure of the loans and any security attached to the loans) remains unknown to the sovereign's other creditors. This approach runs absolutely counter to one of the central principles of the Paris Club, specifically the notion of transparency and information-sharing among the parties.

China committed to working with other bilateral and private creditors when it signed up to the Common Framework unveiled by the G-20 countries in 2020, the framework which was supposed to bring Western bilateral creditors, China, and private creditors such as bondholders into a unified, Paris Club-like restructuring process. Nonetheless, the Western international financial community basically believes that China has been dragging its feet in living up to the terms of the Common Agreement, even if, for example, China has agreed to serve as the co-chair, along with France, of the creditors' committee for Zambia. (The Common Framework has only been relied upon by four sovereign debtors—namely, Chad, Ethiopia, Zambia, and Ghana—and only one sovereign, Chad, has completed a sovereign debt restructuring under the Common Framework. However, the Chad restructuring involved only the rescheduling, but not the forgiveness, of Chad's debt.)

Finally, the Western international financial community faults China for questioning the so-called "preferred creditor status" of international financial institutions such as the World Bank and IMF. By virtue of the preferred creditor status claimed by these institutions, they are excluded from participating in any restructuring of the sovereign's debt (i.e., taking a "haircut") in contrast to other creditors such as bilateral creditors, private sector creditors, and others. China has argued that there needs to be fair burden-sharing for all creditors, including the international financial institutions that claim preferred creditor status, and thus, in China's view, all creditors should participate in sovereign debt restructurings.

However, the Western international financial community is adamantly opposed to eliminating the preferred creditor status for institutions such as the World Bank and the IMF. For example, they argue, that the World Bank would not be able to provide concessional (or below-market rate) financing or grants to its borrower countries if it did not have its preferred creditor status, because otherwise it would lose its top credit rating assigned by the rating agencies and thereby be impeded in its ability to access cheaper financing in the international capital markets.

It should be noted that, although it is sending some mixed signals, China has recently given some indications that it may be softening its position on opposing special treatment for institutions claiming preferred creditor status. In return, China would expect institutions such as the World Bank to provide concessional financing to the sovereign debtor undergoing a sovereign debt restructuring.

China, of course, has countered the foregoing arguments with various defenses of its own. For example, China has claimed that much of the sovereign debt distress that now exists among many developing countries and emerging economies is attributable to the interest rate hikes initiated by the Federal Reserve over the past year. Further, China argues that the bulk of its lending, as it is tied to infrastructure projects, is enhancing the productive capacities of the countries in question whereas the loans from the international financial institutions, for example, may be used for general financing purposes, such as closing budget gaps and meeting external financing requirements. To be sure, many of the BRI projects have not worked out as intended.

Clash of Systems and World Views

It is clear to many observers that China does not want to play by the sovereign debt restructuring rules established by Western powers (particularly under the leadership of the US) and effectuated through institutions such as the Bretton Woods institutions of the IMF and the World Bank and the debt restructuring club for the advanced Western economies, the Paris Club. (Importantly, China is not a member of the Paris Club.)

But fundamentally China's unwillingness to play by those rules may reflect the fact that China is trying to construct its own China-centric international financial system, with its own parallel set of institutions and programs, including the Asian Infrastructure Investment Bank (AIIB), the New Development Bank (the so-called BRICS Bank), and its own ambitious development programs such as the Belt and Road Initiative. China does not believe that its voting power in existing international institutions such as the World Bank and the IMF is commensurate with its economic standing in the global economy. China is also seeking a broader international role for its own currency, the renminbi, in international financial transactions, a move that appears to have gained some momentum in the wake of the Western sanctions that were imposed against Russia after the start of the war in Ukraine.

Furthermore, China has its own distinctive way of looking at the world. China does not see itself as a secondary or subservient player on the international stage but rather views itself as occupying a, if not *the*, central role in the international system (whether this is attributable to China's traditional conception of itself as the "Middle Kingdom" in the international system or to some other factor or dynamic). And this is particularly true now that China has the second largest economy in the world measured in nominal GDP or, as of a few years ago, the largest economy in the world measured in terms of purchasing power parity (PPP).

Thus, it is likely that as China looks out on the existing international financial architecture for handling sovereign debt restructuring, it sees a system dominated by Western interests which is not consistent with what China likely considers its proper place in the international financial system. Moreover, in the light of the Chinese notion of "loss of face," it is unlikely that China welcomes being publicly upbraided by officials from Western governments and the international financial institutions on how it should (or should not) conduct itself in the sovereign debt restructuring system such as it is.

Finally, as some observers have noted, it may well be that China's position on favoring debt rescheduling over debt restructuring (or loan forgiveness) is driven by the fragile financial condition of many of China's largest financial institutions, particularly its large state-owned commercial banks. These institutions had

Continued from p.17

large exposures to China's collapsed property sector and were also adversely affected by the serious economic fallout from the pandemic-related lockdown of the Chinese economy.

If the fragile financial condition of the Chinese banks is indeed a driving factor behind their position opposing debt restructuring, that maybe reminiscent of the position that the US money banks took in the early years of the epic 1980s debt crisis. At that time, these banks were in their own perilous financial condition, given their overexposure to many troubled economies in the developing world and favored rolling over loans to developing countries rather than restructuring those loans, and the US government effectively supported such a stance with the so-called Baker Plan unveiled in 1985. US banks were not in a position to take haircuts until the late 1980s when the banks had rebuilt their capital positions, and that paved the way for the US government's Brady Plan in 1989 and the advent of Brady bonds (which converted bank loans to bonds).

The foregoing is certainly not in any way intended to defend China's way of doing business in sovereign debt restructurings or in its sovereign lending generally. Among other things, one could rightly be very critical of China's opacity in both its lending and restructuring activities. One could also be equally critical of China's past lending to countries that seemed to contribute to debt sustainability problems for many countries that already had heavy, if not virtually unsustainable, debt burdens prior to the Chinese lending. Further, one could legitimately question whether some of the Chinese lending was used to finance certain infrastructure projects that ended up being totally unviable from an economic standpoint.

Other Challenges

The current sovereign debt restructuring landscape poses several other significant challenges.

Local Debt

In some of the new crop of sovereign debt restructuring situations, a new variable has to be taken into consideration: namely, the role of bonds that the sovereign has issued in the local currency. In the past, as these local currency-denominated bonds generally represented only a small part of the overall debt burden, they were not addressed as part of the overall sovereign debt restructuring solution applicable to external debt.

However, there are now countries such as Ghana where the local bonds represent a relatively significant part of the country's overall debt burden. This is a result of the concerted efforts by governments in many emerging and developing economies in the last decade or longer to develop local capital markets. (Pakistan and Sri Lanka also have considerable local debt components as part of their overall debt burden.)

In Ghana, for this year local currency-denominated debt was expected to represent 41% of Ghana's GDP whereas its external debt was expected to represent 45% of Ghana's GDP, according to IMF projections made before Ghana's default last December. However, as reported in the *Financial Times*, Ghana's debt servicing costs this year for its local debt (expected to represent approximately 50% of central government revenues) were projected to actually exceed debt servicing costs this year for its external debt (expected to represent approximately 13% of central government revenues).

Accordingly, in sovereign debt restructurings where there is a large local bond component as part of the overall debt burden, other creditors may want to include the holders of local bonds in the overall sovereign debt restructuring so that there is fair burden-sharing across all creditor constituencies. In fact, in the case of Ghana, the IMF apparently insisted that the government of Ghana include the local debt in its restructuring plan in order to receive an IMF financing package. (There is also the issue of whether there should be different treatment for local holders of local currency debt versus foreign holders of local currency debt).

There is a problem, however, in that many of the bonds issued by the sovereign in the local currency may be held by local financial institutions, such as local banks, pension funds, and insurance companies. Therefore, to the extent that a debt restructuring calls for holders of local currency-denominated bonds to take a haircut, this could potentially cause a big hole in the balance sheet of the country's financial institutions.

In turn, this could risk undermining the stability of the local financial system which would obviously be a very undesirable result of the process of restructuring local currency bonds. Thus, unless the local banks, for example, are recapitalized, what started as a sovereign debt crisis for the country in question could end up also becoming a banking or financial crisis for that particular country.

Pakistan

Today the Zambias, Ghanas, and Sri Lankas of the world may seem like major sovereign debt crises. However, there is one country that is currently experiencing huge economic and financial problems where a sovereign debt crisis in the very near future is not beyond the realm of possibility and whose outstanding debt dwarfs the debt burden of some of the sovereigns currently facing debt crises. That country is Pakistan.

As of early 2023, Pakistan had an outstanding external debt burden of approximately US$125bn. Of immediate concern, it has been reported that Pakistan has a debt payment of approximately US$3bn coming due in June which it looks unlikely to be able to make, unless it receives a financing package from the IMF or funding from a third country. Pakistan's economy is in a serious downward spiral, and obviously Pakistan suffered a huge blow with the catastrophic nationwide flooding last summer. It is suffering from very high inflation, its local currency, the Pakistani rupee, has hit all-time lows against the US dollar, and Pakistan has also been experiencing serious shortages of food, fuel, and medicines. There have been widespread power outages throughout Pakistan since, among other things, Pakistan cannot import the fuel that it needs to run its power plants.

[UPDATE: On July 12, the IMF Board approved a $3 billion standby arrangement (SBA) for Pakistan, with an immediate disbursement to Pakistan of $1.2 billion. Around the same time, Pakistan was also reportedly set to receive $1 billion from the United Arab Emirates and $2 billion from Saudi Arabia. With the new funding from these sources, Pakistan was apparently able to avoid a payment default on its outstanding external sovereign debt.]

Pakistan has also run down its foreign exchange reserves to dangerously low levels. As of mid-March, Pakistan was estimated to have foreign exchange reserves of a mere US$3.6bn, which has been estimated to represent funding for approximately just one month of imports.

The IMF has apparently been mulling a large program for Pakistan, reportedly in the range of US$6.5bn. Nonetheless, while the IMF has noted "substantial progress," it wants to see further progress from Pakistan on finalizing funding commitments—or, in IMF parlance, "financing assurances"—from various countries before it approves any new loan. (Debt restructuring commitments are another form of "financing assurances" that the IMF looks for before approving an IMF program for a distressed sovereign and/or approving loan disbursements to that sovereign, and that is another reason why China's reluctance to commit to the "haircuts" in multi-creditor restructuring situations that are dependent on IMF financing is considered a problem.)

Significantly, it is estimated that as much as one-third of Pakistan's external debt is owed to China and Chinese lenders. Pakistan was one of the major recipients of Chinese lending for China's Belt and Road Initiative projects, and indeed the China-Pakistan Economic Corridor (CPEC), consisting of many different types of infrastructure projects in Pakistan, was considered by China to be a flagship, if not *the* flagship, BRI project. (To be sure, like many BRI projects in various countries around the globe, the CPEC has been beset by a number of problems, including cost overruns, construction problems, debt repayment difficulties, etc.)

Thus, if Pakistan experiences a sovereign debt crisis and requires a sovereign debt restructuring, it could encounter the "China conundrum" discussed above that has been present in some of the ongoing cases such as Zambia and Sri Lanka. But given the size of Pakistan's overall external debt burden, this issue will manifest itself on a vastly larger scale and thus may be even more difficult to resolve than in those other countries.

Private sector creditors

Despite the intense focus in recent public debates on the role of Chinese lenders in sovereign debt restructurings, it should not be forgotten that, for a number of emerging economies and developing countries, the amount of outstanding external debt held by private sector creditors, principally bondholders (but also including commercial banks and non-traditional creditors such as commodity trading firms like Glencore), represents a not insignificant component of their overall debt burden.

In recent years, many emerging economies tapped the international capital markets to raise financing, with some being first-time issuers of eurobonds, including several countries in sub-Saharan Africa. Thus, bondholders have become a critically important creditor constituency in a number of the recent sovereign debt restructuring situations. Yet, the presence of bondholders, especially where there are numerous bondholders and where the bondholders themselves may have differing interests, can potentially complicate the overall sovereign debt restructuring process.

