Distressed M&A: Opportunities & Challenges in Key Industry Sectors

*Presentation to LACBA Business Law Section*

FTI Consulting’s industry experts express their points of view on the pandemic-affected economy
FTI Industry Experts

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Ronald Greenspan is Co-Leader of the Real Estate Solutions industry practice. He has more than 40 years of diverse international experience, applying his broad background to a wide variety of very high profile advisory, bankruptcy and litigation engagements. He advises the full spectrum of stakeholders, including investors and their lenders, bankruptcy debtors, creditors and equity interests, and participants throughout the CMBS and RMBS industries.

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Christa Hart is focused on successfully driving change within large, global companies. She has more than 18 years of hands-on experience leading organizations inside companies and acting as a consultant and strategic advisor. Ms. Hart has worked with a wide range of retailers, consumer products and beauty companies to address specific challenges, including: improving business processes and reduced costs, managing distressed business units, defining and executing product and sales strategies, exploiting new growth opportunities and gaining value from acquisitions.

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With more than 30 years of experience in the real estate industry, Cynthia Nelson assists debtors, investors, lenders and creditors’ committees in analyzing and developing plans of reorganization, analyzing financing options and market rates of interest, evaluating asset disposition and development plans to maximize value, conducting due diligence in connection with acquisition and financing, negotiating resolution of troubled credits, and providing litigation support and testimony in adversarial proceedings.

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Frank Sui is a Senior Managing Director and Financial Services practice Leader in FTI’s Business Transformation practice. Frank has more than 30 years of experience as a business builder and trusted advisor serving senior executives to improve and turn around businesses and reach financial goals at financial institutions including consumer finance, banking, payments networks, asset management/wealth management, insurance and PE portfolio companies.

Larissa Gotguelf
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Larissa Gotguelf has more than 20 years of experience in commercial real estate, restructuring, business strategy and operations consulting. Ms. Gotguelf has provided transaction and advisory services in consulting, restructuring and litigation settings to real estate investors; developers; lenders; corporate real estate users; investors in commercial, mortgage-based securities; and loan servicers. She also has extensive experience in real estate leasing and negotiations, acquisition and disposition, site selection, corporate finance, and business strategy and portfolio analysis.
The Virus has impacted industries in waves as effects have rippled through the economy

THE ECONOMIC RIPPLE EFFECT
Variables surrounding initial outbreak, detection, spread and reporting of the disease have varied significantly since January, and accurate projections are difficult to provide.

But the economic impact is rippling through industrialized nations as depicted here.
As a heavily consumer dependent economy, the US can expect lower demand and changing consumption rippling into many sectors of the economy far deeper and longer than it has since the Great Depression.

This Presentation discusses sectors and companies that we expect will be “Winners” and “Losers” in a variety of important industries. For context, begin with considering the following recovery hypotheses about key sectors that are currently impacted.

<table>
<thead>
<tr>
<th>Quickest to Recover (6-12 months post reopening)</th>
<th>Medium Time to Recover (24-60 months post reopening)</th>
<th>Permanent, Long Term Damage</th>
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<tbody>
<tr>
<td><strong>Sectors with high pent up demand and less price elasticity:</strong></td>
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<tr>
<td><strong>Live Sports:</strong> Will be impacted by lower consumer disposable income plus ongoing concerns about crowds. Pent up demand should buoy a recovery though within a year. Discussion are currently underway to play for TV cameras only to capitalize on lucrative TV advertising and at-home consumption.</td>
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<td><strong>Telecom:</strong> Some impacts are positive, offsetting some negatives. High demand for remote connectivity services.</td>
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<td><strong>Sectors impacted by sustained drop in GDP and consumer discretionary spending:</strong></td>
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<td><strong>Consumer Durables:</strong> Will get hit in second wave and not recover for 2-3 years.</td>
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<td><strong>Healthcare:</strong> The various Healthcare sectors will experience differing recovery time lines from relatively quick to medium.</td>
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<td><strong>Luxury Goods:</strong> Will get hit very hard and not recover for 3+ years.</td>
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<td><strong>Manufacturers in Supply Chains:</strong> Expect trend a little worse than 2008-09 cycle as impact primarily from recession drop in demand. Depends on sector supplied.</td>
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<td><strong>Commercial RE:</strong> Major drop given move to remote work offset by distancing needs. Expect 2-3 year recovery.</td>
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<td><strong>Residential RE:</strong> 2-3 year recovery due to consumer disposable income decline.</td>
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<td><strong>Remote Work &amp; Move to Online Creates Permanent Demand Shift:</strong></td>
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<tr>
<td><strong>Retail:</strong> Already in a long run decline before this crisis which will greatly accelerate it. Something on the order of 20-35% of all retail locations will not reopen. Will cause massive disruption in the retail real estate market.</td>
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<td><strong>Movie Theaters:</strong> Movies will permanently change as consumers get more used to online entertainment.</td>
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<tr>
<td><strong>Business Travel Related:</strong> Airlines, hotels, conferences, event cos. Unlikely to recover for 3-4 years given drop off in demand even after crisis allows reopening. Some areas with a permanent change in trajectory given success of working remotely.</td>
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<tr>
<td><strong>Advertising Industry:</strong> Big drop off in demand expected for 2-3 years. Some areas like radio and print will never fully recover.</td>
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<tr>
<td><strong>Oil and Gas Industry:</strong> Decimated in the US. May not recover to 2019 levels for 5-7 years. Shift to remote work may permanently impact demand.</td>
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**A Recovery Hypothesis**

