# BUSINESS TURNROUNDS

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# Happy days are put on hold

Restructurings are down and refinancings are taking centre stage, but there are concerns about the outlook, writes **Anousha Sakoui**

**Balancing act: Endemol, the company behind Wipeout, has hit the headlines in recent months. Shown is the US version, produced by ABC** Getty

The new year has potentially heralded a fresh start for the corporate world. Many companies are emerging from the "great recession" with stronger balance sheets, record cash piles, and – possibly – the worst of the crisis behind them.

"Companies have weathered the storm, reduced costs, shed non-core assets, and managed working capital better," says Peter Briggs, managing director of Alvarez & Marsal, the specialist restructuring firm.

"They have been given no fresh money, but they have survived by pushing the day of reckoning on their debt maturities further out. That has suited both banks and companies."

There are still some potential debt renegotiations that are catching the headlines. Punch Taverns, a UK pub company, Endemol, a Dutch broadcaster and Eircom, an Irish telecom company, are just a few situations where companies have hired bankers to assess their options.

But the number of restructurings is well below its peak in Europe in the fourth quarter of 2009, according to data from LCD, the debt specialist, part of Standard & Poor's. While there are still some restructurings to be worked through, many restructuring specialists say the market is quiet again.

"There is still a small number of large restructurings working through the market, but otherwise the level of restructuring mandates is down on the past year to 18 months," says Peter Marshall, co-head of European restructuring at Houlihan Lokey. "I expect we will continue to see a much lower level of activity. A big focus will be on companies' ability to refinance maturities in 2012 to 2014."

Philip Davidson, global head of restructuring at KPMG, says that in the US the restructuring market is the quietest it has been since before the summer of 2007, a result in part of abundant liquidity.

"Over the past six months insolvencies have fallen further," says Mr Davidson. "That should be taken as a good sign, but while you would now expect people to become bullish about the recovery, oddly that is not the case. I don't detect any optimism. People are just waiting and seeing. There aren't signs of growth emerging."

And investors in distressed debt paint a similar picture.

"With banks patient and economic growth better than expected, refinancings are dominating at the moment," says Theo Phanos, founder of Trafalgar, a credit fund. "Tough restructurings and true distressed situations are currently modest in number."

There are, however, concerns about the outlook. In particular, these relate to a possible oil price shock driven by recent instability in the Middle East and rising interest rates.

"People are desperately worried about the impact of government spending cuts, rising unemployment and interest rates," says Mr Davidson. "The fear of rising interest rates has significantly curtailed corporate enthusiasm to spend and the same applies to individuals. We are in real danger of knocking along the bottom in the doldrums for an extended period of time."

Mr Davidson believes this year could be a repeat of last, with many companies that have been hanging on for the recovery starting to come under pressure.

Alan Bloom, global head of restructuring at Ernst & Young, says rising rates will increase the number of companies that need to be restructured or may fall into insolvency.

"Until now, it has been the historically low interest rate environment that has kept many businesses afloat," says Mr Bloom. "Any business dependent upon the consumer is finding it tough in the UK.

"With increased commodity prices and the prospect of significant redundancy arising from the government cuts, the consumer is having to be far more discerning. A lot of our activity is in areas that are dependent upon discretionary spend – hotels, leisure, being particularly prevalent."

For many companies, there are still challenges ahead. While credit markets have reopened to many companies, Mr Bloom believes the availability of credit for all but the best companies is scarce.

> 'People are desperately worried about the impact of government spending cuts, rising unemployment and interest rates'

"The strong have definitely got stronger in the past two to three years, have taken some tough decisions and are now well positioned for growth. The weak, on the other hand, have suffered very considerably and in many economies we are experiencing a much greater disparity between the strong and the weak," he says.

Donald Featherstone, partner at AlixPartners, another turnround specialist, expects that eastern Europe and the Middle East will see a robust and sustained level of restructuring activity.

Many companies battened down the hatches to get through the recession, but the situation is now different.

"This financial crisis has had everyone's attention, but the world has not stopped changing," says Mr Briggs. "So just having an economic recovery alone doesn't help companies; they too have to change. For restructuring, there's a balance sheet aspect and increasingly a focus on whether you have a competitive business and have kept up with the developments in your industry, while you've been hunkering down financially."

One of the questions those businesses may face is whether to move capacity or distribution to low-cost regions to be competitive.

And it is not just cost pressures that companies face. Technology and patterns of consumer demand have changed, and advisers say companies need to react to these changes.

"The message is 'reinvent or die'," says Steve Frobisher, business turnround expert at PA Consulting Group. "Most companies are not the lowest-cost producer in their sector and these businesses face the risk that their customers have already changed their behaviour.

"The key to reinvention is to create a portfolio of winning businesses. Companies must refocus on potential winners, harvest capital from value-diluters, right-size their capacity and exit likely losers."

Mr Featherstone at AlixPartners says he sees market leaders consolidating, in particular in the oil and gas sector and shipping.

"Corporate restructurings are providing a number of opportunities for stronger players to acquire market share at relative attractive price," he says.

One pressure for companies will be any impact on consumer demand.

The recovery in credit markets has helped eat away at the wall of maturities that companies face. One big focus for restructuring bankers is a wave of debt maturities coming due in coming years.

"Despite an unsettled global economy, pent-up liquidity in the debt markets is making this a good time for many companies to refinance," says Christian Savvides, managing director at Rothschild.

"However, the outlook is still uncertain for those that are overleveraged, underperforming or in difficult sectors and in some cases looming debt maturities will trigger restructuring."

Dan Schwarzmann, partner and business recovery services leader at PwC, says companies need to pre-empt what their banks and other stakeholders are looking for.

"Regular dialogue and relationship building with key stakeholders needs to happen to understand fully their pressures and how they might impact companies' objectives," says Mr Schwarzmann.

"Companies should also keep an eye on the basics, which are often overlooked. Many companies focused on cash management when the crisis hit.

"However, where increased scrutiny from stakeholders is expected, companies should ensure that forecasts and reporting are accurate and robust and allowances are made for pressures such as interest rate and commodity price rises."

# Economic upturn may bring more bad news

Insolvencies

**Hal Weitzman** and **Daniel Pimlott** look at the effect of recession on two of the world's biggest countries

The number of insolvencies in this recession in the US and the UK may – so far – be smaller than expected but some think this may be the calm before the storm.

A rise in interest rates on either side of the Atlantic, or continuing high oil prices, could tip many companies over the edge.

Paradoxically, a freeing up of credit markets could result in an increase in the number of bankruptcies because companies could see an exit strategy.

In the US, the fate of Borders, the bookstore chain that filed for bankruptcy last month, is the latest event to show how the recession has changed the high street.

The recession particularly hit sectors such as banking, manufacturing, construction, property and media.