It is not uncommon for bondholders, particularly in large, complex sovereign debt restructuring situations, to have challenges in coordinating among themselves, and such coordination challenges among the bondholders can potentially make it more difficult for all of the relevant stakeholders in a sovereign debt restructuring situation to negotiate and come to a consensus on how the overall debt restructuring should be addressed and resolved. Furthermore, to the extent that the various types of private sector creditors (e.g., bondholders, commercial banks, etc.) have differing agendas and/or competing interests, that could only make the sovereign debt restructuring process more difficult since intercreditor disputes in these types of situations can be particularly thorny and not conducive to easy solutions. Finally, it remains to be seen whether private sector creditors such as bondholders will be willing to agree to the same restructuring terms as official sector creditors such as bilateral creditors, whether under a "comparability of treatment" principle set forth in the G-20 Common Framework or otherwise.

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VENTURING INTO THE VALUATION OF VENTURE DEBT

Rittik Chakrabarti, Ian Coffman, and Michael Chiu
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With the collapse of Silicon Valley Bank (SVB) in March 2023, a spotlight was shone on the $6.7 billion of venture debt on its balance sheet, which represented approximately 20% of the total venture debt deal value of $34.1 billion in 2022. SVB had amassed significant levels of bank deposits from its customers by offering flexible terms and rates and bespoke venture debt solutions to its borrowers relative to other private credit lenders.

With SVB's failure, nonbank lenders such as Hercules Capital (NYSE:HTGC), TriplePoint Venture Growth (NYSE:TPVG), and new entrant Blackstone are expected to fill the void, albeit at higher rates and tighter terms. On TriplePoint's Q1 2023 earnings call, CEO James Labe said," The departure of SVB has also resulted in increased deal flow…which also includes providing newer replacement loans previously received from banks." Per PitchBook, venture debt surpassed $30 billion in deal value for the fourth consecutive year in 2022 and approximated a fourfold increase in deal value over the past decade (Exhibit 1). With the capital demand-to-supply ratio as of Q1 2023 at a record 3.2x and 1.6x for late-stage and early-stage companies, respectively, new venture debt demand is expected to remain elevated in the near to medium term.

Venture Debt Considerations

In Q1 2023, with the IPO market effectively closed and valuations down materially from their 2021 peak levels, venture debt has become an important source of minimally dilutive capital for early- and late-stage venture companies. Venture debt represents a lower cost of capital than equity and allows a borrower to extend its cash runway and bridge to the next round of financing. In addition, venture debt financing typically does not require a valuation reset, which may be particularly advantageous in the current market environment. For investors, venture debt typically offers high risk-adjusted returns with historically low loss rates (Exhibit 2).

Growth Equity Company Considerations

Growth equity companies, especially those in the technology space, are often unprofitable as they continually invest in revenue growth. In such situations, metrics such as customer retention, customer acquisition cost, and recurring revenue are considered in order to understand the business fundamentals that drive longer-term valuation prospects.

For debt covenants, annual recurring revenue-based leverage metrics are often used in place of EBITDA-based leverage ratios for rapidly growing technology companies.

The "Rule of 40" is another metric that is frequently applied to such companies. It is the principal that a company's combined growth rate and profit margin should exceed 40%. This metric evaluates the combined profitability and growth metrics of a business in aggregate. In the current environment, companies that are curtailing cash burn to extend cash runway will have lower growth expectations. The Rule of 40 enables horizontal performance comparisons across both public and private companies that are looking to balance growth and profitability.

Companies that secure venture debt typically have strong sponsor support and have completed multiple rounds of financing. The implied multiple and discount rates from these financings can then be adjusted for differences in the subject company and the market performance of the sector between the last round of financing and subsequent measurement dates. Calibration of financial performance to financing rounds provides insight into market-based indications of value, required rates of return, and valuation multiples relative to public market equivalents for these high-growth venture companies.

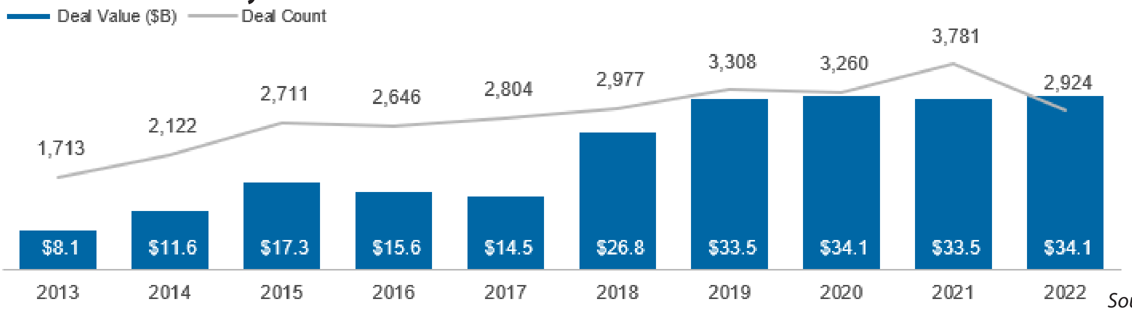
Venture Debt Valuation Considerations

In a typical venture debt financing structure, a debt security is issued with a floating base rate (e.g., SOFR) plus a cash margin and attached equity warrants. Interest payments are often structured as payment-in-kind (PIK) or a hybrid of PIK and cash. Fees charged by the lenders can come in the form of underwriting original issue discount (OID) or backend exit fees.

Per section 4.11 of the AICPA's "Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies" (the Valuation Guide), the unit of account is determined based on the "economic best interest" that market participants would transact the securities at:

> When estimating the fair value of the fund's position in a given portfolio company, the concept of "economic best interest" is relevant to the determination of the nature of the assumed transaction and what grouping of assets may be appropriate. Therefore, the task force believes that it is appropriate to consider the unit of account for investments reported under FASB ASC 946

Exhibit 1: U.S. Venture Debt Activity



Source: PitchBook

Exhibit 2: Venture Debt Considerations

Pros	Cons
Minimal ownership dilution for investors and management	High base rate implies higher cost of capital relative to historical levels (i.e., before the recent Fed interest rate hikes)
Debt issuance doesn't require a valuation reset	Debt typically has shorter duration and is expected to be paid down by rounds of equity financing
Extends cash runway	Potential for restrictive covenants and/or mandatory draw down period terms
Faster to obtain than equity financing	Greater degree of selectiveness exhibited by capital providers in the current macroeconomic environment

> to be the individual instruments to the extent that is how market participants would transact, or the entire position in each type of instrument in a given portfolio company held by the fund (e.g., the entire senior debt position, the entire mezzanine debt position, the entire senior equity position, the entire warrant position, and so on) to the extent that is how market participants would transact.

Section 4.15 of the Valuation Guide discusses typical valuation methodology for hybrid securities as follows:

> When the assumed transaction is based on value being maximized through a transaction in the investment company's entire interest in the portfolio company, then the investment company's Schedule of Investments will generally present the aggregate fair value of the investment in each portfolio company along with each class of debt and equity owned in that portfolio company at its allocated value. One reasonable basis for allocating value amongst the instruments could be to estimate the fair value of each instrument independently, considering the assumptions that market participants would use in pricing each instrument, and then to allocate the aggregate fair value considering either the relative fair value of all the instruments (e.g., the fair value of equity or warrants vs. fair value of debt), or the residual fair value for one of the instruments after subtracting the fair value of the other instruments (e.g., the residual fair value of debt after subtracting the fair value of equity or warrants, or vice versa).

As such, when evaluating a venture debt instrument at the investment date, it is customary to consider both the explicit OID as part of the underwriting process, "bifurcate" the value attributable to the equity features of the instrument (such as warrants), and treat it as an incremental synthetic OID when conducting a calibration analysis of the implied IRR of the venture debt issuance. This treatment is based on the premise that an investor would likely require a higher rate of return for a debt security without the equity upside.

Take for example a $100.0 million venture debt investment issued at fair value with an explicit OID of 2.0% and a warrant kicker with a fair value of $3.0 million. The synthetic OID in this instance would be 3.0% based on the $3.0 million warrant kicker as a percentage of the $100.0 million of debt par value. The effective all-in OID in this case is 5.0% (2.0% explicit OID + 3.0% synthetic OID), and thus the implied yield (or IRR) on the straight debt security at the origination date should be calibrated to a 95.0% price at issuance (i.e., $95.0 million).

Therefore, at the investment date, the debt instrument and warrants are valued separately; the sum of these two components should equal the original purchase price. At subsequent valuation dates, the debt security and equity features would continue to be valued separately and then aggregated for comparison to the original purchase price.

The value of the equity features and/or upside attached to the venture debt issuance can be derived based on either a current value method waterfall constructed on a common stock equivalent basis or via an option pricing method.

Enterprise value coverage for a venture debt issuance at a particular measurement date is determined via calibration to the last known round of financing adjusted for changes in financial performance and market performance between the measurement date and last round of financing. In the absence of a recent round of financing, enterprise value may be determined based on an income approach, specifically the discounted cash flow method or via a market approach, such as the guideline company and/or guideline transactions methods.

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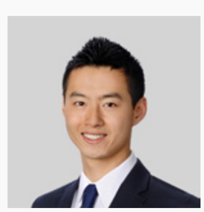

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SYNERGY REALIZATION: MAXIMIZING VALUE IN POST-MERGER INTEGRATION

David Stass, Dominic Orchard, and Peter Platsch
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While there are many reasons for a merger or acquisition, often the success of a transaction is determined by the ability of the parties to identify, plan for, and ultimately realize the synergies that originally motivated the deal. Synergy realization is a critical component of post-merger integration (PMI), as it directly impacts the investment case and value creation potential of the combined entity.

In this article, we leverage years of experience in delivering integration programs and synergy realization plans, and explore the key steps and best practices for maximizing value in PMI.

1. Developing a Synergy Realization Plan

Synergies in a post-merger integration can come in many forms, including cost savings, revenue enhancements, improved operational efficiencies, and strategic advantages that result from the combination of two companies' resources, capabilities, and market positions.

Once potential synergies have been identified, the first step is to develop a detailed synergy realization plan that outlines the specific actions, timelines, and resources required to achieve the desired outcomes. This plan should be aligned with—and part of—the overall integration plan, which may contain other non-synergy related measures; for example "Day 1" activities, relocations, and communications.

A synergy realization plan would typically include the following elements:

- **Clear objectives:** Defining the specific synergy targets and desired outcomes, such as cost savings, revenue enhancements, or operational improvements.
- **Prioritization:** Prioritizing initiatives based on their potential impact, feasibility, and alignment with the organization's strategic goals.
- **Action plans:** Developing detailed action plans for each initiative, including the required resources, milestones, and timelines.
- **Ownership and accountability:** Assigning responsibility for each initiative to a dedicated team or individual, who will be accountable for its successful implementation.
- **Monitoring and reporting:** Establishing a process for tracking progress, reporting on achievements, and adjusting plans as needed.

2. Monitoring and Tracking Synergy Achievement

Ongoing monitoring and tracking of synergy achievements are essential to ensure that the realization plan is executed effectively and that the required outcomes are being achieved. As part of this process, the following steps are typically followed:

- **Establishing key performance indicators (KPIs):** Defining a set of relevant KPIs that can be used to measure progress towards synergy targets. These may include financial metrics (e.g., cost savings, revenue growth), operational metrics (e.g., productivity improvements, process efficiencies), or strategic metrics (e.g., market share gains, innovation capabilities), which should all feed into and be complementary to broader integration program metrics.

  It is important to have a clear plan outlining how each metric will be produced, including the data source, any data manipulation required, scope, frequency, and format of presentation. Each metric should have an accountable owner and all those responsible for producing the metric should be clearly identified.

- **Data collection, analysis, and baselining:** Collecting data on the defined KPIs, completing any data manipulation required, analyzing trends, and comparing actual performance against the targets set in the realization plan. This should include developing a robust financial and headcount baseline, which is crucial in a post-merger integration setting to evaluate success and track the effectiveness of synergy initiatives.

  In our experience, a robust baseline not only highlights changes in performance indicators but also demonstrates why these changes occurred, giving credit where it is due or identifying areas needing improvement. The baseline data should be revisited and adjusted periodically to reflect changing business environments, industry dynamics, or strategic shifts, thus acting as a living document vital for refining the KPIs and enhancing synergy realization. In essence, a robust baseline forms the bedrock of a data-driven PMI process, enabling transparency, boosting stakeholder confidence, and aiding in informed decision-making.

- **Embedding into Business as Usual:** Embedding the synergy plan into Business as Usual (BAU) budgets and targets with the help of the Finance function. By incorporating the synergy-related goals into daily business operations and budgeting processes, organizations not only secure commitment to these objectives at all levels but also facilitate their measurement and tracking as a part of routine management reviews.

