

# Restructuring Trends



*Inside this issue: Restructuring <sup>p6</sup> / In the debt markets <sup>p10</sup> /  
Not all CVAs are created equal <sup>p14</sup> / Growth of ABLs <sup>p16</sup> / Fixing  
cracked China – turnaround and transformation in Asia <sup>p18</sup> /  
Economics corner <sup>p20</sup>*



## at a glance

# 6

### **Restructuring**

Against a backdrop of continuing Eurozone recession, levels of restructuring activity in Q1 2013 remained broadly in line with recent quarters. High-yield issuance is running at a frenetic pace, with YTD issuance to the end of May already exceeding total issuance in either 2011 or 2012. Refinancing with HY debt and continued repayment have reduced further the outstanding wall of maturity and the size of the ELLI universe is shrinking. The peak in maturity is expected in 2014, but for speculative grade debt, the peak will not be until 2016/2017. Average pricing on new issues fell in Q1, largely due to a number of borrowers accessing US markets and taking advantage of cheaper financing.

# 10

### **In the debt markets**

Corporate debt market conditions continue to improve in 2013 and while M&A and LBO activity remains low, borrowers are taking advantage of the ongoing improvement in terms by refinancing, repricing and amending existing debt. Banks are open for business again and in the corporate market, loan issuance has outstripped bond issuance. Investor appetite for yield has also supported a huge increase in hybrid and convertible debt issuance as an alternative to direct equity raisings. By contrast, in the leveraged loan market, non-bank refinancing continues to dominate with HY issuance volume reaching an all time high in the first quarter of 2013.

# 14

### **Not all CVAs are created equal**

Historically, Company Voluntary Arrangements (CVAs) have been popular and saleable to management and shareholders – disguised as a panacea to their problems. The most recent insolvency statistics show that the use of CVAs, the former poster child for UK insolvency processes, has declined at a faster pace than the overall level of insolvencies in the last two quarters.

A large part of the reason is that there are very few large and demonstrably successful CVAs because of a fundamental failure to marry the mechanics of the CVA process with a viable operational turnaround. In this edition, we consider the common pitfalls in making a CVA successful and the key components of creating a CVA that works.



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## 16

### ***Growth of ABLs***

Since 2006, we have seen the Asset based lending (ABL) market grow by 33%. ABL is particularly suited to finance asset rich companies facing a transaction, significant investment or volatile funding requirements. It is also a useful tool in restructuring situations where cash generation may be limited, but the balance sheet and asset base are relatively flat. In this scenario, it can provide a stable funding package for the business while it focuses on cost reduction, efficiency and operational improvements and we are increasingly seeing ABL being deployed as part of a wider package alongside senior lending, mezzanine loans and trade finance.

## 18

### ***Fixing cracked China – turnaround and transformation in Asia***

Cracks are emerging in the Asian growth story and there are growing numbers of inefficient enterprises that survive but do not prosper. The lack of formal restructuring tools has limited the available options to two polar opposites - a consensual restructuring or liquidation. Businesses and their stakeholders have identified the need to address underlying operational and structural issues, rather than simple debt rescheduling. This has created a new opportunity for transformation and turnaround professionals who can effect genuine operational change to secure enhanced financial restructuring.

## 20

### ***Economics corner***

Economic recovery in the US, while lagging emerging markets, is outpacing growth amongst its peers in the advanced economies, creating a three speed global economy. The Eurozone remains firmly in the 'slow lane' of this multi-speed economy and the slowdown has spread to the core. The recovery in the US places it in the 'middle lane', outperforming the Eurozone by 5% since Q3 2011, while emerging and developing economies continue to operate the 'fast lane'.

Progress in debt reduction is a key aspect of Eurozone recovery, but despite significant progress in some peripheral Eurozone economies on getting their public finances onto a sustainable footing, the outlook for private sector debt remains challenging. Economic risks therefore remain weighted to the downside.

# Welcome



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## ***Intriguing times ahead***

Welcome to the June 2013 edition of Restructuring Trends. For those of you who do not know me, I am a restructuring partner based in our London team working primarily on European-based restructuring situations, coordinating where appropriate our work with some of our dedicated overseas teams.

A couple of years can be a long time in restructuring and yet, when considering some of the issues covered by this edition, I reflected on my foreword to the March 2011 edition – New dawn or false dawn?

We could ask ourselves the same question today and there are conflicting data points across the markets in which we operate that increase our sense of uncertainty about the future. How else can we reconcile strong debt market liquidity as well as strong performance by the major equity markets with continued downward macroeconomic trends in a number of major territories?

From a macroeconomic perspective, 17 Euro countries remain in recession and Q1 2013 represented the sixth consecutive quarter of decline in GDP across the Eurozone. Whilst Eurozone countries continue to make progress in seeking to control public finances, the rate of progress is too slow to point to a definitive short-term recovery. In addition, as we reflect in more detail in our Asia update, there are worrying signs across South East Asia and China in particular that growth is slowing with consequent repercussions on global trade flows. The UK on the other hand continues to show gradual signs of improvement although, again, it is probably too early to suggest that all is now well!

On the positive side, the high-yield market has continued to provide more and more liquidity with issuance hitting a record high in Q1 and continuing at pace with 23 debt issues in May alone. This has supported increased activity on amend and extend agreements with a consequent partial shifting of the maturity wall to beyond 2015. Market confidence has also been supported by strong growth in equity markets and sustained liquidity within traditional bank lending for stronger credits.

So what do we make of this and what does it mean for a restructuring market where activity, particularly across

Europe, has remained pretty stable over the last few quarters – with a growing number of cases in Southern Europe (especially Spain with increased focus on cases such as Pescanova and FCC) balanced by a more stable situation across Germany and Benelux?

Positive market conditions, such as those we have been experiencing in the first half of this year, potentially widen the gap between winners and losers across most sectors. Management teams and their stakeholders must continue to focus on the fundamentals and on improving core activities, avoiding over-committing on new activities without the appropriate level of scrutiny.

It is in this context that we cover some topical issues as part of this issue. In addition to our regular features on the debt markets and economic trends, we look at the development of turnaround practices in Asia and how asset based lending and CVAs can be used to good effect in supporting businesses through a restructuring.

Finally, where do we think the market is heading? On balance and taking the above into account, we see sustained restructuring activity in the next 12-18 months, particularly across Europe (France, CEE and potentially the Nordics). Against this backdrop I would like to take the opportunity to welcome the new senior members of our team.

As of 1 July, I am delighted to announce that Steven Moll, Nick Carmichael and Stephen Cave will be admitted to the partnership and will strengthen our restructuring focus in the Nordics, across our Debt and Capital Advisory offering and in Northern Ireland respectively. There will be more from them in future issues.

I am also delighted to welcome our newly promoted directors: Matt Callaghan, Joanne Walton, Sam Tao, Suzanne Godfrey, Rob Moran and Rob Clark – they will add strength in depth across their areas of expertise and reflect our continued commitment to grow our practice and support our clients in these challenging times.

I hope you enjoy this edition and as ever, your feedback is welcomed and much appreciated.

*There are conflicting data points across the markets in which we operate that increase our sense of uncertainty about the future*

Brian Lohead, Partner



# Restructuring



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Against a backdrop of conflicting messages, the restructuring outlook remains (unsurprisingly) mixed. From a macro-economic perspective, 17 European countries remain in recession and in Q1 2013 Eurozone GDP declined for the sixth consecutive quarter. High-yield (HY) issuance, however, is running at a frenetic pace, hitting a recent high of €21.4bn in Q1. The rapid pace of issuance is continuing, with 23 issues in May alone. This means total YTD issuance (to May) is greater than total issuance in either 2011 or 2012.

