March 2013

Restructuring Trends

Launch

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at a glance

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Restructuring

With the corporate default rate continuing to rise and a number of high profile insolvencies in recent months, is the day of reckoning for fragile corporates approaching? Previously restructured credits are becoming distressed again and while refinancing has reduced the wall of maturity, those still needing to refinance are weak credits, which suggests involuntary refinancings will increase. Question marks remain over whether liquidity in the loan market will decrease as CLO reinvestment periods come to an end this year, but greater realism amongst stakeholders on valuations could support activity in the distressed space. Year-on-year pricing on new LBO deals increased in 2012 but the current trend is downwards with borrowers taking advantage of liquidity to re-price existing deals. In restructured deals, we expect to see a continued upward trend in pricing.

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In the debt markets

With markets apparently convinced that Eurozone concerns are over, borrowers across Europe have taken advantage of a continuation of benign credit market conditions at the start of 2013 to raise long-term financing at record low yields. While there has been some M&A amongst larger companies, refinancing activity continues to drive the markets. In their relentless search for yield, lenders are increasingly moving down the risk spectrum, opening up the market for issuance of more exotic instruments as well as to issuers from peripheral Europe. In the high-yield market there has been strong issuance from a wide range of issuers and prices have been pushed to historically low levels amid strong inflows to the asset class. Leveraged loan issuance remains limited while technical conditions remain strong as CLOs seek to stay invested, and for the first time in five years a European CLO has been raised. In the real estate market there has been a shift from bank to non-bank lending, bringing with it much needed liquidity and flexibility.

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The emerging role of funds in restructurings

A trend of banks and funds working together – rather than against each other – in restructuring situations is emerging, with the benefits that both lender groups bring to a deal becoming clearer. In both the Biffa and Estro restructurings, funds contributed by facilitating the early exit of par lenders wishing to reduce their exposure, underwriting new money requirements and helping to drive an expedited completion to these deals. As well as capital, funds can offer operational turnaround expertise, while par lenders, for their part, play a key role on Coordinating Committees in driving the overall process. The result should be a better solution for all.


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North, East, South, West

The fallout from the European sovereign debt crisis and the 'new normal' of slow growth and relatively high inflation is having a significant impact on the restructuring outlook for businesses in Europe. We look at the significant restructuring issues facing the territories away from the central core of Europe in our 'North, East, South, West' section.

We consider the Nordics, Poland, Cyprus and Ireland and give a view on the critical issues that need to be resolved in those jurisdictions, ranging from the contagion risk to the ongoing bank issues.

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Operational restructuring – nice to have or a necessity?

Solving the financial problems of a company is just part of the restructuring story, as without a deeper operational turnaround companies may become 'zombies', able to service their debt but with no plan to improve earnings sufficiently to grow the business and ultimately repay the debt. In some jurisdictions an operational turnaround plan is a mandatory part of restructuring practice, but even where it is not, setting up a strong business plan with a realistic profit target is relevant for all stakeholders. A successful turnaround involves more than just taking cost out of the business; it establishes a competitive platform by setting a vision for the company and generating a sound plan to unlock value. With a long period of low growth being forecast, we ask whether operational improvements should feature more prominently in restructurings.

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Economics corner

This issue includes a new feature, 'Economics corner', which provides an analysis of the most recent UK growth data and our assessment of the economy's prospects for the coming quarters.

After a broadly flat performance in 2012, our central scenario is for the UK economy to return to modest growth of around 1% in 2013, with a further improvement towards trend growth expected in 2014. On a regional basis, London and the South East are expected to show the strongest growth. This gradual recovery is based on our expectations for a calmer environment in the Eurozone and continued growth in exports to emerging markets, such as the BRIC (Brazil, Russia, India and China) countries. The risks to this main scenario, however, are weighted to the downside and include the possibility of further adverse shocks in the Eurozone and higher global commodity prices.

Welcome

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Welcome to the first edition of Restructuring Trends in 2013. As most of you will know, I'm a restructuring partner based in our London team, working mainly lender side on multibank and CMBS restructurings.

In this issue we analyse some of the recent trends in the restructuring market and consider the outlook for the coming year. From a UK perspective, these recent sector trends include seasonal as well as structural economic factors.

Since our last edition, retailers have reported their results for the Christmas trading period, accompanied by some high profile insolvencies – Jessops, Blockbuster, Republic and HMV – as the impact of technology, changing consumer demand and multi-channel competition finally took their toll. The high street remains a challenging environment in 2013 and for many retailers the seasonality of their cash flows means that they will face pressures before the next Christmas trading period. Consumer spending is likely to remain under pressure from falling real incomes this year, as inflation offsets the benefits of improvements in GDP. Consumer confidence will be key, and in a flat market there will be winners and losers.

Alongside retail, other sectors showing continued pressure include construction, steel, solar manufacturers and waste management. But are there any green shoots of spring? The UK house-building sector has continued to show improved results, particularly businesses focused on the South East, with profits up despite flat prices. IPO activity is even starting to pick up. However, this is partly driven by land purchased at good prices a few years ago and is by no means a bellwether for the wider market. Still on the housing theme, we discuss the outlook for the Irish housing market in one of our feature articles, which includes a whistle-stop tour around territories away from the central core of Europe. As well as Ireland ('West'), we share our outlook for the Nordics ('North'), Poland ('East') and Cyprus ('South').

Together with our quarterly restructuring and debt market update, this edition also includes a new feature called 'Economics Corner', which gives our views on the UK economy's current climate along with our assessment of the economy's prospects for the coming quarters. Other feature articles in this edition discuss the growing trend for funds and banks to work together and the benefits this brings, and the increasing importance of operational restructuring as well as financial restructuring.

In addition to operational performance issues, restructuring activity in 2013 will also be driven by impending debt maturity, particularly on property backed deals in sectors such as pubs and healthcare. Mix together OpCo/PropCo dynamics, CMBS debt structures, out of the money swaps and multiple stakeholders and this will create the backdrop to some long running financial restructuring negotiations in 2013.

I hope you enjoy reading this edition and please do feed back any comments to the editorial team or myself.

Consumer spending is likely to remain under pressure from falling real incomes this year as inflation offsets the benefits of improvements in GDP

Julia Dickson, Partner

Restructuring

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Is the day of reckoning nearing for fragile corporates? Over the last quarter of 2012 and into 2013 the level of defaults across a range of larger corporates has been on an ever increasing trend and there has been a spate of high profile insolvencies, including HMV, Jessops and Manganese Bronze.

Looking at recent data, corporate defaults are now at their highest level since early 2010 – in our view this reflects increasing pressure on European corporates from a prolonged period of economic stagnation, coupled with previously restructured credits re-entering distress. There is an increasing readiness to accept more realistic values across stressed M&A situations and a growing opportunity for exits amongst stakeholders who no longer want to work through the restructuring, with distressed funds and investors seeking turnaround opportunities.

The quantum of institutional leveraged loans maturing in the next two years has been cut from €49bn in 2010 to just €8bn, principally through amend and extend and bond refinancing activity. However, those companies who are yet to refinance are the weak credits and we would expect an increase in involuntary refinancing accompanied by covenant resets.

