INSOL INTERNATIONAL

GLOBAL INSOLVENCY PRACTICE COURSE

Financial Restructuring

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Agenda

- **The restructuring market**
- Financial information
- Financial restructuring introduction
- Financial restructuring roadmap – Data analysis
- Financial restructuring roadmap – Negotiating a solution

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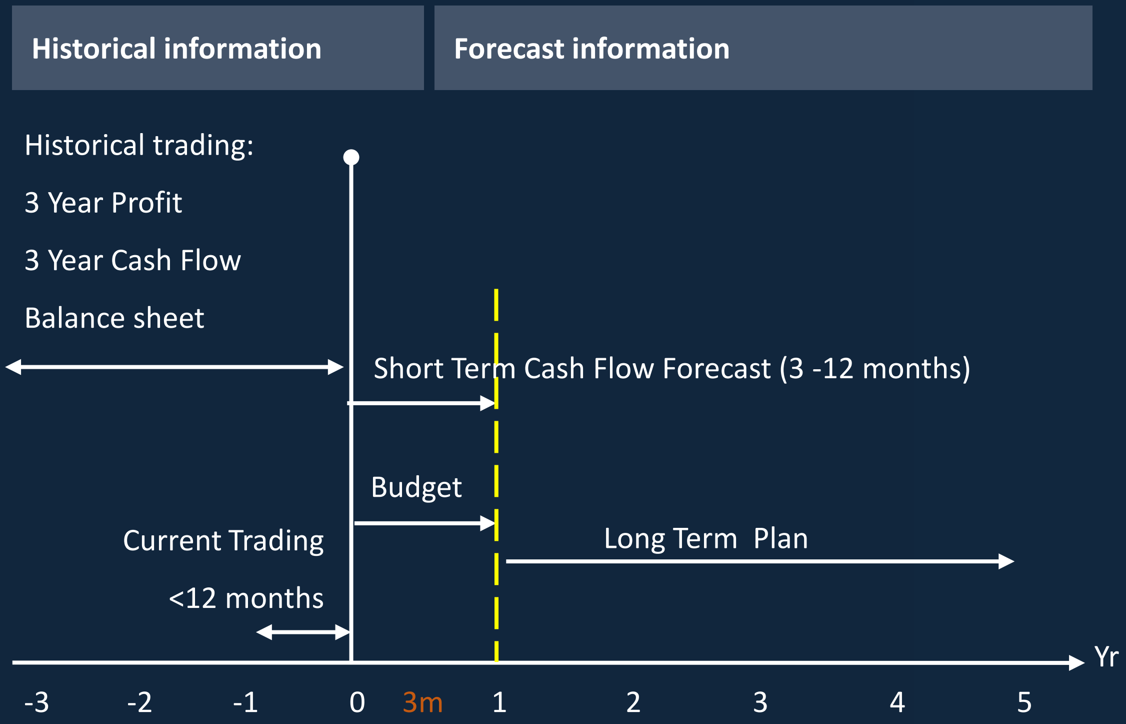
Financial information



The key stages of the Restructuring Process

Bad balance sheet

Trigger

Covenant breach
Forecast cash breach

IBR

- Define timeframe (understand cash position)
- Review forecasts
- Review options

Restructuring

- Define a process
- Stakeholder negotiations
- Implementation
- Completion

Good balance sheet

Historical financial information – relevance to restructuring

What is the current financial position?

- Understand the business and key drivers
- Sustainable earnings/cash flow

Is it reliable?

- Forms the basis for financial forecasts

How did it get here?

Stakeholder agreement/acceptance

IBR used as a platform for negotiations

Historical financial information – what are we looking for?

	P&L	Cash flow	Balance sheet
What?	A financial statement that summarizes the revenues, costs and expenses incurred	A statement of the amount of cash a company generates and uses during a period	A statement of the assets and liabilities at a point in time
Why?	**What has gone wrong?**	**Where has the cash gone?**	**What is the current asset /liability position?**
Typical issues?	• Consistent track record: distortions/one off items • Underlying performance & margin trends • What makes profits/losses?	• Inconsistency between cash and profits • Working capital cycle • Seasonality	• Key areas of subjectivity • Unrecognised liabilities/contingencies • Is it a suitable starting point for forecast?

Historical financial information - EBITDA

What is EBITDA?

A typical P&L

Sales	x
Cost of sales	(x)
Gross profit	x
Overheads	(x)
Operating profit	**x**
Interest	(x)
Profit before tax	x
Tax	(x)
Net profit	x

EBITDA

Operating profit	**x**
Add back: Deprecation	x
Add back: Amortisation	x
EBITDA	**x**

Historical financial information - EBITDA

- EBITDA is often used as a proxy for 'cash profit', as performance metric and as basis of valuation
- ....but ***EBITDA is not 'cash flow'*** and may not be comparable between different companies
  - There are cash flows that are recorded in the P&L, but shown 'below' EBITDA
  - There are cash flows which do not get recorded in the P&L
  - There may be differences in accounting policies or judgemental accounting treatments between businesses that impact EBITDA
  - The underlying nature of the business may create a natural difference between profit and cash flow

Historical financial information - EBITDA

Non-recurring items	• Reported EBITDA may include non-recurring income/expense
Items reported below EBITDA in the P&L	• Interest – cash/non cash • Tax – cash/non-cash
Capex	• Cash flow not in EBITDA • Depreciation charge may approximate, but need to consider maintenance vs. growth
Working capital	• Changes in stock, debtors and creditors do not impact EBITDA • May be significant in distressed scenario (e.g. impact credit insurers)