Restructuring activity in Q1 across Europe, based on distressed leveraged loans, remained in line with previous quarters and there have been a number of recent notable cases including Seat Pagine Gialle, IVE Immobilier and Stemcor. That said, the pace of bond issuance and amend and extend activity has enabled a number of borrowers to push back their maturity profile, such as Maxpeda and Avanza.

Turning to the wall of maturity, recent S&P data shows that the peak in maturities across all European corporate debt is still expected in 2014, when \$981bn is due to mature. Of this amount, \$318bn relates to non-financial corporate debt of which \$41bn is speculative grade. Notably, the peak in speculative grade debt maturity is now in 2016/2017 when \$78bn and \$91bn is expected to mature in each year respectively.

According to the S&P European Leveraged Loan Index data (ELLI), the amount of outstanding institutional leveraged debt has fallen from €142bn in 2008 to €102bn as of May 2013, through continued repayment and refinancing of debt via HY bonds. The HY market has correspondingly increased in size from €70bn to €224bn over the same period. Whilst HY liquidity remains available it is a significant tool for corporate issuers to manage upcoming maturities, although there is speculation regarding how much further the HY market can be tapped before overheating.

Pricing on deals has remained broadly in line with 2012 levels. The exception is new issue deals where average pricing has dropped from 495bps in 2012 to 442bps, largely due to a number of borrowers accessing US markets and taking advantage of cheaper financing.

At 50bps, amendment fees also remain broadly in line with the prevailing levels of the last couple of years. Pricing on deals, however, remains dependent on the specifics of the particular situation, for example the level of new money or debt rescheduling required.



**Distressed credits**

There has been no significant change in the level of distressed credits and related activity from Q4 2012 to Q1 2013. A total of 17 corporates incurred a payment default or entered restructuring in Q1, the highest level since the same period in 2012.

First quarter publicly disclosed restructurings included Central European Distribution Corporation (CEDC), Yioula Glassworks and SEAT Pagine Gialle SpA. Across the non-leveraged market there are also a number of other distressed cases including high profile insolvencies such as HMV and Manganese Bronze.

**Distress metrics**

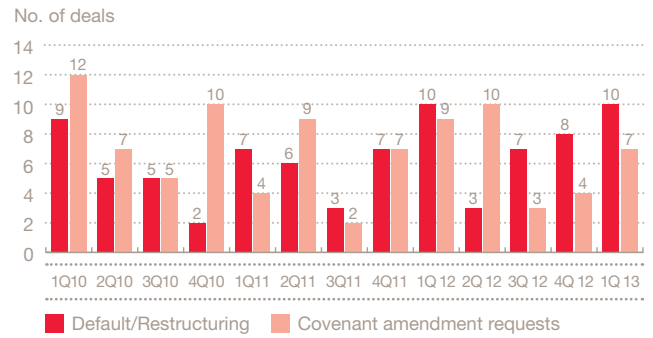
Most of the distress metrics that we monitor each quarter showed little change in Q1. The lagging 12-month default rate for the ELLI remained at 6.6% based on par amount outstanding - the same level as the December figure, which was a two and a half year high. In the year to 31 March 2013, the ELLI tracked €7.2bn of institutional loan defaults and restructurings.

The ELLI default rate measured by number of issuers was 8.5% in March, again the same as in December. During the last 12 months, 15 issuers defaulted or started a restructuring process, down from 18 in December.

The ELLI distress ratio – the percentage of performing loans trading below 80 – continued its decline. In Q1 the ratio fell to a 20-month low of 17.2%, from 18.7% at the end of December, and even further below the peak of 31.5% tracked at the end of 2011.

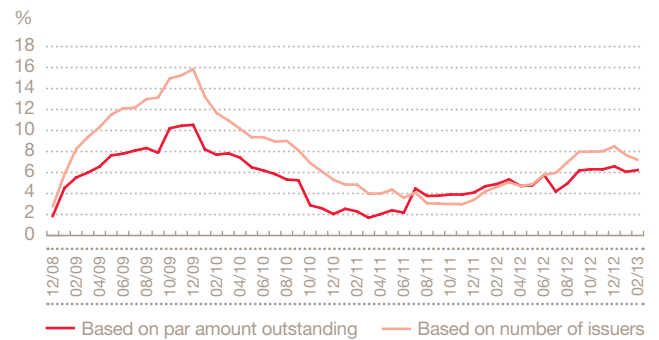
The share of facilities rated CCC+ or lower based on par amount outstanding (i.e. those in default or with a relatively high probability of default) increased to 7.7% in March from 7.3% at the end of December. However, this is in line with the average of the last two years and remains well below the 11.9% level seen at the end of 2011.

**Distressed leveraged loans**



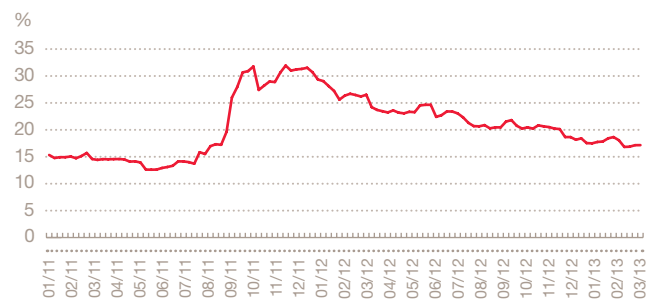
Source: S&P Capital IQ LCD  
Note: Distressed credits are classified as loans rated D or in a restructuring

**12 month default rate**



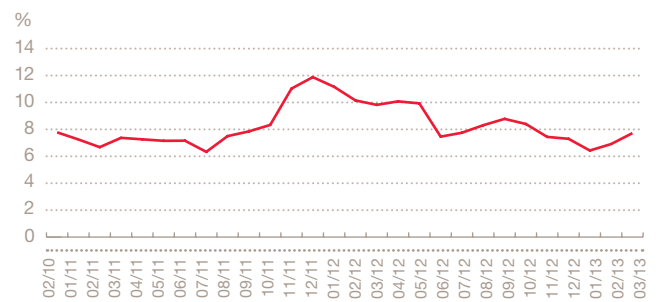
Source: S&P Capital IQ LCD

**ELLI distressed ratio**



Source: S&P Capital IQ LCD

**Share of facilities rated CCC+ or lower**



Source: S&P Capital IQ LCD

**The struggling Eurozone economy continues to provide a range of large European restructuring cases**

Jeremy Webb, Partner

### Maturity profile

The chart on the right shows outstanding European institutional leveraged debt by maturity. The amount of debt outstanding (with maturity before 2020) continues to decline, falling from €142bn in December 2008 to €105bn in March 2013.

As corporates either refinance, amend and extend, or repay debt the level of outstanding maturities due by 2015 continues to decline. As of March 2013, there was €26bn of institutional debt maturing through to 2015, a 23% reduction from the equivalent level of debt at December 2012. One of the key drivers of this decline was HY issuance, with c.50% of all Q1 issuance being used to refinance debt.

Over the last 12 months or so, 18 borrowers have exited the ELLI universe via a bond take-out or other form of refinancing. The result has been a continued transfer between ELLI and HY bonds, and the size of the ELLI universe is now at its lowest level since 2005.

A recent S&P report showed that nearly \$4 trillion of corporate debt, both financial and non-financial, is expected to mature by the end of 2017. Non-financial corporate debt maturing by 2017 is estimated at \$1.3 trillion, of which 20% or \$271bn is speculative grade debt.

