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The BoIC Talks – Maximizing Enterprise Value

www.gerbsmanpartners.com September 2005

The BoIC Talks

Welcome to the Fall 2005 issue of "The BoIC Talks", where members of Gerbsman Partners' *Board of Intellectual Capital* and Industry leaders speak out on important current business topics.

Please visit our website at gerbsmanpartners.com for previous BoIC Talks, White Papers, as well as biographies on our distinguished Board of Intellectual Capital. We look forward to continue to earn the right to assist stakeholders to maximize enterprise value.

Best Regards,
Steve (Steve@GerbsmanPartners.com)

In This Issue

Early Warning Signs for the storm ahead or should the Euphoric Optimism continue?
- by Steven R. Gerbsman, Principal Gerbsman Partners Page 2

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
- by Richard M. Neiter, Esq. Stutman, Treister & Glatt Professional Corporation Page 3

Maximizing Asset Values
- by Rick Ambrose, Michael Fox International Page 9

Sharing May Be A Good Thing, But Not Necessarily In Bankruptcy
- by Robert J. Dehney, Esq. and Gregory W. Werkheiser, Esq. Morris, Nichols, Arsht & Tunnell Page 10

China's Economy in Transition
- by Christian Murck, CEO of APCO Asia Page 12

A Turnaround, or Just Plain STUCK?
- by Jim McHugh, President of McHugh & Company Page 16

Are We Entering the Silly Season Again?
- by Robert Tillman, Investment Banker/Tech CEO Page 18

About Gerbsman Partners
- by Steven R. Gerbsman, Principal Gerbsman Partners Page 21

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Oil prices are reaching new highs, US credit card debt is increasing, the US trade balance is worsening, the European economy (particularly in Italy, France, Germany, Spain, Portugal and Greece) is under-performing, US interest rates are expected to continue on the rise and the US government is printing money to continue to stimulate the economy. If these are not early warning signs for future challenges in the economy and corporations, I do not know what is.

However, optimists about the economy point to the following: high valuations, an increase in M&A activity, the significant availability of CASH, CASH, CASH for investment, more relaxed cash flow lending terms, senor and junior lender¹s portfolios appear to be clean and the IPO market as a liquidity alternative is coming back to take out professional investors.

When I was in Business School, one of my Professors spent half a semester on, “The Past is our Gateway to the Future. Learn, Learn, Learn from Experience and Be Prepared.”

For Investors, Bankers, CEO¹s and members of Boards of Directors who have lived through the business ups and downs of the past 20 years, experience has proven that those companies that take can identify early warning signs of trouble and take swift action have the highest probability for working out of their challenges. In order to manage the process of maximizing enterprise value, companies and their Boards of Directors should:

1. Focus on the control, preservation and forecasting of CASH
2. Develop, implement and monitor “Bottoms Up” financial planning and reporting
3. Provide Leadership, Motivation and Morale for all personnel
4. Insure there is an active Communications plan with All parties on a timely basis
5. Continue to re-evaluate the Business Model and business plan performance
6. Hold the CEO responsible and accountable
7. Determine the product or service offerings are meeting targeted sales, gross margin and cost objectives
8. Be sufficiently capitalized to weather any storm

Regardless of which way the economy and the business cycle is heading, I believe my Professor’s advice will stand the test of time.

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INTRODUCTION

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") into law. [1] The Act made substantial changes to various provisions of the Bankruptcy Code ("Code"),[2] most of which will become effective on October 17, 2005;[3] however, certain provisions become effective on other dates.

While most of the Act's provisions pertain to consumer bankruptcies, many involve businesses. As a result, it is beyond the scope of this article to discuss the consumer provisions, which require a chapter 7 debtor to pass a means-based test if the debtor's income exceeds the applicable state median in order for the debtor to remain in chapter 7 and obtain a discharge of his/her debts. If the debtor's income exceeds the applicable median and he/she fails the means test, his/her case may be dismissed or converted (with the debtor's consent) to one under chapter 11 or 13 of the Code.[4] This article, therefore, will highlight a few of the provisions of the Act that may affect a business case administered under the Code. Due to space limitations, however, this article does not present a comprehensive discussion of said provisions and it is suggested that the relevant portions of the Act be studied in order to decide how to proceed in any liquidation or reorganization case under the Code.

SUMMARY OF AREAS AFFECTED BY THE ACT

The areas of the Act discussed in this article involve the following:

- retention of key personnel
- deposits for utilities
- assumption or rejection of non-residential real property leases, executory contracts and unexpired personal property leases
- preferential transfers
- fraudulent transfers
- small business cases
- single asset real estate cases
- exclusive periods of the debtor within which to propose a plan of reorganization and solicit votes to accept it

[1] The Act is known as S.256, Pub. L. No. 109-8, 119 Stat. 23.

[2] 11 U.S.C. section 101 et. seq.

[3] Section 1501 of the Act provides that generally the Act shall become effective 180 days after its enactment.

[4] Code section 707(b)(2) or (3).

