FINANCIAL NEWS

Roundtable discussion

PRIVATE EQUITY NEWS

Restructuring the survivors as the economy melts

The work of restructuring professionals takes on greater significance in such troubled economic waters. Private Equity News teases the big issues out of industry experts

- The volume of restructurings has increased
- Restructuring professionals expect more insolvencies
- Advisers in the field have found conditions for turnrounds to have worsened

Participants

Private Equity News' editor James Mawson put questions to the panel, at which sat (from left to right around the table):

Del Huse

Del Huse, managing director, leads the Endless presence in London and the south-east of England. Over the past 12 years, Huse has also worked in corporate finance at accountants Arthur Andersen and then as a partner and co-founder of the corporate finance division of Kroll. At Kroll Del was involved in a number of distressed M&A transactions, providing solutions for stakeholders in distressed assets.

Richard Jones

Richard Jones, head of Punter Southall Transaction Services, has spent 10 years advising corporate entities on pension and investment issues. Jones has spent his six years at Punter Southall working on a variety of UK and international pension issues from the corporate perspective. Richard has been involved in a large number of international mergers and acquisitions involving UK & US interests for both corporate buyers and private equity firms.

Paul Daccus

Paul Daccus, principal at Sun European Partners, has spent more than 11 years in M&A, mainly in private equity and acquisition finance. Prior to joining Sun European Partners in 2005, Daccus served as director in the corporate finance teams with Deloitte and Touche and Arthur Andersen executing acquisition, disposals, and fundraisings for public and private companies. He is a Chartered Accountant and a qualified member of the Securities Institute.

Michael Langdon

Michael Langdon, chairman, Rutland Partners, qualified as a chartered accountant with Price Waterhouse where he worked in investigative, consultancy and corporate finance for multinational clients. In 1986, he founded Rutland and led its transition from a quoted industrial holding company into a UK-focused mid-market private equity fund. He is involved in all portfolio management and investment activity and in liaison with fund investors.

Igor Zax

Igor Zax, chief executive at Tenzor, was a key member of computer maker Dell's finance team between 2000 and 2005, with roles in procurement, structuring, credit and trade finance across Europe, Middle East And Africa. He previously worked for Citibank (1994 to 1997), Daiwa Europe (1997 to 1999) and EuroHypo (2005 to 2006) and as an executive director of structured finance at SCF Capital. Zax is a Chartered Financial Analyst.

Restructuring teams are already busy, but expect more to come

Main points

- The volume of restructurings has increased
- Restructuring professionals expect more insolvencies
- Advisers in the field have found conditions for turnrounds to have worsened

Mawson: There is a lot in the papers at the moment that there will be better opportunities for restructuring professionals. How are you actually finding the markets now? Are they better than they were say two years ago, or a year ago, or do you think that conditions haven't yet warmed up for them?

Huse: There is definitely more volume around in terms of distressed situations. I recently read that KPMG have said that they expect there to be something like 5,000 corporate insolvencies this year versus something like 2,300 in 2007. We certainly receive more 'phone calls, but the number of deals that we are interested in doing is probably about the same, if actually slightly less.

Therefore, the reality is that the increased volume has simply made the job of sifting through opportunities to seek out those good nuggets a little harder. Also, PwC have just surveyed around 200 turnround advisers and managers and three-quarters said that the conditions for executing a turnround has deteriorated. So this is clearly is a very challenging environment in which to be doing turnround deals

Langdon: Yes, this recession has come so quickly and with such speed and, probably, depth that there are a lot of banks with debt problems wondering what to do, so I don't think the rush of great deals that you think might come has actually arrived yet.

I suspect the second phase of it, when unemployment comes in and other economic factors turn down, then you will see more deals coming our way that are more price-possible, because the pricing is not as low as we would expect it to be at this stage.

Daccus: We have seen a massive flurry of activity. What we have seen so far has been the real early phase, where there has been that liquidity crisis and the banks have not had the capacity to work these things out.

However, we need to view these things in advance, to look at the operational performance of the business and see how we construct for a turnround.

Huse: For Endless, one problem is that we often get the call too late. If it had been, say, 12 weeks earlier, even I suppose if it was eight to ten weeks, it could have been a very different

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Endless Partners

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Endless Partners

story – a turnround instead of a liquidation. By the time it has reached an insolvency position, it's often beyond saving and the insolvency event itself may be what prevents us doing the turnround.

In simple terms, we tend to look for three types of situation: a decent business with a distressed owner, or a decent business with the wrong balance sheet or a business with real operational improvement potential.

Daccus: Yes, it's about being able to identify the operational issues. If you can see a simple path to profitability, then that is exactly what we are looking for.

Where you are looking at a broken balance sheet, the difficulty is if the only issue is being able to service the debt, in which case the banks can sort that out themselves. They can swap bits of paper and charge new fees.

Mawson: Where exactly are you looking to find these sorts of deals?

Huse: Obviously, we get a lot of calls from insolvency practitioners when it is about to go in, or is in, administration.

There are some of the advisory firms, not just the big four, but also firms like Grant Thornton, Zolfo Cooper and BDO Stoy Hayward, that have grasped the concept of accelerated M&A and distressed M&A very well, and we see good-quality deals from these specialist advisers.

