

Restructuring Trends



at a glance

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Our overview of 2014

As the year draws to a close, we look back at some key events that have taken place in the restructuring market over the past twelve months.

Our overview of 2014 feature includes: commentary on a number of sectors that continue to show signs of stress and distress; our experiences on some milestone cases, including some of the innovative solutions we have implemented; and observations on the regulatory developments affecting companies' risk, viability and going concern.

We consider the ongoing impact of these recent developments on restructuring activity, and how lenders, corporates and their advisors should respond to ensure they are well equipped to keep up with this ever-changing market.



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Restructuring

The Federal Reserve's withdrawal of quantitative easing measures cooled the debt markets in Q3 2014, although, fundamentally, liquidity remains plentiful, particularly as the European Central Bank grapples to stave off deflation in the Eurozone. Following record issuance in H1 the high yield market has also cooled. Default rates continue to paint a benign picture, although concerns have been raised about the high leverage and lack of covenants in some recent deals. Looking ahead, we expect bank deleveraging to continue, a process facilitated by the recent Asset Quality Review ("AQR"), which requires banks to raise more capital.



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Economics corner

The Eurozone is stuck in neutral with economic output still below its pre-crisis level. Poor performance in the periphery is often blamed, but it is the big three economies of Germany, France and Italy that really drive Eurozone growth. Of these, the bloc remains most reliant on Germany, where growth has recently shown signs of faltering. But beyond this short-term weakening, it is the structural concerns about the German economy that are of more concern. With its aging population, Germany's demographics are a drag on the economy; the country has a very low investment to GDP ratio and low productivity in service sectors. In the long-term Germany is unlikely to be able to continue to prop up the Eurozone.

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Welcome

to the latest edition of Restructuring Trends



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The days continue to shorten, the inevitability of Christmas looms large and another year is drawing to a close. It has been a year where the UK economy has performed strongly, with the continued support of record low interest rates, meaning that parts of the restructuring community have reflected wistfully on the heady days of the global financial crisis, whilst others have returned to the deal market.

But while it has not been busy like it was in 2009, there has continued to be a series of fascinating developments, with increasingly complex and innovative restructuring solutions being applied, particularly where cross-jurisdictional issues are present. As a result, the restructuring market in the UK has continued to develop and the UK remains the leading European restructuring jurisdiction, often even for companies that are not domiciled here.

In this issue of Restructuring Trends, we look back at some of the key developments of the year, how the market has continued to evolve and some of the sectors where restructuring has been (and continues to be) necessary. We also look at some of the high-profile cases that we have been involved in and in particular look at how the use of administration continues to push new boundaries with the “flip up pre-pack” of the German company, ATU (January) and the creditor dynamics of Phones4U (September).

We also cover the emerging role of hedge funds in the middle-market space (April). The relative absence of large restructuring cases, coupled with the high levels of capital focussed on the European distressed space, has forced hedge funds to consider less obvious routes to deploy their cash. This

is a trend that we see continuing, at least in the short-term, although whether overseas investors will continue to focus capital on the market if returns do not materialise as expected remains to be seen.

Our regular “Economics Corner” section takes a broader look at the Eurozone, where economic growth continues to be lacklustre and policy debates around how to stimulate growth rage with ferocity. The overall economic performance looks likely to continue to provide a flow of restructuring assignments in the short-term, but the real challenges that the Eurozone must face are not limited to stimulating growth now. Germany, which has been the heart of the Eurozone since inception and has dragged the bloc through the financial crisis, does not show strong medium-term fundamentals and lags behind both the UK and France in the service sector. Will its manufacturing base survive the inevitable onslaught of the Chinese and what is the future of the Eurozone if Germany has to become more introspective?

As we look forward to 2015, we will also continue to evolve our distribution of Restructuring Trends. Articles will continue to be available via our website (www.pwc.co.uk/restructuringtrends), with email reminders as articles are published, and further improvements targeted at those who read Restructuring Trends on their smartphone or tablet are also planned. But to correspond with the ever-increasing pace of change we will be providing more frequent, but shorter, updates.

I hope you enjoy this edition of Restructuring Trends. May I take this opportunity to wish you all the best for the holiday period and, as ever, if you would like to discuss any aspect of Restructuring Trends, then please do not hesitate to contact us.

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January

Some changing dynamics of European restructurings and insolvencies

Over the last few years, the world of restructuring and insolvency has been dominated by the UK's Administration and Schemes of Arrangement processes, alongside the Chapter 11 procedure in the US. Recently, however, several other jurisdictions (such as Germany, France and Spain) have implemented legislative changes in an attempt to replicate some of the best bits of the UK/US regimes, and thereby win "market share".

The changes have generally been well received, but judging by certain recent, high-profile, complex restructurings, the UK continues to lead the way in innovation to offer increasingly complex solutions through the medium of the courts. Given its 'tried and tested' legislation and sound reputation, the UK is well placed to respond to the changing European landscape and to try to stay ahead.

Three recent cases illustrate how the UK's procedures have been used to deliver innovative solutions to clients, where local laws may not have been able to compete.

Auto-Teile-Unger ("ATU")

ATU is an example of a German organisation turning from an untested German insolvency regime to the UK's administration process to effect a large and complex restructuring of its senior debt. The solution identified, which was implemented in January, was a "flip up pre-pack administration".

With an inter-creditor agreement governed by English law (notwithstanding finance documents under German law and bonds issued under New York law), a new company was incorporated in the group, flipped up to a holding position and then placed into administration. The administrator could then sell the group to a new structure, leaving behind the existing debt and releasing the security in the process.

The new structure is owned by the senior lender and provides a recapitalised base upon which the business can now begin the longer process of turning itself around.

New World Resources ("NWR")

With Czech Republic-based NWR, a UK Scheme of Arrangement was used in a dual track solution.

At the time the implementation solution was being devised, it was unclear whether the negotiated solution could be agreed consensually, or whether there might be a last-minute challenge (resulting in a disruptive and expensive requirement to re-cut the deal).