The number of corporate bankruptcies actually dropped last year from about 61,000 to about 56,000, the first decrease in five years. Of these, industry experts say there have been fewer "mega-bankruptcies" of the size of General Motors and Lehman than many had expected at the start of the crisis.

Even the increase in business bankruptcies in 2009 – up 40 per cent on 2008 – was modest compared with the 61 per cent increase between 2007 and 2008, and in line with the 43 per cent increase from 2006 to 2007.

Mark Berkoff, chairman of the financial restructuring and bankruptcy group at Neal, Gerber & Eisenberg in Chicago, explains that, counter-intuitively, there were relatively few large Chapter 11 cases at the peak of the financial crisis.

Lenders preferred to defer bankruptcies and extend loan terms, since business valuations were so low.

"Bankruptcy is an expensive business tool," Mr Berkoff notes. "It only works if there's an exit strategy – typically, either reorganisation or sale."

Although the volume of bankruptcies slowed last year, the trend could yet be reversed. If oil prices stay high, industries such as transport could be affected. Moreover, if US interest rates were to rise sharply, many debt-laden companies could find themselves further under pressure.

In addition, Aaron Hammer, head of the bankruptcy group at Freeborn & Peters in Chicago, says banks appear to be increasingly unwilling to tolerate bad loans on their balance sheets, which could signal an uptick in Chapter 11 filings. He notes the pace of bankruptcies appears higher so far this year compared with 2010.

**A high-profile casualty**

Mr Berkoff echoes that, predicting the economic recovery could lead to a wave of bankruptcies. "If there's more liquidity available, you'll see more bankruptcies," he says. "It would become a viable business tool because debtors would have exit strategies."

The picture in the UK appears to be similar.

Fewer companies have collapsed than might have

**Continued on Page 4**


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# Lessons in navigation yet to be put to the test

**Container shipping**

**Robert Wright** says the sector's rocky times may not be over

The empty, idle container ships that started to fill sheltered bays and unused wharves during 2009 were powerful symbols of a trade slump that took container shipping by surprise.

At the depth of the crisis in the first months of 2010, the industry, which had been used to breakneck growth rates, had more than 10 per cent of its ship capacity sitting unused.

The shipping lines that operated many of the vessels were faring still worse, as were many of the ship owners that leased ships to the lines.

Many lines and owners faced the imminent prospect of insolvency without support from governments, shareholders or their main creditors.

Yet, barely a year after the crisis was at its worst, the bays and harbours are virtually empty of laid-up ships. Many shipping lines, having suffered record losses for 2009, published record profits for 2010, buoyed by a sharp rebound in demand. Some ship owning companies are again considering ordering new vessels.

However, most observers believe the worst downturn in container shipping's 55-year history has left indelible marks on the industry that will affect profoundly how it develops in future.

Claus-Peter Offen, who owns of one of the world's largest fleets of leased container ships, told a conference in Hamburg in February that most owners had spent the past two years "getting the ship around the rocks".

"Now, when most of us have more or less settled these processes, we will be starting again and seeing what will be happening in the future," he told the Marine Money German Ship Finance forum.

Container shipping's storm brewed up partly because demand to ship containers, which had risen every year since the first container ship sailed in 1956, shrank by at least 10 per cent in 2009.

It was far more fierce because the fall came as ship owners were preparing to receive a wave of huge new ships ordered before the sector's good times came to an end.

Ship owners not only suffered from the depressing effect of capacity expansion on the rates that they could charge, but also struggled in many cases to arrange finance.

Even ship owners who had already arranged the finance for new vessels faced demands from banks for extra cash because the ships' falling value reduced their worth as collateral.

Robert Yildirim, the Turkish businessman whose $500m cash injection helped rescue France's CMA CGM, which operates the world's third-largest container ship fleet, portrays the worst-hit shipping lines as hapless victims of market circumstance.

"We knew the company came to this position not because of its fault but because of the industry situation," he says of CMA CGM's problems. "It was a global crisis."

CMA CGM, says Mr Yildirim, had simply ordered a large number of vessels at the wrong time – just before the economic crisis hit.

"The vessels' value went down and the company didn't have enough money to make it up," he adds.

It was, nevertheless, mostly aggressively expansionist lines that faced the biggest problems, as they were forced to finance significant payments to shipyards just as they moved into loss. Many were forced into devising innovative ways of reaching a financially sustainable position.

As well as raising $770m in fresh equity through rights issues, Chile's CSAV offered some of the many Hamburg-based ship owners from whom it chartered ships equity stakes in the company in return for reduced day-to-day charter rates.

"Down the road, we see the stakeholders better off than they were before the crisis and the company in a new competitive position, looking at its future in a different way," Rafael Moreira, CSAV's finance director, told the Hamburg conference.

Israel's Zim was also forced to ask the owners of its chartered ships – particularly the Ofer family, who control the Israel Corporation, its parent – to accept reduced charter rates in return for equity in the business.

The company also raised $700m in equity to fund its ambitious fleet expansion programme.

"We've come a long way since the crisis of 2009," says Allon Raveh, Zim's chief financial officer. "Our financial performance has improved dramatically."

The aggressive lines that ran into trouble in the downturn, ironically now look in far better shape than the more cautious lines that avoided the need for a bail-out, either because of their financial strength or their small order book.

CSAV's fleet has gone from 16th largest at the start of 2009 to sixth-largest now, according to Alphaliner, the Paris-based consultancy.

Denmark's Maersk Line, operator of the sector's biggest fleet, has complained about the market distortions created by the various bail-out deals, as well as the state support extended to some lines, including Germany's Hapag-Lloyd.