Once you have got a good profile in turnround and special situations, you also get calls from management in relevant businesses. Some of the best calls we get are from management teams who run decent subsidiary businesses in poorly performing groups. They might recognise what's coming for the parent and want to prepare themselves to ensure continuity of their own business. These can be great opportunities. We also get calls from restructuring lawyers, certain corporate financiers, and turnround managers who are working in the market.

Langdon: One thing we all recognise, I suspect, is that private equity owners or a business that has got into distress is more complex than just a bad balance sheet where someone needs to put money in.

It is more complex than that and they are not going to wash their dirty linen in public if they can possibly avoid it. Very seldom does a private equity owner ring up and say, 'I've got a problem'.

Zax: Generally, there is a sense of denial within traditional private equity because they are used to thinking that things will eventually recover and grow over time.

Huse: Some of the deals we have done have been private equity-backed, but we are not normally buying them from the private equity house, we are buying them from the banks who have become the de facto owners

Mawson: Do you get many from debt investors, such as hedge funds and collateralised loan obligations?

Langdon: No, we are not seeing hedge funds ringing up and saying, 'Hey, help us out of this problem, help us out of that problem'.

Often, there is confused control; there is confusion between who has got the power and who has not, and there are big debates between them. That is why there is a delay element at the moment. In six months' time, this will all start to look a bit different when some of the reality comes through.

Daccus: We have seen quite a lot of hedge fund-backed businesses where they have bought in through the debt and have gone through and taken control of the equity. Then, they realised that owning businesses isn't actually that much fun, especially not in a difficult environment.

Because these guys typically don't have the skill set to turn businesses round, you are not solving the underlying problems in the business and then you are left with exactly the same problems you had before.

So some of the big pan-European restructurings where the hedge funds got involved – things like TMD Friction and Schafenacker – a lot of these things are coming back round, and, in many of those cases, will get to the level of some form of administration where these guys, typically, are going to get wiped out.

Mawson: With the speed of the recession coming on, is there a feeling that people are trying to catch a falling knife?

Langdon: We haven't done a deal for a year-and-a-bit because of that premise; we are cautious on pricing. I have never been clever enough, and I have been doing this for a very long time, to buy at the bottom and sell at the top. There is more danger on the way down as it takes longer and costs more, and usually forecasts are optimistic.

So, as things start to fall down, you put that into your calculations. The vendor is usually advised by some advisers who are trying to get their fee by promising it being 'not quite as bad as you all think'. People who have bought in the last year or so in turnrounds may get away with some of them, but price hasn't got as low as it will get and catching the falling knife is exactly what everybody is worried about.

Daccus: There is a huge disparity in valuation, so a sellside adviser and a company think the recovery starts tomorrow and will be relatively sharp. Yet, when we look at these things, we think it is going to get worse and the recovery is going to be very slow – put those into the mix and the disparity in valuation between the buyer and seller is huge.

Huse: Experience tells us that whatever you are being told you are getting, the reality is probably worse. If needed, we factor this in, assume we are starting from a lower base, and that it is going to cost more and take longer to turnround.

Langdon: And don't forget the unexpected happens. Murphy's Law is about in the turnround – the thing that you thought was going to be okay will end up not being right.

Be that as it may, however, it is always the tension in these environments between buyer and seller, but at the moment we are falling quickly and I suspect sellers are not selling if they don't have to, or they are protecting their situation. Certainly private equity boys are looking at saying: 'We have got a bit more money in, we can protect the valuation'. When it starts to cut, then maybe we will get a bit more confident about what we are proffering. We will soon get near the bottom. You are never scientifically right, but when you get near the bottom, the desperation comes in for the seller, which is just, 'Get it off my hands', which is music to our ears. That is good our side, and the quid pro quo is that we can put in conservative assessments on how long it takes and typically it takes longer and all the rest of it, and then it starts to work.

Zax: One other issue about this recession is that actual defaults are at low levels – they are lower than in 2002-2003. If you look at the banking system, you then have to make a comparison with 1929. A lot of people still hope that it will stay this way. This disproportionally low default rate cannot stay this way and it will be triggered later. Once it is triggered, there will be a significant price correction.

Langdon: There is a lot of debt in these businesses. There is a huge deferral at the moment while the banks are in deep, deep crisis and have gone through an absolute shock process, are sitting there saying that they don't want to have all of these write-offs all in one go, so there is a deferral there.

The breakdown will start to occur because, underlying it, this recession is as tough as ever. We went into this recession in a better state in some respects, but we were leveraged as an economy, so were all these companies, and for the banks to recognise huge write-offs (which is going to have to take place over time) is a deferral rather than a denial.

Zax: I am a little frightened when I see bank results and financial institution results and you see some of them making absolutely massive write-offs and some of them making much, much smaller write-offs. The question of timing is so very discretionary at this particular point in time.

It is very difficult to derive actual levels of impairment from the financial statements of banks and life assurers. In particular, a lot of asset relief programmes in different countries create a very strong incentive for financial institutions to defer these costs.

Daccus: The banks are not doing anything proactively at all. Unless a business desperately needs money and there is a real liquidity crisis, then they are going to do nothing at all.

They will sit on it, they will monitor it, they may defer some repayments, re-profile their date of debt maturity, reset covenants, charge some fees, but unless it desperately needs money, they will not put it through a process, so you won't see defaults.

