EDITORIAL

Challenging and Exciting Times Ahead for the Restructuring Industry

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The past decade has seen the corporate restructuring market around the world grow far more complex. Broad macroeconomic trends, globalization, regulatory and legislative changes, as well as increasing numbers of stakeholders – and their increasing sophistication – have combined to create a tough and sometimes confrontational market containing what are often very different agendas. Yet these same forces are also creating a market more focused on consensus-based restructurings that save businesses and preserve value.

Being able to balance these different agendas to obtain positive outcomes is setting a high standard for restructuring professionals everywhere. Over the next decade those who thrive will be the ones who are most adaptable, flexible and willing to challenge the status quo. Those who do thrive will find it the most exciting period of their professional lives.

A mixed forecast for the world economy

In macroeconomic terms, with the United States, China and India looking set to drive growth in the world economy, the European Union and companies based within it face particular challenges. The strong cyclical recovery for the world economy as a whole over the past two years has had less of a positive effect in Europe than elsewhere. According to the ITEM Club, the economic think tank sponsored by Ernst & Young, world trade in manufactured goods increased by about 10% in 2004. Many European suppliers missed out on this growth, however, unable to compete with low-cost manufacturing centres elsewhere. At the same time they suffered from the increased costs of commodities that have been driven by Asian demand.

Although taken as a single entity the EU's economy is now the world's largest, growth and investment are predicted to be significantly lower than in North America and Asia over the next four years. The current strength of the Euro and Sterling, as well as the long-term costs of integrating 10 new Eastern European member countries and their 70 million citizens, will help shift much of the world's investment capital to Asia and its promise of higher returns.

Lastly, despite today being a single market, the EU's history means that there are many more companies operating in each industry than are needed. Over the next decade pressures on the European economy guarantee that some will fail. Many others will need to consolidate to create the efficiencies and high-growth opportunities needed to attract global investment. When there are failures, a legal structure with the flexibility to preserve value for stakeholders is essential.

Harmonization not on the horizon

Although many countries around the world are taking positive steps by adopting 'rehabilitative' corporate restructuring regimes, the environment still differs widely from one country to the next. The European Council Regulation on Insolvency Proceedings (ECRIP) has been introduced to act as an umbrella across EU member states, but harmonization of law across Europe, let alone globally, is unlikely to occur during the working lifetimes of any current restructuring professionals, if ever.

Restructurings are always performed against the backdrop of directors' responsibilities and what would happen in a formal insolvency process. Europe finds itself occupying a middle ground between countries with unproven formal processes on one side, and the UK and the United States on the other. UK administration is well tested, and its flexibility increasingly understood; US Chapter 11 bankruptcy protection is now so common that some companies seem to view entering it as a normal part of doing business.

Individual European countries, including Spain, France and Italy, have reformed their insolvency legislation in recent years. But many still have harsh penalties for directors who don't file for insolvency early enough when they see their company is in trouble. This can work against the idea of preserving value and avoiding liquidation by not giving a company's management time to explore all of its options.

Restructuring practioners, recognizing that harmonization of restructuring regimes is not coming any time soon, are becoming very resourceful at using the best of different aspects of restructuring processes in different jurisdictions. In some cases this means leading restructurings from countries where an organization does business but is not necessarily headquartered, and coming up with new and innovative solutions for each case. A very positive sign is that these professionals are being supported by pragmatic and commercially minded courts in different countries, whose judges are discussing cross-border restructurings more and more and establishing protocols for them. Inevitably there are occasions in which these solutions are regarded as antagonistic and controversial, but for the most part they are earnest attempts to resolve cross-border problems.

The complex corporation – and complex restructuring

Ten to 15 years ago most companies were relatively simple. Even large multinationals tended to be made up of a manageable number of subsidiaries. Their debt tended to be held by a small number of groups whose 'best interests' were likely to be broadly aligned in the case of a restructuring.

Today the picture is very different. Corporations are likely to operate in many jurisdictions, through sometimes hundreds of subsidiaries, and answer to a variety of different stakeholders. Their creditors will range from trade creditors to bankers to bondholders, from par holders to distressed debt funds. In the event of a restructuring some creditors will want to get as much money back as quickly as possible, some will want control of the organization and others may even want to force a default so that they can trigger their credit insurance.

These groups are likely based in different jurisdictions themselves, and may have very different levels of understanding of the regime in the country where the company is operating. This, combined with the fact that each group will undoubtedly hire its own team of professional advisers, has a tendency to slow down the restructuring process while increasing its costs.

Each of these sets of advisers will likely be challenging whoever is driving the restructuring process, as well as each other, based on their clients' agendas. Ideally, the company and its advisers will take charge, but in many cases management will be slow to recognize the severity of the problems it faces and the process will be driven by the creditors. The slow recognition of problems is often because corporate managers rightly tend to be optimistic and entrepreneurial and not necessarily the best people to spot looming problems.

A positive change that has taken place in recent years, and looks set to continue, has helped to offset possible confusion and preserve companies' control of their restructuring processes. This is the recognition by corporate boards that they may need people with different skills at different phases in a company's life cycle. The evolution of the 'Chief Restructuring Officer' (CRO) role as a limited-term solution to overseeing a restructuring has been gradually exported from the United States. Bringing in an expert to handle a difficult restructuring has the advantage of letting the company's other officers concentrate on running the business.

Seeing the writing on the wall

Another positive aspect of today's restructuring market is the ability that businesses and their advisers have to see further into the future. More than ever there is a huge amount of information available to warn of future problems in a country, sector or individual company. With so much information available, the art is, of course, being able to interpret it in a useful way – a skill that restructuring professionals will need to develop in order to be able to reach and help their clients early.

Ernst & Young publishes a quarterly report on profit warnings issued by UK listed companies, which provides valuable insight into trouble ahead for different sectors. In 2004 nearly 300 of these warnings were issued, a jump of 40% over 2003, reflecting the impact of interest rate hikes and, to a lesser extent, high raw material costs. Support services, software and computer companies and general retailers issued the highest number of warnings, and companies with turnover of less than GBP 200m were hardest hit. This suggests that smaller organizations were having difficulty competing against larger competitors that were able to drive down prices in their supply chains more easily. This was backed up by a large percentage of these companies citing 'difficult trading conditions' as behind their warnings, rather than one-off events.

Analysing profit warnings isn't quite so simple of course. While in many cases the issuance of a warning is a lead indicator, in others it will be a lag indicator. If a company expects to make a profit of GBP 200m and only manages GBP 130m, it is probably an early indicator of a problem. If a company expects to make a profit of GBP 20m and actually loses GBP 50m, it is almost certainly an indicator of a problem that both management and analysts have known about for a long time. But by examining the information available, restructuring practioners will be able to preserve more value in the companies they work with by getting to them before problems become crises.

The good news

Despite its increasing complexity, the restructuring market around the world has changed for the better in the past ten years by focusing on saving businesses and preserving value. This consensual approach is getting better returns than ever for stakeholders, and signs are good that this trend will continue.

This has raised the bar for restructuring professionals. To succeed in this new world we need to be flexible, fast moving, creative, innovative and unafraid to push the boundaries. We need to negotiate, facilitate, drive change and act as catalysts for achieving the best solutions. The traditional skills of an insolvency practictioner are no longer good enough. We must harness a wider range of skills and bring them together seamlessly. For those willing to rise to the challenge, there are fascinating times ahead.