A Hypothetical Case: Reorganizing A Business With Second Lien Debt

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Quantum Group Ltd.

- **MICo**
  - Until 2001, when it was acquired by Quantum Group Ltd. (Quantum), MICo was a publicly traded medical instruments company
  - MICo's business consists of packaging and distributing medical instruments manufactured by third parties
  - FY 2000 Sales - $85 MM
  - FY 2000 EBITDA - $15 MM
  - $20 MM of senior secured bank debt
- **MICo was taken private by a financial sponsor in 2001**
  - The acquisition was financed partly with an equity investment by the financial sponsor and partly by a new secured bank financing

Quantum Group Ltd.

- **The acquisition of MICo closed on June 30, 2001**
  - Purchase price - $75 million
  - Quantum, a newly formed holding company, is the acquisition vehicle
  - Upon giving effect to the transaction, MICo becomes a wholly-owned operating subsidiary of Quantum
- **Acquisition financing**
  - $ 100 MM senior secured, floating rate credit facility
    - Quantum as borrower; MICo as guarantor
    - Perfected liens on all assets of borrower and guarantor
    - $75 MM term loan – matures June 30, 2006
    - $25 MM revolver (not drawn at closing)
  - Equity investment by sponsor - $25 MM
  - Use of proceeds
    - $ 20 MM to refinance existing secured debt
    - $ 75 MM purchase price to former shareholders
    - $ 5 MM retained for working capital purposes

Quantum Group Ltd.

- **Early 2003 – Quantum acquires a high margin and growing medical testing business (TestCo)**
  - FY 2002 sales - $40 MM
  - FY 2002 EBITDA - $10 MM
  - Purchase price for stock of TestCo - $ 80 MM

- **Financing for acquisition of TestCo**
  - $80 MM – Second secured floating rate credit facility
  - Interest rate 300 b.p. higher than first lien facility
  - Maturity Date – December 31, 2007
  - Both MICo and TestCo provide secured cross-guarantees of first and second lien debt
  - Intercreditor Agreement with typical restrictions on rights and remedies of second lien creditors
  - Certain of the initial second lien facility participants are also participants in the first lien syndicate (approximately 20% of the first lien facility is held by these second lien participants)

Quantum Group Ltd.

- **2003 to 2005 – Performance of MICo deteriorates**
  - Increased competition (direct internet sales by manufacturers to doctors)
  - Higher costs of inventory imported from abroad (especially Asia)
  - Price pressure from customers (cooperative purchasing by groups of hospitals)
  - Poor management (aggressive pricing to hospital chains -- money-losing contracts)
    - FY2003 - $5MM
    - FY2004 - ($1 MM)
    - FY2005 – ($7MM)
    - FY2006 – ($ 10 MM) (projected)
- **Testco continues to perform well and grow**
    - FY2003 - $11 MM
    - FY2004 - $13 MM
    - FY2005 - $15 MM
    - FY2006 - $17 MM (projected)
- **Liquidity – Quantum's revolver fully drawn late-2005**
  - Lack of liquidity beginning to constrain further TestCo growth
- **Interest rates on Quantum's debt are increasing**

Year	First Lien Debt	Second Lien Debt
2004	5.75%	8.75%
2005	7%	10%
2006	8% (proj.)	11% (proj.)

Quantum Group – Recent Results

Recent Financial Information Year-End 2005 and 2006 (Proj.)

