

Financial distress

Lesson 1

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Common Ground

Common ground basics: Enterprise and Equity Value

Example CO

ASSETS		LIABILITIES	
Cash	50	AP	20
Op assets	970	Debt	500
		<hr/>	
EQUITY			
		Equity	500

100 share at 5€ each of nominal value

- Enterprise Value = Value of operating assets – Value of operating liabilities
- Cash is considered as non operating assets or better you can think that you can always use cash to pay down part of the debt and consider a notion of Net Debt
- What is the Enterprise Value («EV») in this example?

Value of operating assets	970
- Value of operating liabilities	20
<hr/>	
= Enterprise Value	950

- Consider that Assets – Liabilities = Equity
- Using the definition of Enterprise value EV – (Debt-Cash) = Equity

Enterprise Value – Net Debt = Equity Value

Common ground basics: Book Value vs Market Value (1/2)

BOOK VALUE

ASSETS		LIABILITIES	
Cash	200	AP	20
Op. assets	970	Debt	500
		EQUITY	
		Equity	650

- I want to do a new plant and need 150 to invest
- I want to finance it issuing new equity and I engage an investment bank to determine how many new shares I should give away to get 150

MARKET VALUE

ASSETS		LIABILITIES	
Cash	200	AP	20
Asset Value	1220	Debt	500
		EQUITY	
		Equity	900

- Based on the new business plan (with the new plant) the investment bank advises that based on DCF the EV is 1200 (the assets 1220)
- Equity will be worth 900
- So for 150 of new money I will have to give away $150/900 = 16,6\%$ of the Equity
- $x/(x+100) = 16,6\%$ means that I need to issues 20 new shares
- Shares are now worth $150/20 = 7,5$

Common ground basics: Book Value vs Market Value (2/2)

BOOK VALUE

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Goodwill	180	Sub Debt	200
Net assets	970		
ASSETS		EQUITY	
		Equity	650

- I decide to buy a company that has some good technology I can use
- The target company is sold for 200 (market value) and I raise 200 in subordinated debt to finance the acquisition
- Target Co. has physical assets worth 20 (book value) so I need to book the difference in value as goodwill (the “excess price” I paid)

MARKET VALUE

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Goodwill	180	Sub Debt	200
Asset Value	1520		
ASSETS		EQUITY	
		Equity	1200

- The market loves my acquisition and my shares reach a value of 10 implying an overall asset value of 1900

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Financial Distress

Financial distress

BOOK VALUE

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Goodwill	180	Sub Debt	200
Net assets	970		
EQUITY			
		Equity	650

- Suppose economic conditions worsen, and in addition the current performance of the company were negative (e.g. the acquisition did not work out, the demand for our products is soft etc etc)
- The market is valuing the equity 0,1 per share*
- Moreover the debt is trading as well below par (e.g. senior is trading 50% of face value, sub is trading 20% face value)

MARKET VALUE

ASSETS		LIABILITIES	
Cash	200	Senior Debt	290
Asset Value	90	Sub Debt	0

MIXED APPROACH

ASSETS		LIABILITIES	
Asset Value	290	Senior Debt	500
		Sub Debt	200
Negative Equity	410		

- A mixed view, which consider that independently of trading values the Company needs to pay the debt in full, shows by how much the equity is negative i.e. "how much restructuring is needed to fix the capital structure"

* We will discuss later in the course why market can still price some marginal value to the Equity even when the debt is trading below face value

Real life: financial distress

Astaldi 7.125% €750M Bonds Drop 12 Points to 86/87 Over Venezuela Uncertainty, Q3 Results Publication Postponement, Capital Increase Concerns; Investors Focus on Net Debt/Equity Covenant

Astaldi's 7.125% €750 million bonds have experienced a sharp decline today after yesterday's three point drop. The notes are down twelve points to 86-87, as the market mulls over the Italian construction business intention to raise €200 million and postpone the publication of its third quarter results. The group currently has significant exposure to Venezuela, with around €270 million of receivables. The recent decision of President Nicolas Maduro to renegotiate the country's debt obligations does not bode well for the business.

Astaldi's shares keep falling and they are now trading at €3.62, a 36.8% decline compared to yesterday's opening.

Uncertainty around Venezuela's compliance with its debt obligation could result in a series of impairments for the company, sources pointed out. The company has a 1.8x net debt to equity covenant which could be triggered following a deterioration of the debt payment situation in Venezuela. At the end of June, the net debt to equity ratio was at 1.66x.

Currently, Astaldi has frozen operations in the country and is pursuing bilateral negotiations with the country alongside the Italian government. Management said that the Italian government continues to work with its Venezuelan counterpart to recover its credit and reactivate construction sites in the country.

Astaldi didn't specify whether its potential €200 million capital increase will be underwritten. According to the Italian newspaper *Il Sole24Ore*, Unicredit, Bnp Paribas, Banca Imi and Banca Akros are already working on pre-subscribing the increase.

