

# Restore 01

The turnaround magazine

ADVISORY

## **Enter the CRO**

How Chief Restructuring Officers can transform an ailing business

## **Bowing out**

When an exit from a market is inevitable, it is vital to get the strategy right

## **Market analysis**

Our specialists discuss some of the key trends driving restructuring activity in Europe

## **New players**

Is the growing interest of hedge funds and private equity in distressed debt a good thing?

## Welcome



Relatively low interest rates, steady inflation and generally robust company earnings have encouraged many businesses across Europe to move into new markets. M&A activity has been strong, and with banks and funds eager to lend, finance is readily available. Meanwhile, private equity (PE) houses are increasingly making their presence felt. Flush with cash from institutional investors, they are hungry for deals, and few companies are too big to fall outside the range of these new 'kings of capitalism'.

All of this has had an impact on the restructuring market. High levels of bank lending have exposed companies to the risk that if a particular market sector turns down, servicing debts can become a real problem. Meanwhile, turnaround strategies are often high on the agenda when a PE House buys a business or backs a management buyout. This means there is plenty of corporate restructuring activity going on, much of it involving some element of cross-border work.

By launching *Restore* magazine, we aim to provide regular intelligence on a changing restructuring market. In this issue, we feature a round-table debate on some of the latest trends in restructuring, and a look at how to make a good exit, the role of the Chief Restructuring Officer, and new players in distressed debt. Welcome to Issue 1.

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## In the round

**Economic conditions in Europe have led to more bank lending and a rise in M&A activity. Philip Davidson and Tammo Andersch, Partners at KPMG in the UK and Germany respectively, discuss how this is affecting business restructuring internationally.**

**What trends are you seeing at the moment? Are there any sectors where there is a lot of recovery and restructuring work taking place?**

**Philip Davidson:** The early part of this decade was dominated, in restructuring terms, by technology, telecoms and power. Specific market discontinuities caused fall out in these sectors despite prevailing benign economic circumstances. Recently the only sector that has created restructuring work consistently is automotive.

**Tammo Andersch:** When you see a shake out in any particular sector, the weaker companies – those that aren't growing as fast or performing as well as their competitors – tend to have problems.

**You say that the economic circumstances are benign and yet there's still quite a lot of corporate recovery work going on. What are the main factors causing this?**

**PD:** Corporate borrowing has increased over the last few years. Availability of liquidity has reduced the cost of borrowing both financially and in terms of control. KPMG firms have seen an increase in highly leveraged transactions funded on the basis of growth plans and sometimes these plans have been difficult to deliver. Typically, given the wealth of available funding,

underperforming companies can refinance or reschedule their debts. Eventually, though underperformance will need to be fixed. What the industry is seeing, therefore, is the crystallisation of some of this underlying underperformance against promises.

**TA:** Yes, companies appear to be increasingly highly leveraged and that means there is less room for deviation from the business plan.

**Private equity (PE) funds have emerged as a power in the economic landscape across Europe and, of course, many of the highly leveraged transactions that you talk about will involve PE houses. What impact are they having on KPMG firms' work?**

**TA:** Our firms' restructuring practices have a strong relationship with PE houses, and they are becoming more and more important. Sometimes when they invest, they don't have a clear exit strategy, and in order to achieve an exit they will have to turn around a business. We work with them, providing services such as cash management, and that can provide real value.

**PD:** One trend we are seeing is banks selling their debts to parties, such as PE houses and hedge funds. The debt market is very liquid at the moment and that shows no sign of reduction.



**How is increased liquidity affecting companies that are going through financial distress?**

**PD:** Increased liquidity has created a rich landscape of diverse investors. Different types of investor often have different investment criteria. What no longer works for one investor might be right, subject to pricing, for another. If lenders want to exit a difficult situation, there will usually be plenty of others who want to replace them. For companies in distress, this can mean a major change of their financial stakeholders – new faces, new expectations and, sometimes, new management.

**Meet the advisors...**



Philip Davidson, a Partner in the UK firm, helps companies return to full performance.

He has worked on assignments across a broad range of sectors and jurisdictions, from Europe to the Americas.



Tammo Andersch, a partner at KPMG in Germany, advises European companies and their stakeholders in restructuring.