Nature of business	• May be a natural disconnect between EBITDA and cash flow, e.g.,
	  • Travel company (cash on advance bookings vs. P&L based on date of travel)
	  • Construction/long-term manufacturing (milestone payments, contract accounting)

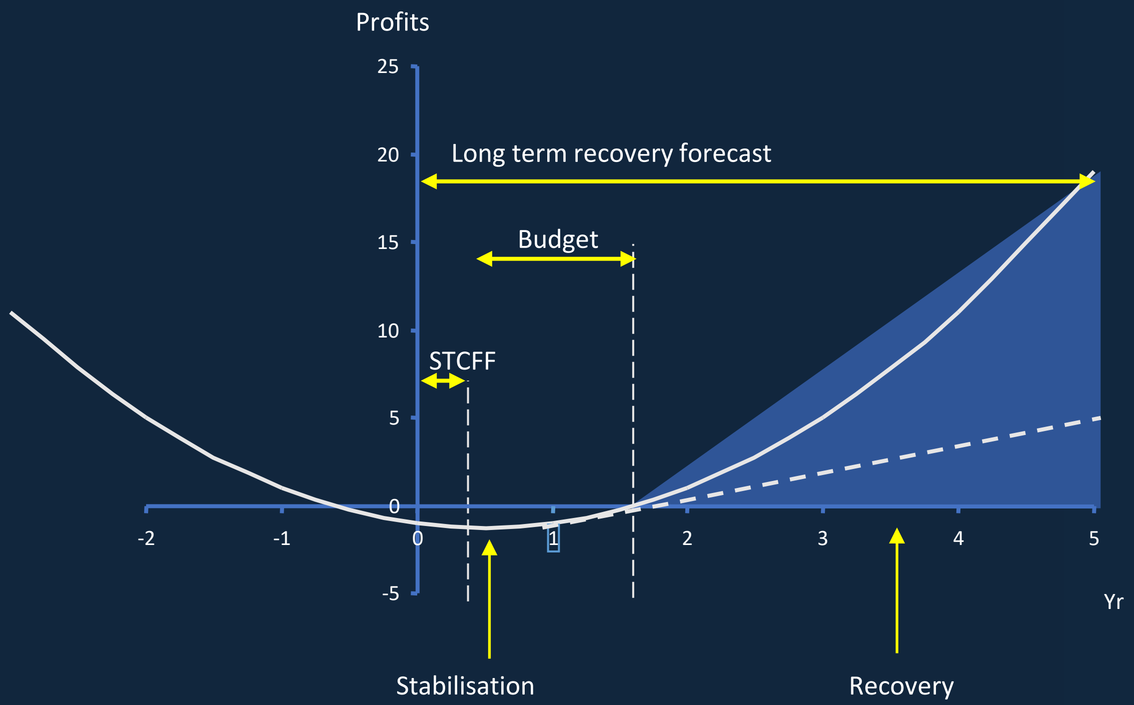
Historical financial information - EBITDA

Leased vs. owned assets	• **Operating lease**: rent expense in EBITDA , no balance sheet liability (i.e. cost in EBITDA = cash flow) • **Finance lease**: depreciation and interest cost in P&L, capital repayments in cash flow, and BS shows finance liability (i.e., no cost in EBITDA but cash flow) • **Owned asset**: deprecation, no cash flow or BS liability (i.e., no cost in EBITDA and no cash flow)
Differences in accounting policies	• Revenue recognition (e.g., where service provided over time, but cash received upfront) • Capitalisation of expenses (e.g., R&D, sales commissions) • Provisions for future liabilities and cash flows
Non-100% owned subsidiaries	• Operating profit EBITDA includes more than proportionate ownership % • Need to understand impact on cash flows – trapped cash?

Forecast information

	What does it look like?	Purpose
Short term plan	• Cash only • Weekly (or daily) forecasts for c.13 weeks • Transaction based • Updated weekly or at least monthly	• **Crisis stabilisation** • Short term cash management • Quick wins
Medium term plan	• 12-18 month budget using monthly rests • Integrated P&L, cash flow and balance sheet • Revised circa quarterly • Rolling – circa 12 month visibility	• Detailed modelling of **restructuring plan** • Covenant and headroom monitoring
Long term plan	• 3 to 10 year strategic plan • Simplified assumptions	• **Strategic planning** • Long term funding requirements

The restructuring profit/cash forecast



Forecasts - Medium & long term

- Integrated P&L, Balance Sheet and Cash Flow
- Focus on cash

1. Base case
('As is')

2. Restructuring case
('Management/Equity case')
- Disposals
- Cost reduction
- Cost and benefits

3. Sensitised case
('Bank Case')
- Realistic downside
- Covenant setting

Forecasts - development and purpose in a restructuring

Stage 1
Base case

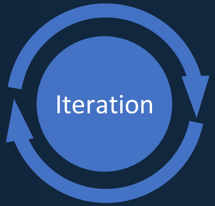
- Do the financial projections reflect the current situation and industry dynamics?
- Are underlying "as is" assumptions supportable?
- Is the existing business viable? – what will happen if we do nothing?
- What is funding requirement?

Stage 2
Model impact of operational Restructuring

- Have underlying problems identified in the diagnosis been addressed in plan?
- What is the cost of implementation?
- What is the timescale/benefit?
- What funding is required?
- Given the risks, are the proposals worthwhile?

Stage 3
Form the basis of any financial restructuring

- Is forecast turnaround achievable and what are the risks?
- What is cash generation?
- What new funding is available?
- How much debt can be supported?
- What is longer term value?



