Deloitte.

The international insolvency & restructuring review

2021/22

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1.

Key developments, the latest trends and solutions in the swiss and german restructuring market

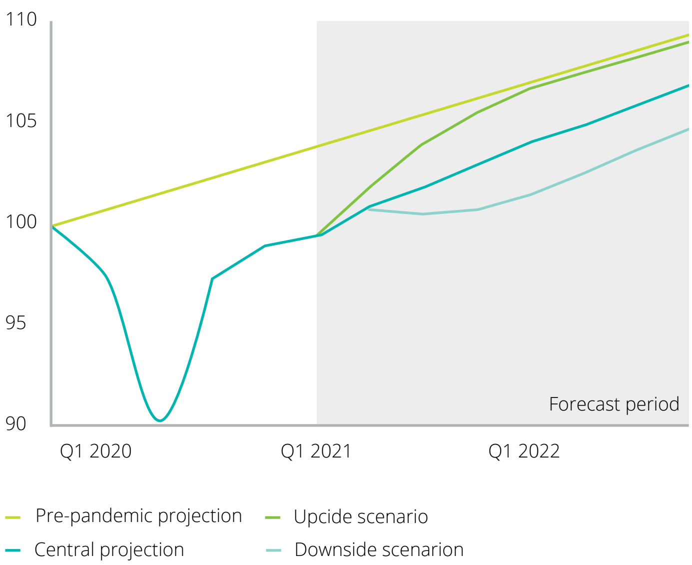
This chapter sets out recent developments in the German and Swiss markets for insolvency and restructuring, with relevant statistics and survey results. It also looks at the refinancing and M&A environment, with particular emphasis on the distressed segment. It then describes the different time frames for recovery from COVID-19 focusing on how business remain undergoing fundamental restructuring can come out stronger than before. Management teams face the challenge of reviewing their corporate strategy and this article sets a strategic option review framework for decision making. It also addresses the issue of how best to prepare an entity for sale where a restructuring is unlikely to lead to a desired outcome.

Introduction

Orchestrating the recovery from the COVID-19 pandemic has required unprecedented coordination and collaboration across organisations, markets, and the economy at large.

The shape of the recovery will depend on the speed of vaccination programmes, the threat from emerging variants of the virus, and the pace of recovery, which is expected differ between advanced and emerging market economies. According to the OECD Economic Outlook released in March 2021, global GDP growth is projected to be 5.6 per cent in 2021 and world output is expected to reach pre-pandemic levels by mid-2021 (see figure 1)[1],[2]. According to an economic outlook developed by Swiss Life[3], at the end of the first quarter of 2021, business sentiment indicators are showing a strong increase in the Eurozone, with GDP expected to recover by 4.4 per cent in 2021 and 3.0 per cent in 2022. The forecast for Germany was for 3.5 per cent GDP growth in 2021 and 3.0 per cent in 2022, and for Switzerland the forecast growth was 3.6 per cent in 2021 and 2.2 per cent in 2022 - driven by the effectiveness of the vaccination campaign over the coming quarters in particular.

Figure 0: World GDP index (Q4 2019=100)



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Jan is a Financial Advisory Partner based in Zurich and is leading the Swiss Restructuring Services practice. His specialist areas include exiting underperforming businesses and winding down and liquidating legal entities. His record of accomplishment includes advising shareholders in the context of global legal entity rationalisation / corporate simplification programmes and setting up new legal entities, including Societas Europaea (SE).

Jan is the lead Swiss partner advising global banks in winding down or setting up private banking and other operations in Switzerland. He has acted as the liquidator in a number of proceedings in Switzerland. He has led major corporate transformations and transactions for multinational corporations and has advised management teams in the context of asset efficiency programmes.

Jan holds a MSc from London Business School, a MSc in Industrial Engineering from the Technical University of Berlin and a Bachelor's degree in Business Administration from Georgetown University.

Dr. Thomas Sittel
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Partner Restructuring Services

