Investing in distressed debt in Europe: an overview

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1. Introduction

The concept of distressed investing in Europe is not new. We have operated in an environment of extreme financial volatility (both boom and bust) from a debt market perspective since the early 1980s, accelerated by the emergence of the European high yield bond market in 1997[1] which heralded a new wave of value investing in Europe. This volatility is not a surprise, one might argue, given the rapid growth of the leveraged buyout market, the subsequent failure of many companies in the mid-1990s and later the boom-bust cycle in the technology, media and telecommunications market at the turn of the 20th century.

Since the financial crisis in 2008 the European distressed debt market has become more dynamic as European and US banks, many of which made significant profits driving leveraged buyout volumes in the mid-2000s, were forced to unwind balance sheets of long positions in leveraged buyout loans, and some of the most complex structured products including mortgage-backed securities and collateralised debt obligations. Arguably US banks (operating in Europe) suffered more heavily than their European counterparts who held onto assets for longer, rather than completing a mark-to-market of their loan books and suffering catastrophic losses at the height of the crisis.

We have witnessed a substantial increase in non-performing loan portfolio trading since the start of the Eurozone crisis, as investors flocked to Europe seeking yield and targeting banks now subject to increasingly stringent capital adequacy requirements and more onerous regulation. The European Central Bank's asset quality review in 2014 identified €879 billion of troubled loans held by 123 banks in the Eurozone's 18 countries, prompting a raft of loan disposals and a flood of capital into Europe. This is hardly a surprise given the growth of the derivatives and securitisation markets in the mid-2000s, as assets on bank balance sheets grew from €18 trillion in 1999 to €45 trillion in 2008.

What is perhaps more surprising is the fact that the speed of bank deleveraging since 2008 (and therefore the opportunity for distressed returns) has not been as rapid as many commentators originally predicted. There has been a great deal of 'amend and extend', in contrast to previous cyclical downturns. However this is

1 Edward Altman, "The Anatomy of the High Yield Bond Market", September 21 1998: pages.stern.nyu.edu/~ealtman/anatomy.pdf.

more likely to have been the result of under-provisioning by banks and an inability to absorb losses on disposal of assets rather than through a lack of appetite itself, particularly since such lending ties up capital and prevents it from being recycled into other opportunities. The year 2015 witnessed a substantial uptick in activity with €140 billion of European loan portfolio transactions recorded, up 50% (in absolute value terms) on 2014, but this was largely driven by non-strategic performing residential mortgage portfolios in the United Kingdom rather than non-performing loans.[2]

On the other hand, deleveraging of Italian bank balance sheets accelerated, with €11 billion of unsecured/non-performing loans trading at large discounts to par.[3] In the context of an estimated €1,180 billion of non-performing loan stock held by European banks, less than 30% had traded by the end of 2015, but the speed of disposal is likely to accelerate in the coming years as lenders have continued to rebuild balance sheets and are now generating earnings capable of absorbing losses on non-core portfolios. In the last quarter of 2016 pressure is increasing on Spain's 'bad bank', SAREB, as well as its commercial banks, to recognise significant impairments in respect of their loan books, which in turn may lead to price alignment between buyer and seller, and allow for an uptick in transactions.[4]

The level of genuine distress experienced since 2013 has been relatively muted, driven by ultra-low interest rates and capital availability across a variety of markets, both debt and equity, which provided solutions (albeit including amend and extend in some cases) for the most stressed borrowers. At the same time, looser credit protection in loan documentation (driven by a shift towards covenant-light bond financings in Europe) suppressed distressed trading volumes as return-hungry investors enabled borrowers to avoid or defer complex workouts.

However, the current European distressed industry is one which still presents a raft of opportunities, given the volatility that threatens the European economic system and a general feeling of anxiety across global markets. The United Kingdom's vote to leave the European Union in the June 2016 referendum has triggered turmoil in the UK, European and global markets. Only time will tell what the medium-term impacts will be, with most market commentators predicting a period of uncertainty and in many cases recession. In the hours after the result was announced, the governor of the Bank of England sought to reassure the UK population, asserting the ability of the UK economy to cope with such shocks and to return to stability, yet before the vote he had predicted that recession was a possible outcome of a Brexit vote.

Indeed, such volatility is playing out during a period in which Europe has also witnessed the most extensive monetary policy stimulus in living history, through quantitative easing, which rather than establishing a robust economic platform has delivered only anaemic growth across the continent. As the Chinese market continues to slow down and restructuring activity picks up in the United States (largely driven by low oil prices) it is likely that the European market will again

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2 PwC, *Portfolio Advisory Group Market update* – Q4 2015.
3 PwC, *Portfolio Advisory Group Market update* – Q4 2015.
4 www.auraree.com/real-estate-news/bank-of-spain-puts-pressure-on-banks-to-speed-up-property-sales/.

provide significant value opportunities for alternative investors over the next five years, although the horizons on which such returns are achieved may necessarily be longer.

With an increasing absence of covenants in many large primary financings (and refinancings) which have closed in the last three to four years, it may be a liquidity crunch (or interest payment default) which ultimately brings distressed investors into play in the current environment. The steady flow of recent high-yield issuances (which has resulted in average annual issuances of €69 billion between 2013 and 2015, compared to €24 billion across 2006 and 2007) will ultimately increase the probability of future distressed opportunities, despite relatively weak volumes in the recent past.

