LOAN WORKOUTS AND DEBT FOR EQUITY SWAPS

A Framework for Successful Corporate Rescues

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FOREWORD

When I was approached to provide a foreword to this book I was enthusiastic for two reasons.

Firstly, I have known the authors personally for many years, having worked with them on major cross-border reconstructions which of necessity involved working into the early hours of the morning in crisis situations. Such was the desire and commitment to achieve a beneficial outcome for all stakeholders outside insolvency. The authors have extensive knowledge of the strategies and techniques required to achieve equitable and successful workouts, and these are shared in this book.

Secondly, although workouts cannot be too prescriptive, I have long believed that a book of this nature was needed in the market place, outlining the principles of voluntary problem debt standstills and associated restructurings and documenting the methodologies which have been established by experienced practitioners over the years.

Although the recessions of the 1970s and early 1980s saw instances where corporates entered insolvency proceedings or were involved in rescue operations mounted by their bankers, subsequent UK recessions have seen an unprecedented level of problems in terms of the number of cases, the magnitude of debt and the degree of complexity involved. Despite high profile collapses, in the vast majority of cases a successful recovery has been engineered to the benefit of all the stakeholders involved in each business.

Many lessons have been learned and re-learned during this period. At the same time, whilst standard procedures have arisen to deal with most cases, the level of general expertise required and flexibility necessary to produce solutions has, of necessity, increased to a considerable degree.

The rescue or 'workout' process will in most instances broadly encompass the various phases outlined below. It has been consistently proven that the earlier a problem is identified/predicted, particularly if this can happen whilst relative stability still exists, then the quicker and, in all likelihood, the more successful the turnaround will be.

These steps effectively cover a three-way process:

- The identification/early warning of distress and an initial assessment of viability.
- The support operation encompassing standstill principles and including, as necessary, a full financial restructuring.
- The recovery process and the commercial measures needed to achieve a turnaround/ rescue.

From an overview of major corporate distress seen in the market place, over the years, there is a clear commonality of some factors.

The root often starts with the quality of executive management and their entrepreneurial propensity to grow the business, together with the inability of the supporting team to cope with an expanded empire. Aggressive acquisitions and diversification programmes, especially into unknown overseas markets, supported by increased debt has crippled many companies. Often these companies have been headed by dominant individuals and/or there has been founder/family involvement.

The problems have then frequently been compounded by poor cash management and deficient internal controls and management reporting, a general trading downturn of the core businesses (particularly in a recessionary environment) and a collapse in property values.

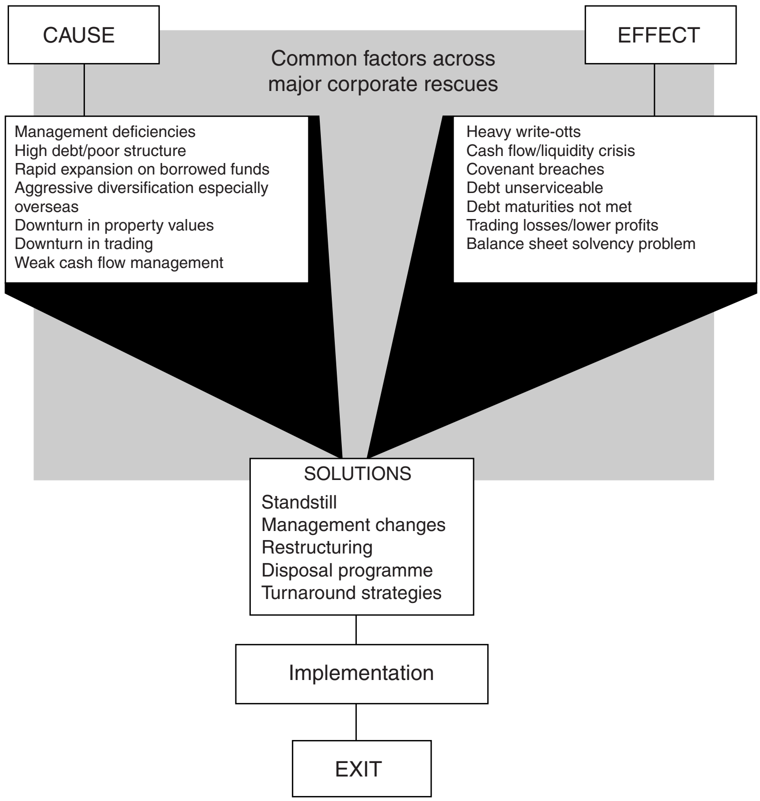
In addition, creative accounting techniques can send up a smoke screen which delays the identification of problem situations. Indeed this can end up as gross misrepresentation and/or fraudulent activities, and there have been some high profile cases which illustrate this.

However, even in these situations there can be a viable underlying business or part of a group worth rescuing outside insolvency.