DISCUSSION OF CERTAIN PROVISIONS OF THE ACT

1. Retention of key personnel.

a. Re KEY EMPLOYEE RETENTION PLAN (KERP)
The Act amended section 503(c)(1) of the Code to prohibit the transfer to an insider (e.g., an officer or director of the debtor) or the incurrence of an obligation for the purpose of inducing such person to remain with the debtor's business absent a finding by the court that: (A) the payment or obligation is essential to the retention of the insider because he/she has a bona fide job offer from another business at the same or greater rate of compensation; (B) the person's services are essential to the survival of the debtor's business; and (C) either (i) the amount of the obligation incurred or the transfer made is not greater than an amount equal to ten times the amount of the mean transfer or obligation of a similar kind given to non-management employees of the debtor during the calendar year in which the obligation is incurred or the transfer is made or (ii) if no such similar transfer was made or obligation incurred for the benefit of non-management employees during such calendar year, the amount of the transfer or obligation is not greater than the amount that is equal to 25% of the amount of any similar transfer made or obligation incurred for the benefit of the insider during the calendar year in which the transfer is made or obligation is incurred.

b. Severance Payments
According to amended Section 503(c)(2) a severance payment may not be made to an insider of the debtor unless: (i) the payment is part of a program that is generally applicable to all full time employees; and (ii) the amount of the payment is not greater than ten times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made.

c. Other transfers outside the ordinary course of business
Other transfers or obligations that are outside the ordinary course of business and are not justified by the facts and circumstances of the case, including transfers made to or obligations incurred for the benefit of officers, managers or consultants hired after the date of the filing of the petition, will not be allowed nor can they be paid.[5]

2. Appointment of a trustee where fraud is suspected.

The Act amends section 1104 of the Code to impose on the United States Trustee an obligation to move for the appointment of a trustee in a chapter 11 case if there are reasonable grounds to suspect that the current members of the board of directors of a corporate debtor, the managing members of a limited liability company, the debtor's CEO, its CFO, or the members of the debtor's governing body who select such officers, participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor's public financial reporting. This provision is in addition to the grounds which already exist under section 1104 of the Code for the appointment of a trustee.

[5] Section 503(c)(3).

3 Utility deposits

The Act amended section 366 of the Code to severely restrict that which the debtor must provide as adequate "assurance of payment" for postpetition utilities. New section 366(c)(1)(A) defines "assurance of payment" to mean: (i) a cash deposit; (ii) a letter of credit; (iii) a certificate of deposit; (iv) a surety bond; (v) a prepayment of utility consumption; or (vi) another form of security that is mutually agreed on by the utility and the debtor or the trustee. The Act specifically states that merely allowing a claim as an administrative expense priority shall not constitute an "assurance of payment". Thus when planning to file a chapter 11 it is now necessary to accumulate sufficient cash or to make such other arrangements that may require cash or the equivalent in order to make adequate assurance of payment for utilities used post petition. This is particularly significant for retail chains and other businesses where the debtor does business at numerous locations.

4. The assumption or rejection of non-residential real property leases

Section 365(d)(4) of the Code has been amended to limit the maximum number of days within which a debtor may assume, assume and assign or reject an unexpired lease of non-residential real property to the earlier of 120 days after the date of the order for relief (e.g. the commencement of a voluntary chapter 7 or 11 case) or the date of the entry of an order confirming a plan. Under the Act this deadline may be extended only on a motion of the trustee (or the debtor in possession) or a lessor filed prior to the expiration of said period, for cause, but not beyond an additional 90 days, without the prior written consent of the lessor.

If a lease is assumed within the time permitted, but later rejected before confirmation of a plan, section 502(b)(7) provides that the lessor shall be allowed an administrative claim for the amount of all monetary obligations due under the lease, excluding those arising from the failure to operate or a penalty provision, without reduction or set off, for two years, except for amounts received from a third party. The balance of the lessor's claim shall be treated as a general unsecured claim and limited under section 502(b)(6) of the Code.

These provisions are particularly significant for the debtor that conducts business at numerous locations since it will now have to assume, assume and assign, or reject its leases unexpired real property leases within 210 days even if it cannot determine the profitability of certain locations or the survivability of its business enterprise within said period. Previously, there was no specific statutory limit on how much time the bankruptcy court could permit a debtor to assume, assume and assign, or reject its nonresidential real property leases, other than upon the confirmation of a plan of reorganization.

5. Preferential transfers

a. Ordinary course of business defense.
The Act has liberalized the ordinary course of business defense available to a transferee under section 547(c)(2) of the Code to an avoidable preferential transfer action if the transfer was in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee, and was made in the ordinary course of business of the debtor and the transferee, **or** it was made according to ordinary business terms. Formerly, a three-pronged test had to be satisfied for a

payment or transfer to be considered as having been made within the parameters required by the ordinary course of business defense, which included: (i) that the transfer was in payment of a debt or the obligation was incurred in the ordinary course of business or financial affairs of the debtor and the transferee; (ii) it was made or incurred in the ordinary course of business or financial affairs of the debtor and the transferee, **and** (iii) it was made according to ordinary business terms. The use of the disjunctive has made it easier to assert the ordinary course of business defense.

b. Elimination of small transfers as avoidable preferential transfers
The Act also added section 547(c)(9) to eliminate as avoidable transfers in payment of debts or obligations incurred where the aggregate value of all property transferred is less than $5,000. This amendment applies, however, only to non-consumer debts or obligations, since existing section 547(c)(8) provides a similar defense to the recovery of preferential transfers of less than $600 involving consumer debts.

c. The DePrizio Fix
The Act also amended section 547(i) of the Code to protect third party lenders from avoiding preferential transfers made to them more than ninety days after the filing of a petition on account of debts guaranteed by insiders. While this amendment protects lenders from such transfers, the insiders who benefited from them are still vulnerable to the recovery of preferential transfers which benefited them that were made more than ninety days, but within one year, from the filing of a petition. Unlike most of the Act's other provisions, this amendment became effective on April 20, 2005, and applies in all pending and future cases.

