

Survey

# LBOs: Restructure now or regret it later



John Houghton, Latham & Watkins

The expected distressed M&A wave hasn't hit Europe yet – but it will. Distressed LBOs would be best advised to carry out a financial restructuring now, in order to be in better shape when it does hit in 2011 or 2012.

These are some of the conclusions of a poll of over 200 European investors and advisers held by Latham & Watkins in London at the start of November.

Around two thirds of the participants were hedge funds specialised in distressed investing. The rest were their financial advisers as well as PE sponsors. So the findings carry weight.

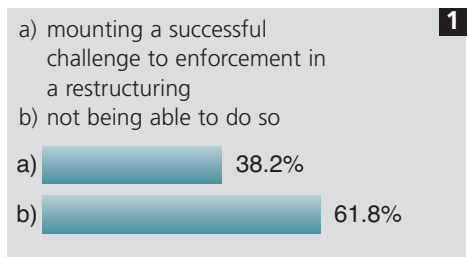
John Houghton, head of the European restructuring practice at Latham & Watkins, said that the findings of the poll confirmed his warning to sponsors and managers; that doing nothing now in the hope that better times were around the corner was not the best option:

*“Companies that have done financial restructurings now will be in better shape for the distressed M&A wave in the future than those who just ‘extend and pretend’.”*

Houghton explained that stakeholders in many distressed LBOs in Europe are preferring to give covenant waivers, alter coupons and provide other exemptions rather than restructure, in order to put the problem off to another day. Such a process had originally been known as “extend and amend,” but this had been modified by sceptical observers to “amend and pretend”.

Houghton said the most surprising finding had been from a question about IMO Car Wash, a high profile European restructuring where junior creditors had lost out.

## 1. Following hot on the trail of the decision in IMO Car Wash, 2010 will see junior creditors:

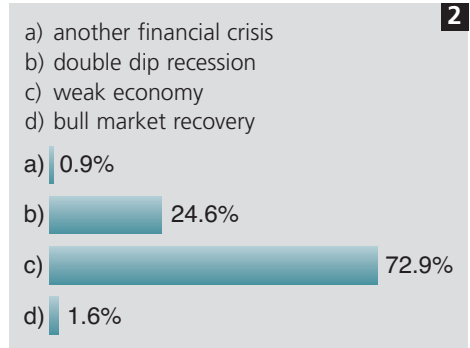


Houghton commented: “IMO Car Wash did not close the door once and for all on future challenges by junior creditors.

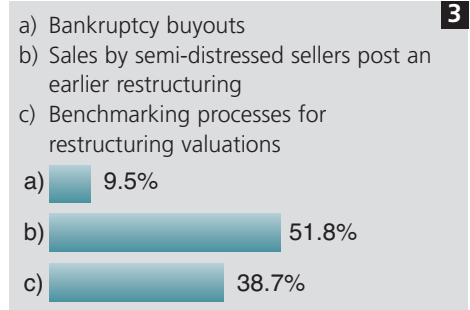
“As valuations start to creep back up, I anticipate a steady stream of challenges by ‘out-of-the-money’ creditors, particularly where valuation breaks on the cusp between tranches of the capital structure. I do not think that such challenges will be limited to simple matters of valuation either.

“Junior creditors could start to challenge restructuring techniques such as COMI shifts and the validity of the appointment of administrators who effect the transfer of the OpCos to NewCo.”

## 2. What do you expect to see from the European economy over the next year?



## 3. Where will the distressed M&A activity be in the next three years?



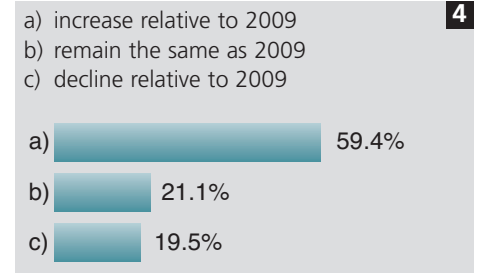
### Houghton commented:

“The reality is that during this restructuring cycle there has not been much distressed M&A activity, in the sense of sales of distressed businesses to third-party trade or strategic buyers.

“What in fact has happened is that the creditors have become owners of the distressed companies.

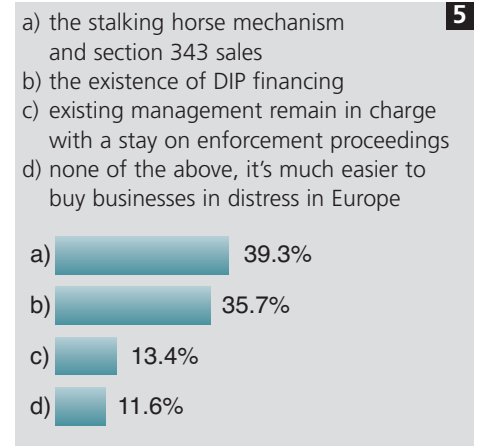
“It is also interesting to note that a significant number of people in the audience thought that the M&A process would continue to be used as a bench-marking tool for striking valuations during restructuring negotiations.”

