

# Continental drift

Trevor Clawson investigates corporate restructuring trends in Europe.

It's a familiar story from the frontline of the economic downturn. A property company slides into financial difficulties. Struggling with a steep downturn in the sector, it breaches the terms and conditions of loans agreed with its bankers and is unable to meet its repayment obligations. Inevitably, the next step is a round of make or break negotiation aimed at restructuring its debt.

Nothing unusual there. The travails of property companies are now common currency in the financial pages. The sector was the first to suffer when the sub-prime mortgage crisis brought the banking system low and, nearly two years on, both the residential and commercial markets remain well and truly in the doldrums.

However, in this case the company in question wasn't British. From the UK, it's easy to forget that ours is not the only property market to slide spectacularly from boom to bust. As Gareth Davies, managing director of the European Restructuring and Debt Advisory Group at Close Brothers Corporate Finance (CBCF), points out: "Spain was the first country to be hit by the recession when its property-driven boom was deflated."

Thus, when Close Brothers was appointed to advise Affirma Grupo Inmobiliario – a Spanish property group – on the restructuring of its debts, the work was carried out against the backdrop of a downturn that predated the UK's slide into recession. Today the contagion has spread across the whole continent. While the worst problems of the property market tend

to be concentrated in Britain and Spain, the slowdown in building work in those countries is impacting businesses operating out of neighbouring countries. "What we're seeing is that companies supplying the housing industry in the UK and Spain are being hit by falling demand," says Philip Davidson, head of accountancy firm KPMG's European restructuring business. "That is affecting suppliers in France and Germany."

## STRAIN

Meanwhile the automotive industry is also feeling the strain. Recent announcements on output cuts from the likes of Nissan, Honda, Jaguar Landrover and BMW's Mini production centre have hammered home the message that the British car industry is buckling as global demand for vehicles falls. No surprises, then, that the European automotive industry as a whole is facing similar problems, with France and Germany particularly hard hit.

As Alan Tilley, a partner at turnaround specialist Bryan, Tappy & Tilley observes, the most obvious manifestation of this is in the form of job losses. "Germany is beginning to face up to the issues facing its auto supply industry and companies there are already beginning to downsize," he says. "There has been less impact in France because the government has moved to protect its key automotive companies by providing support."

There are also echoes of the British experience in the retail sector. "Retailers in the major European countries had a

bad Christmas," says Peter Briggs, a turnaround specialist at business advisory firm Alvarez & Marsal. "It's very unlikely that business will pick up again in time for Christmas next year. They are facing a tough time."

As Briggs points out, foreign exchange movements are also taking their toll on European economies. He cites the example of central and European countries outside the euro that have had to devalue their currencies. "There has been a lot of borrowing in dollars and euros," he says. "When currencies are devalued, that makes it much harder to service the debts."

That said, membership of the euro can be a double-edged sword. When the previously bullish Irish banking sector fell victim to the global credit crunch, a comparison with Iceland was frequently made. According to the running joke, the only difference between the two countries was a single letter in the name and Ireland's membership of the single European currency. It was having the euro, the conventional wisdom said, that saved Ireland from a catastrophic economic meltdown.

However, according to Pippa Wicks, managing director of business advisor AlixPartners, the restrictions imposed by euro membership can cause real difficulties. "If you look at Greece, the economy there is under real pressure and, unlike Turkey, it can't devalue," she says.

Servicing debt is also likely to be a significant issue for at least some of the organisations that were bought out by private equity companies in leveraged deals prior to the banking crisis. At a time of cheap and widely available credit, valuations were ratcheted up and deals typically involved a combi-

nation of cash plus debt that was added to the bought out company's balance sheet. "The ability to service that debt depended on companies in question meeting very ambitious growth targets," says KPMG's Philip Davidson. The downturn makes it likely that a large number of highly-leveraged businesses will not be in a position to deliver on those bullish projections.

