Business Turnrounds

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Low failure rates mask tough times

Frequent fliers: bankruptcy protection is a well-trodden path for US airlines, including American. See Page 3 Bloomberg

Corporate defaults are well below average but the minnows are under severe stress, writes *Robin Wigglesworth*

The restructuring industry is at an inflection point. While the number of corporate debt defaults remains below historical average, storm clouds are gathering and could overwhelm vulnerable indebted companies.

Since the global financial crisis caused a rash of corporate distress in 2008-09, determined intervention by governments and central banks has managed to calm debt markets, allow many companies to raise money again, and limit the number of corporate failures.

Although the actions of policy makers were unprecedented in scope, many restructuring and turnround professionals remain surprised at how quickly markets improved, and how few companies have run adrift as a result.

"Credit markets virtually shut down in 2008, causing an avalanche of restructuring work," says David Kurtz, global head of restructuring at Lazard, the investment bank. "We thought it would take longer than it has to recover. I'm still surprised that credit markets have remained robust despite the global economic weakness and the eurozone's problems."

The value of completed debt restructurings globally jumped to $335.9bn in the first half of 2012, according to Thomson Reuters, but this was overwhelmingly caused by Greece's $263.1bn distressed debt exchange. Stripping Greece out, the value fell 30 per cent from the same period last year to $72.8bn.

Other data corroborate the surprisingly muted restructuring market. Moody's global trailing 12-month default rate for companies rated below investment grade edged up to 3 per cent in August – from 2.8 per cent in July and 1.8 per cent in the same month last year – with 43 companies defaulting on their bonds so far in 2012.

The rating agency forecasts that the global default rate will climb to 3.1 per cent by the end of the year, but this is still comfortably below the historical average.

"Corporate default rates remain low and steady," noted Albert Metz, managing director of Moody's Credit Policy Research, in a recent report. "Of course, there remain risks to the upside, that default counts will accelerate. But to date, we are not seeing evidence of that."

However, restructuring industry insiders say the subdued headline rate of corporate defaults masks more severe stresses among many smaller companies that do not issue bonds and therefore do not appear in the statistics of the rating agencies.

Alan Bloom, global head of restructuring at Ernst & Young, says: "Most of us are astonished at how low the default rates are, but there are many smaller companies that are struggling under the radar. The pressure on many companies is still extreme.

"The economic outlook is poor, and parts of the world that were fine aren't any more."

These smaller companies are usually funded by bank loans, and can often come to a quiet agreement with lenders without involving advisers or even a formal default. As Donald Featherstone, head of European turnround and restructuring at AlixPartners, observes: "Not every restructuring needs to have a default."

This has been especially prevalent in Europe, where companies are far more dependent on bank loans than in the US. Most continental banks are loath to cut a company adrift, and have for the most part continued to "extend and amend" the loans of struggling companies.

> 'There are many smaller companies . . . struggling under the radar'
> **Alan Bloom, Ernst & Young**

Although this practice is often mocked as "extend and pretend" by sceptics, who say banks should be more forceful in admitting to losses, it has kept the levels of corporate distress relatively muted so far.

Yet restructuring professionals say that European banks – under pressure from regulators and investors to shrink – are starting to take a less sanguine approach. Some have even started to offload their loans to so-called distressed debt investors at a discount, which can transform the dynamics of a restructuring.

Richard Tett, a restructuring partner at Freshfields, the law firm, says: "Banks can wobble about being criticised for being nasty. They don't want to be known for bringing down companies, while some of the funds see

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Boom in going bust fails to arrive – yet

Continental Europe Distresssed debt funds and many in the turnround industry are disappointed by the relatively low level of work but economic problems in the peripheral eurozone countries could bring increased opportunities, writes *Michael Stothard*

A tough combination of government austerity, weak economic growth and a shrinking banking sector in Europe has left many restructuring professionals eagerly awaiting a great wall of work coming their way.

Distressed debt funds have been expanding their operations, with some aggressive US operators muscling into the market in anticipation of big returns if they can get the right price for a savable company.

"We anticipate a lot more distressed opportunities coming from Spain and from other peripheral [eurozone] countries given the weak economic conditions and the drop off in bank lending," says Appu Mundassery, a managing director of Bayside Capital, which opened a dedicated Madrid office in February.

Standard & Poor's, the rating agency, has warned that the European banking sector may not be able to meet the needs of eurozone companies over the next five years.

"The banks in Europe are not in a position to meet the large refinancing need over the coming years, and while some will be absorbed into the high yield market, a lot of companies will have to be restructured," said Keith McGregor, European head of restructuring at Ernst & Young.

And, while the situation for European banks has been improved by the loans of more than €1tn from the European Central Bank, the International Monetary Fund still estimates the banks could shed as much as €2tn of assets by 2013, contracting the supply of credit by 1.7 per cent overall.

European companies also face a so-called "wall" of refinancing in 2013 to 2015, where debt issued in the heady days of 2006-2007 starts to fall due.

Many in the industry argue that a number of the blockbuster leveraged buyouts of the credit boom will be likely to need restructuring.

But Europe is already two years into its sovereign debt crisis and with the continent as a whole edging towards recession as well as much of southern Europe battling with high unemployment and sharply lower consumer confidence, the mystery is that the starting-pistol on this wave of restructurings has not yet sounded. In fact, in many places, the trend has been in the opposite direction. So far this year Italy has seen only 12 restructurings worth just $2bn and Spain has seen 43 worth $3.5bn, according to data from Thomson Reuters. Both these figures are the lowest since before the crisis began in 2008.