Today's distressed-debt market participants are notably diverse and varied, ranging from more traditional investment banks and hedge funds to private equity groups who have raised 'special situations' or 'distressed opportunity' funds to drive returns through varied investment strategies from super-senior (debtor-in-possession style financing) through to deeply subordinated, payment-in-kind instruments which provide a route to borrower recovery or lender control. An example of the latter is Kohlberg Kravis Roberts & Co's investment in European vending machine operator Selecta in 2014[5] which, while positioned as a long-term refinancing, ultimately resulted in the fund acquiring a majority equity position from the incumbent private equity owner approximately 18 months later.[6]

2. Market development

Distressed-debt investing has been a consistent feature of the mainstream UK investment market since the 1990s and accelerated following the financial crisis in 2008. Following the crisis, US capital flooded into Europe attracted by the prospect of super-normal returns resembling those that were generated following recessions in the early 1990s and early 2000s. This influx of capital was also partially driven by a view that European banks would need to deleverage more aggressively than US counterparts, focusing initially on commercial real estate portfolios and then more traditional leveraged buyout positions. The reality is that the European market proved more complex than this, given the divergence in restructuring and insolvency regimes, the difference in accounting practices between European and US banks, and the relative balance sheet fragility of many participants.

Despite more recent reforms in Spain, France and Italy (the latter's regime was amended as recently as 2015 to focus on rescue rather than liquidation) the European distressed market was not as uniformly lucrative as many investors had hoped. As we have articulated, however, the European market remains a compelling investment opportunity, with over 70% of non-performing loans still notionally held by European banks, albeit this figure may be overstated by the multiple single asset disposals and 'bid wanted in competition' trades that have also filtered into the market since 2008.

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5 media.kkr.com/media/media_releasedetail.cfm?ReleaseID=855882.
6 www.selecta.ch/krrit/.

The secondary market itself, which allows for the sale and trading of debt after the original loan has been syndicated, has continued to evolve since the 1990s in order to provide market stability and to manage lender risk in a more systematic manner. As a result, single asset or sector concentration can be managed more efficiently by lenders, thereby ensuring frequent loan (or tranche) turnover (among participants). This ultimately acts as a catalyst to free up additional capital, in light of the stringent Basel III and CRD IV requirements,[7] and to maintain system liquidity.

With borrowers (and private equity owners) increasingly concerned by the threat of a potential loan-to-own investor suddenly emerging in a lending syndicate, and lenders themselves keen to retain transfer flexibility, it is now not unusual to see transfer 'white lists'[8] running to several hundred qualifying lenders in loan documentation permitting the sale or transfer of debt without borrower consent. Ultimately, this has not stopped aggressive hedge funds or private equity investors buying into situations where new money is desperately needed and a meaningful return can be achieved, but it has ensured that the secondary market operates in a more fluid manner.

More recently we have seen several private debt funds, having initially underwritten mid-market deals, exploit such flexibility post-financing in order to reduce portfolio concentration and to lay off single asset risk by selling down their exposure. The secondary market ultimately provides the mechanism to facilitate risk management in an environment where private debt funds have achieved market share gains over the last two years, forcing the major European banks to fight back with more competitive terms.[9]

Regardless, the European secondary market has become a relatively robust marketplace despite the absence of an automated system to facilitate trading of positions. This has been supported by the development of standard documentation by the Loan Market Association in the United Kingdom and Loan Syndications and Trading Association in the United States, which have helped standardise trading processes and accelerate the timeframe for execution. This has allowed debt to be traded in a commoditised marketplace, allowing investors to take short-term minority positions, or larger stakes seeking significant influence or even control, according to their mandate.

Funds such as Alcentra, Babson Capital and ICG, among others, have also benefited from the re-emergence of collateralised loan obligation issuance in the last two years, allowing them to deploy institutional capital across the market in a range of situations, supported by increased deal flow in the larger syndicated market. This represented a welcome return of collateralised loan obligation liquidity in Europe since issuance collapsed in 2009,[10] following a peak of €35.5 billion in 2006. While increased regulation has somewhat hindered the structuring of new collateralised

7 www.eba.europa.eu/regulation-and-policy/implementing-basel-iii-europe.

8 A white list represents a schedule of defined lenders or institutions which is appended to the borrowers' financing agreement and which allows for subsequent transfer or assignment by the lenders of record at completion of their facilities (in the absence of a default). In the event of a default, the white list concept falls away and lenders are free to sell their debt to any party capable of holding the positon.

9 *AlixPartners Midmarket Debt Survey – 2015 (Europe); AlixPartners Midmarket Debt Survey – H1 2016 (Europe).*

10 Only €0.4 billion of collateralised loan obligations were issued in Europe during 2009.

loan obligations since 2012, and will fully manifest itself at the end of 2016 when new risk retention rules are implemented,[11] the re-emergence of the product in 2014 and 2015 (when €14.5 billion and €13.6 billion respectively of new collateralised loan obligations hit the market) provided ample liquidity across the market. The level of issuance softened somewhat in early 2016, with increased macroeconomic volatility linked to the depressed oil price, but rebounded in March. Year to date issuance for the eight months to August had reached €10.1 million and 2016 remains on track to deliver another strong period for new paper, despite the month of August itself delivering the lowest level of monthly issuance since August 2015.

The incidence of loan-to-own investment strategies, discussed in more detail below, has not been as prevalent as one might have expected since 2011. Instead we have seen more bespoke investment strategies employed by hedge, credit and private debt funds, investing on the basis of borrower and market fundamentals, rather than as a route to take control of the borrower itself. This is perhaps a function of the lack of genuine (dis)stress inherent in the system as funds have, outside relatively short term macroeconomic shocks (such as the Greek sovereign debt crisis), invested on a passive pull-to-par basis, where public market intelligence and sector knowledge have been used more efficiently to drive pricing arbitrage when debt positions are under-valued by the market. It also reflects the difficulties experienced in some jurisdictions of removing the incumbent equity holders, even when it is clear the economic interest does not lie with them (even if European jurisdictions are increasingly including mechanisms to disenfranchise shareholders within their local legislation). This was notable in the case of Codere, a Spanish multinational group operating in the private gaming sector, where the restructuring was frustrated for a long time by the inability to effect a debt for equity swap without shareholder consent.

Standard and Poor's European Leveraged Loan Index (ELLI) which tracks institutional loan defaults and restructurings has shown a progressive decline since 2011, with the ELLI distress ratio[12] declining from a peak of 31.5% in December 2011 to a low of 2.7% in June 2016, suggesting the market has simply not provided the volume of opportunities one might have expected for activist investors.

