BUSINESS TURNROUNDS

FINANCIAL TIMES SPECIAL REPORT | Friday September 23 2011

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Door slams shut for corporate have-nots

A better outlook earlier in the year has given way to fears over refinancing and funding for growth, writes **Anousha Sakoui**

Three years on from the collapse of investment bank Lehman Brothers and a banking crisis that prompted a worldwide recession, the outlook still remains bleak for companies.

Global GDP is estimated by some analysts to remain stagnant at about 3 per cent this year and next, down from more than 4 per cent in 2010. Recession is still expected in peripheral eurozone economies such as Spain and Italy, according to analysts at Citi. "Recession appears to be a more likely outcome now in Europe and/or the US than three to six months ago," says Jonathan Stubbs, equity strategist at Citi.

While last year in Europe, earnings upgrades outpaced downgrades, today the situation is reversed, with downgrades outstripping upgrades, according to the Citi analysts. As economists lower growth forecasts, earnings expectations are being reset as economic activity slows.

This year, the story in the corporate world has been one of haves and have-nots. Companies that built up strong balance sheets during the crisis have almost unparalleled levels of cash. In one stunning example, computer maker Apple emerged this summer as having more cash than the US government itself.

But for many smaller companies, particularly those that are consumer facing, the economic crisis is still real.

"As the impact of the staggering post-Lehman concerted fiscal stimulus began to take its effect on the global economy in 2009 and 2010, many were lulled into thinking the worst was over," says Jonathan Coltman, restructuring partner at KPMG.

"This stimulus also clearly helped some companies to stagger on and put off hard restructuring decisions. Unfortunately, the stimulus is now waning and nations themselves are being dragged into financial crisis. The resultant impact on demand patterns, confidence and prospects of growth is only just emerging."

Corporate restructuring specialists say deleveraging on the scale required over the coming years will be a long, hard and socially draining process, and will have to take place against a backdrop of heightened, political, social, financial and environmental instability.

"Increased volatility and instability are also here to stay," says Mr Coltman. "The coming decade will be one of the hardest in living memory for CEOs, CFOs and boards to build and protect corporate value."

In the UK, corporate insolvencies slowly fell over the course of 2010 from their peak at the height of the recession in 2009, according to R3, a trade body for the insolvency industry. However, since the start of 2011 they have begun to rise once again.

In early 2011 the steepest rise in insolvencies has been among the real estate, wholesale and retail and manufacturing sectors.

UK company insolvencies rose to 5,974 by the second quarter of this year, having fallen to 5,383 in the fourth quarter of 2010.

Constraints in bank lending and a sluggish economic recovery are both factors in the increase in corporate failures. "Recovery is one of the most difficult times for businesses, as it takes time for a return to growth to translate into tangible relief for businesses, yet creditors tend to be more aggressive in their pursuit of debtors," says Frances Coulson, president of R3.

The first half of 2011 gave many corporates hope, as credit markets rallied, with high yield bond issuance reaching its highest levels.

This return in lending appetite among banks and institutional investors also helped support a revival of mergers and acquisitions activity, as the outlook became more certain.

But in recent months, capital markets have been choked off once again by renewed sovereign debt crises in the US and Europe. Equity and debt markets once again shut to those companies seeking funding for growth or debt reduction. Bankers have already started warning that there may be no new corporate listings in Europe this year if the uncertainty continues.

"If this negative sentiment, flight to safety and associated volatility continue, then we can expect another round of financial and operational restructurings to deal with pending maturities that are faced with limited refinancing possibilities," says Andrew MacCallum, managing director at Alvarez & Marsal, the restructuring specialist.

During the first half of 2011, the high-yield market was active and allowed companies to chip away at refinancing an impending "wall" of maturities that come due between 2012 and 2014.

Lock-out: interest rate rises could trigger restructurings while volatility in capital markets is hampering refinancing Corbis

"The high yield market was providing much needed refinancing capacity in the face of the refinancing wall," says Mark Sterling, restructuring partner at Allen & Overy, the law firm. "That's now shut and may not open for a while, given the volatility in the capital markets. This leaves billions of dollars of debt due for refinancing with no obvious source."

And while global interest rates remain suppressed, some restructuring professionals fear the impact of their eventual increase on companies.

"If interest rates rise and debt service costs crank up – with more groups becoming unhedged, a material interest rate rise could trigger a lot of restructurings," says Richard Tett, restructuring partner at Freshfields, the law firm. "There's a pent up supply of restructurings around Europe that are currently limping along – performing fairly well operationally, but just waiting to be restructured when the markets improve or liquidity or lenders' patience runs out.'

Financing is still available for the strongest companies. Many have taken advantage of cheap debt and bought back shares. In August, more US companies were set to buy back shares than in any month since the peak in 2007, according to Birinyi Associates. Companies in Europe and the UK have also stepped up buy-back programmes, according to Thomson Reuters data.

In recent weeks, companies including AOL, brewer Molson Coors and retailer Lowes have announced plans to buy back their own shares.

Analysts at Citi urge chief executives to consider capital or corporate restructuring as a way of creating value for shareholders. "Given the macro nature of the market, de-equitisation, through spin-offs or buy-backs, offers CEOs the opportunity to focus on self-help value-creation strategies," says Mr Stubbs at Citi. "Get smaller, get smarter, get a higher share price."

Companies have taken note. Divestments rose to a record share of global mergers and acquisitions activity this year, according to Dealogic data. Spin-offs and asset sales accounted for about half of global dealmaking, up on last year. In the US, such activity is up more than 40 per cent on the first half of 2010.

Steve Frobisher, business turnround expert at PA Consulting Group, says companies need to take advantage of the disruption.

"Companies need to secure enough capital to prosper, either by raising capital or by a ruthless focus on cash in the business, including selling off surplus assets," says Mr Frobisher.

"They need to create portfolios of winning businesses, remembering the adage: 'The best way to create value is to stop destroying it.' This means exiting or re-engineering value-destroying lines of business."

This year, US companies were most aggressive in taking advantage of the weakness of others. In the first quarter of 2011, US companies accounted for almost half of global M&A activity, up from about a third in 2010.

"Companies need to be aggressive in pursuing market share, as there will never be a better time," says Mr Frobisher.