Paradox postponed: Spain and the rest of southern Europe is battling high unemployment but so far the number of restructurings has been low Getty

And, looking ahead into 2013, Moody's default rate forecasts suggest that the number of corporate failures will actually decrease. The rating agency expects the European speculative-grade default rate to fall slightly from 3 per cent today to 2.8 per cent in August 2013 on a 12-month trailing basis, although this is slightly above pre-crisis levels.

Some among the restructuring professionals are starting to wonder if the great rise in the number of distressed companies will ever happen.

"The wall of restructuring is always 18 months away and it has been 18 months away for the last five years," says David Ereira, a partner in the restructuring and insolvency business at Linklaters, the law firm.

"I think the great jump in restructurings will never happen, although a gradual increase in coming years is still quite likely," says Mr Ereira.

One reason why the rate of restructuring is so low – and some argue could remain comparatively low for several years still – is the low interest rate environment, which allows even companies with unwieldy capital structures to service their debt.

Few economists think interest rates are likely to rise in the foreseeable future. "If interest rates were higher there would likely be more companies out there in need of restructuring this year," says Ben Babcock, European head of restructuring at Morgan Stanley. "[But] rates appear unlikely to rise in the short term, so companies will probably keep that breathing space for the time being."

A second major factor is the European banks themselves which, due to the tougher regulatory requirements, weak economic fundamentals and perhaps political pressure are often preferring to "amend and extend" their corporate loans rather than force the companies into insolvency and take the short-term hit to their balance sheet. Critics call this "amend and pretend".

Another factor is the slow speed at which these same banks are selling their debt portfolios as part of a move to reduce their liabilities ahead of new regulations on capital requirements.

Distressed funds – which tend to be more aggressive about forcing companies to take firm action – want to buy but often complain that the banks are unwilling to sell at a "fair" price.

Despite all these factors there have already been a number of restructurings in continental Europe, including Wind Hellas, Greece's third-largest mobile telephone company, which has had to restructure its debt twice in recent years.

Insolvency professionals say that – although the data are harder to track – there have also been a growing number of insolvencies and restructurings in small and medium business across the continent. These SME businesses are the most reliant on bank funds and in areas most struck by the troubles, so therefore the most likely to get into trouble first.

"Pressure will only increase on these companies as their customers delay settlement of accounts and suppliers demand accelerated payment," says Scott Pinfield, managing director at Alvarez & Marsal. "There is still no clear light at the end of the tunnel for many troubled companies across Europe."

But, once again, there is something holding back the number of insolvencies in countries such as Spain, Italy and Greece. This time it is the largely untested bankruptcy regime which makes lenders more reluctant to take that route.

In Spain, for example, there is no set-up for a pre-packaged bankruptcy process, which means debt negotiations can take longer than in the UK.

> 'There is still no clear light at the end of the tunnel for many troubled companies across Europe'

Overall, while the distressed cycle is bound to start in earnest at some point, it is still far from clear when that will be and, in the meantime, many in the industry are disappointed that the work is not coming through as they had expected.

"Pure distressed investors are getting frustrated, thinking that there should be two to three times as many restructurings given the economic situation," says Gina Germano, founding partner and distressed specialist at Goldbridge Capital Partners.

But that is not stopping funds piling into Europe in anticipation of what is to come. There are currently 16 funds looking to raise an aggregate €7.8bn for Europe-focused distressed debt as well as turnround and special situations, according to data provider Preqin. Around €17.9bn has now been raised since the beginning of 2008.

Case study Nokia seeks better connection in survival fight

Nokia has been in many turnround situations in its up-and-down history. But the struggle the Finnish group currently finds itself in could be its most serious.

After largely missing the smartphone revolution, the one-time largest in the world maker of mobile phone handsets is down on its luck, outflanked by the likes of Apple and Samsung. So Nokia has tied its fate to Microsoft, hoping to make the Windows platform the third big mobile operating system behind Apple's iOS and Google's Android.

But with its most recent phone launch – that of the Lumia 920 (pictured), its flagship model to run on Windows 8 – widely viewed as disappointing, some are starting to wonder if Nokia really can win its latest fight for survival. With its shares down by more than 90 per cent from its peak, the usual funds that look at distressed situations are starting to sniff around the company.

For some observers, this seems unfair as Stephen Elop, the chief executive recruited from Microsoft two years ago to rescue Nokia, has done much right in his restructuring of the group.

"If you look at Nokia and see what they have done in the past year you can't fault them. They have done all the things you would expect them to: restructured the operations, taken costs out, simplified things in the business, and furiously launched new smartphones into the market," says Michael Weyrich, co-head of the telecoms, media and technology practice at AlixPartners, the restructuring consultancy.

But there is still a sense that the company could quickly get into trouble.

Credit analysts at Société Générale noted in the summer that the Finnish company could effectively exhaust its cash reserves within little more than a year at the rate it was burning cash.

That can seem strange as Nokia ended the second quarter with net cash of €4.2bn and gross cash of €9.4bn. Although the net cash number was down 14 per cent from the previous quarter, all of that was due to a dividend payment. It generated positive net cash from its operations, purely down to a large pre-payment from its well-regarded patent portfolio. But tech industry experts point out that companies in the sector often go bankrupt with significant amounts of cash, pointing to Nortel, the Canadian telecoms group that went bust in 2009 with several billion dollars of cash.