This alignment ensures that the synergy realization is not perceived as an isolated project but as an integral part of the broader strategic and operational roadmap of the newly merged entity. It also minimises the risk of "synergy fatigue" that can occur if these initiatives are viewed as separate from normal operations. By tying synergy targets to departmental budgets and individual performance metrics, an impetus is provided for everyone in the organization to contribute towards synergy achievement, fostering a culture of collaboration and joint ownership. Furthermore, this seamless integration of synergy plans with BAU budgets and targets supports the transparent communication of progress, thereby maintaining stakeholder confidence throughout the integration process.

- **Reporting and communication:** Regularly reporting on the progress of synergy realization to senior management, integration teams, and other relevant stakeholders. Transparent communication helps maintain momentum and alignment throughout the integration process. It is important that benefits and costs-to-achieve can be reported beyond standard reporting so that stakeholders can see the impact of synergy realization. Agree in advance with your stakeholders how and when they would like to receive this data; for example, via an online dashboard, Excel file, or email.

  In order to drive change via leadership, it is critically important to establish a culture of open communication and transparency when reporting on synergy progress. This includes creating an environment where any issues or potential missed targets can be flagged early, without fear of blame or negative consequences. This will allow for timely course correction and ultimately increase the likelihood of achieving the desired outcomes of the integration process.

  Strong financial governance is also key to ensuring that synergies are reported on a consistent basis in line with the "rules of the road" that have been agreed upfront, to provide timely insight into the actual / forecast benefits and to prove synergies have been delivered.

- **Course correction:** Based on the performance data and stakeholder feedback, it is crucial to adjust the realization and action plans as needed to address potential issues and ensure that the target benefits are achieved. To accomplish this, it is helpful to identify lead indicators that can predict whether the desired outcomes will be achieved. These lead indicators act as early warning signals and enable the implementation team to take corrective action before it is too late. For example, if the goal is to achieve office savings in a particular quarter, it may be necessary to issue a service notice several months prior to that to allow sufficient time for necessary changes to be made. By identifying and tracking lead indicators, the implementation team can stay ahead of potential issues and ensure that the project stays on track to achieve the required benefits.

3. Balancing Short-Term and Long-Term Goals

In the pursuit of synergy realization, it is crucial to strike a balance between short-term and long-term goals. While short-term objectives are important to demonstrate early wins and maintain momentum, long-term goals are essential for sustaining the combined entity's growth and competitive advantage. Here are some strategies to achieve this balance:

- **Prioritize quick wins:** Identify and execute initiatives that can yield immediate results, such as cost reductions or process improvements, to build credibility and gain stakeholder buy-in.
- **Maintain a long-term view:** Ensure the synergy realization plan incorporates long-term strategic goals, such as market expansion, product development, and talent management, whilst also retaining focus on a nearer-term and achievable timeframe, such as 12-18 months.
- **Allocate resources effectively:** Allocate resources, including time, money, and personnel, in a manner that supports both short-term objectives and long-term strategic priorities.
- **Monitor progress:** Regularly assess the progress of both short-term and long-term goals to ensure they remain aligned and mutually supportive.

4. Managing Risks and Overcoming Challenges

Synergy realization is not without risks and challenges, and effective management of these factors is essential for success. Some common risks and challenges associated with synergy realization include:

- **Leadership risks:** The role of leadership in the integration process is pivotal. Decisive and committed leaders, when appointed early, are able to set the tone, take accountability, lead by example, and drive the process. Delaying such appointments or the selection of non-supportive leaders can breed confusion, divided loyalties, and decreased effectiveness. Moreover, such decisions may risk unwanted attrition. It is crucial to swiftly identify and empower leaders supportive of the integration and collaboration. These strong leaders can mitigate other risks and underpin the success of the whole integration program.
- **Integration risks:** Merging two organizations can be complex, and unforeseen issues may arise in areas such as technology, operations, or culture. The due diligence process plays an important part here, but even with the most thorough up-front research things are likely to change. Approaches to mitigating this risk include thinking through "what-if" scenarios, developing contingency plans, and maintaining open communication throughout the process.
- **Execution risks:** Execution presents the most common type of challenge in synergy realization. Obstacles such as resource constraints, resistance to change, or regulatory hurdles can often stymie progress. To mitigate these risks, it is critical to clearly define roles and responsibilities, establish a strong governance structure, and continuously evaluate whether adequate resources and support are in place. Deploy change and stakeholder management frameworks to overcome resistance to change and fatigue.

Continued from p.23

- **Financial risks:** Synergy realization may involve financial risks, such as increased costs or reduced revenues. Managing financial risks includes seeking evidence from robust financial models and projections, closely monitoring financial performance, and adjusting plans as needed to maintain alignment with financial targets.
- **Human capital risks:** Integration journeys are typically multi-year programs, and the process will often create uncertainty and anxiety among employees, potentially leading to reduced morale, productivity, and retention. To address this, communicate openly with employees. Emphasize the rationale for the merger and the benefits of synergies, including the future vision and values of the combined organization. Engage and support employees throughout the process and invest in talent development and retention initiatives.

Conclusion

Synergy realization is a critical aspect of post-merger integration that directly impacts value creation. Successfully delivering synergies and maximising value in post-merger situations requires application of best practices, including developing a synergy realization plan; monitoring progress; balancing short-term and long-term goals; and managing risks and challenges. The results will help maximize the value derived from M&A transactions and ensure the long-term success of the combined entity.

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WHY U.S. LONG-TERM INFLATION MAY BE HIGHER THAN TWO PERCENT

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Capital markets are currently struggling to account for the magnitude and duration of the Federal Reserve's battle with the unexpected surge in inflation. Less has been written about the prospects for the long-term inflation rate if and when the current battle is successful. For the US economy, long-term inflation has not been a hot issue over the last two decades or more because of the low level and low variance of inflation. Assuming future inflation to be 2% was defensible from the 1990s to 2019. Beginning in 2021, however, there has been a major departure from this long-term stable rate. By the summer of 2022, year-over-year inflation measured by the CPI exceeded 8%, and the initial belief that the price increases were merely temporary effects of the pandemic gave way to the realization that US monetary policy would need to be brought to bear in a major way to bring inflation back down to the Fed's 2% target. There is a major problem with achieving this 2% target. The Fed has far less control over the money supply and inflation than it did before 2008. The main drivers of inflation today are the liquidity in the banking system and the federal budget deficit.

> *Long-term US inflation may be closer to the ratio of the budget deficit to GDP—5% or more—than to the Fed's 2% target, even if monetary policy is not expansionary.*

The 1970s Inflation Experience and the Changes It Produced

After several decades of low inflation, the US began to see steadily rising prices in the late 1960s and throughout the 1970s (Exhibit 1).

Initially, the problem was seen as an overheated economy due to spending on the Vietnam War. Higher prices from this spending reduced the real income of workers. Workers' demand for higher wages increased employers' costs, which led to further increases in prices. The interaction of these forces was seen as producing a wage-price spiral in which demands for higher wages resulted in higher costs for employers, who then raised retail prices to restore profit levels. The higher retail prices then reduced workers' purchasing power, and a new round of wage demands was created.

The belief that inflation was a problem of controlling cost increases resulted in the passage of the Economic Stabilization Act of 1970.[1] By this measure, Congress gave the President the power to "stabilize" prices, wages, interest rates, and similar measures. From 1971 to 1974, the Nixon price controls used several phases of this act to reduce inflation. Price controls resulted in shortages of many goods. Crude oil and gasoline

were singled out for price regulation, and shortages began to cause problems in 1973, even before the Arab Oil Embargo of October 1973 that is often remembered as the cause of the oil crisis.[2] Price controls were abandoned in 1974 following intense public unhappiness. The overall conclusion of the price-control approach to reducing inflation is that controls caused shortages and huge complications in the economy and merely postponed the price increases that were in the system.

As inflation continued to be a rising problem in the 1970s, market interest rates rose to compensate for rising prices. The Federal Reserve maintained a policy that attempted to control market interest rates within a range. When rates rose above this range, the Fed attempted to reduce rates by buying Treasury securities. The Fed purchased increasing amounts of Treasury securities to raise their prices and thus reduce yields (interest rates). The purchases increased reserves and liquidity in the financial system, resulting in increased spending and more inflation. This became a self-sustaining cycle.

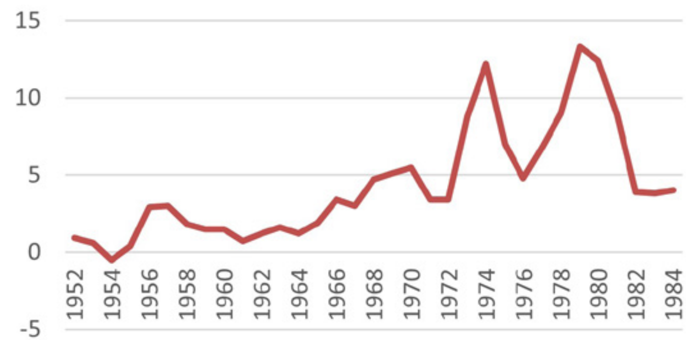
The cycle of interest rates chasing inflation and vice versa ended in 1980 when the Fed, under chairman Paul Volcker, ended the policy of targeting interest rates. Interest rates were allowed to find their own free-market level. A period of instability followed, with interest rates soaring. The Fed funds rate reached as high as 22% in 1981.

The result of the Fed's abandonment of its attempt to reduce interest rates and the sky-high rates that followed was a severe recession that sent the unemployment rate to 10% and broke the inflationary spiral. Interest rates and inflation plunged (Exhibit 2). After the recession, the economy experienced strong growth

[1] Economic Stabilization Act of 1970; Title II of Public Law 91-379.

[2] Robert L. Bradley Jr., "Energy Infamy: Nixon's 1971 Price Controls Turn 50," American Institute for Economic Research (August 14, 2021).

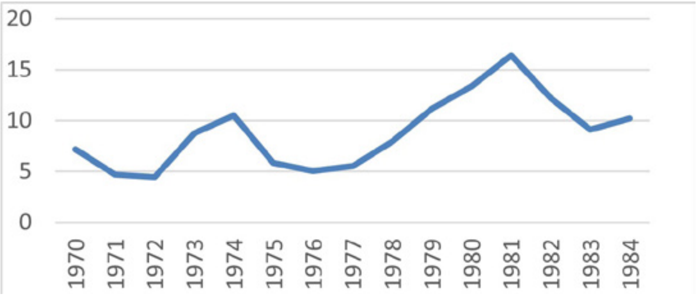
Exhibit 1: US Consumer Price Inflation 1952–1984



Sources: Changes in Consumer Price Indexes, Economic Report of the President, 1985, Table B-56. The data start in 1952, after the Korean War inflation of 1950–1951, and end in 1984, after the 1970s inflation cycle was broken.

Continued from p.25

Exhibit 2: Federal Funds Rate Percent, 1970-1984



Sources: Fed Funds rate 1970-1984: Federal Funds Effective Rate, Annual, Not Seasonally Adjusted, Federal Reserve Bank of St. Louis.

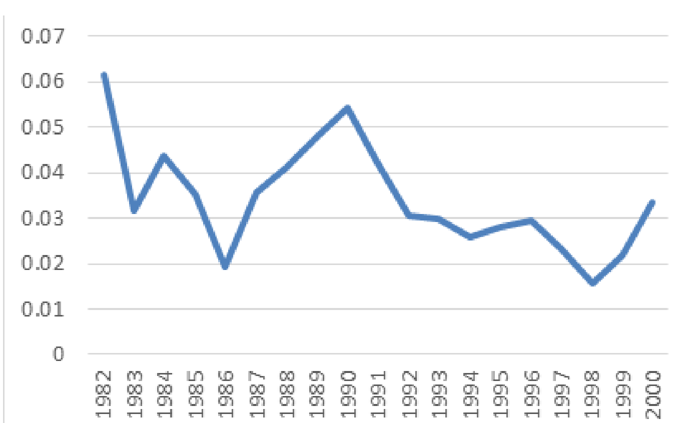
with low inflation. In the 1980s and 1990s, the Fed followed a fundamentally different monetary policy. Instead of trying to lower interest rates when rates rose with inflation, the policy was to raise rates even further to make borrowing more expensive and rein in an overheated economy. Higher rates are achieved by selling Treasury securities in the market, reducing their prices. These sales remove purchasing power from the economy when the buyer of the securities pays the Fed. The payment results in the removal of that amount from the money supply. The Fed's actions to raise interest rates and reduce the money supply thus work in the same direction, as sales of securities both raise rates and reduce the supply of money.