2005	Quantum Group	MICo	TestCo
Sales	$175 MM	$110 MM	$65 MM
EBITDA	$8 MM	($7 MM)	$15 MM
Interest Expense	($15 MM)		
Capex/R&D	($8 MM)	($2 MM)	($6 MM)
2006 (Proj.)			
Sales	$180 MM	$103 MM	$77 MM
EBITDA	$7 MM	($10 MM)	$17 MM
Interest Expense	($17 MM)		
Capex/R&D	($9 MM)	($2 MM)	($7 MM)

Quantum Group – Recent Events

- **Year end 2005 - EBITDA covenant in senior facility breached**
  - In December 2005, senior lenders provide a waiver of the covenant for year-end and the first quarter
  - Interest rate under senior facility increased by 50 b.p. and company agrees to pay for a financial advisor (FA) for the lenders

- **1st Q 2006 - Impending cash crisis**
  - Negative cash flow after interest and capital expenditures
  - No borrowing capacity (revolver fully drawn)
  - Unable to fund TestCo growth
  - Vendors tightening terms
  - Selling non-core assets to meet liquidity needs
  - Unable to refinance upcoming maturity of first lien debt (June 2006)

- **Management believes MICo can be turned around when money losing contracts expire at the end of 2007**
  - $15 MM loss on contracts for remainder of their term

- **Quantum needs additional liquidity and an extension of debt maturities to give it time to turn around MICo and to support continued TestCo growth**

Quantum Group – Recent Events

- **January 2006**
  - Quantum hires turnaround consultant
- **February 2006**
  - Second lien creditors organize and hire FA
- **March 2006**
  - Quantum running low on cash
    - Quantum requests the first lien creditors to provide $ 25 MM additional revolver availability
    - Quantum requests first lien creditors to extend their maturity date to December 1, 2007 (just prior to the second lien maturity date)
- **April 2006**
  - First lien creditors offer only a $10 MM increase in the revolver and a six month extension of their maturity date (to December 31, 2006)
    - No assurances as to future cash infusions or maturity extensions
  - In response, certain second lien creditors offer $25 MM of new financing pari passu with first lien loans if first lien creditors agree to waive their negative pledge and extend their maturity through December 2007
  - First lien creditors refuse

Quantum Group – Recent Events

- **May 2006 – Quantum Board Considers Strategic Options**
- **Option 1 – Out-of-Court Restructuring**
  - Accept first lien creditor liquidity offer - $ 10 MM additional liquidity and six month extension (to December 31, 2006)
  - Sell TestCo – estimated proceeds $130 - 150 MM
  - Repay senior debt ($110 MM after new loan) by December 2006; use excess proceeds to restructure MICo
  - Restructuring Plan for MICo
    - Perform money-losing contracts (or renegotiate) – estimated loss on contracts for 2006/7 - $15 MM
    - Close two inefficient plants and consolidate production in remaining plants – estimated shutdown cost $5 MM
  - Debtor’s projection of MICo EBITDA after restructuring - $10–12 MM
  - Debtor’s estimate of TEV of Restructured Quantum - $50-60 MM
  - Est. debt capacity as restructured - $30 MM
    - In connection with restructuring, second lien creditors will receive in exchange for their claims $30MM of new first lien notes and virtually all common stock of restructured MICo
    - Notably, the financial sponsor, invited to invest additional equity in the restructuring at the projected TEV of MICo, declines to do so, privately expressing doubt that the proposed MICo business plan can be achieved

Quantum Group Ltd.

- **Option 2 -- Chapter 11 (reorganize entire company)**
  - Overall strategy
    - Restructure MICo in chapter 11 while continuing to grow TestCo
    - Extend maturity of existing first lien debt in chapter 11 plan
    - Convert second lien debt into equity of the reorganized company
  - Find DIP lender and file C.11 proceedings before June 30
    - Estimated DIP Need -- $40 MM
    - Must prime pre-petition first lien debt
    - DIP loans expected to be down to $20 MM by POR effective date
  - Possible DIP Lenders
    - Some or all first lien creditors
    - New third party lender(s)
    - Some or all second lien creditors (Intercreditor Agreement?)
  - Pay critical vendors upon C.11 filing ($15 MM)
  - Reject money losing contracts promptly after C. 11 filing, accelerating turnaround of MICo
  - Target date for exit from C. 11 – June 2007
- **Early June 2006 – Quantum files for chapter 11 relief**

Quantum Group C.11 Facts

Debtor's Projection of Cash Flows During Chapter 11 Proceedings (exit 6/30/07)

