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Corporate Finance & Restructuring

Assessing the Value of Distressed European Corporates

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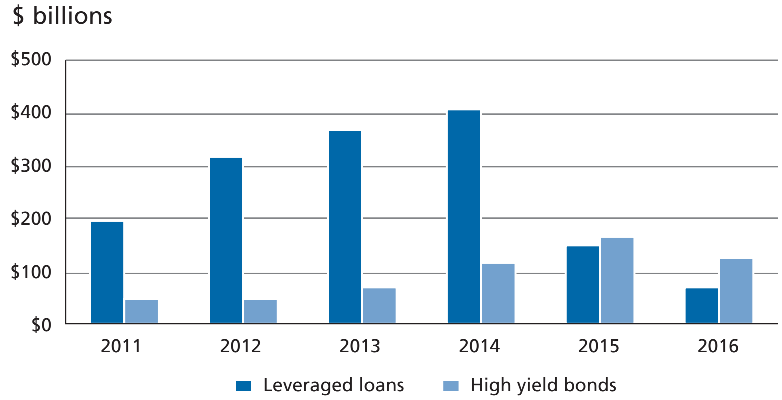
At present, the largest and most creditworthy European corporates have access to exceptionally favourable financing markets and sub-investment grade corporates are benefiting from an active high-yield market. Investors in and creditors of stressed and distressed corporates, however, face an unprecedented set of challenges: **Assessing the value of stressed and distressed businesses and deciding how best to protect and extract that value has never been harder.**

This is due to a lack of robust forward visibility and uncertainty over value and options for financial stakeholders, as a result of a combination of potent factors, including the rapid onset of the recent recession, the sudden bounce back (at least in sectors like automotive, machinery, shipping and aviation), the transformational impact of the rise of China and India and the uncertain macro-economic outlook and impact of fiscal tightening programmes.

This lack of forward visibility is compounded by the refinancing challenges faced by significantly indebted businesses. Many companies still carry the burden of large debt packages from the bull market years prior to the credit crunch. Large volumes of buy-out financing and mezzanine programs must be refinanced—with peak refinancing volume coming in 2012-2014 (Exhibit 1). Unfortunately, many of these financings had

Exhibit 1: European Debt Maturity Profile



Source: Oliver Wyman analysis.

originally been based on aggressive growth plans that cannot now realistically be delivered. Concerns over the prospect of increasing interest rates and competition from the enormous volume of sovereign and bank financing activity further compound the challenge.

Understanding the Root Causes of Stress and Distress

Despite these challenges, there has been a recent marked reduction in European financial restructuring—in part because of the recovery of valuations and in part because of the reluctance of banks and other creditors to crystallise losses. In many cases, this caution has been rewarded by a recovery in asset values. But playing for time and seeking "amend and extend" agreements with bankers has not been and will not be the best route forward if structural change is eroding underlying business value—especially for investors and/or creditors holding the fulcrum security.

Conventional tools of historical financial analysis and top-level "strategic" reviews by industry outsiders however are often a poor guide to longer-term economics, long-term debt capacity and value. They are also a poor basis for making decisions on what operational and financial restructuring may be required or the relative attraction of strategic transactions. (In this environment, it should be no surprise that over 90 per cent of leveraged loan covenant breaches have been dealt with on an amend and extend basis or through interminable negotiation.) So, what must investors and creditors do to make informed decisions around stressed and distressed businesses?

First, to gain meaningful insight into the real causes of stress and distress, one must identify and understand the interaction amongst industry drivers, the macro-economic environment, excessive leverage and management performance. For instance, it is important to distinguish between ordinary cyclicality, material change and transient shocks in creating tough trading conditions. For example, the aggressive behaviour and rapid advance of Chinese players into the high-speed rail industry has adversely impacted Western businesses in this industry. On the other hand, the German machinery industry, which has experienced an extraordinary export-driven recovery, is unlikely to be able to sustain its recent rates of growth.

Secondly, it is crucial to understand how these factors are likely to play out in the future and what the real options are for *combinations* of strategic, operational, organisational and financial restructuring. Depth of industry expertise is key: To assess the potential economic value and debt capacity of a business, as well as potential strategic options, it is necessary to understand probable market evolution, how competitors (new and old) are likely to behave and what the ultimate effects will be on future corporate competitiveness and operating economics.

Insight around strategic options and potential performance is necessary but not sufficient to enable investors and creditors to maximise value. Operational insight and expertise, however—knowing which levers to pull, how to pull them and what can be delivered, in terms of cash and other short-term measures—is critical to the design and successful execution of turnaround programmes.

The Value of a "Deep Dive" Review

In many stressed and distressed businesses, the underlying problem may be easy to identify—e.g., excessive leverage or a weak management team. And, in these cases, the solution may be straightforward, with the only input required by investors and creditors being a simple financial review of recent performance and current financial position.

But for those businesses where problems are the result of a mix of strategic, operational, financial and management issues—especially where the stress or distress has been compounded by the interaction of two or more of these factors—a conventional independent business review (IBR) will not be enough. Instead, what is required is a focused, deep dive examination of the firm's underlying strategic position and outlook that draws on profound industry insight and expertise, as well as on a hard-headed view about what actually could be achieved through an aggressive strategic and operational restructuring. Such a deep dive IBR can thus lead to greater insights into potential value and reduce risk around required execution.