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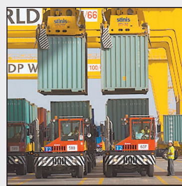

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Companies may founder on wall of maturities

Funding gap

Debt refinancing needs may exceed lenders' resources, writes **Robin Wigglesworth**

Apart from the humbled banking sector, companies across the world have largely weathered the financial crisis and the resulting global economic downturn, and have emerged in fine fettle, having spent the past few years deleveraging, cutting costs and fortifying their balance sheets with cash.

The spectre of insolvency may hover over Greece, while several western European governments have seen their borrowing costs spike, but companies have benefited from rock-bottom central bank interest rates to refinance their debt at attractive rates.

However, looming on the horizon is an imposing wall of maturities. Estimates vary, but Standard & Poor's, the debt rating agency, calculates that companies need to refinance or repay $8,000bn of debt over the next four years.

Given the weakened state of the global economy and still choppy financial markets, some experts predict these imminent repayments could prove a tripwire for many companies. The rash of debt repayments comes at a time when many banks – particularly in the US and Europe – will be more intent on reducing the size of their balance sheets than on extending loans.

"We are not sure that there is enough demand to meet the substantial debt refinancing needs," S&P warned in a recent report.

It adds: "A slowdown in economic growth could squeeze corporate profits, which would affect companies' ability to service debt. As a result, investors would be hesitant to lend their money."

Bankers are generally more sanguine, arguing that the capital markets will be able to pick up much of the slack.

They point out that there is always a wall of repayments looming on

Jeremy Froud: sanguine

the horizon, but it rarely poses systemic problems.

Indeed, the problem may be less ominous than it appears at first sight.

Jeremy Froud, head of debt capital markets for the UK at Barclays Capital, points out that some of the figures cited often include undrawn company credit facilities, which can be left to expire or simply be renewed – albeit possibly at a higher cost.

"I'm not overly concerned

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Pressure of continental debt crisis adds to woes

Calling time: Wind Hellas, Greece's third-largest mobile telephone company, had to restructure its debts twice AFP

Southern Europe

Eurozone periphery nations are lumped together but they have different sets of problems, reports **Anousha Sakoui**

Nearly three-quarters of the way through 2011, and the European sovereign debt crisis has only intensified, heaping further pressure on companies in the region.

Analysts at Citigroup say recessions are expected in Spain and Italy, as well as smaller countries on the eurozone's southern fringe. The cost of credit for these countries is broadly higher than those in Europe's core.

Across southern Europe, there are businesses ripe for restructuring in the private sector and moreover Greece, Spain, and Portugal have all lined up multibillion-euro privatisation programmes.

The difficulties faced by many companies in the region can be illustrated by the impact on their lenders. Barclays, the UK bank, for example, has expanded its team dealing with troubled Spanish borrowers in the past year in an attempt to limit what had been its biggest source of loan losses.

It has transferred some of its skilled UK restructuring specialists to the region to improve the recoveries in corporate restructurings.

One of the issues faced by lenders to regions such as Spain, Italy and Greece, now implementing austerity plans, is that restructurings are made harder by a largely untested bankruptcy regime. 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 are a number of businesses with significant prospects for growth, which will unfortunately find themselves in the eye of the storm, where local insolvency processes could be terminal," says Brian Lochead, partner and co-leader of PwC's European restructuring network.

"Turnround specialists in southern Europe face cultural and legal differences, a lack of trust if they are not part of the local community, and challenges around operating within an environment where there is panic surrounding potential financial meltdown."

Making the situation even tougher is that banks in peripheral eurozone countries, too, are under pressure. "The challenge will be to get banks to accept writedowns on their debt, considering their own balance sheet and capital adequacy issues," says Andrew MacCallum, managing director at Alvarez & Marsal, the professional services firm.

He says the lack of capital at many southern European banks means they "simply cannot afford any significant writedowns or write-offs associated with debt-for-equity swaps.

Most do not have the merchant banking aptitude or private equity portfolio management experience needed adequately to assess and manage converted equity stakes."

Angel Martin Torres, head of restructuring at KPMG in Spain, says it has become commonplace in international economic analysis to bundle up Spain, Italy and Portugal. However, he stresses the importance of remembering that the economies function distinctly from one another.

Mr Martin Torres adds that depressed consumer spending in Spain is not just affecting the retail sector, but is also having a contagion effect on distribution and other service sector companies. Real estate continues to be a focus for the KPMG team in Spain.

"What is clear is that industry needs to adapt; both in terms of restructuring its cost base to save cash but also considering fundamental changes to business models to turn performance round in persistently inclement conditions," he says.

"While restructuring advisers have a whole series of issues to address in the private sector, the public sector expense is still growing, compounding downward market pressures."

He adds: "Most insolvent companies end up in liquidation in Spain, but turnround specialists can stave off problems spiralling out of control, protecting precious business value."

In the private sector, there are already examples of companies taking action to restructure their business. This year, FCC, a Spanish construction company launched the sale of its US cement business, potentially the first of many disposals, in an effort to reduce its €8.23bn ($11.2bn) net debt.

> 'Most insolvent companies end up in liquidation in Spain but turnround specialists can stave off problems'

Spain itself has already launched its privatisation programme, including sale of stakes in some of the country's airports and an initial public offering of its National Lottery.

Greece has been at the centre of the sovereign debt turmoil in Europe. Eric Benedict, managing director at AlixPartners, says: "There are a number of high-profile and acutely distressed situations in Greece where we are likely to see further restructuring and refinancing followed by transformative mergers and acquisitions."

One high-profile example is Wind Hellas – the country's third-largest mobile telephone company – which had to restructure its debt twice, and this year entered into talks with the UK's Vodafone over a merger.

Greece, too, has launched a privatisation programme for its public sector to raise funds. In March, it appointed advisers for the first round of a €50bn privatisation programme aimed at averting a forced restructuring of its sovereign debt. It plans to raise €15bn over the next two years and another €35bn by 2015 from sales of state companies and the development of state-owned real estate.

Italy has also outlined a privatisation programme – Europe's largest to date. State-owned properties and utilities belonging to local authorities – excluding water companies – are expected to come up for sale. It is unclear whether the state will sell its stakes in Enel, Italy's largest power utility, or Eni, the oil and gas group, which could raise more than €30bn.

But advisers warn that privatisation of government owned companies will not necessarily be easy.

Keith McGregor, Europe, Middle East, India and Africa restructuring leader at Ernst & Young, says: "Governments in the eurozone peripheral economies have announced ambitious privatisation programmes.