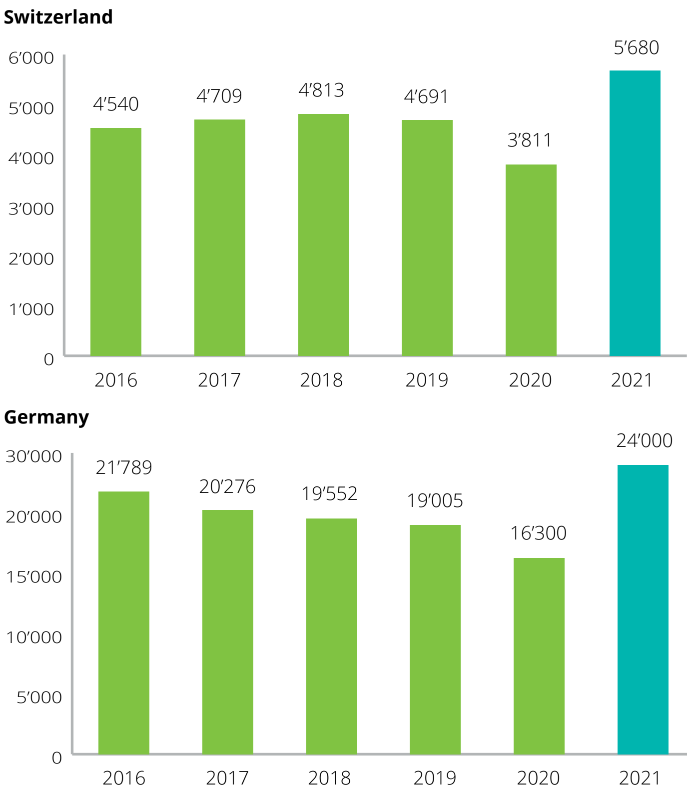
Thomas advises clients on key areas of their entrepreneurial activities, such as M&A, financing and transformation: with 23+ years' experience, he has developed a comprehensive expertise in structuring complex, mostly cross-border M&A transactions. This includes advising on crisis, insolvency, succession and carve out situations.
Thomas has extensive experience in transformation and carve out projects. His client network includes multinational and medium-sized companies, and the restructuring and workout units of banks, as well as institutional investors (e.g. private equity, family offices).

Thomas is a certified bank clerk and accredited lawyer. He studied company and tax law at the Universities of Freiburg and Munich and earned his PhD at the Dresden University of Technology.

1 OECD Economic Outlook March 2021
2 https://www.imf.org/en/Publications/GFSR/Issues/2021/04/06/global-financial-stability-report-april-2021
3 https://www.swisslife-am.com/content/dam/slam/documents_publications/Perspectives Financial-Markets/fm_april_2021/0421_Perspectives_financial%20 markets_ DE.pdf

The pandemic has not yet led to an increase in the number of insolvencies in Germany or Switzerland. The number of insolvencies in Germany has actually fallen by eight per cent between 2019 and 2020 in Germany and by 19 per cent in Switzerland. It seems that measures to deal with COVID-19 kept insolvencies at bay in 2020. Measures that have helped businesses of all sizes to avoid financial distress include financial support from government; short-time working arrangements; the suspension of requirements to file for insolvency; financial restructuring; cost reduction and working capital improvement programmes; and mergers and acquisitions.

Figure 1. Number of insolvencies in Switzerland and Germany FY2016-FY2021



Source: Dun & Bradstreet, Creditreform and the Institut der Deutschen Wirtschaft (IWD)

Euler Hermes expects the number of insolvencies in Switzerland to increase to about 5,680 in 2021, as government measures have expired or are due to expire in the second half of the year, and a number of industry sectors are facing structural changes. A return to historical levels of insolvencies is expected in 2022. The number of insolvencies each year has fallen by more than 50 per cent in Germany since 2009 to the lowest levels in history, but it is expected to increase by almost 50 per cent to about 24,000 in 2021.

The most affected are businesses operating in tourism and hospitality, retail and consumer goods, and manufacturing and chemicals. The reasons why they are affected most by the current situation are mostly financial in nature.

Irrespective of the sector that their company is operating in, the Swiss CFO survey [4] identified some key challenges that organisations should be aware of and prepare for, particularly the risk of default on debt payments.

Figure 2. Business sector and impact analysis, October 2020

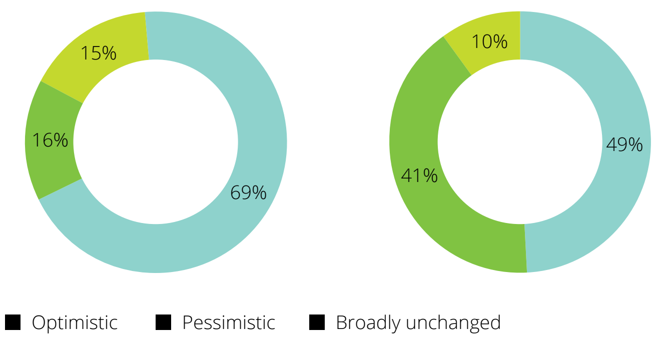
	Total	Services	Tourism & Hospitalit	Retail & Consumer goods industry	Financial Services	Pharma/Life Sciences/ Medical Technology/Health	Manufacturing & Chemical industry	Information & Communication technology	Construction industry
Short-time/wage/ adjustments/pension reductions/dismissals	49%	46%	95%	76%	18%	36%	73%	33%	51%
Stop or delay of planned investments	41%	37%	64%	56%	24%	40%	55%	43%	47%
Waive profit distribution/ dividend payments	27%	35%	32%	22%	14%	17%	36%	33%	40%
Claim COVID-19 credits	20%	25%	45%	20%	10%	17%	24%	33%	15%
Postpone capital repayments/amortisations/ interest payments	13%	12%	23%	10%	8%	12%	13%	10%	15%
Additional debt financing (excluding COVID-19 credits)	12%	5%	23%	22%	11%	17%	15%	5%	11%
Additional self-financing	11%	20%	9%	12%	5%	10%	15%	10%	6%
Precautionary utillisation of exisiting credit limits	11%	6%	14%	20%	4%	14%	20%	5%	11%
Wind-down of underperforming divisions or locations	7%	5%	27%	7%	6%	7%	7%	5%	4%