The "split scheme" involved releasing a consultation to stakeholders and if all agreed to the consensual solution, a fully consensual restructuring would be implemented. However, if all stakeholders (including those who were out of the money) failed to agree, an alternative scheme would be triggered to cram them down and implement an alternative solution. With the requisite number/majority lined up to cover the voting required for the alternative solution, a successful restructuring became a certainty, despite the uncertainty over the precise outcome.

APCOA

Finally, we consider the live case of APCOA, the German car park operator.

Here, rather than argue a traditional COMI shift, which would have been difficult, the company took the unprecedented step of changing the jurisdiction of its documentation (by way of a simple two thirds' majority vote). The company has therefore been able to implement a UK Scheme of Arrangement, firstly to extend the maturity of its facilities (to enable time to negotiate) and subsequently to attempt to implement a solution (using a separate scheme). This second scheme application has been subject to an extended challenge in court from a creditor which, at the time of writing has been overruled. However, there remains the chance that an appeal might succeed.

Conclusion

What is our prediction for the future? With restructurings continuing to push the envelope, the risk of using an untested regime to implement is simply too high. The bigger cases will continue to use the easiest route – it will take smaller, more local successes before the newer laws can compete.

In the past it has been a key differentiator for the UK that the English administration procedure allows the creditor to choose the appointee (and therefore obtain some control, or comfort, over the process). Our view is that the differentiation between the UK is narrowing, as, whilst it remains early days, a number of these countries have recently tried to copy this benefit.



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February

Trading and liquidity challenges in the aviation sector

Airline businesses are not for the faint of heart! Volatile fuel prices, the continuing impact of the economic crisis, political instability and over-capacity are creating particularly turbulent conditions for airlines, in an industry already typified by cyclical and low margins.

A number of carriers are experiencing trading and liquidity challenges, amplified by the reverse working capital cycle, and face a very real need to take action to manage and conserve cash and implement a turnaround to survive. These challenges, along with increased pressure from stakeholder groups such as agents, trade unions, lessors and credit card acquirers, are a drain on management time and resources. This is a particular problem when the day-to-day operational challenges are so complex.

Carriers have responded to the tough market conditions in a variety of ways. Some have consolidated to strengthen and survive; others have chosen to restructure their operations.

The route to recovery can bring further challenges. For example, re-fleeting with next generation aircraft results in 20% lower fuel consumption and a reduction in training, crew, pilot and maintenance costs. However, such wholesale change requires significant upfront capital investment, aggravating existing liquidity pressures.

We have also seen carriers review their route profitability, closing hubs and exiting unprofitable routes. However, this can leave the airline in a weakened position compared with its competitors.

At the most severe end of the scale, some management teams have taken desperate measures, including signing unfavourable lease contracts, borrowing against fuel suppliers at significant expense and selling valuable airport slots, in order to provide short-term relief from liquidity issues.

Over the past two years, we have provided “hands-on” assistance to the management teams of a number of airlines across Europe, Asia and the Middle East to think through and implement properly tailored recovery solutions, ranging from establishing control over cash to planning and implementing a comprehensive turnaround.

Airlines have succeeded in restructuring through effective cash management and conservation to buy time required to bring about the required change. Addressing network and flight profitability, combined with rapidly identifying and implementing cost reduction measures across the business, has allowed the airlines to restructure their operations to a more sustainable level to support future growth. Going forward management teams and their staff are going to have to analyse and understand their business with far more scrutiny.

Most importantly, however, any action requires a collective and collaborative approach across the business to effect sustainable change, which facilitates a long-term and lasting result in contrast to the ‘quick fix’ solutions to a problem.

March

Albemarle & Bond

The sale out of administration of the business of Albemarle & Bond Plc (“A&B”), a jewellers and pawnbrokers, has proven that the administration process remains a key restructuring tool.

A&B ran into difficulties when it over-expanded its store portfolio thereby increasing its fixed cost base and leaving it more susceptible to declining gold prices and increasing competition in the sub-prime lending market. Declining profitability resulted in covenant breaches and a reduced share price.

Following a collaborative process between the company and its lenders, a turnaround plan was developed to prepare the business for a sustainable future. An equity rights issue and public M&A process both failed, and with A&B facing a significant liquidity requirement in late March, the directors put the group into administration as it was seen as being the best way of keeping pledged items safe, and available for redemption, whilst a buyer for the business was sought.

We traded the business in administration; a very unusual thing to do in this highly regulated sector. All 187 branches were kept open despite the high security risks of holding significant levels of gold and jewellery, and all of 120,000 customer pledges, many of which included people’s personal possessions and family heirlooms, were protected.

The critical nature of the service provided to financially vulnerable customers and media attention on associated “pay day lending” competitors meant there was potential for negative PR for all stakeholders. Additional complexities such as changes in regulation were managed in parallel with an accelerated sales process. An accelerated sale was necessary as some competitors took aggressive steps to take A&B’s customers, jeopardising attempts to hold the business together and protect jobs.

We delivered significant improvements in the business’ financial and operational structure, which began in the period before insolvency. Ultimately, after fully exploring all of the options, we made sure that a buyer for the majority of the business was found with sufficient expertise, integrity and resources to drive it forward successfully, preserving over 600 jobs, and ensuring every one of the 120,000 individual stock items were available for customers to redeem.

This complex case, executed under intense media scrutiny, demonstrates that an insolvency process can drive a transaction while it protects a business from creditor action, allowing it to cut costs and restructure in order to retain the underlying good business; the success of our work was recognised as the Large Business Rescue of the Year at this year’s Insolvency and Rescue Awards.



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April

Hedge funds buying debt in the mid-market

Over recent months, we've seen new trends emerging around hedge fund buyer habits, as we've seen a number of funds opting to buy portfolios of debt, and also now showing an appetite for bilateral debt purchases in the mid-market as they look to build platforms in the UK and bolt on to existing investments.

In one recent example, the debt of a care home group with three bilateral lending facilities was sold. The total debt was more than £65m, funding a range of different care homes across the UK. The three banks involved each individually agreed their preference to refinance and also recognised that an insolvency process might be necessary to complete a transaction as a business and that asset sales were the most likely solution.

The sales process kicked off in April this year, and buying interest for the group was wide ranging. A number of trade parties expressed interest, as well as a mix of funds ranging from hedge funds to real estate fund investors.