His work includes cross-border liquidity investigations, the preparation and restructuring of plans, and corporate recovery advice.

**TA:** Another trend is that banks are taking out insurance policies against the debt default. A company's future could end up in the hands of an insurance company.

**There appears to have been a lot of cross-border M&A activity lately. How much of KPMG firms' work is international at the moment?**

**TA:** I would say that about half of our projects have a cross-border element. That can be challenging, but KPMG firms make up an international network which helps give us the ability to work across jurisdictions.

**PD:** The countries in the Europe, Middle East and Africa region (EMA) have as many different legal and regulatory approaches to restructuring as you will find around the rest of the world. It is vital to work with local professionals who know what can and can't be done.

**TA:** Even the range of services that KPMG member firms offer varies from country to country. For instance, while in the UK it is possible to appoint a Chief Restructuring Officer (CRO) to a board. We are not permitted to do that in Germany.

**KPMG firms provide restructuring and recovery services across just about every sector. In practice, how does that work? For example, does**

**a CRO need to be a specialist in a specific sector, or do they tend to be generalists who can apply their skills to any business area?**

**PD:** When our firms work with clients on a restructuring, we will use a team of people, and some members of that team will have skills and experience that is specific to given sectors. We have no shortage of sector specialists in KPMG.

**As you've said, the economic circumstances are benign at the moment. But are there any clouds on the horizon that could spell trouble for highly leveraged businesses in the near future?**

**TA:** I believe that demand for raw materials will push up prices and that can trigger financial problems.

**PD:** Because there is so much borrowing, any deterioration in the economic environment may result in work for KPMG firms in the future. **R**

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## Don't let the door hit you

Getting a market exit wrong can be very bad for business. The Economist Intelligence Unit offers advice on what approach to take.

In October 2006, George Bush signed an act that outlawed online gambling in the U.S. Sportingbet sold its U.S. business for a nominal fee of U.S.\$1 to rival firm, Partygaming, calculating that its exit from the U.S. market would cost U.S.\$250 million. Legislation changes like this that force companies out of markets are thankfully rare, but businesses should think about how they are going to make a graceful exit when it all goes wrong should the need arise.

When it comes to deciding what to do with unsuccessful parts of the business, companies usually have three choices: fix it, sell it or close it. Of course, these

are not isolated components. Failure in a market might require a combination of some or all of these elements, with some assets being sold off, some relocated and others shut down entirely. The recently announced exit of Chinese television maker TCL from much of its European business, for example, involves the sale of some assets and the closure of others as it rationalises its overseas operations.

Fixing the problem is usually the first step companies take, but there is now more pressure to shed loss-making divisions rather than go through a lengthy process of patching them up.



## **“A French company had to pay 4.3 million euro to 270 employees on the grounds that the rationale behind the closure of a French factory was inadequate”**

Pascal Bonnet, Head of Restructuring, KPMG in France

too. One reason for this is that there is a lot more money around. Companies are constantly being assessed by hedge funds and private equity firms. “Hedge funds are increasingly looking for opportunities to generate value by buying into equity as well as debt, particularly where they see the scope for cost savings,” says Richard Heis, UK Head of Formal Restructuring at KPMG. “This can have a positive impact as it constantly challenges Chief Executives to justify the status quo and ensure they realise the savings themselves, before someone else does.”

Similarly, the drive for innovation means that product-and-service exits are likely to increase as their lifecycles become ever shorter. Companies are also increasingly experimenting with different business models to diversify and spread risk, but this means products and services will frequently be scrutinised for profitability.

Multinational companies are also under pressure to find economies of scale by consolidating manufacturing plants, call centres, software development teams and so on. Usually when this happens, something somewhere gets shut down or sold. And, while this may be less of an issue in the IT and telecommunications sectors, for example, it can be a big issue in manufacturing. A redundant software developer may well find work the next day, but a dye maker or a machinist might have to retrain in order to get a new job.

### **The art of the exit**

Exits are tricky and fraught with legal, financial and industrial relations hazards and there is an art to getting them right. Unfortunately, many companies can still make a hash of it, attracting negative press attention, damaging their brand, or worse.