Well below average · Average · Above average · Well above average · Companies particulary affected

Source: Deloitte, Navigating Volatility and Distress, Sector Overview including COVID-19 impact

Deloitte's recent European CFO study, H1 2021, identifies some of the key challenges for 2021 and beyond, based on ratings by CFOs rating of their company's financial outlook compared with three months previously.

Figure 3. CFO rating of their company's financial outlook over the next 12 months as per end of Q1 21, compared with three months previously



Source: The Deloitte CFO Survey, H1 2021 | Results of the Swiss and European CFO surveys

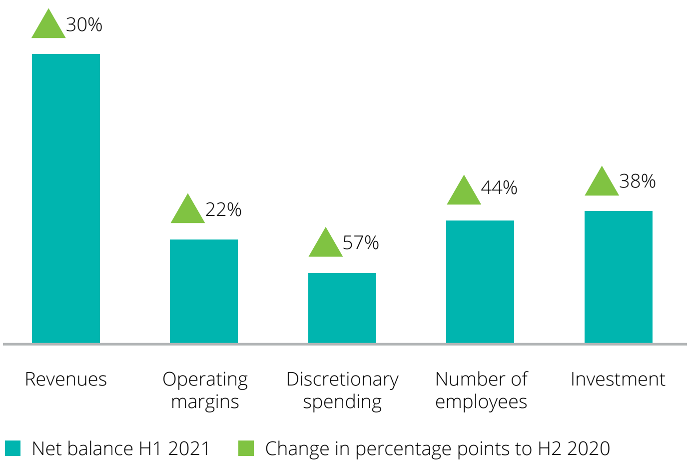
4 Source: 2020 Deloitte Swiss CFO Survey

This study provides evidence of a mixture of both improvement and modest, patchy growth regarding CFOs' expectations about specific corporate performance indicators. The most striking example of greater optimism is in the revenue expectations of CFOs in Switzerland. However, the base line for future growth is relatively low, as companies still must make up for revenue losses during

the pandemic. Expectations regarding operating margins are more modest, with most CFOs remaining pessimistic about a recovery in margins.

The most pessimistic indicator in the survey was for expectations regarding employment: most CFOs continue to rate these as negative. There is evidence of an improvement in performance indicators in most of the European countries surveyed. However, in many cases, this was insufficient to re-establish positive expectations. Some countries, including Germany, are showing a substantial recovery, with expectations for revenues, operating margins and investment all positive, although expectations for employee numbers remain negative.

Figure 4. CFO's expectations about their company's key performance indicators (positive or negative) over the next 12 months



Source: The Deloitte CFO Survey, H1 2021 |
Results of the Swiss and European CFO surveys

Refinancing Environment

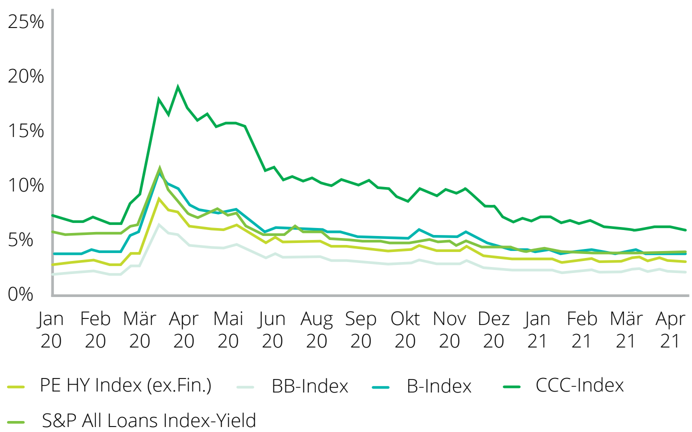
The refinancing environment has changed significantly since the initial peak of the pandemic in March 2020, both in terms of debt availability and the cost of debt. The iTraxx Crossover Index, comprising the 75 most liquid sub-investment grade entities, has eased from around 680 bps during the peak to less than 250 bps in April 2021 (Figure 5).

Figure 5. iTraxx Europe Crossover Index

Source: Bloomberg

European institutional loan issuance declined in 2020, as the exceptionally strong start to the year in January and February came to a halt with the outbreak of the COVID-19 pandemic in March 2020. Amid this market volatility, support and stimulus from central banks calmed the debt markets and restored investor confidence. An impressive increase in loan and bond volumes characterised the start of 2021 driven by restored market confidence and a fall in the cost of debt, especially for non-investment grade debt and alternative financing. The falling average cost of debt for non-investment grade loans is exemplified by the Barclays Pan-European High Yield Index in Figure 6, where the B and CCC indices fell from 12 per cent in March 2020 to 4.3 per cent and 7 per cent respectively at the end of the year.