Mr Weyrich says it is never a good sign when a company prominently refers to its cash levels in its earning reports. He adds: "It is a costly game they are in and it is a game that is changing rapidly. You can improve very rapidly but given the market dynamics it can also go downhill very rapidly."

For many credit investors, however, Nokia does not have enough debt to get them excited. It has only €3.25bn in debt outstanding from four bonds all issued in the spring of 2009 compared with dozens for most companies of the same size.

"They just don't have enough bonds to make them interesting for us. We did play the credit default swaps [insurance on bonds in case of default] for a while but even that is less interesting now. Really, Nokia is a distressed equity play," says the chief investment officer of one of the world's biggest investors in corporate debt.

Anecdotal evidence bears this out with large proportions of Nokia's shares borrowed out to short-sellers. The shares themselves have been on a rollercoaster ride, falling to a 16-year low in July, before more than doubling in the space of a month.

A senior Nokia executive says: "I really don't know what is going to happen. I guess there are going to be lots of chances for investors as there will probably be lots more ups and downs to come."

Richard Milne

Rolling loans gather no loss for banks

UK

A falling number of insolvencies belies the problems for many sectors, writes *Michael Stothard*

The number of corporate insolvencies in the UK has fallen by nearly 10 per cent in the past year as companies benefit from generous treatment from banks, the government and the low interest rate environment.

Despite a double-dip recession, there were only 1,028 compulsory liquidations in the past quarter, 22 per cent fewer than in the same period last year, according to data from the UK insolvency service. Voluntary and non-voluntary insolvencies in England and Wales are down 8 per cent from the first quarter of the year to 4,107.

The substantial drop – when many expected the number to have crept up – has prompted worries about a rise in the number of "zombie" UK companies that can service debt repayments but have no realistic chance of ever paying it back, and the effect this has on the broader economy.

"There are many UK companies out there with very high levels of debt just staggering on, unable to invest money in new product development but servicing their interest payments," says Adrian Doble, a partner at FRP Advisory. "It is mainly because banks do not want to be seen to be forcing the pace of restructuring at the moment only to suffer the writedowns associated with that. In a low interest rate environment their motto is 'a rolling loan gathers no loss'."

The falling number of restructurings, however, belies the problems for certain UK sectors that have been worst hit by government spending cuts, the downturn in consumer confidence on the high street and other sector-specific structural factors.

The leisure and hotel sector, retailing and healthcare in particular have all seen a number of high-profile failures in the last year and are all on the watch list of restructuring professionals going into 2013.

The leisure sector has been particularly active. One of the most recent restructurings has been Travelodge, the debt-laden budget hotel operator bought by Dubai International Capital, an investment arm of the emirate, in 2006 for £675m in a highly leveraged deal that included about £475m of debt.

The weak consumer environment left it struggling to service its substantial debt pile and last month Travelodge was taken over by its creditors – Goldman Sachs and two New York hedge funds – as part of a debt restructuring deal to save it from administration.

Another in the sector was Fitness First, the UK gym chain that had been bought by the private equity group BC Partners for £835m in 2005. The chain is now being restructured, too.

The healthcare sector has been another hard hit by economic woes, this time by government spending cuts, a fall in property values and weak consumer spending. Despite the number of people over 65 exceeding those under 16 for the first time ever, there has been an overall decline in occupancy in care homes.

This is partly due to squeezed family budgets, but also a reduction in government spending with local authority budgets for social care reduced by more than £600m, or 8 per cent, between 2011 and 2012, according to an analysis by BTG Restructuring.

> Leisure and hotels, retailing and healthcare have all seen a number of high-profile failures

Southern Cross was a high-profile failure, but some say it is unlikely to be the last. The number of corporate insolvencies recorded in the second quarter of 2012 was inflated by 156 companies in the Southern Cross group of care homes being declared insolvent in June.

The retail sector is in the worst position, however, as softer consumer demand combines with more structural factors such as competition from online rivals, weighing on profit and driving a number of failures.

Data from the UK insolvency service showed that the number of retail insolvencies rose 10.3 per cent last quarter even as the overall number of companies failing dropped. There were 426 retail insolvencies recorded for the three months to June 30, according to research by PwC, compared with 386 in the same period in 2011.

"In a more normal environment where interest rates were higher and reflected true risk of borrowing money, the bankruptcy rate would be even higher for them," says Jeremy Lytle, a director at ECI Partners, the mid-market private equity firm.

Checkout time: Travelodge was taken over by its creditors to save it from administration

This year Julian Graves, the health food retailer that is a sister company of Holland & Barrett, collapsed into administration along with Clinton Cards, which went into administration after its biggest supplier, American Greetings, acquired £35m of debt from its lending banks.

Barratts Priceless, the footwear retail chain that survived administration in 2009, appointed administrators for the second time late last year while Blacks Leisure, the outdoor retail chain, was sold via a pre-pack administration this year. Others that have found themselves in trouble include Aquascutum, Game Group and Peacocks.

One consequence of a higher number of retail and leisure restructurings this year has been a rise in the number of company voluntary arrangements.

Many of these groups have suffered from having to pay rent on a large number of physical sites, and so have used this tool to renegotiate leases.

"We have seen a rise in the number of CVAs this year, partly because the types of companies that are being restructured in the retail and leisure sector often have large rent payments," says Bryan Green, president of the UK Turnaround Management Association.

CVAs have also been used, he says, because "banks and creditors are increasingly willing to negotiate with struggling companies to try to preserve value".