Economists expect the downturn to continue in force into 2021 with a slow recovery beginning during the second half of 2021.
Retail & Consumer Products
Designation of essential vs non-essential companies has a significant impact on how they manage COVID-19 and who makes it to the other side.

**THE ECONOMIC RIPPLE EFFECT**

The government’s designation of “essential” and “non-essential” businesses has exacerbated the divide between the “haves” and “have nots” in Retail and Consumer Products.

Although businesses classified as “essential” have been impacted by the pandemic, they can still maintain operations and preserve cash flow. A handful of essential companies are even managing to grow during this time of crisis, notably supermarkets and manufacturers of cleaning / disinfectant products.

The reality is starkly different for companies deemed “non-essential” which have ceased operations and have tremendous pressure placed on their top and bottom line.
Retail & Consumer Products are at the center of Virus induced consumption changes

Shifts in certain spending from COVID-19 are shown below

<table>
<thead>
<tr>
<th>Winners</th>
<th>Losers</th>
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<tbody>
<tr>
<td><strong>Household care products</strong></td>
<td><strong>Beauty</strong></td>
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<tr>
<td><strong>Health and wellness</strong></td>
<td><strong>Men and women clothing</strong></td>
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<tr>
<td><strong>Personal care products</strong></td>
<td><strong>Footwear and athletic equipment</strong></td>
</tr>
<tr>
<td><strong>Pet supplies and medicines</strong></td>
<td><strong>Department stores</strong></td>
</tr>
<tr>
<td><strong>Home improvement / DIY</strong></td>
<td><strong>Luxury and fashion accessory</strong></td>
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<tr>
<td><strong>Dollar stores / value stores</strong></td>
<td><strong>Luggage</strong></td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Favorable Trends</th>
<th>Unfavorable Trends</th>
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</thead>
<tbody>
<tr>
<td>Example – Clorox, P&amp;G</td>
<td>Example – Estee Lauder</td>
</tr>
<tr>
<td>Example – Otsuka (Nature Made)</td>
<td>Example – Lululemon</td>
</tr>
<tr>
<td>Example – J&amp;J, Unilever</td>
<td>Example – New Balance</td>
</tr>
<tr>
<td>Example – Petco, PetSmart</td>
<td>Example – JC Penney</td>
</tr>
<tr>
<td>Example – Home Depot</td>
<td>Example – LVMH, Tiffany’s</td>
</tr>
<tr>
<td>Example – Dollar General</td>
<td>Example – Samsonite</td>
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</tbody>
</table>

Winning product categories with increasing demand include:
- **Household care products.** cleaning essentials, toiletries, and personal care products such as sanitizers, soaps, tissues, toilet paper, bleach, shampoos, and household cleaners
- **Health and wellness.** immunity boosters such as vitamins and supplements experiencing year-over-year sales increases of 160%
- **Home improvement.** paint, electrical / lighting, PPE, cleaning products, outdoor
- **Pet supplies.** dog food leading all other categories with year-over-year increases of 159%