"However, there are two significant barriers to achieving value: the requirement to prepare these (generally poorly performing) assets for sale; and the current prohibitive cost of funding acquisitions in these economies."

"Until both hurdles are overcome, it is difficult to see privatisation activity raising the desired value."

Dubai sends discreet ripples across region

Middle East

Restructurings in the emirate have inspired a second wave among family owned conglomerates, writes **Robin Wigglesworth**

Late in the evening on November 25 2009, the ritzy Arab metropolis of Dubai sent out a terse, seemingly innocuous statement calling for a debt standstill for its flagship state-owned conglomerate, Dubai World.

The statement fell like a bombshell on global markets, which had repeatedly been assured the emirate would be able to honour all its liabilities. The missive triggered a sudden and extensive restructuring of Dubai's sprawling, opaque government-related conglomerates.

"It was like nothing on earth. The first two months felt like drinking water from a fire hose," recalls Aidan Birkett, the former Deloitte partner who was swiftly parachuted in as Dubai World's chief restructuring officer.

Three years on, Dubai has restructured most of its companies and appears to be back on track. The Arab uprising has burnished the emirate's reputation as a safe haven in a turbulent Middle East, and attracted tourists and business from revolutionary such hot spots as Tunisia, Egypt and Bahrain.

Yet Dubai's restructurings, some of which are yet to be completed, have both caused and inspired a rash of other, largely family-owned companies to follow suit.

"There's something of a second wave of restructurings under way in the Gulf at the moment," says Keith McGregor, restructuring partner at Ernst & Young. "Once the government-related entities went through their restructurings, it became a little more acceptable for family conglomerates to seek help and do the same."

Most of the restructurings are still discreet. For cultural reasons, admitting problems publicly is rarely done, and regional banks – which are traditionally the biggest lenders to local families – are reluctant to cause a ruckus.

In the past, this would cause stressed situations to fester rather than be swiftly resolved, but the signal effect of Dubai's public restructuring has encouraged private companies to seek help sooner.

"Even though it's still a dirty word locally, we're seeing a lot more companies explore restructuring options earlier," says David Stark, Deloitte's senior restructuring advisory partner in the Middle East.

Prominent situations include the $1.6bn restructuring of Al Jaber Group, part of a large family owned conglomerate in Abu Dhabi, the $2bn restructuring of Saudi Arabia's Al-Ittefaq Steel Products Company, the second restructuring in two years for Kuwait's Global Investment House, and many other smaller and larger companies across the region.

The restructuring industry is also eyeing further work expected to emerge in Kuwait and Bahrain. In the wider region, Egypt is attracting attention, as many companies there are expected to be affected by the country's tumultuous revolution.

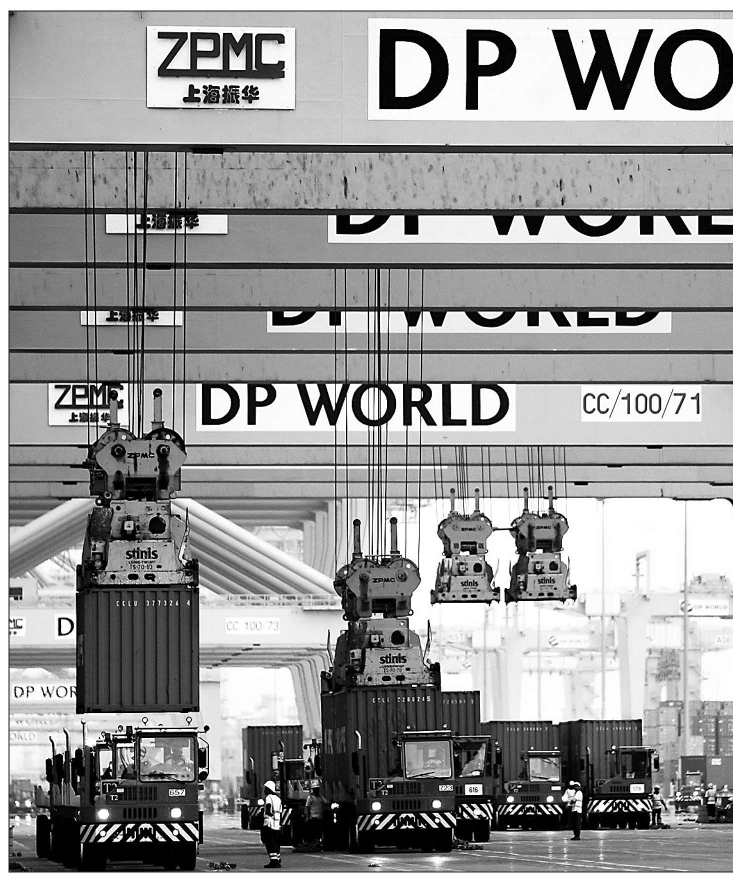
The stuttering global economy is likely to add to the headwinds for some industries, according to Neil Goldie-Scot, co-head of HSBC's European and Middle East restructuring practice.

He says: "The current global uncertainty will cause more restructurings in the region.

"More problems are likely to emerge from the woodwork, as conditions remain challenging, particularly in real estate and it becomes increasingly acceptable to restructure. Some companies are soldiering on, hoping for the best, but will probably have to restructure at some point."

The stream of work has ensured that flights between London and Dubai are still often filled with members of the relatively tight-knit community of restructuring professionals, such as accountants, lawyers, bankers and consultants.

"A large part of London's restructuring community [is] flying back and forward to the Gulf, as there's been a lot of work going on," says Eric Benedict, a managing director of AlixPartners, based in Dubai and London.



Port in a storm; DP World's Jebel Ali terminal in Dubai AP

The rash of restructurings is also helping local banks become more familiar with the process, making things more streamlined and organised, says Mr Goldie-Scot. The banks now know what to expect and are accepting longer terms on the loans, he adds.

Yet despite more experience with the process, creditors in the Gulf still get a raw deal. The regulatory and legal architecture is weak, when it exists.

Local courts are more used to dealing with issues of criminal law and *sharia*, not complicated financial disputes.

Even when rulings can be obtained, enforcement is difficult and can cause consternation in a region where banks – both local and international – are keen to remain in favour.

> 'Even though it's still a dirty word locally, we're seeing a lot more companies explore restructuring options earlier'

"The rights of creditors are less tested in the Gulf than in UK, with most of the international banks looking at the longer term franchise and opportunities in the region," Mr Benedict says.