In our experience, the level of challenge and complexity, and thus the need for such a deep dive IBR, is mainly driven by one or more of the following factors:

- **Material shift in demand:** driven by, for example, major changes in global market demand and/or customer needs
- **Fundamental changes in competitive dynamics:** such as the arrival of substantial new entrants, new business designs, fundamental technological changes and/or a step change in cost benchmarks
- **Lack of clarity around strategic positioning and operations**
- **Lack of business transparency:** lack of clarity on (or reasonable forward visibility into the drivers of) the profitability of business segments and liquidity
- **Poor record of execution:** management teams consistently under-deliver; it is unclear how much of the potential for improvement realistically can be captured
- **Poor alignment around strategic and operating objectives:** differences within the management team, or differences in objectives between management and investors, create confusion over direction and undermine implementation

The more of these factors that are present, the more an independent deep-dive review of the business by industry and restructuring experts becomes necessary. That said, every restructuring case is unique and, in our experience, the best solutions come from combined efforts that draw on the best of thinking from management, financial stakeholders and advisors.

These challenges and the value provided by an intelligent IBR can be illustrated by some of Oliver Wyman's recent work with clients across a range of industries (Exhibit 2).

Exhibit 2: **Example Oliver Wyman Deep Dive IBR and Turnaround Projects**

The Client	The Challenge	What Oliver Wyman Did	The Result
World leading machinery company based in Western Europe, with large export business (40% share of global market), strongly profitable and unleveraged	▪ Sudden dramatic (40%+) drop in revenues as customers cut back, dramatic onset of indebtedness – expected to become unsustainable within 12-18 months ▪ China the largest market and most potent source of rising competition	▪ "Deep dive" IBR confirmed fundamental strength but also need to change manufacturing footprint to address cost base issues, threats and opportunities from emerging markets ▪ Supported manufacturing operations and overhead restructuring programme—working closely with CRO	▪ Comprehensive turnaround and strengthening of business—which is now even more profitable
Western European-based electronic components distribution business, historically modestly profitable	▪ Recession resulted in 25% fall in revenue; business had become loss making with no clarity on how it might recover ▪ Unclear strategic positioning, low transparency and confidence in plans and forecasts ▪ Significant differences on objectives and strategy between stakeholders ▪ No long-term financing arrangements in place, all facilities callable at short notice	▪ Formal (IDW) viability assessment ▪ Deep dive IBR highlighted weak strategic position and need for significant change in strategy as well as material improvement in operating performance to sustain long-term debt obligations ▪ Developed restructuring plan and supported comprehensive operational restructuring programme ▪ Supported communications with lender group and carried out ongoing cash monitoring	▪ Return to profitability and significant improvement in liquidity ▪ Clear strategy and operating plan and long-term financing put in place ▪ Buy-in from shareholders and lenders on the strategic plan and financing
Regional industrial security services business, which had been acquired by a private equity buyout fund on the basis of an aggressive growth plan	▪ Following the recession, sales and profits dropped significantly and came in far below the buyout plan ▪ Core business was now loss making as a result of price pressure in the market, exacerbated by operational weaknesses ▪ Multiple changes in top and middle management ▪ Not enough liquidity to cover debt service; the company faced insolvency within weeks	▪ Assessed fundamental attractiveness and potential profitability of the market ▪ Assessed company's ability to keep and expand market share in core business ▪ Formal (IDW) viability assessment, including determination of potential profits and debt capacity ▪ Defined comprehensive action plan for sales growth and margin improvement ▪ Defined boundary conditions for financial restructuring concept	▪ Clear roadmap for turnaround put in place, which management has begun executing ▪ Trust of shareholders and lenders in company's commercial viability achieved ▪ Consensual solution for financial restructuring achieved

Oliver Wyman's Approach to Assessing Distressed Businesses

Delivering maximum value to investors and creditors requires drawing on a combination of strategic, operational and organisational insights and expertise—as well as legal, accounting and investment banking skills.

Oliver Wyman is distinctive in its depth of strategic and operational expertise in key industrial sectors, its sophisticated financial analytics—built on its position as a leading advisor to the commercial and investment banking industry—and its integrated restructuring capabilities. These abilities enable Oliver Wyman to provide its investor and creditor clients with truly insightful, objective and actionable deep-dive IBRs and robust assessments of value and debt capacity, strategic options and management imperatives, with a goal of delivering maximum near-term cash and long-term value.

For more information on Oliver Wyman's corporate restructuring and finance capabilities, please contact your account representative or one of the following partners:

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Oliver Wyman's Corporate Finance & Restructuring practice offers strategic and transaction expertise to complement the in-depth market and industry knowledge of our expert industry groups. Our practice undertakes more than 250 projects annually for financial sponsors, creditors and corporates. Our capabilities include support for investment, divestment, M&A, project finance, restructuring/workouts, privatization/PPP, concessioning and litigation.

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