Travelodge and Fitness First are two companies to have used CVAs this year. There is some debate, however about how useful they are, with some arguing that they can delay the problem only at the expense of the landlords.

Industry analysts now expect a steady rise in the number of UK restructurings in the coming years, but restructuring professionals expect the most work to come from the sectors that are already limping along.

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Defaults fall to low level but signs of stress mount

Snap happy: Kitty Kramer, the first Kodak girl, in 1890, when the picture for the company was much brighter

US Economic growth and demand for high-yield debt have kept bankruptcies at bay for now, says *Vivianne Rodrigues*

US companies with fragile balance sheets have largely been able to bide their time and avoid potential restructurings, and even bankruptcy in 2012, thanks in part to relatively stronger economic growth in the US and the voracious appetite for high-yielding debt.

That combination has helped keep US default rates at low levels, as companies have been able to push out what could have been a debilitating "wall" of debt maturities in 2013 and 2014.

But the outlook has turned slightly murkier recently, and many restructuring experts expect an uptick in the number of companies that are forced to restructure, or fail altogether.

Failures are likely to include companies that have been in long-term decline, where the combination of tougher competition and lacklustre growth is the final straw that breaks the camel's back – Eastman Kodak's bankruptcy being one such example.

On the other hand, there are entire sectors that face cyclical challenges such as the shipping, natural gas and coal industries.

The questions now are what happens if lingering financial problems in Europe are not addressed, and whether US debt capital markets – which have remained buoyant throughout the year – become less friendly ahead of the presidential elections and a potential "fiscal cliff" at the start of the new year.

"It's been a very good year for the high-yield markets, both for companies and investors," says David Ying, senior managing director and head of restructuring at Evercore Partners. "But we may see a pick-up in volatility. Companies should not assume bond markets will remain receptive all the time."

Throughout 2012, investors have funded companies at higher risk of default – this month pushing their average yields to the lowest level on record – in exchange for higher returns than those offered by top tier debt securities.

"The high-yield bond market doesn't operate in isolation: [it] lives and dies on good credit analysis," says Mr Ying. "While we are living in a world where benchmark rates are phenomenally low, both companies and investors have to realise these are unusual times."

For now, the bet has paid off. Average high-yield debt has returned more than 11 per cent so far this year, compared with 7.5 per cent for investment-grade companies and 1.8 per cent for US Treasuries, according to Barclays indices.

Against that backdrop, trailing default rates in the US have fallen to 2.7 per cent in June from a long-term average of 4.5 per cent, according to the latest available data from Standard & Poor's.

Jason Thomas, director of research at the Carlyle Group, says: "There are reasons to be optimistic that the volume of companies' maturing claims should not disrupt the refinancing of [speculative-grade debt by] cash-generating, solvent businesses, at least in the US."

He adds: "In the absence of extreme macroeconomic stress or illiquidity, the volume of maturing obligations should not generate default risk that is independent of the credit quality of the borrower."

However, S&P forecasts that the default rate will climb to 3.7 per cent by June 2013, implying that 57 speculative-grade-rated companies will default during the 12 months ending June 2013.

Restructuring experts say that some sectors still face problems stemming from the recession and financial crisis. While upcoming debt maturities have been pushed out by a few years, many still have businesses and balance sheets based on the less conservative standards seen before the financial crisis.

Ken Buckfire, chief executive and co-founder of Miller Buckfire, says: "One could argue that in the past year or so, capital markets have been wide open to anybody who needed to refinance their problems away. But companies in bad shape will file for bankruptcy, irrespective of what is going on in the debt capital markets."

> 'Companies should not assume bond markets will remain receptive all the time'

Signs of potential stress for US companies are mounting, as the economy struggles to gain traction at a time when commodity prices are fluctuating sharply, and labour markets remain weak.

During the latest reporting season, S&P 500 members were three times more likely to say they would miss rather than exceed analysts' expectations of third-quarter earnings. That was the worst guidance ratio since the final quarter of 2008.

Perry Mandarino, US business recovery services leader at PwC, says: "Many companies have already undertaken action to cut costs from the bottom line and are running leaner than ever. [But] companies can't foresee a market downturn or always know the true impact of new competition or new industry pressures."

Mr Mandarino suggests companies facing pressure should prepare "contingency" plans and be proactive about their restructuring strategy.

"If the business is not growing and the company is leveraged, chances are it will need some sort of restructuring," says Mr Buckfire.

"But before a company just goes ahead and files for Chapter 11 protection, it pays to know how to manage creditors and be in position to propose refinancing solutions

Case study American Airlines

When AMR, the parent of American Airlines, announced its August 2012 traffic figures on September 11, it was quick to trumpet the speed of its revenue growth.

The airline's passenger revenue per available seat mile (PRASM) – the industry's key revenue measure – had risen 4.1 per cent, against 4 per cent for Delta Air Lines, its biggest rival, only 2 to 3 per cent for Southwest Airlines, the low-cost carrier, and 1 per cent for US Airways. It was the fifth consecutive month that American had come out top of the PRASM figures.

American's growth was achieved under what might, at first glance, have seemed to be unpromising circumstances. Unlike any significant rival during the period, it was in Chapter 11 bankruptcy protection, after in November last year it became the latest large US airline to recognise that it would never honour all its financial obligations with its existing financial structure.

Yet many industry observers regard American's step as long overdue, and likely to be key to the airline reaching the same cost level as rivals that have previously taken the well-trodden path for airlines through bankruptcy.