3. European distressed industry

Given the scale of bank lending through the mid to late 2000s it is unsurprising that the deleveraging of non-core assets by European banks is likely to continue for many years to come. The UK, Irish and Spanish markets proved the most active in the early stages of the European economic recovery, but the Italian, Dutch and central and eastern European markets have seen more transaction activity in 2015 and 2016 as a result of the intense level of competition and number of investors seeking to deploy capital.

High-profile funds, such as Apollo Global Management, Cerberus Capital

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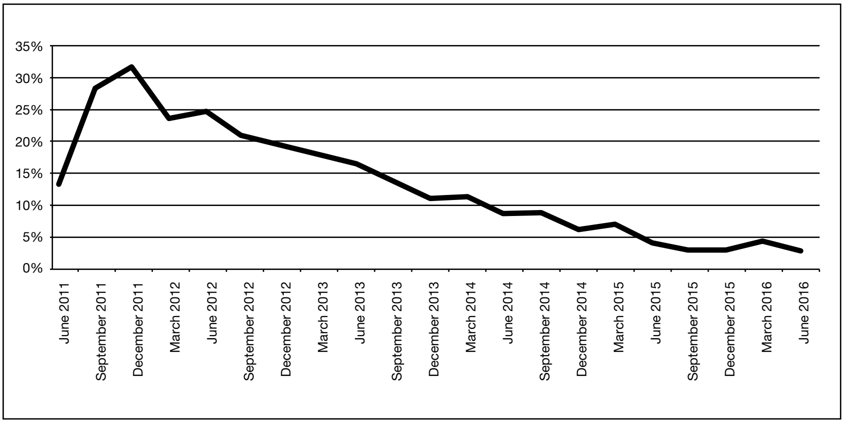
11 Risk retention regulation will require collateralised loan obligation managers to hold a 5% stake in each vehicle managed.

12 This ratio represents the share of credits in the ELLI by deal count that are marked below 80 cents/€.

Figure 1: Standard and Poor distress ratio – ELLI (June 2011 to June 2016)



Management, Lone Star and Oaktree Capital, have proved to be active investors in the European distressed market since 2011, largely in commercial real estate. But we have also seen other vehicles emerge, such as Pillarstone, backed by Kohlberg Kravis Roberts & Co, specifically targeting banking assets in more peripheral geographies such as Italy and Greece with genuine operational turnaround potential. Given the level of competition there is a real possibility that investors will continue to look further afield over the next five years as distressed markets continue to mature in central and eastern Europe.

At the same time, given the emergence of private debt in the European mid-market[13] since 2010, and a continuing transition towards a US-style institutional lending market, we may see a new wave of distressed opportunities emerge in the next 10 years if these private funds, currently eager to deploy large pools of capital, end up stretching leverage to unsustainable levels and borrower distress follows. It remains to be seen whether such funds, without the portfolio management and restructuring resources of major European banks, will seek to work out such loans, or simply to take control where equity upside can be generated. It seems that such funds do not currently have the bandwidth to manage multiple restructurings at this stage of the credit cycle, and there will continue to be insufficient liquidity or appetite in the secondary market to provide an efficiently priced exit mechanism for lenders.

What is clear, however, is that companies will continue to find themselves in distress, whether it is driven by an unforeseen closure of capital markets with increased refinancing risk, wider macroeconomic factors, or changes in industry dynamics making the existing proposition incompatible with the market demand. This will present opportunities for distressed investors able to cherry-pick assets to create synergies and optimise value with existing investments, or simply to wind down structured assets and deliver a value recovery relative to the bid price.

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13 Classified as bilateral financings, club deals or syndications valued below €300 million.

4. Why do companies become distressed?

While the debt markets themselves may often be to blame, in creating unsustainable capital structures that are unable to survive more cyclical economic factors, distress can occur for a variety of reasons, with both internal and external factors playing a part.

4.1 Obsolescence of business model

Societal change and technological obsolescence (which some might argue have accelerated exponentially in the last 20 years) have rendered some business models obsolete in a short space of time, as has been observed for example in the telephone directory 'yellow pages' market. Here, operators such as Hibu have been forced to transition to new business models simply to remain relevant, or at worst just to remain in existence. Such groups' capital structure reflected the expectation of repeat, maintainable cash generation year-on-year. To the extent that old revenue streams were reducing and new ones not sufficiently developed to replace them, debt restructuring became an inevitability.

Parallels of industry-wide change can be seen in the decline of physical digital media (CDs and DVDs), the decline in paper printing and, to a lesser extent, high street retail, with an expanded fixed cost base due to the need to offer a multichannel retailing experience (online, delivery, click and collect, longer opening hours for physical stores etc). It is often the inability of operators to amend such overheads to match industry change which provides the catalyst for distress, including an inability to unwind large leasehold commitments (taken on in boom times to help drive an equity return for investors), which has proven the death knell for many retail chains over the last 10 years.

The pace of technological change is set to increase dramatically, and self-driving cars, predictive coding reviews of legal documents for relevance, rapid, insightful big data analysis and accurate medical diagnosis by robots are no longer part of science fiction. With such change, many once seemingly future-proof companies, if not industries, are likely to become casualties of their unwillingness or inability to move away from what was previously successful and to invest quickly in radical new ways forward.[14]

4.2 Macroeconomic factors

For many businesses, distress follows changes in market fundamentals.

We are all familiar with the macroeconomic trends of the past 50 years, which have had implications for workforces beyond those of providers of capital. Previously profitable manufacturing in western Europe has been significantly supplanted, largely as a result of access to cheap labour in the east. Service jobs have been significantly outsourced to India.

In recent years, we have seen other macroeconomic phenomena: an imbalance

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14 For a discussion of technological changes and their likely impact on the economy and society see Erik Brynjolfsson and Andrew McAfee, *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (WW Norton & Co, 2014).

between supply and demand in the property market (notably in parts of Spain and China), sustained low oil prices and the market uncertainty which was associated with the build-up to the Brexit referendum, and is now set to be exacerbated by a further period of uncertainty as the United Kingdom renegotiates its place in the world and the European Union seeks to steady the ship and avoid further disintegration.

