

**CORPORATE
RESTRUCTURING:**
THE BREAKING WAVE

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First published 2009 by Thomson Reuters, Aldgate House, 33 Aldgate High Street, London EC3N 1DL, UK

Typeset by: Nita Webb, Bina Brown, Nicola O'Hara and Angela Allwright

Printed and bound by: Ikon Office Solutions, Berkshire, UK

CONTENTS

01 Executive summary
Restructuring kicks in

SECTION 01 OVERVIEW

Chapter 01
05 The restructuring cycle: categories of distress and lender behaviour

By Andrew Merrett, managing director and co-head, and Alistair Dick, director, European Restructuring, Rothschild

The origins of the restructuring boom
Factors leading to the increased number of restructurings
The restructuring spectrum
Lender environment and current behaviour
 Senior lenders
 Mezzanine lenders
 Sponsors and new money investors
Debt buybacks
Conclusion and outlook

Chapter 02
11 New capital structures: sponsor challenges, valuations and creditor agendas

By Jonathan Trower, managing director, and Andrew Cleland-Bogle, associate director, Close Brothers European Restructuring and Debt Advisory

Sponsor evolution
Where does the value break?
Diverse lender syndicates – differing agendas
Management incentivisation – a complex issue
Summary

Chapter 03
15 The restructuring process: key issues, stakeholder perspectives and solutions

By Matthew Prest, managing director, and Charles Noel-Johnson, executive director, Moelis & Company

Key issues to consider
Key stakeholder perspectives
 Management Boards
 Lenders
 Equity owners
Restructuring options

Refinancing and debt rescheduling
Debt to equity swaps
M&A solutions
Conclusion

Chapter 04
21 Transaction phases: from immediate needs to restructuring implementation

By Simon Davies, managing director, The Blackstone Group

Is the business salvageable and how much money does it need immediately?
Does the business have a prospect of recovering and what will that require in the medium term?
Contingency planning
What is the business worth?
What should a restructured business look like and how can that be negotiated among the stakeholders?
How can we achieve the outcome practically?
Conclusion

SECTION 02 EXPERT OPINION AND TECHNICAL ANALYSIS

Chapter 05
29 The impact of CDS and CLOs on restructurings

By Alistair Hill, senior associate, Allen & Overy

CDS and empty creditors
The rise of the CLO
 Lack of borrower oversight/declining credit standards
CLOs and restructurings
 The overcollateralisation test
 CCC buckets
 Discount obligations
 Defaulted obligations

Chapter 06
33 Liquidity, loan markets and alternative routes to capital

By Fenton Burgin, partner, Chris Skinner, director, and Floris Hovingh, assistant director, Deloitte debt advisory team

Background
The new norm
Restructuring or repricing?
Debt-for-equity versus covenant reset?

GPs versus LPs?
 Golden rule
New deals
 Alternative sources of capital
 Added value?

Chapter 07
39 Distressed debt trading, complex capital structures and securitisation

By Sonya Van de Graaf, partner, Brown Rudnick

Secondary markets and distressed debt trading
 Trading debt in cross-border situations
 Market participants
 Documentation
 Trading other assets
Complexity of capital structures transactions
 Leveraged finance
 Securitisations
 Primary components of a securitisation
 One current scenario
 Other likely future problems

Chapter 08
45 Where the debt breaks: the cost of capital, financial projections and market testing

By Robert A. Bartell, managing director, Duff & Phelps

Challenges in estimating the cost of capital in the current environment
Assessing the reasonableness of financial projections of financially distressed companies
 Is the business plan reasonable or unreasonable?
 How much 'new money' is needed to achieve the business plan?
 Is a company a going-concern without additional cash infusion?
Potential flaws of the 'market test' in the current environment

Chapter 09
51 Pensions: UK policy shifts and the role of the pension trustee

By Donald Fleming, managing director, Rachel Jones, managing director, and Tony Green, managing director, Gazelle Group
Why it is different this time

Section 75 Debts
Changing roles and behaviour
How the trustee role is developing
Where now?
Conclusion
Case study 1: Restructuring
Case study 2: Bank refinancing

Chapter 10
55 Trade credit insurance: cover reduction impact and market responses

By Andrew Cavenagh, reporter, Acquisitions Monthly

The impact of cover reduction
Credit initiatives

Chapter 11
59 Insolvency and fraud: a two-way street

By Robert Wilson, senior manager, forensic accounting practice, PricewaterhouseCoopers LLP

The hand in the till
The insolvency and restructuring overlap
New skills and tools
Tackling fraud

SECTION 03
CORPORATE SECTORS AND CASE STUDIES

Chapter 12
65 Automotive sector: survival of the fittest

By Philip Wylie, director, Houlihan Lokey

Government support is crucial
USA
Germany
Spain
France
UK
Italy
Effects of EU incentives
Comparison with previous industry recessions
Implications for insolvencies and restructurings
Banks resist debt write-downs
Subdued M&A activity – but some signs of life
Increased investment from financial buyers
Industry outlook: survival of the fittest

Chapter 13
71 Commercial property sector: predicting a fallout
By Edmund O'Kelly, real estate restructuring director, KPMG

A hard road to recovery
Case study: Modus Ventures and retail commercial real estate
Case study: Lehman's Asian real estate portfolio
Case study: JJB CVA

