December 2024

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A Director's Guide to Financial Advisors and Their Conflicts

Introduction

- Directors have duties of loyalty and care with respect to decisions made in connection with a corporate transactional process, such as, among other things, a merger, acquisition, divestiture, or restructuring (each, a "Transaction").
  - The duty of loyalty requires that directors act exclusively with a view to serving the best interests of the corporation and its stockholders.
  - The duty of care requires that directors try to inform themselves of all material relevant information reasonably available to them, and that they exercise reasonable care in making a decision in light of that information.
  - The duties of loyalty and care also encompass an obligation to disclose all reasonably available information that is material to stockholder decision-making.
- Section 141(e) of the Delaware General Corporation Law (the DGCL) provides that, in discharging the duty of care, a director is "fully protected" in relying "in good faith" on "information, opinions, reports, or statements" he or she "reasonably believes" are in the advisor's "professional competence" provided the advisor has been selected with "reasonable care."
- While not legally required, in the nearly 40 years since the 1985 seminal decision by the Delaware Supreme Court (the "DSC") in *Smith v. Van Gorkom*, the solicitation of the advice and opinion of a financial advisor (an "Advisor") has been viewed as an important element in the discharge by public company Boards of directors (including special committees thereof, a "Board") of their duty of care in connection with a transformational Transaction.
  - Although not burdened by the disclosure requirements of the Securities and Exchange Commission (the "SEC"), private companies share the same fiduciary responsibilities as their public counterparts.

The Role of the Financial Advisor

- Advisors play a crucial role by helping Boards understand and evaluate the financial aspects of proposed Transactions.
- An Advisor's role will vary depending upon, among other things, the nature and complexity of the Transaction, the significance of the Transaction to the company, and the financial sophistication of the company's management and Board.
  - At one end of the spectrum, in an outright sale of the company or a large, transformational Transaction, the Advisor may be responsible for driving the process.
  - On the other end, where a large company with a sophisticated and experienced management team and Board is making a small acquisition, the Advisor's role may be limited to providing the Board with a fairness opinion.

- **The circumstances that may call for the retention of an Advisor include, among others:**
  - Buyside and sellside M&A
  - Mergers of equals
  - Leveraged buyouts
  - Divestitures
  - Spin-offs
  - Financings
  - Restructurings
  - Recapitalizations
  - Tender and exchange offers
  - Special dividends or buybacks
  - Debt or equity financings
  - Financial transactions involving related or conflicted parties (e.g. buyback of a tax receivable agreement)
  - Evaluating (or determining) the financial terms of a security.

The Role of the Financial Advisor (cont.)

- **In general, an Advisor will help the Board understand and evaluate the financial aspects of the Transaction by providing advice as to, among other things:**
  – The reasonableness of the company's and/or counterparties' projections and enterprise values
  – The reasonableness of any quantification of potential synergies
  – The optimal capital structure of the company pro forma for the Transaction
  – The availability of financing alternatives for the Transaction
  – The pro-forma financial impact of the Transaction on the company and its stock price
  – The advantages and disadvantages of different potential Transaction structures
  – The financial merit of the Transaction relative to continuing to operate the company on a standalone, status quo basis.

- **Depending upon the nature of the Transaction, the activities undertaken by an Advisor might include:**
  – Providing market intelligence
  – Determining the appropriate process for the Transaction
  – Structuring and evaluating proposals
  – Preparing confidential offering memoranda
  – Screening potential counterparties
  – Valuing the company, the counterparty, and the consideration offered in the Transaction
  – Communicating with counterparties and their Advisors
  – Conducting diligence and coordinating the due diligence of counterparties
  – Arranging financing for the Transaction
  – Negotiating the Transaction with counterparties and their Advisors
  – Negotiating with company creditors and their Advisors
  – Assisting in the preparation of presentations to rating agencies and regulators
  – Rendering a fairness and/or other financial opinion.