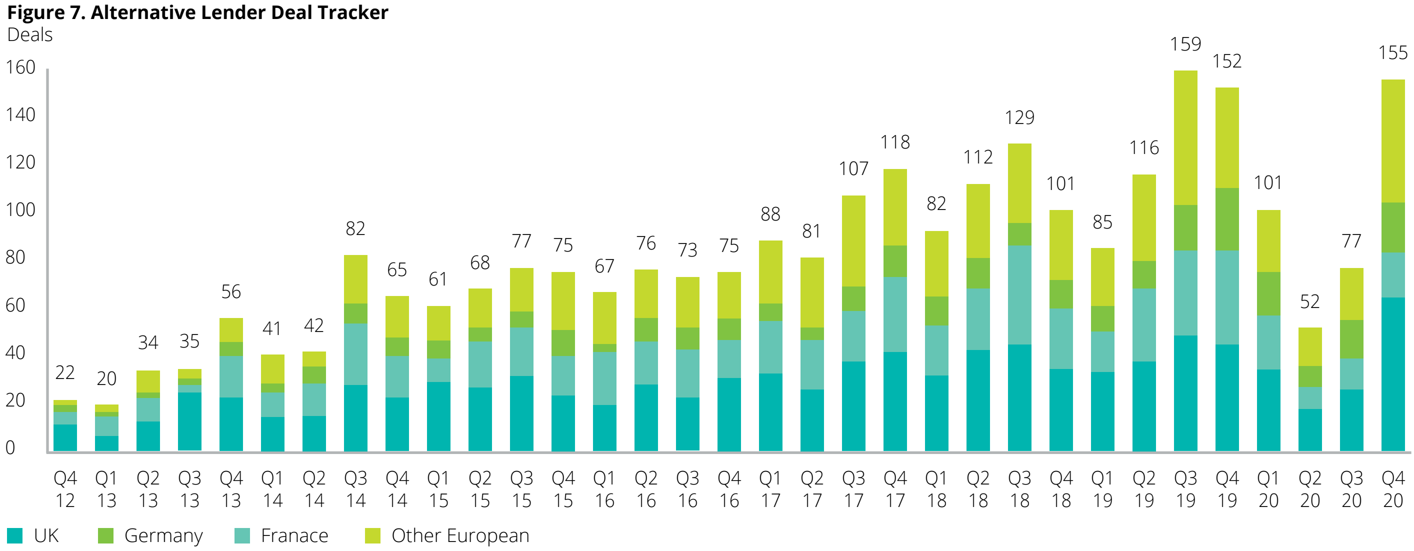
Figure 6. Barclays Pan-European High Yield Index



Source: Bloomberg

The Deloitte Alternative Lender Deal Tracker (see Figure 7) shows the surge in alternative financing in Q4 2020.

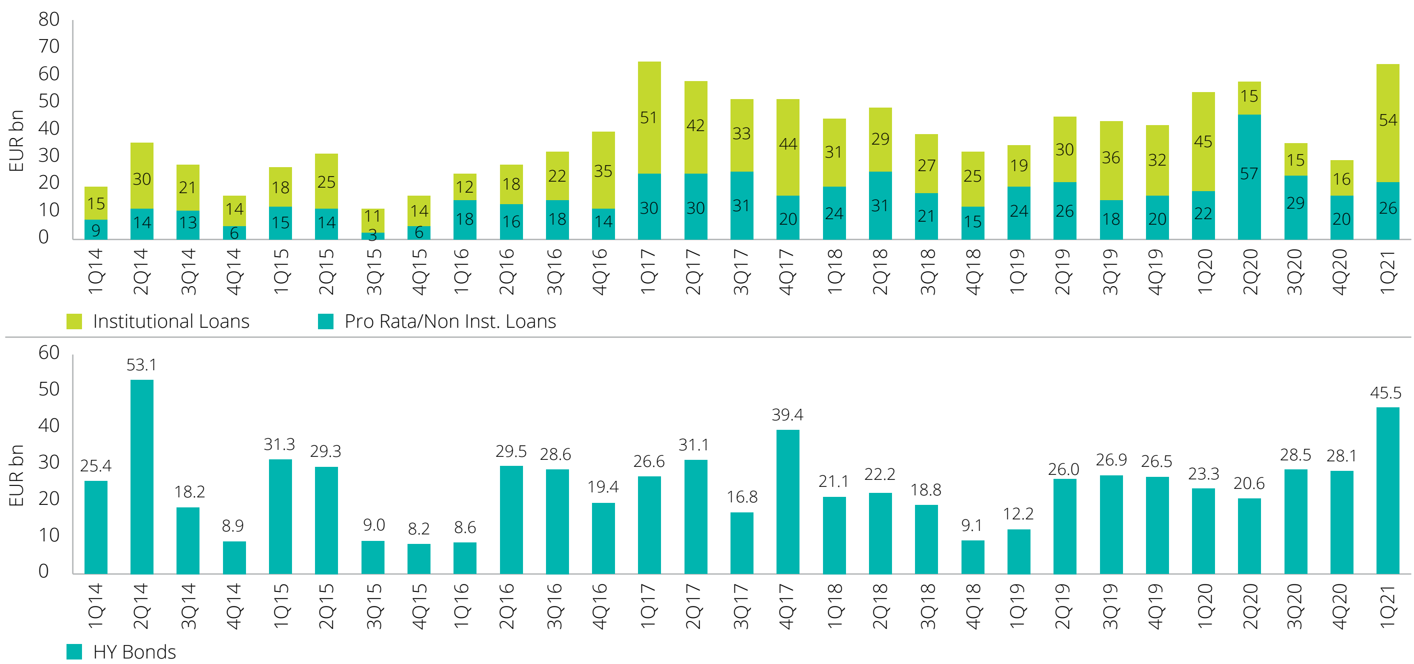
Figure 7. Alternative Lender Deal Tracker



