Achieving successful restructurings in a time of crisis

As the economic realities of the coronavirus pandemic hit home, many businesses are preparing for radical change. Governments have supported the economy so far, but this has only delayed an economic downturn with far-reaching impacts on jobs and wealth

Companies are grappling with huge uncertainties. It is not just a question of when a coronavirus vaccine becomes widely available, but the state of the economy when that happens and how long-term business and consumer behaviours have changed or been accelerated during the pandemic.

Many sectors therefore face a tough 2021, with a slow recovery towards 2024. Businesses must plan for their capital structures to cope with a wide range of scenarios.

Financial restructuring issues

In the first lockdown, many financially affected businesses shored up liquidity by amending debt covenants, raising fresh liquidity and accessing government support schemes. The second wave is forcing them to persist with these measures for longer. But, for many, the prolonged lockdown and worsening macro environment have already caused a significant and permanent loss of value and increased indebtedness which, alongside the continuing need for further liquidity, will lead to a wave of major recapitalisations.

Simon Granger, head of FTI Consulting's Corporate Finance and Restructuring EMEA practice, says: "Businesses struggling with liquidity have to make radical changes now, including large-scale cost-cutting, to stay resilient and position themselves for a protracted recovery. The implementation costs of such changes are high, often requiring fresh liquidity.

"Corporate leverage – the ratio of debt to equity – was already high when the pandemic started. As value erodes, companies have too much debt on their balance sheets and not enough equity. They will not be able to raise yet more capital within their over-levered structures.

"We are talking to businesses about improving their capital structures, typically with debt-for-equity conversions or other deleveraging transactions, and simultaneously raising new money."

Companies will need to start negotiating with debt providers and shareholders to achieve this recapitalisation, which will reduce debt and dilute existing shareholdings.

Banks are still prominent in business capital structures, but there has been an increasing shift towards public and alternative private debt financing from insurance, pension and hedge funds. A debt-for-equity conversion means institutions like these will control the company's debt and become its ultimate owners.

Implications for companies

The complexity of these processes will provide a huge challenge for businesses. Capital structures are increasingly engineered, the stakeholders that need to be managed are numerous and, given ongoing macro uncertainty, businesses will need to plan for several potential scenarios. Managing all this while running a stressed company is extremely challenging.

If you can drive a successful restructuring, you will often end up with a much better business model

"Some institutions will not want to convert debt for equity," says Granger. "We expect for see more contested restructuring processes, which can have a negative impact on value if they become drawn out. This is why governments around Europe are improving their laws to support restructurings.

"There is currently no shortage of funding available to support the turnaround of good businesses. The key questions are who provides that money, where it sits in the capital structure and how easily a full recapitalisation solution can be implemented. Failing to restructure the balance sheet and secure new capital could leave a business as a so-called zombie company, needing cash to reshape the business, but without the capital headroom to do so."

Keeping stakeholder confidence

During a restructuring process, communication with all stakeholders, from suppliers to financial creditors, employees and credit insurers, will be crucial. If you lose their confidence, it could have a profoundly negative effect on your business.

Stakeholders who do not receive the information they need can take aggressive actions that are hard to reverse. For example, a credit card settler may withdraw support and withhold payments, which could materially impact a business's liquidity.

"To keep the support of all stakeholders, you need to understand their concerns and objectives and maintain a regular dialogue," says Granger. "If you are cutting lots of costs, make sure you also have the broad support of workers and unions, and that you are engaging with them regularly and proactively.

"Having a strong finance function is also critical. Demands on the finance team are extraordinarily high during these processes and, if stakeholders lose confidence, it is difficult to deliver a successful turnaround.

"The most critical factor is to maintain strong liquidity, creating enough runway to determine the right approach and implement a solution. Secondly, you need a credible, flexible business plan. Many businesses are facing major strategic challenges, amplified by the pandemic. So you need a strong theory about why your business will be relevant in the next three years, where it is best positioned to be successful and how it will get there.

"Thirdly, you need a contingency plan. This may involve recognising that parts of a business are unfortunately not viable and need to be closed or sold.

"If businesses choose to use an adviser to help address these considerations, using one like FTI Consulting, which is entirely independent and fully dedicated to protecting the interests of the business, will ensure firms maximise the prospects of stakeholder support for their restructuring plans."

Challenging key assumptions

Historically, some boards have been reluctant to challenge long-standing views and assumptions around their business. But to ensure a successful restructuring, boards must confront preconceptions now more than ever.

"It can be difficult to look at your business differently and challenge assumptions, but when facing potential crisis, the earlier that restructuring and recapitalisation options are considered, the more potential routes there will typically be available. This will also increase the chances of achieving an optimal outcome and preserving value in the core business," says Granger.

"If you can drive a successful restructuring, you will often end up with a much better business model, more geared towards your target market and better able to sustain itself in the long-term."

Simon Granger,
Head of the Corporate Finance & Restructuring EMEA practice at FTI Consulting was talking to journalist Tim Cooper.

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