Also, we are looking at a bank level that was written two or three years ago that is incredibly covenant-light. There aren't that many triggers for the banks to pull here, so by the time the trigger is actually pulled it can be too late.

Mawson: And so, for the actual businesses and economy, is that necessarily a problem?

Daccus: It is a problem, because these companies are in a state of limbo. They are effectively the walking dead. They can't afford the things that need to happen: to invest in their future or to restructure, so they are just dying a painful death.

Huse: We see cases where the bank has recognised the business needs a capital injection and they look to the market to price their debt, the market answer tells the bank the value of the debt if new capital is required, but the bank doesn't like the debt price and then nothing happens.

We then see that, rather than injecting the lump sum of capital the business needs to do develop, the bank drips money in very small sums and simply keeps the business ticking along until hopefully something better comes around the corner. But who knows when something better will come along?

For management, this situation is not an attractive proposition. Their own equity incentive is probably dead and they then need to operate the business in a hand-to-mouth fashion in order to support debt levels that are too high.

Langdon: Then it doesn't work, which creates areas that are interesting for us to look at. That, again, is a deferral process which naturally happens through recessions.

Mawson: What are the differences between a restructuring transaction and a classic buy-out or growth capital investment? Is it that you looking for cash rather than price-motivated vendors?

Langdon: It is a good question, and it is a very straightforward answer. Normal buyout and buy-in, you are looking at a business where they are going to back a management team, leverage it, hope to have some arbitrage on the fee at the end of the day and pursue and help and work with the management team to make the growth story come true.

That is diametrically opposite to what we are all involved in. We need management teams that may not be complete, that have missing ingredients, and are in trouble. I always use the example that I can go to meetings where there are bankers in one room, the shareholders in another room, the management in the third room. Everybody is blaming everybody and it has all gone horribly wrong.

It is a completely different environment, and we are assessing risk, return and how you change it and how you refinance it, and probably don't believe the growth story, if that is even put to you. It is about salvaging, changing – a totally different environment. Leverage isn't the issue at the end of the day; you are probably so worried about that you can't borrow money, then how much leverage is in the turnround situation?

It is going to be much more conservative than a conventional private equity story. I suspect we all are trying to change value as well. One way or the other, we are all trying to make changes to the value of the underlying business. In fact, honestly, and it's not being unkind, private equity really was a leverage play.

Huse: In part, the difference is the motivation for the transaction – we look for deals where there is a need to do a deal rather than a desire to do a deal.

Clearly, in distressed situations, stakeholders or administrators have usually worked out that there needs to be a sale or equity event. In the current environment, certainly the past year, if someone was selling then there has generally been a very good reason for it rather than a desire to try and get some value.

Going back to process and how is it different from conventional deals, one of the things is the flexibility of approach that is required for turnround. You have to come at it with a very open mindset about the way deals are funded and the way a deal is structured.

Zax: There is one fundamental difference in terms of what are you buying and what you are relying on. In traditional ideology, you bid

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Rutland Partners

for buying a cashflow projection, so people are saying: 'There is a cashflow there, there will be growth at this level. Whatever the leverage is, we can divert part of this to banks. The remaining part will still be very good and it will provide enormously good return on a small amount of equity relative to a total price'.

Restructurings are much more based on an asset. Does that company have something valuable? Does it have a brand? Does it have a market position? Does it have some physical assets? Does it have something? Now, if the assets are not used in the right way and there is a better use of those assets that actually provides return, we can do a deal.

In terms of financing, nobody believes cashflow projections at this point in time, nobody will lend you a penny just against your projected cashflow.

Now, if you have some assets that are valuable and you can have at price, you can also get some debt funded against a particular asset.

Daccus: Yes, I think we should draw a distinction here. It is useful if there are lots of assets and you can get leverage, but if you cannot, then that just gets reflected in the price. The bit that is important is making sure that the business has got a reason to exist. Does it have a good brand and will people miss this business if it disappears.

Then, how we generate our returns is by making the business better, by improving the profitability of the business rather than financial engineering, or relying on price/earnings arbitrage, so it is very, very hard work.

The big difference between traditional private equity and what we do is the amount of resources we have to commit to it. In Sun, there are 150 people globally. We have got 50 people who just help management teams turn businesses around, and traditional private equity is not set up for that sort of structure, so therefore they can't generate their returns through this method unless they reinvent themselves, but that is going to take a lot of time.

Huse: I guess we are all at the very hands-on end of private equity. It is not a case of backing a management team and hoping things turn out well. A turnround deal for us might need three or four of our own professional staff working in the business for a period helping to design and implement a turnround plan. You hope that, in time, you can start to step away as the business gets onto a better footing, but, in general, turnround is very resource-intense.

Speed as well. Some of our deals are done in days. We probably average a few weeks, so it is a lot quicker than conventional deals. Also, you are often relying on imperfect information. Often, these deals haven't come about with the benefit of foresight, so in a traditional sale process you have had months of planning and it is all neatly packaged and it is in the data room etc… we don't get that, particularly in some of the really quick ones.

Mawson: So how can you get comfortable with that level of uncertainty?

Huse: There is probably more judgment call around risk. You are not afforded the opportunity to do due diligence everything to death over months, so you do have to take a commercial view around certain risk areas and manage your downside risk.