Although it was never explicitly stated by the Fed during the 1980s and 1990s, monetary policy was focused on, first, using interest rates to stabilize the economy by raising rates when inflation began to increase and lowering rates when the economy weakened. Secondarily, the Fed monitored the growth of the money supply to guard against a new inflationary spiral.[3] This policy contributed to a period of low inflation (Exhibit 3), healthy economic growth, and relatively full employment, helped by the absence of wars or energy crises and the remarkable movement in the late 1990s to a fiscal budget surplus.

Along with the low inflation of the 1990s, the Fed funds rate was quite stable, staying in a range of 4 to 6% (Exhibit 4). With inflation under control at 2 to 3%, a Fed funds rate of 4 to 6% implies that the inflation-adjusted or "real" interest rate was about 2%. Note that in 2023 a Fed funds rate of 4 to 6% is expected to be able to put the brakes on inflation and even cause a mild recession, whereas that interest rate level in the 1990s did not slow the economy but rather allowed healthy growth.

[3] N. Gregory Mankiw, *U.S. Monetary Policy During the 1990s*, Working Paper 8471, National Bureau of Economic Research (2001).

Exhibit 3: Consumer Price Inflation, 1982–2000



Sources: Consumer Price Index for All Urban Consumers, Federal Reserve Bank of St. Louis.

Monetary Policy Since the Advent of Quantitative Easing

Inflation is ultimately a monetary phenomenon, usually caused by monetary policy. Modern governments do not literally "print money," but they can use government-controlled central banks to buy the debt that is used to cover government budget deficits, in the process creating bank credit that expands the money supply. This "monetizing of the deficit" occurs most often in countries like Argentina that have weak capital markets that are unable to absorb government debt. In these cases, the budget deficit results in money and credit creation, which causes inflation. The increase in prices will be proportional to the increase in the money supply, at least over some period of time. A rough estimate of the future inflation rate is the budget deficit as a percentage of gross domestic product (GDP).

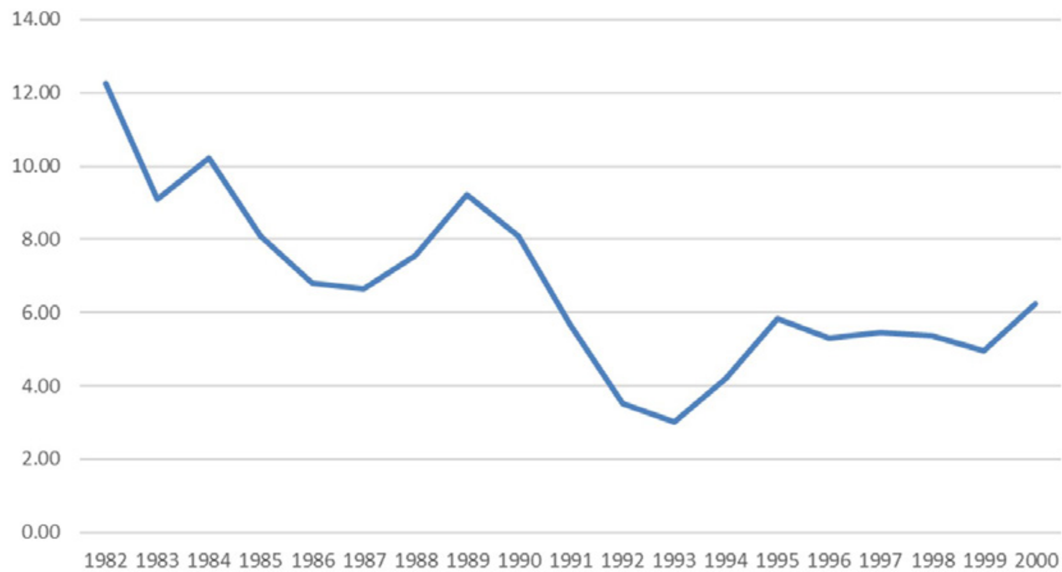
The Federal Reserve attempts to avoid monetizing the US deficit in "normal" times. The Fed buys government debt—Treasury securities—to expand the money supply only in proportion to real economic growth, not in response to financing the deficit. Economic theory used to teach that when the government borrows more, the competition for funds in the capital markets will "crowd out" private borrowing. But this relies on the assumption that the money supply is under the control of the Fed and cannot expand independently of the Fed to accommodate the increased federal deficit.[4] However, the money supply does not increase only as a result of the Fed's actions. If banks have excess reserves, they can expand the money supply by increased lending to individuals and businesses. This makes the money supply "endogenous" (i.e., it is partly controlled by demand and supply in the economy, not just by the Fed). Private borrowing will not necessarily be "crowded out" by government borrowing if banks have the ability to expand their lending to accommodate both private and public borrowing.

In the US, the degree to which the money supply is endogenous has increased greatly since the Global Financial Crisis (GFC) of 2008. Before the GFC, banks had required reserves that limited their ability to expand their lending and thus the money supply. The level of excess available to lend out was small enough that it was more or less under the control of the Fed. When the economy became overheated during the 1990s, the Fed could rein it in by selling securities, which soaked up the limited supply of excess reserves in the banking system.

The new era of monetary policy began with the invention of "Quantitative Easing." In the financial collapse of October 2008, the market for asset-backed securities froze, because investors were uncertain of the value of the underlying assets. The Fed introduced QE1 in November 2008. Over $1 trillion of mortgage-backed securities and Treasuries was purchased in a year's time, helping to stabilize the capital markets. These purchases also

[4] M2, the most commonly used definition of the money supply, includes currency, checking accounts at commercial banks, and CDs of less than $100,000.

Exhibit 4: Federal Funds Rate Percent, 1982–2000



Sources: Fed Funds Rate 1982-2000. Federal Funds Effective Rate, Annual, Not Seasonally Adjusted, Federal Reserve Bank of St. Louis.

resulted in an increase in excess reserves in the banking system of over $1 trillion.

After the crisis, the Fed was hesitant to sell securities to drain that $1 trillion of liquidity out of the credit markets for fear of creating a credit crunch. It took several years for the economy and unemployment to recover from the crisis. By 2013 the recovery was complete, yet the banking system still sat on $1 trillion of reserves. This held the potential for an enormous inflationary expansion of lending. Rather than returning to the status quo pre-2008 by selling securities to remove these excess reserves, the Fed's net asset holdings were held steady from 2014 to early 2020. This was the primary difference in the structure of monetary policy in the new post-2008 world.

The second difference in monetary policy in the new era is the Fed's payment of interest on reserve balances that commercial banks hold at the Fed. Until 2008 banks earned nothing on the reserves, whether in their own vaults or held as deposits at the Fed. This provided a strong incentive for them to lend or invest all of the reserves that were not required—that is, to hold zero excess reserves. But beginning in 2008, interest has been paid on reserve deposits at the Fed. Because QE1 created over $1 trillion of new reserves, the payment of interest on these reserves removes at least a part of the incentive to increase lending, which could be inflationary. As long as the interest paid on reserves is attractive to banks, they will not aggressively lend out reserves.

The third difference in monetary policy is that banks no longer have required reserves. From the inception of the Federal Reserve System until 2008, banks were required to hold cash reserves against their deposits. Cash reserves did not generate any income. Because banks were increasingly competing against other lenders that did not have this disadvantage, and because banks can obtain cash instantly in the overnight market, the Fed dropped the last of its reserve requirements in 2020. This frees up more reserves for banks to lend and removes one of the monetary control levers that could be used to constrain bank lending.

The new structure of monetary policy, including QE, interest on deposits, and zero reserve requirements, has resulted in a new monetary regime in which the Fed's control over the expansion of money and credit is weaker than in the past. As mentioned previously, banks had over $1 trillion of reserves after the economy had recovered from the GFC. From 2014 until the pandemic in early 2020, the Fed used its open market activity to raise interest rates when the economy was perceived to be overheating. But unlike in the past, raising interest rates by selling securities had only a marginal effect on bank reserves and thus credit availability. During this period, the total holdings of securities on the Fed's balance sheet did not increase to accommodate economic growth as in the past. Rather, the growth of the money supply, about 5.2% annually, is explained by banks' ability to use their reserves to increase lending, leading to growth in the money supply. In other words, the money supply was endogenous, rising and falling with the growth of demand for credit in the economy, not because of actions by the Fed.

The Present Inflation Cycle and New Monetary Structure

The Fed began discount rate increases in 2022, when the discount rate was 0%. The increases are expected to continue in 2023 until the rate is 5% or more and are intended to slow the economy and reduce inflation. The hoped-for result of the Fed's actions is that the economy will not go into recession or that any recession will be brief and mild. It is also hoped that this slowdown will cause the inflation rate to settle back down to 2% or less. Thereafter, the economy is expected to return to its normal pattern of 2 to 3% real growth and 2% inflation (i.e., the status quo that existed before the pandemic). When the economy returns to growth and full employment, the Fed expects to control inflation with a discount rate of perhaps 2.5 to 3.5%. This interest rate range is consistent with a growing economy and low inflation in the 1990s, as discussed above.

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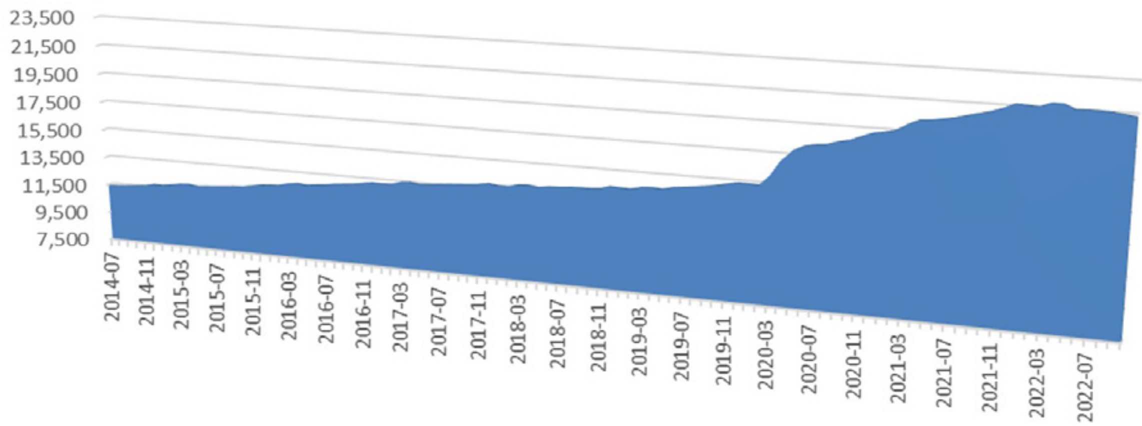
Exhibit 5: M2 Money Supply, July 2014–October 2022 ($ billions)



Source: M2 Money Supply, July 2014–October 2022: Federal Reserve Release H.6: Money Stock Measures (February 28, 2023). https://www.federalreserve.gov/releases/h6/

Exhibit 5 shows the growth of the money supply (M2) from 2014 to 2022. From 2014 to 2019, M2 grew 5.2% annually without the Fed creating new reserves. Banks used their excess reserves from the GFC to expand M2 as the economy grew. During the pandemic, the Fed facilitated an enormous growth of bank reserves, and M2 grew from $15.4 trillion in February 2020 to $21.8 trillion in April of 2022, an increase of 42%, after which the Fed's course reversal began.

The increased money supply has fueled the increase in inflation since 2021. Beginning in 2023 and most likely for years to come, banks will have the liquidity to increase the money supply far more than what we have seen to date. Banks have more free reserves relative to their deposit balances than before the pandemic, in spite of a slight decline since the Fed's tightening began. The reserve/deposit ratio, which is an indicator of how much capacity banks have to expand the money supply, went from 5% in 2008 before the GFC to a peak of almost 30% in 2013 (Exhibit 6). The ratio never returned to its pre-GFC level; it had declined to 13% in 2019 but soared again with the new quantitative easing during the pandemic. Reserves were still 18% of deposits at the end of November 2022.