The hedge funds were specifically interested in buying the debt and using this position to create a platform for expansion in the UK and ultimately into Europe. The funds' strategy was focused on using a healthcare management company to carry out the necessary operational changes post the debt sale and to find other platforms to bolt on. The funds highlighted their belief that the care home sector is in need of consolidation and that they are keen to be part of this trend.

We're expecting to see increased activity across a number of sectors – particularly within the care home, hospitality and retail sectors. In the case above, since the deal completed the funds have been in discussions with PwC's mid-market team about a range of other sectors in the UK where, using their experience in other geographies, they are looking to invest and further build their presence. Purchasing the debt on bilateral deals provides them with greater visibility over the entities they are buying and the level of work needed to make operational and restructuring changes.

Investor appetite is at an all-time high, as a result of increased overall levels of debt in the market and the sizeable returns available for funds in this space. Given there are a number of consolidation opportunities across a range of sectors, including those mentioned above, debt sales in the mid-market are expected to further increase over the coming months.

May

PwC's Working Capital Survey

Earlier this year, PwC released its fourth study of working capital in companies across Europe. Our findings showed that in the three years following the start of the global financial crisis, the largest global companies experienced a strong rebound in sales growth. Since 2011 however, this growth has slowed down considerably, indicating that a return to consistent growth will be harder to achieve in future.

Relative to sales, working capital performance has stagnated over the last five years. Data showed that companies did focus on improving working capital immediately after the credit crunch, but that few gains have been made since then. In fact, absolute levels of working capital have continued to grow. As a result, over the last four years, our sample of the largest companies in the world have had to find an additional €500bn of cash to fund the increase in working capital. All in all, nine out of 21 sectors have shown deterioration in working capital, which indicates that achieving improvements in complex supply chains remains a challenge.

Working capital tells us a lot about how well a company is managed. It is an indicator of good management, as top working capital performers have outperformed across all indicators. An often quoted mantra is that good working capital levels come at the cost of EBITDA. However, our analysis shows that companies that have sustained working capital improvements have also outperformed in terms of EBITDA. Improving working capital requires complex structural alignments at the very core of a business, in order to make the gains sustainable.

To continue to grow and enable investment, companies will require significant extra cash over the next few years. Our survey shows that if companies could move to the next performance quartile, they would generate a total of €900bn of cash, while moving to upper quartile performance would release €1.4tn of cash. Cash for growth is at your finger-tips.

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Al Jaber – restructuring in the Middle East

The recent conclusion of the Al Jaber restructuring in Abu Dhabi highlights a number of key factors for developing market restructurings (and lending).

On 9 January 2011, Al Jaber, a very large multi-jurisdictional family owned business centred in Abu Dhabi, informed its lenders of a need to restructure its numerous debt facilities which totalled c.\$5bn. The restructuring was finally completed on 25 September 2014, following the announcement to the market in June. Why did it take so long, and what can be learnt from this?

The following are critical factors to understand:

- the size and diversity of the group's operations;
- applicable insolvency legislation;
- interaction between corporate and family activities; and
- knowing what (or who) you are dealing with.

The group's core business was construction-based, ranging from residential projects, through power stations to infrastructure projects. In addition the group had numerous other activities related to its core business, run on a relatively autonomous basis, and requiring differing types of operational finance. The group often entered into facilities on behalf of its subsidiaries and offered guarantees of support. As a result, when the need for a restructuring arose there was a lack of clarity regarding who owed what, to whom, on what terms and who might be ultimately be responsible for the liabilities.

The issue on 9 January 2011 revolved around covenant breaches under the group's core English law syndicated loan facility. However, as expected, this caused potential cross defaults in numerous other local law facilities.

The UAE has, for a number of years, been contemplating a new Federal insolvency/restructuring law. As yet nothing has yet hit the statute books and the existing law and its application in the UAE is unreliable for international financing. The law is not current or clear and is rarely used. The courts and legal system are not, consequently, familiar with its practical application.

The absence of suitable insolvency legislation removes the ability of lenders to force the pace of a restructuring. Also, one of the dynamics of construction businesses is that they tend to need less working capital when they are in decline compared with when they are growing. The absence of a need for cash/working capital, coupled with the lack of effective legislation, means there is no burning platform. This provides a borrower with little incentive to progress a restructuring that the owners may find unpalatable.

This dynamic is more critical when the interests of the family owners are fundamentally intermingled with those of the corporate. In the Al Jaber case there were numerous interactions between the family's personal interests and the group's activities. This was, as is common in the region, compounded by a lack of appreciation of the importance of these differences. Examples include:

- the group constructing assets, which were personally owned by the family (e.g. hotel developments);
- the group guaranteeing personal borrowings and vice versa;
- the group borrowing on behalf of the family and vice versa;
- a lack of clarity around asset ownership; and
- companies outside of the group, but owned by family members, having links to the debt structure.

Given these inter-relationships, it is not surprising that it took more than 12 months to reconcile "standstill" positions as of 9 January 2011. In developing jurisdictions, not just the Middle East, understanding personal connections is critical, so that an awareness of the complexities can be factored into negotiation strategy. Viewed from this perspective, once the complexities are understood, three and a half years to conclude a restructuring of a construction group is actually a good achievement!





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July

The perils of infrastructure projects

We have observed a marked increase in the number of Private Finance Initiatives (“PFI”) and Public-Private Partnerships (“PPP”) infrastructure projects experiencing difficulties (both in the UK and internationally). In a number of cases this has led to the de-scoping of O&M contracts, restructuring of the funding base, and in some cases the termination of projects altogether. We have recently been called in to advise lenders in a number of these situations. The drivers of financial stress are often common but the solutions quite unique.

Backdrop

In the UK, PFIs were popular with previous governments as they were seen to improve the efficiency of public spending. It also placed a large amount of debt “off-balance sheet”. In recent years, however, PFIs have developed a bad name as politicians calculate the cost of being tied into “expensive” and “inflexible” contracts.

Typical PFI/PPP projects share a number of common features including a SPV structure and heavy reliance on key subcontractors for construction and subsequent operations. In the market they are perceived to be low risk investments typically carrying high levels of financial gearing, but with low margins and long tenor on the relevant debt facilities (over the life of the project, normally c.25-30 years).