Investors are also questioning the company's ability to generate cash. Astaldi's €214.4 million half-year EBITDA was encouraging after a weak first quarter, but the improvement has not translated into cash flow, according to a JPMorgan research from August. The improvement may have been supported by one-off effects such the completion of several projects during the second quarter. The analysis considered Astaldi's leverage too high for a construction group facing high cyclicity, high construction risk and a high cash balance to run the business. According to Reorg's calculation, the group is 5.4x levered.

Financial distress

- Trading values by themselves are not a trigger of distress
- They can reflect the market vision and may anticipate distress
- There will be no bankruptcy as long as the Company can pay interests (considering its is holding a lot of cash) but...
- If negative performance turns into actual negative cash flow and will burn through the cash available then the clock will start ticking
- What options does the Company have (to increase the assets or reduce liabilities)?
 1. Improve operations
 2. Financial Restructuring
 3. Liquidation
 4. A blend of the three....

1 How to fix financial distress: Operational Improvement

MIXED APPROACH

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Other	90	Sub Debt	200
Negative Equity	410		



MIXED APPROACH

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Other	500	Sub Debt	200

- One obvious way to fix the issue is to improve the operations so that economic and financial performance will benefit and the value of assets will be increased (read “value of the assets” as their capacity to generate cash which is recognized by the market)
- Having successfully increased the asset value the existing capital structure will become sustainable again
- Turning around the operations requires time and resources that the Company may not have

2 How to fix financial distress: Financial Restructuring

MIXED APPROACH

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Asset Value	90	Sub Debt	200
Negative Equity	410		



ASSETS		LIABILITIES	
Cash	200	Senior Debt	100
Asset Value	90	Equity	190

- The balance sheet can be fixed restructuring the capital structure
- In the simplest form the restructuring can be achieved exchanging debt for equity either:
 - convincing the lenders, in an out of court negotiation, that it is the best way in which they can defend the value of their claim
 - forcing the lenders in a bankruptcy process
- The complexities of the game (for later):
 - How much equity should the each debt holder get?
 - Should the old shareholders get anything?

3 How to fix financial distress: Liquidation

MIXED APPROACH

ASSETS		LIABILITIES	
Cash	200	Senior Debt	500
Asset Value	90	Sub Debt	200
<hr/>		<hr/>	
Negative Equity	410		



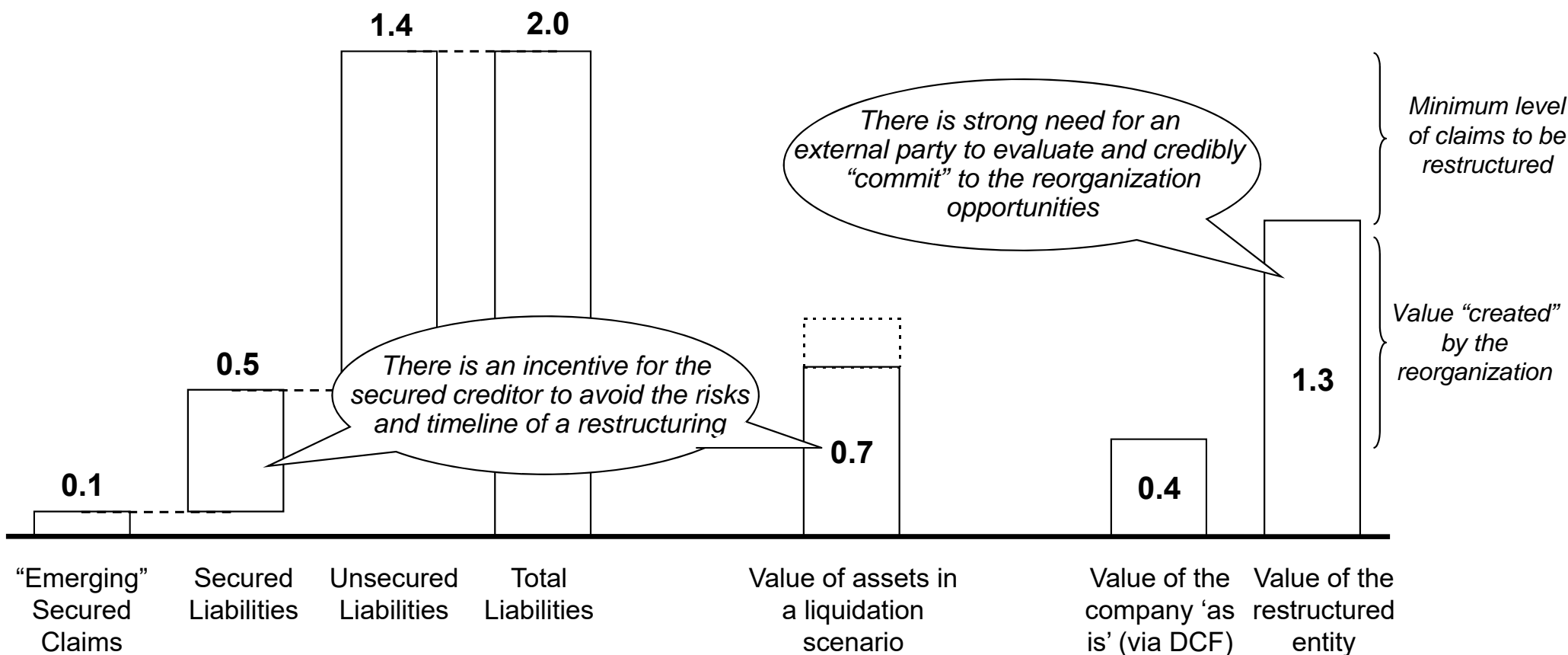
ASSETS		LIABILITIES	
Cash	200	Senior Debt	100
Asset Value	90	Equity	190

