



The restructuring rules have changed: What troubled companies need to know about workouts in the new recession



The effects of the current turmoil in the global financial system will be felt for years to come. Initially the fallout affected primarily companies in the mortgage and financial services industries, but it is now touching the lives of virtually every tax-paying American citizen.

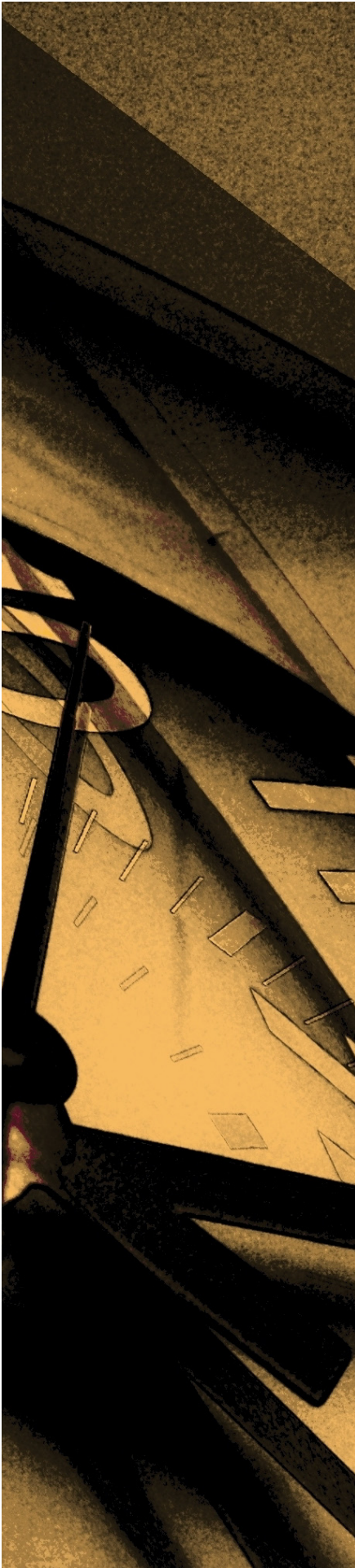
While the current credit crunch has its roots in the subprime mortgage crisis, it has extended far beyond traditional lending institutions, spreading its tentacles to financial firms like Lehman Brothers and Bear Stearns as well as insurance companies such as American International Group. Whether and to what extent the various government interventions attempted will ameliorate the crisis remains to be seen.

How Did This Happen?

A decade ago, prospective homebuyers had to demonstrate to lenders, typically banks, that they had the ability to meet their mortgage obligations. This began to change in recent years as subprime lending, the extension of credit to borrowers with weak or impaired credit, expanded dramatically.

The growth of subprime mortgages was fueled by two major factors. First, hedge funds and other new investment vehicles vastly increased the supply of capital in the market, driving interest rates to historically low levels and causing lenders to weaken their credit standards as they competed to “put funds to work.” With low interest rates squeezing their profit margins, lenders turned to subprime mortgages, with their higher interest rates, as a way to earn a better rate of return. Second, the rapid growth of securitization - the process of pooling loans with similar characteristics, turning them into bonds, and selling the bonds to investors - increased the pace of subprime lending as investors seeking higher yields snapped up securities tied to subprime mortgages.

Moreover, as many lenders transitioned from the traditional “originate-and-hold” lending model to an “originate-to-sell” model, they paid even less attention to underwriting standards. As a result, subprime mortgages exploded from approximately \$10 billion in loans in 2001 to approximately \$600 billion in 2006. Financial institutions and hedge funds bought up the various tranches of mortgagebacked securities, often borrowing heavily to do so. The fatal flaw was the expectation that the default rate for subprime mortgages would match historical patterns. Unfortunately, with the vastly larger population of subprime borrowers and weakened (often non-existent) credit standards, historical default rates no



longer applied. The subprime meltdown occurred when it became apparent that the default rates were much higher than expected. The markets no longer had any confidence in the value of mortgage-backed securities, setting off a liquidity crisis as firms could no longer sell them. Financial institutions were forced to take massive write-downs on their mortgage portfolios, which, in combination with record-high levels of debt, threatened their very survival.

With their capital bases severely eroded by the subprime mortgage crisis, lenders have gone into defensive mode and shut off the credit spigot for companies seeking financing. With lenders reluctant to finance or refinance acquisitions and loans, borrowers have few options. If they are able to obtain a loan from a traditional lending source, the interest rate will increase significantly. Additionally, there will be more restrictions on the amounts of the loans and more performance covenants. Even healthy companies will find it difficult to get deals done or loans refinanced. But for distressed companies with eroding financial positions that threaten their very existence, the outlook is grim.