## RESTRUCTURING ACTIVITY

Against this economic background, there is clearly going to be a huge amount of restructuring activity across Europe over the next few years. While a great deal of that will focus on companies agreeing to restructure debt and/or secure their future through job cuts and the sale of non core assets, inevitably, insolvencies look set to rise.

And it's when the courts get involved that things begin to get complicated. We may live and work within a European single market, but when it comes to the legal framework governing insolvency, the continent is a jigsaw of differing jurisdictions. "In each jurisdiction legislators have tried to strike a balance between the interests of creditors and the interests of other stakeholders," says Alan Tilley. "Some are more creditor friendly than others."

According to Tilley, most European countries have made efforts to create insolvency regimes where there is a fighting chance that value will be preserved rather than assets being sold off to meet the demands of creditors. "Germany was one of the first to adapt and Italy has also made efforts to maximise the chances value being preserved. On the other hand Spain is still creditor-friendly," he says.

The rules under which a company is declared insolvent also vary. For instance, while in Britain, the test is whether suppliers can be paid, in Germany there is a strict test based on the

balance sheet, which tends to leave directors much less room for manoeuvre.

In the past, reconstruction professionals have used European rules allowing companies to move their headquarters – or the "centre of main interest" – to maximise their chances of achieving the desired outcome, be it preserving the company as a growing concern or recovering as much money for creditors as possible. For instance, German automotive parts supplier Schefenecker now has its headquarters in the UK, because recovery work carried out by KPMG was thought more likely to succeed under British law. Philip Davidson says this sort of thing is likely to occur less in future. "Because of Schefenecker, Germany is reviewing its insolvency laws. There was concern that some European countries would try to establish themselves as centres of main interest but this seems less likely now."

## JURISDICTION

However, it remains the case that the jurisdiction has a real impact on the likely outcome of insolvency procedures and this, ironically, may be good news for those distressed businesses seeking to avoid insolvency by reaching agreement with their banks on debt restructuring. "In cases of multiple jurisdiction, the outcome of the insolvency process is hard to predict," says Close Brothers' Gareth Davies. "That makes lenders nervous about going down that road."

But when a company is declared insolvent Europe as a whole lags behind the US system when it comes to salvaging some sort of going concern that the end of the process. "We still don't have anything as effective as Chapter 11," says Alan Tilley. If the current recession is as bad as some are predicting, then lack of a US-style approach to nursing companies back to health may become a priority for European legislators.

## Outlook for bankruptcy levels in export markets, the UK and key sectors

Trading overseas can be much more complex than doing business with a local firm, particularly when it comes to getting paid.

There are differences in payment practices, laws and regulations and even in business culture between the UK and overseas that could cause problems for unwary exporters – problems that could result in slow payment or bad debts.

It is important for a company to do its homework before starting a relationship with an overseas partner. UK businesses need to be confident that overseas customers are a good credit risk, as well as ensuring that the industrial sector they are exporting to is not on the verge of collapse. Local intelligence is vital for this, but also to discover if there are any laws or regulations that could cause payment problems.

The first step is to credit check new customers to ascertain their level of risk. The next step is to agree credit terms, although most European customers

expect open account credit terms, which entail the highest amount of risk. Customers in less developed countries are still willing to provide letters of credit or even payment in advance.

If a UK exporter has problems getting paid the company should turn to a debt collection agency with international experience and knowledge of the country's legal system. The best protection of all against a bad debt is credit insurance as it vets the customer for credit risk. If things go wrong and the export company suffers a bad debt, credit insurance will pay up to 95 per cent of the value of the original invoice.

*This graph (right) is taken from the Atradius Market Monitor. To read the full publication and commentary on all countries shown, visit the publications section of [www.atradius.co.uk](http://www.atradius.co.uk).*

## THE EXPECTED DEFAULT FREQUENCY (EDF) BY COUNTRY

The EDF chart shows the likelihood of companies failing to make scheduled payments or impending bankruptcy proceedings. The probability is calculated from the market value of a company's assets, its

volatility and its capital structure. This latest chart shows that the EDF for the UK rose sharply from 0.35 per cent in January 2008 to 2.05 per cent in November.