Such trends tend to result in industry-wide consolidation, with those with the strongest balance sheets able to take the long view, ride out the storm and survive, often acquiring rivals and vertically integrating suppliers in the process.

4.3 Strategic errors

Poor decision-making or omissions in strategy often lead to distress. These include overly-aggressive expansion into new or existing markets, products and geographies (often funded with increased debt), failure to hedge against exchange rate movements or to fix commodity or energy prices in benign times, or poor management of working capital leading to a liquidity crisis.

4.4 Failures in governance (and/or management)

In some cases, distress is the direct result of errors, or occasionally misconduct, in the business. This can occur because of an inadequate governance framework or where decisions are made by a dominant chief executive officer. Such traits are sometimes seen in businesses where the founder has grown the business from a relatively small concern to a size and presence where the market demands a more sophisticated compliance structure.

Depending on the nature of the misconduct, capital structures may have been established on the basis of projections which are, or become, unrealistic. Examples include products with safety issues requiring a recall, or manipulation of data to understate provisions against asset values, for example in respect of the recoverability of a retail loan book, as was seen in the case of non-standard lender Welcome Financial Services.

The misconduct may be limited to one division or department, but prompt action is required to limit the contagion effect which can rapidly damage the whole business. The problem can be exacerbated when so called bear-raiders seek to take advantage of the woes of ailing corporates through short-selling strategies, sparking exaggerated but then self-fulfilling rumours of a corporate's decline.

The directors often need to be replaced and an exercise undertaken to understand the underlying value of the business, before a discussion can be held on the likely returns to creditors and a recovery strategy. This typically involves salvaging those operations that are worthy of continuation and not irretrievably tainted (perhaps by those distressed investors who can still see value in both core and ancillary assets despite all the background noise). In these situations litigation may also represent a further route to recoveries.

Replacing the directors can often be part and parcel of a more widespread review of the senior management of a business, since many individuals simply do not have the skills necessary to deliver a turnaround or manage a company in crisis situations.

While macroeconomic factors often have a major impact on trading performance, it is equally true that poor management is a major contributing factor in the slide into distress.

At times the appointment of a chief restructuring officer (an independent director parachuted in for a short period to support the board in delivering a turnaround) can help navigate this path to recovery, but fundamental questions must still be asked as to whether the incumbent management team are fit to lead a business out of distress. More often than not, replacements will be required, or additional skills will need to be brought into a business to support a recovery.

4.5 Off-balance-sheet liabilities

In response to the collapse of Enron in 2001, accounting and regulatory changes sought to limit (in many cases successfully) the extent to which liabilities could be held off-balance-sheet by corporates.

However, no reporting regime is perfect, and debates around what constitutes an appropriate and transparent reporting structure will always remain. In January 2016 an international financial reporting standard was issued in respect of leases, which when fully implemented will, it is estimated, have the effect of bringing $3 trillion of leasing commitments on to the balance sheets of listed companies.[15]

Clearly transparency in financial reporting can only assist the potential investor community in assessing the opportunities and risks that any opportunity may bring. At the same time, changes to a company's reporting requirements can also cause sudden and significant changes to the reported balance sheet, which in turn can result in companies that were previously fully compliant with their loan covenants (such as asset cover ratios) suddenly being in default. This can, in turn, cause lenders to reappraise the loan and relationship, resulting in a range of consequences from price increases through to asking the corporate to refinance.

4.6 Lack of access to capital markets

Many countries in continental Europe are dominated by family-owned small or medium-sized enterprises (SMEs). In Italy, for example, around 80% of corporates are family-owned, and 63% of gross domestic product is contributed by SMEs (by way of comparison, in Germany it is 31%).

Such entities have of course traditionally relied upon local banking relationships, but when these banks have not been in a position to provide funding (and in many cases are being required to divest themselves of existing loans), SMEs can struggle to attract alternative investors from global capital markets.

Often the scale of these enterprises makes them unattractive to investors, given the time commitment that is required to manage each connection. Historically regulation has not favoured overseas investors, and owner-entrepreneurs may be wary of foreign investment, in environments where a perception of such investors as 'vulture funds' is commonplace.

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15 www.ifrs.org/alerts/pressrelease/pages/iasb-shines-light-on-leases-by-bringing-them-onto-the-balance-sheet.aspx.

Having said that, the lack of alternatives for local entrepreneurs, the limited number of large-scale opportunities being pursued by a large number of investors, and the impressive level of recent regulatory reforms on continental Europe, has resulted in an increasing number of SMEs seeking and attracting overseas funding.

In 2013, in an interesting variation on the theme, Apollo Global Management LLC acquired Evo Banco, a Spanish bank, providing them with access to an existing book of retail and commercial loans, as well as a local platform from which to make further loans.

4.7 Why do companies become distressed – conclusion

Distress in a large business typically has many contributing factors. The issues may be capable of being addressed within the existing capital structure by strict financial discipline and an operational turnaround plan. Sometimes the shareholders may inject sufficient funds to address the issues.

However, often these issues leave a company with a debt burden which it has no realistic prospect of servicing. In such cases, a financial restructuring is required alongside the appointment of a new management team; and often with a new money need, which is typically provided by the type of distressed investors that can also help implement genuine structural change in a business, rather than simply deferring an otherwise inevitable slide into insolvency.

5. Due diligence for distressed companies

As highlighted below, prospective investors or incumbent lenders may seek to complete an independent business review when a company is faced with financial stress, albeit this may be largely the outcome of a default on existing facilities and the output of the review may come too late to save a company from a slide into insolvency if there is an immediate liquidity issue.