Whilst the level of institutional loans maturing in the near term is relatively low, this understates the further refinancing that corporates will need to undertake. For example, there are €50.3bn of high-yield bonds due to mature by the end of 2014. There will be additional amounts in respect of amortising debt also.

Overall pricing for 2012 on new LBO deals was higher than in the previous year. However, the current trend is very much downwards as borrowers take advantage of liquidity to reprice existing loans.

Question marks remain over whether liquidity in the loan market will decrease as CLO reinvestment periods come to an end this year. However, the launch of a couple of new CLO vehicles plus investors' concerns with interest rate risk on fixed coupon bonds (in a potentially rising interest rate environment) may encourage new funding into the loan market.

Whilst amendment fees were not reported in Q4 due to the low number of European leveraged deals, we would expect the fee level for a covenant reset and an extension to be in the region of 50-100 bps, although fees will depend on the specifics of the situation.

> ***Corporate defaults are at their highest point since early 2010 - a symptom of the long period of difficult low growth market conditions***
>
> Heather Swanston, Partner

Distressed credits

The number of borrowers incurring a payment default in Q4 2012 remained at a similar level to Q3 2012. Notably, relative to the level of defaults, covenant reset activity for distressed leveraged loans was at a low level for another quarter.

Our own experience across the overall corporate arena reflects this trend. We have seen a number of cases where there was a default and the commencement of a fundamental restructuring, rather than a simple covenant reset or waiver.

Distress metrics

The lagging 12-month default rate for the S&P European Leveraged Loan Index (ELLI) climbed to a two and a half year high of 6.6% in December based on par amount outstanding, up from 6.2% in September. In the 12 months ended 31 December 2012, the ELLI tracked €7.2bn of institutional loan defaults and restructurings, up from €7bn at the end of September.

The ELLI default rate measured by number of issuers rose to 8.5% in December – a level last reached in August 2010 and a half a percentage point higher than the September reading. During the last 12 months, 18 issuers defaulted or started the restructuring process, up from 17 in September and this is the highest number since September 2010.

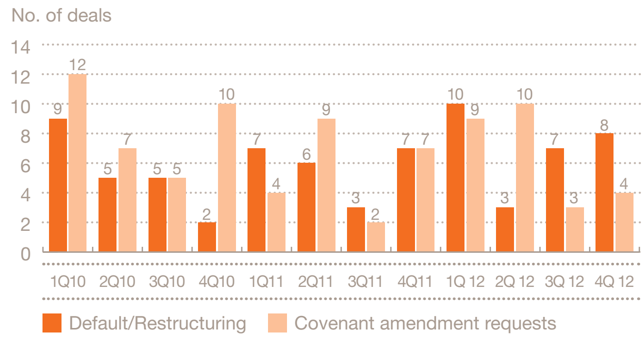
Some commentators estimate that over the course of 2013 there could be an increase of a further 50% in the number of defaults compared with 2012, particularly amongst sub investment grade issuers. A combination of factors will influence this trend, including sustained appetite for debt from credit funds, the on-going fragility of balance sheets and the potential for economic recovery during 2013.

In Q4 2012 the ELLI distress ratio – the percentage of performing loans trading below 80 – continued its gradual decline from the 31.5% peak tracked at the end of 2011. The ratio fell slightly from 20.5% at the end of September to a 12-month low of 18.7% in December. This reflects the general trend for the search for yield to push up secondary prices.

The level of upgrades/downgrades across the ELLI universe shows that over the course of 2012 28% of issuers were subject to a downgrade, the highest level since 2009. On a more positive note, 22% of issuers were upgraded. However, by the fourth quarter the ratio of downgrades to upgrades reached 1.3x, which indicates overall negative sentiment for the ELLI universe.

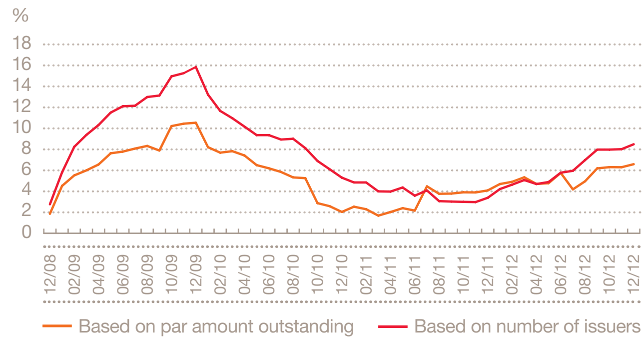
The share of facilities rated CCC+ or lower decreased to a 17 month low of 7.3% in December, down from 8.8% at the end of September (based on par amount outstanding), well below the 11.9% level seen at the end of 2011.

Distressed leveraged loans



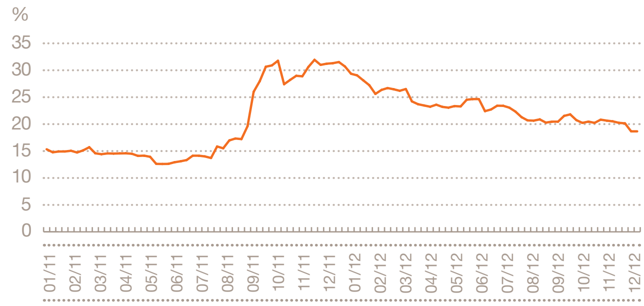
Source: S&P Capital IQ LCD
Note: Distressed credits are classified as loans rated D or in a restructuring

12 month default rate



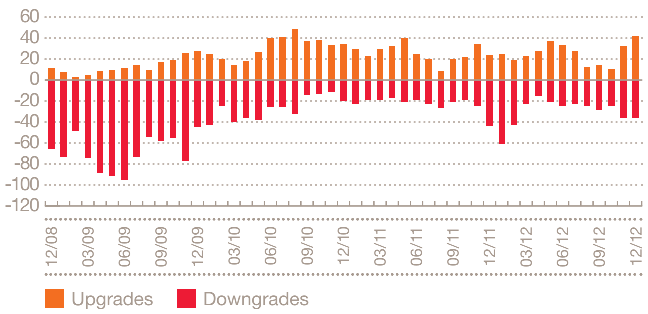
Source: S&P Capital IQ LCD

ELLI distressed ratio



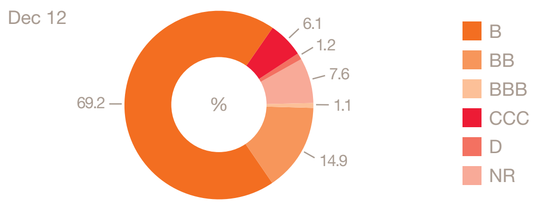
Source: S&P Capital IQ LCD

Upgrades/downgrades for ELLI



Source: S&P Capital IQ LCD

ELLI rating of par outstanding



Source: S&P Capital IQ LCD

Maturity profile

The charts on the right show outstanding European institutional leveraged loans and high-yield bonds. There are a couple of key trends – firstly, the leveraged loan market has shrunk by 25% to €108bn from its peak in 2008. In contrast, the outstanding pool of high-yield bonds has nearly tripled in size over the same period to €205bn. Secondly, the maturity profile of leveraged loans has been pushed back with only €8bn now due to mature by the end of 2014 (the equivalent figure was €49bn in 2010). The peak period of maturity is now 2015/16 due to amend and extend activity.