Mawson: Are you then compensated in terms of the money multiple you are looking? Where does the value come from?

Langdon: We look at money multiple, yes. We don't look at trying to get a higher price arbitrage. We are thinking: 'What is the end value of this business on a conservative basis, and will we make a decent return on it?'

That is over a period – two or three times your money over two or three years, if you can do that. It is probably going to be four years now rather than two years and we have got to work with it for longer, and thereby the price at the beginning has to be less. That is the tension that exists at the moment. We are not trying to hit the ball out of the park and make 20 times the money.

There are funds that do that. In America, they have got several that are very successful. They will do 10 deals and expect six to fall over, but for the other four to make a huge return. We are not in that game.

It is a more conventional return of two or three times your money, if you can get that on a turnround, and it is usually on a multiple of what we think it to be intrinsically worth. Waiting for the boom to come to be able to sell it at eight times, rather than four or five, I think that is wishful thinking at the moment. It might come, and it might not. If it does, it will be a perk.

Daccus: Yes, that's exactly right. It would be a perk. When we are underwriting deals, we assume absolutely no private equity arbitrage. So we expect that whatever multiple we pay for it now is what we expect to get out of. Our returns are purely generated from the operational improvement in the business, which, therefore, generates incremental ebit [earnings before interest and tax] and that is how you get your return.

Langdon: Probably, there is no ebit to start with. There is a pro forma, but certainly I don't really think in terms of price-to-ebit multiple.

Huse: An outside observer would expect that we would be taking on riskier propositions. The likelihood of business failure is higher and this will be reflected in the valuation. I guess turnround investing is a bit old-fashioned, but it is what private equity was originally about – ebit growth and improving the quality of the business – not about particularly whizzy financial engineering. There has been a lot more emphasis on leverage and multiple arbitrage in recent years… some of our businesses aren't leveraged at all.

Zax: What we need to look at is what will be the asset and how would the industry structure look at the time the sale will happen.

Now, when we look at the trade sales, we see what will motivate the buyer. We will come out of this with a very different industry structure. Substantially more consolidated and substantially more vertically integrated ,as it was far too risky the way companies were doing it before in outsourcing strategic parts of the operation.

It is very important to understand the motivation of the buyer and, more or less, fund acquisition for the potential buyers.

Langdon: There are an awful lot of companies that are in dire trouble and need turning round but are 'unturnroundable'. Companies go bust because they have got a bad product, bad management, bad whatever it is, so quite a lot that are shown to us are never going to work. It is a natural process, that is how capitalism is.

There is a surprising number that have survived for a long time, struggling along. Quite a few in the world of private equity have struggled along and are never going to do particularly well, but get over-leveraged and have to be written down to virtually zero, and there might be a little something left in there for a small deal. There are an awful lot of bad companies about.

Huse: Woolworths is an example, isn't it? The marketplace no longer wanted its proposition, and it probably got away with it for a long period in a buoyant consumer market, but, in reality, the market was demanding product specialists and the 'Woolies' generalist business model was redundant.

Langdon: Also, probably a lot of retail. I suspect we are all pretty cautious about retail, one way or the other, as that is the first phase. The more interesting turnround deals come in the phase where there are industrial groups with a reason and a market share and an asset of some sort or other that you can bind to a conservative value.

Daccus: Yes, there have been a lot of retailers that have failed. There has been a wall of money available to these businesses, so they hit the buffers a lot longer after they should have.

Woolworths is a great example. I spoke to my grandfather and he said, 'Oh, Woolworths' day has gone', and if my Granddad is giving me advice and he can see it, why could the debt markets not see it 12 months ago?

But, you know, the money was available, the businesses took this money, they limped on and limped on and limped on until they hit the wall. At that point, there is no point in investing in them because you can't fix them, you can't turn them round. You can't make money from these sorts of businesses, so we pass on a huge amount.

Mawson: Are you finding here that there are more indigenous groups forming? Or are you seeing some of the US players, such as Lone Star, Oaktree Capital and others, come across because they are seeing opportunities in Europe as being relatively more and better than in the US, where the leverage problem is relatively worse?

Zax: Europe is still quite underserved by turnround investors. You have got a handful around the table, and this is probably it out of good-quality turnround investors that are interested in taking a business, making it better and selling it after three, four, five years.

You saw a huge amount of hedge funds coming and having a dabble at this. You have seen quite a few in each individual market spring up, so, in Germany, there are two or three that are very good and very credible, France has got a couple who are actually very good in their own markets, but pan-European turnrounds? There are very, very few people that would do that.

The same is true in each of the individual geographies. You are talking about a handful of credible players.

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Igor Zax,
Tenzor

Huse: In our area of focus, the UK lower and mid-market, we have long expected that more competition will arrive and that more money will come into this space, but it hasn't. For a start, it is clearly a dire market for fundraising, irrespective of whether it is turnround or any other asset class. In this market, I think funders will want to see a track record of turnround investment.

I would have expected more restructuring advisers, and possibly more traditional private equity firms to be entering the space, but the two issues of fundraising and having a track record are preventing the market entry, so there are pretty strong barriers in the sector.

Langdon: The commercial buyer will be the first. If they want to buy something and if they have got the overhead structure and everything else, they probably can beat us on price.

