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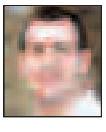

WITH CONDITIONS IN THE CREDIT MARKETS UNLIKELY TO IMPROVE SIGNIFICANTLY IN THE NEAR TERM, **GRAHAM BUCK** REVIEWS THE OPTIONS FOR BUSINESSES STRUGGLING TO STAY AFLOAT.

Executive summary

■ Companies experiencing cashflow or refinancing difficulties don't only have the banks to turn to. Corporate restructuring, debt advice, schemes of arrangement and pre-packs are all strategies that will allow a business to continue operating.

Although Britain's economy appears to have edged out of recession in the second half of 2009, many debt advisers do not expect the credit markets to open up significantly before next year. So while lending to small businesses has improved over the same period in 2008 and money is "trickling through" to small firms, it is still nowhere near pre-recession levels, says John Wright, national chairman of the Federation of Small Businesses. He confirms that FSB members have had problems in getting access to loans or overdrafts and complain of excessive rates when they do find new or existing finance.

On a more positive note, after a slow start there are signs that the government's Enterprise Finance Guarantee is having a positive effect on lending. This is despite the continued reluctance of many companies to approach the scheme for fear of being deemed high risk.

At Lloyds Banking Group, its managing director for corporate real estate business support, Richard Dakin, reports that when the downturn began the group encountered issues with customers at the top end of the market. However, as downturn intensified into recession these issues quickly filtered down to smaller businesses, particularly those in the commercial property market.

"In the same way that no two businesses are the same, the issues they encounter vary dramatically," Dakin reports. "By definition, these are businesses running into cashflow difficulties or refinancing issues – and if there is common ground, it is this."

A HELPING HAND So what assistance can troubled companies expect from their banks in the current climate? Dakin says that Lloyds' ultimate aim is to assist its business customers back to financial health when they encounter difficulties. "We never forget that downturns don't last forever," he says, "and we want to be there for our customers as the outlook improves. Our vision is to be the UK's leading 'through the cycle' wholesale bank, and our business support units are at the heart of this approach. We have continued to

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expand these teams and by the end of 2009 we will have doubled the headcount to over 1,000 colleagues."

Heather Swanson a restructuring partner at PricewaterhouseCoopers, agrees that the UK's main relationship banks are generally supportive when a business gets into trouble, provided there is evidence that it has a future and is generally well run. "If there are things wrong with the company, the bank will want to put them right," she says. "At the same time it will seek to reprice the deal to ensure that it is more in line with what it is receiving on current debt deals.

"There are, of course, not that many options at present. The secondary debt market is not what it was three years ago and new debt financing is hard to obtain. So institutions are generally taking a less aggressive approach to pricing, particularly in the leveraged buy-out space."

However, previous recessions have been marked by banks adopting the London Approach – summarised as "a statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring".

This time around there are many different players, including distressed debt specialists, making it harder to corral them under a single umbrella to agree such a rescue, says Swanson. "In many cases, a support operation needs unanimous – or at least majority – consent from lenders. The dissenters need to be crammed down if the scheme is to succeed. In addition, some lenders in syndicates can be more opportunistic, which also makes things more difficult."

When a bank is ready to lend support to a business, what approach does it adopt? Dakin says the size of the business is immaterial to Lloyds, which essentially operates a "triage" service. The first step lies in unravelling the issues by working closely with the business.

"While the specific issues may vary, the toolkit of support measures we have at our disposal is consistent throughout," he says. "What does differ is the mix of support measures and we always aim to do whatever is best, taking into account each particular customer's situation. Individual tailored solutions can range from providing extra financing through to a full capital restructure."

OTHER AVENUES But while conditions are easier than 12 months ago, the continuing lack of liquidity has encouraged many financially troubled companies to explore other types of creative solution for survival. Not only are lenders less willing to assist with corporate refinancing, but the number of potential buyers ready to move in and rescue a distressed business has fallen.

Another potential major obstacle, exemplified by Woolworths' inability to attract a suitable bidder, is that many vulnerable companies are saddled with a sizable pension fund deficit that effectively acts as a poison pill to thwart any deal.

In addition, many companies are seen as carrying an excessive debt load relative to their earnings. This suggests that the number of corporate debt restructurings will show a significant increase over the latter half of 2009, while many more businesses will be unable to avoid becoming insolvent. The Insolvency Service has reported 5,055 compulsory and voluntary liquidations in England and Wales over the second quarter of 2009; that's a 2.9% rise on the first quarter and 39.1% more than in the second quarter of 2008.

Debt advisers are usually called in when a company realises that breaches of its debt covenants have become inevitable. According to insolvency practitioners, too many vulnerable firms delay action until the problem has become serious – often irretrievably so.

Companies can gain access to free advice on debt from Business Debtline (see end of article for website address), a confidential telephone advice service for both the self-employed and SMEs experiencing financial difficulties. Set up in 1992, in the depths of the UK's previous recession, the service is now part of Money Advice Trust, a registered charity offering free, independent money advice. Its funding comes from private sector donations, including the major high-street banks, and government grants. Business Debtline expects to handle around 28,000 inquiries during 2009, after reporting a 15% increase in the first six months over the same period of 2008.

CRUNCH TIME Despite the support available to companies, insolvency specialists expect a sharp uptake in the number of corporate restructurings over the next few months. Indeed, it may already be under way: September is second only to January as a crunch date in the year for companies and lenders, with companies drawing heavily on their working capital to purchase stock ahead of Christmas and pressure builds on their ability to meet year-end financial covenants.

Ironically, a return to economic growth can expose companies that are financially vulnerable, as growth increases the demand for capital.