There are two things a big airline can do to have a significant impact on its competitiveness, one senior aviation industry figure says.

"You can mark to market your labour costs and your airplane costs," the figure, who declines to be named, says. "Those are the two big things in any airline. In a bankruptcy, you can do a lot to sort those out."

The main outstanding question remains what shape the new, restructured American Airlines will assume. Tom Horton, AMR's chief executive, said in August that merger with US Airways, its smaller rival, could be "an attractive option under the right circumstances". The pair have since signed a confidentiality agreement to facilitate detailed talks on a merger.

The company now had "a line of sight" on its post-reorganisation cost structure, Mr Horton said. "In my view that paints a picture of a very successful, profitable, productive airline. The question then is, could a combination make us even stronger? I think that's a legitimate question."

At the heart of American's longstanding problems was its failure to reform adequately contracts that awarded staff far better conditions, pensions and healthcare provision than are now industry standard. Its competitiveness has lagged behind since large rivals – including Delta and United Airlines – all sought Chapter 11 protection over the past decade as they confronted both unsustainably high labour costs and, for some, unrealistically high aircraft leasing costs.

American's labour unions have all in the past two months either accepted new, sharply-trimmed contracts or, in the pilots' case, had new terms imposed by the bankruptcy court.

"The long-term success of American depends on the extent to which it can promulgate labour savings not just in labour rates but indirect labour costs," the senior aviation figure says.

But the improvements, everyone involved recognises, are unlikely to be sustained if the US airline industry again descends into the kind of fierce, cost-cutting competition that has ruined its financial performance over the past two decades.

Doug Parker, US Airways' chief executive, told a conference on September 5 organised by Dahlman Rose, the investment bank, that the latest figures showed airlines were now succeeding in passing on to passengers

> '[The industry] should be more profitable but the trajectory is good'
> **Tom Horton, AMR**

fluctuations in the price of fuel. Competition used to mean that during fuel price spikes fares would fall, as airlines sought the volumes needed to survive.

Mr Parker has previously suggested that an American-US Airways merger might significantly further the process of making the industry solidly profitable. Mr Horton has also praised the effects of industry consolidation and the greater maturity it has brought to airlines' decision-making.

Yet, whether the pair agree merger terms or not, there is little doubt that significant further effort lies ahead to ensure that American's bankruptcy is the last for a leading US airline.

"I think the US airline industry has a ways to go to be more profitable," Mr Horton said in August. "It should be more profitable, but I think the trajectory is good."

Robert Wright

Government in backstop role

China

As growth slows, many struggling companies are being coddled, writes *Simon Rabinovitch*

LDK Solar began the year on a confident note. Already one of China's biggest solar-panel makers, it bought a German peer, Sunways, in January in a deal that appeared to burnish its credentials as a potential global leader in the renewable energy sector.

Appearances were deceiving.

With demand weak, inventories bulging and revenues collapsing, it has laid off thousands of workers and shut most of its production lines since acquiring Sunways. LDK's US-listed shares have fallen 70 per cent this year.

These troubles are hardly unique to LDK. Throughout the global solar industry, companies are suffering from overcapacity.

But unlike its US and European peers, LDK has had a crucial backstop: the government of Xinyu City in Jiangxi province, where it is based.

In May, Xinyu officials leaned on state-run banks to provide LDK with an emergency Rmb2bn ($317m) loan. Then in July, the government stepped in directly, allocating Rmb500m from its budget to help LDK pay off loans.

As the LDK case illustrates, corporate restructuring in China often hinges on the role of the government.

In the 1990s the central government was instrumental in pushing inefficient state-owned enterprises to consolidate, tolerating a big spike in unemployment in the country's old rust-belt regions in order to modernise the economy.

Now, with China experiencing its worst growth slowdown in more than a decade, government officials have so far refrained from taking such bold moves, instead coddling many companies that might otherwise have failed.

Ivo Naumann, managing director of AlixPartners in Shanghai, points to the auto industry as a prime example. While foreign automakers are doing well in China, many Chinese upstarts are struggling with less than 60 per cent capacity utilisation, when 75 per cent is typically the threshold for breaking even.

"Clearly you need to consolidate the industry and take capacity out. But since most if not all of these OEMs (original equipment manufacturers) are backed by the central government or provincial governments, it's just not happening," Mr Naumann says. "Overall, that hurts the industry because it drives down pricing and profitability for everyone else."

Ivo Naumann: consolidation needed in auto industry

But the story of corporate restructuring in China is not entirely one of government control. Smaller, private companies in sectors that are not seen as strategically important are allowed to fail. And as the economy slows, more and more of these, from retailers to manufacturers and property developers, are running into trouble.

"In the last half year we've seen a very significant uptick, even more so in the last three months, of situations that have come up," Mr Naumann says.

Arthur Kroeber, managing director of Dragonomics, a research firm in Beijing, thinks the pace of corporate restructuring will only increase over the next year.

"The reason that there has not been consolidation in Chinese industries over the last decade is because the money has always been there, either through operating cash flow or through loose bank credit," he says. "Cash flows are going down and government subsidies are drying up, so you are beginning to get market pressure."

In the first half of the year, non-performing loans grew by just 1 per cent across the bank sector, but overdue loans jumped by 29 per cent, according to Mike Werner of Bernstein Research in Hong Kong.

That increase in delinquent loans and covenant breaches is creating new opportunities for business turnround specialists.