Source: Deloitte Alternative Lender Deal Tracker Spring 2021

Borrower-friendly conditions also prevailed in the leveraged loan and high yield bond markets during Q1 2021, as companies had ready access to the market to refinance existing debt or raise new funding (Figure 8). Leveraged loan issuance was extremely active, reaching EUR 79.6bn in Q1 2021, well above the comparative total of EUR 67.7bn in the previous year, with the institutional loan segment alone amounting to EUR 53.7bn – the highest quarter on record. European borrowers tapped the high yield bond market for EUR 45.5bn, the second highest quarterly level on record. From a credit quality perspective, market conditions have reflected a ‘risk-on’ environment at the beginning of FY 2021, with more than two-thirds of institutional loan volumes rated B and below[5].

Figure 8. European leveraged loan and high yield bond markets volume FY2014-Q1 FY 2021

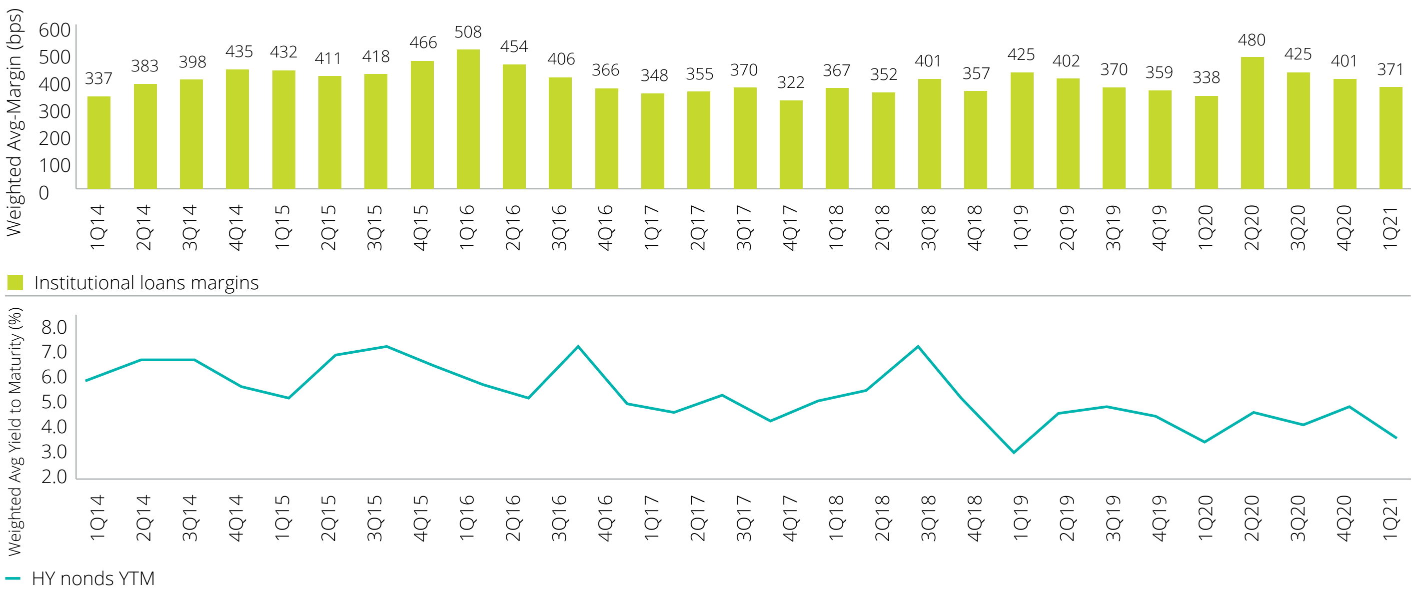


Debtwire Par: March 2021 European Leveraged Insights Report

5 Debtwire: March 2021 European Leveraged Insights Report

In tandem with the surge in loan repricing volume, the supply-demand imbalance led to tighter pricing across the board in Q1 21. Tighter pricing, not surprisingly, was also a feature of the high yield bond primary market, with the Q1 21 average yield to maturity at 3.66% for European currency-denominated notes (Figure 9).