- If the business is not sustainable i.e. an operational turnaround will not be possible or enough and there is more value to stop operating and sell the assets then the Company will face liquidation
- It is likely that the Company will not be able to pay in full its creditors and will need to be liquidated in a bankruptcy procedure in order to
 - Orderly sell the assets
 - Make sure each creditor gets its "fair share"
 - Force the creditors to accept what they get

The decision to restructure in an investment decision

Liquidate or restructure?

Illustrative – different numbers than before



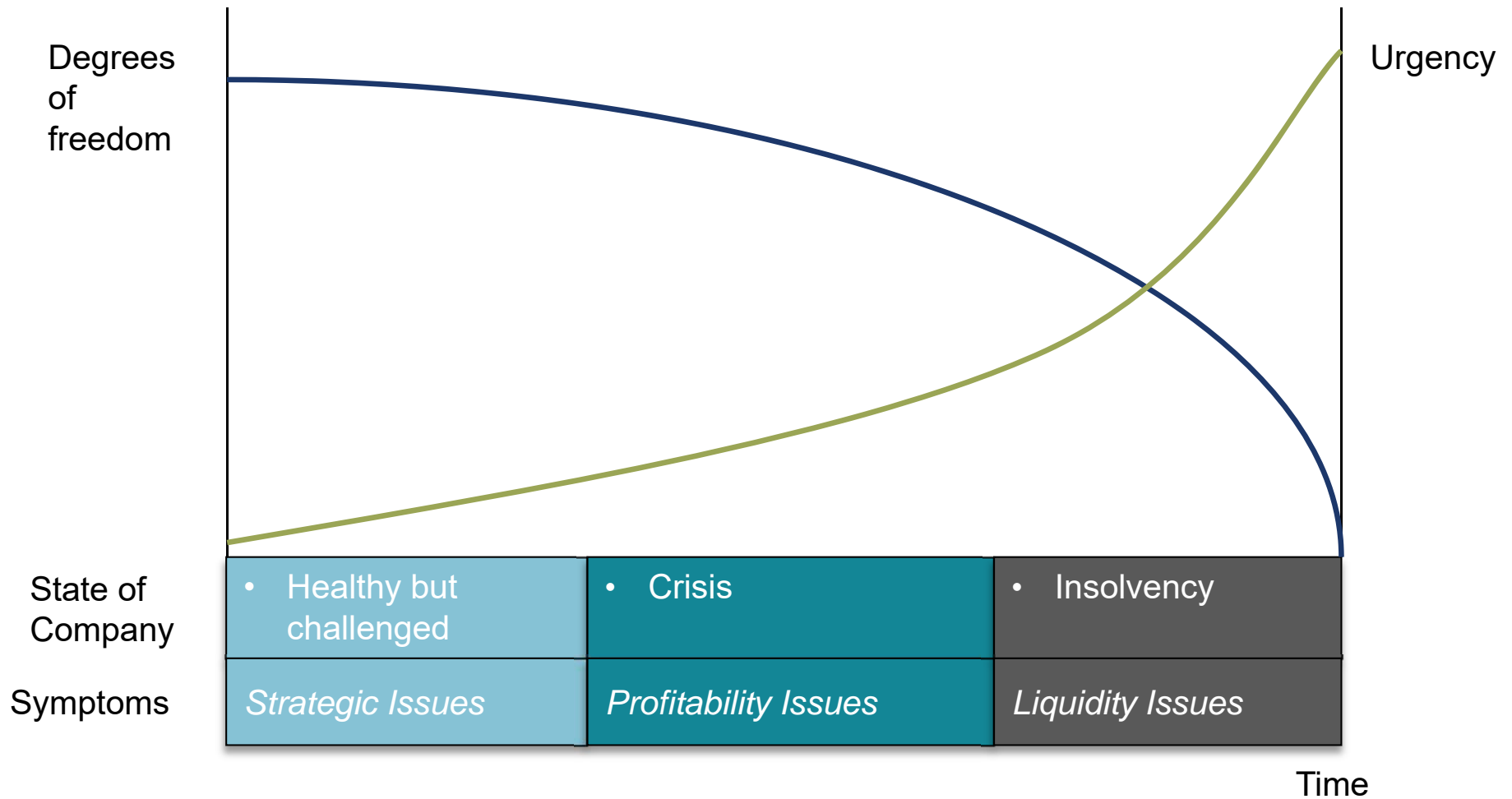
- Key to avoid therapy "at all cost" ($Val_{\text{liquidation}} > Val_{\text{going concern}}$)
- The expectations of the various stakeholders may be very different