Financial Information summary

- Historical and forecast financial information forms the building block for restructuring
- Stakeholders will need to undertake due diligence and 'accept' position
- Fundamental in unblocking other restructuring obstacles
    - Going concern audit requirements
    - Local stock exchange requirements – 'working capital'

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The Turnaround Framework

Financial restructuring cannot be viewed in isolation

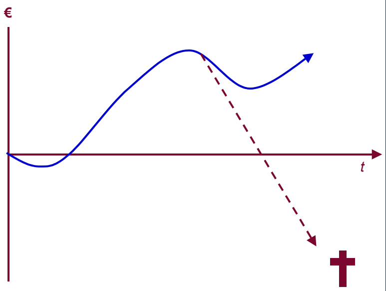
Options when faced with distress

	Do nothing	Operational restructuring	Financial restructuring
Improve EBITDA	✗	✓	✗
Improve cash cover	✗	✓	✓
Fix balance sheet	✗	✗	✓
Conserve equity value	✗	✓	✗
Create equity value	✗	✓	✗ /✓

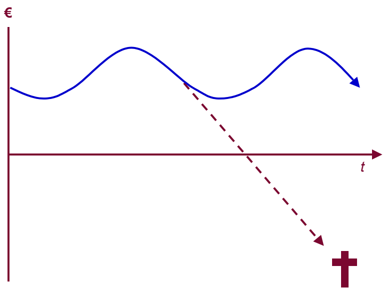
In most cases, doing one of the above in isolation is not enough to fix root causes and position for long term growth

Understand type of crisis

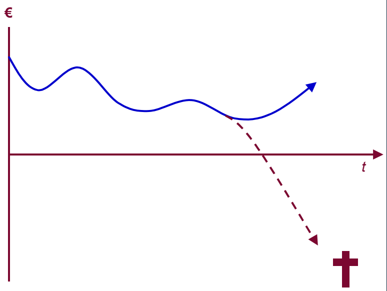
Fast expansion



Trend crisis



Trendsetting crisis



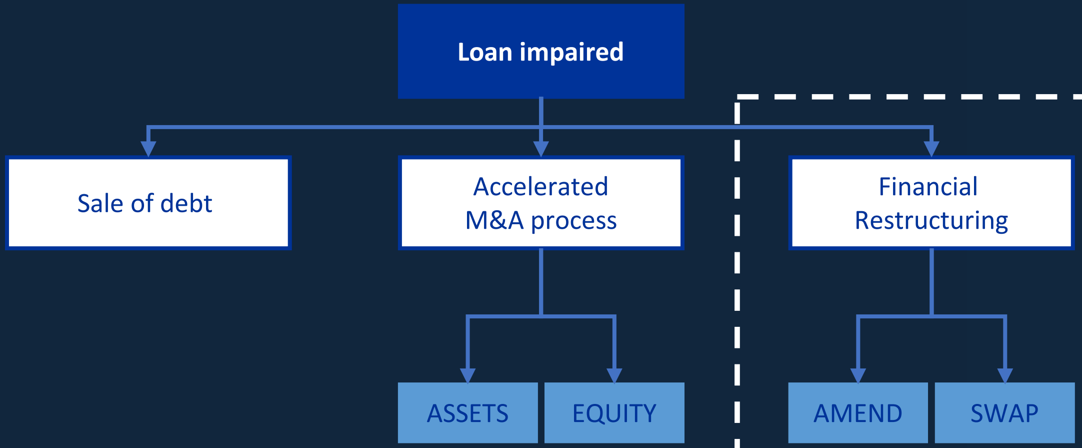
Financial restructuring - “Cash is king”

“There are two types of companies that fail:

- Those that make losses and run out of cash
- Those that make profits and run out of cash”

“Intervention is essential to reduce an inevitable acceleration towards failure”

Options available to the Lenders are limited



- Industry
- Type of debt
- Size of debt
- Geography
- Information

- Pre-pack
- Valuation
- Process
- Planning

- Consensual
- Approvals
- Consents
- Timing
- Disclosure

- Stable in short term?
- Viable business
- Value < debt
- Stakeholder confidence
- Realign stakeholder interests

Financial restructuring

- What is it?
  - A change in the capital and debt structure of the company or group
  - In a distressed situation it arises when businesses are unable to meet the demands of existing debt structure
- What does it look like?
  - Debt rescheduling
  - Debt for equity exchange
  - Debt for debt exchange
  - New funding: debt/equity

Financial restructuring objectives

- Reduce debt to serviceable levels
- Restore balance sheet solvency
- Restore creditor confidence
- Recognise current value of the different debt and equity instruments
- Have regard for the taxman
- Recognise management motivation
- Be commercial, as simple as possible and be 'once and for all'
- Be acceptable to all shareholders

When is financial restructuring needed?

Balance sheet strength

- Strong balance sheet
- Servicing issues
- Requires refinancing
- Simple rescheduling

- Healthy corporate
- No need to restructure

- Poor balance sheet
- Can’t service debt
- Deep financial restructuring
- Likely insolvency

- Good debt servicing
- Poor balance sheet
- Refinancing may involve equity participation

Debt servicing

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Formulating a Financial Restructuring

Data analysis (IBR)

a. What is the new funding requirement?
b. What is the debt capacity?
c. What is the value of the business ?
d. Where does the value break?
e. What’s the value left for the equity?

Negotiating a solution

f. Who funds the new money?
g. What happens to old debt?
h. How is the equity value allocated ?
i. Management team
j. Stakeholder management

A: What is the new funding requirement?

- **Starting point**
  - How much cash is needed?
  - “Extent of the problem”
  - “Cost of fixing”
  - Drives stakeholders attitudes
- **How assess requirement?**
  - Cash flow forecast
  - Need headroom
    - Seasonal requirements
    - Mid month peaks
    - Use sensitised cash flow forecast

A: What is the new funding requirement?