Whilst the bond market remains buoyant, given the prevalence of lower-rated credits among those still needing to push out near-term maturities we would expect an increase in involuntary refinancing accompanied by covenant resets. However, this could still result in an increase in defaults or even insolvencies.

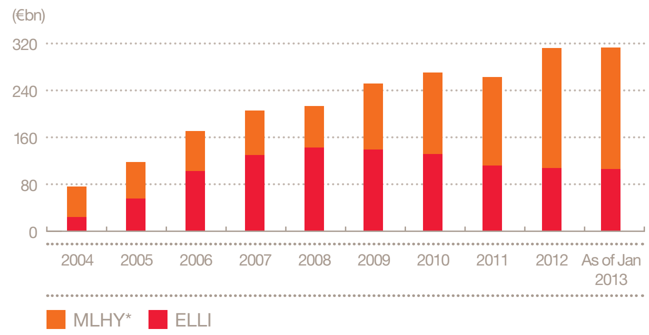
Pricing

Year-on-year pricing on new LBO deals increased in 2012 to 495bps on average. However, the current trend is very much downwards with borrowers re-pricing existing deals taking advantage of liquidity and the lack of non-call provisions on leveraged senior loans.

In restructured deals, we expect to see a continued upward trend in pricing as institutions reflect current market returns for perceived risk, although this will need to be within the confines of affordability.

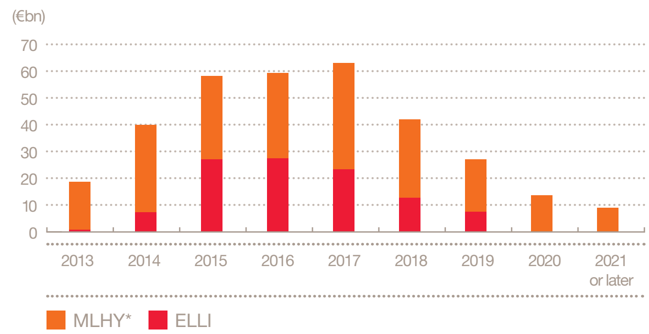
For the second consecutive quarter, relatively few amended deals were reported and consequently no data was published. Based on our experience, we would expect to see fees in the region of 50-100 bps for a simple covenant amendment and year extension, although the specifics of the borrower, jurisdiction and the complexity of the case will be important in determining the fee level.

Market Size – outstanding balance



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

Maturity profile – loans vs high-yield bond

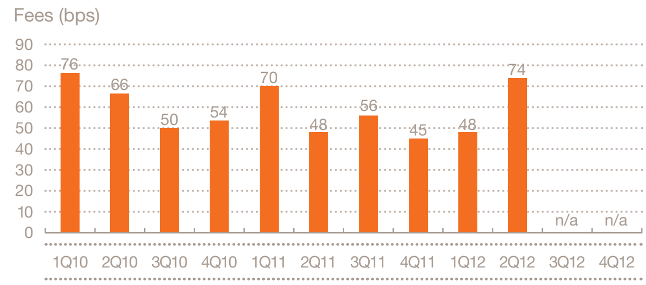


Source: S&P Capital IQ LCD
**Bank of America Merrill Lynch European High-Yield Bond Index*

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

With markets seemingly convinced that Euro concerns are over, larger market mergers and acquisitions (M&A) deal activity returned at the start of 2013. Recently announced transactions include Dell, Heinz and Virgin Media, while there is also press speculation about Everything Everywhere and Elior. Continued strong credit market conditions are an important factor in each of these transactions. However, it remains to be seen whether this activity at the larger end of the market will lead to increased M&A volumes in the mid-market, where the pipeline remains thin.

In the absence of strong M&A volumes, activity in the credit markets has been driven by repricing and refinancing activity. Borrowers across Europe have taken advantage of the benign conditions to raise financing at record low yields. Credit markets have also opened up to issuers from peripheral Europe as investors continue their relentless search for yield. For borrowers with upcoming maturities, or with financing taken out at a time when pricing was higher, this is an excellent time to seek improved terms from the market.

The product choice available to borrowers has also increased markedly through the last quarter to include long-dated RPI-linked bonds and convertibles, as well as bespoke private side instruments. Companies are advised to take advantage of these conditions while they last, as we expect a credit market correction to occur in the second half of the year and a return to more volatile conditions.

Collateralised loan obligation (CLO) issuance in Europe has also returned with Cairn Capital's arbitrage CLO. Questions remain regarding whether this will lead to a steady flow of new issuance, given the lack of primary loan issuance activity and continued regulatory concerns. We remain highly concerned about the depth of liquidity in the second half of the year, given that €25bn of CLO funding will exit reinvestment periods this summer.

Our hot topic in this issue covers the real estate sector. There has been a shift from bank to non-bank lending in the real estate market across both prime and secondary assets. Insurance companies are increasingly seeking prime opportunities, whilst direct lending funds are attracted by the higher yields available from secondary sites. This fragmented investor base, while adding potential complexity for CFOs, also brings much needed liquidity and flexibility to the market.

The rise of direct tenders has significantly increased the product choice available to companies. Now is the opportune time to take advantage of the robust liquidity and consider M&A or refinancing activity.

> ***Bespoke product choice for borrowers is available in the short term driven by significant liquidity in the debt markets***
>
> Nick Atkinson, Partner

Leveraged loans

Issuance has been limited at the start of 2013, despite high investor demand. €7.5bn of leveraged loans were issued in January, with a single issuer, Continental AG, accounting for more than half of the total.

Technical conditions remain strong as CLOs seek to stay invested. Banks have also been much more willing to provide underwritten financing packages, confident in their ability to sell to the institutional market.

The recent preliminary pricing of Cairn CLO III (€300m), the first CLO raised in the last five years, has prompted talk of a potential revival of the European CLO market. However, there are still significant obstacles to overcome including the weak primary pipeline and 'skin in the game' legislation, before a steady stream of European CLO issuance takes place.

Following US trends, European borrowers have taken advantage of market conditions to re-price existing debt. Despite some investor pushback, Iceland and Global Blue have successfully reduced pricing by 50bps and 100bps respectively. Wood Mackenzie secured unanimous consent for a 125bps reduction in its TLB spread to L+450 (Libor floor of 100bps), which unusually could leave the institutional lenders priced below the bank lenders (pro-rata facilities) at L+475.

Despite the announcement of large M&A transactions such as Virgin Media, Heinz and Dell, the primary pipeline for loan issuance remains thin. We recommend that companies take advantage of the current benign conditions as we continue to expect reduced market liquidity in the second half of the year.

High-yield bonds

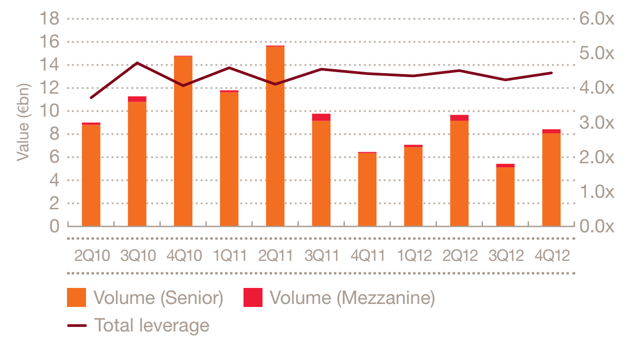
Market conditions in the European primary high-yield (HY) market have started 2013 much as they closed 2012, with strong issuance. January was the third busiest month on record with €7.1bn of issuance (compared with €1.5bn in January 2012).