6. Re fraudulent transfers

a. Two Year Reach Back
Section 548 of the Code was amended to enable a trustee to avoid fraudulent transfers made within two years of the filing of a petition; however, this provision applies only to cases commenced more than one year after the date of the enactment of the Act.

b. Transfer under Employment Contract not in the ordinary course of business
Section 548 was also amended to make transfers to insiders under employment contracts that were not made in the ordinary course of business vulnerable to attack as fraudulent transfers.

7. Small business debtor

A "small business debtor" is defined under the Act[6] as a person engaged in commercial or business activities (other than real estate activities), including any affiliate of such person that is also a debtor in a case under the Code, that has aggregate, non-contingent, liquidated secured and unsecured debts as of the date of the order for relief in an amount not more than $2 million (excluding any debts owed to one or more affiliates or insiders). For such small business debtors, the Act provides a streamlined procedure, which has expanded the small business debtor's exclusive period within which only it may file a plan from

[6] Section 101(51D) defines "small business debtor"; section 101 (51C) defines "small business case."

120 days to 180 days after the entry of an order for relief, unless the date is shortened or extended by the court for cause. The Act, however, establishes a deadline for the small business debtor's exclusive right to file a plan and a disclosure statement, which is 300 days after the order for relief. The court may then extend the date for confirming the plan beyond this date, but only if the small business debtor proves by a preponderance of the evidence that it is more likely than not that it will confirm a plan within a reasonable period of time, a new deadline for filing a plan is imposed, and an order is entered before the existing deadline has expired.[7] The Act also imposes substantial new reporting requirements on small business debtors. Other provisions, too extensive to be mentioned here, apply to small business cases.

8. Re single asset real estate cases

Under Code section 362(d)(3), a "single asset real estate" debtor must, within 90 days after the order for relief, either (i) file a "plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time," or (ii) commence monthly interest payments to the secured mortgage lender. Section 101(51B) of the Code defines a "single asset real estate" debtor as a debtor (other than a family farmer) that owns real property constituting a single property or project, other than residential real property with fewer than four residential units, that generates substantially all of the gross income of a debtor, and on which no substantial business is being conducted by the debtor other than the business of operating the real property and activities incidental thereto. Existing section 101(51B), however, excludes from the definition of a "single asset real estate" a debtor with more than $4 million in non-contingent, liquidated, secured debts. The Act eliminates this $4 million ceiling, thereby making many larger real estate ventures single asset real estate debtors, subjecting them to the 90-day deadline under section 362(d)(3) to file a plan or to commence interest payments. The Act also amends section 362(d)(3) to provide, among other things, that interest payments, if required, must be at "the then applicable nondefault contract rate." There are other important changes to the rules that govern a single asset real estate case, but the space allotted to this article does not permit further discussion. Accordingly, anyone involved in such a case must study the relevant provisions of the Act.

9. Exclusive period to confirm a plan of reorganization

The Act has also changed some of the rules pertaining to the exclusive periods within which only the chapter 11 debtor may propose and confirm its plan of reorganization. However, the debtor may no longer seek unlimited extensions of these exclusive periods. Existing section 1121(d) of the Code does not set an absolute deadline for a debtor to seek extensions to the original 120[8] day period within which it has the exclusive right to propose a plan of reorganization nor the 180[9] day period within which it has to obtain acceptances of said plan. Upon the effective date of the Act, the exclusive period within which a debtor may file a plan (assuming the court for cause extends the original 120 day period and no trustee has been appointed or the court has not set an earlier date for the debtor to file a plan) cannot exceed 18 months after the entry of an order for relief. Similarly, the 180 day period within which the debtor has the exclusive

[7] Section 1121(e).

[8] The debtor's 120 days of exclusivity may be shortened or lengthened, for cause, by the Court or terminated upon the appointment of a trustee (sections 1121(c)(1) and 1121(a) of the Code).

[9] Ibid.

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right to solicit acceptances to its plan may not be extended beyond 20 months after the date of the entry of the order for relief.

FUTURE ARTICLES

Since this article was intended to highlight only a few of the Act's provisions, future articles will contain a more in-depth discussion of selected portions of the Act.

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Maximizing Asset Values

by Rick Ambrose, Michael Fox International

A very wise and successful person once showed me a diagram that he called "The Rule". Try it yourself: Draw a triangle on a piece of paper. Now place these three words at the three angles: "Fast", "Cheap" and "Good" What does it mean? Quite simply, in life you can always have two of these, but not the three. What you can get fast and cheap won't be good, What is good and fast is rarely cheap, and What is cheap and good is never fast. The same applies with appraisals of industrial assets. While delivery time and price are negotiated items, what makes an appraisal good? Some Rules to follow:

Always Employ An Appraiser Who Is Also An Internationally-recognized Auctioneer

An appraisal isn't worth the proverbial paper if the company who produced it can't produce its conclusions. In today's market, new equipment manufacturers are the enemy of used equipment values. Until they regain pricing power, demand for used equipment in the US - especially equipment more than 7 years old, will be minimal. An international auctioneer sells to end-users in foreign markets, who find used US assets extremely attractive at current prices, especially in light of a weak dollar.

