

MARKET OVERVIEW

The battle to restore confidence in companies

BY CLAIRE SPENCER

The global credit crisis has its roots in the Americas, and the impact there has been absolute. The old financial models have been swept aside in a cacophony of cutbacks, bailouts, and bankruptcies, and as the smoke clears, the region is preparing for a new future. 2009 represents the beginning of that future, but it is going to be a difficult journey into growth and profitability – the results of which will affect the recovery of the entire global economy. Despite numerous comparisons to the Great Depression, no crisis prior to this has been so widespread – American problems are global problems, and vice versa. As such, American companies must have a very different global stage in mind when establishing their restructuring goals and processes.

The Americas are struggling under the weight of five main issues: the credit crisis; stock market decline and volatility; currency fluctuations; fluctuations in oil prices; and employment. Access to credit ranges from expensive to impossible, depending on the quality of the borrower. This has been exacerbated by the failures of several large financial institutions over the past year – many of whom had damaging exposures to weakened financial assets such as subprime mortgages. The US government issued its first bailout (the \$700bn TARP) to try and get financial institutions to lend again, but the capital infusion has been used to shore up balance sheets, and lending remains frozen. The credit drought has been severe, and has led to some companies defaulting on their loan covenants, a trend which is projected to worsen in 2009.

Currency fluctuations and declines in consumer spending have had a negative impact across the board – notably on exports such as coal, timber, paper, and grains. Canada has found these currency fluctuations particularly trying. The US is its closest trading partner, and with the Canadian dollar so

strong against its US counterpart, demand for Canadian commodities in the US has dwindled. Equally disruptive has been the chaotic changes in oil prices. Summer 2008 saw record highs of around \$140 a barrel, and while few were prepared for the peak, fewer still were prepared for the sub-\$50 trough that would come mere months later.

In reality, unemployment is at reasonably low levels, but the uncertainty that has pervaded the markets still looms. For example, the fate of Detroit's Big Three automakers is yet to be decided, and while it is unlikely that they will be allowed to fail, job losses will be unavoidable. Concerns regarding the extent of these losses have helped to paralyse the automotive market, from its workers through to its consumers. Until it is clear that the market has hit the bottom, the pressure is on American companies to show that they are prepared for the worst. Ultimately, uncertainty is the glue that binds these issues together – market participants cannot plan for a future they cannot see, and the short term consequences of that are crises and chaos across all regions and sectors.

Widespread trauma and interim solutions

The distress has been extensive, but has been particularly relentless in the banking, real estate, automotive, and airline sectors. The US has had the lion's share of the financial sector problems due to its lightly regulated markets; Canada, with its strictly regulated and conservative banking system has escaped largely unscathed. However, there have been layoffs throughout the financial services sector, as well as the more widespread issue of inaccessible credit. Furthermore, it is thought that this will lead to consolidation within the alternative lending space.

Residential property has also suffered, effectively grinding to a halt across the board.

The commercial side of property is also cause for concern. "We went through a period in the late 90s and the first part of this decade where values were extremely high and perceived risk was low," explains Ian Ratner, a principal at GlassRatner Advisory & Capital Group LLC. "On top of that you had financial institutions that allowed this sector to operate at record levels of leverage. The real estate segment continues to suffer and there is universal concern that the trouble is migrating from residential to commercial and the commercial market is just starting to weaken," he notes. In most areas, housing prices are still in freefall, due a combination of constrained mortgage lending and buyers waiting for the market to 'hit bottom' before making their move.

In addition, the plight of the automotive sector is at the forefront of American consciousness; not only because of the number of jobs at stake, but also the importance of those brands to the people. Those in real danger of collapse – General Motors (GM), Chrysler LLC, and the Ford Motor Company – may be important, but they are only paying for years of operational inefficiency and mismanagement. Jonathan Cooperman, a partner at Farber Financial Group, believes that certain of their errors have now come back to haunt them. "In the past the auto industry has created strong sales often through the use of their vehicle leasing divisions which put more cars on the road, but with questionable profitability as these cars were returned 3-4 years later – with no recourse to the lessee and uncertain resale value. Significantly, some auto makers are now exiting the leasing business. Furthermore, the huge legacy costs associated with past employees are not matched properly against the real current revenue." Mr Cooperman adds that "when the auto industry is no longer growing, there are ►►

insufficient funds available to pay the albatross which they created.”