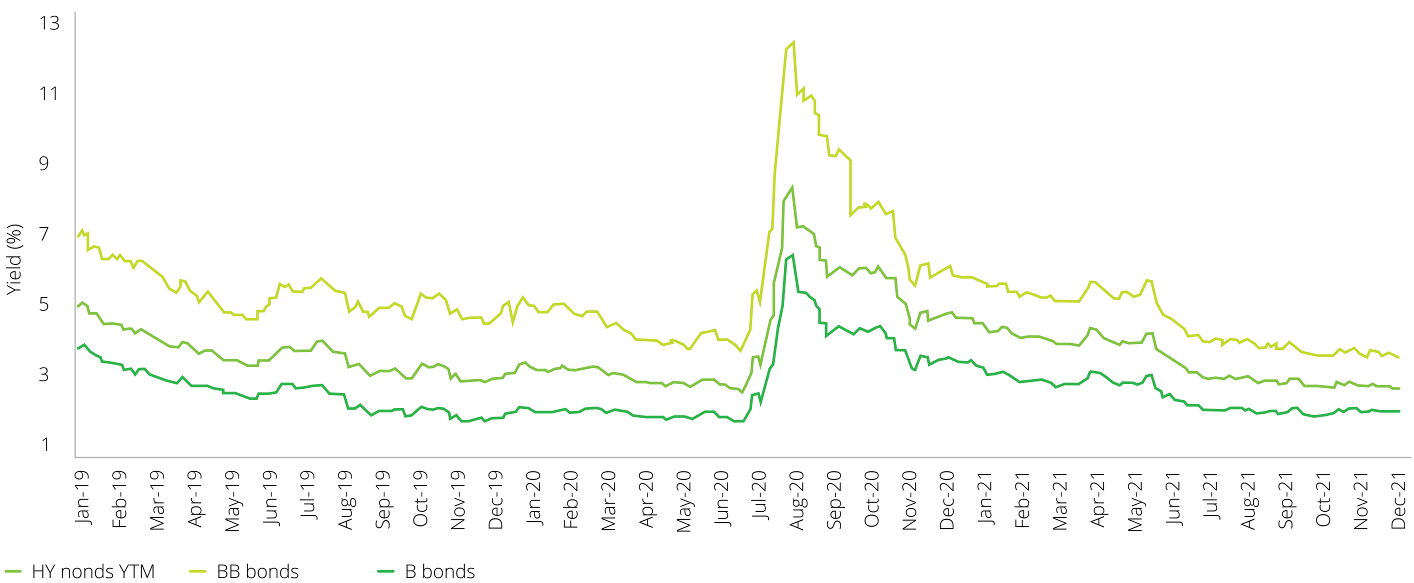
Figure 9. Institutional loan margins and HY bonds YTM FY2014-Q1 2021



Source: Debtwire

The secondary markets have also been supportive of issuance in the primary markets. Given the appetite for credit, secondary loan prices have recovered fully from the pandemic-driven slump in 2020. The pandemic-hit retailing and entertainment and leisure sectors led the market lower in March, although both sectors were up overall in Q1 2021 (Figure 10).