I do think that the banks' workout groups' attitude of 'put in a company doctor, change it around, let's see what happens, don't write it off yet, and, by the way, certainly don't let Endless, Rutland or Sun or anybody else near it because they will try and steal it from you', will be a phase.

Then, I fear, there will be quite a few people in some of the larger private equity houses who will respray themselves 'turnround specialists'. Usually, they have a dabble in the market, have a couple of failures and then back off again. Because it is a different mindset (and, by the way, the people we employ worked with us for years), it is a different game.

Mawson: Is that because there is so much trust involved?

Langdon: There is an issue about if you are an adviser with a big firm of accountants or whatever and you are called in to advise on a difficult situation. Knowing that the people who are going to come and have a look at it are going to be able to deliver and will be familiar with the issues involved is a big plus.

If you have got experience in it, then you are unlikely to pick up the telephone to a competitor. A typical situation, they will ring: 'We want to deploy £20m to £30m worth of deals as an equity element of it. Perhaps £50m to £60m if necessary – money is being thrown at us at the moment.' They will want to know that you are familiar and can move quickly, that you are going to take a view on commercial issues, that you are going to work with an incomplete management team.

You are not going to sit there and say: 'Hang on, there isn't a managing director here.' That is where the adviser will focus a bit more, because after all, they want to get their fee and they want to get it done quickly, so that will start to come. It is already coming in.

Daccus: Yes, it is about speed of execution and providing certainty. Traditional private equity will take a couple of months to do a deal, and we are doing deals in two, three weeks, which is the speed part of it. But the certainty part of it is that dependability. Having worked with work-out teams before, they know that Sun can write the cheque and that we will deliver if we say we are going to do it, and that is incredibly important to these guys, because what they do not want is to run a process for two to three weeks and be left with nothing at the end of it.

Huse: On the competition point, if there is some form of process run by an intermediary on a distressed situation, it is the same competition and group of buyers we see time and time again.

However, for some reason, I haven't seen many situations where we have got excited about a deal and ended up in a bidding war with another turnround investor.

You do not tend see five or six houses competing for a deal as they would for a traditional buyout.

On turnrounds, it is about speed and certainty. The stakeholders need somebody who can deliver and this for them is much more important than in a traditional deal – they don't usually have the luxury of turning to buyer 'B' if buyer 'A' doesn't work out.

The other area of potential competition for us is banks doing turnrounds themselves. For example, Barclays, Lloyds and RBS all have private equity in-house turning their hands to turnround deals.

Mawson: Are there any conflicts of interest in that?

Daccus: If the banks want to do it, then more likely they will do it. You might not even see these things. There is a certain process they have to go through to justify it, but if they want to swap some debt for some equity, they have pretty much got all the cards in that situation.

Huse: The question is as much about skill sets and approach. Yes, the bank can do a balance-sheet restructuring, but will they go into the business, put people in full time and drive operational change?

It is interesting how many deals we see that have been restructured by a bank, but nothing has changed at the heart of the business, problems continue and then we see it the next time it runs out of cash.

Zax: There are also two issues. One is cultural, one is regulatory. From a cultural standpoint, in Germany or Japan, banks hold significant stakes in a company. In UK or US, however, that is not considered to be normal or a proper long-term solution. I don't think that this is something that will be accepted culturally.

On the second issue, it is yet to be seen what will be the view of regulators, which will have a lot of implications. What type of regulation do you get, because, at the end of the day, the regulator is concerned about depositors?

Now, they sort of understand when your deposits are secured by some type of debt instrument that has some type of rating on it. If your depositors are secured primarily by equity estates, that will be a major regulatory issue and it remains to be seen what will be their reaction.

To a very limited extent, it will probably be allowed, but it will become more than a temporary feature. I think we will get both cultural and regulatory factors.

Jones: Well, one thing I would say about the restructuring cases we have worked on is the quite interesting behaviour of the banks. First, they don't really want to be owning these businesses themselves and they would much rather have somebody to come in and take over these businesses and manage them, but the competing tension against that is that they don't want to take write-offs.

So, economically, they take write-offs, but they restructure the deal in such a way that allows them to keep it at book value. So, they get worse debt priced at the same par value at day one.

Mawson: The Conservatives [a UK political party] have also talked about UK and Europe, although they are talking more about the UK, say we need a sort of US-style Chapter 11 where the businesses can trade through administration and there is less of the damage caused by that. We have seen a number of companies coming through successfully. Do you think it could be beneficial here, or do you think that the current rules are set up reasonably well?

Daccus: It could be very beneficial. The issue with the UK administration is it is an incredibly hard landing. There is no funding available in these situations, so the business deteriorates over the period of the administration.

The only way the administrator can continue to run the business is by squeezing a stakeholder (whether it is the suppliers, customers or whomever) to generate enough cash to continue running the business.

In the US, the DIP financing (or debtor-in-possession financing), enables there to be funds provided to the business so they can run it in a better way. That is not about destroying the value, and therefore businesses can trade through this.

In the UK, unless you bring funding into the equation, it is not going to help.

Mawson: Well, why can't the UK have the equivalent of DIP financing?

Daccus: We have seen a few instances where people have tried to do that. The issue comes in that if you are the incumbent bank with a big security package and the business goes into administration, why would you allow somebody else to go in and take senior security to you?

