Restructuring in Distress - Instruments Available

Financial engineering in the course of a distress-related restructuring will add value, provided a convincing long-term corporate strategy can be developed and implemented.

Available instruments in distress-related financial restructurings can be distinguished according to whether old or fresh money is involved:

Starting with the existing funding structure of a firm (i.e. “old money”), all imminent as well as future cash outflows incurred by debt positions will have to be addressed: In a radical step, (all or part of) the firm´s existing debt may be eradicated with creditors forced to write off (all or part of) their claims. Even if less radical steps were taken, adjustments of interest rates and payments due as well as a re-configuration of upcoming payment schedules may have to be swiftly agreed with all creditor groups.

Such measures can be accompanied by debt-equity swaps: Whilst not providing liquidity, they reduce a firm´s debt burden and hence facilitate the assumption of new, fresh debt, if needed. In parallel, debt holders participating in a debt-equity swap could benefit from a (later) rise in the firm´s share price, should the turnaround be successful, compensating them for already assumed losses (or a part of them).

However, in most cases additional liquidity (“fresh money”) will also be required. This will have to be raised either through the divestiture of assets or through cash committed in form of debt, hybrid or equity capital.

Fresh cash equity can be contributed by existing investors. In the course of a restructuring this investor group is often approached first, as current shareholders know the firm already, besides speed is of the essence. Even more important, though, current investors´ participation is in most cases in their own interest: Otherwise, they may just be wiped out. - In parallel, frequently also new investors, such as financial sponsors or strategic investors reign in. Latter have very specific interests and criteria, and they will certainly focus on all sorts of synergies. Besides, a unique opportunity may open up to get hold of corporate assets for (very) favorable conditions.

In the course of restructurings in the United States and the United Kingdom, offering shares at a (very) deep discount is popular. If implemented, the consequence of radically diluting existing shareholders is entirely intended: This should incentivize them to participate in the transaction, else facing severe marginalization.

The challenge in managing a corporate´s financial restructuring is to align different investor groups pursuing different interests. Whilst the burden will have to be shared among all investor groups, shareholders will often be invited to contribute significantly more, though, in order to send a positive signal.

Empirical research indicates that financial restructuring is key for making restructuring a success: Not surprisingly, a cash capital increase combined with a debt-equity swap and a haircut of financial liabilities seems to have most impact and chance for success.

However, it is always the operational turnaround and its swift implementation coming first in any distress-related restructuring, with financial engineering playing an (important) support role.

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FINANCIAL RESTRUCTURING INSTRUMENTS

OLD MONEY

EQUITY

- DEBT-EQUITY SWAP

DEBT

- HAIRCUT
- INTEREST RATE ADJUSTMENT

FRESH MONEY

EQUITY

- INCREASE
- M&A

DEBT

- DIP

OTHER

- ASSET SALE

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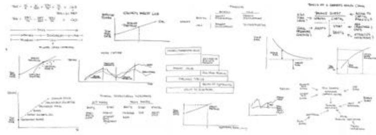

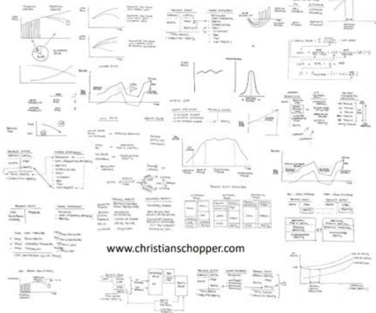

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