Chapter 14
77 Retail sector: restructuring options for struggling businesses
By Michael Rutstein, partner, Laurent Assaya, of counsel, and Christian Staps, associate, Jones Day

The UK
Company voluntary arrangement
Pre-packaged administration
Trading administration
Acquisition of under-performing businesses or divisions
Purchase of distressed debt positions
Case study: Stylo plc
Case study: JJB Sports plc
Case study: Birthdays France

New money under the ad-hoc mediation and conciliation procedures
Restructuring plan under a safeguard procedure
Sale plan under a reorganisation procedure or a liquidation procedure
Germany
Insolvency proceedings
Case study: Wehmeyer
Case study: Sinn-Leffers
Conclusion

Chapter 15
83 Airline sector: consolidation through attrition
By Andrew Cavenagh, reporter, Acquisitions Monthly

Consolidation activity
Funding issues
Acquisition and restructuring options
Conclusion

Chapter 16
87 Case study: Oilexco
By Roy Bailey, partner, and Kevin Haywood, director, Ernst & Young

Background to the insolvency
History of the company
Events leading up to appointment of administrator
Initial tasks in the lead-up to administration
Immediate requirements
Asset sale / share sale process
Company voluntary arrangement
Proposals
Completion process
Attachment orders
Implications
Outcome

Chapter 17
95 Case study: Baxi France
By Yahya Daraoui, managing director, Claude Dampierre, director, Renaud Montupet, vice president, AlixPartners, and François Hiriart, general manager, Baxi France

The situation
The approach
Devising a turnaround plan
Implementing the turnaround
A special assignment to sell a cast iron foundry
Conclusion
Viewpoint: François Hiriart, general manager, Baxi France

SECTION 04
COUNTRY REPORTS

Chapter 18
103 UK: cram-down of junior creditors using schemes of arrangement
By Jackson Taylor, partner, and Nicola Stewart, associate, Latham & Watkins

Criticisms of the current insolvency regime
Schemes of arrangement – background
Treatment of out of the money creditors
Debt release

Chapter 19
107 UK administration and receivership procedures
By Sonya Van de Graaff, partner, Brown Rudnick Administration

CVAs
Pre-packs
LPA receivership and
administrative receivership

Chapter 20
109 Germany: restructuring models, latest legislation and state aid

By Tom Oliver Schorling, partner, and Florian Brügel, partner, White & Case

Introduction
Overview of the current restructuring market in Germany
The difficulties with share pledge enforcements
The debt-for-equity model
The trust model
Failed restructurings
New legislation – legal trends
Temporary framework and state aid

Chapter 21
113 Germany: in-court versus out-of-court restructurings

By Frank Grell, partner, and Daniel Ehret, associate, Latham & Watkins

Reasons to file for insolvency in Germany
Restructuring of business in German insolvency
Reasons for out-of-court restructurings in Germany

Chapter 22
119 France: state intervention and support tools

By Sophie Moreau-Garenne, managing director, Duff & Phelps

FSI: strategic investment in France
Automotive investment through the FMEA
Credit Mediator
French banking conservatism
Conclusion

Chapter 23
121 France: M&A opportunities within restructuring

By Isabelle MacElhone, partner, and Quentin Lagier, associate, Hogan & Hartson
Corporate restructuring options
New M&A opportunities, new M&A challenges

Chapter 24
127 Spain: on to the second wave of restructurings

By Manuel Zulueta, Managing Director, and Ainhoa Landa, Close Brothers

Introduction
Capital structures in place
Untested and flawed insolvency legal framework
Unravelling corporate restructurings
Conclusion

Chapter 25
133 Italy: bankruptcy law and reforms

By Andrea Novarese, partner, Latham & Watkins

Restructuring procedures pursuant to the Italian Bankruptcy Law
The pre-bankruptcy agreement
The procedure
The debt restructuring agreement
The out-of-court debt restructuring plan

Chapter 26
137 Poland: two-level market for cross-border and domestic restructurings

By Lech Giliciński, partner, White & Case

Cross-border restructurings
Domestic restructuring – a Polish example
Amendments to insolvency legislation – consumer bankruptcy
Other new laws – Insolvency and restructuring proceedings
What constitutes insolvency?
Commencement of restructuring
Documents to be attached to the bankruptcy petition
Debtor in possession
Conclusion

Chapter 27
141 Romania: insolvency, distressed M&A, and loan-to-own strategies

By Dieter Spranz, managing partner, and David Ayres, partner, Wolf Theiss

Basic framework for insolvencies
Criteria for opening insolvency proceedings
The insolvency proceedings

Priority of claims
Effect of insolvency proceedings on debtor obligations
Rights of avoidance
Permitted or recommended pre-insolvency dealings
Loan-to-own strategies
Purchasing a controlling block of the class of shares that will control the reorganisation process
Purchasing senior secured debt
Providing debtor-in-possession financing

Chapter 28
145 Russia: restructuring in progress

By Maya Melnikas, partner, White & Case LLC

Introduction
The growing NPL problem
The legal framework of Russian bankruptcy
Conclusion

SECTION 05
151 DATA

Stock market performance
Corporate earnings and increased leverage
Interest rates
Commodities
GDP growth
Bankruptcies and debt for equity transactions – post credit boom and into restructuring
Maturing loans and defaults – post credit boom and into restructuring
LPC secondary trading data – post credit boom and into restructuring
Key dates
2008
2009