The diversity of issuers also demonstrates the strong performance of the European HY market in 2012 and early 2013. Repeat and new issuers from a range of industries and credit ratings and across the capital structure (including PIK Notes) have successfully placed paper. Investors' high-risk appetite and search for yield has also helped Eurozone peripheral issuers return to the market.

Technical conditions remain strong with €1.7bn of inflows into European high-yield funds in January (compared with €8bn for all of 2012). Liquidity in the asset class has pushed pricing down to record low levels. The average primary yield to maturity of BB rated bonds declined to 5.54% for the three months through 31 January, whilst the average yield on B rated bonds dropped below 8%.

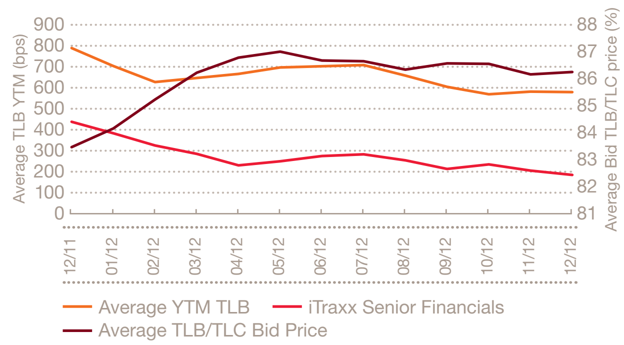
More recently, following significant US outflows from HY funds, secondary HY prices have fallen and yields have risen. We continue to expect HY issuance to be strong this year, driven by continued bond-for-loan refinancing activity.

European leveraged loan volume and debt multiples



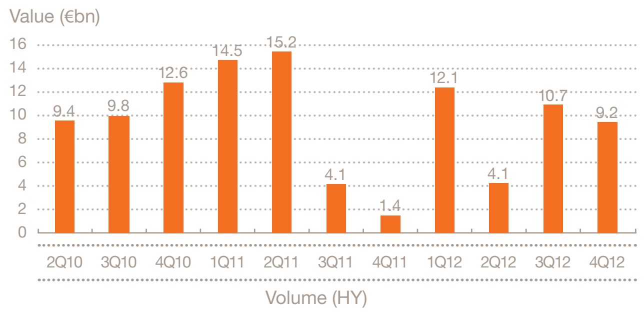
Source: S&P Capital IQ LCD

Comparative analysis of primary and secondary loan pricing



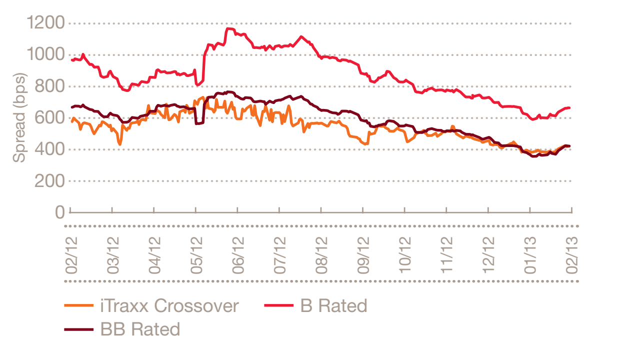
Source: S&P Capital IQ LCD, Markit

European high-yield volume (primary issue)



Source: S&P Capital IQ LCD

European BB and B rated bonds vs iTraxx Crossover



Source: S&P Capital IQ LCD, Markit

Corporate loans and bonds

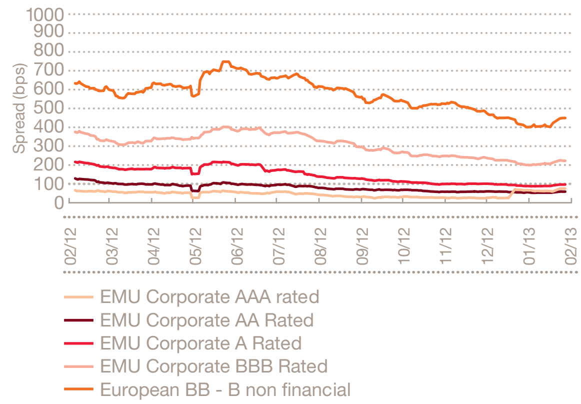
A key feature of the corporate debt markets in 2012 was the structural change from loan to bond financing. Combined issuance in loan and bond markets was virtually flat (up 1% compared with 2011). But this figure masks the huge shift from loan issuance (down 31%) to bond issuance (up 70%) that occurred during the year. As a result, bonds represented 53% of all corporate debt raised last year.

Greater risk appetite has also led to increased lending to borrowers around the periphery of Europe. A number of opportunistic borrowers (Telefonica, EDP) have taken advantage of currently low yields through forward start agreements. Greek borrowers have also returned to both the loan and bond markets (€605m loan to Hellenic Petroleum, €700m bond issue by Hellenic Telecom).

2013 has started strongly as the downward pressure on yields evident during the second half of last year has continued into the New Year. As a result, yield-hungry lenders are increasingly moving down the risk spectrum. This has opened up the market for issuance of more exotic instruments such as hybrids and convertibles. ArcelorMittal, Eni, Abengoa and Beni Stabili raised a total of $4.7bn through convertible bonds in the first half of January (compared with $23bn for full year 2012). We also advised AirBerlin on its recent €140m convertible bond issue.

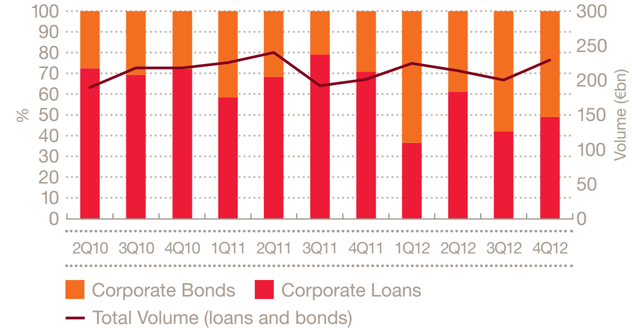
Overall, macroeconomic conditions remain fragile and it is therefore far from certain that the currently favourable conditions will prove durable. Both opportunistic borrowers and those with a short/medium term financing needs should therefore consider taking advantage of current market conditions.

European corporate investment grade bond yields



Source: S&P Capital IQ LCD, Markit

Corporate loans and bonds volume (primary issue)



Sources: Dealogic - PwC Analysis

Real estate

Liquidity in the real estate market has suffered more than in most other financing markets. Bank lending appetite has diminished significantly as a result of the regulatory impact of Basel III and troubled existing real estate debt portfolios. The real estate securitisation market has also all but disappeared for new issuance in Europe. Against this backdrop it is clear that it will be a challenge to refinance the $750bn of real estate debt that is due to mature over the next four years, let alone fund new development.