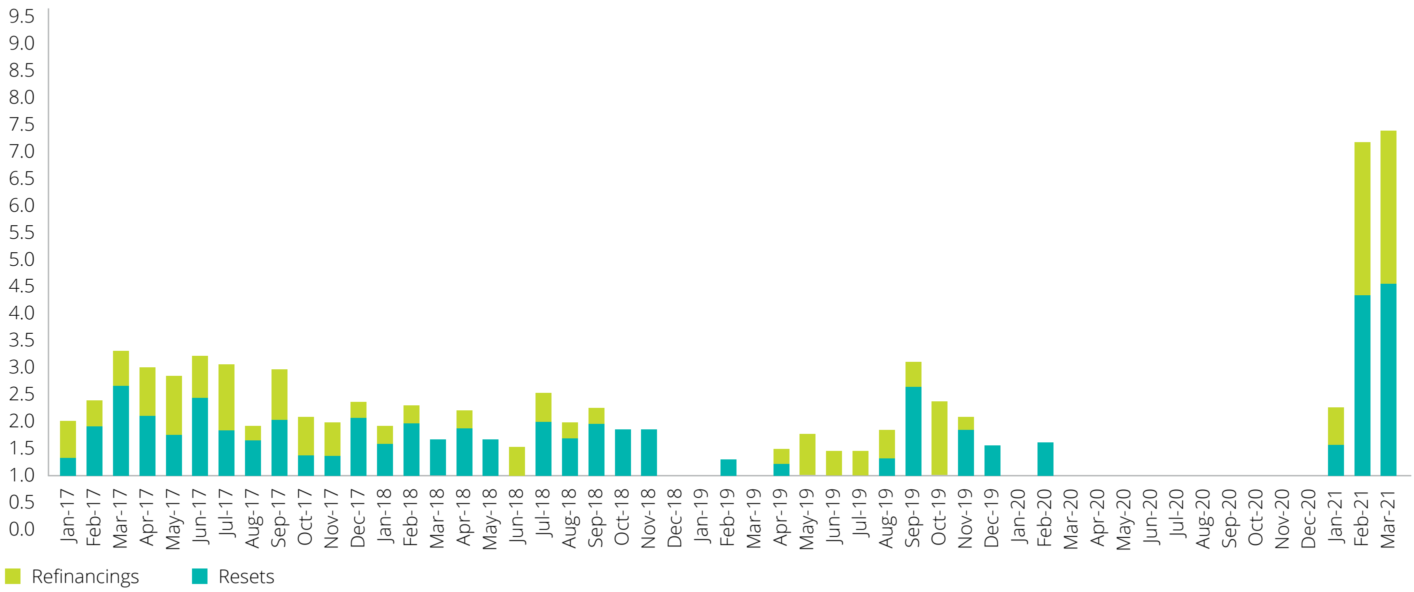
Figure 10. ICE BofA Euro High Yield Bond Index



Source: Debtwire Par

From a collateralised loan obligation (CLO) perspective, lower pricing and tightening in liability spreads facilitated a surge in refinancings (EUR 8.3bn) and resets (EUR 9.8bn) in Q1 2021. This was in sharp contrast to 2020 when there were no CLO refinancings, and resets amounted to just EUR 790m over the course of the full year (Figure 11).

Figure 11. CLO refinancing and resets



Source: Creditflux

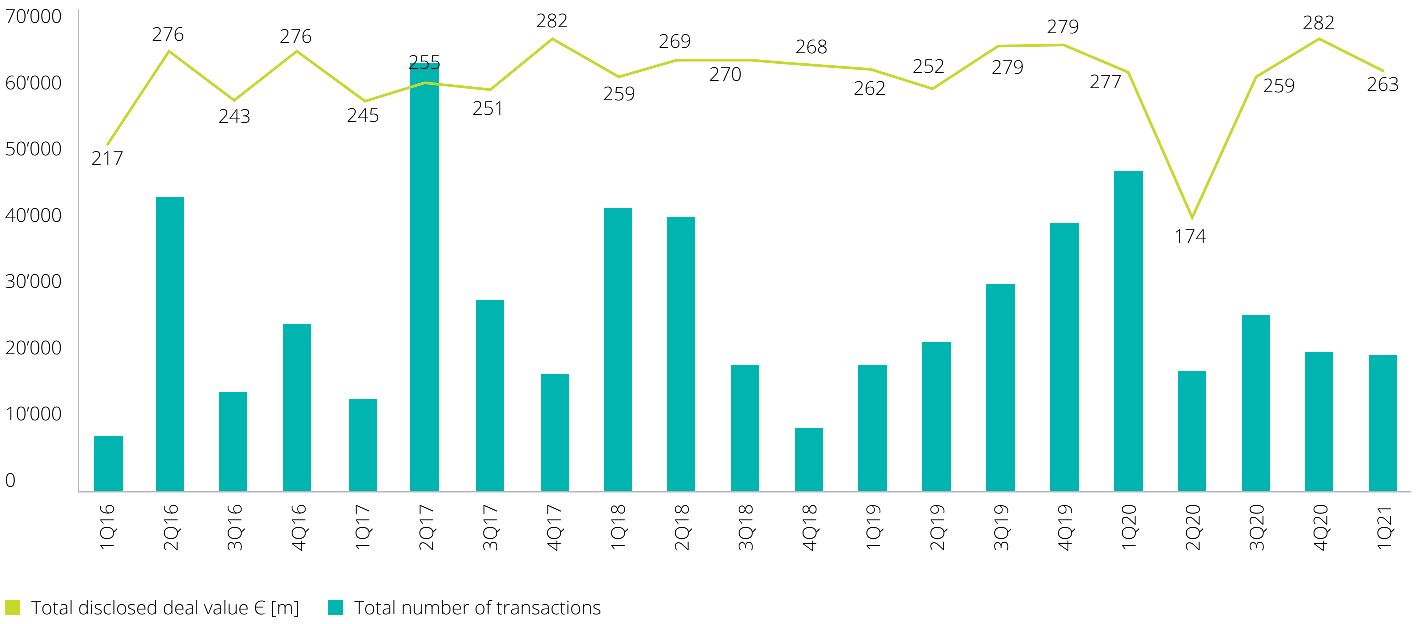
M&A Environment

After increasing for years, the M&A market showed already some weakness regarding the economic development in Q3 2019, much earlier than COVID-19. Despite historically high levels of 'dry powder' of strategic as well as financial investors, a change in sentiment was already noticeable.