Many companies that have already explored every potential for saving cash may have quick-fix financial engineering to thank for staying afloat, while others may have hung on in the hope that credit conditions will improve. But the prospects for highly leveraged companies being able to refinance their debt appear doubtful.

While banks can offer to assist with both insolvency and a restructuring, insolvency generally offers less cause to believe that the company can be rescued. Insolvencies result from general difficulties caused by a company's business model. A fundamentally weak or flawed business model means that while a turnaround solution can be devised for an insolvent company, the odds on it proving successful are not that high.

There is no readymade insolvency framework in this country although the UK operates the administration process, under which an administrator is appointed for the company to get it out of trouble, and trading again if possible. Although administration has much in common with the Chapter 11 process in the US, which permits companies to mount a reorganisation while under court protection, the procedure for working out an insolvent company's problems in the UK tends to be an out-of-court procedure.

The UK also sets a clear distinction between the duties owed by the company's board when it is operating on a solvent basis, which are principally to its shareholders, and those it owes when insolvent, which are to the creditors.

A restructuring represents a different challenge to insolvency, being focused on a company whose level of indebtedness has become a problem but which is underpinned by a basically sound business model. In many cases, a private equity firm will have acquired the company for an elevated price in the pre-2007 boom period.

Restructuring a good business with a bad balance sheet involves reallocating values to those parties that still have an interest in the company, says Jackson Taylor, a restructuring partner for law firm Latham & Watkins. The question is how to reallocate in the forgiveness of debt.

The need for liquidity and a breach of the company's banking covenants are usually the triggers for a restructuring. The first issues to be addressed are what the long-term value of the business is and what level of debt it can sustain. The next step is to decide how to go about implementing a deal, a process that generally excludes any attempt to retrieve money for the shareholders. If the company is unable to repay its debt, this group is effectively wiped out and the interests of its shareholders removed from the equation.

So with the shareholders left empty-handed, the company's level of impaired debt is then calculated and those banks represented at the senior level of debt differentiated against those in at a lower level. Junior-level debt is next in line to be erased, and potentially even some senior debt, with the banks affected getting a stake in the restructured company instead. The business is restructured into a new capital package and a new company, with junior debt residing in the shell of the old company.

RESCUE VEHICLES A number of other rescue mechanisms for troubled companies are available, including a scheme of arrangement under the Companies Act and a company voluntary arrangement or trading administration under the Insolvency Act. Schemes of arrangement are possibly the most common implementation technique at present, says Taylor.

A scheme of arrangement – also known as a scheme of reconstruction – is a court-approved agreement between a company and its shareholders or creditors including lenders. The provisions for effecting a scheme of arrangement in the UK are set out in parts 26 and 27 of the Companies Act 2006.

Schemes of arrangement can be used for purposes such as rescheduling debt, takeovers or returns of capital. As they involve arbitrary changes in the structure of the business they are used only when reorganisation cannot be achieved by alternative means. A scheme of arrangement can involve writing off as much as 50% of the company's debt, and requires the agreement of all the banks involved before it can be effected.

A company voluntary agreement, as recognised under the provisions of the Insolvency Act 1986, enables a company to enter into a binding agreement with its creditors – provided that at least 75% consent – detailing how its debts and liabilities will be addressed. The directors are able to retain control of the company and organise the repayment of its liabilities, either in part or in full, over a period of time.

DEBT ADVISERS ARE USUALLY CALLED IN WHEN A COMPANY REALISES THAT BREACHES OF ITS DEBT COVENANTS HAVE BECOME INEVITABLE. ACCORDING TO INSOLVENCY PRACTITIONERS, TOO MANY VULNERABLE FIRMS DELAY ACTION UNTIL THE PROBLEM HAS BECOME SERIOUS – OFTEN IRRETRIEVABLY SO.

PRE-PACKS A further option that companies can consider, and which has gained in popularity since the introduction of the Enterprise Act in 2002, is the pre-pack administration. This is a deal for the sale of an insolvent company's business or assets that is put into place before the company goes into a formal insolvency process and prior to the appointment of an insolvency practitioner. Typically, the sale of the company is then completed fairly swiftly once the appointment is made.

Pre-packs are regarded as particularly suited to owner-managed businesses and those where most of the value of the business resides in key staff, who are likely to leave, or assets that are likely to depreciate in value once the administration or liquidation is announced. Their main advantage is that the debts of the business remain with the old company and the new or "phoenix" company can begin operating free of this burden. At the same time, continuity of supply is maintained so customers are kept happy, contracts honoured and key employees retained.

There are potential drawbacks however, particularly if the company's creditors suspect that the assets have been sold too cheaply, or that the speed of the deal means that goodwill has not been fully valued. There have been instances of phoenix insolvencies, in which the former owners of bankrupt companies have been able to buy them back again for a nominal sum.

Bodies such as the Association of British Insurers believe that unsecured creditors get a particularly raw deal from pre-packs and is lobbying for this group to get greater protection; for example, by preventing the same insolvency practitioner from acting as adviser to a distressed company both before and after administration. So the success of a pre-pack is contingent on the expectations of all those who will be affected being carefully managed.

Since the start of this year, the Insolvency Service has attempted to regulate the use of pre-packs by introducing the SIP 16 rules. These require insolvency advisers to provide extensive details to justify to the company's creditors the decision to opt for a pre-pack. They include disclosing any links between the directors of the insolvent company and its buyer, and the advisers must confirm that they have fully explored alternative means of either selling the company solvently or refinancing it.

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The Business Debtline website is at **www.bdl.org.uk**