It would be amiss not to mention the important role of non-executive directors in providing a truly effective, independent counterbalance both strategically and operationally (for example in ensuring that adequate management reporting and audit systems are in place), with a view to helping avoid the characteristics seen in corporates in difficulties.

Ultimately, the effect of the problems referred to is to render debt unserviceable with breaches or impending breaches of covenants, cash flow shortfalls and a heavy write down of asset values against net worth. The bottom line to an impending collapse is that the company eventually and simply runs out of cash.

The general scenario of cause and effect and solution can be summarised as follows:



Whilst any voluntary approach requires flexibility on a case-by-case basis, there are clearly defined parameters which need to be adopted to achieve a successful result where time is of the essence, and this book helps to enshrine the tried and tested approaches which have developed over time.

Fundamentally, a workout emerges from the general premise that voluntary support for a distressed multinational corporate is likely to be better than insolvency to preserve value, and accordingly there needs to be a high level of co-operation and communication amongst lenders on a cross-border basis.

This voluntary approach has been encapsulated in a formalised statement by the INSOL Lenders Group:

> In the event of financial difficulties being experienced by a multinational corporate the major financial creditors should act in a co-ordinated manner to facilitate short-term viability and stability whilst confirmation of the present position of the debtor and relative positions of the creditors is obtained in a timely and cost effective manner enabling the available options to be presented, assessed and a way forward agreed upon.

Put another way, a rescue culture on which this book is based can be defined as the spirit of co-operation, understanding, support and commonality of approach of lenders on a cross-border basis outside formal insolvency or court rehabilitation processes that facilitates an attempt to preserve value for all stakeholders where a commercially viable multinational corporate enterprise is confronting financial difficulties.

Importantly, lenders need to avoid failure of potentially viable businesses for want of reconciling competing creditors' interests.

Apart from a company addressing its underlying commercial trading problems a critical area of any workout is the complexity of inter-creditor priorities.

Lenders will need trust and confidence in a rescue process and this will include the experience and abilities of the co-ordinator or leader as well as the adoption of established principles on a consistent basis.

More specific issues which will need to be addressed include:

- *Identification of key participants and their relative contributions to a restructuring.* The increasing diversity of financial instruments available and markets accessible to corporates inevitably leads to an equally wide variety of providers. Therefore, whilst historically there may have been a fairly narrow group of participants in workouts this is no longer the case, with a far wider range of creditors who now have the right to become involved. For example, high yield bonds are an increasingly common feature in the European market. However, this brings certain obligations for them to participate in the process. Indeed in any workout it is appropriate that all major financial creditors/creditor groups whose rights are likely to be affected be involved in the support operations.
- *Moratorium or standstill/stay.* Given the fact that a corporate has reached the position where it is in need of a support operation from its creditors, this suggests that matters have become or are close to becoming critical (the likelihood is that the directors will have tried everything they can to avoid having to enter a workout). This is likely to mean that willing and unilateral support has been tried and failed and as such the overall situation is highly unstable. To give time to assess the position and the options open to lenders and the corporate it is essential that a stable environment is established. At the broadest level this will involve a moratorium (standstill/stay), but there are a number of associated issues that will arise in the context of achieving such a state, particularly where the corporate operates across national boundaries.
- *Sufficient and reliable information to enable judgements to be made.* Information must be shared and produced in a timely manner. The need to make decisions on an informed basis is fundamental to any credit assessment process. This is particularly important in the case of potentially highly complex multinational corporates with multiple operations and creditor arrangements. It is essential to obtain a sound information base both in the context of the status and prospects of the corporate and creditor relativities and to provide the base for decisions on the provision of new money and the overall restructuring.
- *Independent professional review of the financial position, viability and options.* It is essential to obtain independent advice for the benefit of the lender group and this may need to be accountant, lawyer and investment banking advice.