Infrastructure projects usually involve large scale construction projects and the subsequent operation of an asset such as a hospital, school, waste facility or road. PFIs and PPPs have utilised private capital for major public sector infrastructure projects; the private company typically designs, builds, finances, operates and maintains the asset, receiving revenue either from users of the asset or from government under a long-term contract.

Drivers of stress

The problematic infrastructure projects we have encountered have predominantly been in the aviation and airport sector, waste management/treatment facilities, hospital and toll roads space. The key drivers of stress have been:

- **Demand risk** – where the underlying revenue streams are exposed to a certain level of demand, changing economic circumstances, or errors in the original forecasting model, which can seriously impact lenders’ recoveries and returns on equity; this is most evident in more complex projects in terms of their operations and contractual arrangements.
- **Ability to meet contract specification** – in the past, government bodies may have accepted an element of non-compliance, but now, faced with budgetary constraints, local authorities (in the waste and hospital sectors for example), are increasingly taking a harder stance, seeking to use any non-compliance as leverage to renegotiate or exit certain contracts.

- **Cuts to tariffs** – in some territories, changes to government policy and legislation have resulted in a reduction to project revenues, most notably in the Spanish renewable energy sector.

Restructuring dynamics

The challenges outlined above have, to some degree, been inherent in all of the infrastructure restructuring deals we have been involved in as a team. Recent projects we have worked on include Global Renewables Lancashire Limited (“GRL”) which completed in July wherein PwC advised a diverse syndicate group in negotiating an exit of a PFI waste project, which resulted in an upfront repayment of debt and hedge close out and a handover of the plants to the Council; and a number of Iberian toll road situations where we have supported the lender syndicates in their negotiations with the company, following material revisions to the concession agreements with the government authority.

Unsurprisingly, agreeing a consensual solution more often than not delivers the best value for stakeholders, in contrast to more challenging alternatives. However this is easier said than done:

- The negotiating leverage of the different stakeholders is not balanced and the stance taken by government bodies on projects can be forceful, often driven by budgetary pressures.
- Where the underlying asset is complicated to operate, subcontractors may not be easy to replace as credible alternative operators may not exist or be unwilling to become involved in a project with known problems.
- Larger more complex projects may contain structural or operational anomalies which need to be identified early such that the best solution could reside outside of the existing contractual provisions.

Early engagement and understanding the differing stakeholder requirements and leverage are key to agreeing a solution. Notably, equity sponsors may have direct links to the operator in which case taking control without their help will be challenging and they may well be the most willing to temporarily stabilise liquidity for the business. Conversely, government bodies are motivated by a combination of the possible public reaction, the financial impact on the public coffers and ensuring the relevant services continue uninterrupted.

Conclusion

Each infrastructure project should be considered on its merits and the structural and stakeholder dynamics need to be properly understood. Successful restructurings have to date been predicated on a conciliatory approach, buying time to stabilise liquidity, developing effective relationships with the relevant parties (in particular government bodies), understanding any contractual or structural flaws and an acceptance that all stakeholders may need to share in some of the pain even on “low risk” PFI deals.



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August

The refinancing of AFG Properties

In August the Debt & Capital Advisory (“DCA”) team working alongside Corporate Finance (Real Estate and Northern Ireland teams) completed the refinancing and restructuring of AFG Properties (“AFG”).

AFG was the owner and operator of eight shopping centres in the British Isles, banked by RBS and Ulster Bank. The RBS group’s total exposure to AFG was c.£800m going into the transaction, and AFG’s portfolio had been significantly over-levered since the financial crisis. PwC anticipated that RBS would seek to exit the loan facilities, because of the onerous capital weighting requirements and high running costs the bank was facing. PwC approached the company to develop pre-emptively their options for dealing with this eventuality, which became a reality with the formation of the Capital Resolution Group within RBS.

Following detailed discussions with all stakeholders, it was agreed that a consensual approach with RBS was the best way to achieve AFG’s objective of retaining ownership of a number of centres in conjunction with an investment partner. This objective was reconciled with RBS’s requirement to maximise recovery on its lending through a consensual disposal process in which AFG were able to bid. In the transaction, Kildare Partners, who were introduced by PwC, came in alongside the existing owners for the two centres AFG believes have the greatest future value potential and other investor groups bought out the remaining six centres. Thus maximising returns to RBS, whilst retaining significant equity interest for the existing owners and management.

The transaction is a great example of our corporate side work to optimise outcomes for borrowers facing stretched and underwater financial situations. The DCA group’s approach demonstrates how pre-emptive and pro-active engagement with the existing lender and new investors can optimise corporate outcomes in stressed situations. The DCA group advises owners and managers on debt and capital structuring and raising across public and private markets.

September

Phones4U – a unique appointment

The speed of the Phones4U group’s collapse and the urgency with which administrators needed to be appointed gave rise to some important challenges. When key contract negotiations failed, the directors concluded that in light of the cost of running the business, it was necessary to cease trading immediately and file for administration in order to protect the company’s assets. Under the Insolvency Act, qualifying floating charge holders are given five days’ notice of the appointment of administrators, but, given the circumstances, the Court permitted an immediate appointment. This illustrates the Court’s willingness to intervene to protect the position of creditors where assets are at risk.

Another unusual aspect of the Phones4U administration is that the main creditor body derives from a £430m listed senior secured bond that is actively traded and held by a diverse group of investors, some of which are unfamiliar with the English insolvency process. Despite having no day-to-day visibility regarding the current holders, from the start of their assignment the administrators adopted a strategy of comprehensive disclosure to the secured creditors. Given the circumstances, the only means to achieve this was via public calls, which provided challenges regarding protecting the commercial sensitivities of the case. The resounding feedback from the investment community has been that the level of transparency has been unique and has greatly facilitated market liquidity.

Because relatively few high yield structures have suffered insolvency, there are a number of aspects of the capital structure, which have presented unexpected challenges and dealing with the interpretation of the underlying documentation is an on-going challenge. The relevant parties to those agreements, including the Security Trustee (ING Bank N.V.) and Senior Note Trustee (Citibank N.A.) have been attempting to determine how the agreements can be implemented in the current situation but it has become clear that in certain cases this has not been practically feasible. As a result it was necessary to apply to Court to release noteholders’ security in order enable key store disposals early in the administration and although there will be no further disposals of that nature, there are other situations where it is likely to be necessary to return to Court.