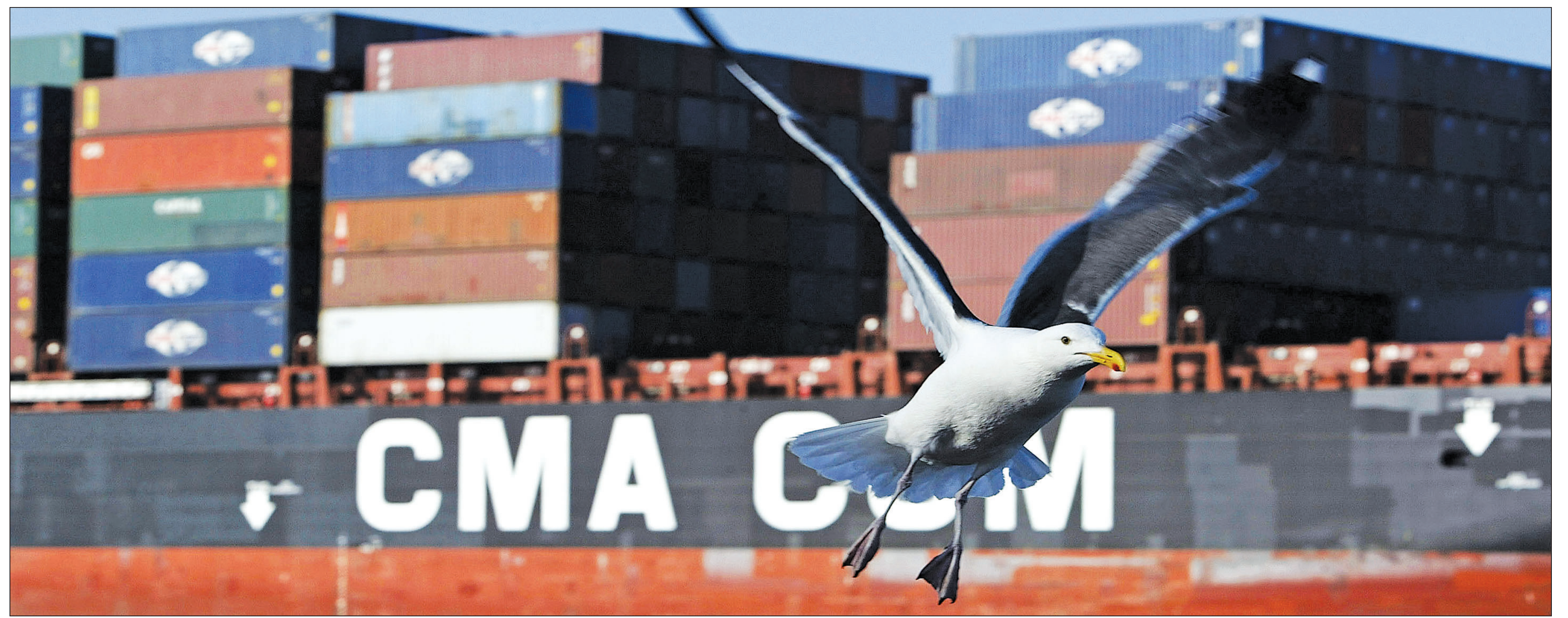
Mr Raveh denies that Zim has gained special advantages through forcing down its charter rates in the depth of the recession.

"Many of the lines renegotiated charter rates," he says. "I don't think Zim did anything exceptional."

Yet it may not be long before the restructured lines have to show they learnt the lessons of the recent downturn and can handle another one calmly.

Paul Dowell of Howe Robinson, a London shipbroker, described to the Hamburg conference how shipping lines and ship owners were awaiting container ship deliveries that would increase the world's fleet capacity by 24 per cent. Yet, demand to move containers this year was expected to grow by only a modest 6.9 per cent.

"Don't be blinded by the apparent light at the end of this tunnel," he warned.




Port in a storm: the businessman whose $500m cash injection helped rescue France's CMA CGM portrays the worst-hit lines as hapless victims of market circumstance Getty

# Rush to sell non-core assets risks flooding the market

**Banks**

**Sharlene Goff** examines the difficulties of such widespread restructuring

Banks around the world are taking an increasingly aggressive approach to restructuring their businesses in the face of an era of constrained profitability as tougher regulation starts to bite.

Many of the US and European banks that were hit hardest in the financial crisis are already deep into drastic overhauls that will see them shed hundreds of billions of dollars of unwanted assets over the next few years.

Now that the immediate aftermath of the crisis is behind them, banks are bracing themselves for a sea change in regulatory legislation that will demand they hold far higher levels of capital against their risky assets.

Even the banks that did not require state bail-outs are looking to rebalance their businesses by cutting capital-intensive activities and taking a more scrupulous view of the returns generated from individual divisions.

Daniel Meere, a financial services specialist at PA Consulting, explains that the banks' restructuring efforts fall into two categories.

"First, those imposed by regulators or as a condition of public ownership, for example offloading branches or specific business units. Second, those that address strategic imbalances, for example cutting back operations in non-core markets," he says.

The latter is largely a response to increased pressure on profitability.

During the recent results season, a disconcerting trend emerged for bank investors.

While banks mainly reported considerably improved performances for 2010, as loan impairments fell sharply, the news was countered by a number of downgrades to their future profitability targets.

Credit Suisse, the Swiss bank, together with Barclays and HSBC in the UK, cut their expectations for targeted return on equity by up to a fifth, while many of the big US banks also made moves to temper investor expectations.

These banks are targeting a return on equity of up to 15 per cent compared with previous expectations of a number in the top teens.

"Poor underlying core profitability is a critical issue," says Steven Pearson, a business recovery partner at PwC.

"Extensive and ongoing cost reductions, as well as increases in product pricing, will be required to ensure the banks can deliver sustainable profit growth."

In the UK, the profit downgrades have followed a wave of management changes in recent months. Barclays and HSBC both promoted the heads of their investment banking divisions to become the chief executive at the start of the year, while Lloyds brought in a new head this month. The new bosses have launched root-and-branch reviews of their businesses.

> As the global economy recovers, banks are having more success in finding buyers

As well as strengthening their capital bases and boosting profitability, banks are also having to reshape their funding profiles, as they attempt to meet new regulations requiring them to hold a greater proportion of liquid assets.

Many are simultaneously weaning themselves off cheap central bank finance.

While significant changes are afoot in banks such as Barclays and HSBC, the most radical restructurings are taking place at institutions that required direct government bail-outs.

These banks are having to shrink their balance sheets drastically, siphoning off huge portfolios of legacy loans that triggered large losses.

As stricter regulation threatens to make certain assets more expensive to hold, some banks are trying to pick up the pace of restructuring this year. Royal Bank of Scotland, for example, the UK bank that is 84 per cent owned by the government, is two years into a five-year plan to sell or wind down £250bn worth of non-core assets.

In February, it announced it had made faster than expected progress last year in reducing non-core assets and it cut the target size of its non-core asset base this year from £118bn to £96bn.

Another development is that, as the global economy starts to get back on its feet, banks are having more success in finding buyers.

Citigroup, the US bank, which is working its way through a mammoth disposal programme that will see it remove more than $800bn (£500bn) of non-core assets, recently sold to Barclays its portfolio of 1.15m Egg credit card customers, which had been on the block since last summer.

Citi has now sold more than $400bn of assets since the first quarter of 2008.

However, efforts to speed up asset sales are threatening to flood the market with buying opportunities, potentially triggering a downward spiral of prices.

PA's Daniel Meere

Already one of the largest bank restructurings – that taking place in Ireland – has been put back because of a lack of appetite. among buyers.Irish lenders are being forced to sell as much as €140bn of assets, including portfolios of mortgages and small business loans in the UK as they shrink their balance sheets to a more sustainable level.

But the authorities have pushed back the disposal, as they fear that selling now would trigger too severe a loss for the banks.

"A lot of loan assets are available to investors, which has served to drive prices down and make disposals more difficult to complete for value," says Mr Pearson.

"Losses on any sales will likely require new capital, which is priced at a premium to historical levels."