Where action has been taken by a company early in the process an independent business review will often be the only due diligence available to distressed investors examining an investment opportunity, unless the company itself, or its shareholders, have commissioned other third-party due diligence reviews (commercial, operational or strategic) in advance as part of a more coordinated capital-raising process.

In reality the due diligence available to a distressed investor will often be very limited, and many market participants will rely on their own internal sector expertise and analyst resource to provide industry insight and context for the performance or operation of a potential investment target. There is often simply insufficient time to complete more detailed due diligence. As a result, certain investors will also seek to partner up with industry experts (individuals) from within their network (eg, plural non-executives or fund advisers) to provide investment guidance, based on prior knowledge of the asset or experience from having worked with its competitors.

More often than not, the absence of detailed analytics and diligence materials prior to investment will result in investors triangulating their views on the potential turnaround or value-recovery story based on multiple data points which do not emanate from the company itself. In-house sector expertise can therefore make a real difference in making critical investment decisions in short timeframes.

6. Investment strategies

6.1 Introduction

The investment strategy of any capital provider will be driven by a combination of the funds it has available to invest, the ultimate beneficiaries' appetite for risk, the timescales within which a return is required, the fund's investment criteria, and the skill set and resources of the team.

As mentioned earlier, the emergence of onerous capital adequacy requirements following the financial crisis meant those institutions with the largest exposures (clearing banks) had to set aside specific capital provisions to protect against default risk. Where the customer is in distress and there is a high probability of default, the required capital hold is greater – often in excess of 100% of the par value of the loan. Conservative lenders who invested before distress was apparent may therefore find themselves in an unsustainable position, and prefer to exit at a manageable loss rather than take their chances in a protracted restructuring process, which would require them to set aside precious capital throughout the process, with a significant resultant opportunity cost regardless of the final outcome.

As such, there are opportunities for investors who are relatively unconstrained by considerations of capital adequacy, represent investors with a suitable risk appetite, and have a distress-specific skill set.

6.2 The context of a business requiring debt restructuring

In order to explain some of the main strategies available to distressed lenders, it is necessary first to explain at a very high level the dynamics involved when a company recognises it has to restructure its balance sheet.

In many cases the capital structure of a business means that it has no prospect of meeting an imminent interest or capital repayment, or, at worst, its debt facilities are maturing with little hope of refinancing the par value in full. In such cases some level of restructuring of the affected debt, at the very least a deferral of repayments, is required. The alternative may be an unplanned insolvency process, often with catastrophic consequences for a company and its existing investors.

When the debt is in the form of a syndicated, traded debt instrument, it can be complex to achieve the required restructuring. Typically, finance documents are drafted so that any decision to vary the terms of the debt (extending repayment terms, reducing interest rates or accepting a reduction in the value of debt – a 'haircut') requires the unanimous approval of all holders of that debt instrument. As such, holders of relatively small stakes can (tactically or otherwise) prevent a restructuring under the terms of the finance documents.

In these situations, depending on the governing jurisdiction and the applicable law, 'cram-down' mechanisms may be available. These are typically court-governed processes which allow debt to be restructured, notwithstanding the presence of a dissenting minority of debtholders. The exact approval threshold, and which subset of creditors it applies to, varies by jurisdiction.

This is the backdrop against which investments into larger distressed companies are usually made. The strategies outlined below are described in respect of individual groups. Investors may acquire a portfolio of non-performing loans and seek to apply a combination of these strategies as appropriate.

6.3 Some of the more common investment strategies

(a) Short-term investment in liquid debt instruments

This is a common strategy of the trading desks of investment banks, as well as fixed-income investors. These investments are made based on publicly available information and typically involve taking minority stakes in liquid, tradable debt instruments. The aspiration here is to spot opportunities where the market may have mispriced the debt. There is no desire to hold a stake for the long term, to have influence or control, or to have input into any longer term financial or operational restructuring.

(b) Holdout or blocking stake

In this scenario, an investor or a group of investors acquire traded debt instruments at a discount, and are able to prevent a solvent restructuring on terms put forward by the company, or exert significant influence on the terms offered.

The amount of debt the holdout group needs in order to have a blocking stake depends on the restructuring options available to the company in question. Under perhaps the best known European cram-down mechanism, the UK's scheme of arrangement, up to 25% of creditors by value of those voting within each class[16] of creditor can be forced to compromise their debt, if 75% vote in favour of a proposed restructuring.

The aspirations of the holdout group vary from case to case, but they may include:

- limiting the amount of day one write-down in debt;
- accelerated payments compared to the timescale put forward in the company's proposals;
- being part of any new money solution;
- taking an equity stake;
- having the ability to convert debt to equity;
- tighter covenants in respect of post-restructured debt management;
- the appointment of a chief restructuring officer to manage any proposed restructuring;
- additional security over the company's assets; and
- maintaining control for existing equity.

(c) Loan-to-own

In this scenario an investor or group of investors buys a majority stake in a tranche of debt, where the value is believed to break, with the aim of acquiring an equity

16 The constitution of classes of creditors under a UK scheme of arrangement is a technical area beyond the scope of this chapter. For a discussion of this topic see Christian Pilkington, *Schemes of Arrangement in Corporate Restructuring* (Sweet & Maxwell, 2013).

stake in the business. The debt seller, aware of the risk of not being fully repaid, often sells their position at a significant discount to par. They may not have the appetite or mandate to take equity stakes themselves. Exactly what rights the investor acquires will depend on the specifics of the debt instrument, including inter-creditor provisions.

The investor, now in the role of lender, will then require a detailed independent review in order to consider where the value of the company lies. That review will usually show that the investor's debt will not be capable of being repaid at par on the timescales set out in the documentation (if at all).

In reaching a restructuring proposal, the company will have to take account of this shortfall to the debtholders, which is typically done by giving the opportunity to exchange some of their debt for an equity stake in the business. Depending on the level of the shortfall, this may need to be a majority equity stake.