Losing product categories with declining demand include:
- **Apparel and accessories.** men and women clothing, athletic equipment, and accessories sales down over 50%
- **Department stores.** department stores sales declined ~20% for March
- **Beauty.** cosmetics, salon services, specialty retail
- **Luggage.** luggage and briefcase sales down over 70% in comparison to last year

Sources: US Census Bureau, FTI Analysis
The abrupt halt in demand forced the retail value chains to adjust to volatile market conditions and demonstrate its strategic differentiation.

**Protracted implications of COVID-19**

<table>
<thead>
<tr>
<th>Demand Drivers</th>
<th>Marketing</th>
<th>Value Chain</th>
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<tbody>
<tr>
<td><strong>Shutdown of non-essential retail and rising unemployment halted demand outside of key essential retail categories</strong></td>
<td><strong>Retailers curtailed marketing and advertising spend since the shutdown, with significant increases in promotional activity expected for some retailers</strong></td>
<td><strong>Retail value chains rapidly adjusted to volatile market conditions and provided a point of strategic differentiation for some retailers</strong></td>
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<tr>
<td>■ <strong>Consumers spending less.</strong> Discretionary spending decreased over 50% since the shutdown with 1/3 of customers expecting to spend less post-COVID-19</td>
<td>■ <strong>Decreasing ad spend.</strong> Ad volume decreased significantly (traditional media down 39% and digital down 33%) as retailers pulled back; potential for advertisers to shift ad mediums going forward</td>
<td>■ <strong>Agile distribution &amp; fulfillment.</strong> Retail supply chains adopting to eCommerce-only sales while learning how to operate within the confines of social distancing, given 160-200k retail door closures</td>
</tr>
<tr>
<td>■ <strong>Uncertain employment outlook.</strong> With unemployment planned to spike at 32%, consumers are reducing cash flow and deferring purchases of non-essential products</td>
<td>■ <strong>Traditional advertising suspended.</strong> Planned marketing campaigns deferred in favor of ads focused on uniting people and brand efforts during COVID-19</td>
<td>■ <strong>Uncertain demand outlook.</strong> Inventory management at the forefront as retailers try to manage seasonal assortments and open POs with limited knowledge of how consumer demand will manifest post-shutdown</td>
</tr>
<tr>
<td>■ <strong>Work from home.</strong> Nearly all (80%) consumers working from home during COVID-19 expect to maintain some level of work-from-home after the shutdown</td>
<td>■ <strong>Rising promotional activity.</strong> Promotions / markdowns of up to 75% anticipated as non-essential retailers work to sell-thru spring and fall inventory,</td>
<td>■ <strong>Contact-free shopping.</strong> As retailers plan for the new normal post-shutdown, they must develop new strategies to support consumer desire for social distancing and a contact-free shopping experience</td>
</tr>
<tr>
<td>■ <strong>Focus on personal safety and cleanliness.</strong> COVID-19 driven concerns regarding personal cleanliness and hygiene driving 100-200%+ increases in personal care and safety product spend</td>
<td>■ <strong>Consumers are paying attention.</strong> Over 35% of consumers are connecting more with brands that are supporting employees and the community during COVID-19</td>
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</tbody>
</table>

Sources: FTI Consumer Research, GlobalData Retail, FTI Analysis
Sectors in which to expect transaction activity include beauty, holistic home cleaning, ‘comfy’ business attire and DIY

**Investment alternatives**

**Capitalize on beauty sector malaise**

**Why.** Beauty sales declined 50-60% YoY in March and April YoY as consumers abridged their daily beauty routine and stores closed, driving need for short-term financing for some brands to stay afloat

**What.**

- Specialty beauty retailers will grow as they capture market share associated with bankruptcy of traditional beauty outlets (e.g., department stores)
- Large beauty behemoths and/or beauty brands from broader personal care portfolios will face short-term cash-flow challenges; these issues will resolve over the longer term as the economy rebounds and normal life is re-established
- Carve-out beauty brands from struggling department stores (e.g., Bluemercury) or consumer product companies