> Smaller, private companies in sectors not seen as important are allowed to fail

Ted Osborn, leader of the PwC business recovery practice, says his firm had been marketing its restructuring services in China for years with little success. "Finally some of that is starting to pay off," he says.

A branch of one of the nation's biggest banks recently contacted PwC to ask for help in recovering loans. "For the first time they started listening and taking some of our suggestions," he says.

However, he is doubtful that this will be a big new trend. "The politics involved at these banks and with their customers that are in trouble are very complex, and they are typically solved behind closed doors," he says. "So we think only a handful of these cases will emerge."

For foreign investors who find themselves entangled in corporate basket-cases in China, the question of restructuring is a particularly vexing one. Because of restrictions on China's capital account, foreign investors often have limited claim to the assets of the Chinese company.

Instead, they own equity in an offshore entity that has a creditor-like relationship with the Chinese company.

So when the Chinese company runs into trouble, defaults and bankruptcies are not feasible options for the foreign investor – their entire investment would be wiped out.

"In many of those situations creditors have taken a very pragmatic approach because their debt is offshore, so taking an aggressive approach may not get them far," Mr Osborn says.

Mr Naumann says it has been a learning process for foreign investors, with the main lesson being that once a Chinese company is in serious trouble it is probably too late.

"Legal agreements do not give you the protection that you need," he says.

"At the end of the day it's really about how deeply do you get involved in companies early on when you see trouble."

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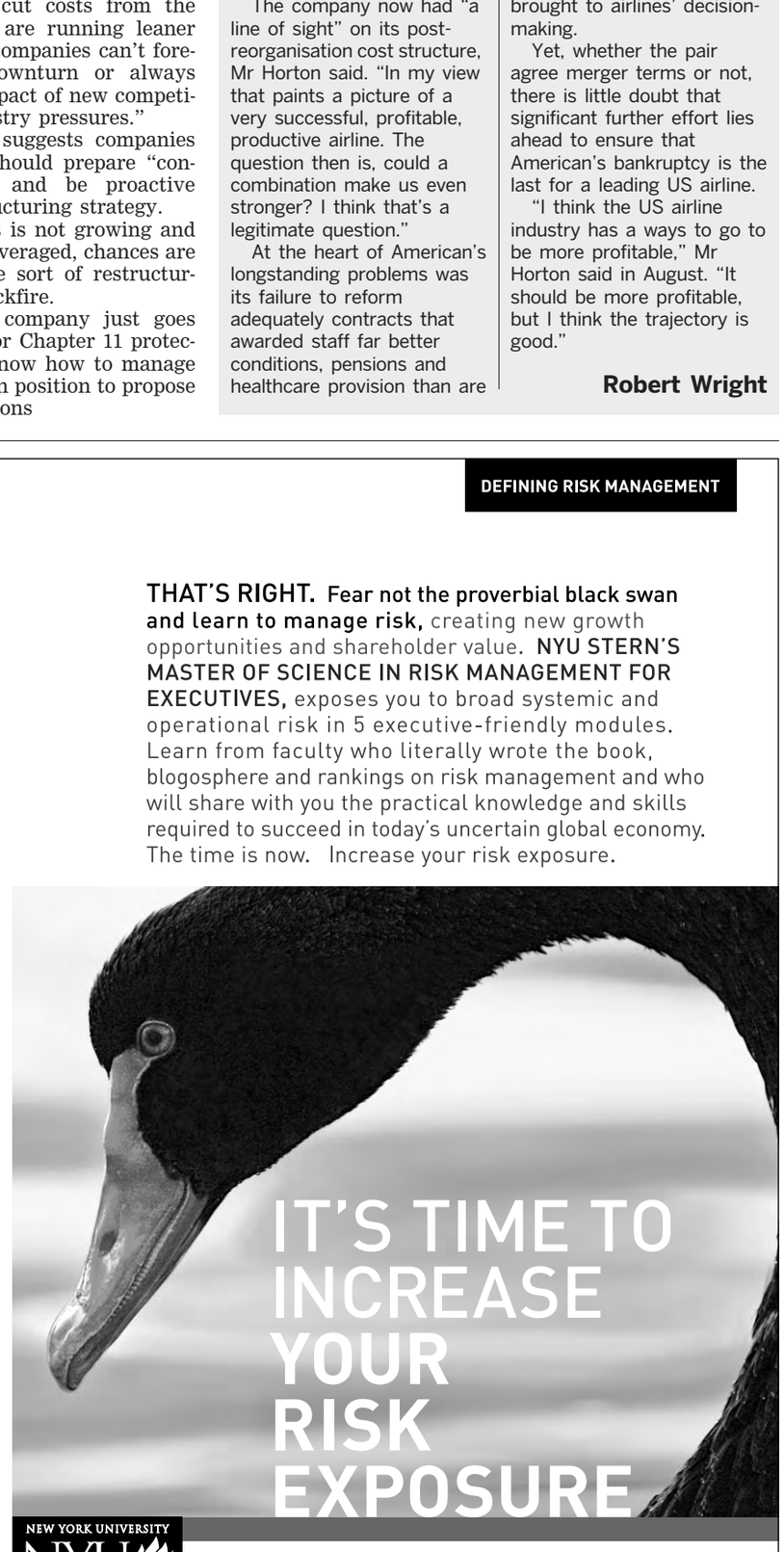

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Debt funds move in on weak stores

Retail The 'loan to own' route can bring faster restructurings, writes *Andrea Felsted*

Buyout funds and distressed debt investors are circling struggling retailers as they grapple with the consumer downturn, too many outlets and the inexorable rise of internet shopping.