For example, debt-for-equity swaps are rarely used, as indebted families and governments are loath to give up assets.

The result is that most restructuring agreements consist merely of extended repayment periods.

According to a report co-authored by Hawkamah, a Dubai-based corporate governance group, the World Bank, the OECD and Insol International, an insolvency body, the relevant laws in the Middle East and north Africa score an average of 88 out of 153.

The average among developed countries is 124. Saudi Arabia, the Arab world's largest economy, scored 85 and the United Arab Emirates scored only 74.

The average recovery rate in Middle East and north African bankruptcies is only a miserly 30 cents on the dollar, compared with an average of 55-60 cents in developed countries, says Insol.

Even the long-term success of Dubai's restructurings is still uncertain.

The extensive debts of Dubai Holding, a conglomerate owned personally by the emirate's ruler, Sheikh Mohammed bin Rashid al-Maktoum, still need to be dealt with, and even Dubai World, the Gulf's flagship restructuring, could unravel, some experts warn.

The conglomerate is largely dependent on the continued good fortunes of DP World, the global ports operator and a jewel in Dubai's crown of corporate assets, some experts say.

One experienced industry insider cautions: "It's still questionable whether Dubai's economy and finances will recover sufficiently to allow the 'extend-and-pretend' to work, or whether, in a few years, some more drastic restructuring will be required."

Institutions urged to kill or cure the zombies

UK

Concern grows over businesses in limbo, writes **Rod Newing**

The first phase of the UK recession was the result of a lack of credit, with a number of high-profile retailers failing, and a significant amount of debt restructuring activity.

The brake on economic growth has switched to a lack of consumer spending. Inflation has eaten away at income; pay is constrained; jobs are insecure; and a shortage of housing is pushing up rents.

"People have less disposable income, so we have a wave of insolvencies in the retail, leisure and hospitality sectors," says Lee Manning, a restructuring partner with Deloitte. "There will be a number of casualties."

However, low interest rates and HM Revenue & Customs' discretionary Time To Pay arrangements are keeping many businesses going that might otherwise fail.

Known as "zombie" businesses, they can pay interest on their debt but have no viable means of repaying the principal over the long term.

"They can't generate cash or attract development capital in their current state," says Christine Elliott, chief executive of the Institute for Turnaround. "They are in a state of limbo, being neither alive nor dead. Some banks and private equity companies claim to have very few in their books, but for others they may comprise 70-80 per cent."

The institute's research reveals that more than 60 per cent of its members have been involved with zombie companies. The concern is that any interest rate increase or public spending cuts could cause a wave of insolvencies among businesses that could be made viable.

Alan Bloom, head of restructuring at Ernst & Young, thinks some of the companies nursed through the challenging economic climate of the past two to three years have not necessarily justified that support.

"The decision to differentially support weaker businesses may have made some markets tough for the stronger players," he says. "This stance is now changing and lenders are becoming more discerning in their prognosis of which companies they will and will not support."

The same applies to HMRC, which is perceived to be less willing to defer much needed tax payments. Anthony Spicer, London head of recovery services at Smith & Williamson, the accountants, says that if this continues it could result in a number of companies finally going under after a prolonged period of suffering.

The latest PwC analysis of corporate insolvency reveals that 3,531 companies became insolvent in the second quarter of 2011, compared with 4,216 in the previous quarter, a 16 per cent decrease. However, the latest figure was 2 per cent up on the second quarter of 2010.

"The current economic downturn has not seen the same volumes of UK insolvencies as in the past," says Mike Jervis, a business recovery services partner at the firm. "This is because of much more sophisticated stakeholders, rescue techniques and early warning systems.

Christine Elliott of the Institute for Turnaround says some companies are 'neither alive nor dead'

"Being heavily indebted has not rung the death knell for companies with viable operations. However, declines in consumer demand and government spending cuts, which are capable of decimating turnover, will be the catalysts for new corporate distress."

Tyrone Courtman, lead partner for the turnround and insolvency practice of Cooper Parry, business advisers, says most people involved in business restructuring and insolvency have found the past 24 months quiet. As immediate past president of the Turnaround Management Association, he attributes the falling insolvency numbers largely to the UK rescue culture and the work done by turnround specialists.

The UK is generally considered to be a turnround-friendly environment, due to the range of flexible options available.

One that has attracted considerable controversy is the pre-packaged administration, which allows a non-viable business to be discreetly marketed to new owners and a contract negotiated. The business is then simultaneously put into administration and sold, thereby removing the risk of losing key employees or contracts during an uncertain and expensive period of administration.

However, key stakeholders feel excluded from decision-making, so the government has suggested giving three days' notice, although this has not been enthusiastically received.

"It could lead to suppliers, customers and creditors becoming reluctant to deal with a business that is seen to be in fundamental trouble," says Jeremy French, managing partner at FRP Advisory, a restructuring, recovery and insolvency firm. "Pre-packaged administrations are a way to safeguard jobs, so this proposal could make that aim even more difficult to achieve."

Mr Manning at Deloitte warns there could be a lot of value destruction in businesses where the intellectual capital can walk, such as recruitment and advertising agencies or software developers. In the construction sector, for example, the company could be thrown off the site. He thinks it would be better to put the case to a court in a transparent process.

The Institute for Turnaround recognises that pre-packaged administrations can be a useful tool, but its members always strive for a solvent solution.

Insolvency is a last resort and should be considered only if a business does not have a viable future in its present form. Even then, there has to be a turnround plan.

"Insolvency is not an aspiration – it is what happens when things go wrong," says Ms Elliott. "The taxpayer, shareholders, trade creditors and landlords all lose out."

She would like to see institutions that have potentially viable businesses under their care change their mindset. They should either recognise non-viable businesses and deal with them through insolvency or put in place a transformation plan to achieve their potential.

"State-owned banks are prepared to 'amend, extend and pretend'," says Mr Courtman. "There are hordes of zombie businesses being supported by the banks because – for political or capital reasons – they are simply not prepared to crystallise their positions."

There is a concern that leaving potentially viable companies on life support could weaken them. By contrast, turning them round would contribute much needed growth to the economy.

Air of risk aversion raises fears of tighter credit

US

Companies whose debt is rated as junk have been able to bide their time, writes Nicole Bullock, but how long can this last?

Some restructuring experts say it could be the calm before the storm.