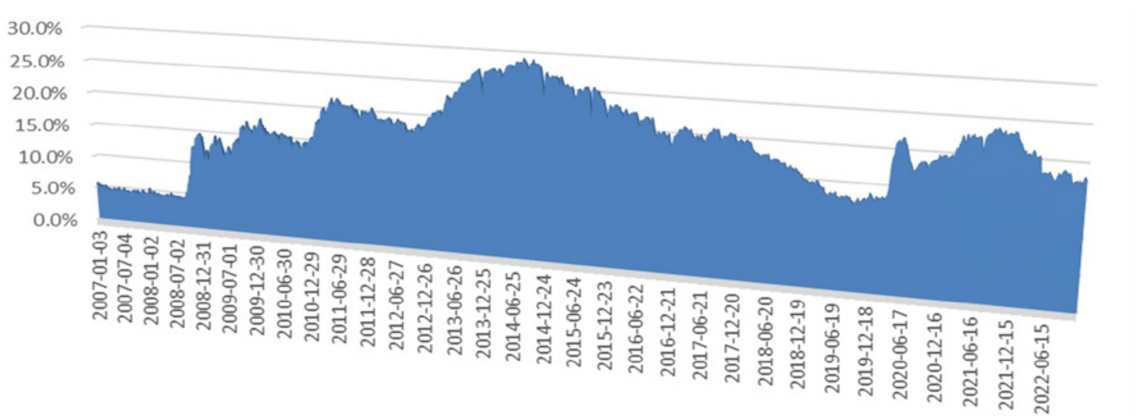
This means that banks have the capacity to expand their lending, which expands the money supply. The trillion-dollar deficits in the coming years constitute a demand for funds of about 5% of GDP on top of the private-sector equilibrium, which may result in at least a 5% inflation rate.

As of the end of 2022, commercial banks had reserve balances in the Federal Reserve System of $3 trillion. In contrast, bank reserves at the Fed in September 2008 were only $10 billion. At that time the Fed did not pay interest on bank reserves, so banks kept their money working elsewhere. But since October 2011, banks have been able to earn interest (currently 4.65%) on their reserves.[5] This reduces the incentive to lend out the reserves and expand the money supply. The rate paid on reserves, which the Fed terms IORB (Interest on Reserve Balances), is adjusted frequently. As of March 7, 2023, the IORB rate was 4.65%. By comparison, the market rate on one-month commercial paper was 4.55%; the rate on one-month Treasury bills was 4.63%; and the bank prime rate was 7.75%.[6] The Fed appears to be paying interest on reserves that is keeping up with other risk-free short-term rates (but not with the riskier prime rate).

[5] Federal Reserve, "Interest on Reserve Balances" (last updated March 13, 2023). https://www.federalreserve.gov/monetarypolicy/reserve-balances.htm

[6] Federal Reserve, "Selected Interest Rates (Daily) - H.15" (release of March 8, 2023). https://www.federalreserve.gov/releases/h15/

Exhibit 6: Reserve–Deposit Ratio US Commercial Banks, 2007–2022



Source: Reserve Deposit Ratio, US Commercial Banks. Federal Reserve Release H.8: Assets and Liabilities of Commercial Banks in the United States, and author's calculations. https://www.federalreserve.gov/releases/h8/

Conclusion

When the expected economic downturn of 2023–2024 is over, economic growth will resume. Banks will have enormous reserve balances to finance that growth and, possibly, inflation. The Fed's monetary policy is commonly viewed as the control of short-term interest rates to control economic activity. This paper has argued that more attention should be paid to the level of bank reserves available to finance expanded credit, the level of the federal budget deficit, and the actions of the Fed to "contain" bank reserves by raising the interest paid on those reserves. The current cycle of monetary tightening by raising market interest rates will come to an end. After that, the banking system will share control with the Fed over the future of inflation.

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John Hekman is a director in BRG's Downtown Los Angeles office. He has been testifying on economic damages matters, real estate markets and finance, antitrust, and other subjects for over twenty-five years. He earned an MBA in finance and a PhD in economics from the University of Chicago. He was on the faculties of UNC Chapel Hill and Boston College, as well as an economist for the Federal Reserve Bank of Boston.

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2023 BANK SECTOR DISLOCATION AND THE IMPACT ON THE FINANCIAL SERVICES SECTOR

David Villa
Houlihan Lokey

The Bank Backdrop

March 2023 lived up to the old elementary school adage "March comes in like a lion and leaves like a lamb." In 2023, however, the saying more appropriately described the conditions in the U.S. banking sector than it did the weather. Over a period of 72 hours, including one whirlwind weekend, two large, well-established regional banks failed, creating a shockwave that would impact the entire U.S. and, to some extent, the global banking system. Less than two months later, these two failures were eclipsed by the failure of First Republic Bank, which marked the second largest bank failure in U.S. history. The failures of Silicon Valley Bank, Signature Bank, and First Republic Bank, along with the unwinding of the crypto-focused Silvergate Bank, have created significant uncertainty across the banking sector.

Several key factors contributed to the crisis of confidence, fueling the recent bank dislocation:

- Inflation and interest rates
- Overexposure to niche industries (venture and crypto)
- Balance sheet growth and fair value losses
- Deposit outflows and composition of deposits (percent uninsured/concentration risk)
- Liquidity and capital position

The banking dislocation of 2023 will continue to have implications on the broader financial services industry. While it may be too early to know the full extent of the disruption, March 2023 will prove to be a watershed moment in the industry. Many new challenges will arise from the recent turmoil, and opportunities will also present themselves.

It Is Not Always Easy to See with Two 'I's

Inflation and Interest Rates

In March 2022, approximately one year before the Silicon Valley Bank, Signature Bank, and First Republic Bank failures, the Federal Reserve began its current interest rate hike campaign in an effort to address inflation and prevent the historically high levels from becoming entrenched. Among the various causes for the elevated inflation levels, the key factors were supply chain bottlenecks, higher energy prices as a result of the Russian invasion of Ukraine, and a tight labor market driving up wages. Upon review of the CPI data available on the U.S. Bureau of Labor Statistics, by March 2021, the CPI reading had already ticked above the 2.0% inflation target level and stood at 2.6%. By November and December 2021, the CPI levels had risen to 6.8% and 7.0%, respectively (Exhibit 1).

With CPI readings for January and February 2022 showing a continued upward trend to 7.5% and 7.9%, respectively, the Fed began raising the benchmark rate in March 2022. An initial 25 bps increase was followed by a 50 bps and four consecutive 75 bps increases before stepping down to 50 bps and (currently) 25 bps hikes (Exhibit 2, next page).

While the rate hikes were necessary to stem the rise in inflation, the speed of the rate increases had unintended negative externalities.

Canary in the Crypto Mine

Crypto Collapses and the U.S. Banking System

Even though the role that cryptocurrency will play in the global economy remains undetermined, its daily impact to the non-crypto world is unequivocal. Bitcoin is often used as the primary barometer to measure current public sentiment toward crypto. The crypto market experienced strong tailwinds in 2020 and 2021, driving the value of Bitcoin to an all-time high of more than $67,000 in November 2021. The steady increase, however, was soon followed by a similarly spectacular sell-off in 2022. Currently, Bitcoin stands at ~$30,000, which is close to its three-year average beginning in 2020 (Exhibit 3, next page).

Exhibit 1: Consumer Price Index (CPI)

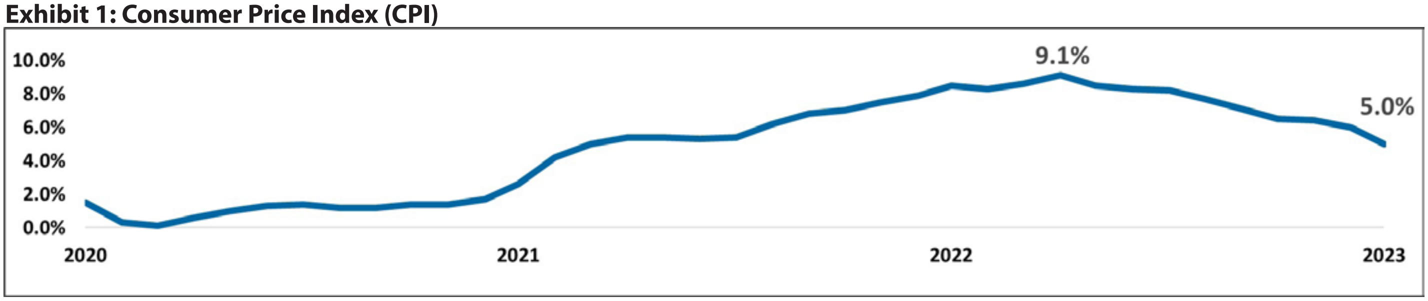

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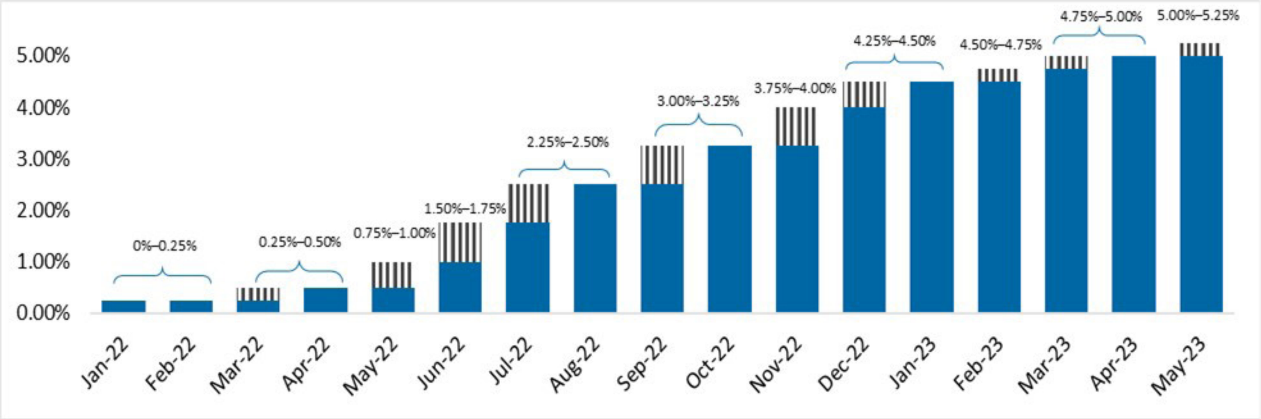
Exhibit 2: U.S. Fed Funds Rates (Jan. 2022 – May 2023)



With increased adoption of cryptocurrency, numerous market participants emerged to service the various aspects of the crypto economy. Among them, two businesses whose success and undoing were closely tied to crypto were FTX and Silvergate Bank.

The FTX collapse began with concerns around the company's financial solvency, which was exacerbated by the decision made by Binance, a rival crypto exchange, to sell all its FTX tokens in early November 2022. FTX filed for bankruptcy a week later after failing to complete a sale or raise additional capital. FTX Founder and CEO Sam Bankman-Fried was later arrested on fraud charges.

Like FTX, Silvergate Bank played an important role in the crypto industry. The bank was an early crypto market participant, providing a full suite of banking services to the crypto community, including its popular Silvergate Exchange Network, which allowed for instantaneous transfers between Silvergate accounts 24/7. Silvergate Bank experienced robust growth between 2014 and 2022, with assets growing from ~$1 billion up to ~$16 billion during that period. In mid-2022, however, the bank began experiencing operational challenges largely due to the growing malaise in the crypto market.

Between October and December 2022, the bank's crypto-centric model proved to be unsustainable. Silvergate Bank reported a significant disruption to its operations in January 2023 and announced emergency measures undertaken to address an exodus from its depositors (Exhibit 4).

Coincidentally, Silvergate Bank would announce its intention to liquidate its business on March 8, 2023, the same day Silicon Valley Bank launched an unsuccessful strategic balance-sheet repositioning that ended in a failed capital raise and, ultimately, its failure. Signature Bank, which by this point had become the biggest crypto bank rival to Silvergate Bank, was also caught in the crosshairs. At that time, First Republic Bank began an aggressive campaign designed to reassure investors and depositors that it had substantial liquidity and a more stable deposit base after it escaped failure in early March. This effort would ultimately prove unsuccessful; the bank failed on May 1, 2023.

Danger Hidden in Plain Sight

U.S. Bank Balance Sheets and Fair Value Accounting

U.S. bank balance sheets experienced unprecedented growth following the COVID-19 pandemic stimulus period compared to the growth seen between 2005 and 2019. During 2020, assets and deposits grew 5x and 6x the annual average, respectively. Meanwhile, loan growth remained in line with historical levels during this period, and the loan-to-deposit ratio at banks decreased in 2020 and 2021 by more than 20% each year compared to historical levels. In other words, banks found themselves flush with significant amounts of excess deposits. As a result, the assets on a typical bank balance sheet had higher levels of cash and securities (Exhibit 5).