They are interested in recoverability and having somebody sat ahead of them in the structure just doesn't work for them.

Huse: At present, raising new money in an administration needs to be underwritten personally by the administrator. What administrator is going to take on that risk? So a proposed introduction of some form of DIP lending will be an interesting development.

I don't think either the UK or the US insolvency systems are perfect, and each has got its merits and critics. The UK administration process is pretty robust, it is certainly up there with the best in Europe.

Zax: I think we probably want to go a little bit to the history of how the UK system happened. The idea was the companies were rich with assets and show a high recovery.

Historically, that was normally the case, which is why credit was available at good terms to UK companies. If you look at recent lending, however, typical companies have much less of an asset and much more of expected cashflow from business and, therefore, this whole mechanism is no longer making a good recovery. To keep it as a going concern in some form and getting some sort of funding is a sensible proposition.

Langdon: Just on Chapter 11, there are some attractions. We did buy Castle Music out of its holding company, which was in Chapter 11 in America, and I flew out there to attend the court hearing.

There is a lot of power concentrated in the court-appointed judge on a Chapter 11 situation. If we have faith in our judiciary and everything else, that is fine, but it is not quite such a wonderful process where you get to the point where the judge sits down and says: 'Right, put your bids in. I will decide who is the most appropriate owner', and he has got huge power in doing that.

Daccus: Well, we are seeing that at the moment with Polaroid.

Langdon: Yes, absolutely, and in a way that is good, but he has got to be very independent about it, so you have got to come to some sort of arrangement where something can happen swiftly and the thing can get financed. There are attractions to Chapter 11 and I suspect that type of technique should be used. However, it does concentrate the power in one man, who will have his advisers – the judge is allowed to have advisers on it – but it is a 'yes' or 'no'.

Mawson: In terms of concentrating on pre-packs, where do you look to find the most opportunities?

Langdon: The damage done by receivership and liquidation to a business's good will and relations with the customers and suppliers is usually very, very serious. If we can get in before that, it is worth paying that bit more to keep that trade relationship going.

Daccus: We want to get in before the receiver or an administrator is appointed. On the road to receivership, the amount of damage is done in those two weeks before and you can guarantee that those customers will be actually already thinking about contingency plans for their suppliers – so the earlier, the better. If it has to get done in a receivership and there is still value there, fine, but you have to price it accordingly.

Zax: I would say there are probably some specific cases where it is actually easier to purchase from administration, and that is typically when these are vital assets that cannot be replaced.

There are probably some occasions when this is a better case when you just want to buy specific assets, but only in this specific business.

Mawson: How popular are the company voluntary arrangements (CVAs), or the scheme of arrangements?

Daccus: A CVA is definitely better than a formal insolvency or a pre-pack. You may not get the decision, but if you have got a whole group of disparate stakeholders all wanting different things, to actually get them into a consensual restructuring without some form of procedure is almost impossible.

You have seen it in the pan-European restructurings, in Germany in particular, where these things only get sorted out when an administrator is appointed, because all the hedge fund owners are all trying to do different things. They are all in different parts of the capital structure and there are just too many people to make a decision over something unless they are absolutely forced to.

Huse: With an increasing amount of secondary trading going on in the debt markets, you need know who you are dealing with. The parties around the table will change sometimes on a daily basis on some of the bigger transactions. And a guy who has bought in at 40p has got a very different agenda to someone who bought in at 100p, so trying to get people into the same place is very hard at times.

> **What the banks need to do is sit down with the management and agree something that gets the management team committed and invigorated to perform for them. That is an unusual mindset for a bank.**
>
> Paul Daccus, Sun European Partners

Mawson: Given the number of debt standstills, where a company will not have to pay interest until the restructuring is decided, what will force a change of ownership?

Daccus: If a management team is still running the business, that is a good example of where the balance sheet is broken rather than the business itself.

So the business continues to operate, it is absolutely fine, but there is no catalyst for anybody else to make a decision higher up in the capital structure.

The debt holders do not necessarily want to crystallise a loss. They don't want to put themselves in a position where the business is up for sale and they need to make a write-off.

They will sit there and effectively hope for the best, hope that the management team can ride out the difficult economic environment, and when things come back, they will get a decent exit. Why sell now unless you absolutely have to?

Langdon: The catalyst then would be management walking out saying: 'We are fed up with the job.'

Daccus: And that is about management incentivisation. I don't know what their incentivisation package was before, but you can guarantee it does not look very pretty now. So what the banks probably need to do is sit down with the management and agree something that gets the management team absolutely committed and invigorated to perform for them. That is an unusual mindset for a bank.

Huse: In many cases, we see debt holders who are de facto owners but don't necessarily operate as such. Management incentives are one of the obvious issues. Management are working hard to maintain value for the debt holder or prevent further deterioration, but when management start talking about incentivisation, a debt holder may say: 'Well, that's for the shareholders to deal with.'

So it will be interesting to see if, over time, banks do bring the equity ownership skill sets in-house into some of the work-out teams – from private equity or turnround-management backgrounds who can operate as owners.

Mawson: Would any of you consider buying the actual debt in order to potentially take over the ownership of the company?