Changing Times

In previous economic downturns, such as those in the early nineties and in 2000 after the dot.com bust, borrowers and their lenders had relationships that typically spanned a period of several years. They understood each other's business models and needs. The lender needed the company to regain financial health so they could retain a valued customer. For that reason, the lender was typically more patient if the business was experiencing distress.

Today, companies are operating in a far more complex credit environment. Debt has become a commodity, one that often changes hands. A company approaching its lender about a workout may find that the lender instead decides to manage its risk by selling the loan to a hedge fund at a discount. The hedge fund is not looking at the loan as part of a long-term business relationship – it is looking at the loan as an investment on which it wants to see an immediate return. Therefore, the hedge fund is likely to have very limited patience with the debtor company. In some cases, hedge funds have even pursued a loan-to-own strategy, through which they buy debt from a company that they believe will default as a way to take over the operation.

Debts from lenders are far from the only concern. A supplier to a troubled company may sell its debt to a claims trader as a way to control its risk. The trader buys the debt at a discount, and then looks to collect the full amount from the debtor. Unlike the supplier, the claims trader is not interested in the long-term health of the debtor – its focus is turning a profit on its investment. While hedge funds, private equity groups and other entities have broadened the number of options that companies have in seeking capital – and may even provide options to troubled companies during a turnaround effort – their expanding presence as debt holders is leaving companies with less time to react to trouble.

Globalization also complicates turnaround efforts for businesses today. Even smaller companies are far more likely to be sourcing goods and services around the world and selling to markets outside U.S. borders than they were during the last broad based recession. It's rare, for example, to encounter a middle market U.S. manufacturer that doesn't have a Canadian affiliate or subsidiary. While these international efforts have provided new avenues for growth, in a turnaround situation, they present a variety of complications. For example, troubled companies often must make layoffs in order to survive. Yet making layoffs overseas can be more difficult, and more expensive, than making them in the U.S. For example, in many European countries, there are statutorily required severance packages, often tied to longevity. In France, labor laws make it more difficult to lay off more senior workers than more junior employees, regardless of their relative performance.



Labor laws also may have strict rules about exactly how layoffs are conducted, while bankruptcy laws and procedures also differ from jurisdiction to jurisdiction. International operations also often mean subsidiary operations or other additional legal entities – and the more such entities are involved in any restructuring effort, the more difficult that effort becomes. While attempts have been made to compile a set of common procedures for dealing with financial distress throughout the world, the explosion of regulations in the various countries requires a different type of analysis for dealing with a global company in distress.

Finally, companies today simply have less time to execute a turnaround than they had in the past. Bankruptcy law changes allow companies less time to reorganize. Creditors are less patient. Markets in general move more quickly. Early recognition of problems and decisive action to address them always has been vital in any turnaround effort – now it may be the difference between survival and liquidation.

Signs of Distress

A variety of current market conditions can cause stress. Energy and commodities prices, while moderating now due to the slowing economy, are still relatively high. And, while the slowing economy may be pushing down costs, it also can push down revenues. Home equity, which had risen steeply for years and had provided ready credit to the consumer market, is now falling. Demand for products associated with the homebuilding industry, such as furniture and appliances, has declined steeply. The high price of fuel has led to a major decline in the purchase of SUVs, and the tight credit market is also slowing auto sales. Consumers are paying more for such basic commodities as food and transportation, so they are cutting discretionary spending on restaurants and entertainment.

Other business trends can be pushing companies toward trouble. Companies anxious to supply the big box retailers may have agreed to contracts that not only leave very narrow margins, but that also require goods to be supplied on a just-in-time basis with significant fines for not meeting those requirements. As economic conditions contract, these arrangements may be coming back to haunt the suppliers. Whatever the root causes may be, symptoms of trouble are often the same. The first, and most obvious, is difficulty servicing debt load. Companies that are not able to keep current with lenders have clear issues they should face immediately.

Access to sufficient credit can be another issue. In the current tight credit market, even companies that have good credit histories are finding it difficult to access credit, and some are even seeing their credit lines cut. A company also may be having trouble paying vendors or suppliers. If you are behind on payments, are stretching terms, or find yourself looking at lower quality suppliers in order to manage costs, your company may be heading for trouble.