Always Employ An Appraiser Who Asks The Same Questions As Your Credit Committee

Most appraisals raise more questions than they answer. A good appraiser will include an analysis which answers the following:

a. How much of the equipment was actually seen?
b. Who did the appraiser interview at the subject company?
c. What is the average age of the assets?
d. Is the equipment name-brand or custom?
e. Is it suitable to only one or many industries with slight modification?
f. How strong is demand worldwide?
g. What is the expected remaining useful life?
h. Is the equipment state of the art or becoming obsolete?
i. What is the expected annual depreciation in a stable market?
j. What would be the recommended way to liquidate the assets, and what would the expenses be to do so?

Always Update Your Appraisal Within 12 To 18 Months, Maximum

Like milk, appraisals have a shelf-life. Continuously updating the values will give you the best picture of how things are faring. An appraiser will be the first to recognize trouble - idle equipment, deferred maintenance, fewer employees - so you can take pre-emptive action. The best capitalized appraisers/auctioneers are even willing to guarantee their valuation with cash buyouts based upon some discount for risk and expenses - lowering your risk from unknown to quantifiable, and possibly giving you a competitive advance advantage.

The commercial finance market is extremely competitive now, as we enter the fifth year of a less than robust expansion. With cycles typically lasting 7 to 10 years, developing a good relationship with a high-quality appraisal/auctioneer now may be your best defense for what is inevitably to come.

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Sharing May Be A Good Thing, But Not Necessarily In Bankruptcy

by Robert J. Dehney, Esq. and Gregory W. Werkheiser, Esq. Morris, Nichols, Arsht & Tunnell

One of the leading goals of the modern Bankruptcy Code is to facilitate consensual business reorganizations. That principle notwithstanding, the Bankruptcy Code is not without restrictions on the ability of stakeholders to agree on the manner in which property will be distributed among various creditors and equity interest holders. A recent decision of the United States District Court for the District of Delaware, In re Armstrong World Industries, Inc., 320 B.R. 523 (D. Del. 2005), particularly highlights one such limitation. Under the Armstrong court's reading of section 1129 of the Bankruptcy Code, a senior class may be constrained from voluntarily reallocating its distributions to a junior class when a dissenting intervening class has not been fully compensated.

Introduction

The confirmation of a plan of reorganization gives a debtor a fresh start by allowing it to discharge its debts. There are two ways a plan of reorganization can be confirmed. One is consensual and occurs when all classes accept the plan or are not "impaired." The other is non-consensual and occurs when the plan is "crammed down" on one or more classes that are impaired and have rejected or are deemed to reject the plan. A nonconsensual confirmation can be achieved only if the plan is determined to be "fair and equitable" and does not discriminate unfairly.

Often, the success of a plan of reorganization is dependent upon how successful the plan proponent has been in reaching compromises with the various constituencies. This idea of compromise and consensual resolution, however, on which a successful plan of reorganization is so dependent, may sometimes be at odds with a literal reading and strict application of the Bankruptcy Code.

The fair and equitable standard of section 1129(b)(2)(B) of the Bankruptcy Code, which implements the "absolute priority rule," provides that in a plan each creditor of a class of unsecured claims must receive a distribution equaling the full amount of its claim before any junior class of creditors may receive any consideration. Thus, in general, stockholders will not be permitted to receive or retain any property on account of their shares unless unsecured creditors have been paid in full.

With increasing frequency plan proponents have attempted to use novel mechanisms to lever the support (or at least the non-opposition) of various constituencies perceived as necessary to the success of a plan of reorganization. Often, such approaches involve the agreement of senior creditors to "gift" a portion of their distribution down to a class of creditors or interest holders that would not otherwise be able to receive or retain property consistent with the constraints of the absolute priority rule. The Armstrong decision is significant in its holding that such arrangements, at least when implemented through a plan of reorganization, may not always be consistent with the requirements of the Bankruptcy Code.

The Armstrong Decision

In Armstrong, the plan provided for one class of unsecured creditors, comprised of asbestos personal injury claimants, to waive their right to receive warrants under the plan and share that portion of their distribution with equity interest holders, a junior class, in the event that the class of general unsecured creditors rejected the plan. This distribution to the equity interest holders would occur, however, despite the existence of another senior class of general unsecured creditors who would not receive distribution for the full amount of their claims. The committee representing the interests of general unsecured creditors objected to the plan, claiming it violated the absolute priority rule.

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The court, applying what it described as the plain meaning of section 1129 of the Bankruptcy Code, held that the plan violated the absolute priority rule because it permitted a distribution to a junior class of creditors over the objection of a senior impaired and non-accepting class. Further, the court found support in the legislative history of section 1129 for restricting the ability of unsecured creditors to bypass a dissenting intervening class and hand over their distributions to a junior class. Using strongly worded language, the Armstrong court explicitly rejected the "'unconditional proposition' that creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors."