Huse: We do buy debt but there are a range of approaches in this area – at the moment, some investors are buying into performing leverage loans at such a discount, with very attractive yields, that investors are buying them purely for yields.

Others are sitting out waiting for the default event to occur and then execute a 'loan to own'. However, some of them, having done that loan-to-own transaction, do not seem to be that clear about what to do next – i.e. operate as the owner and develop the business.

We have done loan-to-owns at Endless where a senior or junior lender has lost patience and is looking for an exit. If and when we take control, we do this with a firm view on how we will run the thing and have a clear plan for improving the business.

We approach the bank work-out teams in several ways. If there are businesses with which they have lost patience and don't believe in the turnround story, then we can look at taking them off their hands. However, we have also done a number of deals where the bank has suffered some form of loss but does believe in the turnround story, but it needs someone like ourselves to come in with operational turnround skills to drive it. We then roll the bank debt over at some level, with us bringing new money as required.

We were talking earlier about trying to find ways to protect the debt's par sum. We have done deals where we have been able to deliver a higher value of debt rollover for the bank, with Endless taking a position somewhere in the bank security rather than being like traditional private equity – sat on top of a large pile of leverage. In effect, it is almost like a joint venture arrangement. We share the downside between us and we share the equity along with the banks, so they get a route to enhance value or, perhaps, get them back to par when we successfully deliver the turnround.

Daccus: Where debt is widely traded, it is almost impossible to build a sufficient stake that would be the path to ownership. Sometimes you don't even know who owns this debt. To get enough of it, you might move the market very considerably, so the price you thought you were paying for the debt to get that control position is not available.

Where these things work really, really well is if there is one, two, three or four banks and you can go to all of them to negotiate a deal which delivers you their entire debt package or sufficient debt that you can actually make that path to control.

It depends on documentation as to how much debt you need. You need to understand exactly what the powers the various tranches of debt have got, as well as making sure you get it under control. For us, having debt just sat there and claiming a yield is not our model. We are about buying a business and taking control and making it better.

Langdon: We are exactly the same as that. We want control, but we will buy a lump of debt if we have to get them in the room together and do a deal. I think you need to have 75%.

As a matter of fact, it does depend on the documentation, but you want to have at least half, but for us it would be a route to owning the whole thing lock, stock and barrel. We don't mind having a passive shareholder alongside us, however.

Daccus: But the issue of trying to buy debt in the market is you don't get to diligence the company, so you don't really know what you are getting. Unless you can actually get in and effectively find that data, just the mechanics of getting the deal done is a big risk.

Zax: Getting a minority debt position is a high-risk strategy if you cannot co-operate with others. It is probably not that important whether you get physical control or not, what matters is you get a control of the debt action.

There is quite a lot of value that can be added in pension schemes, and, actually, they are not the toxic waste people seem to think they are.

Richard Jones,
Punter Southall

Huse: The regulatory regime around debt trading is far more liberal than it is around equity trading.

Debt traders use information they receive as part of a restructuring process to trade. Then, at the next meeting, the debt has traded, and it is a different set of people sat there. It is extraordinary.

Langdon: It is a good, old, fundamental free-for-all market where everything leaks left, right and centre, which doesn't help fundamental turnrounds that we all want to do.

Mawson: Do you think that will change, that the regulators will crack down?

Langdon: There are going to be some scandals in the debt-trading world to do with exchange of information. There are going to be more scandals about what people pay at one stage only to be left holding a huge loss, to which their backers are going to say: 'How on earth did you get involved in this?' The answer was they were speculating.

Mawson: We have seen situations where some of the debt holders have credit default swaps. Is it that what they really want is for the business to fail so they get paid out?

Langdon: This happens in larger companies, and if there are equity backers that are prepared to put in hundreds of millions of pounds and they think there is a great deal to do. Some people have got different agendas, so it is a very murky area.

Zax: What you do not know is the net position of who is in the debt, i.e. whether someone has a CDS to offset the bond position they hold. So you see somebody that is written as a debt holder, but, in fact, his net position may be more or less zero, or maybe even the other way around, and therefore alignment of interest may be much weaker than on equity, where these things are generally not allowed.

Mawson: In terms of the techniques, there does seem to be a split between the financial and the operational restructuring. What sort of techniques can people use and how much are pensions a help or a hindrance in this?

There are going to be more scandals about what people pay at one stage only to be left holding a huge loss, to which their backers are going to say: 'How on earth did you get involved in this?'

Michael Langdon, Rutland Partners

Jones: Pensions is a good area in this sort of situation, because there is a lot you can do. If you are going in there to improve a business, to make the business better, then the pension scheme finds that a very attractive thing for you to do. Pension schemes are willing to assist you, and the regulators have been quite open that the pension scheme is allowed to help you out.

That could be a variety of different ways. One of the most straightforward ways is, because most pension schemes have deficits, you would normally have to put cash into the pension scheme in a takeover.

If you come in with new money to fix the company, then you can get a deferral for that cash cost for three years, for example, where you do not have to put any money into the pension scheme while you concentrate on the business.

There are also lots of aspects of the pension scheme that are controlled by the trustees, whose consent you need to do things such as changing the benefits or investment strategy that the actual money is invested in.