Thanks to near-zero benchmark rates and voracious demand for high-yielding debt, US companies considered to be "junk" by the credit-rating agencies and thus the most likely candidates for default and bankruptcy have largely been able to bide their time over the past few years.

Default rates are historically low, as a robust market for risky corporate debt has enabled companies to push out what could have been debilitating debt maturities. But a recent downturn in sentiment in the so-called leveraged finance markets has raised the spectre of tighter credit ahead.

The question now is what happens if the problems from the recession and financial crisis do not reverse – or indeed worsen – at a time when investors are less willing to give companies more breathing room.

"Until now, there have been low interest rates, adequate liquidity and the hope that the economy was getting better," says Barry Ridings, co-head of restructuring at Lazard. "Among lenders, there has been the willingness to kick the can down the road."

Companies, primarily those that borrowed heavily to fund leveraged buy-outs in the boom years of 2006 and 2007, had been faced with a now notorious "maturity cliff" – a sharp incline of debt maturities.

Since the maturity cliff reached its zenith at year-end 2008, some $354bn, or 70 per cent of the total amount due in the years 2012, 2013 and 2014, was extended. This was done primarily by issuing longer-dated junk bonds or amending existing loan agreements to due dates farther into the future, according to Standard & Poor's Leveraged Commentary and Data, a research group that tracks the leveraged finance markets. The peak years now are 2014, 2015 and 2016.

Investors have continued to fund these companies in the hopes of higher returns, as the Federal Reserve has kept official rates low. A rebounding economy and falling default rates – both a cause and effect of the greater demand – gave them the confidence to be buyers in spite of the higher risk.

Against that backdrop, trailing default rates in the US have fallen to a paltry 2.1 per cent in August from a peak of 14.5 per cent in November 2009 and an average of nearly 5 per cent since 1987, according to Moody's Investors Service. The default rate is the percentage of the issuers it rates below investment grade that default versus those that do not.

In August of this year, for example, there were no defaults. There were none in April, either.

But an air of risk aversion has blown into the financial markets. Concerns about a slowdown in US economic growth and the possibility of a second recession, alongside fears of default in the eurozone, have tempered the appetite for risky corporate debt.

US mutual funds that buy junk bonds and leveraged loans faced heavy redemptions in August. And, although net inflows have returned for junk bond funds, the rates on this type of debt have risen sharply.

After reaching a record low of 6.61 per cent in May, average yields on junk bonds were 8.6 per cent in mid-September, a Barclays Capital index showed.

"We have a growth shock at the moment," says Bill Repko, senior managing director at Evercore Partners, the investment banking advisory firm. "[The US] is not growing, and not growing soon will create a huge uncertainty and a net effect on restructuring."

Signs of potential distress are beginning to emerge. Moody's speculative-grade corporate distressed index – a measure of the percentage of junk-rated issuers that have debt trading at what are considered distressed levels, soared to 19.3 per cent in August.

This was more than double July's 8.9 per cent level and represented the second largest increase since 1996, when Moody's began tracking this measure.

The largest increase was from September to October of 2008, when Lehman Brothers went bankrupt.

Restructuring experts say there are still fundamental problems left from the recession and financial crisis. While companies have pushed out large payments by a few years, many still have businesses and balance sheets based on pre-recession economics. Without a significant rebound, some could stumble.

Joe Bondi, a managing director at Alvarez & Marsal, a professional services firm, says: "Companies, particularly in the areas of retail and those related to housing, could struggle because of the trends of high unemployment, depressed house prices and weak consumer spending that have persisted in the wake of the financial crisis.

"Certain companies in these areas have not restructured enough to align themselves with the new [economic] realities. There are likely to be instances of default."

For the health of the financial markets, most observers agree Europe is the wild card. Should problems worsen, investors could become even more averse to risk, causing rates on speculative cogs of the market to rise further.

On the other hand, amid the late-summer turmoil, the Fed announced it would not raise rates at least until mid-2013. Persistently low benchmark rates have made junk bonds very attractive.

"It is really a function of rates and available cash," says Ken Buckfire, chief executive and co-founder of Miller Buckfire. "If the Fed keeps suppressing the cost of capital, all of these over-leveraged companies will be able to kick the can down the road again. But if you financed a balance sheet at 7-8 per cent and rates back up to 9 per cent, how do you refinance?"

Price-sensitive: EFH subsidiary Luminant's natural gas power plant at Lake Hubbard, east of Dallas, Texas — Bloomberg

Case Study Debt maturities extended at Energy Future Holdings but price of natural gas holds key

The equity of Energy Future Holdings, the US power company born out of the largest leveraged buy-out ever, has been dubbed an out-of-the money call option on the company's merchant energy and distribution assets.

Based on debt market values, observers say the roughly $40bn of debt surpasses the value of the assets. This year, KKR and TPG, its private equity owners, bought more time on that option.

It is one of the more extreme examples of a trend that has defined the debt markets since the financial crisis.

Debt-laden companies, primarily those such as the former TXU that were taken private at the height of the boom years, have been able to refinance and extend their debt repayment schedules thanks to robust financial markets and low benchmark rates, buying time in the hope that their prospects improve.

After a series of smaller transactions, EFH this spring pushed out the due dates on most of the $22bn in loans at a unit from 2013 and 2014 to 2016 and 2017.

Some observers have questioned the logic. The extra time cost about $850m, according to a regulatory filing.

The overarching problem for EFH is the price of natural gas, which is the primary driver of power prices in Texas, where Texas Competitive Electric Holdings, the EFH unit that owes much of the debt, sells it.

That price of natural gas has fallen from about $7-$8 per million British thermal units at the time of the LBO to about $4 now. The decline began as a consequence of the financial crisis and economic recession, but it has persisted thanks to additional supply in the US.

In the first half of this year, the consolidated interest on EFH's debt was about $1.9bn, compared to about $1bn in unadjusted earnings before interest, taxes, depreciation and amortisation, and $1.7bn, on an adjusted basis, including mark-to-market accounting on the hedges and dividends from Oncor, EFH's regulated transmission unit whose debt is ring-fenced from the holding company.

The credit derivatives market shows that investors are girding for (and speculating on) the near certainty of default for EFH. Dealers were demanding $5.7m upfront plus $500,000 annually to insure $10m of EFH's debt for five years, just shy of a recent record.