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# Day of reckoning approaching for the have-nots

**Refinancing needs**

Gravity may be about to apply to overleveraged companies, writes **Jennifer Hughes**

When Del Monte came to the market last month with a $4.75bn bond offering to fund its buy-out by Kohlberg Kravis Roberts, the deal was notable for more than just its size or the storied names it involved.

Included in the offering were so-called "cov-lites" – bonds with few restrictions on the borrowers that had come to symbolise the excesses of the pre-crisis credit bubble.

The US food group is not alone. So far this year, cov-lite loans have accounted for about a quarter of all new US leveraged loans – a rate above the level reached in their 2006 heyday.

With junk-rated bond issuance running at record levels and the return of cov-lites, it could appear as if the financing woes of struggling companies are over. But that would be a mistake; watchers warn that the real "credit crunch" may be only just beginning for many groups.

"There's a huge spike in companies' refinancing needs and, at the same time, banks are still having to deal with their own regulatory capital position, so we're talking about a real supply-demand imbalance for capital," says Keith McGregor, a partner in Ernst & Young's corporate restructuring practice in London. "In lots of ways there is still a real battle for capital and it is only just beginning to heat up."

Banks' own struggles are well known, but as Mr McGregor says, those problems are still very much part of the landscape, as lenders try to shrink their existing loan books, let alone raise the funds for new loans.

This is particularly acute in Europe, where many midsized companies have traditionally relied on a group of banks rather than the capital markets, only to find their former friends are cool on the idea of fresh financing.

For the better positioned companies, the market is willing to provide new friends. Household names and those with strong investment stories can tap private placement specialist investors or, if their needs are big enough to interest the public markets, sell junk bonds. They have been doing this in record amounts.

> Lenders have eased loans in what the industry calls 'extend and pretend' or even 'delay and pray'

But that is only for the best companies – the "haves", perhaps, since there are also a large number of "have-nots" whose day of financial reckoning could be drawing closer.

Although default rates have fallen heavily from their recent crisis peak, many suspect that is because lenders have been prepared to ease covenants and extend loans in what the industry calls "extend and pretend", or, even more cynically, "delay and pray".

"Eventually, gravity takes over," says Peter Briggs of Alvarez & Marsal, the restructuring specialists. "If you're overleveraged, you may have been able to keep the plates spinning, but the banks can't stretch much further for the have-nots. Even as the capital markets come back, lenders are going to have to spend time on – and invest money in – these work-outs."

The upshot is that the better companies face another set of competitors for what fresh funds are available. On top of accepting losses on their existing loans, lenders to troubled groups might have to put up fresh cash to have any hope of seeing their investment recover fully.

"Most companies have done all the right things – managing working capital, selling non-core assets – but you can only do that for so long if you want to grow your enterprise value. Companies need to be moving forward at some point," says Mr Briggs.

Talk of a looming "wall" of refinancing needs has been particularly strong in Europe. From less than €10bn ($13.8bn) this year, refinancing needs will jump to €40bn by 2013 and leap half as much again in 2014, according to data compiled by Fitch and PwC.

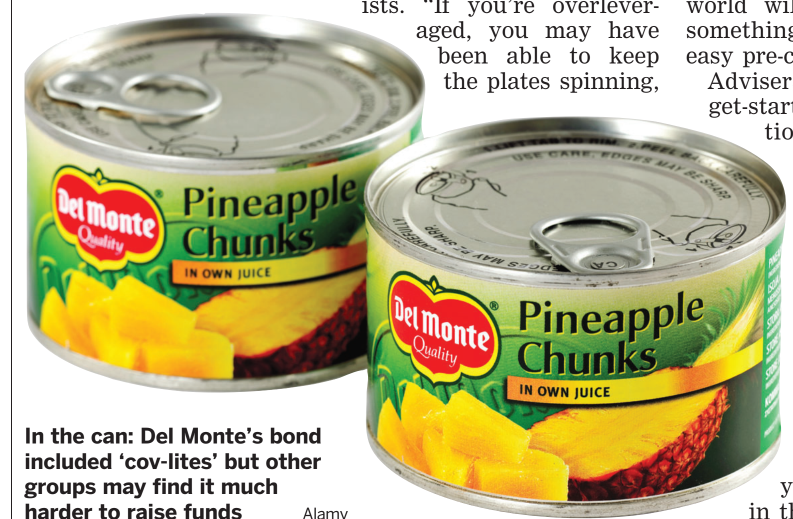
"Its going to be about how these companies get from here to refinancing," says Heather Swanston, a partner in PwC's restructuring practice. "This means looking at operational improvements to enhance profits and cash, and removing volatility from their balance sheets.

"Next they need to look at all sources of financing to reduce their dependence on the banks – maybe that means asset-backed lending, or perhaps looking at the high-yield or private-placement markets."

According to the professionals, a lot of companies have followed this advice. However, even more have not fully thought out their options, hoping the credit world will soon revert to something more like its easy pre-crisis ways.

Advisers concede their get-started-now exhortations can appear self-serving, but stress it is important to do so.

"It is the adviser's mantra – 'if only you'd told us earlier'," says one. "But like all these expressions there's truth in it. You've got no time to waste if you need financing in this market."




In the can: Del Monte's bond included 'cov-lites' but other groups may find it much harder to raise funds Alamy