Junior debtholders and shareholders have some opportunity to negotiate, but their 'out of the money' status (ie, having no economic interest) often means they do so from a position of relative weakness. Ultimately, depending on the jurisdiction, they may be forced to suffer a dilution of their stake, since the alternative, an insolvency process, would see their returns reduced to nil.[17]

(d) Strategic use of an insolvency process[18]

There are circumstances where an investor, having bought into debt, can emerge as the owner of the business through an insolvency process.

Where (in the United Kingdom) an administrator is appointed and puts the business up for sale, the secured lender has the opportunity to 'credit bid' in order to acquire the business. That is, as the beneficiary of any sales proceeds (subject to dilution by certain other preferential creditors which must be paid in cash), the secured lender can bid up to the value of the amount it is owed in order to acquire the business. A competing bidder would have to bid, in cash, above the value of the debt, thus repaying the investor (who has invested at a discount) at the par debt value. If no alternative cash bidder emerges, the secured lender can absorb the business and assets into a newly formed company. Under certain circumstances this might be conducted on an accelerated basis by means of a pre-packaged (prearranged) administration, which is when a marketing process is undertaken and a sale negotiated before the insolvency appointment, allowing the sale to be executed shortly after appointment. A pre-packaged administration can also be used to remove operational subsidiary companies from an over-leveraged structure with group lending into an entity towards the top of the structure. 'Pre-packs' (as they are known) are often an expedient way of moving a business forward with minimum

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17 This applies to the UK context. In practice the ability of shareholders to frustrate a restructuring process and force a better deal when being out of the money according to the insolvency waterfall analysis varies immensely between jurisdictions. In this regard, in other European jurisdictions the inability to cram-down equity and the lack of alignment between the economic position of shareholders and their rights under a restructuring process provide shareholders very relevant negotiation leverage and impact the restructuring dynamics.

18 This analysis describes the UK context. The legal framework and application varies greatly by jurisdiction.

disruption with a sustainable capital structure, although there have been examples of abuse of process, which led to the Graham review being commissioned by the UK government and additional compliance measures being brought into place.

In other jurisdictions, the mechanisms to allow a similar restructuring do not exist, or the implementation is more difficult. In the past companies have transferred their centre of main interest to the United Kingdom to take advantage of the regulations in place (such as WIND Hellas), although there are strict criteria in place, and the migration of a company solely to take advantage of another country's insolvency laws often attracts controversy.

An insolvency process can also be seen as an opportunity to acquire only those parts of the business which are attractive to an investor. For example, an investor may seek to acquire only those stores in the portfolio of a multi-site retailer that are profitable (or capable of turnaround). Of course, the administrator will consider each bid on its merits, and may favour a bid which takes more or all stores, if one is forthcoming.

The approaches of credit bidding and selective acquisition of part of a store portfolio were seen in the 2012 administration of Clinton's Cards. Another way of exiting certain sites, in the United Kingdom, while renegotiating rents on others is through an alternative insolvency process, a company voluntary arrangement, which is a debtor-in-possession process, albeit typically with an insolvency practitioner acting as supervisor.

(e) Providing debtor-in-possession financing

In a US Chapter 11 restructuring, in order to allow a business to address a liquidity crisis and continue trading in the short to medium term, there is a well-established process for the providing of debtor-in-possession financing. This is often (but not exclusively) provided by existing lenders. The debtor-in-possession finance provider will normally seek super-priority and liens on assets which are already pledged to existing lenders, who as such may object. In this case the court will decide whether to allow the funding to be provided on the proposed terms.

Very few European jurisdictions have fully developed debtor-in-possession-style financing mechanisms, and it can be difficult to structure the loan so as to ensure its recovery, limiting the market for debtor-in-possession financing in Europe. Typically, the incumbent lender(s) provide the required funding through any restructuring, often through existing facilities, on the basis that in the long term the funded strategy will lead to a better return than an unfunded liquidation.

(f) Providing post-restructuring debt

Some distressed investors make good returns by lending money to businesses who have been through a restructuring process but, as a result, do not have an established credit profile, and as such are avoided by mainstream banks without the mandate to lend in perceived higher risk situations.

Debt is provided at an interest rate above that which the mainstream lending market would provide (at the time of writing say between 10% and 14% as an all-in effective rate). Once the business has established its creditworthiness (after between

12 and 18 months of successful debt service and achieving its business plan), it will be able to refinance to a cheaper, mainstream debt provider (say at between 5% and 8% initially and with scope for further reductions over time).

7. Valuation methodologies of a distressed business

7.1 Introduction

Setting aside the multiple strategies which investors may deploy in acquiring distressed assets, all investments (other than perhaps very short-term opportunistic ones) will be underpinned by potential assessment of value, both today and in the future. The valuation of distressed businesses is a complex, multifaceted, imperfect and contentious process. This is particularly true when we consider that the theory underpinning the majority of conventional valuation methodologies and techniques is predominantly based on an adaptation of a 'going concern' approach.

Regardless, any distressed valuation is fundamentally impacted by situational factors, including:

- valuation timing (ie, pre- or post-investment assessment), which can be significantly impacted by asymmetric information or uncertainty regarding the future business plan;
- the investment parameters (eg, to justify a bid price relative to return requirements); and/or
- the underlying purpose (eg, to drive a short- or long-term investment return, or to help position negotiations as part of a wider restructuring which shifts the balance of power toward certain stakeholders).

Despite all these factors, distressed asset valuations are still likely to be triangulated using some of the more conventional techniques which include the discounted cash-flow, relative valuation and liquidation methods. Other, less common, methods for valuing distressed entities include option pricing and Monte Carlo simulations, both of which are outside the scope of this chapter.

It should be noted however that conventional methods often fail to consider certain traits of distressed businesses, and therefore are not the complete answer to valuation in all distressed scenarios. A skilled valuation will use conventional approaches as a starting point; however, it will also amend certain elements of the process to reflect situational factors and nature of the target business.

Set out below is a high-level review of some of the core valuation techniques which can be employed, and some potential adjustments that can be made in order to consider the impact of distress. We also address some of the issues commonly encountered when undertaking such valuations, from an investors' perspective.