The course will be about the rules, the players and their goals in the restructuring game

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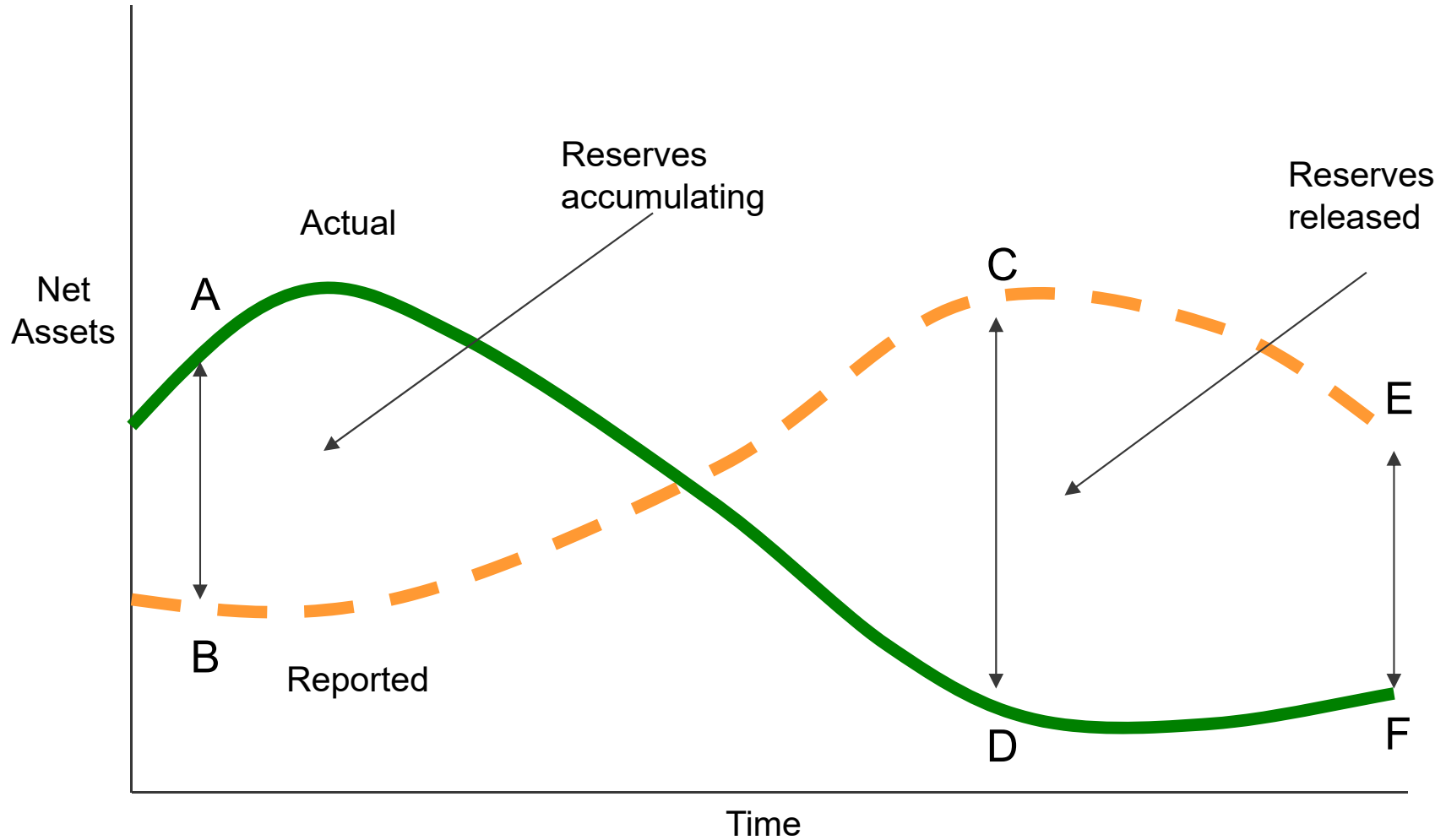
Signs of Financial Distress