- Why is it needed?
  - Normalisation of creditors
  - Fund turnaround: redundancy/investment/advisor costs
  - Fund losses
  - Pay interest!
- Fundamental that stakeholders understand and agree funding requirement
- Must be adequate
- Iterative process
  - Desired plan versus Fundable plan

A: What is the new funding requirement?

Calculation methodology

	Cumulative to FY18 €m	Cumulative to FY19 €m	Cumulative to FY20 €m
EBITDA	3.3	8.1	14.2
Free cash flow	1.4	5.1	10.1
Interest	(4.0)	(8.0)	(11.7)
(increase) in net debt	(2.7)	(2.9)	(1.6)
Scheduled debt repayments	(5.7)	(8.6)	(11.4)
Shortfall	**(8.3)**	**(11.5)**	**(13.0)**
Funded by:			
RCF drawn	1.0	1.0	1.0
Opening cash (1 January 2018)	1.4	1.4	1.4
New money	**6.0**	**9.1**	**10.6**
Total	**8.3**	**11.5**	**13.0**

B: What is the debt capacity ?

- How much debt can be supported
  - Adopt a sensitised view to earnings and cash generation
- Free cash flow forecast
  - FCF = EBITDA – working cap movements – capex – tax
- What are existing debt service requirements?
  - Cash pay interest/PIK/capital repayments
- Desired debt service?
  - Leverage/Interest cover/debt service multiples
  - What are assumed interest rates/margin/coupons on new instruments?

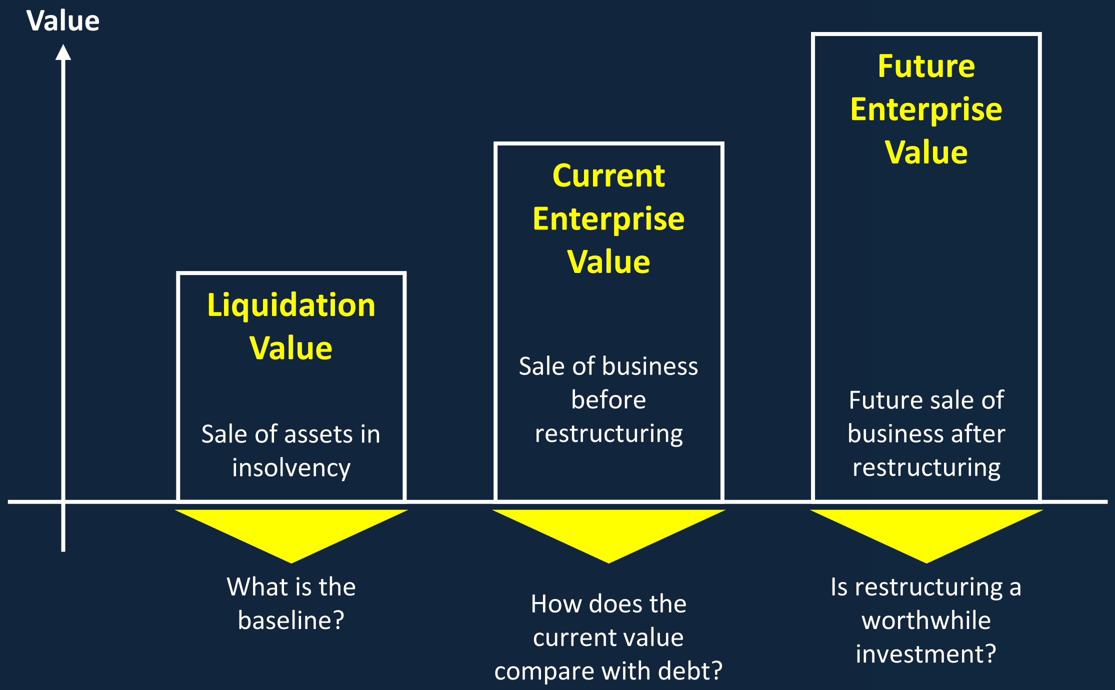
Debt capacity

Calculating debt capacity – example

€m		Year 1	Year 2	Year 3
EBITDA		29	30	35
Movement in working capital		1	(2)	(3)
Capex		(8)	(10)	(12)
Tax		(2)	3	3
Free cash flow		**20**	**21**	**23**
Assumed blended interest rate		10%		
Straight line repayment period (years)		10		
		Debt capacity		
FCF: debt service ratio	**1.25**	80.00	84.00	92.00
(FCF / DSR) / (IR + P/100)	**1.50**	66.67	70.00	76.67
	1.75	57.14	60.00	65.71
		Debt capacity		
FCF: interest cover ratio	**1.50**	133.33	140.00	153.33
(FCF / ICR) / (IR)	**2.00**	100.00	105.00	115.00
	2.50	80.00	84.00	92.00

C: What is the value of the business?

Three valuation scenarios in a restructuring



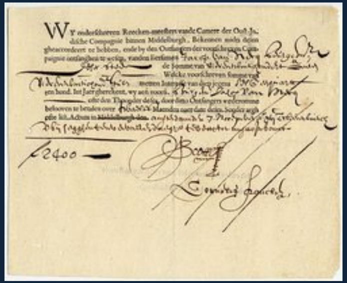
What do you want to value?

A simple asset

An intangible

A business

A brand name



A stock

A bond

A similar asset may have different values

Intangible Value

Store Price

Operating Value

Valuation Approaches

1. Income Approach
   - Discounted Cash Flow (DCF)
   - Historical/current/past period earnings capitalisation
2. Market Approach
   - Guideline companies (public companies)
   - Transaction multiples
   - Other rules of thumb
3. Cost Approach
   - [   ]

EY applies the income approach in general as the preferred option, and this is preferably corroborated with a market approach and/or cost approach

Valuation - Income Approach

How does it work?