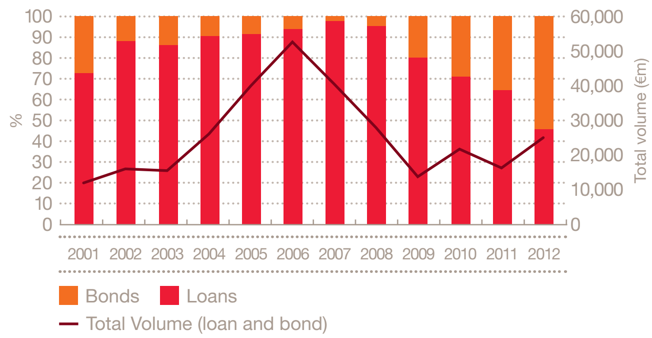
However, in a similar way to the wider financing markets, there are several encouraging signs. Borrowers are increasingly tapping capital markets (c.€6bn of issuance last year) and non-bank lenders for their funding needs. This signals an increased appetite for the asset class from both institutional investors (public bonds and private placements) and retail investors (retail bonds).

Investor feedback largely suggests that the key driver of this appetite is the ability to achieve attractive returns by lending against safe, strongly performing assets. Clearly, the implication is that, thus far, the private placement and retail bond markets have solely been accessible to investment grade borrowers with prime assets.

As in other sectors, investors are increasingly seeking higher yields and are willing to move down the risk spectrum. Last year there was a substantial increase in senior debt funds raised with more flexible mandates. Increasingly, lenders are interested in considering both secondary assets and development funding.

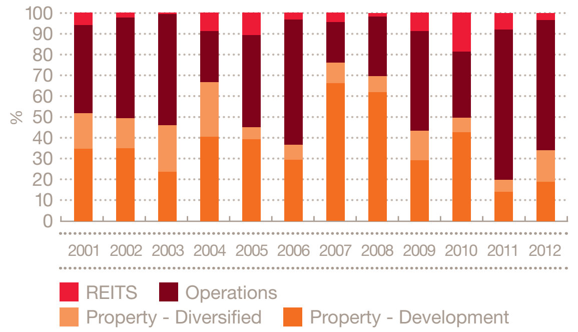
A wider range of options is now available to an ever-increasing range of borrowers. Key advantages are the ability to opportunistically tap the most attractive market/instrument, to diversify the lender base and to achieve longer (and more staggered) maturities at attractive margins.

European real estate financing



Sources: Dealogic - PwC Analysis

European real estate financing by issuer type (loan and bond)



Sources: Dealogic - PwC Analysis

The emerging role of funds in restructurings

The Biffa and Estro (Catalpa) restructurings closed at the end of January with banks and funds in each instance working together to take control of these businesses.

These transactions reflect the developing trend of cooperation amongst lenders, following a period in which funds had been viewed as a threat. But funds do bring challenges to a restructuring, with the possible changes to existing processes, an unwillingness from funds to take on 'insider' status, a potential for misalignment of lender objectives and the inevitable debate over the rights and treatment of any new money injected.

Biffa

The Biffa restructuring commenced in June 2012 with a bank-heavy senior syndicate of 60+ lenders intent on 'not giving value away to other stakeholders'. Funds looking to buy into the situation were forced to be patient, but once in, worked collaboratively with par lenders to deliver a solution suitable for all stakeholders.

The situation was complex, requiring a significant turn-around of the main operating business coupled with a series of non-core disposals post-completion and a fundamental debt restructuring.

These value drivers were geared towards the lenders taking control of the company, which unsurprisingly presented an interesting secondary opportunity for funds. However, while there were willing buyers, there were less than willing sellers.

In contrast to previous transactions, such as Fitness First, existing par lenders were intent, collectively, on seeing how events unfolded. These included a potential junior-led proposal, a possible sale of the group and a potential senior-led restructuring. Their overriding belief was that value had been given away too cheaply on previous transactions.

The result, to the frustration of many funds, was that secondary trading activity was limited for many months. It was not until October/November when the prospect of an M&A process fell away and the requirement for new money became clear that a significant volume of trades began to occur. Notably, these trades were at higher levels than had been anticipated and the secondary market remained at these levels through to completion.

The key challenge was to maintain restructuring momentum as the lender base changed. A flexible protocol was put in place allowing the funds to continue to build their positions, while working with, rather than against, par lenders to develop a balanced expedited solution for all and to avoid any competing proposals emerging. Significant new money was forthcoming from the funds and in parallel, the senior committee of banks continued to drive the other key stakeholder deals – bonds, pensions, hedging and BACS agreements.

This combined effort and protocol was implemented over only three weeks and culminated in a lock-down period during which a balanced deal was thrashed out which accommodated everyone.

The best results will be where there is cooperation, not competition, between different stakeholders

Mak Mwenya, Director

Estro

A similar dynamic emerged in the Estro restructuring where funds bought into the debt, albeit at substantially lower prices than Biffa. Jurisdictional issues further complicated the Estro dynamic as the corporate was located in the Netherlands and there was also a requirement for a significant new money injection prior to completion in January.

For a number of reasons many stakeholders viewed the entry of funds into the structure positively.

Firstly, the funds were able to underwrite the group's liquidity needs on reasonable terms, which was particularly important given the absence of any alternative credible sources of liquidity. A key factor in delivering the deal was that all lenders in the structure had the opportunity to participate in the new money, subject to certain parameters.

Secondly, it was clear that to deliver value an operational restructuring of the group would be required after the balance sheet restructuring. The funds involved in the deal were able to offer this hands-on operational restructuring expertise, thereby enhancing value for other lenders in the structure.

Thirdly, and finally, the funds were able to provide an early exit for those par lenders who had no interest in the longer-term turnaround of the business. Unanimous consent was eventually achieved, enabling the proposed UK scheme of arrangement to be dropped prior to the sanctioning hearing.

We believe that a new restructuring model of banks and funds working together in restructuring situations is emerging, with the benefits that both lender groups bring to a deal becoming clearer with both sides willing to compromise.

In both the Estro and Biffa restructurings, funds contributed by underwriting the new money requirements, which all lenders were able to participate in, as well as facilitating a debt consolidation that allowed for an expedited solution. Available operational expertise provided by the funds was also key on Estro. Par lenders, for their part, played a key role on the Coordinating Committees of both processes, finding and delivering solutions to the myriad of issues arising.

Given the significant levels of capital being raised by funds coupled with banks' Basel III requirements, we should anticipate these dynamics more often going forward. This should result in a scenario where cooperation trumps competition.

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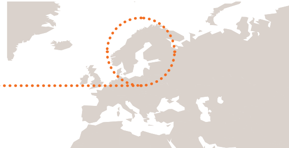
North, East, South, West

North



Nordics

There is a growing view that Europe will face a 'new normal', characterised by weak economic growth with relatively high inflation and volatile commodity prices. What this means for the Nordic economies remains to be seen but there seems to be a growing awareness of the risk of contagion – Sweden for example has exports equivalent to 50% of its GDP of which approximately 70% go to the Eurozone.

Sectors currently feeling the pain are retail – a common barometer of consumer confidence, renewable energy and manufacturing - particularly exporters with exposure to European markets. The outlook for Nordic restructurings will also be impacted by other European themes including the wall of maturity and the recurrence of amend and extend type deals.