The company hedged the price of natural gas, which has helped, adding about $1bn to ebitda annually in recent years, says Jeffrey Cramer, an analyst at UBS. But the existing hedges begin rolling off in 2013. And, while the company extended the majority of its upcoming debt maturities, it still faces about $700m in payments in 2013, and more importantly, a $3.8bn debt bill in 2014.

About $3bn of unsecured bonds matures in 2015 and another $1.5bn in 2016. Warren Buffett's Berkshire Hathaway is a major holder of these bonds, creating expectations that Mr Buffett could play a leading role in an eventual restructuring.

What is more, if the company does not refinance most of this unsecured debt ahead of the maturity, it triggers the payments on $18bn of secured loans that were extended this spring.

In the latest twist, environmental regulators have ruled that the power company must comply with new regulations to reduce emissions. The Electricity Reliability Council of Texas, the operator of the Texas grid, has estimated that bringing plants into compliance could cost the company $1.2bn. EFH is suing to block the requirements.

The volatile commodities markets could always turn in a moment and revive EFH's finances. But if the current downturn in the market for risky corporate debt continues, with rates rising and investors feeling risk-averse, it will be harder and more expensive for the owners to buy more time.

"They have definitely made a lot of progress [on the debt maturities]," says Mr Cramer. "But they still need some help from the power markets."

Nicole Bullock

Companies risk foundering on wall of maturities

Continued from Page 1

at the funding gap," Mr Froud says. "Companies are aware of these repayments, and have deleveraged markedly in recent years. Indeed, many are sitting on excess cash."

US non-financial companies held more than $2,000bn in cash and cash-equivalent assets at the end of June, up more than $88bn from the end of March, according to the US Federal Reserve.

Cash now accounts for 7.1 per cent of all company assets, the highest level since 1963. European companies are generally less cash-rich, but are also hoarding.

However, although the "maturity wall" may not pose a systemic risk, it is clear that debt capital from repayments is likely to be redeployed quite differently – with potentially adverse effects for many sectors, countries or individual companies, argues Richard Tett, a restructuring partner at Freshfields Bruckhaus Deringer, the law firm.

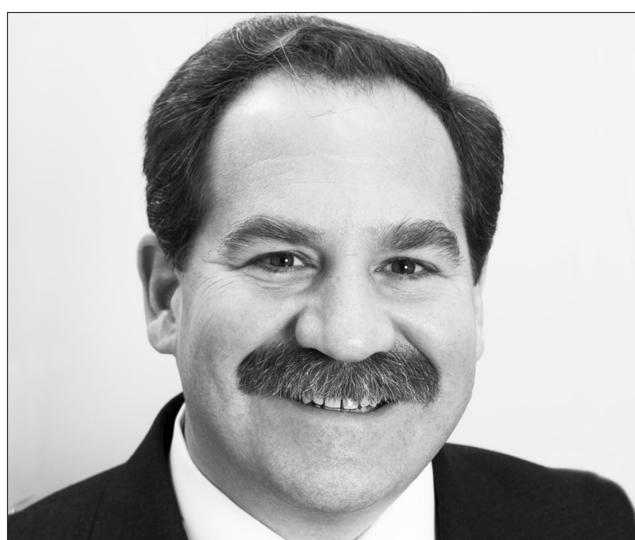
"There is always debt maturing, and the money that comes from repayments has to be reinvested, often in new loans, so it doesn't just disappear. But periods with lots of refinancings can lead to instability, as lenders have to re-evaluate where to lend," Mr Tett says.

There are indications that this summer's turbulence is now crimping demand. The volume of global investment-grade corporate bond sales has reached only $1,762bn so far this year, according to Thomson Reuters, indicating that the market may not surpass last year's $2,257bn total.

Although highly-rated deals are still being done – and often at rock-bottom interest rates – the riskier high yield market has been worse hit.

The global volume of junk bond sales has reached only $238bn so far this year, compared with 2010's total of $328bn, Thomson Reuters estimates.

Europe looks most exposed to a potential funding gap. S&P estimates that about $4,000bn of the $8,000bn investment grade and junk grade corporate debt that is maturing between mid-2011 and the end of 2015 is found in Europe, which is currently wracked by the sovereign debt crisis on its periphery.



Peter Griggs: 'We're seeing a flight to safety'

Refinancing that debt has become more challenging, as investors have taken billions of euros out of any bond funds that are exposed to Europe – whether sovereign or corporate.

"The maturity wall is always going to be there, but given what's going on in European capital markets and the global economy, it will be far more challenging to refinance than before," says Peter Briggs, a managing director of Alvarez & Marsal. "We're seeing a flight to safety as a result of the turmoil."

> 'Periods with lots of refinancings can lead to instability as lenders have to re-evaluate where to lend'

Europe's non-investment grade companies, and those in Ireland, Portugal and the continent's indebted southern rim, look like the biggest potential losers from a redeployment of debt capital.

After a robust start to the year, the euro-denominated high yield market has almost shut down, and credit default indices indicate elevated worries about a rash of defaults in coming years, particularly on Europe's southern fringe.

Keith McGregor, a restructuring partner at Ernst & Young, says: "The debt capital markets will absorb some of the refinancing demand for better performing corporates, but we expect them to remain volatile. So we're telling companies to have a fully developed plan B ready, in case markets aren't open when they need them."

Restructuring industry experts say the expectation of a funding gap causing distressed situations is luring in specialist funds from the US, many of which are setting up European offices for the first time.

Some are circling around debt that may have been oversold; others are sniffing around companies that they can take over by buying their debt and converting into equity ownership in a restructuring.

Some funds may even look to acquire entire portfolios of loans from banks under pressure to trim their balance sheets by investors and regulators.

"Europe needs to right-size and deleverage," says Corinne Ball of Jones Day, the law firm. "There's clearly a funding gap looming, and it won't be entirely filled by either the banks or the capital markets."

"If we want a recovery, we should welcome new money. We need to work out these situations and restructure them, get new capital into business, so we can move on," she adds.

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Fortunes vary as consumers and revenues go digital

Media sector

Salamander Davoudi sees restructurings ahead for companies that have not adapted to the internet era

The media industry has undergone seismic structural change in the shift to digital, which saw the migration of advertising revenue and consumers to the internet and led to serious challenges for most companies across the sector.

The road ahead still looks uncertain as advertising markets remain depressed and audiences and readerships continue to be fragmented among the multitude of media choices.