In general, all of these sectors are affected adversely by the growth of unemployment and the corresponding decline in disposable income and the drop in discretionary and mandatory spending by consumers. Another commonality is the short and medium term direction of energy costs, adds Anthony HN Schnelling, a managing director at Bridge Associates. “Airline costs are very high and consumers are flying less this holiday season which is depressing revenues. Furthermore, automakers are not producing sufficient numbers of energy efficient vehicles. It is imperative that they do this to attract those consumers who are afraid of being stuck with a gas guzzler if oil prices climb again.”

Deborah D. Williamson, a shareholder at Cox Smith, agrees that the rapid changes in oil prices have been causing significant difficulties. “We were experiencing significant oil and gas related bankruptcies even before the recent rapid drop in prices. When the prices were escalating, there were issues with availability of pipe and other materials. Combined with the high costs for drilling rigs, many producers found themselves over-extended and unable to complete drilling programs. With the rapid drop in prices, there is now an over-supply of some materials,” she says. Significantly, lenders who advanced based upon \$60 or higher oil are now putting pressure on borrowers to reduce their loans.

Central banks and regulators have taken various steps to try and relieve the pressure from the worst-affected areas, but the effects have not been instantaneous or even stabilising. However, “recent actions by central banks, governments and regulators have been crucial in reducing the probability of a further deterioration of financial institutions, minimising the deterioration of asset prices, and minimising the negative effects that this situation will have in the real economy,” notes Steve Smith, Global Head of Leveraged Finance at UBS Securities LLC. “There is less pessimism about the months ahead vis-à-vis September or October of this year; and the most recent actions by the US government are clear evidence of its commitment to using the country’s resources to stabilise the situ-

ation in the capital markets.” Governments, banks, and regulators have clearly learned the lessons of the Great Depression, and it is unlikely that the Americas will see anything quite like that this time around.

However, there are still some concerns, maintains Mr Ratner. “Is the approach fully thought out? Are the investments that are being made sufficient enough to make a dent? Several firms are extremely deep in the current crash in the real estate side of the world, and there is a view that the government’s investment must be significantly larger than it has been so far to really shore things up. Of course we should also get into the question from a policy perspective: should we allow things to work through the system, or should we prop them up with government intervention?” These questions will see answers in time – all that is clear right now is that the US bailout packages do not have the consistency to bring stability to the equity markets. Liquidity is not enough – governments across the Americas, and indeed the world, must work together as a unit to ensure that taxpayer money is used effectively.

Operational vs. financial turnaround

Unsurprisingly, the current and anticipated increases in corporate defaults can be traced back to the banks. As well as refusing to lend to new clients, they are desperately trying to reduce their exposures in other distressed sectors by lending less to their current, healthy clients in those sectors – including each other. This has served to increase the distress, leading to more defaults. “In addition, for companies which finance operations through the factoring of their receivables, factorers will reduce the amount that they will advance to companies because of the reduced creditworthiness of the companies’ customers,” says Mr Cooperman. “Even companies with invoices to established customers such as General Motors, Ford or Chrysler have found that the lenders’ assessments of the creditworthiness of such previously stalwart customers have been significantly reduced and therefore the amounts available by factoring invoices to these customers are in turn significantly reduced or not available at all.”

It is obviously desirable for companies to

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avoid becoming just another default statistic, and many will start to consider (if they haven’t already) a restructuring plan that will enable them to survive the crisis. However, restructuring is not as straightforward as it was two years ago, nor is it so easy to choose between balance sheet and operations-led efforts. On the one hand, operational change should ensure that the money is not lost in the first place – evaluating and improving the products, services, customers, processes, distribution, staffing and any other pertinent, potentially loss-making areas of the business. “Since easy and quick financing is gone, companies are compelled to focus on operational issues to downsize and hopefully survive without significant new financing, at least in the short to mid term,” says Ms Williamson. “In areas such as healthcare, operational restructuring is the focus because of systemic and long term decreases in government subsidies coupled with anticipated larger demand given the demographics of our population.”

On the other hand, this will not be suitable for all companies – for example, most oil and gas firms would be well-advised to focus on financial restructuring to give them breathing space while prices stabilise. “Operational ►►

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improvements are important, but the situation is so serious that when a company is going through a major balance sheet restructure with the hope of saving the company, slight improvements in margin in operations or efficiency gain is just not that important. When an enterprise is fighting to stay alive, decreasing the IT spend by a fraction of a percent, for example, is just not relevant,” asserts Mr Ratner. For most companies, financing is too important to be an afterthought in the current climate. Businesses need to achieve reasonable debt levels to achieve realistic profit levels and returns on equity.