List of tables and figures

Table 6.1: Reported financial covenant amendment activity, 2009

Table 6.2: Loan buybacks with amendments, YTD Jul 2009 (%)

Table 8.1: Example equity valuation (€ 000s)

Table 8.2: Example analyst EBITDA estimates, 27 May 2009 (€m)

Table 12.1: Top 10 bankruptcies in the automotive supplier sector in Europe & North America, Mar–Aug 2009

Table 12.2: Leading acquisitions by trade buyers in the European and North American automotive supplier sectors, 2009

Table 12.3: Leading investments by financial buyers in the European and North American automotive supplier sectors, 2009

Table 13.1: Maturity profile of loans in loan book for years 2008–11 (£bn)

Table D1: Top 50 European sponsor-backed loan deals, 2003–07

Table D2: Top 50 European buyout deals, 2003–07

Table D3: European restructuring deals, 2007–09

Table D4: US restructuring deals, 2007–09

Figure 1.1: Moody's speculative grade default rate, Jan 2000–Jan 2010

Figure 6.1: Western Europe leveraged annual volume, 2000–H1 2009

Figure 6.2: Western Europe LBOs and recaps – average debt to EBITDA ratios, Q1 2002–Q1 2009

Figure 6.3: Trends by rating, Jul 2006–Jul 2009

Figure 7.1: Sample LBO structure

Figure 7.2: Sample securitisation structure

Figure 8.1: Equity valuation – the Red Zone

Figure 12.1: World industrial output, Jun 1929–Aug 1933 vs. Apr 2008–Feb 2009

Figure 12.2: Leveraged loans in payment default or bankruptcy, 1996–Jun 2009 (%)

Figure 13.1: Aggregate vale of outstanding debt, 1999–2008 (£bn)

Figure 13.2: Proportion of debt due for repayment – all lenders (%)

Figure 24.1: GDP – Spain vs. EU, 1983–2009 (%)

Figure 24.2: Unemployment – Spain vs. EU, 1983–2009 (%)

Figure 24.3: Spanish equity investment, 2004–H1 2009 (€m)

Figure D1: Share indices, Jan 2000–Jul 2009

Figure D2: Global buyout transactions, Q1 2003–Q3 2009 (US\$m)

Figure D3: Global sponsor-backed syndicated loans, Q1 2003–Q3 2009 (US\$m)

Figure D4: G7 interest rates and US Federal Fund rate, Q1 2000–Q3 2009

Figure D5: Inflation rate for G7, Jan 2000–May 2009

Figure D6: Selected commodity prices, Q1 2000–Q3 2009

Figure D7: Real GDP growth, Q3 1999–Q2 2009

Figure D8: US bankruptcy rates, Q1 2000–Q1 2009

Figure D9: UK bankruptcy rates, Q1 2000–Q1 2009

Figure D10: US restructuring deals, 2003–09

Figure D11: European restructuring deals, 2003–09

Figure D12: US speculative-grade defaults, Jan 2000–May 2010

Figure D13: EMEA maturing sponsored volume, H2 2009–2015 (US\$bn)

Figure D14: EMEA maturing sponsored volume by industry, H2 2009–2015 (US\$bn)

Figure D15: EMEA maturing sponsored volume by country, H2 2009–2015 (US\$bn)

Figure D16: DIP financings, 1999–2009 YTD (US\$bn)

Figure D17: Institutional loan pipeline, 2007, 2008, 2009 (US\$bn)

Figure D18: Loan and HY bond prices, Jan 2006–Aug 2009 (%)

Figure D19: US flow names and European loan bids, Jan 2006–Aug 2009 (%)

EXECUTIVE SUMMARY

By Quentin Carruthers, assistant editor, Acquisitions Monthly

Restructuring kicks in

Going into 2010, the expert consensus is that corporate restructurings will become deeper, more fundamental, across the board, across every sector.

To date, for the most part, 'Band-Aid' sticking plaster solutions have been used to patch up distressed companies. Transactions in 2008 were characterised by the application of short-term measures, such as debt covenant waivers and resets, sending corporate patients back out into the world as walking wounded, expected to return some day.

However, so great have been the falls in corporate value that comprehensive balance sheet restructurings, involving debt write-offs and injections of new money, are seen as increasingly unavoidable and necessary.

To give an idea of how steep certain falls have been, commercial property values are estimated to have dropped by around 50% and continue to decline under the pressure of falling rents. There have been significant restructurings already around property-based companies – not least in Spain – but the eventual realisation of commercial property losses is described as the next major challenge facing the financial world.

Undoubtedly, a watershed moment in the restructuring cycle was the 'financial crisis' – the collapse of confidence in the global banking system, triggered by Lehman Brothers' bankruptcy in September 2008, and followed swiftly by state-sponsored, emergency rescue efforts.

Since then, spilling over into the corporate world, sharp declines in trading and economic activity have been piling pressure on companies, as much so as the closure of markets and drying up of liquidity since the 'credit crunch' struck in mid-2007.

In Central and Eastern Europe it was the delayed trade shock, not the financial crisis, that began causing corporate distress in the first quarter of 2009. On a global level, the withdrawal of trade credit insurance has been a compound of the two woes, both economic and financial: that problem, though, is viewed within the trade insurance industry as a cyclical issue, albeit one with no clear turning point.