The path to distress: why it is important to see it coming

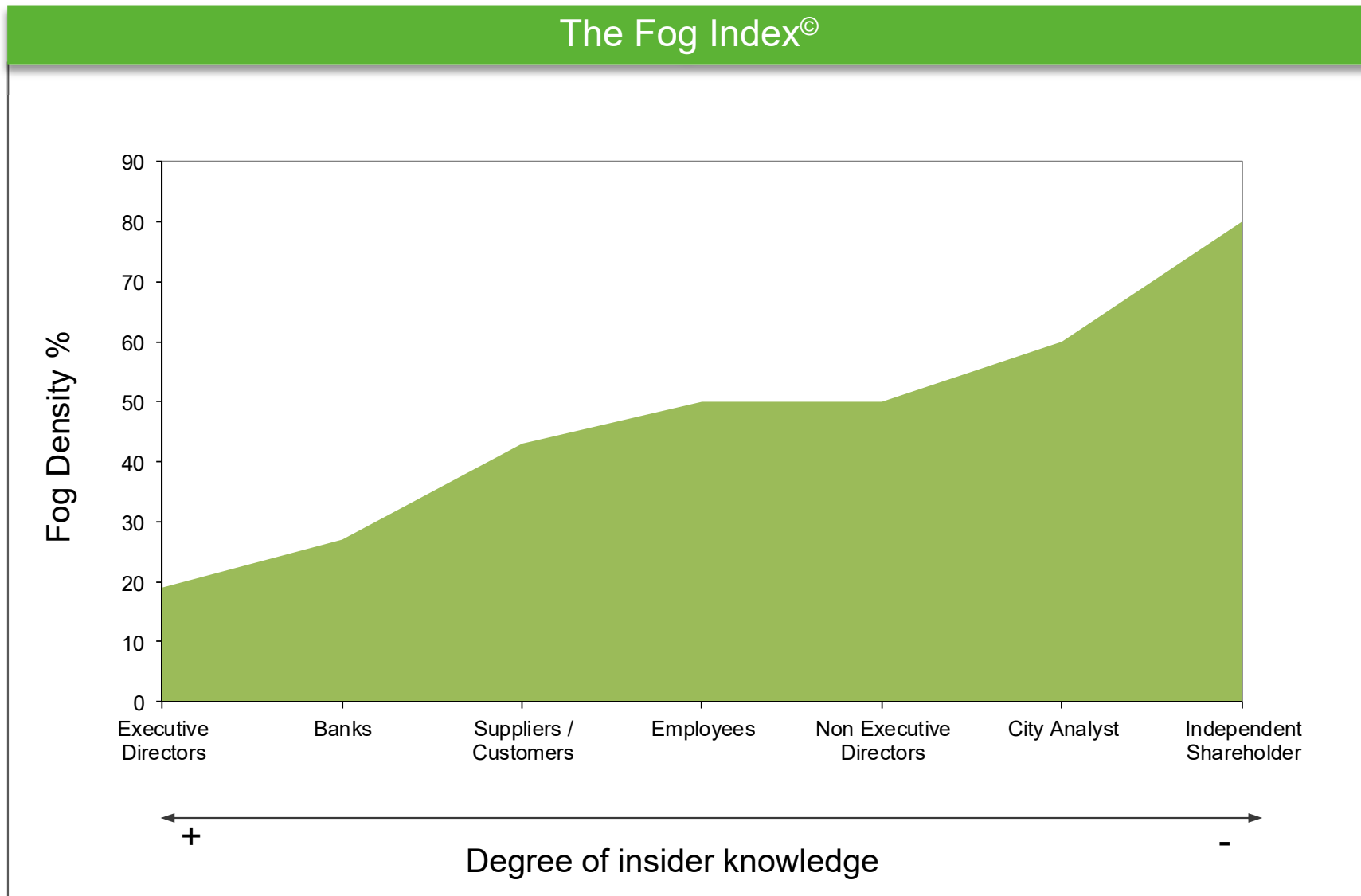


In theory the difference between market and book values often reflects what is called the reality gap....

The Reality Gap



Unfortunately it's not easy to have 100% foresight especially from an external perspective



Unfortunately it's not easy to have 100% foresight especially from an external perspective

Early warning sign	Metric	Could be a result of...
<ul style="list-style-type: none"> Declining operating performance 	<ul style="list-style-type: none"> Operating cash flow Operating margins 	<ul style="list-style-type: none"> Grew too fast Cost structure outdated
<ul style="list-style-type: none"> Increasing inventories 	<ul style="list-style-type: none"> Inventory levels, turns 	<ul style="list-style-type: none"> Grew too fast Old products (not selling)
<ul style="list-style-type: none"> Lowered debt rating 	<ul style="list-style-type: none"> Rating agencies opinion Increased cost of debt 	<ul style="list-style-type: none"> Too much debt Poor financial management
<ul style="list-style-type: none"> Increased stock volatility and/or analyst questions 	<ul style="list-style-type: none"> Analyst ratings Number of issues raised 	<ul style="list-style-type: none"> Industry correction Outsider questioning of strategy
<ul style="list-style-type: none"> Sales growth slowing 	<ul style="list-style-type: none"> Period comparisons % of sales from new products 	<ul style="list-style-type: none"> Product laggard, Regulatory change Too few customers Industry restructuring, new competitors
<ul style="list-style-type: none"> Personnel defections 	<ul style="list-style-type: none"> Executive turnover 	<ul style="list-style-type: none"> Frustration with results Lack of belief in products
<ul style="list-style-type: none"> Worsening working capital 	<ul style="list-style-type: none"> Days sales outstanding, A/R 	<ul style="list-style-type: none"> Grew to fast, poor cash management
<ul style="list-style-type: none"> Low utilization/ overcapacity 	<ul style="list-style-type: none"> Manufacturing utilization Personnel productivity 	<ul style="list-style-type: none"> Industry correction Poor asset management/overbuild
<ul style="list-style-type: none"> Accounting disclosures unclear, late, glossed over 	<ul style="list-style-type: none"> Understandability Timing of disclosures to board 	<ul style="list-style-type: none"> Underlying performance issues
<ul style="list-style-type: none"> Customer issues or defections 	<ul style="list-style-type: none"> Customer churn Issues raised at Call Center 	<ul style="list-style-type: none"> Poor product/service quality New competitors Inattentive management