- *Appointment of a co-ordinator or leader*. Experience shows that there is a need to approach support/workout situations in a co-ordinated and timely manner, particularly where a corporate has a broad range of financial creditors and/or operations (be that type or jurisdiction). This is important on a number of fronts to ensure that:
  - Inter-creditor relativities are maintained.
  - The corporate and its advisors have a main point of contact for dealing with creditors. This provides the reassurance the directors may need to satisfy themselves they can continue rather than seeking the protection of the relevant court procedure.
  - The potentially scarce resources of the corporate are focused on finding a solution rather than 'fire-fighting' with creditors, which should save costs and may provide a swifter solution. This also focuses on the need for the co-ordinator to possess the appropriate skills, experience and resources to chair the committee, take responsibility for overall co-ordination and drive for a solution.
- *Usually provision of short-term liquidity and/or continuation of existing facilities*. The cash position of a group has to be established as an absolute priority. In order to achieve stability and allow time to obtain information to make a decision on the way ahead, some form of short-term liquidity needs to be achieved, usually involving new money and/or the release of headroom in facilities and/or disposal of surplus unencumbered assets and/or deferment of interest.
- *Understanding and acknowledgement of the relative strength of differing claims*. This is often referred to as entity priority positions and is vital for drawing up a notional liquidation model and for preparing the restructuring plan and facility agreement.
- *Understanding local jurisdiction issues*. In order to devise appropriate workout strategies some knowledge is required of local jurisdiction issues relating to group operations in those countries. For example, the relevant local voluntary rescue cultures and processes, rehabilitation and insolvency legislation will impact on a rescue plan.
- *Voting structures*. Voting structures will need to cover issues requiring either all-lender agreement, majority lender or individual agreement. There is clearly a need to reach agreement on a number of issues relating to a workout, and these range from covenanting aspects (e.g., restrictive covenants on capex, inter-company trading/loans, etc.) through to matters of more fundamental lender rights (e.g., term, pricing, new money, etc.). Whilst understandably all affected parties will want to have a say in these issues, it is clear that unless agreement can be reached the attempt to achieve a workout/rescue will fail. Therefore this is a critical area for debate which necessarily impacts directly on all other areas of a workout. Importantly, no approach outside legislation can remove the rights of a lender, and therefore any understanding reached on voting will be purely voluntary and not mandatory.

These above mentioned ingredients will all be needed to lead to the ultimate objective of a successful restructuring plan.

International debt problems have been around for decades, but there have been new developments driving a more sophisticated and consistent approach, namely:

- Increasing complexity of financial structures both in types of facilities and diversity of global credit providers and, for example, capital market instruments.
- Evidence of increased internationalisation of corporate borrowers with complex legal structures.
- Emergence of a more active debt trading market beyond that established in the US, which has brought new players into the equation who may have a different agenda depending on their entry price and exit objectives.
- Timescales for workout periods have tended to lengthen as a result of increased complexity.
- More active use and acceptance of debt to equity conversions in restructuring solutions.

Arguably this has further endorsed the need for a strong co-operative rescue culture.

Indeed realistically we cannot look to any global harmonisation of insolvency laws in the short- or even medium-term which would at least give a uniform backdrop for a rescue. This to me wholeheartedly endorses the importance placed on voluntary approaches and the methodology required in these cases.

In one of my previous roles as Head of Credit Risk Management at Nat West Bank and as Chairman of the INSOL Lenders Group established to take a leadership role in encouraging and developing cross-border support, co-operation and communication, I have been a strong advocate of a rescue culture approach and standardisation as far as possible of the principles involved whilst retaining some flexibility on a case-by-case basis.

These views also transcend into the need for corporates themselves to seek appropriate independent financial advice at the earliest signs of distress or impending financial problems. These need to be competent professionals who understand all the issues on both sides of the table (debtor and creditor related) for an equitable and timely solution for all stakeholders.

This book covers all the issues I have mentioned above, and more, detailing how workouts can be achieved in practice taking into account all the many variables and including an insight into ways of running a workout department.

I commend it to readers whether they be new or more experienced practitioners.

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Subhrendu Chatterji is a consultant specialising in corporate and financial restructurings. He also advises on financial sector and banking strategy. He has advised UK banks on a large number of loan workouts, with a particular emphasis on debt for equity swap aspects of transactions. In addition, he has lived and worked in Central Europe for over four years, directing consultancy projects and advising banks on organising loan workout departments and on their non-performing loan resolution strategies. He also advised local banks on the financial restructurings of their large clients. In addition to the United Kingdom, Subhrendu's country experience includes Australia, China, Poland, Romania, Tanzania and Turkey. He has organised and participated in a number of seminars on commercial, investment banking and financial stability issues and has published articles on corporate restructurings in professional journals.

Prior to becoming a consultant, Subhrendu was with NatWest Markets, an investment bank, and worked on corporate acquisitions, disposals, flotations and fund-raisings. He is a Fellow of the Institute of Chartered Accountants in England and Wales, a qualified Corporate Treasurer and has an MBA from Oxford University.

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Paul Hedges

Paul Hedges is a Senior Manager with the Royal Bank of Scotland. His career with NatWest Bank, prior to its takeover by the Royal Bank of Scotland, spans twenty years, primarily in corporate banking and more specifically since 1989 in the credit risk and debt workout areas. During the early 1990s' recession in the UK, Paul was closely involved with a number of loan workouts involving large corporates, particularly those involving multiple banks. His focus is particularly on the structuring aspects and inter-creditor issues involved in senior debt moratoriums and restructurings.

In the early 1990s, Paul spent two years living in Poland advising a major Polish bank on creating and managing a debt workout department and on individual company restructurings.

Since returning to the UK Paul has worked in NatWest's and the Royal Bank of Scotland's senior credit functions with responsibility for approving and reviewing many of the bank's largest corporate, leveraged and mezzanine exposures as well as maintaining a close working relationship with the bank's loan workouts department.

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