The corporate sector hardest hit so far has been automotives. In the first half of 2009, light vehicle production fell by 50% in North America and by 30% in Europe, while governments have committed about US\$100bn to prop up the job-intensive industry.

In both the automotive and the commercial property sectors, the recovery timeline may take as long as five years: for automobile production volumes to recover to 2008 levels, and for property values to recover to meet related debt burdens. Before then, further fall-outs and restructurings are expected.

In mid-2009, restructuring work went into a certain limbo, caught in transition. The interests of potential new money providers, expecting seniority in the capital structure and mark-to-market valuations, have been naturally opposed to those of existing lenders, reluctant to crystallise any further write-downs. Differences over who controls restructuring situations – who is in or out of the money and against what basis of valuation – are being tested.

Extending the stasis has been the position of CLO funds, providers of the cheap debt that fuelled the buyout boom of 2005–07, and found to be designed with little incentive to accept write-downs. As for the public capital markets, they have offered only limited recourse for companies seeking to refinance their way out of trouble.

Whatever the obstacles to swift, consensual restructurings – and they include the contrarian position of 'empty creditors', holders of credit default swaps – the pace towards full-scale restructurings is being forced by the dwindling state of corporate cashflows to the most desperate point when a company, maybe already unable to service its debt, needs cash at an operating level.

EXECUTIVE SUMMARY

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Other triggers lie over the horizon: many LBOs, for example, will find debt amortisation schedules kicking in during 2010 and 2011.

Europe's legal landscape can add to the complications. While the US has established and well-regarded legal processes for restructuring – Chapter 11 – Europe has diverse regimes with different sympathies and many largely untested laws. No wonder that forum shopping is sometimes favoured, or out-of-court settlements.

The primary goal at this stage of the restructuring cycle, for many companies, sponsors and lenders, is simply survival as much as value maximisation. Beyond that, the issue about restructured companies is how they fare going forward: Is management incentivised adequately to participate in value recovery? Will new equity holders be committed towards the business as owners? And will there be sufficient investment of money and expertise in operations to ensure a competitive edge?

If recession were to come to a definitive end, and recovery proved to be strong and sustained, then many stressed companies might make it through with their sticking plasters and their old, over-leveraged business plans. But right now, there is no sure sign of that salvation, no visibility on future performance. Instead, what vexes economists is the next big question in the systemic crisis and ensuing policy response: When and how swiftly to recall liquidity injections. Time it wrong, and you have either recession, again, or inflation.

SECTION
01
CHAPTER
01

THE RESTRUCTURING CYCLE: CATEGORIES OF DISTRESS AND LENDER BEHAVIOUR

By Andrew Merrett, managing director and co-head, and Alistair Dick, director,
European Restructuring, Rothschild

In the last two years the European market has seen a huge increase in the number of companies in financial stress or distress. The boundaries of restructuring technology and insolvency legislation across Europe are being tested as companies, shareholders and creditors all seek the most innovative mechanisms for value-recovery.

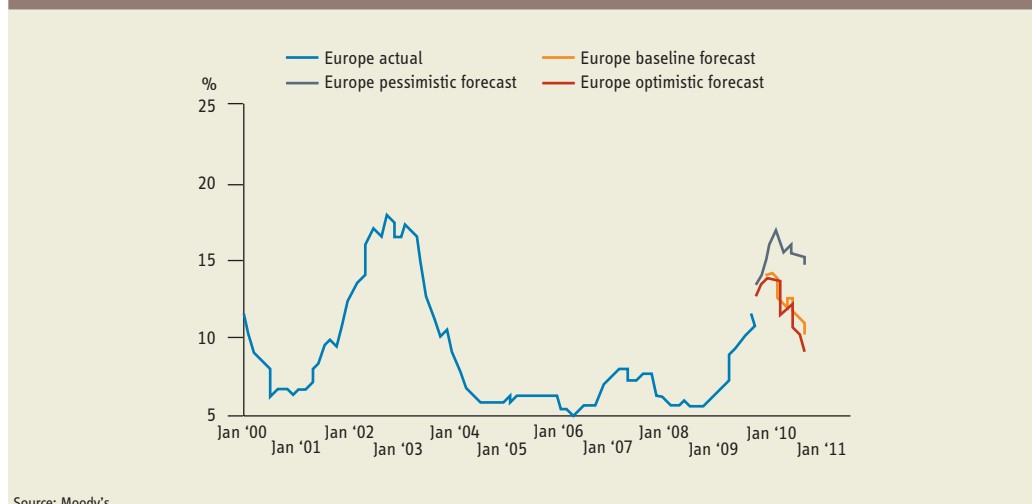
In this chapter we provide an update on some of the key issues and developments in financial restructuring and consider how they are being used in transactions in Europe today.

The origins of the restructuring boom

A financial restructuring can be defined as any corporate transaction that occurs where creditors must agree to amend the company's capital structure. Typically, this occurs when the enterprise value of a business is less than its debt and the risk/return/control characteristics of the layers of the capital structure have fallen out of line.