Many companies have embarked on heavy restructuring and refinancing in the sector over the past 18 months but media observers agree that few have turned themselves round fully. Many still face structural, operational and financial hurdles.

Douglas McCabe, an analyst at Enders, says: "The reason that there isn't a long list of turnrounds is because the companies that are surviving and thriving in digital are typically those that are undermining the models of traditional businesses."

The advent of the internet turned the media sector on its head. It lowered barriers to entry and removed geographical limitations. Ten years ago 50p of every £1 of advertising spend was channelled through print media, but now it is less than a third and will soon account for a quarter.

"What made these media businesses valuable was that their model was built around scarcity and there were huge barriers to entry," says Mr McCabe. "It was expensive and difficult to launch a newspaper or magazine, for example. And that made those businesses very attractive from an advertising perspective."

Many large media companies, some of which had not yet woken up to the full extent of the competitive threat from the internet, had also built up considerable debt.

"Media companies had been leveraging and investment bankers and analysts were all saying that leverage was good," says Alex DeGroote, analyst at Panmure Gordon.

He adds: "The downturn was predicated on excessive leverage. These were cyclical companies that were highly operationally and financially geared and that's a toxic mix."

Yell, the publisher of the UK's Yellow Pages, is often held up as an example of one of the sector's most troubled stocks. The directories business has struggled in a difficult economic and competitive environment, and there are concerns that the business model is no longer viable in the internet age.

Yell's net debt stands at £2.7bn ($4.3bn) against a market capitalisation of £102m and analysts have raised concerns that Yell could breach covenants in the second quarter of next year. The group is currently trading on a net debt-to-earnings ratio of 5.4 times.

Yell's new management, led by Mike Pocock, unveiled a turnround plan in July that aims to see revenues, earnings and cash flow return to growth by 2015. Only two years ago, the company launched an equity offering to raise £500m to reduce debt.

"Yell is the obvious one with the turnround ahead," says Mr DeGroote. "The company has already been through a refinancing. The issue here is the continuing cost of refinancing which greatly compounds the underlying structural challenges that it faces."

Similar issues face Seat Pagine Gialle, the Italian directories group and one of the most highly leveraged media companies in Europe. Seat has a capital structure that the company itself acknowledges is unsustainable. A debt-for-equity swap is expected next year.

Seat has net debt of €2.7bn ($4.4bn), which is 5.2 times earnings before interest, tax, depreciation and amortisation. The group must repay €1.4bn of senior debt before 2014. Its shares have fallen 98 per cent in Milan since their peak in 2007.

Mr McCabe says: "The problem with these companies and the scale of their financial problems has little to do with operating performance. These are good cash flow businesses today, despite the big downturns in the top line. Yell bought very expensive assets at the peak of the market that proved to be worth significantly less within a short time.

"The consequence is that you end up writing down very expensive assets and moving into a debt profile that is off the scale in comparison with the operating business you are running."

At the other end of the "turnround spectrum" sits Auto Trader, the UK motor sales classified group, which is held up as one of the publishing success stories of the digital age, as it restructured early on.

The group has seen its weekly magazine circulation drop sharply to 136,000, from 365,549 in the first half of 2003, but its website Autotrader.co.uk has 10m users a month and is the seventh biggest brand in the UK, according to Experian, the data provider.

Mr McCabe says: "In terms of print to digital migration, this is absolutely the success story in the UK. There isn't another company even globally that has been able to apply the same kind of formula."

Another media analyst says: "The company is a case study for taking a strong offline brand and turning it into a strong online brand without cannibalising the business. Management was forward-looking and saw where the industry was going."

This transition has been much harder for the newspaper industry. Regional newspapers are badly placed, being in a sector out of favour with investors. As sales dwindle, print costs rise and advertising remains weak, companies owning local papers are struggling.

Johnston Press, which has net debt of £370m, saw its interim pre-tax profits to July almost halve on the back of continued weakness in advertising revenues. The regional publisher of more than 250 newspapers across the UK reported pre-tax profits down by 47.4 per cent from £26.1m to £13.8m.

"Johnston Press has been one of the biggest victims of everything. They were being encouraged by the market to invest in Ireland on multiples that, looking back, seem absolutely absurd. Those deals tipped them over," says one media analyst.

Analysts agree there are several cycles of refinancing and restructuring ahead in the media sector. Some companies will survive and stabilise and they will continue to be cash businesses.

However, this scenario assumes that structural change does not accelerate too quickly and that enough revenues can be generated from digital. "This is far from certain," says Mr McCabe.

One media lawyer comments: "The current challenges are largely faced by old media businesses. If you are not already down the path to a new business model and are trying to turn a business round on a permanent decline, it doesn't work.

"It is different if you are trying to turn round a business that has already fundamentally shifted its strategy," he adds.

> 'Media companies had been leveraging up and investment bankers and analysts were all saying that leverage was good'

Deep in the country: acts such as Lady Antebellum are part of EMI's profitable new music business — Getty

Case Study Remixed EMI offers greater hit potential for new owners

Does EMI deserve to be seen as a turnround story? Soon after Guy Hands bought the home of The Beatles and Coldplay in August 2007, it became a byword for the follies of financial buyers who think they have a better idea of how a creative business should be run.

The £4.2bn ($6.6bn) deal was the last big European buy-out to be completed before the credit crunch that heralded the start of the global financial crisis. Before the transaction closed, Citigroup was already tightening the terms of its £2.5bn loan to Mr Hands' Terra Firma group. In February 2011, Mr Hands lost control of EMI to his lender.

Yet Citigroup has been able to spend the summer presenting EMI to potential bidders as a cleaned-up business, with strong margins, chart hits and improving earnings, albeit in an uncertain industry. A healthy list of bidders has been competing to own it.

Much is disputed about Mr Hands' tenure. His blunt assessment of how few of EMI's artists were profitable made him few friends, but few would challenge his analysis that EMI presented a turnround case. He saw EMI as a stagnating company struggling in the first digital decade of the 21st century with a bloated 20th century cost base left over from the golden age of the CD.

As frozen credit markets foiled his plans to securitise music publishing assets and a dire economy weighed on consumers' spending, Mr Hands announced plans to "streamline" the recorded music division, to chase fewer hits and focus on exploiting EMI's catalogue to the full.

He split the division into new music, catalogue and music services units, hoping to provide transparency about where money was made (and lost) and how cross-subsidies flowed around the company.