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Causes of distress

The causes of distress are very relevant in the restructuring investment decision

EXAMPLE 1:

- Blockbuster was a retail chain renting movies on physical support (cassette, DVD etc.)
- It was a good business till web enabled disruptive business models (the first Netflix) and new technology (streaming) came on the market
- Blockbuster started making losses and burning through cash
- What is the investment rationale?
- Obviously there will be no operational turnaround that will fix the business and there exists no capital structure that will be sustainable
- The only game here will be liquidation

EXAMPLE 2:

- Take any American “frackers” oil company
- With the oil price below 40USD per barrel, extracting was not profitable for them
- They had a lot of debt (based on their oil reserves valued at higher prices) which became unsustainable
- But oil will still be needed for the foreseeable future and price won’t stay below 40 forever
- The game here is on one side reduce the operational costs to the maximum so it makes sense to extract even at low prices
- On the other side renegotiate a sustainable capital structure

Causes of financial distress

The main common cause of financial distress is that the firm is performing below expectations. That can happen for different reasons:

Economic downturn

- Economic cycle may impact significantly demand for certain product or services
- It is hard to assess if the economic cycle is the main cause or it is just highlighting other issues

Uncompetitive product

- Rapid technological changes may quickly alter demand for certain products or generate category killers (e.g. see what happened to Kodak or Blackberry)
- Is there a future? In what shape or manner?

Unsustainable cost structure

- Legacy uncompetitive cost structure, lack of streamlined processes, structural disadvantages, uncompleted merger integration

Unrealistic business plan

- In an unrealistic Business Plan the firm fails but the underlying products or services have demand
- Usually the Firm becomes distressed because the capital structure was based on unrealistic assumptions of margins and cash generation (LBOs, M&A): key issue here is valuation

Poor management

- Talent, fit and conflict of interests
- Key issue is to understand if you can force change or push CRO, consultants

Triggers for restructuring

- Distress by itself does not trigger a restructuring process
- The main trigger point for a restructuring is a liquidity issue
- The analysis to be done is to understand if the liquidity issues will lead to a bankruptcy or an out of court restructuring process
- Three most common type of **liquidity** issues:

Covenant* violation

- When a **covenant** on a loan is violated and not cured the loan is accelerated (i.e. becomes due before maturity)
- Usually that is a minor issue which can be cured with a **waiver** and some fees (no lender will want to be seen as forcing a bankruptcy over a minor issue) but
- In theory if the lender realizes that bankruptcy will be inevitable at a later stage may want to **accelerate** to protect from erosion of the available **collateral**

Interests payments

- Missing an interest payment usually will start an attempt at an out of court restructuring process
- Sometimes firms who are deeply in distress and are already planning for a bankruptcy procedure may decide not pay interests to preserve cash

Debt maturity

- The question here is to understand if the firm will be able to refinance the debt or not

* We will talk more later about covenants

Other triggers for restructuring

- Tort claims:
 - the firm may need to protect itself from large claims (e.g. asbestos or other environmental issues) filing for bankruptcy
 - bankruptcy will allow the firm to put a cap on the claim and force a binding agreement on all the claimants

- Contract liabilities:
 - liabilities due to bad contracts (e.g. derivatives on commodities)
 - bankruptcy offer the chance to reject contracts

- Fraud and crisis of confidence

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What a distress situation looks like in reality

Background

Noè brief profile

- Largest manufacturer/distributor of safety footwear in Europe
- Merger of 2 companies through a highly leveraged LBO in 2000
- Annual revenues of €180million from 10 million pairs of footwear
- Over 4,000 staff employed
- Across Italy, France, Spain, UK, Germany, and Tunisia
- Head-quartered in Italy, 90% of production in Tunisia
- CEO centric organisation, with CEO also a minority shareholder
- Company managed with informal processes
- Complex capital structure, especially considering size
 - Senior bank syndicate of 15 banks (5 of which Italian)
 - Mezzanine led by another global institution
 - Various shareholders loans

Corporate decline causes and trigger of restructuring process

- Revenues growth lower than planned
- Competition increase, also from LCCs, led to falling margins
- Breach of covenants in Q1 2004
- Critical cash issue - €7.5 million Senior debt repayment due on 20th June 2004

The “Strategy”: a PE Firm, with Company 1 in Portfolio, Decided to Buy Company 2, to Create the European Safety Shoe Market Leader