The forms of restructuring vary from complex corporate debt-for-equity swaps, through business disposals, through to new money injections by existing or new stakeholders. The trigger is often a default or the risk of default on the terms of a company's borrowings – this may be either technical in nature (e.g. not meeting financial covenants), or more fundamentally, and increasingly commonly, running out of cash.

Figure 1.1: Moody's speculative grade default rate forecast, Jan 2000–Jan 2011
(as of Sept 2009)



Source: Moody's

Since 2007, cyclical sectors have been most vulnerable: construction, real estate, hotels and leisure, retail, consumer goods and advertising related sectors. However, the global nature of the current economic downturn has hit traditionally more resilient sectors and left few safe havens.

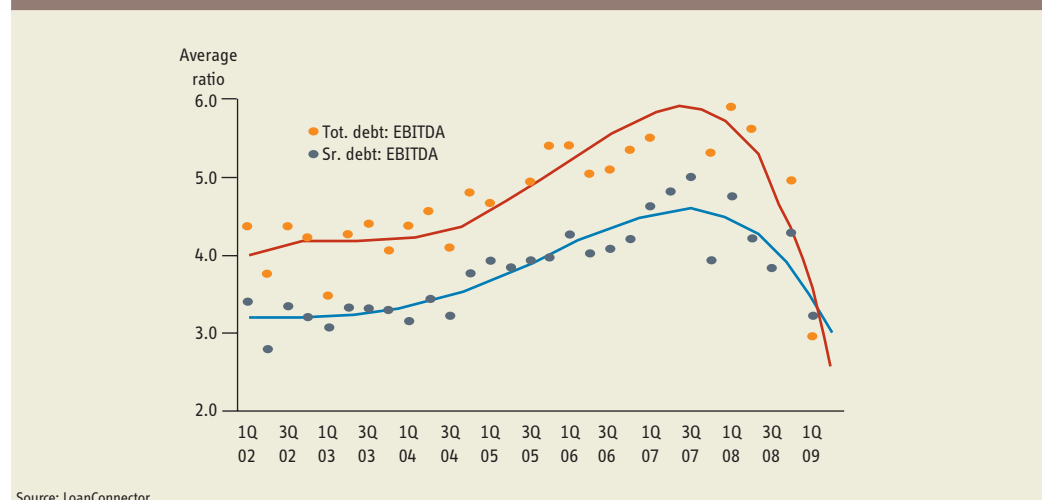
Even governments have been drawn into the restructurings – state-led bailouts of the financial and automotive industries have taken place in Europe and the US. General Motors, RBS, Lloyds TSB, Citigroup and Goldman Sachs are just some of the recipients of government support including direct capital injections and asset protection schemes, as they have sought to repair damaged balance sheets and ride out the sustained adverse trading environment.

characteristics and was a relatively 'easy' sell with the majority of the syndicate members simply rolling over from what could be seen as off-market cheap pricing to on-market pricing.

Whilst there have only been a limited number of leveraged finance deals in 2009 (e.g. Kalle Nalo, Wood Mackenzie, NDS, Bodycote, Bol.com and Terveystalo), we see the following trends in structuring:

- ▶ Lower multiple: While for smaller buyouts 3.0x senior and 4.0x total debt is the norm, better credits attract higher multiples;
- ▶ Higher equity contribution: Lenders will require at least an equity buffer of 40–45% in new transactions; however, one will find that lenders start negotiations with a higher number;
- ▶ Higher pricing: Market clearing pricing seems to have settled down at around 425–475bp over for the amortising Term Loan A and 475–525bp for the Term Loan B. Mezzanine pricing remain in the mid-teens, whilst sponsors are still tending to resist warrants on larger mid market deals;
- ▶ Shorter term: Six-year amortising / seven-year bullet, without a Term Loan C, seems to be the structure of choice with the latest completed deals rather than the 'pre-crunch' 7/8/9 term loan maturity; however, we will need to see if this structure becomes the norm of the 'new world';
- ▶ Less refinancing risk: Amortising A loans now typically represent c.45–50% of the total structure versus one-third of the senior debt 'pre-crunch';
- ▶ Participation fees: Substantial upfront fees (up to c.500bp) are offered to lenders for primary deals, partly to compensate for any drop in price in the secondary market;
- ▶ Non-call: Significant numbers of mezzanine transactions have non-call features. Prepayment fees on deals without a non-call feature are typically c.250bp in year 1 and 150bp in year 2 respectively.

Figure 6.2: Western Europe LBOs and recaps – average debt to EBITDA ratios, Q1 2002 – Q1 2009



Restructuring or repricing?

The biggest impact of the banking crisis and the subsequent economic slowdown will undoubtedly be felt on those 2006 and 2007 transactions whose covenant package was structured using business plans which, with the benefit of hindsight, were overly aggressive.

When faced with a difficult trading update from an investee company, UK lenders are typically reviewing the business along the following lines:

1. What is the likely time to covenant breach/default?
2. What is the underlying reason, i.e. is the cause an internal/external issue or is the company simply overleveraged?

SECTION 02 WHERE THE DEBT BREAKS: THE COST OF CAPITAL, FINANCIAL PROJECTIONS AND MARKET TESTING

CHAPTER 08

By Robert A. Bartell, managing director, Duff & Phelps

Never before has valuing debt or equity been more complex in consensual restructurings or non-consensual formal court processes. ‘Where the debt breaks’ is the threshold that often dictates the actions of senior lenders, mezzanine lenders, and companies. In fact, where the debt breaks can determine the whole restructuring process.