It has already been necessary to involve the Courts in order to preserve the position of creditors and it is expected that there will be other situations where the administrators will need to find ways around the insufficiencies of the contractual framework.



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October

The impact of the AQR results

Many are viewing the results of the Asset Quality Review (“AQR”), which were published on 26 October 2014, as an end in themselves. In our view, the AQR is just the beginning of an unprecedented period of change for banks.

Media attention has largely been focused on those institutions, which have failed and will need to raise additional capital, quickly. As they seek to do so, shareholders will challenge the future sustainability of these banks. What will shareholders get in return for the extra capital? How quickly can banks deliver results? By and large, the failing banks do now have capital plans in place and are making progress towards implementing them. In future, however, they will need a compelling plan for sustainability in the new regulatory environment.

Aside from the banks that have failed, the industry should now focus on those banks that have passed the exercise, but do not have a clear vision of their future. They may have a business built on an old idea of what a bank should be. Many have under invested and have out-dated platforms, many also are still sitting on high volumes of non-performing loans. Higher capital requirements, a change in customer expectations and competition from the shadow banking sector in the medium-term all combine to make banking a more challenging enterprise. These banks will continue to function, but as profitability falls, they too will come under pressure. The European Central Bank as the new single supervisor will not allow non-viable banks to persist indefinitely.

The winners will be those which have a clear vision of their strengths and which focus on their customers’ needs. They must also be open to changes in the way they fund their business. These banks will consider what the new regulatory environment will mean for them strategically and will recognise the need for material change. They will be confident in segmenting their business to focus on those areas where they have a clear competitive advantage and will exit from areas not essential to this strategy.

To keep up with new competitors, all banks need to embrace technology and be leaner across their cost base. Those that are agile and quick to change will be the real winners. Those that cannot change quickly will face continued and increasing scrutiny under the new supervisory regime.

In summary, while the AQR may not itself have resulted in large numbers of bank resolutions or disposals, it has resulted in a better capitalised banking system, which needs to move quickly to shed underperforming businesses and assets and transform its operating models to remain competitive.

November

The distribution of the LBIE surplus

The insolvency of Lehman Brothers International Europe (“LBIE”) continues to break new ground.

In April 2014, we reached the 100% dividend milestone for unsecured creditors. Over £40bn will eventually be returned to creditors, making it the biggest and most successful administration in Europe.

The focus is now on how to distribute the surplus, currently estimated at c.£7bn on a high case basis.

Surplus claims are a valuable asset for creditors, with the value depending on how the surplus is allocated. Different creditor groups have different views on this allocation, which has so far meant that a consensual solution has not been possible. Consequentially there are two court actions underway designed to provide answers on surplus entitlements and provide a practical framework for making distributions.

Waterfall 1 decided that currency conversion claims (foreign exchange losses arising as a consequence of foreign currency claims being converted to sterling in September 2008) exist as a non-provable liability which gets paid if there is sufficient surplus after statutory interest is paid on unsecured debts. This is a new concept which has become relevant as a result of the possibility that statutory interest will be paid in full. The judgment is currently being appealed.

Waterfall 2 contains 39 questions which are a mixture of insolvency, contractual and practical issues identified by the administrators and the respondent creditors. Questions cover the calculation of statutory interest (including the interrelationship with contractual interest under ISDA master agreements), the calculation of currency conversion claims, and the impact of post administration contracts.

The respondents and administrators have been setting out their positions on the questions in preparation for a Case Management Conference that was held on 21 November. The matters will be heard at three separate trials during 2015. Publicly available documents in connection with the process are posted on the LBIE website: www.pwc.co.uk/business-recovery/administrations/lehman

While the administrators’ preference is still to reach a consensual agreement it is currently likely that court decisions which have a wider impact on the financial and insolvency markets will be required to underpin the surplus distribution.

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Risk, viability and going concern – the Corporate Governance Code

The 2014 UK Corporate Governance Code has hit the headlines principally because it implements the recommendations of the Sharman Inquiry, including the new viability statement looking at the prospects for companies beyond the going concern horizon. But the 2014 Code – and the Guidance that was issued alongside it – also includes updates on how boards should tackle and report on risk that will cause many companies to look again at areas such as setting risk appetite, encouraging the right attitude to risk throughout the organisation, and monitoring and reviewing risk management and internal control. One of the aims has been to attempt to strengthen the focus of companies and investors on the longer term and the sustainability of value creation.

The new version of the Code applies for premium listed companies for periods beginning on or after 1 October 2014 but it should be high on the agenda of boards and audit committees now so that they are in a position to make the related formal statements and confirmations when the year-end comes.

There are a number of key considerations that boards will need to consider as part of these changes, three key areas being:

1. The Viability statement

The Code requires that directors must state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a set period. Directors will need to explain how they have assessed the prospects, over what period they have done so and why they consider that period to be appropriate. We consider the key practical issues for companies are:

- Deciding on the period to cover – Code Guidance suggests that in all but rare circumstances the assessment period should be significantly longer than twelve months.
- Identifying and describing the relevant qualifications and assumptions.
- Making an assessment that is appropriate and proportionate to the company's circumstances.
- Robust and realistic forecasting, taking into account the business, industry and macro-economic factors.
- Appropriate stress testing, and exercise of prudence.

2. Robust assessment of principal risks

Directors will be required to confirm that they have carried out a robust assessment of the principal risks facing the company (including describing those that would threaten its business model, future performance, solvency or liquidity), as well as explain how these risks are being managed or mitigated. Key considerations should be:

- Making the assessment 'robust', including:
 - Having the right people (including on the board)
 - Providing the right information
 - Open and honest discussions
- Capturing, assessing and describing risks
- Effective management and mitigation
- Linking risk assessment to the viability statement

The Guidance has a particular emphasis on identifying risks that would threaten the company's business model, and suggests the use of stress testing and sensitivity analysis to help assess both the company's overall resilience to stress, its adaptability and the significance of particular variables to the projected outcome.