**Enable a holistic home cleaning and disinfecting capability for consumers**

**Why.** COVID-19 has re-invigorated focus on living in a clean (and disinfected) home; this trend is expected to continue as consumers will not soon forget the virus

**What.**

- Consolidation of national home cleaning service providers (carpet/steam cleaning, home cleaning) provides the opportunity to provide branded, capital intensive cleaning services that differentiate from local service providers
- Industrial cleaning brands can supplement their market by providing direct-to-consumer offerings, providing the deeper cleaning that customers desire

**Capture shift in market share for ‘comfy business’ attire**

**Why.** Ongoing downtrend for business attire has quickly accelerated as consumers have shifted to working from home; we expect this change in customer preference to continue post-shut down. Consumers are embracing the desire for more comfortable, nice-looking business attire as they adjust to the ‘new normal’ work environment

**What.**

- Athletic, athleisure, and outdoor lifestyle brands will ride this trend and capture growing share of customer spending at the expense of more traditional brands

**Invest in growth and digital enablement in the DIY sector**

**Why.** Growth in the DIY market will persist as projects tackled during the shutdown provided consumers with confidence that they are capable of completing house projects and can preserve cash (and get more done) on their own

**What.**

- Hardware stores can yield significant upside through investments in operational capabilities and deeper focus on digital innovation

**Support automation of the retail value chain**

**Why.** Given the complexities of operating a warehouse during social distancing, retailers in a stable cash position will look to add automation to their DCs to mitigate operational risks in the future

**What.**

- Consumers are also looking for contactless transactions while shopping in stores. Successful retailers will look for ways to reassure customers that their stores are a safe environment
Real Estate
Understanding what is *known* and what is *knowable* about the ongoing effects of the virus on the Real Estate industry can lead to new opportunities.

**THE ECONOMIC RIPPLE EFFECT**

Variables surrounding initial outbreak, detection, spread and reporting of the disease have varied significantly since January and accurate projections are difficult to provide.

But the economic impact has rippled through industrialized nations with a similar pattern as depicted here.

All of these industries are dependent directly or indirectly on real estate for their operations—whether retail, office, industrial or special use properties. The impacts are wide-reaching across virtually all property sectors.
Ongoing effects of the pandemic will accelerate trends already in evidence, and hasten bad outcomes for under-performing and highly leveraged properties.

Change breeds opportunity whether among “winners” or “losers.”

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<td><strong>Favorable Trends</strong></td>
<td><strong>Unfavorable Trends</strong></td>
</tr>
<tr>
<td>Accelerated adaptation of technology</td>
<td>Data centers, last mile industrial</td>
</tr>
<tr>
<td>Suburbanization</td>
<td>Suburban office</td>
</tr>
<tr>
<td>Re-cocooning</td>
<td>Retailers with robust omni-channel/on-line capabilities</td>
</tr>
<tr>
<td>Market dislocation</td>
<td>Dry Powder</td>
</tr>
<tr>
<td><strong>Winning trend categories with increasing demand include:</strong></td>
<td><strong>Losing product categories with declining demand include:</strong></td>
</tr>
<tr>
<td>Large shared spaces</td>
<td>Dense shared spaces</td>
</tr>
<tr>
<td>Increase in home-based activities</td>
<td>In-person shopping</td>
</tr>
<tr>
<td>Increasing adaptation of, dependence on and loyalty to technology</td>
<td>Convention/Group Hotels; Hotels relying on airline lift</td>
</tr>
<tr>
<td>Distressed real estate assets</td>
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</table>
Opportunities may lie in privatization of public REITs and acquisition of assets from weak and secularly challenged owner/operators

### REIT Consolidation & Privatization - Opportunities

Interesting opportunities may present themselves for privatization of public REITs and acquisition of assets from weak private owner/operators, particularly those that are overleveraged and/or not operating at scale.

- Many REITs are viewed as trading below their net asset value (NAV), which means (at least in theory) the shareholders would benefit from dissolution (the sum of the parts is worth more than the whole).
- The requirement to distribute earnings challenges the REIT model that cannot “save for a rainy day.”
- REITs cannot raise capital without diluting shareholders so they can’t grow; they are not able to retain profits for growth capital.
- Private Equity may have opportunities to 1) acquire REITs, 2) be catalysts to force liquidations or 3) acquire parts of REIT portfolios.
- The cost to maintain public REIT status is staggering and disproportionate to declining asset bases; could be eliminated with privatization.
- Management opposition to being acquired notwithstanding, increasing financial pressure on weaker REITs will compel consolidation.