In the end there is no single method to value a business, and due to various weaknesses in each methodology a valuer will often triangulate the outcomes of each approach, evidencing the old cliché that valuation is an art and not a science.

7.2 Key considerations

As highlighted above, the appropriate valuation method will depend crucially on the purpose and intended use of the valuation, the level of access to information and the overall facts and circumstances surrounding the valuation. An initial assessment must also be made of any business to determine whether it is in terminal decline, or whether it remains economically viable and merely requires a balance-sheet restructuring.

7.3 Valuation techniques in distress

The core valuation techniques[19] considered in distress may include the following.

(a) *Discounted cash-flow valuation*

The discounted cash-flow approach is a fundamental valuation methodology used around the globe to ascertain the intrinsic value of a business, derived from the present value of its projected free cash-flow. There are a number of variations of the discounted cash-flow approach that can be used to calculate the intrinsic value of a business, including the leveraged buyout and adjusted present value methodologies.

The discounted cash-flow approach requires the same fundamental steps to value a business regardless of whether the company is considered healthy or distressed. This includes initial due diligence on the target entity to analyse historical performance and determine key performance drivers relative to its sector, before projecting free cash-flows over a forecast period. Depending on the perspective of the potential investor, this phase of the valuation presents an opportunity to overlay expected operational improvements and the potential effects of a new management team, or alternative strategic positioning, to determine potential upsides should the asset be acquired. This may impact on the amount an investor is willing to pay to acquire a distressed asset.

Ultimately any investor or incumbent stakeholder will seek to consider the return on capital deployed (or retained) to assess the price that they may be willing to offer to acquire a company or the negotiating position they will take in restructuring negotiations, considering their own cost of funding and return requirements. While the discounted cash-flow method is perhaps the purest theoretical tool for assessing value, given the sensitivity to input assumptions involved (eg, the cost of equity/debt, beta factors, target capital structure and terminal value), it must always be considered alongside other valuation methods to conclude on an applicable valuation range.

Indeed, one of the key limitations often cited in utilising the discounted cash-flow approach in a distressed valuation is that forecast cash-flows, which are traditionally forecast to infinity, are at greater risk due to default and therefore might never be realised, thereby potentially skewing any valuation. There is always a risk of failure which must also be factored in, which will normally manifest itself on the discount rate applied in assessing the present value of future cash-flows.

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19 Aswath Damodaran, *The Dark Side of Valuation: Valuing Young, Distressed and Complex Businesses* (FT Press, 2009) provides a much deeper analysis on the key methodology underlying distressed valuations including the application of probabilities of distress under both the discounted cash-flow and relative valuation approaches.

(b) Relative valuation

Another common approach for valuing companies is relative valuation based on two comparisons:

- the comparable company (valuation multiples for a basket of companies with similar characteristics or profile); and
- the comparable transaction (valuation multiples achieved on similar businesses in the same sector).

Both comparisons invoke the core foundation of finance theory which postulates that in efficient financial markets two assets with identical cash flows must trade at the same price.

The approach is often considered the most straightforward method by which to value both going concerns and distressed businesses. The relative valuation method is widely used and often preferred by practitioners as it requires fewer assets, time and information than the discounted cash-flow approach.

Furthermore, the relative approach is much less subjective than the discounted cash-flow approach, and is considered easier for wider audiences to comprehend, particularly when it utilises well known listed companies or recently completed transactions as a reference point.

Under both comparisons, an estimate of firm value is reached by multiplying a ratio estimated from comparable firms (a valuation multiple) by earnings before interest, taxation, depreciation and amortisation (EBITDA), or another appropriate multiple, to arrive at an enterprise value for the business.

In a distressed situation, directly comparable company data is often unavailable. Therefore it is necessary to make subjective adjustments to incorporate the impact of distress on the market multiples. Making such adjustments can often lead to over- or under-valuation, and enables personal biases to emerge in the analysis. In order to mitigate these risks, it is preferable to have a sector specialist opine on this situation, in addition to analysing historical data on similarly restructured publicly listed entities.

Other adjustments to consider include consideration of net working capital and capital expenditure. Whereas the comparable company approach assumes a normalised working capital position, it is often the case that a distressed business is suffering from both a working capital 'stretch' and capital under-investment, meaning initial investment is required to normalise the position.

More importantly, the relative valuation method requires a detailed assessment of the target's key financials to determine the appropriate EBITDA (or equivalent) on which the valuation will be based. When undertaking a valuation, it is imperative that non-recurring items are excluded in order to determine the normalised EBITDA of the business. Additionally, it is often the case that adjustments are required to the financial statements in order to make them truly comparable with international companies (if applicable) while also ensuring that year-end calendar adjustments are taken into account.

In a distressed context, comparable transactions may provide the most appropriate guide to multiples in a valuation, as there is often data on companies that have previously been acquired in distressed situations, therefore providing a reasonable proxy for the valuation.

(c) Liquidation valuation

When a business is in terminal decline, or where a substantial break-up of the business seems inevitable, then using either a discounted cash-flow or a relative valuation approach may be inappropriate. In these circumstances the most applicable method is a liquidation approach, involving a valuation of any profitable and separable business divisions and break-up values of the company's residual assets (a 'sum of all parts' valuation). This may also be completed in conjunction with an estimated outcome analysis utilising insolvency experts to assess potential asset value discounts in liquidation and overlaying potential additional costs to liquidate (including administrator costs and various statutory deductions), all of which can vary by jurisdiction.

The liquidation value may be the worst-case scenario in valuing any business or assets, but will itself be fraught with input assumption complexities. In the end it will often simply be used as another data point to assess asset recovery value and to support investment or restructuring decision-making. However, liquidation valuations (and estimated returns to creditors) also inform the offers made to creditor classes in many company-led restructurings, since there is often a minimum statutory requirement that each class of creditor has an outcome which is better (or at least not worse) than that which they would receive in a liquidation).