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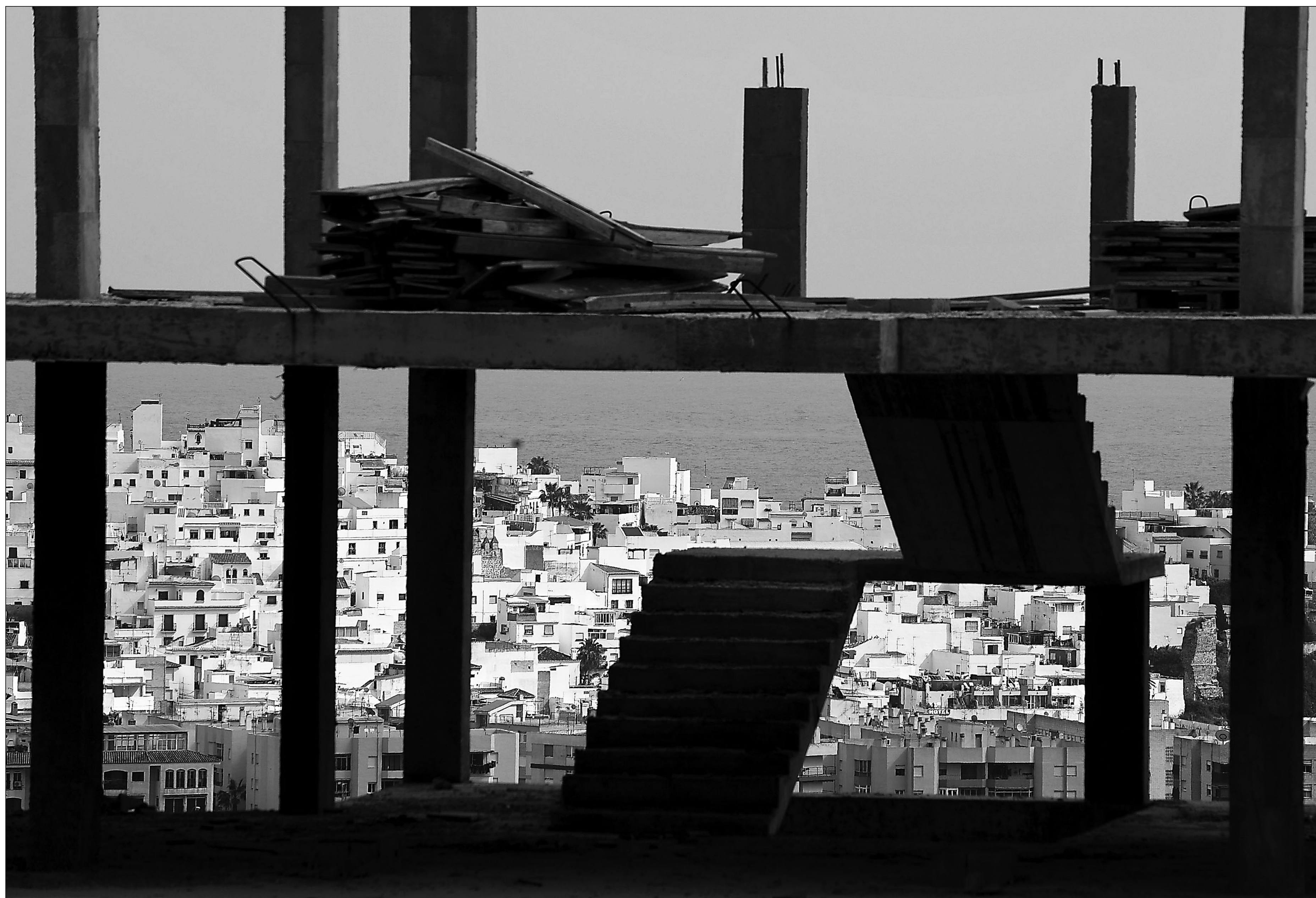
# Prospect of a recovery heralds new threats

**European construction**

A 'flight to quality' will present a risk to smaller groups, says **Ed Hammond**



**Concrete corpse: an abandoned building skeleton at Almunecar in south-eastern Spain** Getty

Guardian Road Business Park in Exeter, in the south-west of England, is forgettable in the way all out-of-town office clusters are.

Its roads, punctuated by dozens of mini-roundabouts, crisscross the square mile or so of gently sloping hillside. Beige corrugated hangars and glass-clad showrooms nestle behind neat hedges and slivers of lawn. There is not a pedestrian in sight.

Yet this unremarkable development, which overlooks the region's main trunk road, has been at the centre of the storm that has swept through the UK's construction industry for the past three years – and is mirrored across the rest of Europe.

Connaught and Rok, two of the UK building industry's highest profile victims of the recession, were based within a few minutes' walk of each other on the Guardian Road site. Then, during a fateful two months last autumn, both companies collapsed into administration.

The resulting fallout, which saw some 14,000 workers made redundant and hundreds of millions of pounds in debt go unpaid, left a trail of bankruptcy and financial hardship at the two companies' many small trade creditors and subcontractors.

This domino effect along supply chains, combined with falling workloads and squeezed cash flow, has made construction companies acutely susceptible to business failure. Indeed, in the two years to the start of 2011, more than 6,000 building groups have fallen into insolvency in the UK – more than any other sector, according to data from PwC.

However, while the pressures of a declining market have taken a harsh toll on the European construction industry, the prospect of a recovery heralds new and equally perilous threats to the continent's builders.

The shortage of work during the past three years has meant that a lot of companies have taken on contracts at minuscule margins, or even at a loss, simply as a way of creating cash flow and utilising workers.

"The idea has always been that they are then able to go to their supply chain with guaranteed work and orders and drive down costs to push up the overall contract margins," explains Jonathan Hook, global head of engineering and construction at PwC.

The practice of so-called "suicide bidding" or "buying work" was a way for many companies to stay afloat during the hardest passages of the recession. Now though, with raw-material costs creeping up and subcontractors having been "beaten up" on rates for the past three years, the possibilities for clawing back profit margins sacrificed on the original contract are evaporating fast.

For construction companies, this poses a tough question: Does the need to keep generating cash outweigh the risk of taking on work which is likely to be lossmaking?

The larger construction companies can afford to take on work on low-margin or lossmaking terms for long periods, as many will be generating profits from contracts negotiated before the recession.

However, for the smaller companies, which typically work on short-term projects, the need to mitigate against the risk of misjudging inflation in the supply chain could prove fatal, as they

> Another concern for building groups is the fall in public-sector spending on new construction projects

are forced to overprice contracts or face possible financial collapse.

"The price pressures from beneath are going to be the biggest risk to the sector during the next two years," Mr Hook says.

Construction companies, particularly building contractors, traditionally work on the basis of a large upfront payment for starting a project, followed by a series of smaller payments when the work reaches certain stages.

However, this low-risk model, which Ian Tyler, chief executive of Balfour Beatty, one of Europe's largest construction companies by sales, has described as "building something with someone else's money", is under threat.

"As construction companies come out of recession, they should, in a good market, get a rapid injection of cash as advance payments are made," says Jack Kelly, an infrastructure partner at Deloitte.

"The difficulty this time round could be that customers become unwilling to make such large advance payments, especially if there is a lot of competition and the need to offer upfront payments is less prevalent," Mr Kelly adds.

Another concern for building groups is the fall in public-sector spending on new construction projects, with governments across Europe cutting investment on new schools, hospitals, roads and railways as they seek to tackle debt burdens.

The sector has always depended heavily on state sponsored contracts, but the past three years have seen public-sector projects account for an increasingly large chunk of workloads, as private spending on construction has fallen.

Now, though, with government spending on the industry expected to decline, competition is rife for getting on to framework agreements with local authorities and winning what little work there is.

As well as the pressure that increased competition creates for smaller builders, there is a flight to quality by customers. The upshot of this is that many of the biggest spenders on the industry will avoid using contractors that they perceive as lacking financial and operational muscle.

"Having strong relationships between customer and builder is going to be crucial, as people don't want to put money into a project and then have the contractor fall over halfway through," Deloitte's Mr Kelly explains.

# Insolvency is 'last resort' for sector weighed down by debt

**Case study**
**UK property**

Further action by banks on problem loans is in prospect, writes **Daniel Thomas**

While the fast-growing economies in Asia and Latin America are underpinning a sense of optimism in global property markets, the story is very different elsewhere.

Along with the US, the heavily indebted UK property sector has been among the worst hit by the credit crisis.