Step 1

Projections

Project the operating results and free cash flows of a business over the forecast period.

Step 2

Terminal value

Estimate the terminal value of the business.

Step 3

Discount rate

Use the WACC or cost of equity to determine the appropriate discount rate range.

Step 4

Present value

Determine values for the Enterprise/ Equity by discounting the projected free cash flows and terminal value to the present.

Step 5

Adjustment

Adjust your valuation for all assets and liabilities not accounted for in cash flow projections.

Valuation - Income Approach

- WACC = ((E/(E+D))*Re) + ((D/(E+D))*Rd) * (1-Tc)

- Terminal value = value of projected expected cash flow beyond the explicit forecast horizon

Valuation - Income Approach

Project the cash flows (Enterprise Value/Equity Value) = **Explicit cash flow** + **Terminal Cash flows**

Explicit cash flow

- Over a representative business cycle?
- Finite life?
- Inflation?

Terminal Cash flows

- Reliability of last period cash flow
- Normalised to represent a starting point for sustainable operations over the terminal period

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Application of appropriate discount rate

- Considerations include
- Risk free rate of return
- Additional risks to equity and debt investors
- Specific risks to the entity being valued
- Size

- Subjectivity of growth over terminal period (e.g. remaining life of asset or perpetuity

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NPV

= Sum of discounted explicit cash flows and terminal value (Enterprise Value/Equity Value)

Valuation - Market Approach

How does it work?

Step 1

Earnings

Supportable indication of Future Maintainable Earnings (FME) or cash flows

Step 2

Comparison

with public quoted co or recent transactions to give appropriate multiples

Step 3

Adjustments

- Company or shares?
- Controlling interest?
- Minority holding?
- Other non-operating assets.
- Contingent liabilities

Valuation - Market Approach

Enterprise Value	=	Earnings before interest	x	Appropriate multiple
Equity Value	=	Earnings after interest	x	Appropriate multiple

Valuation - Market Approach

Considerations

- Determination of Future Maintainable Earnings is a matter of professional judgement, having regard to the following:
  - Activities and value drivers of the business
  - Position and potential of the business in comparison to listed comparable companies or transactions
  - Company track record in achieving its forecasts
  - Reasonableness of the forecasts and consistency with your understanding of the business and market
  - Is management capable of delivering the expected profits?
  - Consideration of business life cycle

Valuation - Asset based approach

- Generally assets are worth no more than the earnings/cash flow they are capable of generating
- Asset based approach used when earnings are insufficient to justify a value more than net tangible assets
- Always a factor in valuation – provides a frame of reference for main valuations

Going concern:

- Assumes a company will continue to trade
- Requires determination of market value of assets and liabilities
- May require elimination of intangible assets if earnings not justifiable

Valuation - What is the position on an insolvent basis?

- What are the assets worth on an insolvency?
- Range of asset based valuations
  - Sale of business as an insolvency
  - Liquidation value
- Requires valuation/insolvency skills and experience
- Lower than enterprise value since assets are written down, liabilities crystallised and costs incurred

Liquidation analysis

	Book value	Sale of business	Liquidation
Fixed			
Freehold property	30.0	21.7	10.8
Floating			
Land & Building (non fixed charge)	8.0	7.2	3.6
Plant & Machinery	6.5	3.0	1.5
Stocks	1.0	0.3	0.2
Trade Debtors	14.5	11.1	7.8
Sundry Debtors	3.0	1.2	0
	33.0	22.8	13.1
Preferential Creditors	–	(2.8)	(2.8)
	33.0	20.0	10.3
Total estimated realisations in insolvency	**63.0**	**41.7**	**21.1**

Note: Items valued at nil – goodwill, fixed asset investments and loans to other subsidiaries

Where does money go on insolvency?

- Based on:
  - Legal structure
  - Legislation
  - Security position
  - Intercompany debt structure
- Must be undertaken on a legal entity basis
- In a large group structure with multi-stakeholders, this can be a very complex exercise requiring sophisticated modelling.
  - Arguably the single most powerful tool in complex restructuring

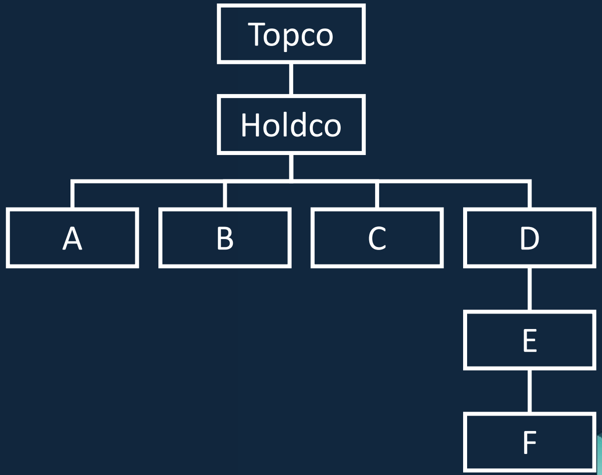
Where does money go on insolvency?

€m	Book value	Sales of business		Liquidation	
Total estimated realisation on insolvency before costs	63.0	41.7		21.1	
Example 1					
Single company, single bank loan of €35m					
Return to bank		35.0	100%	21.1	60%
Return to unsecured creditors		6.7	–		
		41.7		21.1	
Example 2					
Bank 1 secured loan of €20m					
Bank 2 unsecured loan of €15m					
Return to bank 1		20.0	100%	20.0	100%
Return to bank 2		15.0	100%	1.1	7%
Return to unsecured creditors		6.7		–	
		41.7		21.1	

Where does the money go on insolvency?