The Original Strategy

- C1 is a French-based safety shoe manufacturer with top range products made in Europe
- C2 is an Italian-based safety shoe manufacturer with low and middle range products made in Tunisia
- The PE firm wants to relocate C1's operations in Tunisia and using C2's production system to manufacture C1's shoes
- The merger would have cost benefits for C1's operations

Supporting Evidences

- C1 has a reputation for top range products while C2 is a low to middle market player in the safety shoe industry
- The European safety footwear market is expected to grow at around 3% a year in volume, with the highest growth in the middle and low range segments
- C2 is best positioned to compete in a European market with increasing competition
- Relocation of C1's manufacturing to Tunisia, with the help of C2, is the best option
- Manufacturing C1's products to current standards through C2's production system is feasible with minor adaptations
- C2 and C1's projections of sales seem to be achievable and relocation costs are rather conservative

Apparently a fairly good performance in 2003, but...

	<u>Actual</u> <u>2002</u>	<u>Actual</u> <u>2003</u>	<u>Budget</u> <u>2004</u>	<u>CAGR%</u>
Volumes (mil pairs)	10.4	11.0	11.6	5.9%
Average price (euro)	17.4	17.2	16.9	-1.4%
Revenues (net)	180.0	193.8	200.4	5.5%
COGS	(124.6)	(138.4)	(143.4)	7.3%
Gross Profit	55.4 30.8%	55.4 28.6%	57.0 28.4%	1.4%
Selling Costs	(11.0)	(10.7)	(11.3)	1.4%
G&A	(24.0)	(21.6)	(20.1)	-8.5%
EBIT	20.4 11.3%	23.1 11.9%	25.6 12.8%	12.0%
EBITDA	26.3 14.6%	28.2 14.6%	31.6 15.8%	9.6%

- Banks and shareholders had significant concerns over accuracy of accounting records

- (e.g. significant un-reconciled materials cost, generally attributed to 'overconsumption rates' within the main production facilities in Tunisia)

... cash generation swallowed up by debt repayments, interest and restructuring costs in 2003

		<u>2003</u>	<u>Q1 04</u>
Sources	EBITDA	28,2	4,4
	Working Capital	10,0	-8,1
<hr/>		38,2	-3,7
Applications	Repay banks	13,0	0,4
	Restructuring	10,0	0,7
	Interest	13,0	3,0
<hr/>		36,0	4,1
<hr/>		2,2	-7,8
Unapplied cash / Absorbed			

• Cash absorbtion in Q1 2004 mainly due to Working Capital increase, effectively reversing Q4 2003 position

Critical cash issue: € 7.5 Mio Senior Debt repayment due on 20th June 2004, dispersed treasury management and position

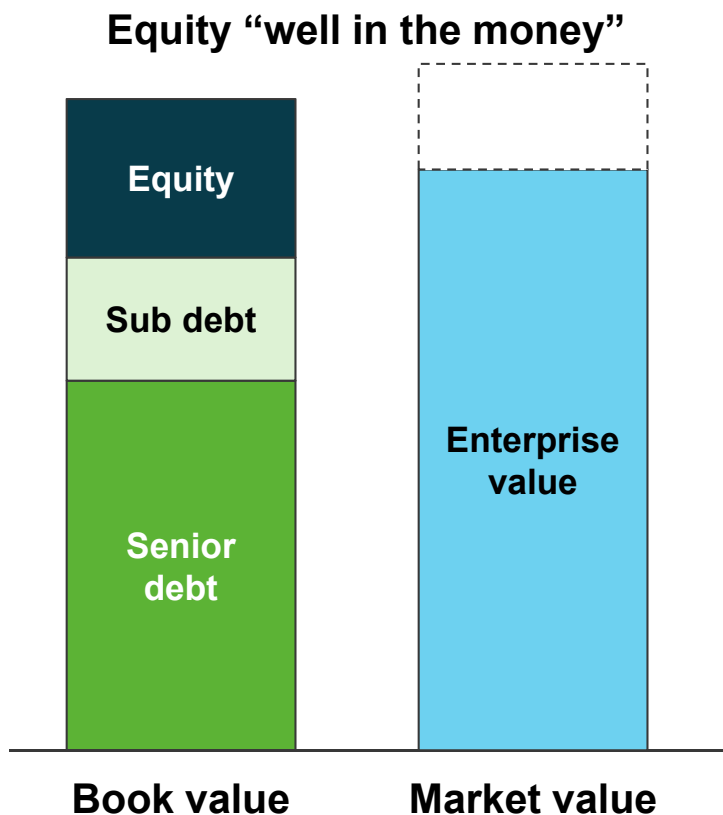
Cash position as at 29th April and forecast 31st May 2004