The good news is that the sector has recovered from the crash in values during the recession but many fear that addressing the worst of the problems has merely been delayed.

The recovery has seen the number of business failures in the property sector drop over the past year by 1.5 per cent in January, according to Experian, the UK-based information services company.

Mark Batten, real estate partner at PwC, says companies are making progress in dealing with debts. "Lenders are managing businesses carefully to find solutions to help them stay afloat," he says.

"By and large, they have a good handle on portfolios and are looking to work through problems with their borrowers. They are only resorting to insolvency as a last resort."

But, he adds, the real estate sector was certainly not out of the woods, and distressed property companies are still struggling to survive at a time when there is no sign of widespread value growth.

The biggest problem is that the value of property is still below the level of debt in many investments made during the boom across the UK, particularly in regional markets that have regained little ground since the bottom of the downturn.

So far, banks have been loath to take on too many of the problems, often preferring to extend loans or agree consensual deals to buy extra time, in part because the scale of the losses would have been too much to deal with during the recession.

Some insolvencies have been prevented by swapping debt for equity in businesses, which has meant that banks avoided a loss through a forced sale.

However, with the UK's banking sector returning to strength, there is the prospect of further action on problem loans, in the face of adverse economic factors that will impact rental income. This has so far helped cover interest payments.

Lloyds alone, which has about £60m of outstanding property loans and some £20bn in its business support unit, now has more than 400 people working on its real estate book.

According to De Montfort University in the Midlands, about two-thirds of the £220bn outstanding to property borrowers due for maturity in the next few years, with some £50bn of the total either in default or breach of its covenants.

Chris de Pury, real estate partner at Berwin Leighton Paisner, predicts problems in future, as banks work through loan books and look to partner with new equity investors at the cost of the old borrowers.

"The market has never really recovered outside London, but people have been able to carry on because income was holding up and servicing interest. Many loans had the protection of swap liabilities, which prevented action.

> The recovery has seen the number of business failures in the property sector drop slightly

"But banks are now stronger, while swap losses have lessened and refinancings are coming due. Banks are pretty sensible in how they work out their problems, however. That should prevent a flood of sales and the government will be reluctant to see too much pain."

He says investors are still sitting on significant cash resources to help distressed situations.

Neville Kahn at Deloitte says banks have dealt with the small number of large borrowers in trouble, and are now moving to the larger number of smaller problem loans. Even so, he does not see a widespread problem. The problems are now mostly outside London, he says.

Fraser Greenshields, partner at Ernst & Young, says the "liquidity squeeze" for secondary, highly leveraged property assets is likely to be prolonged.

"Refinance risk is becoming a primary concern for real estate borrowers. The general lack of available credit has been compounded by the two largest lenders, Lloyds and RBS, deleveraging through the sale of non-core assets. [They] account for almost half the £226bn commercial property lending market."

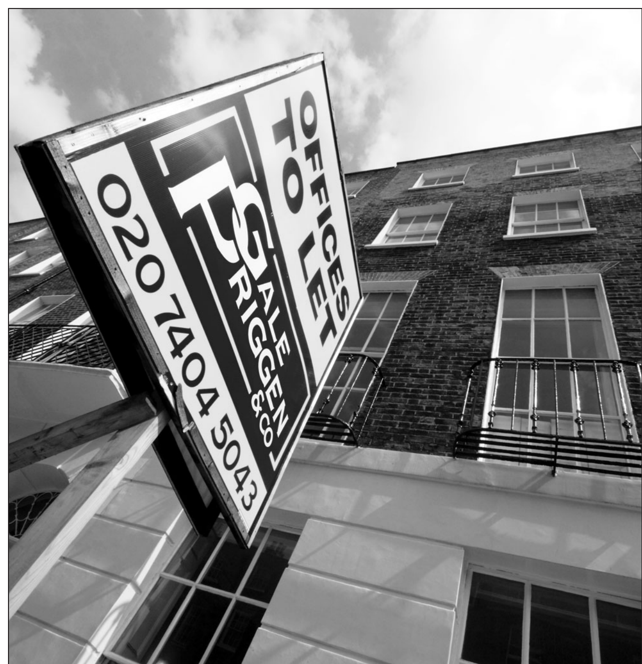
Richard Fleming, UK head of restructuring at KPMG, says there has also been an increase in more innovative insolvency practices, such as company voluntary arrangements (CVAs), which would continue to be case in worsening conditions.

"There was nearly double the number of CVAs agreed by property companies with their creditors than retail companies in the last quarter.

There is no doubting that the property industry faces some tough negative economic factors; whether it's the ever-increasing issue of empty stores on the high street or the continued polarisation of the property market."

Many property companies remain worried that such a further economic dip could lead tenants to cut back space and demand lower rents. This would hit their own income and cause a rise in insolvencies, as companies struggled to pay their debt obligations.

However, the immediate concern is the refinancing risk in the sector, given expectations that debt will remain scarce in the near future. While the worst of the fall-out from the recession may have been avoided, there are still some testing times ahead.




**Not yet out of the woods: borrowers are struggling** Alamy

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Business Turnrounds

# Important weapon in the armoury

Pre-packs

**Anousha Sakoui** explains why the process has become more accepted

In February this year, an insolvency brought to an end one of the longest running and high-profile corporate sagas of the post credit-crisis world. And it took just a matter of hours.

Citigroup, the US bank, announced it had finally seized control of EMI, the UK music group. On that morning, administrators at PwC had been appointed to a holding company for the group and sold the business to its lender.

The move brought to an end a long-running tussle with the UK group's owners Terra Firma, the private equity firm led by Guy Hands.

The battle for control had involved Terra Firma injecting millions of pounds to remain within financial covenants, attempts at restructuring negotiations, and even a courtroom battle.

But in the end, Citigroup took control via a pre-packaged administration – or pre-pack.

It was the UK's largest such administration on record and a reminder of the use of this controversial insolvency process.

Throughout the crisis, the pre-pack has been a tool many companies relied on as a way to implement restructurings.

Unlike in the rest of Europe, a well tested court-based process is available in England under which, if secured lenders agree, a business can be sold to a new owner, potentially wiping out the claims of unsecured creditors.

It is a process that many continental European companies have also made use of by relocating their so-called centres of main interest to England.

Peter Spratt, a PwC partner and lead administrator of Maltby Investments, an EMI holding company, says: "The EMI case is one of the best examples of why pre-packs are necessary in certain situations.

"The sale . . . had to be quick, so as to minimise the chances of artists leaving the label, to protect the underlying strengths that made the company what it is today and ultimately to preserve value for creditors.

"A pre-pack maximised the certainty of those objectives being met."

At first, pre-packs had been seen as controversial, with particular concerns about the treatment of unsecured creditors and cases where the business is sold back to the owners.

But the process has evolved into a more accepted restructuring tool, say advisers. "We have come a long way in recent years in improving the image of pre-packs," says Mr Spratt. "They play an important part of the armoury available in restructuring businesses.