### Opportunistic Capital’s Shopping Spree

Before the market downturn, private equity firms were challenged to find investment-worthy deals. These firms now are taking advantage of depressed pricing to acquire assets at deep discounts.

- Private Equity return to its roots as “Opportunity Funds”; great fortunes to be made from this dislocation.
- Increased purchases of high-quality CMBS, CRE CLO, and government-backed multifamily bonds at steep discounts.
- Rescue capital to bridge owners through this crisis to stabilization; platform level recapitalizations.

But buyer beware of risks associated with distressed buying in the highly regulated COVID-19 world: The unknown future smorgasbord of government regulations affecting mortgage payment/foreclosure deferrals, rental collection and eviction necessarily impact cash flow of the borrowers who are the obligors of mortgage debt. These are particularly important considerations for distressed debt investors who have high target ROIs which are adversely affected by near term cash flow deferrals.

### Accelerated Adaptation of Technology

Consumers were forced to adjust to Instacart, Amazon Prime, Hulu, Zoom and a host of new applications and technological innovations to access necessary services.

- **Investment Opportunity**: Growth opportunities for data, logistic and industrial assets.
- **Continued Decline of Brick & Mortar Retail**: COVID-19 necessitated online transactions, which will accelerate closures of many non-essential retail stores.
- **Re-purpose of space**: Spaces will be repurposed but likely at much lower rents for community service, cultural and other purposes or entirely redeveloped for non-retail uses.
Financial Services
Opportunities in financial services during and post COVID will emerge from significant acceleration of existing market forces driving structural change in specific segments.

THE ECONOMIC RIPPLE EFFECT

Changes in consumer behavior in financial services during COVID crisis are unprecedented in scale: requesting forbearances, delinquent payments, digital only servicing and transactions.

The impact on companies has been equally unprecedented: ramping up servicing to handle forbearances and delinquencies, addressing work at home issues, managing liquidity and responding to demand shocks.

Finding investment opportunities requires looking beyond near term effects and identifying how to capture competitive advantage as COVID impacts ripple through financial services segments.
Long term winners (& losers) will emerge as a result of structural changes accelerated by the crisis

**Factors Driving Winners and Losers**

**Winners**
- Non-Bank Mortgage Servicers – Scale, Operational Excellence, & Advanced Analytics
- Integrated Mortgage Originators (w/ Servicing & Asset Mgmt.) – Scale, Adv. Analytics
- Small Business Lending Platform – Scale, Operational Excellence & Advanced Analytics
- Merchant Processors – Dominant players in High Potential Verticals Online
- Digital B2B Payment Platforms
- Debt Recovery – High Potential Asset Classes
- Technology Platforms – Work at Home Call Centers

**Losers**
- Commercial Real Estate Lenders – Retail and Office in Secondary Markets
- Indirect Auto Lending
- Retail Credit Card Issuers and Services
- Traditional Branch Banking Services
- ATM Networks, Hardware, Software, and Services
- Non-Bank Mortgage Originators and Servicers – Subscale

**Factors Driving Winners and Losers**

- Contact-free economy driving secular demand shifts
- Resilient business model players that take share from weak competitors who exit
- Accelerated adoption of disruptive attackers offering consumers and businesses a convenient, digital experience
- Accelerated change in industry structure
- Low interest rate environment

- Legacy businesses reliant on in-person transactions or support at physical locations
- Lenders dependent on consumer facing discretionary spending to drive incremental credit lines (POS credit card signups, lacking online equivalent in shopping cart)
- Upstarts with less robust underwriting experience
- Digital laggards dependent on aging user bases. COVID driving the slow technical adopters historically reliant on out-dated processes to embrace new digital processes due to COVID
Response to the virus will reward companies with greater emphasis on scale, innovation, analytics, and digital transformation