“Closing plants in France is becoming increasingly risky, as the company’s works council is a critical factor in the process and can denounce any perceived irregularity to the courts,” says Pascal Bonnet, KPMG’s Head of Restructuring in France. “As an example, a major French company was required to pay a total of 4.3 million euro to some 270 employees, around 15,000 euro each, on the grounds that the rationale for the closure of a French factory and the information given on potential redeployment were inadequate.”

If efforts to resuscitate the failing division haven’t worked, companies will next try to sell it off. Only after that has failed will someone make the decision to close it down entirely.

Exiting a market is not something that companies do lightly. Cable & Wireless operates in a lot of emerging markets where there are often strict rules on foreign direct investment that can make it very difficult to exit. “The reason that the regulatory authorities approve local joint ventures is because they believe that you’re committed to investing in their home economy over a long period,” says Mike Barnard, Director of Marketing and Strategy at Cable & Wireless, “so to pull out can be effectively kissing goodbye to being a significant player in that market for a long time.”

But when an exit becomes necessary, companies typically seek to minimise the pain by selling off whatever assets they can. Cable & Wireless, for example, exited the U.S. market in 2004 by selling its business there for U.S.\$155 million to SAVVIS Communications. A business has to be severely challenged not to be sold, because there is currently so much money chasing after the available

‘Fail fast, fail cheap’ seems to be today’s corporate mantra. Sometimes it makes sense to relocate a division or manufacturing plant to a site that is less costly, such as when Dr Martens Airwair moved its manufacturing arm from the UK to China. Finally, there is selling and closing. These can be the more emotive options and may require a carefully constructed exit strategy.

The rise of shareholder activism is forcing senior management to continually review their portfolio of businesses. American shareholders have often been a vocal group, but now their habits are taking hold in Europe,



**“When an overseas investment is made, there is usually a huge amount of due diligence conducted before getting into that market, but very little consideration of the costs of getting out if it all goes wrong”**

Richard Heis, Partner, KPMG in the UK

assets, especially with the current number of private equity (PE) firms looking to invest their funds. Even businesses that are not particularly appealing are being bought rather than closed, although this may require a significant reverse premium to be paid, such as in the recent sale of MFI Furniture's retail arm to PE firm, Merchant Equity Partners (MEP).

Although company directors are under closer scrutiny by shareholders than ever before, there are more options when it comes to deciding what to do with an unprofitable division nowadays. The new attitude towards openness and collaboration means that companies are more creative with the way they work, especially with adjacent players in the value chain.

But sometimes the best option is the closure of a division and the piecemeal sale of its assets, as with the sale of retailer C&A's stores after leaving the UK market in 2000. The closure option should always be considered during the decision-making process, even if it is often seen as a last resort, as it will usually have some advantages. For example, it may protect any remaining businesses from additional competition or produce a better return than a sale.

However, the right preparation is vital for a closure to be beneficial. “Poor planning and implementation of a

business closure will lead to delays, costs getting out of hand and damage to the remaining business, plus potential personal liability for shareholders,” warns Karsten Heilemann, a Director of KPMG in Germany.

#### **Honesty is the best policy**

Whether companies are selling or closing a division, it is vital to get the public relations (PR) right. Poor PR can kill investor and customer confidence. Clearly, effective PR is going to be more important for a high-profile organisation. Marks & Spencer's exit from its continental European business, for example, caused a lot of media interest, but most of it was negative.

A common PR blunder is talking to the analyst community before any other stakeholders. “Make sure your staff don't read it in the newspapers first,” says Jim Donaldson, Managing Director of Corporate Communications at PR firm Hill & Knowlton.

For companies bound by stock exchange rules, which dictate that the investor community needs to be informed of divestments first, there is no reason why any communication cannot be sent to the rest of the stakeholders a few minutes later. A lot of corporate communication is focused on keeping shareholders comfortable, with less thought given to employees, suppliers, distributors and others. What's more, it is not just divestors who should be worrying about good PR; the buyer of the divested company should be concerned, too. After all, they need to justify why they are taking on what is often seen as a poorly performing unit.