"As long as the guidance available to insolvency practitioners is followed when considering the key issues on whether a pre-pack is appropriate, then creditors should be adequately protected from potential abuse of the process."

Another recent example is that of the East London Bus Company holding company. Administrators at KPMG successfully used a pre-pack to restructure its debt and sell the share capital to Stagecoach.

The operating business was completely untouched, there were no redundancies, and little impact on the organisation.

"It's good to see 'pre-pack' administrations starting to lose their negative connotations," says Richard Fleming, UK head of restructuring at KPMG.

"Pre-packs have always been an important tool in the insolvency practitioner's kit. However, a small number of unscrupulous directors – who used 'pre-pack' administrations to get rid of debt and then buy back businesses – had given them a bad name."

'The EMI case is one of the best examples of why pre-packs are necessary in certain situations'

**Peter Spratt, PwC partner and lead administrator of Maltby Investments**

Mr Fleming adds that restructuring overleveraged companies has been one of the defining trends of this downturn and pre-packs have proved an effective mechanism for achieving that.

"Perfectly strong companies, which could have been dragged down by their debt, have been able to move forward with no redundancies or any discernible disruption to day-to-day business because of pre-packs," he says.

While it had been expected that EMI might not meet its covenant test at the end of the first quarter of 2011, the bank moved quickly to seize control, wanting to avoid the situation being drawn out further.

With most pre-packs, a default is pinpointed by a test of performance-related covenants or non-payment, but in the case of EMI the bank enforced a balance sheet insolvency test triggered by the weight of its £3.4bn debts.

Those close to the move believe one thing that made it possible was the fact that information had already been published about the value of the company being well below the value of the debt.

Mr Hands himself had previously estimated in court that EMI was worth just £1.8bn.

After the restructuring, Citigroup said it was writing off two-thirds of its loans to EMI, or £2.2bn.

"People will look at recent cases and be interested to see if banks will take a more robust approach, for example enforcing on a balance sheet insolvency default," says Richard Tett, restructuring partner at Freshfields, the law firm.

"Banks prefer enforcing on 'bright line defaults' like actual payment or financial covenant defaults. The default needs to be clear and certain, otherwise the lenders could end up on the wrong end of litigation."

Greg Campbell, a partner at Gibson, Dunn & Crutcher says: "Notwithstanding some legitimate concerns surrounding the lack of transparency of pre-pack administrations, they are here to stay."

# Upturn to bring bad news

Continued from Page 1

been expected, given the 6.4 per cent contraction in the economy. But this good-news may yet mean bad news.

Many "zombie companies", kept alive partly by low interest rates, are expected to die this year.

Overall, insolvencies in the UK were down 12 per cent on 2009 at almost 23,000 last year, although still at levels well above anything seen since the early 1990s recession.

In the property sector, liquidations more than doubled, as estate agents, chartered surveyors, and architects practices went to the wall. Closely following were construction companies.

Wholesale retail and motor trades also saw a jump in failures. And manufacturing – after construction the sector that suffered the deepest recession – also saw insolvencies surge some 50 per cent, although the number is now back close to pre-recession levels.

Insolvency experts say there have been fewer bankruptcies for three reasons.

First, interest rates are at their lowest ever level of 0.5 per cent.

Second, banks have not been calling in bad debts as readily as in the past, partly to protect their balance sheets from displaying the true size of debts and partly because of political pressure.

Third, HM Revenues and Customs has been letting thousands of businesses delay tax payments through its "time to pay" programme.

However, crisis settings are set to unwind, and as policy creeps back to normal many companies still struggling may die.

Brian Johnson, a partner in insolvency at HW Fisher and Company, suggests that even a half or 1 point rise in Bank rate could push many businesses over the brink.

'The first thing is to carry out a complete business healthcheck. Cash is king in most businesses'

Industry experts say HM Revenue & Customs is getting tougher on payments, particularly for repeat requests for time to pay delays.

"HMRC has toughened up on time to pay," says Stephen Law, president of the R3 bankruptcy industry group.

HMRC denies that the criteria for time to pay have changed, although businesses that try to defer for a second or third time may find they are subject to more thorough questioning.

Last but not least, public sector cuts will have an impact.

R3 estimates corporate insolvencies will rise to 27,000 this year, up nearly a fifth from last year's dip.

"A vast number of companies – call them the walking wounded, or zombie companies – were allowed to continue to trade," says Mr Johnson.

Usually, insolvencies rise as recessions draw to an end and orders suddenly rise. Businesses become crushed between needing to pay for supplies quickly and receiving payments slowly.

Insolvency practitioners believe that wholesale and retail trades are likely to suffer the most business failures this year, followed by construction companies and hotels and restaurants, according to an R3 survey.

Mr Johnson advises worried companies to make sure they have stocked up on cash.

"The first thing is to carry out a complete business healthcheck. Cash is king in most businesses," he says.

He advises delaying payments, and bringing in debts, focusing on cash flow and reducing costs.

Finally, he advises companies in trouble to seek other sources of cash if the banks will not lend.

"Look for investments. You are not going to get money from the banks, so you might as well give up some equity to keep your business going."

Better assembled: GM's new paymasters, directors and managers have accomplished much more than anyone thought possible two years ago Bloomberg

# The ups and downs of having Uncle Sam come to the rescue

**Case study**
**General Motors**

**Bernard Simon** reports on the carmaker's return from the dead

General Motors' remarkable recovery from a near-death experience underlines a tenet of corporate restructurings.

As one participant in the Detroit carmaker's revival puts it: "He who has the gold makes the rules."

The rules at GM were made by the US government, which forked out $50bn to put the company back on its feet in return for a 61 per cent stake. Canada chipped in another $10bn, but generally followed Washington's lead.

Whether a private-sector saviour could have done the job as quickly and smoothly will long be a matter of debate.

Those who think so note that court approval was required every step of the way.

Judge Robert Gerber, the New York judge who oversaw the GM case, would arguably have applied the law in exactly the same way to any other entity.

Even so, the government had some clear advantages. Other parties in the restructuring – such as bondholders, the United Auto Workers union and dealers – might have fought much harder in the courts had their adversary been anyone other than Uncle Sam.

Scores of dealers whose franchises were summarily terminated subsequently turned to Congress for help.

Looming over GM's restructuring was a fear that, so long as the 101-year-old company's future remained in doubt, buyers would shy away from its cars, putting its survival and that of thousands of suppliers in jeopardy.

By late 2008, GM was burning through $3bn of cash a month. It warned that it could run out of liquidity in early 2009. Speed was thus of the essence.

The Obama administration's auto taskforce, led by Steven Rattner, a former private-equity investor, expedited the process by resorting to Section 363 of the US bankruptcy code.

Under this provision, viable assets are parcelled into a new company, while unwanted ones remain under protection from creditors.

