SPOTLIGHT

GLOBAL RESTRUCTURING

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Global restructuring: view from Europe

BY CLAIRE SPENCER

Downturns generally beget restructurings, so logically, a global downturn of this magnitude would beget a correspondingly huge amount of restructurings. This has not happened on the scale anticipated. An important reason for this seems to be the almost complete lack of credit available from the banks, a situation which has prevailed in spite of a number of significant bank bailouts. But things are slowly starting to improve – very slowly. The market may have avoided a complete meltdown, but equity market recoveries to date have been tentative at best, and the distress is ever-present. As such, it is vital that complacency does not blind market participants to the significant numbers of companies that are still in dire need of financial and operational restructurings.

The restructuring landscape

Europe had been due a recession for some years before it actually hit, and it is fair to say that it is all the worse for the wait. The depth and breadth of the current downturn has taken its toll on all the countries in the region, and some have suffered acutely. But the region's major economies knew, at least to some extent, what they were in for. "The present turmoil is evolving as expected," confirms Filippo Cesaris, a partner at NCTM - Studio Legale Associato. "In the first few months after Lehman's collapse, the crisis had a considerable impact on the consumption of durable goods, the purchase of which is always postponed during a recession. Now, the crisis is broadening to non-durable goods and the spreading of the crisis towards non-durable goods sectors means that the crisis is deepening," he notes. Under ordinary circumstances, sellers of such goods would have been able to borrow to compensate for flagging consumer demand, but access to credit has been tightly restricted. As such, those with existing loan obligations have struggled to meet their covenants, and many have been forced to restructure their balance sheets, and even their operations in order to survive.

Already, this downturn has been exceptional in terms of how many companies are in this position. This is partly due to the rise of leveraged buyouts in the M&A boom, which has left a number of companies carrying more debt than they can manage. Many of these will be fundamentally sound businesses, but equally many will not. Either way, there is plenty of distress in the market, although curiously, relatively low levels of formal insolvency. This suggests that banks and other lenders are willing to be flexible for the right customers – albeit at a cost. "Finance is available, but a much more cautious approach to lending, combined with severely reduced and uncertain asset values, means that attractive terms are in short supply and the amount of additional due diligence required can significantly lengthen timeframes for refinance," notes Philip Winterborne, a partner at Clarke Willmott LLP. "Unlike previous recessions, there appears to be a more measured response from the banks, which have taken time, drawn breath, reviewed their portfolios and have only now started to steadily go through and weed out problem cus- ▸▸

tem is now recognised to be the underpinning of the coming rampant inflation heralded by the recent rise in short term rates). The result was that no one could get a handle on the banking, the insurance or the automobile industries' problems which exploded into worldwide prominence in 2008. 'To bail or to let fail' was the early question, and as 2008 ended and the Obama era began, our government showed great insight in doing some of both. Interestingly, the government required no accountability for the money it ladled out. Accountability would have required real effort, expertise and time in monitoring where the money being accounted for had gone.

The car companies were handed $25bn to show Congress and the Executive branch that they could be 'viable' and avoid having to file for bankruptcy protection by the end of March 2009, AIG was handed in excess of $100bn because everyone concluded that only AIG insiders could figure out how to undo the mess created by AIG's staff with the endless amounts of 'credit default swaps' and other derivative contracts put on their books by existing staff. Interestingly, one effect of this government largess is that, absent accountability, large amounts of money were given without supervision by AIG to precisely those banks and financial institutions the government was trying to rein in with their own TARP and other programs.

Today, with a new administration in place, we have replaced last year's fixers with – surprise last year's fixers. The names have changed in some cases, Geithner for Paulson, but the pedigrees have not. The masters of the universe are still in charge. Bernanke is still parading at the Federal Reserve touting his, as yet unproven, ability to understand and manage the intricacies of a Great Depression. If you look at the appointees at Treasury who are charged with executing the fix, they still come from Goldman, JP Morgan, Lehman (a/k/a Barclays). The public is also still being asked to take on faith that this group, which grew up, worked and played with the last group, knows what it is doing. High powered investment bankers still insist that their projections for the future should be taken as gospel pronouncements without being willing or able to demonstrate why this should be so, provide cash flow support for these projections or demonstrate that they have or can sensitivity-test their numbers.

In other words, nothing has changed – I am trading new lamps for old. Can I interest you in a new lamp? ■

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Retailers and their fight for survival

BY MICHAEL GOODMAN

With shelves stocked with inventory, the good thing about retail stores is they can use that inventory as collateral to access more debt capital than businesses in many other industries. The bad thing is that leverage can choke a retailer when the business goes sideways, often resulting in liquidations. Retailers that live and grow by asset-based lending also very frequently die by it. Unfortunately, there have been many casualties of late, as the combined forces of a contraction in consumer spending and reduced access to capital have befallen the retail sector like a plague.

For many retailers, the reduction of consumer spending has been a double hit. First, top line revenue has cratered, with many retailers seeing comp store sales declines well above 20 percent. To cover the reductions in profitability, retailers have been forced to utilise more of their asset-based borrowing capacity. In addition, the consumer spending environment has negatively impacted realisations in inventory liquidations, velocity of inventory turns and other drivers used by appraisers to calculate asset-based advance rates. With appraisals coming in lighter, the borrowing capacity for retailers can shrink overnight. The spiral begins. Just when retailers need more debt capacity to cover losses, that capacity is taken away. A solidly performing business transitions into a highly levered business into one with no liquidity and a fatigued lender.

Up until 2008, the ready solution for retailers with two much leverage was simply more leverage. Hedge funds seeking double digit yields happily pushed aggressive second lien loans that were underwritten based on the belief that there was still equity in the inventory collateral behind senior lenders that were advancing 85 to 90 percent of net orderly liquidation values. Unfortunately, many of these institutions learned the hard way that net recoveries often left them partially or fully undersecured. Now saddled with massive write-offs, these hedge funds are either not in business or have reverted to much more conservative credit criteria.

With no access to second lien loans, distressed retailers often must look to private equity. Even today, there is substantial liquidity in the equity markets for companies in transition, even in the out-of-favour retail sector. However, these firms are underwriting deals to lower leverage profiles and conservative projections, which translates into valuations that are often below the debt.

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With these dynamics in the debt and equity capital marketplace, there are few solutions available to keep a struggling retailer from liquidating. The retailers that have circumvented liquidations have been those with management teams ahead of the curve in reducing costs through headcount reductions and negotiations with landlords, thereby maintaining some profitability in spite of a deteriorating top line. We have also seen the owners of private companies write additional equity checks, although it has been more often the case with family owned businesses than private equity owned businesses. Although bankruptcy is a tool associated with the liquidation of a company, it has also been utilised well by some struggling retailers to facilitate cost reductions and equity contributions.

With continuing unemployment and restricted consumer credit, many retailers will still be facing an uphill battle for survival in 2009 and 2010. If management and ownership are proactive and are able to fight to live another day, they will find a healthier competitive landscape on the other side of the recession and will be poised to return to historic levels of profitability and growth. ■

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