The temporary dislocation in asset prices creates transaction activity

- **Residential Mortgage Servicers and Investors**: market liquidity issues are causing servicers and investors to exit positions (e.g. MSR, CRT, Whole Loans) at distressed prices

- **Asset / Wealth Management**: valuations of public firms have declined (e.g. Focus Financial declined by +30%), resulting in private market opportunities to aggregate such firms as a long-term play

Acceleration in industry structure change concentrates value in select companies

- **Residential Mortgage Servicers**: consolidation of non-bank servicers by scale players with operational excellence and advanced data analytics

- **Small Business Lending Platforms**: in U.S. and U.K./Europe: potential opportunity to acquire "stage 1 leaders and enhance capabilities to win in stage 2" evolution - e.g., platform with high operational excellence + data science AND ENHANCE: credit underwriting + add deposit gathering/funding

- **Unsecured consumer lending**: in U.S. and other countries there is the potential opportunity to acquire platforms with high operational excellence + data science. Need to enhance credit underwriting

Resilient business models consolidate markets

- **Residential Mortgage Servicers and Originators** with integrated asset management as part of their business model will stand apart

- **Debt Collections & Recovery Services Providers** will buy newly written off debt and collect for their own account, utilizing new trends in data science to allocate capital across different unsecured assets beyond traditional credit card

Contact-free economy accelerates adoption of “digital first, myMobile app” for lending and payments

- **B2C Payments**:
  - In U.S. and other countries, merchant processors who dominate verticals that will experience accelerated online commerce - e.g., online grocery, online delivery, alternative to subways/bus transport
  - Accelerated adoption “beyond millennials” of P2P payments like Venmo, PayPal who take on the role of a consumer's banking savings and checking accounts

- **B2B Payments**: in U.S. and other countries, digital B2B payments platforms as payments by check dramatically decline - given need for people in office and cost

- **Purchase Finance at POS**: in U.S. and U.K./Europe, potential opportunity to acquire "stage 1 leader and enhance capabilities to win in stage 2" evolution platform with high operational excellence + data science. Need to enhance credit underwriting
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Transactions
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- Valuation
  - Intangible Asset Valuation
- Post-acquisition Resolution
- Integration/Synergy Planning & Execution
- Merger Integration
- Carve-Outs
- Anti-Trust Consulting
- Special Situations Investment Banking

Our Transaction professionals have a heritage of working in distressed situations throughout their careers at FTI, which allows us to take advantage of opportunities in the current environment.

Note – Any diligence and transaction related work can be performed remotely utilizing cloud based data rooms, video conferencing and other sharing technologies.

Times of Distress
- Restructuring
  - Take advantage of procedural and substantive protections offered by bankruptcy via 363 sale
  - Interim Management
  - Minimize costly bidding wars
  - Break-up and topping fee protections
  - Minimize successor liability
  - Defer/reduce tax liabilities
  - From single-asset acquisitions to complex buy-outs to minority investments
- Interim Management
- Crisis Communications
- Public Affairs
- Real Estate Optimization

Growth & Transformation
- Strategy Development & Implementation
  - Operational Excellence
  - Customer Profitability
  - Data Analytics
  - Sales Force Effectiveness
- Merger Integration/Carve Outs
- Interim Management
- Litigation Support
- Cybersecurity
- Public Affairs / Investor Relations
- Technology Transformation

WHY FTI
All our industry teams bring a combination of operational & financial know-how to meet the opportunities & challenges presented by the ongoing economic affects of the virus.

Steeped in various industry specialties, finance, operations, tax, IT and restructuring our experts are well placed to understand risks and identify opportunities.
FTI has been recognized as a leader in Distressed & Stressed companies for decades

14th Annual Turnaround Awards  
Honored in 6 Categories  
The M&A Advisor (2019)

Global Strategy Consulting Firm of the Year  

# 1 Restructuring Adviser  
The Deal (2008 – 2019)

America’s Best Management Consulting Firms  

Mega Company Transaction of the Year  
Turnaround Management Association (2019)

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~$4.5B  
Market Cap

5,500+  
Employees Worldwide

82  
Cities

27  
Countries

Advisor to 96  
of the world’s top 100 law firms

53  
of Fortune Global 100 corporations are clients

Advisor to 8  
of the world’s top 10 bank holding companies
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