#### **Planning ahead**

As companies battle in increasingly competitive marketplaces, exits are more than likely to increase, especially for businesses pursuing a ‘fail fast, fail cheap’ strategy. Given this, you might think that there would be more domain expertise in this area, especially when it comes to closures. Many people see exits as being the flip-side of acquisitions. But while a lot of companies have built up teams to specialise in acquisitions, few companies have formal structures for dealing with exits, especially when a sale cannot be executed and a closure is required. To use management-speak, there is a lot of reinventing the wheel.

#### **Exit checklist**

Consider possible exit strategies when entering a new market. You can't know the unknowable, but some plans can be put in place to make the exit easier if the time comes.


You can't pay enough attention to public relations. Mess up the message and you could do irreparable damage to your brand. The amount of negative column inches firms accrue is usually inversely proportional to the amount they communicate.

When exiting, soften the blow for local stakeholders in order to re-enter the market at a later date.

If your company finds itself entering and exiting markets on a fairly regular basis, consider building and retaining in-house expertise, or at least conduct a post-exit review so that you have a record of ‘lessons learned’.

Learn to fail fast. Divestments are seldom popular, but the appearance of having weak management can be even more devastating.

Get the valuation right. Don't undersell.



**“As you see a higher frequency of exits taking place, companies will also end up building skill and some expertise”**

Phanish Puranam, Assistant Professor of Strategic and International Management at the London Business School

“When an overseas investment is made, there is usually a huge amount of due diligence conducted before getting into that market, but very little consideration of the costs of getting out if it all goes wrong,” says KPMG’s Heis.

Despite the regularity with which some industries enter and leave markets, few companies plan their exits in advance. Exits are nearly always a reaction to change. When Cable & Wireless, for example, enters a market, they do so with an enormous investment in infrastructure. “Actually pulling out of those markets is something that we wouldn’t have a plan to dust off at any moment in time because we would have ticked off all the risks and concerns before we invested in the infrastructure,” says Cable and Wireless’ Barnard.

If the assets are highly specialised in some way, it can be difficult to sell them when the company decides to close that particular division. Not enough businesses give thought to how they structure their assets, considering which to buy and which to lease, in the context of potentially having to exit from them in the future. Getting this right can save an enormous amount of money when it comes to closing shop.

Companies are not closing down businesses or selling off divisions at a high rate compared to the speed at which they are entering new markets. Many exits happen through gradual decay and decline, but things are beginning to change. “As you see a higher frequency of these exit deals taking place, I think that companies will also end up building skill and some expertise,” says Phanish Puranam, Assistant Professor of Strategic and International Management at the London Business School.

As the market gets more efficient and as the analysts and shareholder community exercise more influence on the portfolio composition of corporations, the pressure to justify why any business should be in the portfolio is likely to continue to increase. **R**

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**“Poor planning and implementation of a business closure will lead to delays, costs getting out of hand and damage to the remaining business”**

Karsten Heilemann, Director, KPMG in Germany



## Enter the CRO

Whether called in by lenders and investors or appointed by the company itself, Chief Restructuring Officers (CROs) can play a hugely important role in turning a business around. John Darlington, Head of CRO services at KPMG in the UK, explains.

There's probably never been a better time for European companies to borrow money. Not only are banks across the continent lending more – borrowing currently exceeds £500 billion – but they have also tended to soften their covenants and eased their policies on borrowing as a multiple of earnings. With interest rates remaining relatively low, this has given businesses a chance to borrow cheaply without many of the onerous conditions that prevailed in the early and mid-1990s.

By and large, this has had a positive impact on the European economy. With abundant finance available, companies

have been expanding organically and by acquisition – often across borders – while private equity (PE) firms have also taken advantage of the availability of credit to support their buy-out plans.

However, the willingness of banks to lend, coupled with softer terms and conditions, has exposed borrowers – and indeed creditors, lenders and investors – to the risk that any financial problems will be addressed later rather than sooner. For instance, covenants impose a certain discipline on borrowers. If a covenant is breached, alarm bells ring and the lender demands action. Soften those covenants, and potentially fatal financial problems may not be exposed until much later. What's more, the longer a problem is left to fester, the harder it can be to put right.