Notwithstanding the above, the Nordic lending market has undoubtedly unique characteristics. These include lenders in a stronger financial position than many of their European counterparts, a developing high-yield bond market now starting to play a role in some major restructurings and unique insolvency regimes. This will require stakeholders to give careful consideration to the underlying business model and their individual options in a restructuring. This may involve making difficult decisions.

We recently provided advice to the stakeholders of a heavily leveraged Nordic manufacturing business which had a strong market position. However, further operational restructuring was required and staying ahead of the competition would require dynamic, agile management with the ability to make future investments to protect and grow revenues with key customers. As such the capital structure required a radical overhaul with more 'pain' shared amongst a wider range of stakeholders than management had originally envisaged. However, our view was clear – failing to right-size the debt burden would result in a business facing only terminal decline.

So, while we wait to see how 2013 plays out in the Nordics we expect some difficult negotiations between stakeholders with competing agendas.

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Ireland

The rise and subsequent decline of the Irish economy has been well publicised: rapid growth earned Ireland the title of 'the roaring Celtic Tiger' but was followed by a significant property bubble which, when deflated, left the country's businesses, consumers and banks with a significant debt hangover.

Ireland has been held up as an example of a country that swallowed its bitter pill early and was one of the first to restructure and recapitalise its banking sector. Large commercial properties were transferred into NAMA, the national 'bad bank', and a number of loan portfolios and overseas businesses were sold as the banks deleveraged. The Irish Central Bank then turned its attention to residential mortgages and latterly SME lending, seeking clear commitments from the banks that their distressed loan holdings would be dealt with proactively.

All this restructuring activity, coupled with recent signs of life in the Dublin property market, would suggest that the 66% peak to trough fall in property prices marked the low point of the market and, now, the only way is up. Unfortunately, the picture is not that clear.

Most banks are still at the very early stages of implementing the plans that they have submitted to the regulator and are doing what they can to support businesses and to leave customers in their homes. However, the profile of many borrowers means that the only viable option is enforcement and 2013 will see the conclusion of a long-standing legal case that has prevented lenders from foreclosing on many mortgage loans.

2013 will also bring a personal insolvency reform which will significantly ease borrowers' access to insolvency (many of whom borrowed for their businesses in their personal capacity). Consequently, many expect a new wave of defaults.

Green grass or weeds? At this point, it's very hard to tell.

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East

Poland

Construction has been a hive of activity across CEE (Central and Eastern Europe) driven by countries joining the EU and seeking to improve access to the wider European market. However, PwC's CEE Business Recovery practice is seeing signs of construction industry strain.

Poland joined the EU in 2004. Regional investment was (and remains) a major priority for the Government and big EU co-funded projects drove massive demand. But a rich seam of initial contracts was soon overtaken by increased supply as more and more construction companies entered the market. A combination of cut-throat competition and poor pricing decisions, particularly in not indexing cost inflation on raw materials, meted significant pain on the construction sector.

Poland continues to promise continued co-funded investment to expand its road, highway and railway systems all aimed to increase Poland's accessibility. However, despite promises from the Government, the construction industry still expects an overall slowdown, requiring job cuts in a country where domestic unemployment tops 10%.

In particular, all is not well with road building contracts in Poland. After winning contracts based on price, a number of construction companies were declared bankrupt just weeks before Euro 2012 was due to kick off. Further to this, the EU has just announced suspension of payments for road construction of nearly €1bn, amid suspicions of price fixing by construction companies. The Polish Government has stated that it does not understand the decision as it had informed and been cooperating with the EU over an alleged cartel as early as 2010 and has said the EU could lift the suspension in mid-March.

However, delays in obtaining payment were already a problem before this announcement and the suspension piles further woe on a construction sector that expanded rapidly to meet the significant investment in infrastructure post-accession.

A number of businesses are already facing the need for financial restructuring. Any further EU delays will simply pile more pain onto this critical sector of the Polish economy.

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South

Cyprus

The restructuring landscape for Southern Europe continues to be dominated by the need for bank recapitalisations. With the Spanish and Greek recapitalisations agreed, if not yet fully implemented, and the risk of an exit of Greece from the Euro receding, the attention has turned to Cyprus, one of the Eurozone's newest and smallest members.

Commentators suggest that €15bn-€18bn will be sufficient to bail out Cyprus (both the sovereign and the banks), so the total cost looks easily manageable. But against a context of GDP of around €18bn, the bailout in GDP terms is very significant.

Unlike Greece, Cyprus does not have a significant amount of debt that could be subjected to a write-down and furthermore, much of this debt is held by local banks – a write down would simply increase the level of recapitalisation required by the banks. If this is provided by the Government, which seems likely, a write-down provides no net benefit.

However, a bail out of €15bn+ would take Cyprus to a debt/GDP in excess of 140% - a ratio that the IMF has previously deemed unmanageable.

This has led to the consideration of a bail-in of senior bank creditors and uninsured depositors of the banks. If this looks like it is anything more than a theoretical exercise it will be extraordinarily destabilising for the Cypriot banks, but the contagion risk would be much more damaging – any second-tier bank in Europe may be subject to a deposit 'run'. With concerns that sustained instability in Italy could reignite Europe's debt crisis, following the indecisive election outcome, a bail-in looks out of the question.

Finding a solution to the Cypriot economic crisis will be a critical issue for the new centre-right Government. Cyprus may be small, but the solution will be keenly followed across Europe.

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Operational restructuring – nice to have or a necessity?

Solving the financial problems of a company is just part of the restructuring story. The 'new normal' demands deeper operational restructuring, firstly to avoid ending up around the table again, and secondly to generate the recoveries and returns required by stakeholders.

Before the current debt crisis, financial restructuring was the prevailing instrument for bailing out companies. Solely restructuring the balance sheet, however, is in many cases no longer enough, as recent corporate cases have demonstrated. If insufficient attention is devoted to operational restructuring, companies reappear on the restructuring radar sooner rather than later – as has already been witnessed in cases such as JJB, Jane Norman and many more. A key value driver for lenders is a successful operational restructuring and their recoveries and returns are completely predicated on the turnaround being a success. Affordable liquidity, legitimately, will remain scarce for companies that are unable to convey confidence in their business plans.

Despite the UK being well known for its restructuring-friendly legislation, other jurisdictions arguably put greater focus on addressing operational aspects by including them as a requirement in their legislation. In Germany, for example, the demand for a mandatory operational turnaround has found its way into common restructuring practice.

Depending on the multiple and the cash conversion rate, in some cases even relatively small incremental EBITDA changes can have a huge impact on the company's enterprise value and therefore in determining whether a stakeholder ends up being 'in-the-money'. Setting up a strong business plan with a realistic profit target is not only relevant for the equity stakeholders, but also for the debt holders to ensure the business does not become a zombie and their capital can be repaid. We anticipate that a broader range of funders will want to understand more deeply how the turnaround plan will drive value for them and how they can participate.

A successful turnaround establishes a competitive platform, which typically involves more than just taking cost out of the business. Experience from our Accelerated Change and Efficiency team shows that creating a vision for the company and establishing a USP are the most crucial steps. Once this vision is formulated, it is important to generate a sound plan to unlock value. This often includes a range of initiatives, from carving out non-core businesses, through optimising the product portfolio, and generating alternative sales concepts to optimising the production footprint. Implementation is the next essential step for a successful turnaround and support through a Chief Restructuring Officer or Project Management Officer is a useful option to ensure that day-to-day operations and the turnaround plan can run in parallel.