As shown in the chart opposite, the peak in maturing European corporate debt across both financial and non-financial categories is in 2014, when \$981bn is expected to mature. The peak in speculative grade debt, however, is now in 2016/2017.

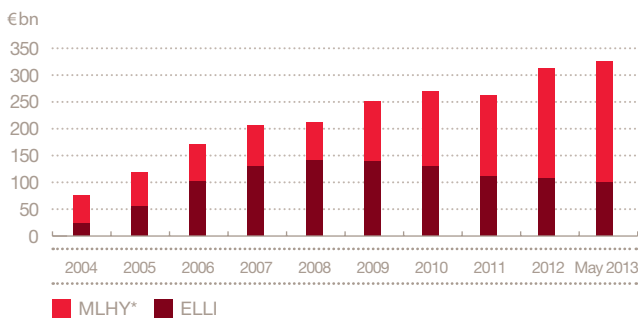
### Pricing

Over Q1 2013, average margins on new deals broke the trend of the last three years and declined to 442bps. This reflected the relatively high number of issuers who were able to tap the US market and achieve lower pricing on Euro denominated institutional debt. 'Domestic' issuers achieved margins in line with Q4 2012.

Whilst no margin data was reported by S&P on amended deals we would expect there was no significant change in pricing from the levels seen during 2012.

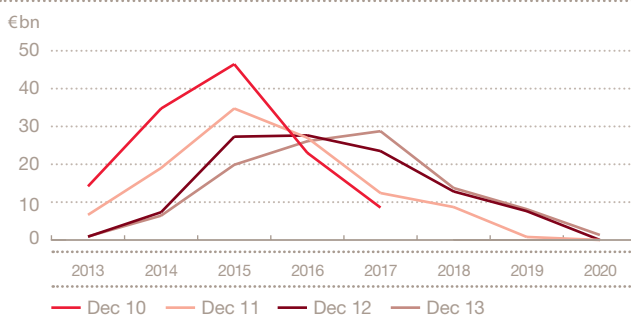
In Q1 average amendment fees on deals were 50bps. Deals ranged from 25bps for Gruppo Coin where new money accompanied a request for a covenant reset and debt rescheduling to 75bps for Mauser for a covenant reset and an extension of up to two years on certain facilities.

Market size - outstanding balance



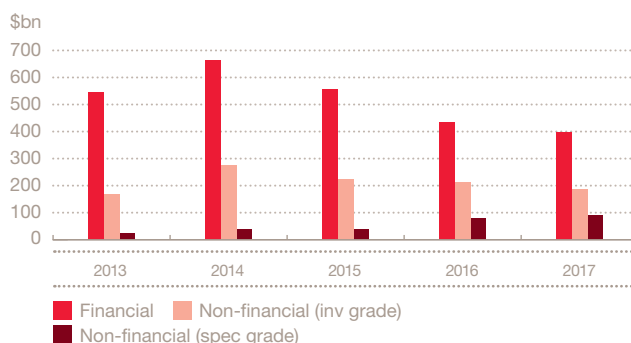
Source: S&P Capital IQ LCD  
\*Bank of America Merrill Lynch European High-Yield Bond Index

European institutional leveraged debt



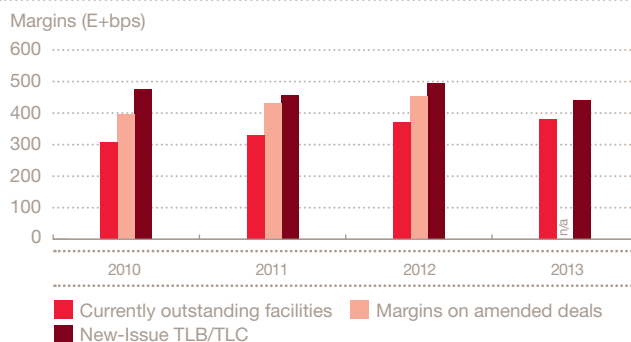
Source: S&P Capital IQ LCD

European corporate debt maturities (2013 - 2017)



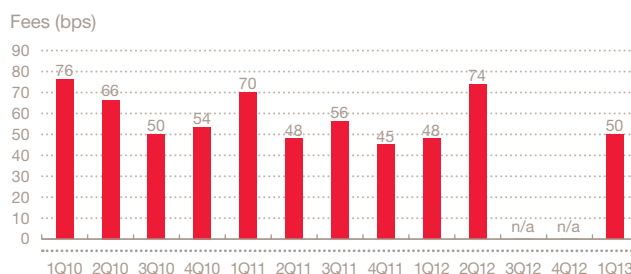
Source: S&P Capital IQ LCD

Average margins on LBO facilities



Source: S&P Capital IQ LCD

Amendment fees (bps)



Source: S&P Capital IQ LCD





## *In the debt markets*



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### **CEO/CFO summary**

Conditions in the corporate debt markets have improved in 2013 continuing last year's strong performance. An important new trend is that banks are once again liquid and open for business. This has resulted in loan volume growth outpacing the bond market, in spite of continued strong appetite from bond investors.

Despite the availability of funding, acquisition activity has remained low. Corporate borrowers are mainly taking advantage of current conditions by improving the terms of existing facilities through refinancings.

Similarly, acquisition activity in the leveraged market has also proven disappointing. Sponsors and their portfolio companies are, however, proactively taking advantage of market conditions through refinancings, repricings and amendments of existing debt.

However, in direct contrast to the key trend in the corporate market, non-bank sources of funding continued to be the key driver of activity in leveraged deals. Investor demand for HY remains extremely high with record issuance in the first quarter of 2013. This liquidity is further supplemented by significant appetite from collateralised loan obligations (CLOs) and an ever increasing list of specialist debt funds.

Another noticeable development in the corporate debt market is the significant increase in hybrid and convertible bond issuance. The issuance of hybrid bonds in the first quarter of 2013 exceeded previous full year highs. Investor appetite for both instruments is strong, as institutional investors continue to chase yield.

Due to strong equity market performance and as a result of the way that rating agencies may view these instruments, corporates consider hybrids and convertibles as an attractive alternative to raising equity directly.

With continued investor appetite across the risk and product spectrum (bonds, private placements and loans), borrowers should take advantage of current attractive terms before liquidity in the markets reduces over the summer.

***Corporates continue to diversify their sources of funding, buoyed by significant liquidity both in Europe and the US***

Nick Atkinson, Partner

### Leveraged loans

In the five months to May 2013, €31.6bn of leveraged loans were issued in the European market, which is more than double the level of issuance in the prior year corresponding period. It is also higher than the €28.5bn of issuance in the whole of 2012. The largest contributors, representing over €10.3bn of issuance, were Schaffler AG, Ista, UPC Holding, D.E. Master Blenders and Merlin Entertainment. For the first time since the credit crunch, the market is showing significant liquidity.

Technical conditions in the European market remain strong. New CLO issuance from investment managers including Cairn, Pramerica, Apollo, Alcentra with others in the pipeline, has further contributed to liquidity. However, regulatory uncertainty is casting a cloud over new issuance.

The US market remains very attractive to European issuers, driven by deep investor liquidity and looser covenant requirements. Doncasters, Allflex and CSM Bakery are three examples of companies that have recently chosen to raise funds in the US rather than in Europe.

The European market is competing with the US market by reducing requirements around covenants. Transactions from Ista, Merlin and D.E. Master Blenders all feature fewer financial covenants than might be expected in Europe.

As many CLOs in Europe exit their re-investment period, sponsors and arrangers have structured new refinancing transactions such as Merlin Entertainment, as an amend and extend, to allow existing CLOs to roll over their investment. We expect to see this structure being used in the coming months to refinance and extend transactions.