Having a higher level of cash and securities can be a good thing, as it often implies higher levels of liquidity. However, these

Exhibit 3: Bitcoin ($ Value)

Exhibit 4: Bitcoin and Silvergate Relative Share Price Performance Since 2021

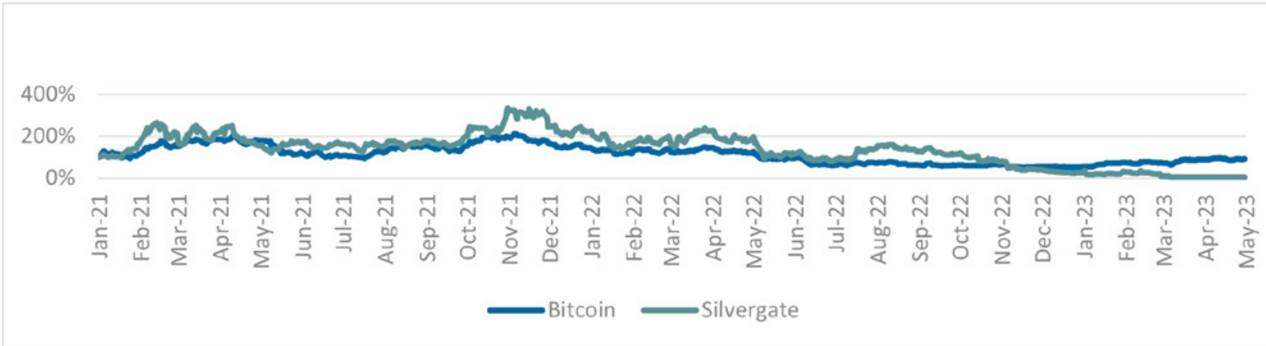


Exhibit 5: Post-COVID Growth Impact on U.S. Bank Balance Sheets

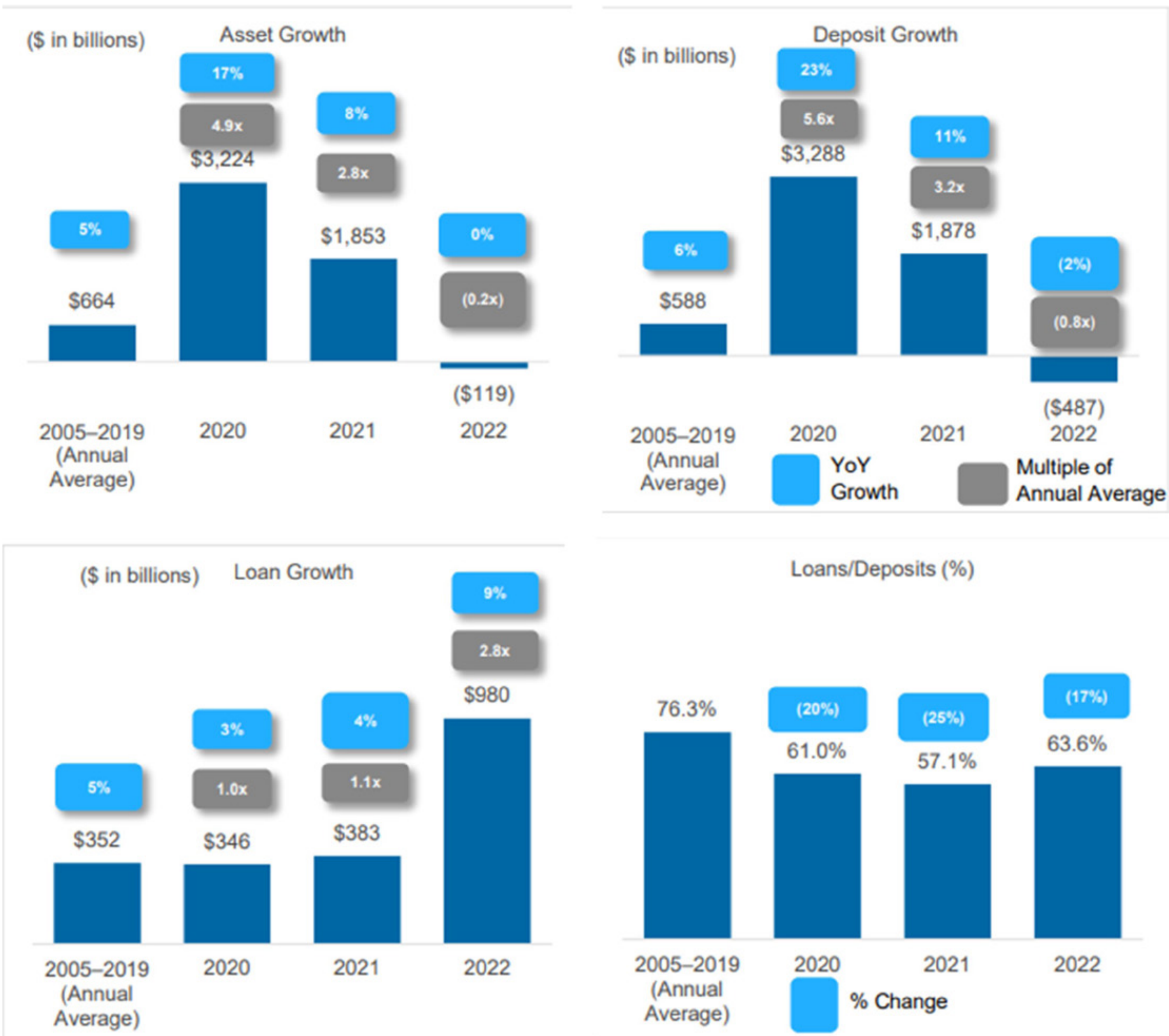


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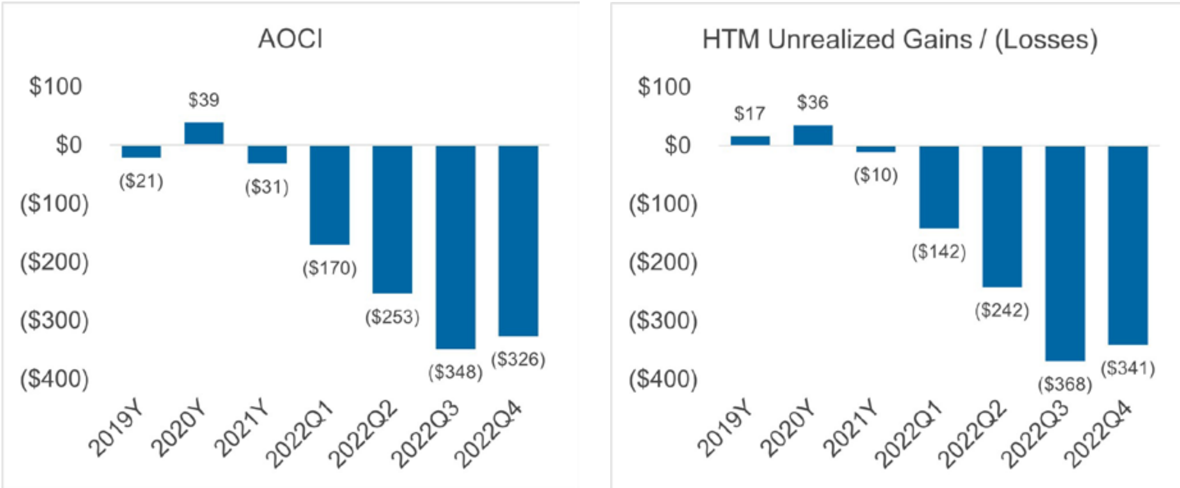
Exhibit 6: Impact of Rapid Interest Rate Change on AOCI and HTM



zero- or low-yielding assets also led to net interest margin (NIM) compression. To reduce the NIM compression and improve profitability, many banks chose to invest in securities, most commonly agency-issued mortgage-backed securities, which provided a relatively attractive yield at the time. While these securities were safe from a credit risk perspective, they were not immune to interest rate risk.

Fair value accounting is a reporting requirement through which companies provide an estimated price for their assets and liabilities should they need to be sold or settled at current market prices. In the absence of an asset sale or M&A transaction, the implied loss or gain on an asset that is held to maturity (HTM) does not have an impact on a bank's financial performance. For assets classified as available for sale, which are marked periodically, the loss or gain is captured through accumulated other comprehensive income (AOCI) under shareholders' equity. With the rapid change in the interest rate environment, both the AOCI and unrealized fair value losses in bank HTM portfolios ballooned rapidly.

Moreover, it is important to note that neither AOCI nor unrealized fair value losses from HTM securities are included in the calculation of regulatory capital for many banks. This is an area that may come under greater scrutiny from both investors and regulators. Should the market or regulators start considering AOCI losses (and, potentially, the unrealized fair value losses in HTM portfolios) as part of regulatory capital calculations, many banks would find themselves with significantly lower capital ratios than currently presented.

Moreover, as Silicon Valley Bank learned the hard way, having elevated levels of unrealized fair value losses can be fatal if a bank finds itself in a liquidity crunch that requires it to sell assets and realize the losses.

Don't Judge a Bank by Its Cover

Concentrated Business Models and Core Deposits

Prior to their failures, Silicon Valley Bank, Signature Bank, and First Republic Bank had experienced a long stretch of success and were widely viewed favorably as having differentiated, high-growth, profitable business models. Silicon Valley Bank was synonymous with venture capital. Signature Bank focused on private client banking while selectively expanding into niche verticals, including crypto. First Republic's business catered to high-net-worth individuals, offering attractively priced, low LTV loans to its high-quality customers (Exhibit 7).

While these three institutions differed in many ways, they shared two key shortcomings. First, they all had a high concentration of uninsured deposits. Second, all three focused on niche sectors with highly concentrated customer bases. On the one hand, Silicon Valley Bank almost exclusively catered to the venture/tech community, a sector that experienced significant headwinds in 2022. On the other hand, Signature Bank had grown its crypto business rapidly over the past few years with crypto deposits in excess of $10 billion, making it the largest crypto bank rival to Silvergate Bank. Lastly, First Republic Bank focused on high-net-

Exhibit 7: Relative Share Price Performance Since 2021

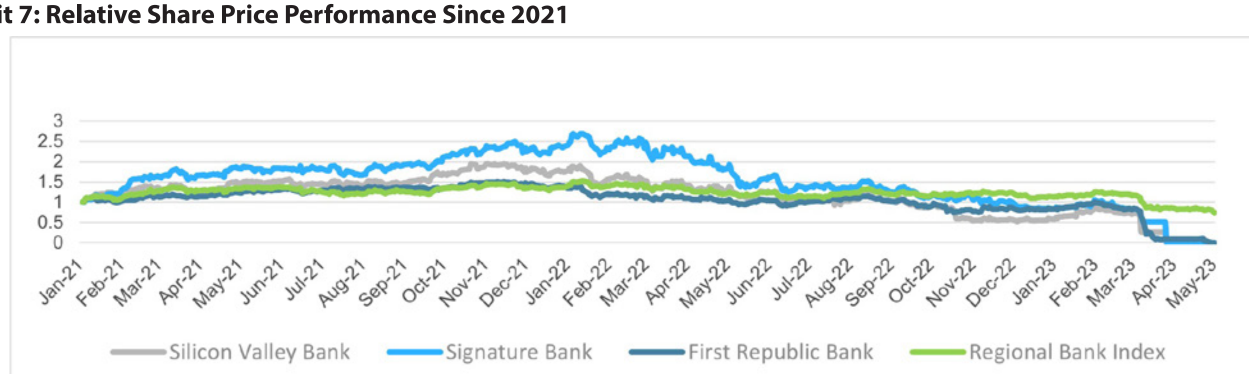
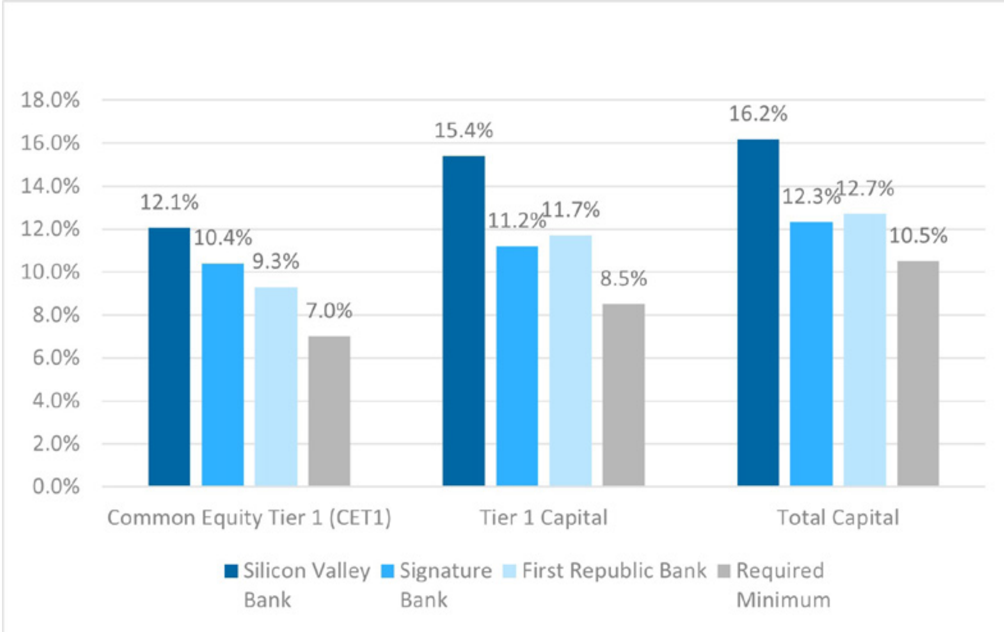


Exhibit 8: Regulatory Capital Ratios



worth individuals, and its balance sheet had a high concentration of low-rate mortgage loans and some venture lending exposure. However, the specialized nature of their respective business models was not the nail in the coffin.