Table 8.1 provides a simple equity valuation of a highly levered company that maintains an EBITDA below historical performance and is in an industry experiencing lower than normal EBITDA multiples.

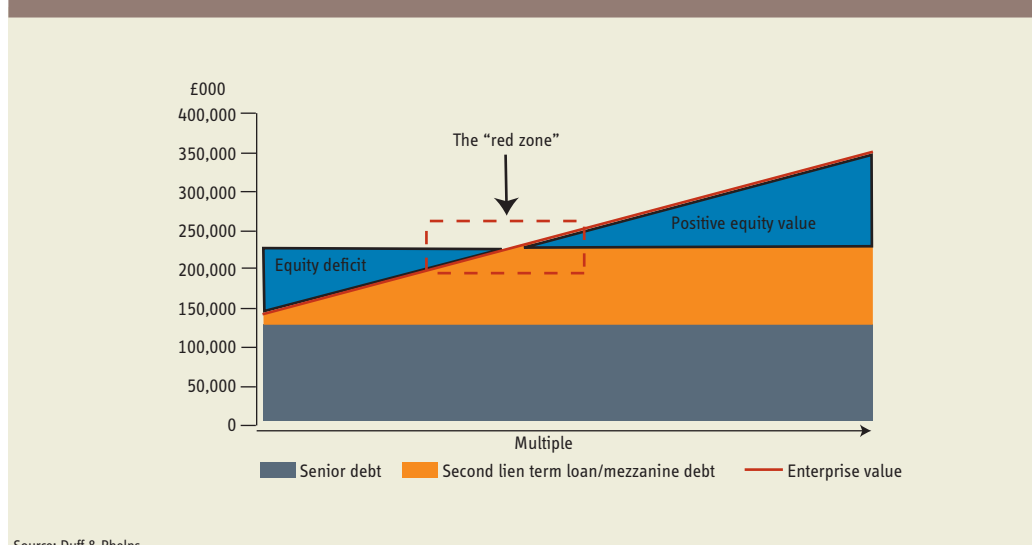
Table 8.1: Example equity valuation (£000s)

	Multiple EBITDA	Valuation assuming		
		Going-in multiple 7.0x	Current multiple 4.0x	Projected multiple 5.5x
Going-in EBITDA	50,000			
Current LTM EBITDA	35,000			
Projected EBITDA	42,500			
Enterprise value range (rounded)		350,000	140,000	233,750
Less: senior debt		(125,000)	(125,000)	(125,000)
Aggregate equity value surplus/ (deficit)		225,000	15,000	108,750
Less: second lien term loan/mezzanine debt		(100,000)	(100,000)	(100,000)
Aggregate equity value surplus/ (deficit)		125,000	(85,000)	8,750

Source: Duff & Phelps

A graphical representation, as given in Figure 8.1, further demonstrates the importance of understanding the intricacies of valuing a company. Selections are even more critical if the value falls within the ‘Red Zone’, in which slight adjustments to the applied multiple or the selection of an EBITDA will affect the result as to where the debt breaks.

Figure 8.1: Equity valuation – the Red Zone



Source: Duff & Phelps

on loans, financial restructuring and bankruptcies in the automotive sector are expected to rise throughout 2009 and into 2010.

An additional difficulty for the automotive sector is that many banks have the sector on their blacklist for investment. This means that debt financing is extremely difficult and potentially impossible to source for those with a volatile track record.

Subdued M&A activity – but some signs of life

Looking at the M&A environment, overall activity in the European market has fallen by over 50% (in deal numbers) in the first half of 2009 versus 2008. With enterprise values down by as much as 50%, the reality is that the value of the M&A market is running at about 25% of historic highs. Given that banks earn fees as a percentage of deal size, the pie for investment bank M&A departments has shrunk dramatically. The demise of many bulge-bracket banks has taken some of the capacity out of the market, leaving the remaining banks and boutique advisory firms to fight over the remnants.

In the European and North American automotive components sectors, there has been a slight recovery in M&A in the second and third quarters of 2009, compared to the last quarter of 2008, with the bulk of the deals not surprisingly stemming from restructuring. Trade buyers, particularly from developing countries, have been picking up assets that are strategically attractive to them (see Table 12.2).

Table 12.2: Leading acquisitions by trade buyers in the European and North American automotive supplier sectors, 2009

Announcement date	Target description	2008 revenue (estimated)	Bidder
Aug 09	ArvinMeritor – wheels division	US\$280m	Iochpe-Maxion (Brazil)
Aug 09	Edscha – roof systems division	€375m	Webasto (Germany)
Apr 09	Vredestein Banden – tyre producer	€300m	Apollo Tyres (India)
Mar 09	Delphi – suspension & brakes activities	US\$650m	Beijing West Industries (China)
Mar 09	Visiocrp – mirror systems	€660m	Sumi-Motherson (India)

Source: Houlihan Lokey research

Increased investment from financial buyers

Financial buyers, with particular expertise in restructuring, have also been active (see Table 12.3) in the automotive component sector, in some cases picking up businesses at bargain basement prices.