Driven by growing liquidity, the prices of all classes of debt products are being pushed down. The average institutional spread dropped to E+427bps for the three months to 30 April 2013, down 12bps from the first quarter and a four-year low.

### High-yield bonds

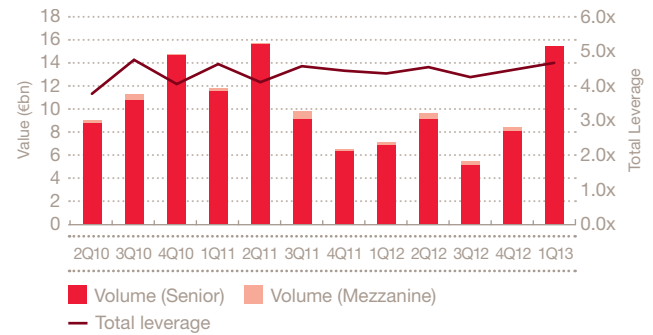
Investor sentiment has turned cautious in June following a record breaking first five months of the year. HY investors are nervous of the US Federal Reserve ending its quantitative easing actions, and yields have risen, in line with other fixed income markets.

The European primary HY market had a record first quarter in 2013, resulting in issuance of €21.4bn, equivalent to 58% of total 2012 volume. May was also a record month with issuance of €9.5bn.

Until spreads widened in June, investors had demonstrated a strong level of risk appetite. The market has supported aggressive structures such as payment-in-kind (PIK) toggles. There have been four such transactions in Europe this year including the most recent deals from R&R Ice Cream and Kloeckner Pentaplast. By comparison, only three PIK toggle deals were issued between the whole of 2006-2012, according to S&P Capital IQ LCD. Technical conditions in the European market remain strong with inflows into the market of around €3.7bn through May according to J.P Morgan data.

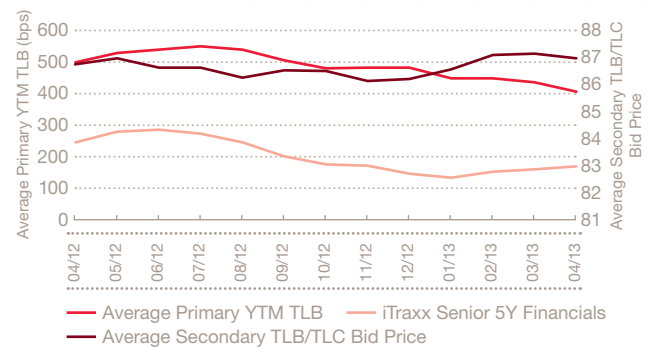
In the US market, Lipper data shows a net inflow of \$2.5bn in 2013 up to May. However technical conditions have since deteriorated with record outflows of \$4.6bn in the first week of June, pointing to a more turbulent summer period.

### European leveraged loan volume and debt multiples



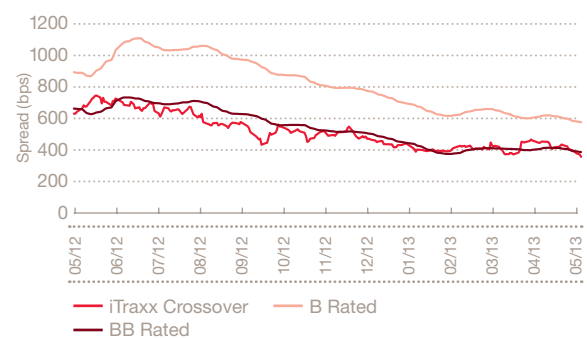
Source: S&P Capital IQ LCD

### Comparative analysis of primary and secondary loan pricing



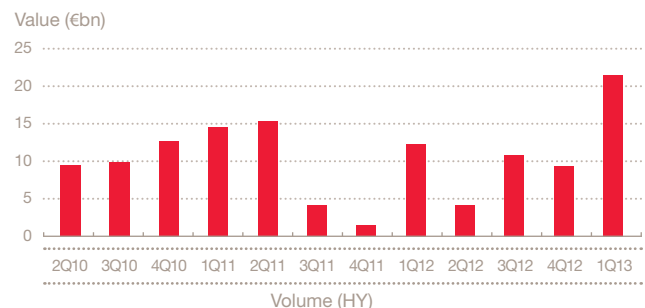
Source: S&P Capital IQ LCD, Thomson Reuters

### European BB and B rated bonds vs iTraxx Crossover



Source: S&P Capital IQ LCD, Thomson Reuters

### European high-yield volume (primary issue)



Source: LCD Q1 2013 overview

### Corporate loans & bonds

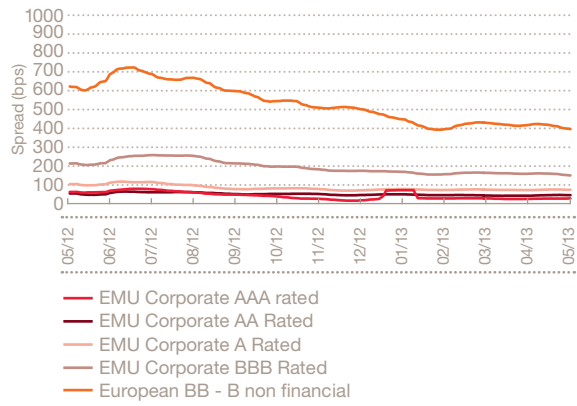
Total debt capital market (DCM) volume in the first quarter of 2013 increased to €257bn (up 15% from Q1 2012). However, in contrast with the overall trend of 2012, the rise was the result of a significant increase in loans (up 51% from Q1 2012). This was only partly offset by a decrease in bond issuance (down 7% from Q1 2012). In spite of significant bank appetite in this part of the market, investment grade M&A loan volume only amounted to \$26bn.

Increased bank lending appetite and the resulting competition among lenders helped borrowers obtain financing on improved terms. Average pricing for BBB-rated European non-financial companies in Q1 2013 reduced to 160bps (down 20bps from Q4 2012).

As a result, lenders sought yield elsewhere, expanding their scope both in terms of instruments and geographies. There was increased activity in Spain and Italy as well as in hybrid and convertible bonds. Both hybrids and convertibles provide borrowers with an effective way to raise capital and strengthen their capital structure. Hybrids accounted for 15% of total euro bond issuance and 50% of sterling issuance.

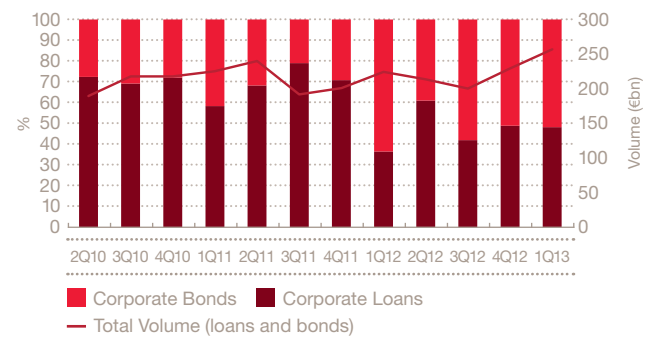
With continued appetite and liquidity across products (bonds, private placements, loans) and across the risk spectrum, borrowers should take advantage of the ongoing improvement in terms before markets shut down over the summer.