Even if you are not yet having trouble making payments or accessing credit, there are other signs that can indicate that you may soon experience difficulty. Is your market share declining? Are margins trending down? Are you falling behind benchmarks in your industry? Are sales falling off? If the answers are yes, then liquidity issues may not be far behind.

In any of these cases, it is important to act quickly and decisively. Companies that wait in hopes that conditions will improve are those that fare most poorly in turnaround efforts. Those that move quickly to analyze and correct their situations are most likely to succeed.



Time to Restructure

For those companies that are faced with an increasing inability to meet their obligations, restructuring is required to re-establish cash flow and long-term viability. Recognizing problems early and addressing them aggressively will be vital if the company is to survive.

Typically, the lender will bring in an outside professional or restructuring specialist to help find a way out of the current morass. In a distressed situation, liquidity is a key issue. Cash flow must be enhanced to reduce indebtedness or meet debt service requirements.

Only after the company's liquidity needs have been assessed can the restructuring specialist conduct a more thorough analysis of its operations and develop a plan to stabilize the company and meet its long-term needs.



Some Steps to Take

In any restructuring, certain steps need to be taken to stabilize the company and improve operational performance. A short-term tactical plan prevents the company from slipping into further distress while the restructuring is in process.

► **Step 1 Analyze the entire operation.**

Take a serious look at forecasted operations, both the demand and the costs. This results in a level of analysis for cash flow, income statement, and balance sheets that is far more detailed than most companies are used to preparing. Some company owners have a tendency to think they can grow their way out of debt. Management will forecast an increase in sales or new product launches as a turnaround strategy. It is, however, almost unheard of for a company to grow its way out of problems. Product launches or other growth strategies generally require significant upfront investment, with projected revenue increases lagging behind. For a company already experiencing liquidity issues, such strategies will exacerbate, not help, their problems.

► **Step 2. Determine if there are sufficient resources to achieve forecasts, taking into account unexpected surprises.**

If there is an inability to fund operations or if there are projected deficits, look at making changes to stabilize the company. Look for the core business and jettison non-core assets or lines of business. The restructuring specialist may also have to break through a logjam of denial. The company may have never had liquidity issues, and management may not understand how serious a liquidity crisis can be to the company's operations. Management may also be blinded by a feeling that it can resolve the situation by itself without seeking outside assistance. In either case, whether management is driven by arrogance or by denial, a company will need operational restructuring to get back on its feet.

► **Step 3 Look at credit terms.**

Which creditors have been overextended? Figure out a process to deal with them. Rank payments to determine the necessary cash outflow. Stick to reasonable credit terms and monitor them properly.



► **Step 4. Develop a plan to deal with customers and suppliers.**

Assure your customers, if you're able to, of your ability to continue to supply them with goods. Look at contracts with your suppliers. Which are sole-source suppliers? If they fail, they can disrupt the balance of your supply chain. Develop a plan to procure the goods necessary to meet your needs and continue the flow of liquidity.

► **Step 5 Communicate with your stakeholders--your lenders, customers, vendors, suppliers, employees and board of directors.**

This may involve meetings and phone calls, as well as written communications regarding the company's status. Inform your stakeholders that you're embarking on a restructuring process and share the timetable. Allow them to understand the situation, your needs, and your course of action. Clearly your employees are among your key stakeholders. You need to develop a process that not only informs them of the status of the company but also empowers them to help implement a restructuring plan. Although it is not always feasible to communicate all the details of the restructuring to your employees, it is important to keep your key people informed and communicate to them what their new roles will be.

Observing Some Golden Rules

In addition to the steps that need to be taken to stabilize a distressed company, there are three "golden rules" paramount in any restructuring:

Rule one: Don't make promises you can't keep.

Don't tell suppliers they'll receive payments if there's no possibility those payments will be made. One of the biggest problems in a restructuring is the loss of management's credibility, and nothing destroys credibility faster than broken promises.

Rule two: Don't try to do it on your own.

There's a tendency on the part of management to want to work its own way out of problems, since asking for help can seem like an admission of failure. Unless you've worked in a distressed situation, it's difficult for the management team to understand and react to the significant shifts in dynamics that occur within the company and in its relationships with stakeholders.

Rule three: Cash is king.

Without liquidity, nothing else matters.

Limited Opportunities Exist.

Any increase in distressed situations will provide opportunities for those still in the money looking for strategic investments that may be valued at far lower price/earning multiples than in the current market. Smart, patient debt traders will have a significant amount of opportunity in the marketplace. While success isn't guaranteed, a fundamentally sound business may well generate sufficient returns to justify the risk.