3. Going concern

The changes bring the going concern confirmation in the Code in line with accounting and auditing standards. It has become standard practice for directors to look forward at least twelve months when considering it appropriate to adopt the going concern basis of accounting, we do not anticipate a significant impact from this change.

All of this will clearly have implications for the conversations directors will have with lenders and other stakeholders, and each of these parties will need to be alert to how these regulatory changes impact companies as they come into force over the coming year.

Restructuring



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Summary

Liquidity was abundant in 2013 and the first half of 2014, but the market has cooled since then as volatility has increased because of the uncertain impact of the US Federal Reserve's withdrawal of quantitative easing measures and, more locally, the sudden collapse of Phones 4U. The gradual shift in US monetary policy may lead to further periods of instability as the market assesses its impact, although, in recent weeks, the market has started to recover. Fundamentally liquidity remains plentiful, particularly as the European Central Bank grapples to stave off deflation in the Eurozone.

The high yield market has also cooled with less new issuance following a record H1. There is still a pipeline of companies seeking an opportunistic refinancing that are on hold. We anticipate that there will continue to be liquidity in high yield for better credits, but opportunistic issuance may be more challenging.

Distressed credit metrics continue to paint a benign picture. S&P reported a 12 month trailing default rate of 4% in Q3 2014 (down from 8% a year ago), whilst for companies with public ratings, the default rate is just 2%. Given that refinancing activity has pushed out near-term maturities on leveraged credits, default rates will probably remain low for the next 12 months.

Against this backdrop, some concerns have been raised about a number of the deals launched in the last 12 months. This reflects the increasing leverage accepted by the market on new deals. However, the increasingly limited use of financial covenants on leveraged deals (whether bank or bond) may limit lenders' ability to act for some time.

Following the results of the Asset Quality Review ("AQR"), we anticipate portfolio sales will increase, particularly in Italy. We anticipate that bank deleveraging will continue and the AQR has been helpful by requiring banks to raise more capital, which should facilitate that deleveraging process.

In terms of sectors, the commodities industry remains stressed and we are following the situation closely, particularly in Spain, working with players from all sides of the market. Declining oil prices are causing concern in the oil and gas industry, particularly on the exploration and services side. On the extraction side, lenders will need to deal with credits where the marginal cost of production of newer endeavours is above recent oil prices.



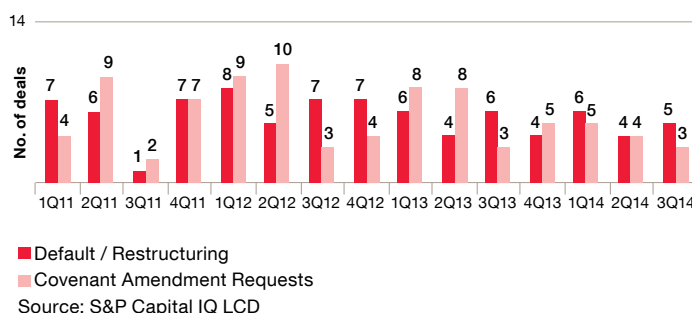
Distressed credits

The trends evident during the first nine months of the year continued in Q3 2014, with credit metrics showing minimal signs of distress, reflecting the easy credit conditions over the past 18 months which have allowed many corporates to refinance or amend their facilities.

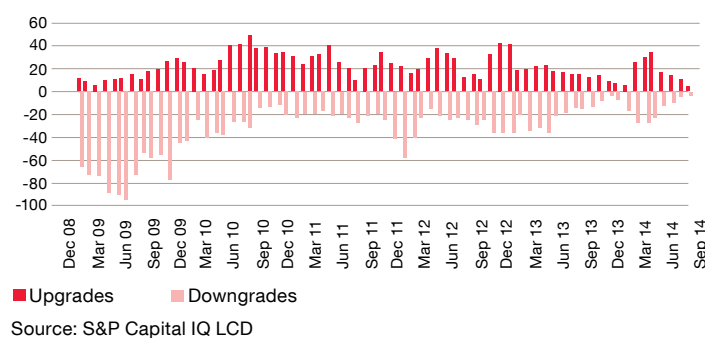
The European Leveraged Loan Index ("ELLI") distressed ratio remains unchanged since June with 8.8% of loans trading below 80. In fact many of the same names remain in this distressed bracket including Van Gansenkinkel, Tunstall, and Northgate Information Solutions.

The lagging 12-month default rate for S&P's ELLI has moved marginally down as there was one fewer default in Q3 2014 compared with Q3 2013. The lack of activity or volatility is further reflected in few changes to credit ratings in Q3 (27 upgrades and 17 downgrades). The net increase in ratings means the number of borrowers rated CCC+ or lower continued its decline from 8.7% in June to 6.7% in October 2014.