### European corporate investment grade bond yields



Source: Thomson Reuters

### Corporate loans and bonds volume (primary issue)



Sources: Dealogic - PwC Analysis



### Schuldschein

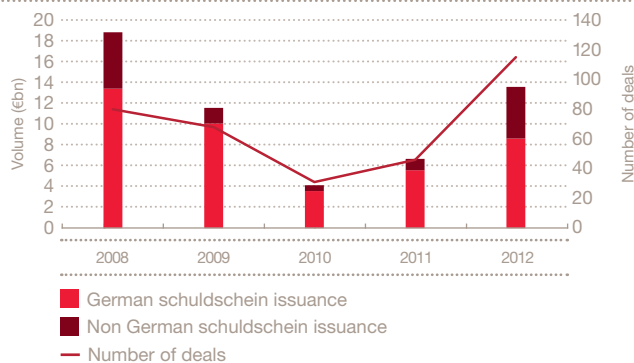
A Schuldschein loan is the German equivalent of a private placement. It is a private and unlisted bilateral loan agreement. Its benefits are similar to a US private placement: competitive pricing, longer tenures, accessible to smaller borrowers, diversification of lender base and no formal rating requirement.

In line with the general shift away from traditional bank loans, corporate Schuldschein issuance increased to nearly €13.6bn in 2012 (up 104% compared with 2011).

Schuldschein loans were traditionally issued by German companies. However, the market has recently attracted international borrowers such as Clariant (Switzerland), Huhtamaki (Finland), Sonepar (France) and Sainsbury's (UK). Total 2012 issuance by non-German companies increased to €5.0bn (up 356% compared to 2011).

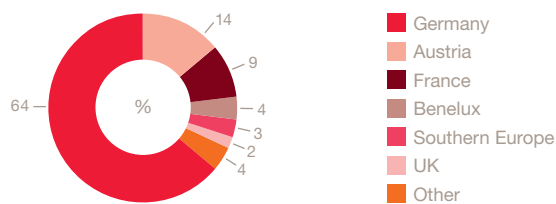
The majority of investors in this market are still German banks and insurance companies, but international investors are taking a close look at the market. Last year a deal by Neopost was placed with Taiwanese investors and Societe Generale teamed up with German banks to arrange Schuldschein for French borrowers Plastic Omnium and Orpea.

### Schuldschein issuance



Source: Thomson Reuters LPC

### Corporate Schuldschein volume by country



Source: Thomson Reuters LPC



# Not all CVAs are created equal



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Despite the UK economy narrowly avoiding a slide back into recession, the most recent insolvency statistics, surprisingly, show fewer and fewer corporate failures. Notable amongst the data is that the use of CVAs has declined even more than other procedures - just a few quarters ago CVAs were being touted as the poster child for UK insolvency processes. Over the last two quarters there was a 20% reduction in CVAs compared with the corresponding quarters of prior years, which is a steeper decline than the drop-off in the overall level of insolvencies.

A large part of the reason is that despite the blaze of publicity there are very few large and demonstrably successful CVAs. Most have failed at a practical, if not technical level, especially in the retail space. The reason for the failure lies in the commercial inter-relationship between the process itself - not forgetting a CVA is an Insolvency Act process - and the company or debtor.

The most fundamental issue has been the failure to marry the mechanics of the CVA process with a viable operational turnaround. There has been a tendency to focus on the areas of the business to be jettisoned in the restructuring, meaning that management - and to a certain extent the supervisor - have failed to see the larger threat to the overall business. The supervisor has narrowed the scope of their

responsibility, but in doing so has left management with free reign to make cuts to reflect their views of the business, which have then proved insufficiently deep. In some cases those cuts have been made to ensure that the voting thresholds are achieved as opposed to what is right for the business, leaving a sense that the business could spiral downwards again. Many well-known CVAs have done little to address the post-deal operational issues facing the business, such as merchandising, marketing and customer confidence.

It is the supervisor's duty to ensure compliance with the CVA proposal and to distribute funds to creditors. However, in some cases the supervisor has taken on a 'Jekyll and Hyde' role - keen to be associated with the initial success, but with an ongoing role assuming no responsibility for when the business does subsequently spiral down. This begs the question of whether the supervisor is there to do the deal or also there to supervise for several years? If the latter is the right role, it is unhelpful if the supervisory remit is narrowly focused on only a small part of the problem. There are a number of larger issues that continue to create uncertainty over a business, its customers and, most of all, its creditors and landlords. The latter in particular are often left with the feeling that the votes of the (uncompromised) trade creditors have been applied to reach the requisite voting thresholds and that there is no upside for them when the business recovers.

***CVAs will only work if they accompany a viable operational plan***

**Mike Jervis, Partner**



***Is there a type of CVA that does work and what does it look like?***

We have undertaken a series of CVAs in the care home sector and, several years after concluding the deals, the businesses are working more effectively than before. The key factors in this success have been:

- (1) To understand the business and the business plan first and foremost and not immediately focus on shaving liabilities off the balance sheet;
- (2) Having made that assessment, to treat all creditors the same way or as near to the same way as economically possible; and
- (3) To engage with all stakeholders, including the regulator, from an early stage, before the cash crisis became terminal.

The most important factor, however, was to use the CVA only to do the deal and then to leave the process. Within a couple of months, the supervisor distributed the pot equitably to reflect the concessions made and then ceased to act.

The conclusion is straightforward. CVAs have been popular and saleable to management and shareholders as a panacea to their creditor problems, especially in a multi-site environment. They may well be, but will fail to achieve the expectations set for them unless the operational plan works and the duration of the formal CVA insolvency process is kept to a minimum.

# Growth of ABLs



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### What is asset based lending?

Asset based lending (ABL) provides the borrower with a revolving credit facility secured against its balance sheet assets. These assets range from working capital assets, such as trade debtors and stock, to tangible fixed assets such as plant and machinery and property. In exceptional cases intangible assets can be taken into account as security and ABL providers may also offer amortising term loans based on cash flow generated in the business to increase available funding.

The borrower reports asset levels to the ABL provider on a regular basis (ranging from daily to weekly or even monthly) and the ABL provider makes available a fluctuating line of credit dependent on asset levels. The calculation of available funding starts with total assets, deducts those that are not suitable as security for the ABL provider (ineligible assets), and then provides funding against the remaining (eligible) assets at an agreed percentage (advance rate).

### Situations where ABL funding may be suitable

ABL is used in a wide range of situations and it is particularly suited to the following:

- To finance asset rich companies where a transaction or event (e.g. a buy-out) requires leverage in the business;
- To finance growth companies that need a significant investment in working capital and equipment to expand;
- To provide working capital finance for companies trading in commodity markets - fluctuations in prices require flexible credit facilities that can meet a volatile funding requirement;
- Businesses that need to fund a seasonal peak in working capital – they often require a peak level of seasonal funding that is disproportionate to the level of all year round profits when assessing debt capacity using an earnings multiple approach; and
- Situations where a business is going through restructuring and turnaround.

A cash flow lender assesses debt capacity by focusing mainly on the level of cash flow generated by the business. However, an ABL provider takes a different approach. The ABL provider is interested in the cash flow generated in the business but is also able to take a high level of comfort from the asset security available to it.

In recent projects we have helped clients maximise the opportunities presented by ABL funding in asset intensive businesses such as haulage and printing; in an oil and gas sector client whose working capital requirements fluctuate with underlying hydrocarbon prices; and businesses that sell seasonal products into retailers in advance of the Christmas holiday season. We have also worked increasingly with clients on financing structures where ABL is deployed as part of a wider package alongside senior lending, mezzanine loans and trade finance.





**Restructuring**

In a restructuring situation cash generation may be limited, uncertain or even temporarily negative whilst losses are being stemmed and restructuring costs are being incurred. Conversely, the balance sheet and asset base may be relatively stable. The ABL provider’s approach can therefore provide a stable funding package for the business whilst it focuses on cost reduction, efficiency and operational improvements.