Table 12.3: Leading investments by financial buyers in the European and North American automotive supplier sectors, 2009

Announcement date	Target description	2008 revenue (estimated)	Bidder
Aug 09	Metaldyne – powertrain & chassis	US\$1,570m	Carlyle & Solus
Jul 09	Delphi – conglomerate	US\$18,800m	Elliot, Silver Point & Monarch Alternative Capital and others
Jul 09	Michel Thierry – auto textiles	€245m	HTP & FMEA Investments
Jun 09	ArvinMeritor – Gabriel Ride Products	US\$200m	Open Gate Capital
May 09	Sator Holdings – parts distribution	€275m	H2 Equity Partners
May 09	Peguform – interior & exterior plastic parts	€1,400m	Cross Industries
Apr 09	Honsel – cast alloy parts	€700m	Ripplewood (recapitalisation)
Apr 09	TMD Friction – brake friction	€640m	Pamplona
Mar 09	Autodistribution – parts distribution	€1,100m	Towerbrook
Feb 09	Avon Automotive – hoses	US\$240m	Crystal Capital

Source: Houlihan Lokey research

The proposed CVAs were ultimately voted down by the landlords since the proposal would have put them in the undesirable position of subsidising Stylo's other creditors, who would be paid with the money the landlords would concede. They also believed that it was likely, even if the CVA had gone ahead, that under continuing pressure they would lose their tenants in the subsequent few months anyway. However, commentators believe that the key reason for the rejection was that the landlords were worried about setting a precedent which other struggling retailers might follow. The property industry intended to send a clear message to the retail sector – that CVAs were not going to be an easy way out.

Following the rejection of the CVA proposal, administrators were appointed over the listed parent company, Stylo, and the core profitable elements of the business were pre-packed to an entity owned by the chairman of the Stylo group, with the non-profitable stores closing.

Case study: JJB Sports plc

JJB Sports, the sports equipment retailer, was struggling with a combination of a high cost base and low sales. In contrast to the rejected CVA proposed by Stylo, JJB proposed a CVA to its creditors on terms that the landlords of closed stores would be able to claim from a fixed pot of £10m on two payment dates in September and December 2009 and that the terms of the leases for the open stores would be varied to permit monthly, as opposed to quarterly, rental payments. The CVA was approved by 99% in value of creditors, saving the retailer from administration. Early engagement with the landlords, and other creditors, is said to have been the determining factor for the success of the JJB CVA. The success of the CVA also showed that most landlords are coming to the view that CVAs will not be rejected out of hand.

Case study: Birthdays

Birthdays owned over 330 stores nationwide selling greeting cards and related products. A combination of high rentals and reduced trading made its business uneconomical, although many individual stores were profitable and viable. Birthdays had to rationalise its store base but the cost of doing so outside insolvency was prohibitive and so it entered into administration. The administrators traded the business for a month and sold 196 of the stores as a going concern.

France

The current financial downturn has crept into every sector of the French economy, including the retail sector. Out of 60,000 formal insolvencies in the past year in France, about 13% of the total have arisen in the retail sector.

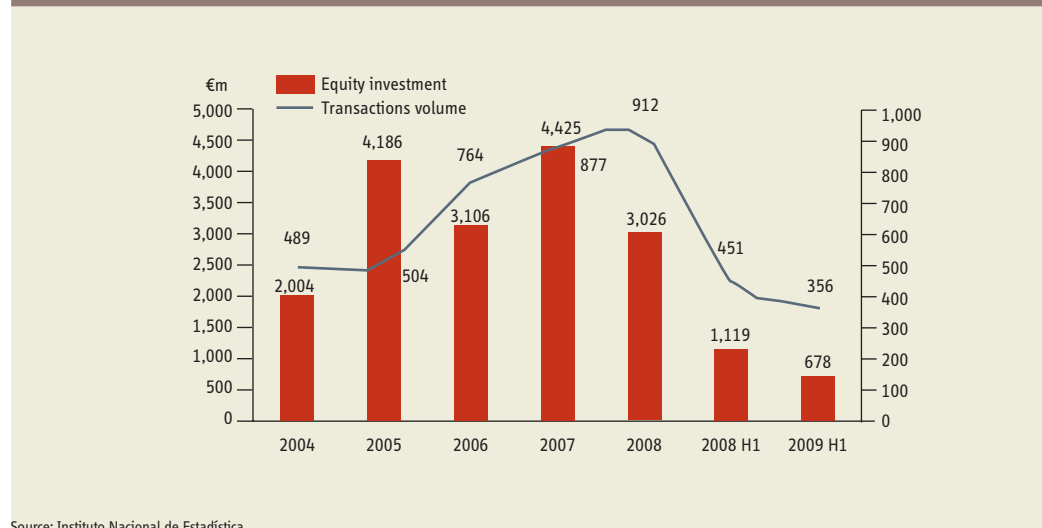
France's insolvency law provides for the following procedures for restructuring a distressed retailer.

New money under the ad-hoc mediation and conciliation procedures

The ad-hoc mediation (*mandat ad hoc*) and the conciliation procedures (*conciliation*) are two out-of-court confidential pre-insolvency proceedings that are widely used to restructure distressed businesses in France. In each case, the management has the right to request that the President of the Commercial Court appoint a mediator to help the debtor to reach a voluntary agreement with its creditors or investors. In practice, the conciliation procedure can be extremely effective in distressed M&A transactions because new money investors benefit from a 'super priority' (*privilège de conciliation*) over the debtor's other liabilities if the French court publicly approves (*homologué*) the conciliation agreement entered into by the debtor, its creditors and the new money investor.