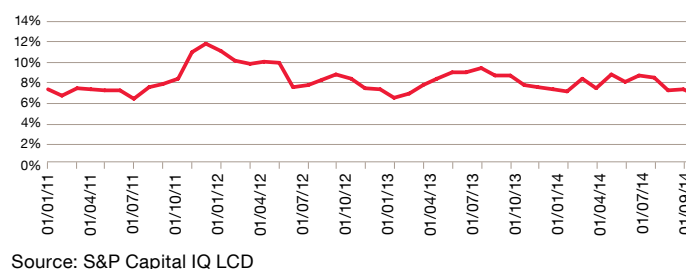
Distressed Leveraged Loans



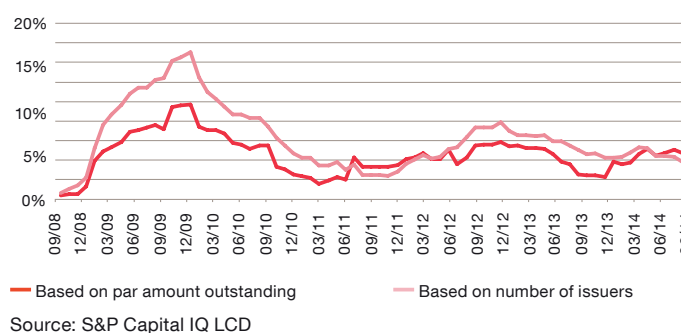
Upgrades / downgrades for ELLI



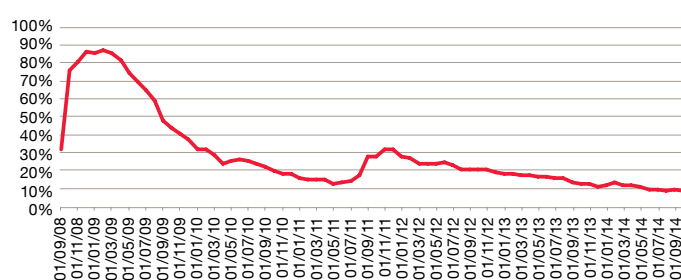
Share of Facilities Rated CCC+ or Lower



12 month default rate



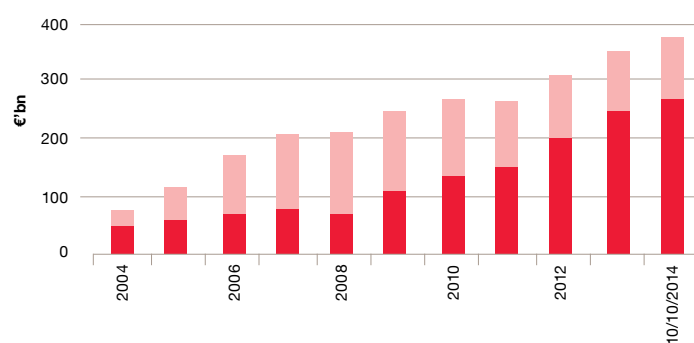
ELLI distressed ratio



Market size and maturity profile

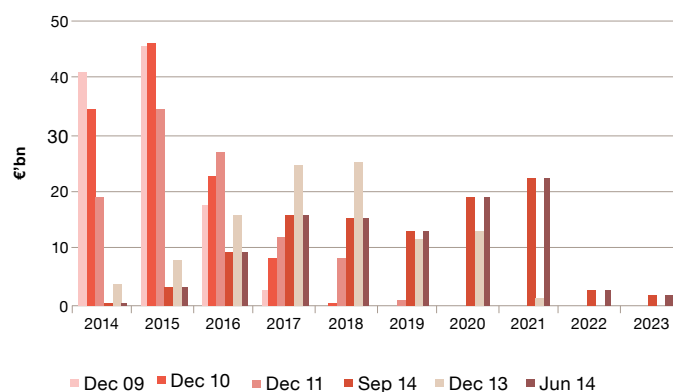
The total debt market has remained relatively static with both high yield bonds and leveraged loans largely unchanged between June and September 2014. However, there has been a marginal shift from high yield back to the loan market as high yield issuance levels off. Meanwhile, recent refinancings have continued to push maturities out with €12 billion of 2016-2018 maturities pushed back to 2019-20. There is still c.€3.5 billion of debt due in 2015 that needs to be refinanced.

Market size outstanding balance



■ MLHY* ■ ELLI
Source: S&P Capital IQ LCD

European institutional leveraged debt



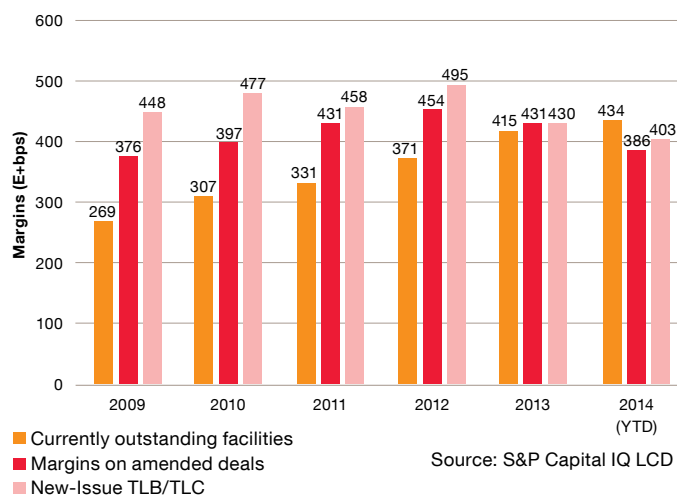
■ Dec 09 ■ Dec 10 ■ Dec 11 ■ Sep 14 ■ Dec 13 ■ Jun 14
Source: S&P Capital IQ LCD



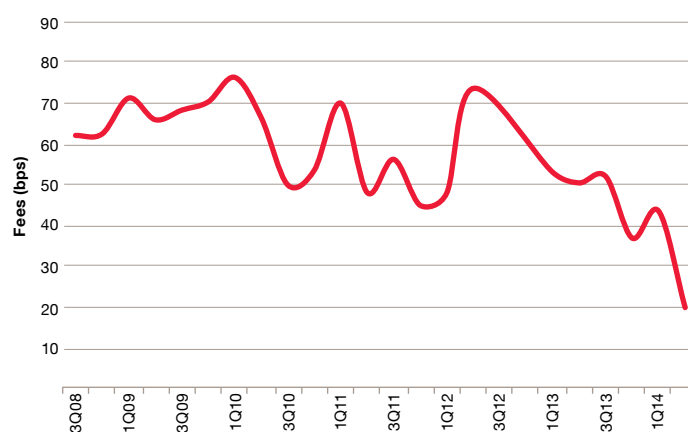
Pricing

Pricing has softened slightly over Q3 2014 despite resistance shown in July, particularly through amended facilities where average margins are 386 bps YTD at the end of Q3 compared with 413 bps in H1. New issuance pricing has dropped just 3 bps to 403 bps.

Average margins on LBO facilities



Amendment Fees



Economics corner: The Eurozone's reliance on Germany for growth looks shaky



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Eurozone growth has stalled again

Eurozone growth is stuck in neutral. The bloc has not grown in net terms since the first quarter of 2012 and economic output remains below its pre-crisis level (which we've defined as the fourth quarter of 2007). As a comparison, the US has grown by around 7% over the same time period.