The structure of ABL facilities can also be beneficial to companies with limited cash generation. This is because a majority of the funding package is often secured against working capital assets. The funding availability flexes to meet unexpected changes in working capital levels (e.g. a debtor paying a few days late or a delay in a major customer ordering stock). It also means that for a large proportion of the facility there will be no requirement for debt amortisation and this reduces the overall debt service burden on the business.

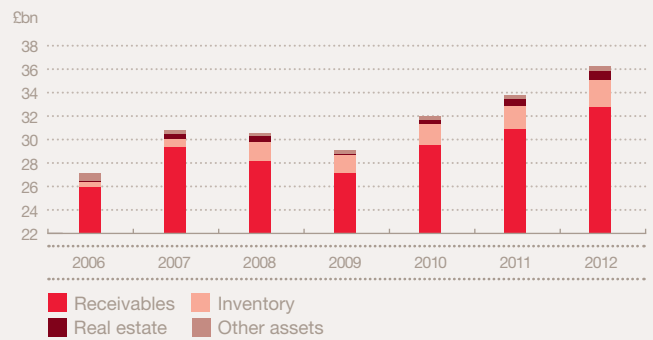
Finally, once the turnaround of the business is complete and the green shoots of recovery appear, ABL provides a platform to fund growth. Therefore businesses that first look to ABL as a funding package to support restructuring often retain it going forward, due to its flexibility and the additional liquidity it can provide.

We recently worked with a family-owned distribution business to source an ABL financing structure when their incumbent lenders did not have the appetite to support them based on their existing facility structure. We were able to reduce substantially the proportion of cash flow needed for debt service via a facility that provided funding against debtors, stock and properties.

**ABL growth**

The ABL market in the UK is growing rapidly as awareness of ABL as a funding proposition increases. The level of assets financed has increased by 33% since 2006, to £36.2bn in 2012. ABL is often competitive on price compared with alternative lending structures and the private equity community is increasingly aware of the other advantages of ABL facilities deployed in the right situations. In future, we expect to see increased use of ABL, both in restructuring scenarios and more widely.

**Recent growth of ABL sector (assets financed)**



Source: Asset Based Finance Association

# Fixing cracked China – turnaround and transformation in Asia



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Asia is one of the few current growth stories in the world, but all is not rosy with businesses and cracks are emerging. A lack of capital, declining growth and profitability and less aggressive creditor banks are creating an environment of inefficient enterprises that survive, but do not prosper. Shareholder disputes are long standing, but now magnified cultural differences are emerging, no longer hidden or ignored as dividends are distributed.

Businesses and their stakeholders need to address underlying operational and structural issues. The days of amend and extend are a distant memory. Outdated insolvency legislation means that insolvency practitioners are facing the prospect of marginalisation, limited to core formal insolvency proceedings and the users of turnaround practitioners in Asia are internationally experienced and demand deep operational and industry expertise. As cracks appear, what will fill them?

### **Hong Kong as a regional centre**

Hong Kong provides the head office and corporate holding vehicle for the majority of Chinese multinationals, regional investors, financial institutions and foreign multinational corporations with operations in China and neighbouring countries.

A primary attraction is the judiciary and common law legal system, which is based on the UK's Companies Act from the 1940s. It is proven and trusted by both Chinese and foreign investors.

Hong Kong law, however, has not evolved in the way of other common law jurisdictions with regards to insolvency and restructuring. Since 1986, Hong Kong has been through more than six iterations of a draft corporate rescue legislation called Provisional Supervision – similar to a UK Administration. Inhibited by political interests and an unwillingness to embrace insolvent trading provisions, the legislation remains in draft format and the earliest it will be considered again for enactment is 2016.

Today, a distressed workout will culminate in either a consensual restructuring or liquidation.

### **Changes since the last economic crisis**

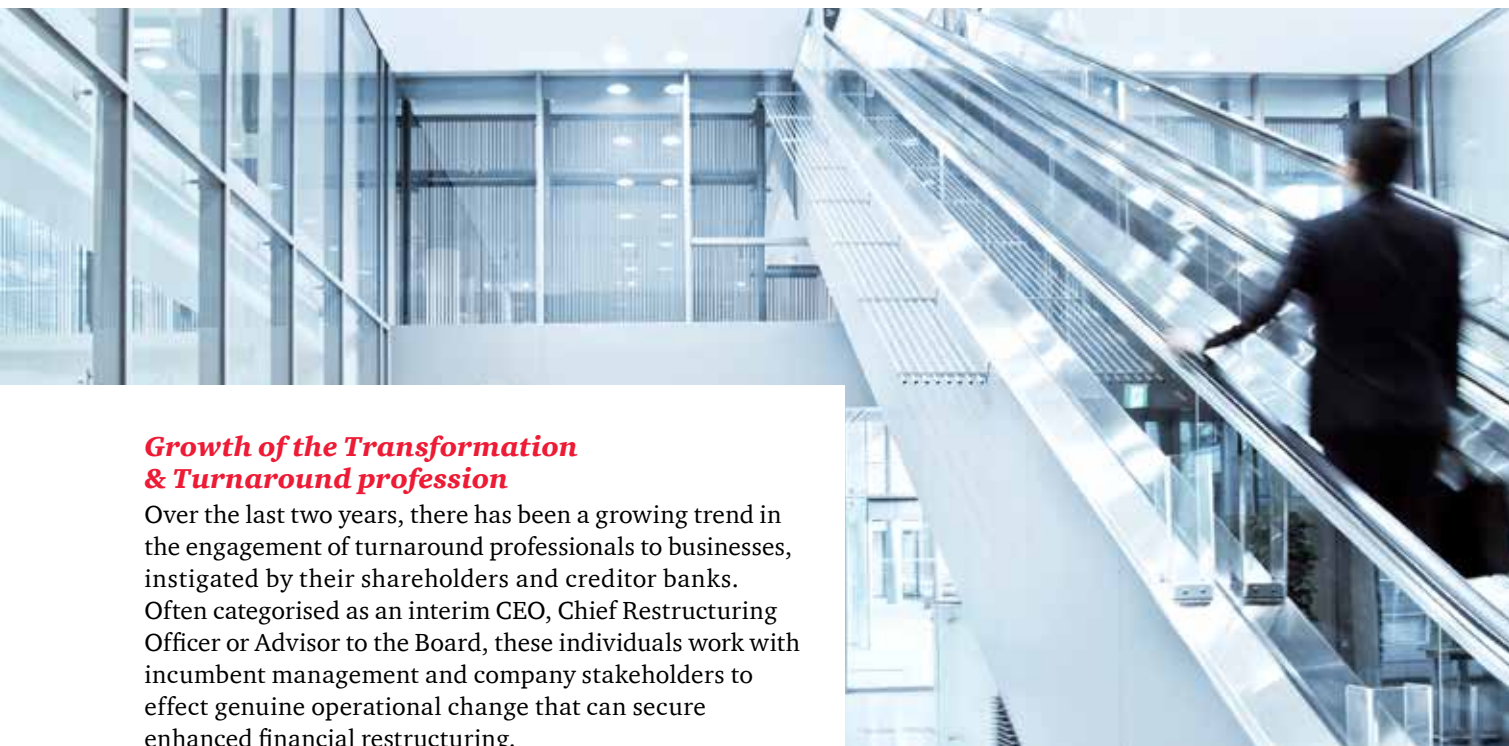
Stakeholder groups have changed since the Asian economic crisis in the late 1990s. At that time, many viable businesses found themselves marginally profitable, but technically insolvent because they were unable to support their levels of debt, which had been easily accessible. A lack of corporate governance was also exposed, where separation of distinct businesses and their assets and liabilities and between businesses and owners (often families who were also the managers) was blurred at best. Those businesses that survived the Asian economic crisis have much lower levels of debt and improved corporate governance – many founded since the early 2000s have been purely financed through equity.