8. Impact of valuation on restructuring transactions

The value of a company on a debt-free basis plays a key part in any restructuring, since it is in effect a forecast; it serves as a projection of what is likely to be returned to each stakeholder within the current capital structure. Projections (usually competing ones) are then used to form the basis for negotiations amongst different stakeholders to determine the holdings that each party will have in the newly restructured business. As discussed above, valuation is a very subjective process, and there is scope for a wide range of views which will often be fiercely contested, sensitised and flexed in order best to serve the purpose of each stakeholder, and also to drive negotiations when the perceived value break implies that some stakeholders have no economic interest.

Typically, a senior lender's adviser will be more inclined to take a realistic but conservative view of projected forecast performance in light of historic underperformance. This may result in an implied value break in the senior debt, which would justify a revised capital structure where the future economic interest of the business would lie primarily in the hands of the senior lender. In other words the senior lender would become the sole lender and majority equity holder (or beneficiary of equity value) in the new structure. This is typically achieved through a debt-for-equity swap. Junior lenders and existing equity holders would be offered subordinated debt instruments and/or minority equity holdings in the new structure, often having minimal value unless the company goes on to exceed expectations in performance terms, but preferable to being eliminated from the equation altogether through an insolvency process.

Junior lenders and equity holders will be independently advised, and will typically argue that the senior lender's view is overly pessimistic, that (depending on the situation) it is possible that the senior lender will be repaid in full over a longer period, and therefore that the more junior ranking debt and current equity ought to retain a substantial element (or indeed all) of their existing holdings (albeit potentially subject to revised terms in the case of junior debt holders).

The senior creditor will respond that, if that were truly the case, the company would have been able to refinance the senior portion of its debt with other debt providers. They will invite existing equity holders to inject the funds to reduce the senior lender's exposure to more manageable levels.

The senior lender may insist on a market-testing exercise where a select group of industry and financial players are invited to bid for the business, thus demonstrating the market's view of value. These valuations will be impacted by the perception of distress. Such an exercise can pave the way for senior lender ownership, either by setting the parameters for a solvent restructuring or (in some jurisdictions) providing a benchmark for the consideration in a pre-packaged sale of the business through an insolvency process. The process can also bring the distress of the business into the public eye and increase operational and creditor pressure, exacerbating the situation. As such it will typically be resisted by equity, whose future returns depend on the valuation of the business following a turnaround process rather than a sale in its distressed state (or a restructuring based on the distressed value).

The power dynamic in this negotiation is complex and highly dependent on the jurisdiction, the restructuring tools and insolvency procedures available, and the potential need for new money investment to drive future value out of situation. Typically, after protracted negotiation, to move beyond a deadlock, one party (often the company or the senior creditor) may present other stakeholders with an ultimatum, in the form of a best and final restructuring proposal, offering a much reduced stake in the business. The implied alternative is an insolvency process where returns to equity or junior creditors may be little or nothing, but the senior lender may be substantially repaid and/or able to take ownership of the business. Whether this is capable of being implemented is situation-specific.[20]

Traditional providers of senior debt may be reluctant to take such a stance, or have a policy which prohibits the taking of (majority) equity stakes. In such circumstances an alternative capital provider may take the role by acquiring the senior debt, typically at a sub-par price, with the clearing bank content to remove the risk in its position by recognising a loss that has already been provided for.

The valuation ascribed to a company or asset will significantly influence each stakeholders' decision-making process at the outset, and will potentially dictate their strategy during negotiations. It is not uncommon to see multiple valuations in restructuring situations, which can ultimately be held up in court if a restructuring reaches an impasse or dissenting stakeholders look to block a course of action which is pushed forward by other participants. Valuations are, in the absence of any other

20 For a more comprehensive explanation of the practice of restructuring in the UK context, see Chris Howard and Bob Hedger, *Restructuring Law and Practice*, second edition (LexisNexis, 2014).

tool which can influence decision-making, often used to positon the balance of power in negotiations, and will often be driven by the intended strategy of each stakeholder.

Ultimately distressed investors will look to take a view on value to assess the bid-ask spread before they purchase a position in a restructuring situation, but will also then look to develop their valuation thesis once they have a seat at the table. These two views on value might be very different and will be impacted by the information at hand, but they will inform negotiations throughout, and also support the ultimate exit and recovery story for each participant.

9. Overall conclusion

Despite an active distressed market operating in Europe since the late 1990s the last six to eight years have proven more complex for investors given the sheer scale of the economic crisis, unprecedented quantitative easing and a period of interest rate depression that may not be witnessed again for generations.

However, with continuing global economic uncertainty, Eurozone and sovereign debt travails, the likely protracted post-referendum Brexit negotiations, a correction in Chinese demand and a significant volume of non-performing loan assets still absorbing capital on bank balance sheets, there is likely to be a raft of opportunities for distressed investors.

High levels of corporate bond issuances have increased the opportunity to invest in tradable, multi-stakeholder debt, but this does not address a business's issue of over-leverage, it merely postpones the issue until the bond maturity is pending. Short-term and systemic shocks will continue to generate idiosyncratic opportunities for both passive and active investors alike over the next five years.

Attempts to invest in these situations have also laid bare the very different laws and regulations that prevail in Europe on a country-by-country basis, and are often a reflection of deeply held cultural values.

Valuing these opportunities, understanding the potential upsides and pitfalls, and interacting with the various stakeholders to ensure a successful outcome is a complex matter. There is no substitute for situational and jurisdictional expertise. No two situations are alike, and advice from senior professionals is key. There can be no comprehensive guidebook.

Recognising that context, this book represents a highly valuable, suitably focused contribution to those who aspire to have an understanding of the European distressed debt environment.

This chapter 'Investing in distressed debt in Europe: an overview' by Tom Cox, Damian Malone and Mark Sinjakli is from the title Investing in Distressed Debt in Europe: The TMA Handbook for Practitioners*, published by Globe Law and Business.*