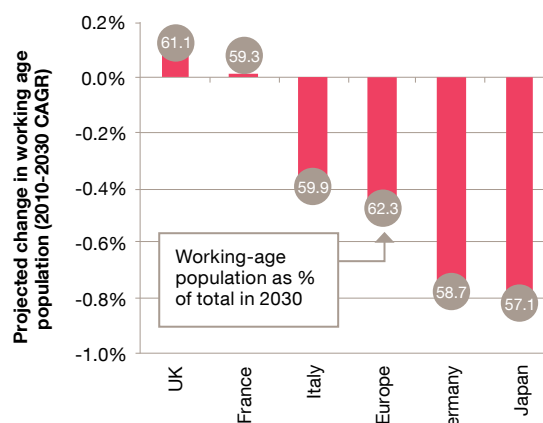
Much attention has been centred on the poor performance of the peripheral economies – Ireland, Spain, Portugal, Greece and Cyprus – which have shrunk by around 1.8% per annum on average since 2009 in GDP-weighted terms. However, they make up less than 20% of Eurozone GDP. So, how have the three largest economies of the Eurozone – Germany, France and Italy – been performing?

- Italy, the third largest Eurozone economy, has fallen back into recession for the third time since 2008 and is projected to remain a drag on Eurozone growth for the rest of the year. Recently there has been some more positive news on structural reforms, but these are unlikely to drastically change the short-term outlook;
- France, the second largest economy, is at a cross-roads and is trying to convince its EU partners of the merits of a relaxed fiscal stance compared with implementing structural reforms, which are usually painful, but have long-term benefits; and
- Germany, the largest economy of the bloc, has had a much stronger growth profile until recently, but lately it has been facing some pressure from the Ukraine-Russia situation and the gradual slowdown in China, one of its key export markets. The August industrial production figures (down 4% month-on-month) have already taken the shine off its previously good economic performance (although some of this effect was due to one-off factors) and forward looking surveys (e.g. ZEW and Ifo) suggest the short-term economic outlook has turned sour. On the flip-side though, two out of Germany's three key export markets (the US and UK) are growing at relatively fast rates, which could help offset some of the effects described above. Based on this analysis we have revised down our main scenario for German GDP growth from around 1.5% to around 1.2% per annum for 2014-2015.

On the whole, despite its recent slowdown, the picture in the Eurozone has still been one of excessive reliance on Germany. In fact, our analysis suggests that Eurozone output would have been smaller by around 2.7% compared to its pre-crisis level had Germany not grown at all since 2008.

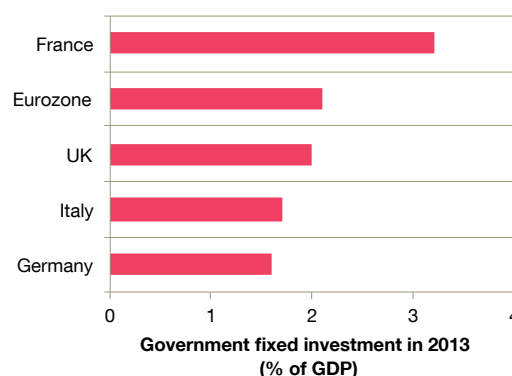
So while Germany is still expected to achieve positive, if relatively modest, growth for the next two years and remain a key driver of Eurozone growth in the short-term, it does beg the question, how long is this going to last?

Fig 1: Germany's working-age population is expected to shrink quicker than in wider Europe



Sources: UN World Population Prospects, PwC analysis
Note: Europe category is as defined by the UN

Fig 2: Government investment in Germany is the lowest in the core and is below that of the Eurozone



Source: Eurostat

The long-term German picture is different

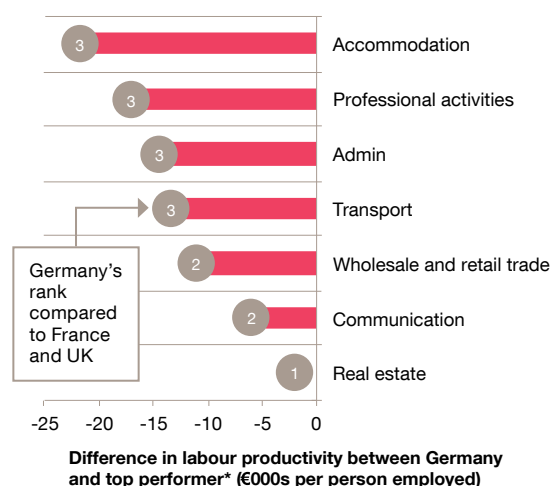
In our view, Germany faces three main challenges in the longer term. These are:

- **Poor demographics:** Figure 1 shows that Germany's working-age population is projected to shrink by almost 8 million people between 2010 and 2030. The knock on effect of this will be to drag down the potential average growth rate of its economy to only around 1%¹ in the 2020-2030 period, compared with actual average growth of 1.2% from 2000-2010 even including the deep recession of 2008-2009. One way German policymakers can counter this is by tapping into the excess labour supply of the peripheral economies, although the resulting increase in immigration could run into some political opposition.
- **Low investment to GDP ratio:** The German private sector channels much of its savings abroad rather than into investment in the domestic economy. As a result, Germany has an investment to GDP ratio of only around 17%, lower than the average for the Eurozone (17.8%), and an abnormally large current account surplus. Public sector investment is also lower than in the other core countries (see Figure 2). The IMF has already called on economies with sound public finances, like Germany, to boost infrastructure spending, which would make sense at a time when long-term German bond yields are so low.
- **Low productivity in the services sector:** When compared with the UK and France, workers in Germany are the least productive in four out of the seven main services sub-sectors (see Figure 3). Even though this effect is offset by Germany's international excellence in the manufacturing sector, we think this is an area where policymakers will need to focus their attention as countries like China move up the value-chain into high value added manufacturing and so Germany needs to switch more into tradable services in the long-run to sustain its growth.

In the short-term, Germany may be able to keep propping up the rest of the Eurozone, but with long-term challenges on the horizon, this is unlikely to be able to continue.

To read more on this, please sign up to our monthly Global Economy Watch on www.pwc.com/GEW

Fig 3: The only service sector where German workers are the most productive is real estate



Source: Eurostat

Note: *Compared to France and the UK, 2011 data

¹This analysis is from our World in 2050 modelling which we will be updating in the first quarter of next year when these numbers might change.





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