Group Example

- Topco owns €5m unsecured bonds
- Unsecured bank debt of €10m owned by Holdco
- F is the only company with assets. They have a liquidation value of €20m
- D has a minority interest of 50%
- F owes A €6m intercompany debt
- F owes €4m to suppliers
- A owes €3m to suppliers

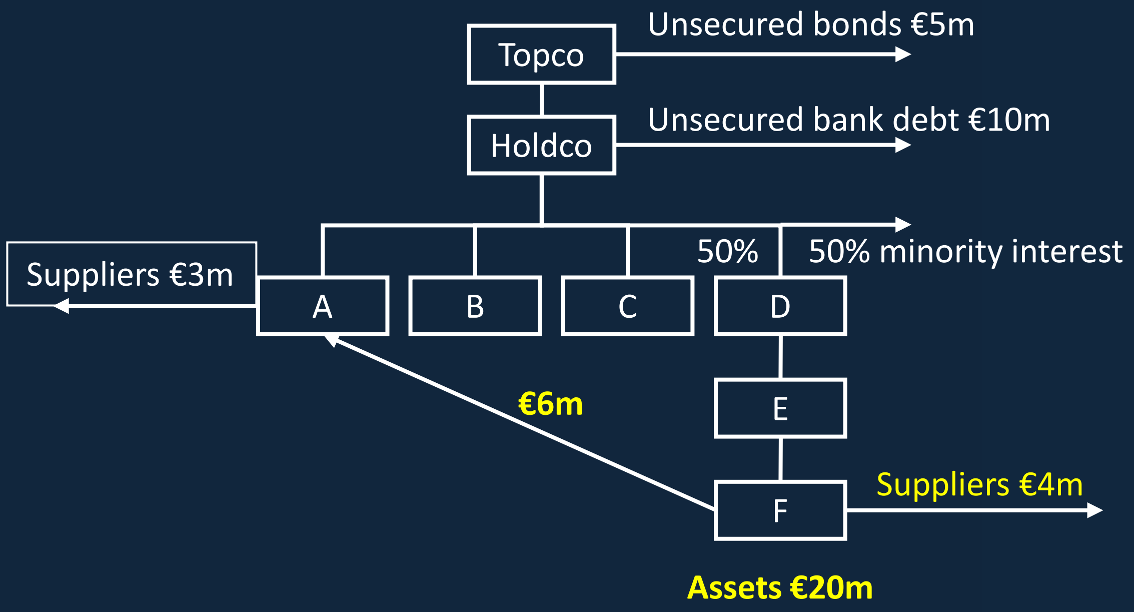


Question: In an insolvency of the group

- How much will bond holders recover?
- How much will the bank recover?

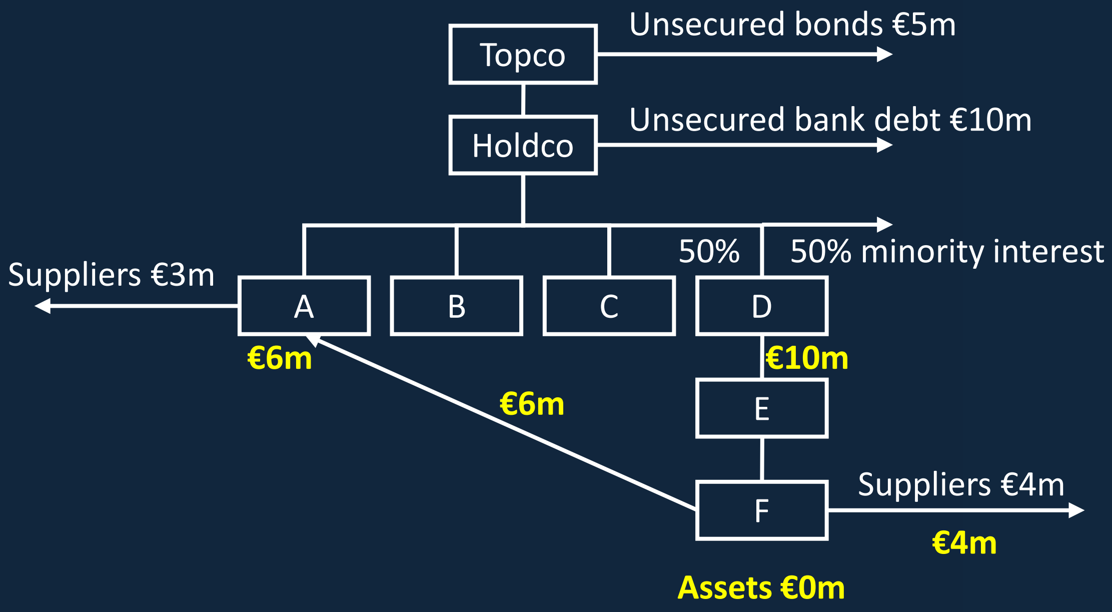
Where does the money go on insolvency?