Both approaches offer benefits to struggling American corporates, and as such it may not be possible to perform one without the other in the current climate. Take the dispute between Congress and the US automakers, for example. Congress will not agree to a bailout unless the automakers come up with a solution to their structural problems. This is fairly logical – they need a guarantee that taxpayer money will not be wasted on delaying bankruptcy. Ultimately, the need to restructure represents some form of structural and financial failure – they are now strongly linked, and

companies need to bear that in mind.

This is easier said than done. Clearly, companies that are able to renegotiate existing debt and raise new capital for their restructuring efforts have a much better chance of succeeding in the long term. “Sourcing any capital will be the problem,” suggests Mr Schnell. “Existing financing sources may be less willing to renegotiate than in the past unless their debt coverage ratios are so wide that they are willing to take the risk of restructuring debt to avoid liquidation of the assets. New capital is very much a problem at present because so many sources are busy trying to shore up their own balance sheets and not willing to put money at risk right now,” he says. Debtor-in-possession (DIP) and exit financing are particularly scarce at the moment, and where available, require a very lean business model that illustrates management’s commitment to operate in the new financial environment.

“Furthermore, DIP financing, if available, is even more expensive”, explains Mr Cooperman. “A business must have strong fundamentals to operate during the period of restructuring to generate sufficient cash flow to pay for this financing. In addition, as is often the case, the business needs sufficient core assets upon which a lender can secure the DIP advances. Even if the business does secure DIP financing that it might need during the period of restructuring, its lenders must themselves have sufficient resources to extend credit to allow for the debt to be renegotiated,” he says. Indeed, this has been a feature of the financial crisis: many lenders have no cash resources or available credit to continue with their business of lending. As such, they do not have the ability to extend credit to their customers.

In more fortunate cases, DIP financing may not be needed, and there have been an increasing number of instances wherein lenders are willing to accept a reduced payout or forego covenant defaults in a non-bankruptcy situation. As such, if a new source of capital can be located, the existing debt structure can be renegotiated without the need for a bankruptcy. There is no reason to suspect that this will not occur in time – historically, there are always entities waiting to capitalise on market distress. There is still liquidity in the Ameri-

cas, and that will eventually filter through to the businesses that need it. In the meantime, corporates should attempt to conserve their cash resources. There are many ways of doing so, including extending terms with suppliers, collecting accounts receivable from customers more quickly, turning over inventory more quickly, and selling off surplus assets. These measures are difficult to accomplish due to market conditions, but could buy much-needed time.

Formalities and barriers

Prior to the global financial crisis, many American corporates found it easier to reorganise outside of the formalities of Chapter 11 protection. This trend has not declined per se, but it has been through some changes. On the one hand, out-of-court restructurings have become increasingly popular in sectors such as real estate, with participants more than happy to do what is needed to waive the temporal and monetary costs inherent in the formal process. Of course, informal efforts still require capital, but it is often acceptable to conduct purely financial restructurings in this manner.

However, such simple restructurings are quite rare, and if there are overriding operational issues (particularly when significant job cuts are imminent), then a full bankruptcy is more usual. Indeed, the notable absence of quick and easy financial fixes may actually drive more companies into formal bankruptcies, which may buy them some time to slim down operationally before the lending markets pick up again. Furthermore, paying difficult creditors may not be possible on an informal basis. Many creditors will feel that a hard position is necessary for them to protect their interests, and will want to ensure that there are firm rules and processes in place that treat all stakeholders equally. Also, if the resolution is an assets sale, potential buyers will often require formal approval to be assured of their quality.

A popular compromise has been to conduct restructuring negotiations pre-filing, which enables bankruptcy proceedings to become short and effective. Either way, the earlier a firm starts to deal with its financial difficul- ►►

ties, the greater its chances of success. Generally, stakeholders cooperate if they perceive that management are dealing with the problem – it is in their best interests to do so. On the other hand, if they themselves are short of cash, they may be less inclined to acquiesce. Ultimately, such intricacies should be decided on a case by case basis – there is no ‘one size fits all’ restructuring solution. All restructurings are expensive on some level, and require confidence in management and confidence in the process. It is the lack of confidence that is making it difficult to reorganise, rather than a lack of capital.