Starting Cash	None
First Day Payments (Critical vendors, utilities, etc.)	($20 MM)
Post-petition interest paid currently to first lien creditors as adequate protection	($10 MM)
MICo Operating Cash Flow (after rejection of loss contracts and admin expenses associated with plant closings)	None
Chapter 11 professional expenses paid prior to exit	($10 MM)
TestCo Operating Cashflow	$20 MM
DIP Borrowings at exit	$20 MM

Quantum Group C. 11 Facts

Indebtedness to be Addressed in Chapter 11

DIP Loan (payable at exit)	$20 MM
First Lien Lenders	$100 MM
Second Lien Notes	$80 MM
Pre-petition trade	MICo $20 MM TestCo $15 MM
Rejection claims, other unsecured	MICo $15 MM Testco $5 MM
C. 11 prof. expenses (unpaid at exit)	$5 MM
Total debt to be reorganized	$260 MM

Quantum Group – C.11 Facts

- **Bankruptcy related provisions of Intercreditor Agreement**
  - Second lien creditors consent to
    - Priming DIP financing by first lien creditors (or a third party consented to by first lien creditors)
    - Use of cash collateral to which first lien creditors have consented
    - Any adequate protection afforded to first lien creditors
    - Exercise of remedies by first lien creditors, and agree not to exercise their own remedies (including seeking relief from the automatic stay)
  - Second lien creditors waive adequate protection, except for adequate protection liens junior to first lien creditors' adequate protection liens
  - First lien is reinstated with respect to any claim arising from an avoidance recovery
  - *No provisions, however, requiring second lien creditors to vote for any plan supported by first lien creditors*

Quantum Group C.11 Facts

Debtor's (Optimistic?) Estimated Liquidation and Reorganization Values for Quantum

Asset	**Liquidation Value**	**Reorganization Value**
TestCo	$100 MM	$150 MM
MICo (going concern)	None	$60 MM
MICo Receivables (book val. $15 MM)	$5 MM	N.A.
MICo Inventory (book val. $10 MM)	$5 MM	N.A.
MICo PPE (book val. $25 MM)	$5 MM	N.A.
Totals	**$115 MM**	**$210 MM**

Quantum Group C.11 Facts

Debtor's (Optimistic?) Projected Recovery Analysis By Class

Class	Out-of-Court Deal	Chapter 11 Reorganization
New Loans	**$10 MM (Sr. Lenders) (100%)**	**$20 MM (DIP) (100%)**
C.11 expenses	**N.A.**	**Paid in ocb, plus $5 MM on eff. date (100%)**
Sr. Lenders	**$105 MM (100%) (Principal and interest)**	**$100 MM (100%)**
Noteholders	**$45 MM (56%)**	**$80 MM (100%)**
Gen. Unsec.	**Paid in ocb (100%)**	**$5 MM (13%) (Critical Vendors 100%)**
Shareholders	**Nominal**	**None**

Quantum Group – C.11 Facts

- **DIP proposals under consideration by debtors**
  - First lien creditors
    - Amount - $ 40 MM
    - Liens priming first and second lien facilities
    - Pricing – LIBOR plus 1%
    - Maturity – Earlier of March 31, 2007 or POR effective date
    - Usual adequate protection provisions
      - AP liens junior to DIP
      - Payment of post-petition interest to first lien creditors at non-default contract rate
      - Reservation of all parties' rights on default interest
      - 60 days for "scream or die" review of first lien claims by creditors committee
    - First lien creditors consent to priming by this facility but do not consent to priming by any other party
  - Third party DIP Lender
    - Amount - $40 MM
    - Liens priming first and second lien facilities
    - Pricing – LIBOR plus 3.5%
    - Maturity – Earlier of December 31, 2007 or POR Effective Date
    - AP package comparable to first lien creditors' proposal
  - No proposal from second lien creditors
- Second lien creditors own 30% of first lien facility after recent trading