## 4. Will equity led de-levering in 2010:



Martin Saywell, M&A partner at Latham & Watkins said: “Equity offerings are now often seen as part of the restructuring kit bag. Restructurings are now often used as a bridge to a rights issue.”

## 5. Is the US a more favourable distressed M&A market than Europe because of:

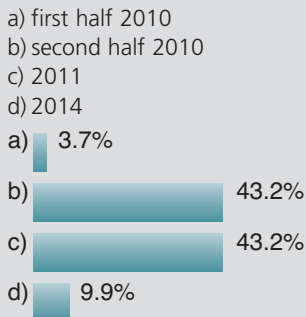


Jan Baker, New York partner and global co-chair of Latham & Watkins' insolvency practice said: “This was an audience with a vast amount of restructuring experience. The poll results confirm that the great majority of the audience believes that the US provides a

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framework for distressed M&A that is very hospitable for all investors.”

### 6. When will we see the peak in European distressed M&A?

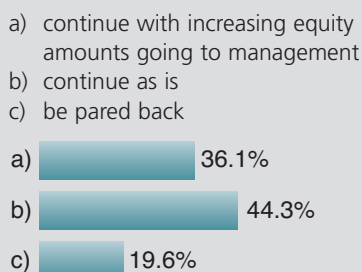


#### Houghton commented:

“What is interesting in the current restructuring cycle is that creditors to some distressed companies have bitten the bullet and undertaken a full-bodied financial restructuring. Other situations have simply resulted in an “extend and pretend” whereby there has been no restructuring of the capital structure, but simply a covenant waiver and a few amendments to the credit documents.

“When the M&A markets do come back, which according to our audience should be 2010/2011, those companies that have already undergone a financial, and most likely operational, restructuring will be in far better shape to be put on the auction block.”

### 7. Management have done well with meaningful equity stakes in distressed businesses in 2009 – next year this trend will:

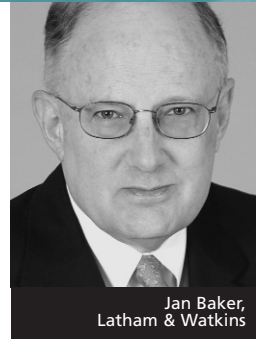


### 8. When will banks meaningfully begin to sell off their holding in companies they have acquired through Debt-for-Equity swaps in 2009:



# Chapter 11: pros and cons

One of the US’s most experienced debtor bankruptcy lawyers, Jan Baker, recently moved from Skadden Arps to complement the strong creditor practice at Latham & Watkins in New York. This month the American Bankruptcy Institute (ABI) is hosting a wide-ranging review of Chapter 11, in which leading practitioners will debate what reforms, if any the US Bankruptcy Code needs (see pages 10/11). Baker says changes would be welcome, but warns there are political obstacles.



#### Example 1

“When Chapter 11 works, it continues to work very, very well indeed,” says Baker. This year’s obvious examples are GM and Chrysler.

“These businesses needed emergency surgery,” says Baker, “they were on the operating table and turning blue.”

“Nobody would have dreamed even five years ago that they could have entered Chapter 11 and been sold in a section 363 deal so quickly, and put so many of their problems behind them.”

#### Example 2

Charter Communications, Paul Allen’s company, was loaded down under far too much debt. The company then fought a court battle with its senior lenders over ‘reinstatement’.

“These restructurings all depend on what you get when you trade the debt. In Charter Communications’ case they were able to convince a bankruptcy judge that they should get reinstatement, which meant their debt could trade at close to par. This made all the difference in the world,” says Baker.

#### Example 3

Spectrum Brands had a US\$3 billion turnover and took out US\$1.5 billion of secured term debt at the height of the boom. The lenders wanted to re-price the debt. The debtor took the case in front of a bankruptcy judge,

and five months later he confirmed the Chapter 11 plan. “The exit worked superbly,” says Baker.

“However, some Chapter 11s don’t work superbly,” Baker admits. “Increasingly you get people buying into the debt and using litigation as a terrorist tactic,” says Baker. “They reckon the longer they can string things out, the more value they can extract.”

Short-termism is on the increase. Hedge funds are increasingly important in capital structures, and they usually have a short term view, says Baker.

A two-year restructuring inside Chapter 11 is not attractive for them, and this is why you are not seeing such cases these days, he says.

But, Baker warns, any debates about Chapter 11 reform may ultimately prove futile. The great American public, and therefore its elected politicians, are simply not interested in bankruptcy law reform.

There is some interest in how individuals are treated, but corporate cases are not of interest.

“The US is envious of the UK, where politicians are interested in insolvency reform,” says Baker, noting that the British Conservative party has called for the adoption of Chapter 11. “For the US public it’s not an issue,” Baker laments.