The Terms of Engagement

- Given the various roles that an Advisor might play, the process by which the Board retains an Advisor can be an important ingredient in the success of a Transaction. In that regard, it is a best practice for the Board to interview multiple firms to assess their respective strengths and weaknesses.
- **Among the considerations a Board should consider in hiring an Advisor are:**
  - Industry experience:
    - An Advisor with industry experience adds value to a Transaction process. Certain industry sectors or subsectors can be highly specialized and technical and require a sophisticated and nuanced understanding of market factors to provide valuable advice. A skilled Advisor will leverage their industry relationships to provide the Board with useful insights into current valuation trends and market dynamics.
    - Depending on the role, an Advisor with relationships with the key decision-makers at a potential counterparty can have a significant impact on the ultimate price paid in a Transaction. However, such relationships need to be vetted for conflicts.
  - Relevant transaction track record:
    - Many Transactions involve complex structural, tax, financing, and accounting issues. The Board should ensure that a prospective Advisor has recently successfully completed Transactions of a similar nature and complexity.
  - Senior Advisor involvement:
    - An experienced lead Advisor with a breadth of Transaction experience can provide valuable counsel to navigate any unforeseen circumstances during an M&A, restructuring, or other corporate finance process.
  - Fee structure:
    - As described under "Advisor Conflicts," the fees to be paid to an Advisor might consist of several elements. The Board should ensure that the fees payable are "market," are consistent with achieving the objectives of the Transaction, and do not pose the risk of creating a conflict of interest (see, e.g., *El Paso, Inovalon, and Foundation Building Materials*). A prospective Advisor whose fees are materially below market should raise a red flag.
  - Conflicts:
    - As described under "Advisor Conflicts" the Board needs to consider any potential conflicts of interest on the part of a prospective Advisor that could jeopardize the Transaction and possibly impugn the reasonableness of the Board's decision-making process.
  - Chemistry:
    - Transaction processes can be lengthy and emotional experiences, and the Board should choose an Advisor they and management are comfortable working with on a day-to-day basis and are confident will provide advice based on sound judgment and with the company's best interests at heart. References should be checked to assess cultural fit and the level of client service.

The Terms of Engagement (cont.)

- Financial Advisory firms are independent contractors with no fiduciary duty to the company, or the Board or stockholders of the company. Therefore, the terms of the Advisor's engagement letter are critical in analyzing an Advisor's responsibilities to its client.
  - Both the Board and the Advisor should have a clear understanding (articulated in the Advisor's engagement letter) of the services to be performed by the Advisor.
- The typical engagement letter consists of four principal elements: (i) a description of the services to be provided, (ii) the fee arrangement, (iii) indemnification, and (iv) termination.
- Transaction fees are generally structured with a relatively small retainer, an opinion fee payable upon delivery of a fairness or other financial opinion, and a "success fee" contingent on consummation of the Transaction.
  - Sellside success fees have been sanctioned by the Delaware courts insofar as they provide the Advisor with an incentive to seek a higher value.
  - However, in some contexts, contingent fees have been questioned by the Delaware courts (see, e.g., *In re Tele-Communications, Inc. S'holders Litig.*).

Considerations for the Board: Have we structured the engagement in a manner that addresses potential conflicts? Have we incented our Advisor to achieve the optimal outcome for the company and its stockholders?

- Other ancillary Advisor fees may include a progress fee based upon achievement of certain milestones, a fee payable upon announcement of the Transaction, and a "break-up fee" payable in connection with the termination of a Transaction.
  - Depending on the nature of the Transaction, the engagement letter may also contemplate fees for additional services such as financing.
- Certain discreet roles of an Advisor may be structured as a fixed fee, such as when advising a Special Committee. An Advisor should not be overly incentivized to recommend a Transaction if no Transaction is the best outcome for the company and its stockholders (see, e.g., *Foundation Building*).
  - An Advisor should be financially incentivized to maximize the outcome for the constituency to which the Board owes its fiduciary duties.
- Typically, the Advisor will be reimbursed for its expenses regardless of whether a Transaction is consummated.
- Often, the Advisor's engagement letter will contain a "tail," pursuant to which the Advisor will be entitled to a fee in the event a Transaction is consummated within a specified period of time following the termination of the Advisor.
- Advisors manage risk by requiring clients and/or certain of their affiliates to indemnify and release the Advisor from and against losses, claims, damages, expenses, and other liabilities related to or arising out of the firm's engagement, subject to limited exceptions (e.g., gross negligence or willful misconduct).