The Practical Implications of Armstrong

While the Armstrong decision represents a potential hurdle to formulating and confirming a plan of reorganization in certain circumstances, its reach is far from certain. Indeed, the Armstrong court affirmatively distinguished a number of scenarios which it considered inapposite, including that presented in the oft-cited decision, Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.), 984 F.2d 1305 (1st Cir. 1993). The Armstrong court determined SPM was inapposite because SPM involved the agreement by a secured creditor, rather than unsecured creditors, to share distribution with a junior class and because the arrangement was consummated outside of a chapter 11 plan. The court reasoned that because of the unique position occupied by a secured creditor, such an arrangement did not do violence to the Bankruptcy Code's absolute priority rule.

The lesson of Armstrong is that plan proponents must tread cautiously when formulating a plan that attempts to vary the Bankruptcy Code's priority scheme. Under Armstrong's holding, it may not be possible to bypass a class of non-accepting impaired unsecured creditors along the way of implementing a reallocation of distributions from another class of unsecured creditors to holders of claims or interests that are junior to those of the objecting class. Nevertheless, a variety of other tools appear to remain available to implement a distribution scheme in the context of a bankruptcy proceeding, including agreements by secured creditors to "carve-out" from their collateral and one-off intercreditor subordination agreements. Accordingly, despite some furor that has arisen, the ultimate legacy of Armstrong may prove to be nothing more than to encourage more creative lawyering.

The authors gratefully acknowledge the assistance of Curtis Miller, Esq. and Joanna Newdeck, Esq., associates in the Bankruptcy Group of Morris, Nichols, Arsht & Tunnell, in the preparation of this article.

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China's Economy in Transition

by Christian Murck, CEO of APCO Asia

The economic performance of the People's Republic of China since the reform period began in 1979 has been extraordinary by any measure.

Gross domestic product growth per capita has been sustained at 7.5 percent per year, hundreds of millions of people have been lifted out of poverty and an urban middle class has emerged with all the social changes that implies. Consumer demand rotated from better clothing, food and bicycles in the 1980s, through refrigerators, washing machines and televisions in the 1990s, to cars, mobile phones and homes today. For a number of products, such as mobile phone handsets, China is both the largest manufacturer and the largest market, whose consumers are driving the introduction of new styles and features.

The acceleration has been particularly noticeable since 2001, when China joined the World Trade Organization. Today it is the world's third-largest trading nation, behind the United States and Germany and ahead of Japan. Foreign exchange reserves stand at more than US$600 billion, having increased 47 percent in 2004 alone.

China as "the world's manufacturer" attracts both admiration and concern. There is much to admire in the win-win partnership between foreign companies sourcing high-quality products inexpensively and Chinese suppliers providing employment and a rising standard of living to hard-working people. On the other hand, there is rising concern in the United States and elsewhere about how to compete with "the China price" and the "hollowing out" of manufacturing and other sectors of the U.S. economy.

The frequent and vocal criticism peaks during elections and never entirely goes away. What are the sources of Chinese competitiveness? Is the glossy progress dependent on exploitation of labor, theft of intellectual property, currency manipulation, despoiling the environment and authoritarian suppression of free speech and political opposition?

China's competitiveness in world markets rests on a combination of factors: relatively low labor cost; an exchange rate that has been basically stable throughout business cycles; a well educated, eager work force; technology and management skills transferred by foreign investors; good infrastructure; and the creation of highly responsive, integrated supply chains.

My favorite example is the Toshiba laptop computer factory near Shanghai. The work force of approximately 2,000 (95 percent young women) are paid slightly more than US$100 per month plus room and board. They live in factory apartments and work in a clean, air-conditioned factory that operates 24-hours a day in three shifts. Turnover is low and labor is approximately 10 percent of total cost. There are more than 900 suppliers or competitors within an hour and a half by truck. Some are locally owned; many are Taiwanese, Korean or other foreign companies. The technological level is world class. The factory operates a just-in-time inventory system, with the only imported component, the Intel chips, arriving by air freight. If you order a Toshiba laptop online from the U.S. or Europe, four days later that machine has been manufactured, shipped and is sitting in the warehouse nearest you waiting for a delivery truck. Shifts in any one of these factors, such as upward pressure on wages or a different exchange rate, will have limited effect on competitiveness. If the Chinese renminbi appreciates against the U.S. dollar, for example, the price of the final product will go up, but this will be partially offset by a reduction in the cost of the imported chips, paid for in dollars.

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But if the current success of the computer industry in China is well deserved and soundly based, is China a menace to living standards in the rest of world, a competitor whose rise is unstoppable and accelerating? Not at all.

First, we should not forget that there is substantial participation in this industry by foreign companies, not only Toshiba, but also Intel and other suppliers. The quality and low cost of the laptops supplied to American and European customers are factors powering the sustained productivity increases on which the prosperity of those markets depends. When trade is based on comparative advantage and open competition, it is mutually beneficial. That is certainly true in this instance. The employees and shareholders of Intel – and the American consumers of the products – receive a major share of the value created.

Second and more important, if we look ahead it is clear that China is now at a turning point. Its performance over the next 25 years cannot be based on the policies and growth model of the past. Success has created new opportunities and serious challenges that require adjustments. We now hear a consistent rhetorical emphasis from China's senior leadership on the quality of growth, rather than simply the rate of growth, and on sustainability rather than short-term gains.

There are four imperatives which I believe will change Chinese economic policy over the next five years in ways that will make China in the medium term both more successful and less threatening: 1) the need for greater capital efficiency; 2) the need to reduce the urban-rural income disparity by increasing the income and wealth of rural residents; 3) the need to ameliorate environmental and natural resource constraints; and 4) the need to care for a rapidly aging population.