As Head of Chief Restructuring Officer (CRO) services at KPMG in the UK, John Darlington is well positioned to assess the consequences of late action. KPMG in the UK currently provides CROs at the request of both distressed companies and stakeholder groups, such as lenders and investors. As he observes: "Because of the softer terms, we're being called to look at situations much later," he says.

This could have unforeseen consequences for borrowers, as banks have become increasingly willing to sell their debt to third parties, rather than negotiating a turnaround strategy with a customer. "We're seeing a lot more trading of debt, even among banks that have traditionally been strong supporters of corporate recovery," says Darlington. "One reason is that there is much more liquidity in the debt market. It has become much easier to sell debt."

Indeed, the emergence of both PE and hedge funds as powers in the economic landscape have added to the liquidity. Within both those communities, distressed company specialists have been active in buying discounted debt. This isn't necessarily a bad thing for the company in question. PE companies, in particular, have earned a reputation for

### John Darlington



John Darlington joined KPMG in the UK in 2006, bringing with him a wealth of experience both as a company director and a restructuring specialist.

Between 2003 and 2005, he was restructuring officer at MyTravel, playing an active role in planning and implementing the turnaround of a tour company that had seen its business badly hit by the 9/11 disaster. Prior to that he was a special advisor to drinks company HP Bulmer at a time when it was restructuring its business.

He is Head of Chief Restructuring Officer services at KPMG in the UK.

adding value by taking a pro-active approach to management and strategy. However, distressed companies should be aware that both hedge funds and PE funds will have a different agenda to the banks.

Indeed, a transfer of discounted debt may well result in a debt-for-equity arrangement, which will give the new owners a direct incentive to build a successful new business from the ruins of the old, and ultimately take a profit on exit.

### The role of the CRO

Regardless of who owns the debt, it is in everyone's interest that a distressed company is turned around as quickly as possible, and in these circumstances the appointment of a CRO has become common. As Darlington admits, this can be a bitter pill to swallow. "Sometimes it is the company itself that appoints a CRO, but often the appointment will be made on the instruction of the stakeholders," he says. "For some companies, the CRO is a reluctant hire."

Understandably, the arrival of an outsider may be greeted with suspicion by existing staff, and some assignments

are more diplomatically tricky than others. For instance, if the CRO is there to strengthen the existing management team, the initial relationship may be guarded, but it will most likely be positive. If, however, the CRO's arrival heralds a round of board and senior management changes, winning hearts and minds may not be so easy.

But whatever the situation, the CRO needs to show – and rapidly – that his presence on the board can add value. "One of the things I do is try to show some quick wins," says Darlington.

Even then, the CRO will almost inevitably meet resistance from someone within the organisation. Companies find themselves in financial distress for a whole variety of reasons. Sometimes it is because the management team is not as strong as it should be, but it's equally common to find good managers struggling with a flawed corporate strategy. In these circumstances, the CRO faces the task of helping boards recognise that the company needs to do more than simply shed staff or tighten up on its cash flow, and that the only answer is a change of direction. "What people have to realise is that the CRO is there to change the game," says Darlington.

That can mean a root-and-branch rethink. For instance, Darlington cites the example of a company that had been spending heavily on research and development, launching new products into the marketplace. It was an ambitious strategy, but it was also one that was harming the company. "The cash flow simply could not support business development on this scale," Darlington recalls.

To put the company back on track, it was necessary to take radical steps. Two thirds of its products were taken off the shelf, allowing the business to focus on the lines that were making money.

In another case, Darlington was involved in managing a series of asset

**“The most important weapon at the CRO’s disposal is the ability to communicate exactly what has gone wrong with a given company and win a consensus on what can be done to put it right”**

disposals to enable a client to escape a crippling expensive mezzanine facility.

Changing the rules of the game, invariably means ripping up plans that may have been lovingly nurtured by Chief Executives and their senior management colleagues, and in these instances, the challenge facing the CRO is to achieve buy-in. To be effective, the restructuring officer needs more than tacit backing for a particular course of action – he or she needs a real mandate to take action and bring about change.

To achieve this, one of the most important weapons at the CRO’s disposal is the ability to communicate exactly what has gone wrong with a given company, and win a consensus on what can be done to put it right. Sometimes this can be relatively straightforward.