Advisor Conflicts

- One of the most important roles of an Advisor, particularly in connection with a Transaction, is to provide unbiased advice. In that regard, a recurrent litigation theme in the Delaware courts has been the failure of directors to identify, assess, neutralize, and disclose conflicts of interest on the part of their chosen Advisors.
- **Given the scope of activities conducted by large investment and universal banks, there are innumerable opportunities for conflicts of interest to arise. Such conflicts have been found by Delaware courts to stem from, among other things:**
  - Concurrently acting in any capacity for any identified counterparty (see, e.g., *Archipelago*)
  - Past, present, and anticipated relationships with potential counterparties (see, e.g., *Presidio, PLX*, and *Inovalon*)
  - Ownership of debt or equity securities (or derivatives related thereto) of the company or of a potential counterparty (see, e.g., *El Paso* and *Brookfield*)
  - Attempts to market the company without authorization (see, e.g., *Del Monte* and *Zale*)
  - Acting as a counterparty in a hedging or structured product arrangement
  - Participation as a lender to the company or a potential counterparty (e.g., stapled financing), unless the Board believes such financing will benefit the company by facilitating a Transaction (see, e.g., *Emergency Medical, Toys "R" Us*, and *Rural/Metro*)
  - Compensation structure (see, e.g., *El Paso* and *Foundation Building Materials*)
  - Principal investments in PE funds managed by PE sponsors who are potential buyers (e.g., *Brookfield*)
  - Advising contemporaneous sellers of similar assets if the sale of such assets could be competitive with the Transaction (see, e.g., *Rural Metro*).

Advisor Conflicts (cont.)

- **If a prospective Advisor is conflicted, the Board needs to be apprised of the nature of the conflict and should carefully consider how to address it. Disclosure to stockholders is critical to the process (see "Disclosure Issues"), and a Board can't disclose what it doesn't know. Among the questions the Board should attempt to answer are:**
  - If a conflict is disclosed, would it still be reasonable to retain the Advisor?
  - Is the conflict material? What is the measure of "materiality" (see "Disclosure Issues")?
  - Are certain conflicts so material as to be disabling?
  - Are there potentially other undisclosed conflicts?
  - Can the conflict be addressed in the engagement letter?
  - Can the personal conflict of a Transaction team member create a conflict for the Advisor (see, e.g., *El Paso*)?
  - Are "informational barriers" a solution? Is there a conflict if the Transaction team is unaware of a conflict with another division of the Advisor firm?
  - Does it make sense to limit the universe of potential Advisors to boutiques to avoid conflicts?
  - Should an additional Advisor be retained to act as a co-Advisor and/or render a second fairness opinion?
- A Delaware court's answers to those questions could undermine the Board's ability to rely on Section 141(e). In that regard, in *Del Monte*, Vice Chancellor Laster opined that "[b]ecause of the central role played by [Advisors] in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court .... has examined [Advisor] conflicts closely to determine whether they tainted the directors' process."
- An Advisor's conflict can result in a related breach of a Board's fiduciary duty and can subject the Advisor to liability under Delaware law as an aider and abettor of that breach (see, e.g., *Rural/Metro, El Paso, Del Monte,* and *Inovalon*).

Advisor Conflicts (cont.)

Identifying and Managing Potential Conflicts

- In connection with the retention of an Advisor, it has become standard practice for the Board to receive a "conflicts letter," which discloses any known potential conflicts of interest that the prospective Advisor's firm may have. Disclosures should encompass members of the deal team (especially the lead Advisor) as well as the firm in general.
- **The conflicts letter should be updated and provided to the Board:**
  - Prior to engagement
  - When a potential conflict is first identified by the Advisor
  - When a potential counterparty is first identified
  - Before delivery of any fairness opinion.
- **The Board and its counsel should scrutinize each prospective Advisor firm it is considering hiring regarding past, present, or anticipated relationships with any entity they envision as a potential counterparty in a Transaction. The areas of inquiry should include, among others:**
  - the nature of any past or current relationships
  - the fees received or contemplated to be received
  - the proximity in time of any relationships
  - Whether there are any senior bankers on the deal team that are involved in other matters on behalf of a potential counterparty (see, e.g., *Inovalon*)
  - the expectation of future business from potential counterparties
  - any meaningful conversations with any potential counterparty regarding a Transaction
  - how often and how recently the prospective Advisor has "pitched" the counterparty for new business
  - Is the Advisor in possession of material non-public information about a likely counterparty as the result of a prior engagement with that counterparty?