Unlike a normal corporate reorganisation which must be approved by a substantial number of creditors, the Section 363 process requires only the court's assent.

The same provision was used to rescue Lehman Brothers' money-management and Asian operations.

GM filed for bankruptcy protection on June 1 2009. The Section 363 "sale" was finalised just 40 days later. Unwanted assets, mainly comprising about 200 plants, buildings and other properties, remained in Chapter 11.

The auto taskforce also kept GM under constant pressure to lower its break-even point.

Whether a private-sector saviour could have done the job as quickly will long be debated

"We were determined from the start to be hard-headed in our assessments," Mr Rattner wrote in his book* recounting the rescue of GM and its smaller rival, Chrysler. GM's management was sent back three times to revise its viability plans, each more ambitious than the last.

The carmaker eventually trimmed enough capacity and costs to ensure that it could make money at US industry sales not far above the lowest levels reached during the recession. The taskforce was also ruthless in overhauling GM's management and board.

Rick Wagoner, the chief executive under whose watch the company racked up losses of $80bn, was ousted in the run-up to the bankruptcy filing.

As Mr Rattner saw it: "Wagoner proved more adept at manipulating the board than at running the company."

Eight months later, Fritz Henderson, Mr Wagoner's successor, once regarded as GM's Mr Fixit, was also gone.

The new GM began life under the leadership of Ed Whitacre, a former telecoms executive, whose easy-going Texas drawl masked an iron determination to shake up the company's operations and its culture.

All but one of 12 members of the executive committee were replaced.

The committee emerged from its first, two-hour meeting under Mr Whitacre's leadership with a plan to overhaul GM's core North American operations as well as a crisp new vision statement "to design, build and sell the world's best vehicles".

The old board was also thrown out. According to Mr Rattner, "a key component of management failures like GM's is almost always the board of directors, historically the weakest link in American corporate governance".

Shorn of four of its eight brands, hundreds of dealers and most of its debt, the new GM made a $4.7bn profit in 2010.

It came within a few thousand vehicles last year of recapturing from Toyota its crown as the world's biggest carmaker.

Not all of GM's problems are solved. Many North American car buyers remain unconvinced that the leopard has changed its spots. The troubled European operations remain a millstone.

The job of bringing a more entrepreneurial culture to a company once famous for interminable meetings and omnipresent committees is a work in progress.

Even so, GM's new paymasters, directors and managers have accomplished much more than anyone thought possible two years ago.

Investors gave their thumbs-up last November by flocking to a public share offering that cut the US government's stake from 61 to 33 per cent.

**Overhaul – An Insider's Account of the Obama Administration's Emergency Rescue of the Auto Industry, by Steven Rattner, published by Houghton Mifflin Harcourt.*

**Case study** Reader's Digest

When Reader's Digest Association announced plans for voluntary bankruptcy in 2009, it was yet another US debt-laden media company that had fallen victim to the advertising recession.

The publisher had been taken private for $2.8bn at the peak of the debt bubble in March 2007 by a consortium led by Ripplewood, a private equity firm, which ended up losing its entire initial $600m equity investment.

"It was a very, very poorly thought out transaction, done at the top of the market, and they massively overpaid," says Phillip Sykes, head of corporate advisory services at Moore Stephens and administrator of Reader's Digest UK.

"It was classic top of the market froth and it crucified Reader's Digest, which was already a declining business."

Working with Kirkland & Ellis, the law firm, the publisher struck an agreement with its senior lenders to cut its debt load from $2.2bn to $550m, but the Chapter 11 process was delayed because of pension issues at its UK subsidiary.

Fast-forward six months and the parent company announced it was placing its UK subsidiary into administration. This was because the UK regulator had failed to grant it immunity from claims for a £125m shortfall in its UK pension scheme that would only be partly filled through the corporate restructuring.

As part of the planned financial restructuring, the US parent company had agreed to make a payment of £10.9m and transfer a one-third interest in the equity of the UK business to the UK pension scheme trustees. The pension fund had 1,600 members.

The scheme would then have transferred to the Pension Protection Fund (PPF), the insurance scheme that ensures insolvent employers can meet pension promises. However, the UK Pension Regulator did not approve the company's application.

The UK subsidiary was bought from administration by Better Capital, the turnround private equity group run by Jon Moulton, for £13m last year. The group was attracted by the publisher's loyal customer base and strong brand.

Mr Moulton negotiated two deals, one to acquire the company's UK assets and another securing a licence agreement with the US parent to keep using the Reader's Digest brand.

Mr Sykes says: "One aspect that made it [administration] complicated was that, both in the UK and the US, it had outsourced a tremendous amount of its operations ranging from mundane things such as logistics, printing, packaging to invoicing and debt collection. The core of Reader's Digest was the editorial and creative side.

"When I was appointed administrator, we had to get in touch with outsource partners to re-establish a relationship in the context of the administration to keep the business going. That was difficult, because there were both UK and global relationships."

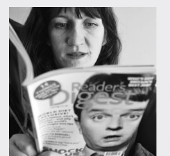
The deal with Better Capital left the company's pension scheme with the PPF and freed it from an expensive lease on offices in Canary Wharf. The company emerged from administration with 100 staff and no debt or pension liability.

Sean Cooper, chairman of Reader's Digest UK and director of operations at Better Capital, says: "We picked them up out of Canary Wharf where they had been since the 1980s when Reader's Digest employed 2,400 people. But today they are only 100, so they were stuck with a lease where they had too much space."

Better Capital brought in its own management team, including a new digital editor. It has invested £3m in IT systems and brought the publisher's call-centre back onshore.

"We went back to the supply chain to look at how the money was being spent," says Mr Cooper. "There was a lot we could do to find new suppliers for the business and reprocure."

Reader's Digest UK had sales of £75m in 2009, helped by selling DVDs, books and insurance to its readers and running a prize draw. Better Capital hopes it will generate revenues close to that in 2011.



**Reader's Digest is no longer just known for its flagship magazine**

Mark Aldridge, chief executive of Better Capital, says: "When you take a business out of administration, there is no magic answer. You can do specific things such as resizing and putting in place new contracts, but you have to invest. That is how you get the return."

"First, you have to capitalise the business properly, then you achieve stability and get things on an even keel so you can start to invest. Then, you extend the brand to a wider group."

Reader's Digest UK has seen its circulation drop from 2m in the 1990s to 432,000. Better Capital is hoping that, following investment in the businesses, it will have risen to 600,000 within 24 months.

Reader's Digest Association, the US parent company, completed its financial restructuring and emerged from pre-arranged Chapter 11 in February 2010. It came out well capitalised and had cut its debt by 75 per cent. The group had $525m in exit financing and a new board.

Reader's Digest is no longer just known for its flagship magazine. The group has almost 80 branded websites and sells 40m books, music and videos around the world each year.

**Salamander Davoudi**