Solution – Step 1



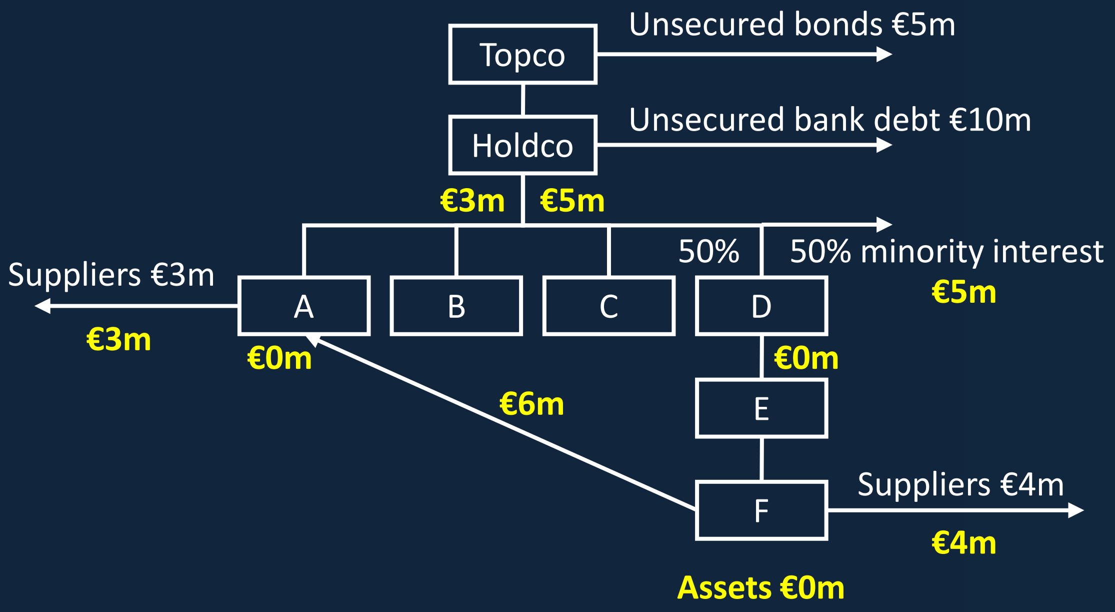
Where does the money go on insolvency?

Solution – Step 2



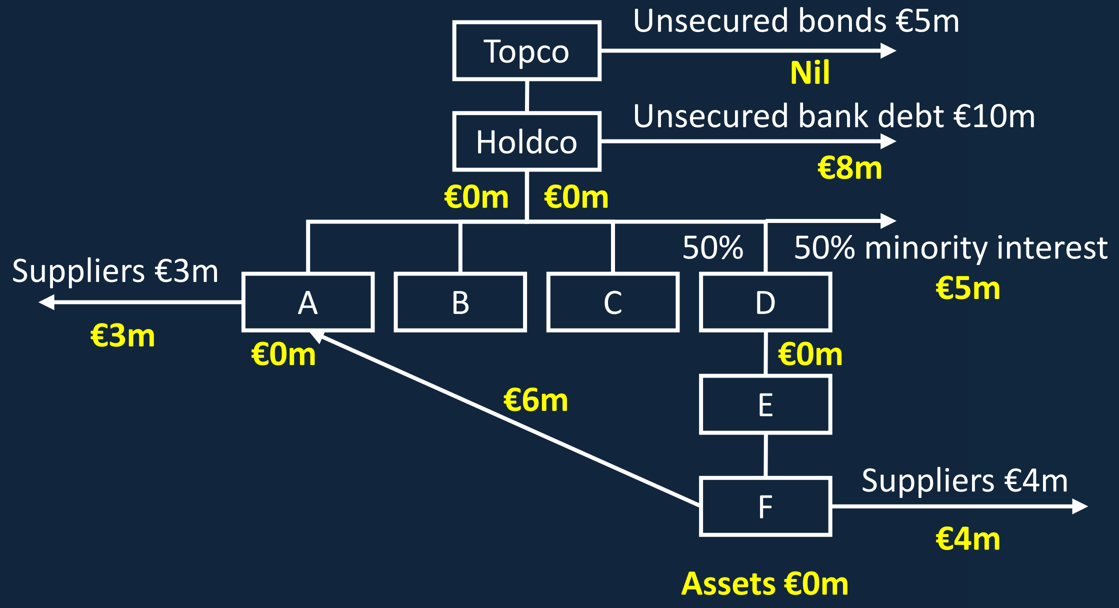
Where does the money go on insolvency?

Solution – Step 3



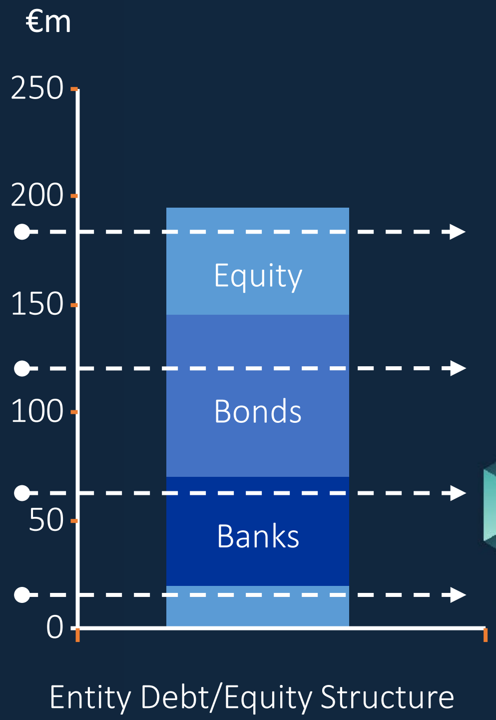
Where does the money go on insolvency?

Solution – Step 4



D: Where does the value break?

- Position of the value break indicates who holds negotiating power
- Requires a valuation to be agreed between the parties



E: What's the value left for the equity?

What's left after the debt number?

	€m
Enterprise value	90
New Money	10
	100
Total debt (debt capacity post restructuring)	(90)
Equity value	**10**

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F: Who funds new money?