Advisor Conflicts (cont.)

- Does the Advisor hold any interests in either the company or any of the likely counterparties, including, among other things:
  - holdings of debt or equity securities (or derivatives related thereto)
  - principal positions in private equity or hedge funds who are likely counterparties (see, e.g., *Brookfield*)
  - current lending relationships with counterparties or ones that the Advisor believes are likely to arise in the future
  - counterparty positions to hedging or structured product arrangements.
- How should we address the fact that Advisors need to balance full transparency with maintaining client confidentiality?

- The engagement letter with the Advisor should include a specific duty to update conflict disclosures (to the extent feasible consistent with the time constraints of the Transaction) and should covenants prohibit actions that might constitute a conflict going forward—e.g., prohibition against working for any actual counterparty.
- The Advisor's fee structure should be tailored to mitigate any potential for conflicts.
  - The Board should retain the right to hire a second Advisor if a conflict develops, with the fee for any such second Advisor to be paid out of the fee otherwise payable to the conflicted Advisor.
- To the extent a conflict surfaces during the course of a Transaction, the Board needs to balance the severity of the conflict against any unique experience or expertise possessed by the conflicted Advisor.
- The Board and its counsel need to determine whether the Board can reasonably rely on a conflicted Advisor to provide independent financial advice.
  - Can the conflict be cured through the imposition of an informational barrier?
  - Would the conflict be mitigated if disclosed to stockholders?

Advisor Conflicts (cont.)

- If a conflict is identified on the part of an otherwise indispensable Advisor, the role of that Advisor should be limited to the extent practicable, and the Board should carefully review any advice received from the conflicted Advisor to assess whether such advice has been influenced by the conflict.
- The Board and its counsel should consider engaging a second Advisor if a potential unexpected conflict arises during the process (e.g., a previously unidentified bidder arises during a go-shop period that has a material relationship with the Advisor). In that regard, the Board and its counsel should ensure that any second Advisor has an active role in the Transaction process (e.g., *Inovalon*) and be compensated in a way that mitigates the primary Advisor's conflict (see, e.g., *El Paso*).
  - Advisors will generally decline to render a fairness opinion if the Advisor knows it has a potential conflict unless the company obtains a second opinion from an independent, unconflicted Advisor.
  - However, there can be benefits of also getting a fairness opinion from the first Advisor.

Considerations for the Board: Have we identified and addressed any likely Advisor conflicts? Have we implemented a process to identify and address any potential conflicts that might arise during the course of the Transaction?

- As the Transaction process unfolds, the Board and its counsel should:
  - require frequent status reports regarding the Advisor's discussions with counterparties
  - closely monitor or participate in any substantive negotiations with counterparties or their Advisors
  - ensure that the written minutes of Board meetings accurately memorialize:
    - the Board's careful deliberation regarding, and rationale for determining, that the benefits of hiring a potentially conflicted Advisor outweigh the potential risks
    - the steps taken to mitigate the impact of any conflict.

The Work Product: Fairness and Other Opinions

- A fairness opinion addresses the fairness, from a financial point of view, of the consideration to be received by the company or its stockholders in the Transaction, or to be paid by the buyer.
  - The phrase “from a financial point of view” limits the scope of the opinion, as the Advisor is not opining that the Transaction is fair from a legal or normative point of view or is the best alternative strategically.
  - Only in connection with a Transaction in which the stockholders are directly receiving consideration will a fairness opinion address the fairness, from a financial point of view, of the consideration to be received by the company’s common stockholders. Otherwise, the opinion might address the fairness of the transaction to the company.
- Fairness opinions do not typically address the allocation of the consideration to be received among holders of different classes of equity securities, nor do they address the relative merits of the proposed Transaction versus other alternatives that may be available to the company (see, e.g., *TeleCommunications, Inc*. and *John Q. Hammons*).
  - If the consideration includes stock or other securities, the fairness opinion will not address the future trading prices of such securities.
- **Receipt of a fairness opinion serves two purposes:**
  - Provides the Board with relevant information to assist it in making its decision
  - Provides evidence in litigation that the Board exercised reasonable care in reaching its decision.
- **A fairness opinion is based on an analysis that presents a range of valuation indications derived from several valuation methodologies, including, among others:**
  - Discounted cash flow
  - Guideline companies
  - Guideline transactions.