Improving capital allocation

China's real gross domestic product growth in 2004 was 9.5 percent. But this required fixed asset investment of over 45 percent of gross domestic product, a pattern consistent with the recent past. This level of investment is extremely high; in recent economic history it was briefly matched only by South Korea. The drivers have been three unsustainable factors: massive government infrastructure spending, overinvestment from state-owned enterprises relying on readily extended bank loans and a highly leveraged private sector rushing to diversify and build market share. The result is a high level of waste, overcapacity and bottlenecks.

Since about 95 percent of all new capital for Chinese enterprises comes from bank loans, reform of the banking system is crucial. Thus we observe the Chinese government embarking on massive recapitalization of the major banks, welcoming foreign-bank investments, tightening prudential regulation, encouraging offshore listings to improve corporate governance, deregulating interest rates, experimenting with new ways to dispose of nonperforming assets and approving new products. Other reform efforts are underway in the bond market and the securities industry.

Another requirement of efficient capital allocation is an effective bankruptcy law to clear away failed enterprises. It exists in draft form, but has not yet been passed. It will be.

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Reducing urban-rural income disparity

Because China's growth has been heavily concentrated in urban coastal areas, the discontent of the rural population has become an explosive political problem. The Chinese population is urbanizing at about one percent of the population per year, much faster than the historical experience of Europe or the United States. This will continue putting pressure on job creation, education and health systems. From another point of view, China is too large a proportion of the global population – at about 20 percent – to depend on exported growth indefinitely. There aren't enough foreign consumers. China's biggest markets in the future must be domestic. That means rural people and people living in second-and third-tier cities must somehow be brought into a virtuous cycle, where they have enough money to buy the goods China is producing or importing.

As a result, a fundamental change in agricultural policy has occurred. Instead of insisting on subsidizing self-sufficiency in grain, a foolish policy for a country short of arable land but with a labor surplus, China now is relying on world markets to supplement its production of commodity grains. American soybean and wheat producers are benefiting. And Chinese farmers are shifting to labor-intensive cash crops such as fruits and vegetables, putting American apple growers under pressure. There also have been policy decisions to invest more in rural health care and education, while reducing taxes on farmers. All this is raising both rural incomes and the wages that factories must pay in the Pearl River delta to attract migrant workers.

Facing environmental and natural resource constraints

China's growth model not only wastes capital, but also consumes large and increasing amounts of imported natural resources. China is the marginal buyer of most world commodities and is actively investing abroad to secure long-term sources of supply. Yet even with long-term contracts, prices are determined in global markets, forcing Chinese steel mills to accept a 71 percent increase in the cost of iron ore in recent contracts.

In the case of water, there is a near-term crisis in many parts of China. The United Nations defines the danger level of availability at 1,000 tons per capita per year; the north China plain has less than 500 tons per capita per year. China consumes 15 times the water per unit of gross domestic product as a typical developed country, yet delivers water at a lower cost. Meeting the water crisis will drive conservation and investment, and the price will inevitably increase.

The demographics of an aging population

Chinese population control has been successful in preventing an estimated 300 million births. What is the implication of this for the future of the Chinese economy?

Today many Chinese humorously bemoan the way single child Little Emperors and Little Empresses are each spoiled by two parents and four grandparents. If we fast forward 25 years, each will be a young adult in the work force with four retired grandparents and two parents soon to retire.

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Estimates vary, but sometime between 2010 and 2020, the working population will peak and begin to decline. China therefore will have a labor surplus for years to come as it absorbs underemployed workers from state-owned enterprises and the countryside. But once the population reaches the tipping point, the country will be under tremendous pressure to support its rapidly aging inhabitants. The unfunded pension liability of the Chinese government is estimated at approximately US$500 billion, or close to half of gross domestic product, very similar to the amount of nonperforming loans in the banking system at its peak. This is a very loose estimate but suggests the scale of the problem. Moreover it will begin to bite in China a full generation before difficulty financing social security in the United States.

Policy adjustments to improve the quality and sustainability of growth will make China a more successful country by many measures, but also one which is a less threatening competitor, better integrated in the global economy and a more confident regional power. Of course, if policy is not adjusted appropriately, there could be a spectacular collapse. We can take comfort in the fact that extrapolating current trends is usually wrong, especially when market forces and rising popular expectations are at work. The implication for the United States and other trading partners is that there is much more to be gained by participating in Chinese growth and shaping its direction than in returning to protectionism or containment.

Christian Murck is CEO of APCO Asia and former chairman of the American Chamber of Commerce in China. He has 25 years of experience in financial services, public affairs and academia in Asia. Prior to joining APCO, he headed operations for The Chase Manhattan Bank in both Beijing and Taipei.

A Turnaround, or Just Plain STUCK?

by Jim McHugh, President of McHugh & Company

If a company is barely profitable, hardly growing, and achieving a marginal return on investment, doesn't this describe a "turnaround" or workout situation? Nope, I say the company is "stuck". Being stuck means some part of the business is a little off-kilter. Even though many stuck companies are in somewhat decent shape, I have seen some of these common characteristics:

- Sales, margins and profits may be flat or declining. "We have a cost problem" is a familiar refrain. There are excessive costs that are hard to eliminate (it's like a rising tide at the beach…the water is all around your feet before you realize it)
- Shareholder value is being eroded even though the owners/managers are receiving very healthy compensation
- Either the organization is working harder than necessary ("corporate high blood pressure") or, the organization is hardly working (no sense of urgency).

