CORPORATE RESTRUCTURING

Restructuring Instruments Available in Distress

Modigliani and Miller had already observed this a long time ago: One cannot change the value of an underlying (real) business just by shuffling paper. Therefore, one should only invest in or keep assets as long as the required return on equity can be achieved. Still, though, financial engineering will add value when restructuring a firm, provided a viable, long-term strategy can be developed.

Available instruments for a financial restructuring can be clustered according to their respective liquidity effect: Starting with the existing funding structure of a firm ("old money"), in most cases the liquidity squeeze caused by cash outflows amid the corporate´s debt position will have to be immediately addressed. Such can be achieved by simply eradicating (part of) the existing debt position through a haircut. Thereby, creditors (are forced to) write off part or all of their claims. This step may be accompanied by an adjustment of the interest rates and payments due as well as a re-consideration of their respective payment schedules.

Frequently, such measures are supported by debt-equity swaps: This transaction reduces a firm´s debt whilst at the same time boosting its equity position. However, a debt-equity swap will have no effect on liquidity. Nevertheless, it will reduce a firm´s leverage and hence facilitate the assumption of fresh debt, if needed. Further, debt holders participating in this transaction could participate in the upside of an increasing share price, should the firm achieve a turn-around. This would compensate them for (part of) already assumed losses.

One way or another, a firm in distress will in all likelihood require additional liquidity ("fresh money"). This will have to be raised either by cash equity through existing or new investors, or alternatively by the sale of assets. Raising equity in form of new common or preferred shares by new investors will be either through financial sponsors or strategic investors. Naturally, latter will have markedly different interests and criteria in regards to an investment, as such players would foremost look for all sorts of synergies. Possibly they would also be happy to invest, as there may be a chance to get hold of a corporate asset for favorable conditions.

Not unusually, shares offered in the course of a distressed restructuring situation are issued at a (very) deep discount. If implemented, the substantial dilution caused to existing shareholders is actually intended: It should provide an incentive for them to participate and support the intended restructuring, otherwise they would be practically marginalized.

Clearly, different investor groups will pursue different interests. Therefore, a restructuring concept ideally aims an optimal alignment of diverging positions. Whilst the burden will definitely have to be shared among all stakeholders, shareholders will often be invited to contribute significantly more in order to send a positive signal.

Empirical research indicates that financial restructuring has a major effect on overall restructuring success: A cash capital increase combined with a debt-equity swap and a haircut of financial liabilities indicates most impact and chance for success, provided that the intended transaction is specially tailored to the underlying case.

Having said this, the operational turnaround must always be at the heart of any turnaround success. Therefore a fully-integrated restructuring approach will always be required.

FINANCIAL RESTRUCTURING INSTRUMENTS

OLD MONEY		FRESH MONEY		
EQUITY	DEBT	EQUITY	DEBT	OTHER
DEBT-EQUITY SWAP	HAIRCUT	INCREASE	DIP	ASSET SALE
	INTEREST RATE ADJUSTMENT	M&A		