What ultimately led to the failures was a classic run on the bank. In each situation, these institutions experienced unprecedented levels of deposit withdrawals in a short period of time—approximately $40 billion and $10 billion in one day for Silicon Valley Bank and Signature Bank, respectively. The size of these withdrawals put each bank in a position where it could not, or soon would not, be able to meet customer requests to access funds, rendering each one insolvent. These two banks were particularly vulnerable to a bank run because of the significantly elevated level of uninsured deposits relative to total deposits—each bank had approximately 90% uninsured deposits compared to 50% or lower for many other regional banks. Similarly, First Republic Bank had approximately 70% uninsured deposits as of December 31, 2022. Efforts from large U.S. banks to stem the deposit outflows by contributing $30 billion of deposits to First Republic Bank were unsuccessful, and First Republic Bank had $100 billion of deposit outflows between December 31, 2022, and March 31, 2023.

When a bank fails, the uninsured depositors could potentially experience losses on any amount above the $250,000 FDIC deposit insurance limit. Consequently, when depositors became concerned that these three banks could fail, many chose to withdraw their funds. This created a vicious cycle through which the failure of the banks was inevitable because as more deposits were withdrawn, more liquidity was required to meet those withdrawals. To address the additional liquidity needs, the banks would need to sell their underwater securities and recognize losses. These losses would eventually result in undercapitalized, insolvent banks.

This dynamic underscored the importance of having a true core deposit franchise. Banks with the highest-quality core deposit franchises are those that have moderate levels of uninsured deposits and loyal customers that bank with them because they receive superior service. Depositors at these banks, whether insured or uninsured, are sticky and will not head for the woods if the bank comes under pressure. While many banks have boasted about having high-quality core deposit franchises, the relative strength of the deposit franchises will become more apparent following the events of March 2023. Banks that are able to grow deposits while minimizing NIM compression will be best positioned to weather the storm.

Cash Is King

Rethinking Regulatory Capital and Liquidity

Silicon Valley Bank, Signature Bank, and First Republic Bank were well capitalized at the time of their failures.

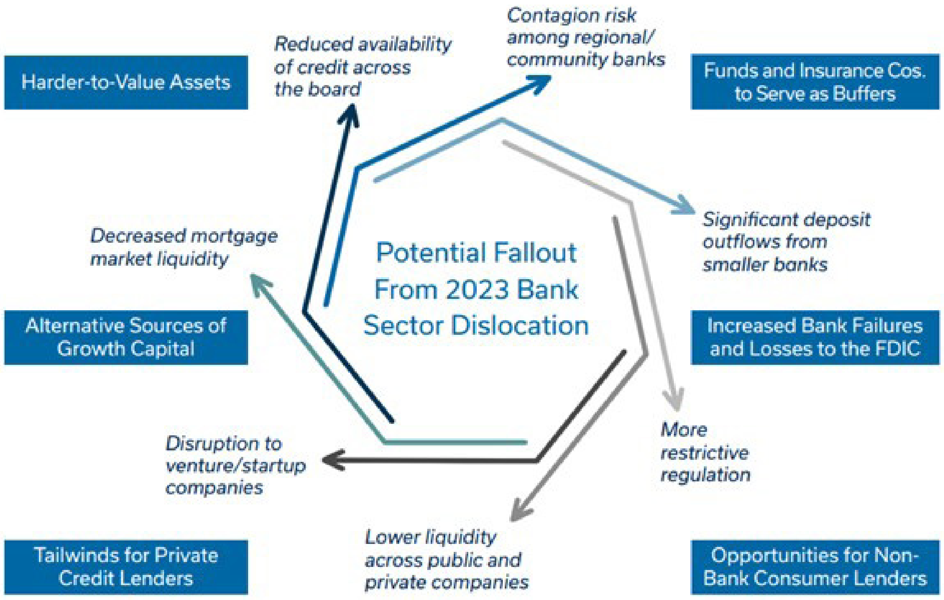
Moreover, even when accounting for an additional 2.5% capital conservation buffer, all three banks were comfortably above the required levels (Exhibit 8).

The immediate conclusion is that the current regulatory capital construct does not fully address potential risks facing many banks. The interest rate risk mismanagement and uninsured depositor concentration at Silicon Valley Bank were not captured. Crypto risk and uninsured deposits of Signature Bank were not accounted for in the metrics. In the case of First Republic Bank, the ratios did not consider the contagion risk from other bank failures and the uninsured depositor concentration.

This poses a structural problem for all banks. An operating model that requires banks to maintain significant amounts of cash and equivalents or short-dated securities would drastically change the current bank model of utilizing customer deposits to make loans and investments at yields above what they pay for those deposits. Moreover, considering the role that fair value marks played in the recent bank dislocation, it appears that factoring them into required capital would be prudent.

Continued from p.35

Exhibit 9: Potential Fallout from 2023 Bank Sector Dislocation Crisis



Carpe Diem

Collateral Damage, Implications, and Opportunities

The ripple effect of the 2023 bank dislocation will be profound and protracted. Despite efforts from regulators to address concerns around the strength of U.S. banks, investors and depositors remain skeptical. Although the storm appears to have somewhat subsided, it is unclear whether it has fully passed or if the sector currently sits in the eye of the hurricane. Many questions remain unanswered, and it is too soon to tell whether the scale will tip toward greater clarity or more uncertainty (Exhibit 9).

Q1 earnings provided instructive data points for the sector that have helped clarify the outlook for the remainder of 2023. To a large extent, the outlook will be shaped by the letter R.

- **Rates**: The Federal Reserve will have a tall task in managing inflation. With inflation currently more than 2x the target level, pausing the current rate hikes may also pause the progress made so far in the inflation fight. The 25 bps increase in May signals a commitment to fighting inflation. Subsequent rate increases are less likely, although the Fed remains data dependent.
- **Retention of Deposits:** Banks will come out of Q1 2023 with a wide range of outcomes from the bank sector dislocation. Those banks that can minimize deposit outflows or grow deposits while maintaining low deposit betas and strong net interest margins will be best positioned to weather the storm. The biggest risk banks face today is a potential run on the bank, but strong deposit performance helps mitigate that risk.
- **Regulation**: After very public and large bank failures, regulators and legislators will be conducting thorough postmortem analyses to identify problem areas. Although it is hard to anticipate what form regulation/ legislation will take, a few potential outcomes could be a higher FDIC insurance limit, higher regulatory capital requirements, changes to the treatment of fair value impacts in regulatory capital, increased liquidity requirements, and a return to more stringent regulation for smaller non-GSIB banks.
- **Recession**: Several recession probability trackers indicate a greater-than-50% chance of a recession in 2023. Recent comments from money center banks seem to support the belief that there is a greater chance of recession following the bank sector dislocation.
- **Returns**: One of the biggest unknowns is how the bank sector dislocation will impact bank profitability. If banks tighten credit and loan growth stalls while deposit costs rise, the sector will experience net interest margin compression. This scenario would likely lead to lower ROAA and ROATCE, which in turn will impact valuations across the board.
- **Real Estate**: Commercial real estate (CRE), particularly office exposure, has emerged as an area of concern. The refinancing environment will be challenging. Decreasing property values, tightening credit conditions, and high vacancy rates could result in credit deterioration across CRE.

Closing Thoughts

The bank sector remains dynamic, and many opportunities will continue to emerge. Banks may elect to divest noncore business lines to free up capital and reduce costs. Credit tightening will help maintain strong credit performance should the economy enter a recession, and with delinquencies starting to tick up across certain asset classes, it may be necessary rather than precautionary. Nonbank lenders may find themselves beneficiaries of increased credit demand because of the bank tightening. New or expanded regulation could require banks to raise capital to address potential concerns from regulators. On the M&A front, fair value marks make transactions challenging but not impossible. Moreover, as the industry selects winners and losers, valuation gaps may widen sufficiently to make strategic transactions financially compelling today that perhaps were previously not feasible.

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ABOUT THE AUTHOR

David Villa
Houlihan Lokey

Mr. Villa is a Managing Director in Houlihan Lokey's Financial Services Group. He has more than 15 years of experience in investment banking coverage, specializing in advising financial services companies on mergers and acquisitions, capital raising, strategic advisory engagements, and recapitalizations. Mr. Villa's coverage focus includes specialty finance companies, banks, and asset management firms. He is based in the firm's New York office.

Mr. Villa has advised a broad range of financial services companies. His transaction experience includes advising CURO on its acquisition of Flexiti Financial; Mechanics Bank on its acquisition of Rabobank, NA; Lancaster Pollard on its sale to Orix Group; CIT Group on the sale of its Canadian Equipment Finance business to Laurentian Bank of Canada; Opus Bank on its acquisition of PENSCO Trust Company; Lone Star on its acquisition of DFC Global; IPO of CURO; IPO of Opus Bank; various lead-left equity and debt capital markets offerings (public and private); and a number of buyers on failed-bank acquisitions during the Great Financial Crisis. To learn more about Houlihan Lokey please visit www.hl.com.

39TH ANNUAL BANKRUPTCY & RESTRUCTURING AWARDS & HONORS

2023 MANNY KATTEN AWARD

WILLIAM A. ("BILL") BRANDT, JR.

Bill was a long-time AIRA member and a regular speaker on AIRA programs. The firm he founded, DSI, has been and continues to be a long-time supporter of AIRA with sponsorship and Board presence. This award represents a recognition of Bill's contributions, not only to AIRA, but to the wider realm of the insolvency and restructuring community.

— Jim Lukenda

ACCEPTANCE REMARKS BY: Bradley D. Sharp, *DSI*

While I am heartbroken to have to do so, I am honored to accept the Manny Katten award on Bill's behalf.

In March of last year, Bill was diagnosed with the neurodegenerative disease, ALS. Bill tragically passed away on May 28, 2023, before he could accept this award. It then falls to me in a few short moments to talk about what Bill has meant to the restructuring community, and to many of us personally.

Bill was one of the pioneers in our industry. Bill's introduction to turnarounds came from helping with the bankruptcy of a family business. Bill enjoyed the process so much that he started DSI (Development Specialists, Inc.) in 1976 to pursue restructuring full time.

Bill devoted his life to his family and to the turnaround and restructuring industry. Bill was a panel trustee in Chicago for more than 20 years. He was one of the first people named as the "responsible individual," the predecessor to the function we now call the Chief Restructuring Officer. Bill was involved in large and small cases across the country, and internationally. Bill was known for being innovative and creative, as well as occasionally aggressive.

Bill served on ABI's Board of Directors and was a member of the International Insolvency Institute. Bill was also a member of the ABI's Commission to Study the Reform of Chapter 11, which was instrumental in securing the passage of Subchapter V in 2019.

Bill was very active in politics and thought of it as a noble profession for public service. He was a member of the President's National Finance Board during the Clinton administration and was elected as a delegate to the Democratic National Convention for the states of Florida and Illinois.