With global economic conditions reducing growth in Asia and China in particular, domestic companies are focusing on R&D and technology as opposed to cheap manufacturing and the domestic consumer market. Manufacturing plants in China are being relocated either to cheaper destinations or multinationals are repatriating manufacturing facilities where the cost differential is no longer justifiable to offset the benefits of being close to market ('near-shoring').

The gap in available legislative tools to stakeholders in distressed businesses in Hong Kong and China coupled with a growing demand for business improvement and change management of businesses rather than simple debt rescheduling has resulted in a growing trend of transformation and turnaround strategies – as opposed to insolvency based strategies – and a definition of transformation and turnaround professional as distinct from an insolvency practitioner.

When the Global Financial Crisis hit in 2008, a mass of corporate failures and distressed workouts were anticipated, but have not materialised. This is due to numerous factors including creditor banks not aggressively enforcing their rights, general low levels of debt and in China, low interest rates and state sponsored support.

Since 2008, access to debt - including trade and project finance - has been severely curtailed and businesses have been left to survive upon internally generated capital and private equity. An increase in zombie companies, where businesses are neither profitable nor attractive to investors, is now as equally prevalent in Asia as have emerged within the UK.



### ***Growth of the Transformation & Turnaround profession***

Over the last two years, there has been a growing trend in the engagement of turnaround professionals to businesses, instigated by their shareholders and creditor banks. Often categorised as an interim CEO, Chief Restructuring Officer or Advisor to the Board, these individuals work with incumbent management and company stakeholders to effect genuine operational change that can secure enhanced financial restructuring.

On occasion the turnaround professional will work in conjunction with an insolvency practitioner, where both the turnaround professional and the insolvency practitioner have clear roles and responsibilities. Many insolvency practitioners have attempted to rebrand themselves as turnaround practitioners. This has caused some confusion in the marketplace, where creditor banks and private equity managers, perhaps experienced in using turnaround professionals in other jurisdictions, have been unclear how to access experienced and accredited turnaround professionals.

As a counter to this, a group of transformation and turnaround professionals established the Asia Transformation & Turnaround Association (ATTA) in 2010 in conjunction with the support of the UK's Institute for Turnaround (IFT). PwC are one of the ATTA sponsors.

With a focus on managing step changes in growing businesses as well as the turnaround of distressed ones, this professional body provides definition to the profession, accreditation of experience of its members and a conduit between users and providers of its members' transformation and turnaround management services.

Domestic Chinese companies, including government-backed state-owned enterprises, are beginning to use international transformation professionals in support of their outbound expansion and acquisition strategies. In addition, foreign multinationals are using Asian based transformation and turnaround professionals to add corporate governance to their businesses and realign communications and objectives between the local shareholders and management to their aspirations, where in times of economic downturn areas of conflict and cultural differences become more visible.

The missing ingredient in a genuine turnaround has often been access to capital in order to finance the changes required to business operations, while maintaining a standstill agreement with creditor banks and maintaining trading and staff relationships. ATTA's activity has been complimented by a growth in providers of asset-based lending and private equity funds investing in turnaround opportunities. The Hong Kong courts have accepted the principle of priority in security and risk-related returns to providers of working capital. With private equity looking for quality deals and demanding quality management, access to professionals to mitigate execution risk accredited by ATTA and trusted service providers, presents one of the most interesting growth areas in the region.

### ***Nuances of Asian restructuring & turnaround***

Factors that influence the conduct of any Asian workout include:

- The multinational nature of businesses;
- The location of their assets and the layers of domestic and foreign creditors related to those businesses and assets;
- Over-complicated corporate structures (based upon past regulations with regard to tax, foreign or family ownership and convenience);
- The need to deal with multiple and sometimes conflicting laws from a number of territories; and
- Lack of legislative tools available.

## Economics corner

### Bumpy and uneven: Recovery in a three speed economy

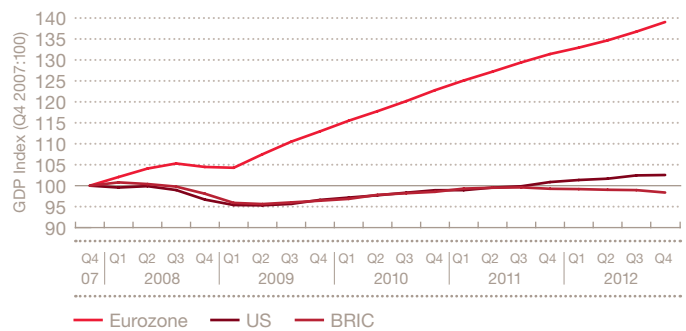
Economies around the world are recovering at differing speeds. At the beginning of the year we highlighted the rise of a ‘two speed’ global economy, with emerging markets growing faster than advanced economies. But whilst the Eurozone continues to focus on crisis management and Japan puts the finishing touches to its reforms, the US appears to have broken away from the pack, gradually returning to trend growth. As pointed out by the IMF, we are now seeing the rise of a ‘three speed economy’.

Figure 1 shows the multi-speed global economy in practice. Emerging and developing economies continue to occupy the ‘fast lane’ of growth, led by Brazil, Russia, India and China. These economies are 40% bigger in real terms than they were in 2008 and continue to roar ahead.

The US economy is firmly in the ‘middle lane’ of growth. A sounder financial system coupled with an accommodative fiscal and monetary environment means that the US is growing at around 2% and has created 2 million jobs in the last 12 months. As a result, the US economy is now 3% larger than it was when the financial crisis began at the end of 2007.

By contrast, the Eurozone remains firmly in the ‘slow lane’. The economy is still contracting and output remains below its 2008 peak. The latest data released showed this trend continuing as the Eurozone entered a sixth consecutive quarter of contraction in Q1 2013. Alarmingly, the slowdown has now spread to the core, with France — the second largest economy in the Eurozone — falling back into recession.

**Figure 1: The BRIC economies are in the fastest lane of global economic growth**



Source: Thomson Datastream, PwC analysis

### Light at the end of the austerity tunnel

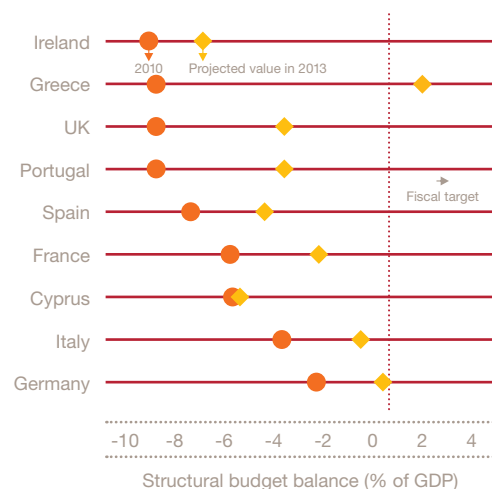
So how long might it be until the Eurozone recovers? This is clearly a very difficult question to answer with any precision, but we have focused here on one key aspect of the problem: the stock of public and private sector debt.

Figure 2 shows the degree of success that Eurozone governments have had in getting their public finances under control. We have used the 0.5% structural deficit target (adjusted for the business cycle) outlined in the Fiscal Compact, as our reference point.

