Restructuring in Distress - Instruments Available

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

Available instruments in the course of a distress-related financial restructuring can broadly be clustered according to whether old or fresh money gets involved:

Starting with the existing funding structure of a firm (i.e. “old money”), cash outflows incurred by various debt positions will have to be immediately 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, adjustment of interest rates and payments due as well as a re-configuration of upcoming payment schedules will 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 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 alternatively cash committed in form of debt, hybrids or equity.

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. But even more important, current investors´ participation is in most cases in their own interest: Otherwise, they may likely be wiped out. - In parallel, though, frequently new investors, such as financial sponsors or strategic investors reign in. Latter have very specific interests and criteria, will certainly focus on all sorts of synergies. Besides, an opportunity may open up to get hold of corporate assets for (very) favorable conditions.

Especially in the course of restructurings in the United States and the United Kingdom, offering shares at a (very) deep discount are popular. If implemented, the radical dilution of existing shareholders is entirely intended: It should incentivize current shareholders to participate, else facing marginalization.

The challenge in the course of 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 having to come first in any distress-related restructuring, with financial engineering playing an (important) support role.

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		

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