<u>Euro Mio</u>	<u>Actual At 29 April</u>	<u>Forecast At 31 May</u>	<u>Number Of Banks</u>	<u>Number Of Countries</u>
Cash at Bank				
Current Accounts	4,1	1,1	23	7
April Bills of Exchange not yet credited	0,2	-		
	<u>4,3</u>	<u>1,1</u>		
Local Overdraft Lines				
- Facilities	5,2	5,2	3	1
- Utilisation	(3,2)	(4,2)		
Headroom	<u>2,0</u>	<u>1,0</u>		
Revolving Facility				
- Facilities	15,0	15,0	12	3
- Utilisation	(15,0)	(15,0)		
Total Availability	<u>6,3</u>	<u>2,1</u>		
Note:				
Amount in Escrow for interest on Bonds	2,4	2,4	1	1

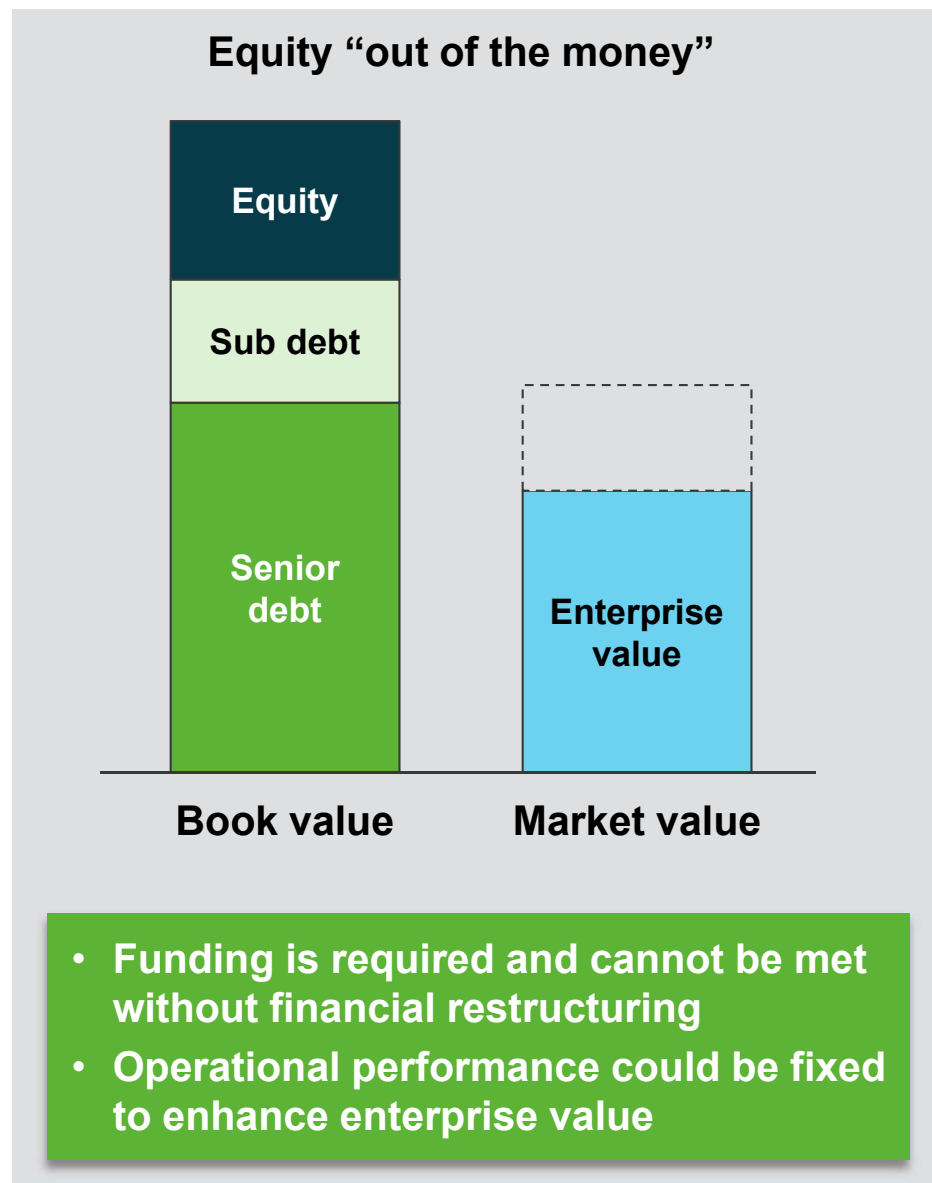
Shareholder Funds at 31st March 2004: equity value was close to zero

Assets	Euro (Mio)
Goodwill	130
Tangible assets	36
Inventory	56
Receivables	54
Other receivables	13
Other assets	3
Cash	11
	303
Liabilities	
Trade payables	(38)
Leasing	(2)
Available to financial stakeholders	263
Banks (includes accrued interest)	(121)
	142
Mezzanine (includes capitalised int.)	(43)
	99
Shareholder loans	(100)
Available to shareholders	(1)

The clock is ticking...where are we?



- Financial issues likely to be curable without new funding
- Only most forward looking debtors will tackle operational restructuring



- Funding is required and cannot be met without financial restructuring
- Operational performance could be fixed to enhance enterprise value