This year has seen several funds take control of retailers in a trend that restructuring experts say is set to continue.

In March, OpCapita, the privately owned investment firm, bought the UK assets of Game Group out of administration, after trying to acquire its debt before the collapse.

A few weeks later, Jon Moulton's Better Capital paid £19.5m for all the secured debt and 90 per cent of the equity of Jaeger, the fashion retailer. Better Capital also looked at JJB Sports but did not make a bid for the sports goods retailer.

Acquiring the debt of a distressed retailer "can often be viewed as a no-lose situation," says Dan Coen, director and co-head of retail at Zolfo Cooper, the corporate advisory and restructuring services group, formerly known as Kroll. If the retailer is able to repay the debt, the buyer recoups its outlay plus a little interest.

This is the "worst case scenario", he says. The best case, from the buyer of the debt's perspective, is if the company is in default of its lending facilities, and the buyer can take control of the business, make tactical use of insolvency proceedings, and then embark on a radical restructuring.

This would allow the buyer "to restructure the business significantly more quickly and effectively than if it had to do it solvently", says Mr Coen. "By cutting store numbers and restructuring hard, you are ultimately coming out with a much stronger and, most importantly, more relevant business."

Indeed, Mike Jervis, a partner in PwC's business recovery services, says: "Almost all the retailers that get into the distressed space have one thing in common. They have far too many stores."

He says the "loan to own" route, taking control of the debt, is a "potent weapon" with which to force a restructuring, which existing management may be reluctant or unable to do.

"If you try to exit from 100-plus stores, it's going to take you several years; it's very uncertain in terms of how much money you are going to have to put into the deal; it's going to tie up masses of management time, and there is no guarantee of success," he says.

Mr Jervis says that for a fund to buy the debt, there has to be a seller of the facilities in the first place.

Better bet: Jon Moulton's Better Capital paid £19.5m for all the secured debt and 90 per cent of the equity of Jaeger Alamy

'Almost all the retailers that get into the distressed space . . . have far too many stores'

Ian Gray, a director at Baronsmead Consulting, a restructuring advisory practice, says some banks are shrinking their balance sheets.

But buyout funds "are prepared to go further than the banks and do it very quickly. When they review these assets, they often look at the insolvency options."

Banks may also be concerned, he says, about the "domino effect" of insolvency on other companies to which they are exposed. A buyout fund or distressed investor is not likely to have such exposure.

Alan Hudson, head of restructuring for the UK and Ireland at Ernst & Young, says distressed retailers also tend to be heavily operationally geared, as well as being financially geared.

The funds looking at distressed retailers are "coming in with a mindset of ownership and investment and [are] quite comfortable with operational turnrounds".

Indeed, OpCapita's approach is to inject experienced managers into the companies in which it invests, in an attempt to improve their performance.

Not all the acquisitions by buyout funds or distressed debt investors lead to an insolvency process.

Mr Moulton says Better Capital has stabilised Jaeger, investing in the business, and providing comfort to suppliers. "We are pretty optimistic that it will be a robust and profitable business very shortly," he says.

Indeed, Mr Gray says, for there to be a sustainable turnround and recovery, it is important for the business to be viable.

"It is often not just a question of reducing the debt burden. There can be little point in buying the debt, even at a discount, if there is little chance of a business surviving," he says.

But if a radical restructuring can be carried out, and a recovery plan executed, then the rewards can be very large.

According to Zolfo Cooper's Mr Coen: "People are still spending. You have just got to have the right structure in place to deal with the change in consumer demand. At the centre of all these big restructurings is a very well known, trusted, loyal brand, which has lost its way, because it has been operating on a 1980s retail model in 2012.

"If you can cut back the tail of underperforming stores, invest in a multi-channel strategy, and focus on financial and operational excellence, you can still in theory run a very profitable retail business".

Failure data hide hard times

Continued from Page 1

aggression as a badge of honour.

He adds: "Distressed debt funds tend not to have such broad relationships to care about, and acquiring the debt at a discount allows them a flexibility that banks often don't have."

Most bankers, lawyers and advisers in the field expect that distressed debt funds will become a more visible part of the European restructuring landscape, as defaults continue to mount in the coming year – primarily caused by the eurozone crisis.

Even the UK – which has benefited from controlling its own monetary policy and emerged as a "safe haven" amid the storm – noticed mounting stresses as the economy entered a double-dip recession this year.

Tony Lomas, chairman of PwC's UK Business Recovery Services, says: "We are seeing a steady flow of companies struggling with huge debt built up in the boom years. This is prompting a significant number of companies to enter into restructuring conversations".

He adds: "At the smaller end of the market, bank deleveraging is making it particularly challenging for companies to access both bank funding and the bond markets."

Some industries are more exposed than others. Restructuring experts have identified shipping as one of the most vulnerable, as the cost of transporting goods has fallen to near record lows.

The industry's woes have attracted the attention of distressed debt funds, but one senior London-based fund executive comments: "The fundamentals of the industry are dreadful.

"There's just way too much capacity in the industry. Some of these ships are worth more as scrap."

The situation looks somewhat brighter on the other side of the Atlantic.

US economic growth may have disappointed, but it remains considerably higher than that in Europe, and US banks tackled their dud debts more aggressively earlier in the financial crisis.