Figure 2 shows that, amongst the peripheral nations, Greece has led efforts to get public finances in order and has reduced its structural deficit by around 11 percentage points of GDP. In fact, Greece is projected to be the first peripheral nation to meet (and exceed) the 0.5% deficit target, indicating it has largely implemented fiscal measures designed to put its public finances on a sustainable footing.

At the other end of the spectrum, Spain, Ireland and Cyprus are still at the early or mid-stages of reforming their public finances. Although the scale of fiscal consolidation needed is considerably less than for Greece, the task will become more challenging given the Eurozone-wide recessionary environment. These countries could be a source of instability in the coming quarters.

**Figure 2: Peripheral Eurozone economies have made significant progress in putting their public finances on a more sustainable path**



The structural budget balance is the cyclically adjusted budget balance net of one-off and other temporary measures.

Source: European Commission, CBO

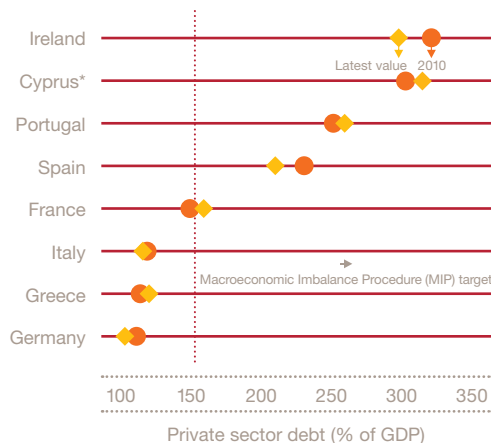
## Private sector debt outlook is still challenging

Figure 3 looks at progress in making the debt position of the private sector (defined as businesses and households) sustainable in the Eurozone. Although there is no clear definition of what constitutes a healthy level of private debt, we have used the 160% threshold specified in the European Commission's surveillance mechanisms (also known as 'Macroeconomic Imbalance Procedures').

Figure 3 shows that the private sector in the periphery has managed to reduce its leverage, despite their shrinking economies. However, the countries that have experienced real estate bubbles continue to have high levels of private sector debt and will need to undertake more measures to gradually reduce their leverage.

This will by no means be an easy task. At times of high unemployment, house price decreases and subdued corporate profitability, businesses and households in the high-debt peripheral economies (Cyprus, Portugal, Spain and Ireland) will find it difficult to pay-down their debt levels.

**Figure 3: Most peripheral economies continue to carry high levels of private debt which will be difficult to pay down in the current economic climate**



Private sector debt refers to that held by non-financial corporations and households.

\*For Cyprus, the latest available data-point is 2011.

Source: Eurostat

In a three speed economy, the US and emerging economies could provide European businesses with opportunities to grow their revenue base. Given their comparatively large and sophisticated service sectors, peripheral economies could, for example, divert more resources towards exporting services. Ireland, for example, specialises in the provision of professional business services, whereas Greece has a comparative advantage in shipping service exports.

In our June edition of the Global Economy Watch we highlighted that 2010 was the first time since reliable records began when service imports by the seven largest emerging economies exceeded those of the G7. As emerging economies grow bigger and wealthier, their demand for more sophisticated services will increase.

### Conclusion

Overall, despite significant progress in some of the peripheral Eurozone economies on getting their public finances onto a sustainable footing, the outlook for private sector debt remains challenging and the growth outlook is weak. At the same time, policymakers are still dealing with structural and financial sector reforms and economic risks remain weighted to the downside.

We therefore continue to advise our clients to stress test their business plans against downside risks in the Eurozone.

For a more detailed analysis of UK economic trends, you can visit [www.pwc.co.uk/UKEO](http://www.pwc.co.uk/UKEO). The next edition of this report will be launched on 11 July 2013.

For a more international perspective on economic trends, you can sign up for our monthly Global Economy Watch on [www.pwc.co.uk/GEW](http://www.pwc.co.uk/GEW).



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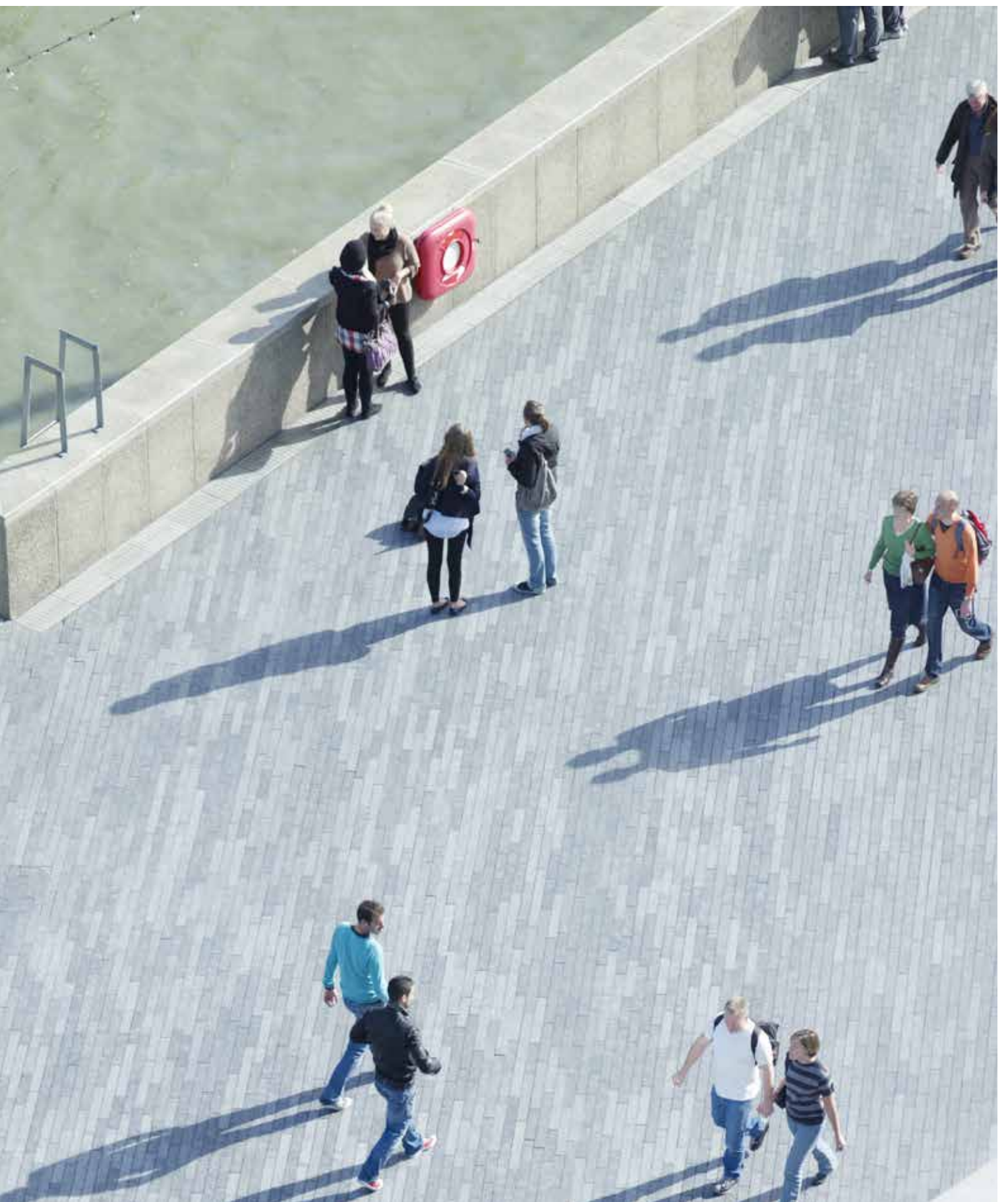
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