This is a critical point. Satisfying creditors is of utmost importance – in many restructuring efforts, it is they who can decide whether a company disappears or survives. However, the increasingly complex lending structures seen in the years leading up to the subprime crash may have created a timebomb of intercreditor strife to come. “Lending structures will definitely play an important role in creditors’ negotiations,” says Mr Smith. “Intercreditor battles are likely to make restructuring efforts more difficult, but will not necessarily derail these efforts. For example, the second lien market is a relatively new market and there are few precedents of restructuring transactions with related intercreditor issues.” Hiring a skilled Chief Restructuring Officer (CRO) and a supportive management team may help mitigate these situations by directing dialogue and supporting beneficial creditor positions. However, if it takes too long and delays capital inflows, the business could be at risk. Ultimately, the level of success in these negotiations relies on choice – for example, if one of the creditors is in a financial position to pay out another creditor, the conflict is easily resolved. However, this option is not always available.

Naturally intercreditor conflict will always occur in large, complex cases, and while not all creditors are willing to put a company’s long term survival over their short term gain, many will be. “My sense is that, at least right now, all parties at all debt levels are very focused on making accommodations to allow the pieces of a full puzzle to be properly arranged,” notes Ms Williamson. “They know that the option of foreclosing on their security is not attrac-

tive and thus have an incentive to allow other lenders to benefit, to a point, if the ultimate deal materially benefits the primary lender. As secondary markets for collateral improve, this mutually assured destruction awareness will lessen, and I suspect that intercreditor issues will re-emerge,” she says.

This is likely to have an impact on more rigid structures such as pre-packaged bankruptcies and Section 363 sales. These require all large stakeholders to agree on a course of action in advance of a filing. In many senses, they are highly appropriate for uncertain times, but intercreditor issues might prevent them from taking a stronger hold. However, they can be very useful in cases where a business has a few large, agreeable creditors and many smaller, dissident ones. In addition, recent BAPCPA changes to the timescale of bankruptcies may force some companies into timely pre-packaged processes.

However, Section 363 sales are still declining in popularity – with fewer entities able to buy, the prices associated with such sales are in freefall. Furthermore, the courts are increasingly of the opinion that such sales are being used to circumvent the plan process and avoid the scrutiny that plans focus on such sales. On the other hand, “sale transactions in jurisdictions that allow Section 363 sales or equivalents under domestic law can be an expedited way to transfer parts of a business so as to efficiently effect an operational restructuring by selling the more viable parts of the business,” explains Ken Kraft, a partner at Heenan Blaikie. It is likely that there will be a greater impetus to sell assets, particularly if bankrupt companies are liquidating. However, whether most sales will occur through Section 363 sales, or a part of a liquidation or reorganisation is hard to say.

Regional concerns

While bankruptcy is a costly, disruptive, and lengthy process in all jurisdictions, there is a fair amount of variation as to methods and eventual goals. “Insolvency laws, particularly in common law countries, tend to favour saving a viable business, although the exact methodology to accomplish this varies from country to country,” explains Mr Kraft. “The one area

where there is weakness, however, is with the potential insolvency of financial institutions. Most jurisdictions do not treat them differently and the result can make it virtually impossible to reorganise a financial institution and so the only choice is to liquidate.”

Naturally, the US also has its own concerns. Amendments to the US Bankruptcy Code have imposed stringent time limits on debtors with respect to exclusivity, the plan process, and several other areas. This means that the more complex restructurings will be difficult to accomplish within these mandated periods and may drive many debtors which could be restructured to liquidate instead. This issue has manifested itself in several sectors. “One of the biggest issues we have encountered is with the short window for decisions on real estate leases,” explains Ms Williamson. “The now extended time it can take to slim down operationally and thus attract new financing can run a retail debtor solidly into the wall of mandatory lease rejection/acceptance deadlines. However, the absence of obvious replacement tenants in the current environment is likely to make the landlords somewhat more reluctant to pull the trigger on the lease rejection process if a tenant can show a rational business plan to survive in place,” she adds.

Many things about the market are opaque at this stage, but what is clear is that the Americas can expect a significant wave of bankruptcies in 2009. Whether this wave will bring more liquidations or restructurings is less clear. The US, the region’s main economy, has always preferred the latter, and distressed companies are generally keen to take that option where possible. However, unless the second government bailout loosens the credit markets, they may be forced to liquidate against their wishes. Confidence in the market is at an all-time low, and governments across the Americas need to work together to ensure that viable businesses still have the option to restructure. ■