The 2,000 job cuts he announced at the same time were not carried out for months, leaving the people he needed to build the new corporate structure uncertain and demotivated, but their sheer scale transformed the group's profits. Earnings before interest, tax, depreciation and amortisation improved from £68m in 2007 to £334m in 2010.

A trimmed artist roster allowed EMI's marketing team to focus on big releases – from Katy Perry to a Beatles reissue – while building a profitable new music business with acts including David Guetta and Lady Antebellum.

Central to this was the development of an "insights" business, which brought hard data to bear on decisions about which albums to back and how to promote them. Insiders who doubted the idea soon embraced it.

Dismantling label heads' power bases helped make EMI a less ego-driven place, but the "matrix" structure Mr Hands put in its place initially made collaboration harder, insiders say. With confusion about reporting lines and frustration among those working closest with artists at having to wait for decisions from a separate music services division, it became an organisation focused more on itself than on its customers.

It took Mr Hands a year to find a chief executive, and Elio Leoni-Sceti, the former consumer industries executive he chose, lasted just 18 months. The appointment in June 2010 of Roger Faxon, a 16-year EMI veteran, helped calm the operational turmoil, even as the financial turmoil became more pressing.

Mr Faxon articulated a mission of turning EMI into a global rights management company. He also killed the matrix, replacing its "global business units" with a simpler structure comprising a strong office of the chief executive, regional operating hubs and empowered local business units.

One executive who lived through the changes credits Mr Hands with creating the conditions from which a more sensible operational structure could emerge, saying that by the time Mr Faxon took over staff had no doubt that change was essential.

In the music business, companies may not see the returns on the artists they sign for some years, so the final conclusion on whether Mr Hands cut too deep will have to wait.

But if EMI has turned round, it has been an almost accidental turnround, in which external circumstances upended the original plan, which was then modified again by management chafing under the revised strategy.

New owners will no doubt have new strategies of their own. But they are at least less likely now to see their task as a new turnround.

Andrew Edgecliffe-Johnson

Europe's banks ramp up teams for real estate work-outs

Property loans

Aim is for quicker, more flexible restructuring deals, says **Rod Newing**

Banks have been expanding and restructuring their property management teams to work more closely and flexibly with property companies.

"In the 1990s property downturn, there was some restructuring, helped by a well funded acquisition market, but it was mainly enforcement and sale," says Mark Batten, business recovery and property partner at PwC.

"The banks had small relatively unsophisticated departments. This time, however, there are not a lot of funds available for debt refinancing or acquisition. They knew they would have to work out the loans a lot more, so they have geared up significantly with people from a property or restructuring background."

Mathieu Roland-Billecart, director of corporate finance at Ernst & Young, says the main real estate lenders are now fully resourced and organised to deal with the scale and complexity of their exposures to non-performing loans.

Although no single solution has emerged, banks have a more established range of restructuring strategies and tend to reach conclusions faster than at the start of the crisis.

"We learnt from our heavy exposure to property in the last downturn and are determined not to repeat those mistakes," says Kevin Booth, head of UK business support at Barclays Corporate.

"Although our exposure to distressed property assets in the UK is more modest, with fewer clients in need of restructuring, we also increased team numbers through the downturn. The corporate memory was retained and a disciplined risk management approach taken, so we are in a relatively strong position."

The banks are driven by their need to balance increasing liquidity by exiting their property loans with a desire not to take any losses beyond those already provided for. To avoid this, they have rolled over many loans to allow for market recovery or more complex exit strategies.

Simon Martin, CB Richard Ellis professor in real estate finance at Henley Business School, says: "We haven't seen evidence in the market of the huge amount of deal flow from bank balance sheets that was being claimed over the past few years. However, there has been a change in the past few months in the banks' keenness to start moving assets they have had on their books for some time."

> 'We learnt from our heavy exposure to property in the last downturn'

There is almost no market for development property, so buildings must be completed and then leased or sold. Deals are being struck with existing or third-party owners to fund completion of the development and share the profits.

Mr Batten says: "There have been a number of cases where the bank could have sold a part-completed development and taken an absolute 'bath' on it.

"Instead, we have entered into joint venture agreements for a third party to provide the development expertise and share the upside from the activity."

Another mechanism is to sell a property facing a large write-off with the loan still attached and then share profits, depending on its subsequent performance.

There are also problems selling occupied properties that have only a few years left to run. They can require investment to upgrade them to encourage the lessee to re-sign, but the banks may not wish to finance it.

Prof Martin, who is also a partner heading research and strategy at Tristan Capital Partners, real estate investment managers, points out that banks are sometimes quite happy to retain their interest in a building. Many European banks are under pressure to show they are maintaining the size of their loan book and are quite comfortable lending back to the new buyer of a leased building.

"If they can lend 50 per cent loan-to-value on a familiar property that has 50 per cent new equity in from a third-party buyer, their position has been reset and it is a good asset," he says.

"It is all about the equity in the underlying collateral. If you have an overleveraged asset, you just inject equity and restructure the loan, and you have good collateral and a good loan that comes back on the balance sheet.

"They can demonstrate to their government, which probably owns a large part of their equity, that they are continuing to expand their balance sheet."

Mr Booth at Barclays says that without the legacy of a large portfolio of problem property loans to work through over the next few years, Barclays can support key clients in the sector with new debt. Nevertheless, much of the traditional debt market remain paralysed by lack of liquidity.

Madison International, a real estate private equity firm, is finding that providing flexible, institutional-grade equity capital to recapitalise existing properties and portfolios is buoyant in Europe.

The banks are approaching these situations in a highly collaborative fashion.

"They are much more willing than might be expected to consider the non-traditional route of facilitating a friendly equity capital injection and to make concessions," says Ronald Dickerman, Madison International's founder.

"Many of these relationships are not adversarial, as they have been on good terms with their clients over the years. It is providing lenders with an innovative 'win-win' solution to problems that previously could only be solved through the injection of expensive, inflexible debt."

The European financial system is in a state of turmoil and its banks are under stress from loans to overborrowed governments.

Prof Martin expects some sort of bank recapitalisation, which could be good in the long term, as it might help the banks finally to clean their balance sheets of their distressed property loans, which is currently a very slow process.

Mr Batten is also optimistic. He points out that, against a background of gloom, there is always money to be made.

He says: "With the right opportunities and the right restructuring there is still good value to be recovered from real estate.

"You just have to be more imaginative about it," he adds.