Examples of these include Amadeus, ONO, Panrico, Cortefiel, Telepizza and Parques Reunidos. Most of the international investors taking positions at different levels in these complex capital structures never gave adequate thought to the possibility of being exposed to the untested Spanish insolvency regime and the impact of the centre of main interest for many of the borrowers being Spain rather than the UK.

Figure 24.3: Spanish equity investment, 2004–H1 2009 (€m)



Source: Instituto Nacional de Estadística

Untested and flawed insolvency legal framework

The Spanish insolvency framework or '*Ley Concursal*' was passed into law in 2003 to unify the old insolvency and bankruptcy proceedings into a single process. This new framework has, however, barely been tested with only a few small companies entering into '*Concurso*' since its inception. In contrast with the UK regime, the Spanish framework has a focus on preserving the business as an ongoing concern and hence limits the ability of creditors to enforce their rights.

This new legal framework, which was not viewed as a problem by international lenders during the years of economic expansion, is now one of their worst nightmares. *Concurso* is a lengthy (current expectation of at least two years) and uncertain process, resulting in a business liquidation in most cases.

Companies only embark on this procedure as a last resort; directors fear the impact that a filing has on clients, suppliers and short-term financing triggering claims from different stakeholders. Creditors know that *Concurso* will mean very little recovery at an unknown future date.

The first sector to test the insolvency regulation was real estate; *Martinsa-Fadesa* filed for *Concurso* on 14 July 2008. Over a year later, there is still no composition agreement.

Unravelling corporate restructurings

As mentioned previously, many companies are facing the consequences of excessive indebtedness. Unlike previous downturns, it is not only an issue of breaching covenants and a need for new funds to continue operating, but also a significant imbalance between the value of assets and liabilities.

Spanish banks are heavily exposed to the real estate sector, financing all layers of the capital structure and all asset classes; including residential and commercial speculative developments, rental assets, corporate loans and margin loans to equity investors.

The first red lights came on when margin loans came under pressure; some institutions enforced them and took large stakes in public companies (e.g. *Colonial*, *Martina-Fadesa*). However, banks were generally reluctant to take these stakes, as they would suffer equity subordination on any other credit they made available to the company if their equity stake was more than 5%.

Interest rates

From 2000 to 2003, the United States Federal Reserve lowered the federal funds rate from 6.5% to 1.0%. This was done to ease the effects of the recession of the early 2000s and the September 2001 terrorist attacks.

The resulting easy access to credit over this period and the overconsumption by investors and consumers alike has been identified as one of the key contributory factors in the development of a housing bubble.

The Fed eventually raised the Fed funds rate between the second quarter of 2004 and third quarter of 2006 which affected one-year and five-year adjustable-rate mortgages (ARM). As a consequence ARM interest rate resets became more expensive leading to increased defaults and ultimately to the financial crisis.

The Fed rate was dropped in the third quarter of 2007 in response to the onset of the financial crisis and has dropped for seven successive quarters and currently stands at 0.18%, a total drop of 5.07% from the third quarter of 2007.

Figure D4: G7 interest rates and US Federal Fund rate, Q1 2000–Q3 2009

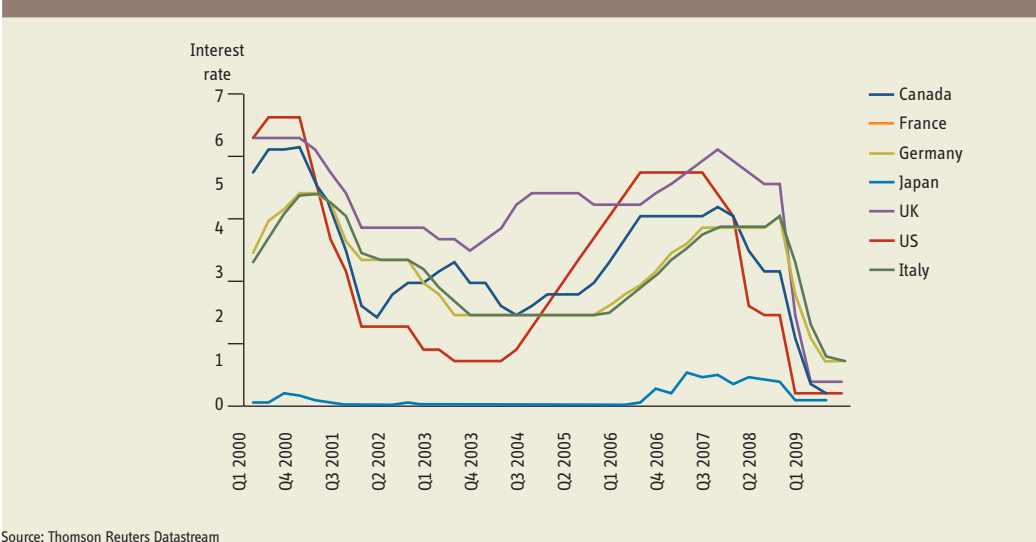


Figure D5: Inflation rate for G7, Jan 2000–May 2009