> ***All stakeholders need to understand and be assured how operational change will drive value for them***
>
> Tim Allen, Director

Case study

Caird Capital LLP

We recently worked with Caird Capital LLP, which had a portfolio company where one of its divisions was underperforming, significantly lowering both the company's profits and its cash generation. It is obvious that the lower the profit and cash generation, the more complex and expensive the refinancing becomes. In cooperation with Caird and the management team, we were able to stabilise the business as a sustainable cash and profit-generating platform by taking the following steps:

- flexing the labour model to achieve a higher labour efficiency in production
- recycling waste into a valuable product
- improving the production layout to optimise the material and work flow
- optimising the factory footprint and reducing the number of sites

To overcome the barriers to implementation, we seconded a team member into the business as a CRO with CFO responsibilities. As CFO/CRO he led the finance department and drove the restructuring activities. The sustainable, higher EBITDA that was achieved as a result led to a refinancing with broad cooperation from the bank.

Key questions for funders to ask:

- Does the company have a clear vision that will allow the company to regain competitiveness?
- Is the ROS (Return on Sales) within the competitive range?
- Is the ROCE (Return on Capital Employed) above the WACC?
- Is the bridge to improve the profit well understood?
- Is the management team capable and does it have sufficient capacity to achieve the turnaround?
- Does the business have sufficient cash to implement the turnaround plan?

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Economics corner

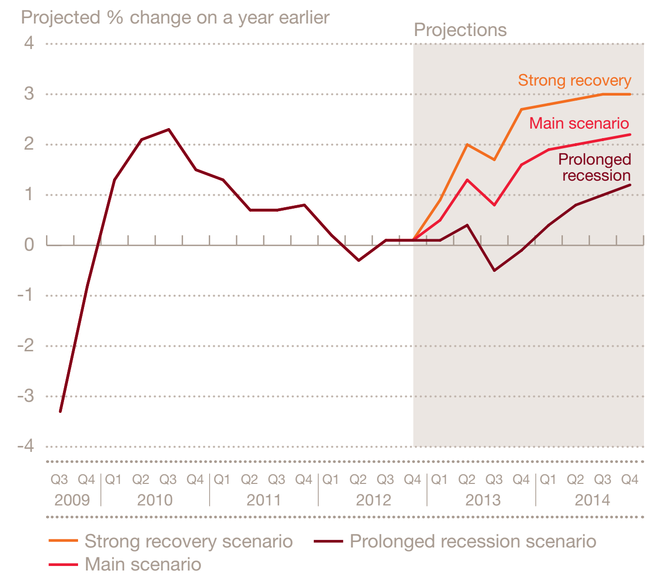
UK growth:

The UK economy shrank by 0.3% in Q4 2012 relative to the previous quarter and was broadly flat over 2012 as a whole. The negative growth in Q4 2012 was mainly due to the reversal of the 'Olympics effect' and continuing contraction of North Sea oil and gas output. Excluding oil and gas, UK GDP grew by 0.3% on an annual basis in 2012 and has recovered by more than 4% since its trough in the second quarter of 2009, but was still 2.3% smaller than at its pre-recession peak at the start of 2008.

UK growth is expected to return to positive territory during 2013 but remain modest, averaging only around 1% over the year. It is then expected to pick up gradually towards trend, averaging around 2% in 2014. However, we think that risks remain weighted to the downside, as shown in the alternative scenarios in Figure 1 opposite.

Consumer spending is expected to remain relatively subdued due to a continued squeeze on real wages, while Government spending growth is expected to decelerate during 2013 and 2014. However, we are expecting business investment and net exports to rise more strongly as the Eurozone crisis shows signs of stabilising and the global economy picks up a little in 2013 and 2014. UK exports to the faster growing emerging economies should continue to grow relatively strongly.

Figure 1: Alternative UK GDP growth scenarios



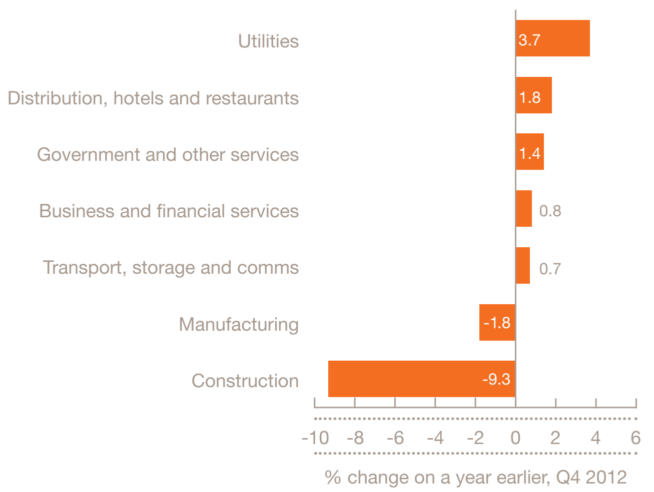
Source: ONS, PwC analysis

UK sectoral growth:

In Q4 2012, electricity, gas and water supply showed an annual increase of 3.7%, but manufacturing fell by almost 2% relative to a year earlier as exports to the Eurozone were hit by continuing problems in that region. Construction was even weaker, falling by close to 9% over the past year due to reduced public investment and subdued housebuilding. The services sector, which now accounts for around three-quarters of UK GDP, has recorded weak but positive annual growth, driven mainly by the distribution and government services sectors.

Looking ahead to 2013, the latest Purchasing Managers' Index (PMI) for construction shows a modest revival of confidence, as does the latest PMI for manufacturers, who are expecting a pick-up in domestic demand as well as stronger exports to Germany and China. Finally, the outlook for services also looks somewhat more positive based on the latest PMI reading for January 2013 and this is also reflected in rising employment in the sector. Confidence has picked up since December, reflecting a recent rise in new business. Against this, retail sales data was disappointing in January.