Typically, the slide into a 'stuck' mode is more insidious than a quick turnaround crisis caused by an unforeseen circumstance such as a drastic change in the customer base or a significant quality problem. Getting stuck develops more subtly over a long period of time. Frequently, because of emotions or being too close to a situation, it can be hard for management to recognize the specific issues that need to be systematically and collectively addressed. In addition, the lack of a clear direction can be frustrating to both the shareholders and management.

I use a simple, six-point strategic assessment model to diagnose a stuck company that seems to work very well with the management of mid-market companies.

1 - Assess the Industry Attractiveness (Stuck in Another World)

Many industries are changing significantly; radically and quickly; others have shifting dynamics that are more subtle. In either case, it's important to know the overall structure and trends and understand where the company currently fits. There needs to be a critical look at whether this is an industry that should support continued investment. Some typical factors that can freeze a company are: a) customers demanding technological changes that require substantial investments in physical plant or processes, b) The China Factor, c) industry overcapacity.

2 - Identify the Sources of Competitive Advantage (Stuck in the Past)

A Partner of a Private Equity Group once told me that he tries to look beyond a company's warts to determine the "…pockets of strength" (at the time I was assisting a company that didn't have very many, so our conversation was pretty brief!). In short, look at:

- What are the underlying capabilities, core technologies and core competencies of the company? How can these be capitalized on to fuel future growth? Have once superior technologies or products become commodity-like?
- Are there inferior operational practices (e.g. unwieldy, outdated bills of material or inconsistent/weak business processes) that negatively impact the daily operations?

3 - Understand the 'Business Definition' (Stuck in the Middle)

Using the simple 80/20 rule can help determine the complexity of a business. For example, an improper combination of operating entities, customers and products can result from a lack of strategic focus. The poor business definition can become exacerbated by inefficient operational conditions, weak management practices and negative industry forces. The guts of an 80/20 analysis is really about simplifying and focusing on the key parts of a business; action on simplifying inventory items, bills of material, customers, suppliers, etc. can reduce costs and get a company unstuck.

4 - Evaluate the Competitive Position (Stuck in Traffic)

A company's overall competitive position is based on its posture with competitors and from its relationships with customers and suppliers. Being ineffective or non-responsive to customers, suppliers or competitors can definitely cause a company to become stuck. Companies should 'fire' individual or groups of customers because they have a) become unprofitable, b) put unreasonable demands on the business, c) are part of a dying segment of the industry.

5 - Evaluate the Financial Condition (Stuck in the Mud)

This seems obvious, but the lack of aggressiveness (laziness, sloppiness, ignorance) around pricing, gross margins, working capital and spending can cause a company to be endlessly slopping around in their own mud. The financials can be producing 'comfortable' results, but being comfortable may not be enough to generate profits or cash needed to fund initiatives to improve the competitive position, introduce new products, shore up the plant with necessary capital expenditures, etc.

6 - Evaluate the Management Team and Organization (Stuck in the Moment)

An anonymous quote, "You can't change the past, but you can ruin the present by worrying about the future" reflects the state of mind and attitude of stuck management teams. Basically, companies get and stay stuck from a) management inaction, b) no strategic outlook, and c) too many "sacred cows".

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Are We Entering the Silly Season Again?

by Robert Tillman, Investment Banker/Tech CEO

How close are we to another hard economic reset, like those of the Bubble of 2000, the Asian Crash of 1997, the Savings and Loan Crisis of 1989 or the Stock Market Crash of 1987?

Here are some trends that we are currently seeing:

Valuations and Leverage

1. According to Venture Source, the median venture capital pre-money valuation in Q1 2005 was $15 million, the highest it has been since 2001. We bet that it will be higher yet in Q2 2005. Although we have not reached the $21 million level of 1999 or the $23 million level of 2000, we are getting there.
2. We are seeing valuations paid by private equity investors now in the 10X to 12X trailing EBITDA range. Strategic buyers are having a hard time competing at these price levels.
3. We are seeing banks finance these deals in the 7X to 7.5X trailing EBITDA range. This high level of debt financing is what allows the private equity firms to pay 10X to 12X trailing EBITDA.
4. In many instances, the private equity firms approach a deal with the expectation that they will be able to refinance within a year and then pull out all or a substantial part of their equity investment. Clearly, a deal financed in this way must continue to show substantial EBITDA growth in order for such leverage to be repaid. Such highly leveraged deals are extremely vulnerable to any EBITDA downturn.
5. As professional turnaround and restructuring people, we talk regularly to investors, i.e. lenders, hedge funds, private equity firms and venture capital firms. We also are in contact with most of the top bankruptcy attorneys around the United States and with many investment bankers. The general consensus is that there is a very large amount of cash chasing a limited number of quality deals. Almost every deal of any significant size is professionally shopped by an investment banker, resulting in a highly competitive auction situation and high valuations.
6. Most bank and investment firms report few problems in their portfolios. Bankruptcy attorneys report very slow business. Certainly, most of the 2000 Bubble deals have been cleaned or sold or have died. Nevertheless, we feel that investment firms are simply covering up their problems using the large amounts of cash currently available. Many investment firms are in the process of raising new funds and are thus reluctant to face up to the problems represented by their “living dead” portfolio companies. Even with “healthy” companies, rapid growth often masks underlying structural problems.