- Internal/external
- Existing/new
- Cost increases in distress
- Gives provider leverage:
  - Super priority: fully secured, priority payback
  - Equity: dilution of other equity holders

F: Who funds new money?

Sources of funds

Details	Source	Details
	Working Capital Disposal of surplus assets	Internally generated Sustainable improvements require change programmes
Regional enterprise grants EU R&D grants	Government Assistance	
	Overdraft	Uncommitted Circa 100-200 bps > base rate
Discounting debts (70-80%) Factoring debts (70-80%) Security/control issues Circa 200 bps > base rate	Invoice discounting	
	Term loan	3-5 year term Pricing depends on security
5-10 year term 500-1000 bps > base rate	Sale & Leaseback	
	Mezzanine	5 years + IRR 15-20% Includes Equity kicker
Circa 40% IRR on rescue finance	Equity	

G: What happens to the old debt?

- **Amount:** Banks seek to maximise debt / Conversion of unsupportable amount to equity
- **Term:** Reschedule to meet cash flow
- **Secured:** New security will be sought
- **Margin:** Increase, equity kickers, participate in asset disposals, PIK

G: What happens to old debt

- Other considerations may include:
  - What other debt exists and how is it being treated – is subordinated debt also being converted or written off
  - Might some of future interest be PIKed to support higher debt
  - What are the industry norms
  - Belief in business and management
  - Negotiating starting point
  - Entity priority model – evaluates returns for stakeholders usually based on insolvency distribution assumptions. Can determine relative stakeholder positions
- Ultimately, there is no ‘right’ answer….

H: How is the equity value allocated?

Simple example	
EV	100
Debt post restructure	(90)
Equity value	10

- If original debt was 120 pre-restructure (i.e., 30 written off) and single debt provider – good argument to be allocated 100% of the equity
- More complex where providers of debt are in different jurisdictions with multiple layers in capital structure
- Based on liquidation principles and the use of a liquidation based entity priority model to determine payouts in an insolvency
- Position in negotiation driven by points of leverage

H: How is equity value allocated

Other considerations

- Implications of shareholding %:
  - Risk of consolidation
  - Ability to pass resolutions/control
- Need to incentivise management
- Debt for equity may be accompanied by new equity from new or existing shareholders
- Reputational impact as owner

H: How is equity value allocated

Tax considerations

- Release of debt covered by specific statutory exemption. Formal release of debt by Bank not taxable in debtor if release is in exchange for issue of ordinary shares
  - Care is required to ensure requirements for exemption are met and taxable waiver does not arise – wording of legal documents is important

- Does this result in a change of ownership?
  - Impact on utilisation of tax losses going forward
  - Does this create/break connection with other companies in group? May have impact on group relief
  - Degrouping charges

H: How is the equity value allocated?

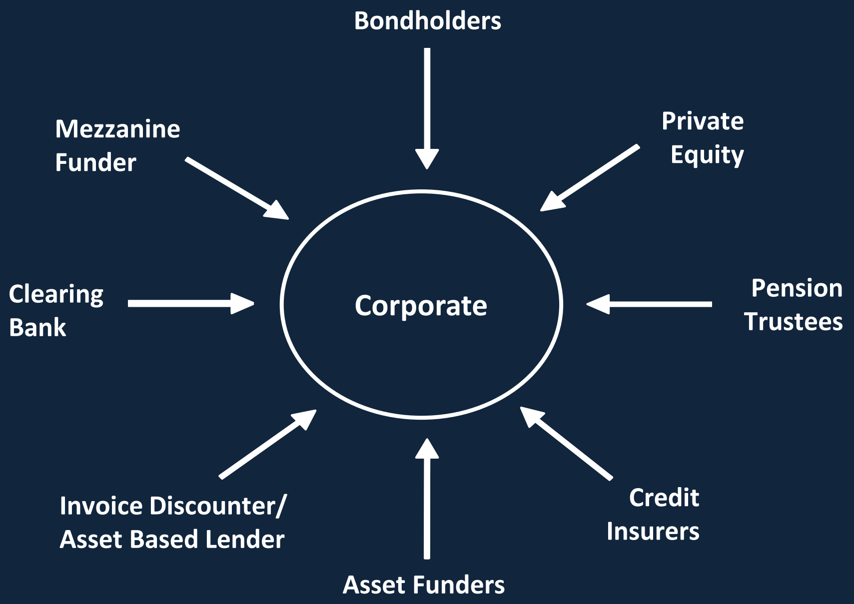
- Traditional players seek to maintain the same economic result they would have had
- Banks in syndicate may not have same economic position: purchased at a discount, insurance
- Opportunity funds may be seeking more… e.g., via “loan to own”
- Usually simplifies to all “trying to get as much of the value as possible”

I: Management team

- Does the current Management team have experience of a Turnaround?
- Do we have confidence that they can deliver the EBITDA forecast?
- Strength of Management team a key factor for the achievability of the restructuring plan

J: Stakeholder management

Understand stakeholder agendas



Influencers

- Equity analysts
- Debt analysts
- Rating agencies
- Trade insurers

J: Stakeholder management

- Stakeholders may have hidden agendas – may hold out
- A purely technical approach may allocate >100% of the equity
- Need shareholder consent to the plan
- Need to maintain plc status
- May have additional equity provided
- Management may need an incentive to see the plan through

…reaching a solution may require protracted and delicate negotiations…

Financial Restructuring summary

Analyse current position

a. Understand funding requirement
b. Calculate debt capacity of business
c. Calculate the value of the business
d. Understand where the value breaks
e. Future equity value

Negotiating a solution

f. Identify source for new funding
g. Negotiate on old debt
h. Allocate equity value
i. Review Management team
j. Stakeholder management