Figure 2: Sectoral output growth



Source: ONS

Regional trends

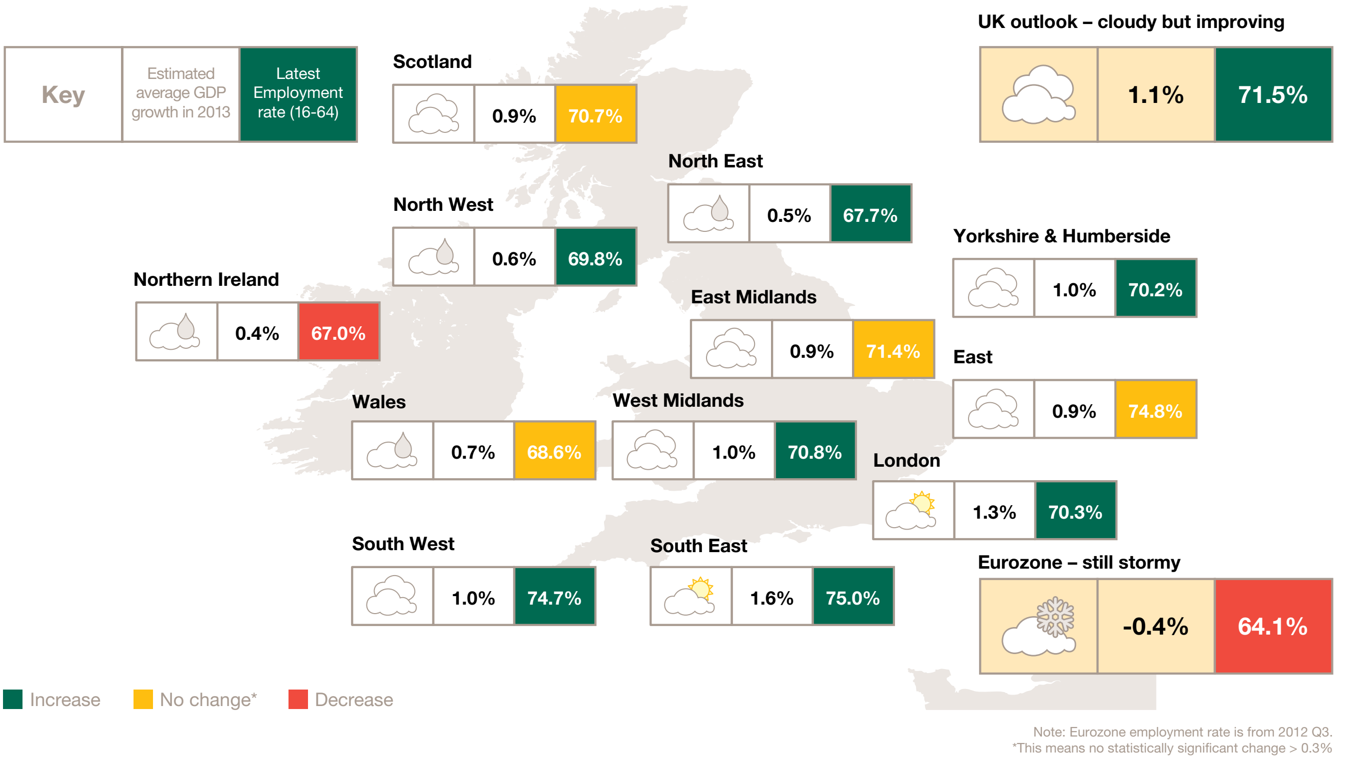
On a regional basis, while London and the South East were the only regions that we estimate to have seen positive real growth during 2012, in our main scenario we expect all the regions to return to modestly positive growth during 2013. However, London and the South East will continue to see the strongest growth rate as indicated by our business climate map below.

Overall, therefore, our main scenario envisages a gradual UK economic recovery in 2013-14 on the back of a calmer environment in the Eurozone and continued growth in UK exports to emerging markets such as the BRICs. But economic risks remain weighted to the downside, so businesses would be well-advised to stress test their business plans against a downside scenario where the economy remains in a more prolonged recession. This could be due to further adverse shocks from the Eurozone and global commodity prices in particular.

These issues are discussed further in our UK Economic Outlook report which also includes a look ahead to the Chancellor's high level options for the Budget. This is available at www.pwc.co.uk/UKEO.

For a more international perspective on economic trends, you can sign up for our monthly Global Economy on www.pwc.co.uk/GEW.

Figure 3: Regional trends



Source: ONS, Eurostat, PwC analysis

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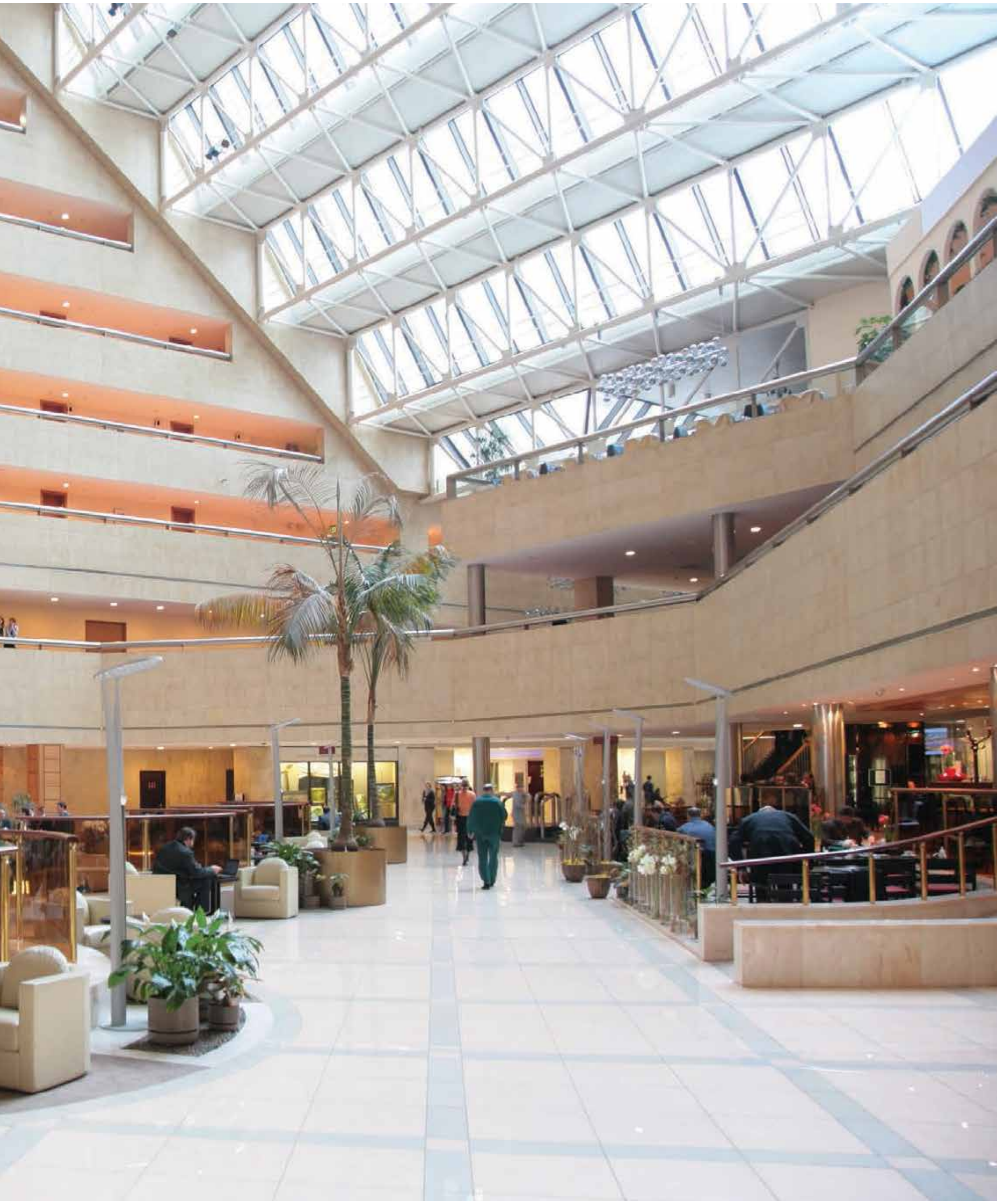

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