Worrisome Developments

1. Owing to increasingly globalized competition, there is little ability for businesses in many sectors to raise prices. In fact, prices in certain areas, particularly electronics and telecommunications services continue to fall in real terms.
2. We see cost pressure on businesses in the following areas.
   - Interest rate increases that will likely continue. In the past year, interest rates have increased 2.25%.

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- Interest rate increases that will likely continue. In the past year, interest rates have increased 2.25%.
- A more than 2X rise in energy prices over the past two years, with oil now hitting $70/barrel. Since this rise in energy prices appears to be driven by higher consumption in both China and India, it is likely to be a long-term trend. The effect of this long-term energy price rise is still percolating through the economy.
- Health care cost increases which is felt by businesses as health insurance cost increases. Part of these increases are owing to an aging population.
- Workman's compensation cost increases.
- Liability insurance increases.
- Wage escalations.
- Built in commercial real estate lease rent escalations.
- Water price increases, particularly in the Western United States (On a personal note, as the owner of 18 coin-operated laundries, I am feeling particularly the upward pressure of energy costs, rent escalations, interest rate increases and water rate increases.)

3. There is increasing evidence that we are in the end stages of a residential real estate bubble. See:
   - http://money.cnn.com/2005/01/13/real_estate/realestate_shiller1_0502/
   - http://www.economist.com/opinion/displaystory.cfm?story_id=4079027
   - http://money.cnn.com/2005/05/01/news/fortune500/buffett_talks/?cnn=yes%20Z

   Real estate price increases continue. June 2005, the national median existing home price was up 4% from the previous month alone. See:
   - http://money.cnn.com/2005/07/25/news/economy/homesales/index.htm
4. Consumer leverage is up substantially, in large part because of the real estate price increases. See:
   - http://bigpicture.typepad.com/comments/2005/05/as_prices_rise_.html

   In many instances, consumer have spent at an unsustainable level by cashing in on the equity value of their homes.
5. Other major uncertainties concern us greatly, including:
   - The potential for a major terrorist attack in the United States using some form of nuclear weapon.
   - The potential for a major global influenza epidemic on the scale of that of 1918.
   - The potential destabilizing effects of the huge increase in hedge funds and in all forms of derivative contracts. For the clearest explanation of derivatives and their consequences, see pages 12-14 of Warren Buffet's 2002 Letter to the Berkshire Hathaway shareholders:
     - http://www.berkshirehathaway.com/letters/letters.html

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- The upcoming revaluation of the Chinese Yuan, which is currently pegged to the dollar.
  - http://money.cnn.com/2005/07/21/news/international/china_yuan/
- An increasing trade deficit.
- A major ongoing budget deficit.

Conclusions

- Increasing business and consumer leverage makes the overall economy vulnerable to any sort of shock. That shock can come from one of the sources we have cited or from ones that we have not yet seen. We are not certain what it will be or when it will come, but we know from history that it will come.
- Market prices often continue to rise even when everyone "knows better." For example, Sir Isaac Newton, the Master of the Mint and likely the smartest man in England at the time of the famous Southsea Bubble foresaw a stock market crash and sold out his holding for a profit of 7,000 pounds. When the market continued to rise, he bought back in and subsequently lost 20,000 pounds. (This was at the time that the annual wage for a skilled craftsman was about 30 pounds: http://www.stock-market-crash.net/southsea.htm) People who invest on the greater fool theory often find themselves looking at the greater fool in the mirror.
- We strongly suggest that our clients review all their portfolio companies and take aggressive steps immediately to address any weaknesses.
- We also urge you to maintain pricing discipline in your investments. Based on our experience with 1999 and 2000 era funds, it is far better to miss a deal than to overpay.

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About Gerbsman Partners

www.gerbsmanpartners.com

Since 1980, Gerbsman Partners has focused on maximizing enterprise value for highly leveraged, under-performing, under-valued and under-capitalized companies and their Intellectual Property. Gerbsman Partners has also assisted numerous emerging growth and middle market companies develop and execute their financial and capital formation strategies, access the capital markets and provide for technology and life science strategic alliances and licensing of Intellectual Property. Gerbsman Partners provides the following services:

- Crisis/Turnaround Management
- Private Investment Banking
- Balance Sheet Restructuring
- Maximizing Value of Intellectual Property
- Domain Expertise – Technology & Wireless

Gerbsman Partners has been involved in transactions totaling more than $1.9 billion, in industries as diverse as:

- technology
- wireless
- bio-tech
- software
- apparel
- internet
- distribution
- telecommunications
- hotel/time share
- specialty retail
- manufacturing
- financial services
- natural services
- life sciences
- gaming

We have a wealth of experience in the capacity of "Crisis Manager" as acting "CEO" and "Chief Restructuring Officer", as a member of the Board of Directors and as an Examiner for the Office of the United States Trustee.

Thanks for taking the time to read this issue of The BoIC Talks. We hope you enjoyed it. Please visit our website for additional information and other publications or contact us at:

GERBSMAN PARTNERS
211 Laurel Grove Avenue
Kentfield, CA 94904
USA

Web site: www.gerbsmanpartners.com
Email: info@gerbsmanpartners.com
Phone: +1 415 456 0628
Fax: +1 415 459 2278

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