The Work Product: Fairness and Other Opinions (cont.)

- **Additional analyses that an Advisor may present to the Board include, among other things:**
  - Historical stock trading analysis
  - Premiums paid analysis
  - LBO analysis
  - Accretion/dilution
  - Contribution analysis (stock-for-stock deals).
- The Board should carefully review the draft fairness opinion and board books, including changes between drafts, and should be prepared to question the Advisor on its analyses and the underlying assumptions.
  - Unless management is deemed to be conflicted, it should vet the fairness opinion presentation before it is presented to the Board to assess whether the projections and underlying assumptions are correct.
- In the context of leveraged Transactions (including recapitalizations, spin-offs, special dividends, and stock repurchases), the Board may consider it advisable to secure a capital adequacy opinion from its Advisor. In general, such an opinion is a collection of determinations on the valuation, capitalization, and cash-flow-generating ability of the company after giving effect to a transfer, dividend, repurchase, or leveraged Transaction.
  - A capital adequacy opinion is designed to assist Boards in determining the legality of a proposed dividend or distribution in light of applicable fraudulent transfer and capital surplus laws, the violation of which can result in personal liability for the company's directors.
  - Such opinions can be extremely helpful in addressing creditor claims regarding a Board's breach of duty in the event of subsequent litigation resulting from a financial deterioration of the company (oftentimes years after, and unrelated to, the transaction).

The Work Product: Fairness and Other Opinions (cont.)

- **Specifically, a capital adequacy opinion is predicated upon the satisfaction of four tests, in each case after giving effect to the Transaction:**
  - The "balance sheet" test assesses whether the fair value of the company's assets would exceed the company's stated liabilities and identified contingent liabilities.
  - The "cash flow" test assesses whether the company should be able to pay its debts as they become absolute and mature.
    - This includes an analysis of the reasonableness of the company's projections as well as an analysis of the sensitivity of those projections to changes in key variables.
  - The "reasonable capital" test assesses whether the capital remaining in the company should not be unreasonably small for the business in which the company is engaged, as management of the company has indicated the company's business is proposed to be conducted.
  - The "capital surplus" test assesses whether the fair value of the company's assets would exceed the company's stated liabilities, identified contingent liabilities, and par value of issued stock.
  - The precise language of a capital surplus opinion may vary depending upon the applicable jurisdiction and/or the nature of the entity involved (e.g., an LLC).

Considerations for the Board: Have we had enough time to carefully review and understand the Advisor's work product? Has the Advisor highlighted and explained any material changes in the Board book from prior presentations?

Disclosure Issues

- Full and accurate disclosure to stockholders of Advisor compensation and conflicts is addressed by the SEC, the Financial Industry Regulatory Authority (FINRA), and Delaware law.
- In transactions subject to the federal proxy rules, the SEC requires (in Rule 1015 of Reg. M-A) detailed disclosure of the financial analyses underlying an Advisor's fairness opinion.
  - Rule 13e-3 under the Securities Exchange Act of 1934 contains additional disclosure requirements that apply to "going private" Transactions between a company and its affiliates.
    - Pursuant to the rule, **the SEC requires that reports, opinions, and appraisals "materially related" to the Transaction**, including any reports, opinions, and appraisals prepared by an Advisor related to the fairness of the Transaction, be disclosed to the SEC staff. Such materials may also possibly be required to be publicly filed.
  - The SEC takes an expansive view of what reports are covered. The Board and its counsel and the Advisor and its counsel should be aware that documents such as Advisor Board books and other similar materials (including pitch and preliminary materials containing valuations or other substantive analyses) shared with the Board, may need to be disclosed and filed with the SEC.
  - In the context of a Transaction subject to Rule 13e-3, Advisors need to be careful about what analyses and other presentations it provides to the Board, with the recognition that any material discrepancies between iterations of such documents could be fodder for subsequent litigation.