There has been a spate of high-profile situations – most notably AMR, the bankrupt parent of American Airlines; Hawker Beechcraft, the jet maker that was eventually sold to a Chinese aviation group; and Eastman Kodak, the once-dominant photography company. However, experts say the overall level has been no higher than usual.

Morgan Stanley's credit analysts forecast a default rate of 2.9 per cent for non-investment grade debt in the US, compared with 5 per cent in Europe. Citigroup analysts forecast that European defaults will rise to 6 per cent by the end of the year, but remain at about 2.5 per cent in the US.

"There have continued to be some larger US situations, but not many," says Mr Kurtz of Lazard. "The mid-market has been busier than the larger end. That is no surprise, as they are more exposed to the weak domestic US economy."

Yet even in the US, there are tentative signs that restructuring activity is set to pick up, in part caused by the eurozone crisis spilling over into both developed and emerging markets.

Company executives can draw comfort from the bond market's continuing willingness to lend, and the slow-motion deleveraging of European banks – but they should not be complacent about the challenges that loom over the next year.

Changing channels bring risks

Media

Some groups have responded too late to evolving consumer habits, writes *Robert Budden*

From broadcasters to music labels and book publishers to newspapers, consumer habits are changing – and fast. This is creating huge opportunities for new entrants in the media world. But it also poses significant risks for the established media companies.

At the heart of these changes lies technological innovation. Whether it is the growth of ebooks and self-publishing, wider adoption of digital video recorders and time-shifted viewing or the rapid growth of online news and advertising at the expense of newspapers and magazines, many long-established revenue streams are being eroded. The responses from companies have been to cut costs and change their business models. But often these moves have come too late.

The companies now undergoing the most dramatic changes are those burdened with debt, operate in structurally declining businesses and have been too slow to adapt to the rapidly changing consumer. Companies that fall into this category cover a wide range of sectors from newspapers to directories businesses.

Yell, the telephone directories business, is a prime example. The company floated on the London stock market in July 2003 with a market value of approximately £2bn, securing itself entry into the FTSE 100. But it failed to adapt quickly enough to dramatic changes in its marketplace, which has seen swaths of classified advertisers migrate online, eroding revenues.

Now investors in the company's £2.2bn of debt – Yell has been renamed Hibu in a bid to capitalise on the dramatic shifts online – are engaged in a second round of restructuring talks in less than a year that could lead them to seizing control of the directories business and formalising a huge destruction in shareholder value.

Mecom, the London-listed newspaper publisher that owns titles in the Netherlands, Scandinavia and Poland, is another, though far less dramatic, example. The company has been undergoing a cost-cutting programme that has involved closing a number of its freesheets.

It is also moving to a digital pay model across its best-selling papers following a review by Tom Toumazis, who took over as chief executive last August.

Non-advertising revenues, which includes circulation and consumer sales, have been stabilising. But overall revenues at Mecom's last set of results in July fell 8 per cent, weighed down by a 14 per cent fall in advertising revenues.

The company's problems are far from unique. Johnston Press of the UK, the regional newspaper publisher, has responded by moving many of its titles from daily to weekly publications. Last year the company axed 670 jobs, around 11 per cent of its workforce.

Revenues at regional newspapers have been steadily declining over the past decade as circulations have fallen and readers have migrated to the internet, damaging advertising revenues.

In books, rapidly growing sales of ebooks, pioneered by Amazon, are affecting publishers. In some book categories such as adult literature and romance, ebooks have been particularly successful.

In the US, almost a third of adult literature is sold as ebooks, up from 22 per cent a year ago, according to the Association of American Publishers. Those publishers too heavily weighted towards physical books have been hurt by these developments.

Companies now undergoing the biggest upheaval cover a wide range of sectors

In the world of TV there are different challenges. TV advertising is holding up in many markets. But fears persist that growing adoption of digital videorecorders will kill the 30-second advert and hurt the commercial broadcasters.

These challenges and the greater volatility of ad revenues, are driving some broadcasters such as ITV deeper into the world of content ownership where popular formats can be sold across the globe and revenues are more stable. ITV is also moving deeper into time-shifted TV and introducing micropayments as it seeks to capitalise on changing viewer habits.

In Italy, Mediaset, controlled by former Italian prime minister Silvio Berlusconi, has been hit by declines in advertising as the economy suffers amid the eurozone crisis. Its commercial TV arm is also being hurt by technological change as Sky Italia, the pay-TV satellite broadcaster, makes incursions into its home turf. The company is implementing a cost-cutting plan as it seeks to survive in the digital age.

But not all pressure for media companies to restructure is coming from wider trends within the industry. Vivendi, the French company whose assets span media and telecoms, has come under pressure from some analysts and investors who argue the company suffers under a "conglomerate" discount, a gap between the company's market capitalisation and the underlying value of its separate holdings.

Vivendi owns Activision Blizzard, the video games maker, Canal Plus, the French pay-TV group, as well as telecoms companies in France, Morocco and Brazil. In April the company launched a strategic review announcing nothing was taboo, prompting widespread speculation over what assets may be sold.

The company explored the sale of Activision but failed to find a buyer at the right price. Jean-René Fourtou, chairman, is understood to favour returning Vivendi to a pure media company. But, with the market for mergers and acquisitions subdued, finding buyers for its telecoms assets will not be easy.

Until the markets for initial public offerings and M&A pick up, this means the restructuring options for most media companies will remain focused on cost-cutting and seeking to position themselves for the digital world.

Game theory: a strategic review by Blizzard owner Vivendi has prompted speculation over asset sales Bloomberg

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