As Darlington says: “It’s easy to win support, if it is clear to everyone that the consequences of not changing could be disastrous. Once the reasons for what you’re doing have been clearly communicated, you find you pick up supporters in the company quickly.”

However, if agreement isn’t forthcoming, a good CRO must be prepared to exercise power, and, if necessary, face down those that are

reluctant or unwilling to give support. “You have to speak softly, but carry a big stick,” says Darlington.

Winning board support may be a big hurdle, but the immediate prize for the other directors is that they are free to get on with the nuts and bolts of running the company, such as winning clients, negotiating with suppliers, talking to investors, while the CRO takes charge of the corporate recovery plan.

#### **Faith can be rewarded**

Nothing is guaranteed of course, and for banks in particular, calling in a CRO is something of an act of faith. The choice they have is stark: instruct the borrower to bring in a third-party fixer in the hope and expectation that a successful turnaround will be achieved, or cut their losses and sell the debt at a discount.

Increasingly, many banks are choosing to take advantage of a liquid debt market and sell, but, as Darlington points out, if the company in question can be turned round, those who sell their debt may well be losing out on the upside. For instance, when a post 9/11 downturn in the holiday market triggered a cash crisis at tour operator MyTravel (formerly known as Airtours), lenders agreed an £800 million debt-for-equity swap, which left existing shareholders with just 4 percent of the company. Within six months, the value of shares allocated under the arrangement had risen to £1 billion following a successful recovery operation.

The outcome at MyTravel was a testament to what can be achieved when lenders/investors get behind the restructuring of a troubled company, with the CRO playing a crucial role in driving the turnaround. As Darlington points out: “For some investors, faith in the company will be rewarded by a good return.”

It’s not just the banks that stand to benefit. With increasing numbers of hedge funds and PE houses buying the debt of distressed companies and converting it into equity, CRO’s are playing an increasingly important and prominent role creating the circumstances for a profitable exit. **R**

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# New faces

Hedge funds and now also private equity firms are major players in distressed debt. No bad thing, says Heike Munro of Deutsche Bank.

**“The private equity houses and their counterparts in the hedge fund community have brought money to the table that wasn’t there before, and this is a positive development”**

It’s a trend that all of us in restructuring have seen develop over the last few years. While banks are lending more to the corporate sector (and at higher multiples of earnings than even a decade ago), they are also more willing to sell their debt in struggling companies to third parties, such as hedge funds and private equity (PE) houses.

For some directors – especially those on the boards of underperforming companies – this may be alarming. Gone is the old relationship with traditional lenders. Instead, directors of an underperforming company are likely to discover their debt has been bought up by a hedge fund or specialist PE investors. What’s more, current financing structures replace original simple relationships between lenders and debtors, often by much more complex arrangements that will be more difficult to restructure.

I don’t find it surprising that boards tend initially to be negative about the arrival of PE investors and hedge funds due to the negative press they sometimes receive, but I believe the high liquidity in the distressed debt market is no bad thing for the companies themselves. The PE houses and their counterparts in the hedge fund community have brought money to the table that wasn’t there before, and this is a positive development.

Today, there is more opportunity to restructure the debt, and, as a result, allow a restructuring of the company as a whole. Of course, there is also the fear that the arrival of PE and hedge fund investors means the exit of staff

after a boardroom shakeout. Not necessarily. When a company underperforms or finds itself coping with a financial crisis, lenders and investors will look long and hard at the management team and may demand changes. But if the management is strong and the problems the company faces are caused by external factors, then there will not necessarily be pressure to bring in new faces. Good management teams are valued by all stakeholders – including PE houses and hedge funds.

In addition to money, PE funds bring with them a reputation for extracting the best value from their investments. This is where there is a certain amount of uncertainty over their role as buyers of distressed debt. Many PE firms have a well-earned reputation for making good companies better. It remains to be seen how they will fare with severely troubled businesses.

Equally, restructuring a company successfully is a field where hedge funds have yet to demonstrate their expertise – we’ll have to see what happens. But hedge funds can draw on the expertise of company turnaround specialists, and there is a high demand for Chief Restructuring Officers and interim managers at the moment. So PE and hedge funds should be welcomed by underperforming companies, not least because the new finance offers new opportunities and a possible future. **R**

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