Bill advised Congress on bankruptcy and restructuring matters throughout his career and was the principal author of an amendment of the Bankruptcy Code permitting the election of trustees in Chapter 11 cases. He also helped draft several amendments to the code that became part of the Bankruptcy Abuse Prevention and Consumer Protection Act in 2005.

Bill worked closely with Bob Keach in pushing the Sub Chapter V debt limit increases through Congress the last three times, so more companies can make use of the simplified bankruptcy process.

Bill gave back in other ways, serving three terms as chair of the Illinois Finance Authority and as chairman of the national advisory board of the Institute of Governmental Studies at the University of California, Berkeley. Bill served on the Board of Trustees of Loyola University Chicago from 2007 to 2016 and was a Life Trustee of Fenwick High School in Oak Park, Illinois. Bill was also a member of the Board of Directors of Tina's Wish, a New York-based foundation for ovarian cancer research.

Before joining DSI more than 30 years ago, I had the pleasure of working on the other side of the table from Bill on a deal in Dallas, Texas. Once the case was over, Bill offered me a job and became my mentor and friend for the next 30 years.

Bill's mentoring was filled with pithy quotes such as:

- If you do your job right, you will need to buy lots of spam and pillows. You may not eat well, but you will sleep great.
- When asked why we had to wear suits, Bill would respond "we deal with other people's money, we should dress like it."

In Bill's mind, one of the primary goals in a restructuring is to save jobs, and he took that seriously.

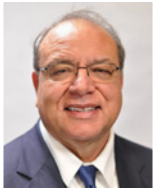
In February, I informed Bill that he was selected by the board of the AIRA to receive the Manny Katten Award. Bill was honored, particularly given the other individuals that received the award previously. Bill told me that he knew Manny Katten well, and often encountered him in cases in the Chicago area in the 1980s and early 1990s. Bill described Manny as a great guy and a good friend. Bill was truly honored to receive this award named in Manny's memory.

Bill dealt with ALS with courage, grace, and humor. He was grateful for the life he led and the love of his family and friends. As we follow in the footsteps of pioneers such as Bill and Manny Katten, let us never lose sight of what we have learned from them.

Thank you.

AIRA INDUCTS 2023 DISTINGUISHED FELLOWS

The AIRA inducted the 2023 Class of Distinguished Fellows during its 39th Annual Conference in June.



ACCEPTANCE REMARKS BY PROF. JACK WILLIAMS

On behalf of my colleagues, we thank the AIRA for the honor of being named Distinguished Fellows. This honor is humbling; it comes from an exceptional organization of our peers that is dedicated to the betterment of the bankruptcy and restructuring profession and the institution of bankruptcy. Although all of us followed different paths to this point in our careers, the contours and milestones of those paths are remarkably similar. We are all beneficiaries of those who came before us and who cared enough to guide us, to make us better professionals and better members of our communities. We learned from these exemplars the unique responsibilities of teamwork, honor, integrity, and leadership. We learned the importance of giving back to an institution and an organization dedicated to helping those less fortunate, whether it be an individual or business in distress. We learned that, as we grew professionally, we had to commit to giving back to the AIRA and the bankruptcy institution. We learned that the most important thing we can do as leaders is to prepare the next generation of those that would steward the AIRA well after we are gone. We learned that together we can accomplish things that we could never accomplish alone.

I look around the room tonight and see so many faces of those that have taught us and grown up with us, as well as many new faces, reflecting the youth and vigor that is so vital to the lifeblood of this organization. I am also saddened by the faces that are not here tonight – those that have left us, those that have walked on. We miss them dearly.

For those new to the AIRA, I say that this is a wonderful organization, one that contains within it a mystical power – for what you dedicate to this organization, you will be repaid tenfold. This is a welcoming place, a place where we care for each other, where we watch out for each other, where we learn from each other.

On behalf of my friends and companion Distinguished Fellows, thank you again for this wonderful honor.

2023 Class of Distinguished Fellows

David Bart, CIRA, CDBV
Baker Tilly US, LLP

Andrew I. Silfen, Esq.
ArentFox Schiff LLP

Kevin Clancy, CIRA
CohnReznick LLP

Michael C. Sullivan, CIRA
Deloitte Financial Advisory Services LLP

Hon. Rosemary Gambardella
United States Bankruptcy Court, District of New Jersey

Jack F. Williams, Ph.D., CIRA, CDBV
Georgia State University

Brian Ryniker, CIRA
RK Consultants LLC

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1st PLACE: Blair Woolheater – *Portage Point Partners*

Blair Woolheater is a Director at Portage Point Partners, based in Pittsburgh, specializing in Performance Improvement and Interim Management. At Portage Point Blair has led operations for two large, private maritime transportation clients and has conducted multiple successful performance improvement engagements. Prior to joining Portage Point, Blair was a strategy consultant at Wilson Perumal & Company and a submarine officer in the US Navy. While not working on engagements, Blair serves as a Lieutenant Commander in the US Navy Reserve, providing strategic support to real world submarine operations. Blair graduated with a Bachelor of Science degree in Biomedical Engineering from Duke University.

2nd PLACE: Alejandro Ramirez Disla – *Alvarez & Marsal*

Alejandro Ramirez Disla is an Associate with Alvarez & Marsal North America in Los Angeles. He specializes in restructuring and financial reporting, including capital budgeting, cash actualization, liquidity management, bankruptcy preparation, and cost reduction initiatives. Prior to joining A&M, Alejandro spent four years with PwC's Deals Valuation team in Washington, D.C., where he served as a Senior Associate, advising some of the world's largest public and private companies in financial reporting and strategic value matters. Alejandro earned a Bachelor's Degree in Commerce with a concentration in finance from The University of Virginia. He is a Chartered Financial Analyst (CFA).

3rd PLACE: Kirsten Cellier – *Deloitte & Touche LLP*

Kirsten Cellier is a Senior Manager in Financial Advisory at Deloitte & Touche LLP in the Cayman Islands. She focuses on insolvency, restructuring and forensic investigations, specializing in solvent and insolvent liquidations of distressed investment vehicles and holding companies domiciled in the Cayman Islands. She has managed all aspects of liquidations, including those under the supervision of the Grand Court of the Cayman Islands. Areas of experience include developing liquidation and asset recovery strategies, advising stakeholder and creditor groups, realizing illiquid investments and restricted securities, and investigating potential claims related to breach of fiduciary duty, asset misappropriation, and preferences. Kirsten is a chartered accountant and completed her INSOL Foundation Certificate in International Insolvency Law.

3rd PLACE: John Ferretti – *M3 Partners, LP*

John Ferretti is a Vice President at M3 Partners, LP and is based in New York. John specializes in financial and operational restructuring, liability management and capital markets advisory for distressed businesses and lenders across a wide variety of industry verticals. Prior to joining M3, John was a Senior Strategy Consultant for KPMG where he focused on M&A and strategic advisory for companies in the consumer, healthcare and telecommunication sectors. John received his MS and BS in accounting from the University of Alabama and is a Certified Public Accountant (CPA).

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Malek Capital Advisors is a team of operations, interim management, corporate transaction, valuation and litigation support professionals providing services throughout the United States. We combine decades of experience with a hands-on client service model, personal commitment and on-call attention, devoted to helping you solve your business challenges and move forward. MalekRemian's senior level expertise drives value-added results across a range of industries, including energy and power, financial services and real estate, healthcare, manufacturing, technology and transportation.

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Province is a nationally recognized restructuring and financial advisory firm. The firm specializes in creditor & investor services, trust & liquidation, corporate advisory, litigation services and performance improvement services. The firm creates exceptional value to its clients consisting of individuals, trustees, official committees and companies, across a wide array of sectors, by providing solutions to some of the most complex business challenges imaginable. With firm offices in Los Angeles, Las Vegas, Baltimore, Stamford and Miami, Province is always looking for high-performing talent to expand its professional team. www.provincefirm.com

Restructuring Solutions, LLC™
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Restructuring Solutions, LLC is a boutique restructuring, bankruptcy, wind up and transaction support service provider to lower-middle market companies facing liquidity challenges. The company was formed with the underlying commitment to provide a level of personal service that cannot be found with other professional services firms. Restructuring Solutions brings over 30 years of experience providing financial advisory services to distressed businesses large and small, across a variety of industries, and operating through several economic cycles. www.restructuringsolutionsllc.com

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11th Annual Energy Summit

September 13, 2023, Trammell Crow Building, Dallas, TX

AIRA and TMA Dallas/Ft. Worth are excited to present the 11th Annual Energy Summit on September 13th! This innovative program will bring together bankruptcy and restructuring advisors, attorneys and other practitioners for an afternoon of informative programming on the energy industry's current issues, trends and developments. A networking reception will close out the program.

CPE/CLE: Up to 2.5 CPE / 2 CLE*; Field of Study: Economic-Technical.

**Application for accreditation pending approval.*

Visit www.aira.org for more information and registration!

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22nd Annual Advanced Restructuring & Plan of Reorganization Conference (POR)

November 13, 2023, at the Offices of CohnReznick, LLP, New York, NY & Online

Mark your calendars and plan now to attend AIRA's Annual POR Conference! POR will be a hybrid event, offering attendees a live, in-person experience and a virtual option for those who choose to attend from home or office, featuring six panel presentations:

- **Subchapter V Update**
- **Liability Management**
- **Commercial Real Estate**
- **DIP Financing**
- **Ethical Issues & Cybersecuritys**
- **2023 - The Year in Review from the Perspectives of Judges and Attorneys**

The in-person conference includes a luncheon and a reception honoring the recipient of AIRA's 2023 Judicial Service Award.

CPE/CLE: Earn up to 7.0 CPE / 7.0 CLE*

**Application for New York accreditation pending approval. CLE for other states applied for on request.*

Visit www.aira.org for more information and registration!

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PRESS RELEASE

PROVINCE WELCOMES PUBLIC ENERGY SECTOR EXPERT BRAD HOLLY

Province recently announced the addition of Bradley J. Holly and the launch of a new Houston office.

Mr. Holly will play a pivotal role in Province's energy-sector engagements by offering expert advice and building compelling and executable strategies for the future. His extensive experience providing strategic, operational and portfolio management services to Fortune-ranked companies; success in regulatory and government affairs negotiations; and distinguished ability to create cost efficiencies and improved performance for oil & gas companies position him to be an integral member of the Province executive professional team.

David Dunn, who will co-lead the Houston office with Mr. Holly, remarked that "Brad joining our firm fortifies our oil and gas advisory quals and demonstrates our commitment to the segment and to the Texas market."

Most recently, Mr. Holly served as Cofounder and Managing Partner of Stein & Holly Advisors, a financial advisory firm that provides consulting services to public and private companies and institutional investors. Prior to that, he served as Chairman, President and CEO of Whiting Petroleum Corporation, and had a 20-year career at Anadarko Petroleum Corporation as Executive Vice President, where he oversaw all U.S. Onshore assets.

AIRA UPCOMING EVENT

AIRA BREAKFAST AT THE 97TH ANNUAL NCBJ

Friday, October 13, 2023, 7:30-8:45 am
Conference Hotel, JW Marriott, Austin TX

"Valuation Conundrums – Finance as the Handmaiden of the Court and Not Its Jailer"

Experts may aid a trier of fact in measuring fair market value, fair value, investment value, or some other measure of value; however, courts make determinations with regard to a legal standard, not a financial standard.

The learning objective of this program is to identify various assumptions and inputs to classic valuation approaches and methods that have been rightly contested or unnecessarily confused in the cross-over between employing common valuation standards using traditional and well-accepted techniques and fashioning equitable relief demanded by bankruptcy law.

Moderator:
Stephen Darr, CIRA, CDBV—*Huron Consulting, (Boston)*

Speakers:
Professor Jack F. Williams, CIRA, CDBV—*Georgia State University College of Law (Atlanta)*

David Bart, CIRA, CDBV—*Baker Tilly, US, LLP (Chicago)*

See https://aira.org/conference for more information

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The Association of Insolvency and Restructuring Advisors is governed by a board composed of up to 40 directors (several former directors continue to serve as directors emeritus). Directors are elected by majority vote at a meeting of the Board, serve for a term of three years (or such less term as the Board may determine or until their successors are duly elected and qualified) and may serve an unlimited number of terms, whether or not consecutive. The majority of the directors on the Board must have a CIRA Certificate; although most are financial advisors, a number of directors are attorneys. New officers assumed their duties at the end of the June AC20 Virtual Series and will serve for one year.