If you are doing something for the benefit of the pension scheme in the long run by fixing the company, then you have a lever with the trustees to go to them and say: 'Okay, we need to change the benefits in order to make this deal work.' Or: 'We need to take out or increase some risk from the pension scheme', if you are feeling daring. There is a role to play for the pension scheme, and the regulators have been quite supportive of this sort of approach.

Mawson: What about the pensions buyouts?

Jones: In most cases, the most expensive solution is to go to the insurance companies making these buyouts. In a turnround situation, therefore, where cash is short, you probably do not need to look at that option because it is just going to make the economics fail.

Where it has become a bit more of an option is in the pre-pack scenario. If you were lucky enough to have sufficient money in your pension scheme to not need to do a deal with the Pension Protection Fund, then you can go to these insurance buyout firms with the pension scheme and get the members something slightly better than the PPF would offer.

Daccus: Do you think the trustees can move fast enough in a consensual restructuring? Because the issue we have had when we have gone to talk to the trustees is that they are just not set up or geared to deal with having to make decisions at that sort of speed.

Jones: Yes, it is often a bit too fast for them. If it is the pre-pack type, where it is really going to be quick, then you do it with the PPF and they are very commercial and used to dealing with these things on that sort of timeline.

If you have got a little bit longer and you are trying to get a consensual solution, you just have to push the trustees. Trustees have changed completely in that they are a bit more geared up now for moving quickly, but you really have to drive them.

However, it is quite difficult for them to go from the process of meeting once a quarter to having two weeks' worth of regular interaction and 'phone calls and conference calls.

Therefore, to get the deal done, you really need management to be pushing the trustees to speed up. Their advisers are usually quite willing to speed up because it is in their interests in the long run.

Mawson: In the classic restructuring, is there the equivalent of a private equity 100-day plan?

Langdon: Back at just before the turn of the century, we gave our presentations to all the private equity houses, and one of our slides (which I have kept preserved) was our 100-day plan. I explained it was not really a 100 days, that it was a free-plan process, that we went in and if they wanted to do due diligence on our turnrounds then they could go and dig up and look at our 100-day plan and see how it changed.

We had a plan and we knew exactly what we were going to do. We know that the idea was stolen, and everybody then had one-hundred day plans.

The first rule about plans is it has got to be flexible enough to deal with the unexpected, because we all agreed that turnrounds are much more difficult. But if you don't go in with a clearly defined plan of what you are going to do with that business, then you are not going to get anywhere.

Usually, management has been a bit distracted and gone through the process of running into difficulties, so they want a certainty. So we do have pretty definitive plans that are pretty carefully worked out before.

We have milestones, we have all sorts of processes whereby we know what are we going to do with this business after six months, six weeks, six days. And we are better than we were. We were always pretty good at it, but that is key to the whole thing.

Huse: At Endless, we don't have a generic plan or a turnround 'check list'. There will obviously be common features on deals, such as getting the right management, for example, and the people around this table are probably more likely to change management than traditional buyout firms.

Beyond that, we look at what drives the value in the specific turnround case. It can be a whole range of things. It might be the management issue, or a product issue or the cost base, or manufacturing footprint… each case is unique

Some of the operational turnround value can be created by the actual restructuring event or the deal itself. Say in pre-packing a retailer, for example, where you have dropped one-third of a store portfolio that wasn't contributing, the event itself can create a valuable and profitable business.

Daccus: We have built up a plan so when we are underwriting a deal initially, we will look at what we think we can do to improve the business and a whole list of specific things that need to happen. If it is consolidating a couple of warehouses into one, whatever it is, you build a plan and you make sure that you understand what the impact is going to be, the profitability, how much it is going to cost and what it is going to pay you back and then you monitor that really, really carefully.

That 100-day plan then morphs into the full-year budget, that morphs into effectively a rolling hundred-day plan in which you have always got a series of value drivers you are going to deliver on and if you deliver on them, it makes the business better and more profitable.

Zax: One of the very important aspects is setting up a precedent, because a lot of people who get into the situation where they need a turnround get there precisely because of lack of planning and control.

It is very important to enforce this culture from very, very early because that is what makes the difference between successful companies and unsuccessful companies.

However, if you focus only on one thing, that is what you get. You end up with a disaster. Cash, of course, is very important, but you can focus on cash and the business becomes unprofitable in a very short period of time, then you can focus on profitability and run out of money very quickly.

Huse: We actually like situations where we can see that parts of the business are broken, where we can see lots on tangible fixes. This is why we are comparatively hands-on. We then give bandwidth to our management team by using our own staff to do deliver some of those fixes and to support management in delivering those fixes.

Mawson: Final thoughts?

Langdon: To move quickly once the situation has been assessed and a vendor knows they want to do something. For us, 'deliverability' is the quid pro quo.

Zax: The industry needs to understand the reason for companies to exist, the way it fits, who will be the stakeholders and what do you do with all this.

Daccus: Don't let these businesses have a long and lingering death. It is very easy to mis-price and underestimate how much restructuring is required.

It is a fascinating time to be in turnrounds, but don't assume it is a walk in the park.

Del Huse,
Endless Partners

Jones: The only thing I would say is not to be too negative on pension schemes. [Laughter] There is quite a lot of value that can be added in pension schemes, and, actually, they are not the toxic waste people seem to think they are.

Huse: It is obviously a very fascinating time to be in turnrounds, but don't assume it is a walk in the park.