Disclosure Issues (cont.)

- **FINRA Rule 5150 also requires Advisors to disclose, among other things:**
  - The Advisor's compensation arrangement
  - Any prior relationships within the past two years or which are contemplated between the company and the Advisor, and past fees paid or contemplated to be paid
  - Potential conflicts.
- Satisfaction of regulatory disclosure requirements may not satisfy the Delaware courts. As observed in *In re Atheros*: "[B]efore shareholders can have confidence in a fairness opinion or rely upon it to an appropriate extent, the conflicts and arguably perverse incentives that may influence the [Advisor] in the exercise of its judgment and discretion must be fully and fairly disclosed."
- Under Delaware law, stockholders are entitled to a "fair summary" of the substantive work performed by the Advisor and relied upon by the Board (see, e.g., *In re Pure Resources*).
  - A fair summary generally includes the valuation analyses performed, the key assumptions relied upon, and the range of values generated by the analysis.
  - However, subject to the applicability of Rule 13e-3, not all analyses prepared by the Advisor and given to the Board must be disclosed to stockholders.
  - The issue is whether a reasonable stockholder would consider the omitted information important in a decision pertaining to its stock
    - In that regard, stockholders need to have sufficient information to determine whether to exercise their appraisal rights, if any.
  - It is not enough that the additional information might be "helpful" to the stockholder. It must significantly alter the total mix of information available (see, e.g., *Brookfield*).
  - Whether omitted information is material is context specific and must be evaluated in light of the nature of the transaction and the other information available.

Disclosure Issues (cont.)

- The failure to adequately disclose involvement of a conflicted Advisor can negate the applicability of the business judgment rule accorded by compliance with *MFW* or *Corwin* and can subject the transaction to Delaware's exacting "entire fairness" standard of review (requiring a fair price and fair process). In that regard, the DSC has recently issued two opinions addressing disclosure of Advisor conflicts:
  - *Brookfield:*
    - The Advisor held a $470 million equity investment in the counterparty for its own account, which was not specifically disclosed. Rather, the proxy statement disclosed that the Advisor "may have committed and may commit in the future to invest in private equity funds managed by [Brookfield] or its affiliates."
    - The DSC found the use of "may" misleading inasmuch as the Advisor had an existing concurrent investment
    - Even though the investment accounted for only 0.1% of the Advisor's portfolio, the DSC indicated that materiality must be assessed from the perspective of the company's stockholders and not from that of the Advisor.

Considerations for the Board: Have we reviewed the disclosure document carefully? Is the disclosure consistent with the Board's understanding of the Transaction process, the Advisor's fee structure and any conflicts, and the Board's deliberations?

  - *Inovalon:*
    - Affiliates of the Advisor were concurrently representing the Transaction counterparty and a member of the investment consortium in unrelated transactions.
    - The Advisor disclosed that it had earned approximately $15 million for previous work with the counterparty, but failed to disclose the $400 million it earned from all members of the consortium that was investing in the transaction.
    - As in *Brookfield*, the DSC found the use of the term "may" to be misleading.
  - In each case, the DSC reversed a dismissal of the case by the Delaware Court of Chancery on the grounds of *MFW* or *Corwin* compliance and remanded the case for trial.
- Subsequent to *Brookfield* and *Inovalon*, in *Foundation Building Materials*, the Court refused to dismiss breach of fiduciary duty claims against a Board for failing to disclose its Advisors' conflicts and refused to dismiss aiding and abetting claims against those Advisors.
  - The information statement issued in connection with the Transaction failed to disclose that the compensation payable to the Advisors was tied to the amount payable to the controlling counterparty under a tax receivable agreement.
- *Brookfield, Inovalon*, and *Foundation Building Materials* highlight the importance of fully and accurately disclosing the specifics regarding an Advisor's compensation and conflicts. Such disclosure may extend to the Advisor's affiliates and to those of the counterparty to the Transaction.

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