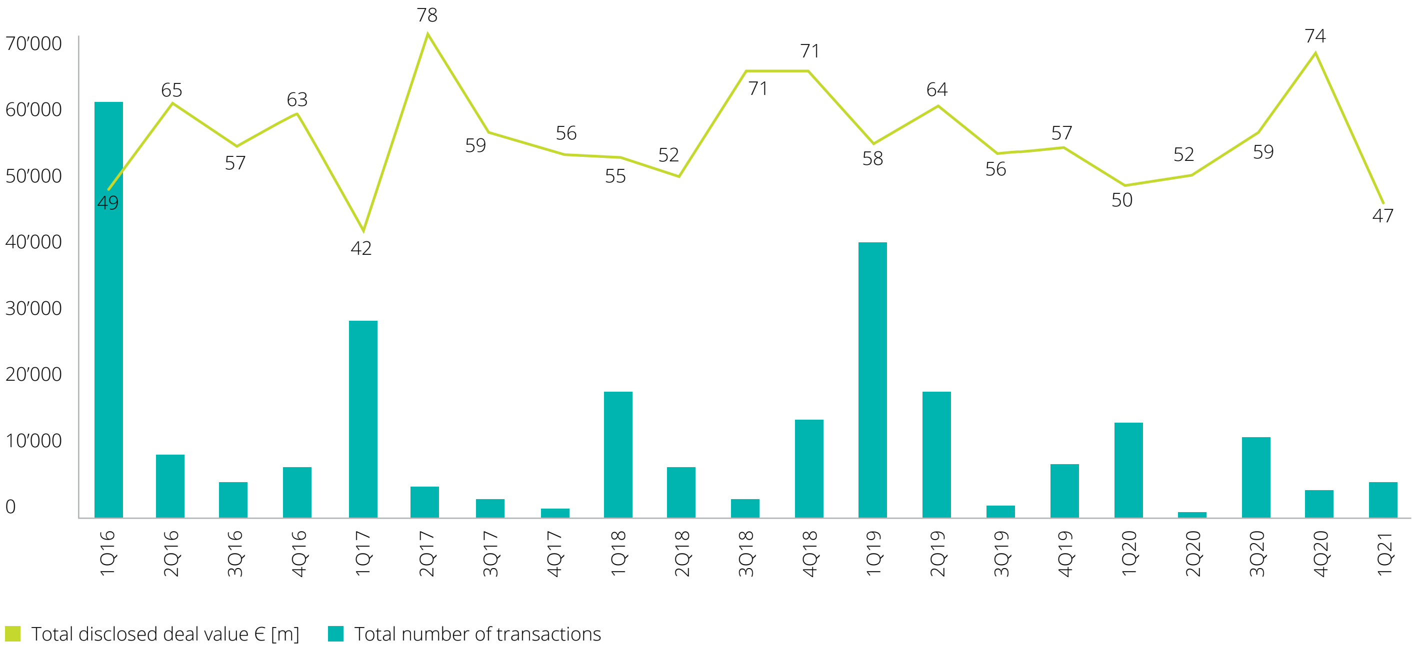
With the COVID-19 pandemic outbreak in the Western world followed a dramatic decline of more than 50% in Q2 2020 compared to previous year's quarter, resembling the lowest level of M&A activity since 2009. Since then the M&A market has rebounded in Q3 and Q4 2020 and the positive trend has continued in the first quarter of 2021, recording the highest quarterly figures since 2007.

Figure 12. Number and value of M&A transactions in Germany and Switzerland through Q1 2021

Germany



Switzerland



Source: Mergermarket, Merrill Corporation Switzerland

For many years strategic investors carried out about two-thirds of all M&A transactions in Europe, and the remaining one-third was executed by financial investors. This ratio shifted dramatically in 2020. The share of private equity deals rose from 32% in Q1 2018 to a historical high of 42 per cent. Possible reasons for this change are a disproportionate increase in 'dry power' by private equity investors, and more conservative behaviour by strategic investors, preserving liquidity and showing restraint in adding further to their debt levels.

With regard to transactions out of insolvency, a Deloitte analysis shows that the number of transactions in Europe fell from 279 transactions in 2019 to only 231 in 2020 – in line with the decreasing number of insolvencies during that time period.

In a recent Deloitte study focussing on Distressed M&A, restructuring experts were asked what developments they were expecting in the next 12 months. Their answer was clear. The majority (83 per cent) expected a moderate to significant increase of distressed M&A transactions. Compared to a similar previous study, the number of participants expecting 'significantly more transactions' had tripled – a remarkable development.

More than two-thirds of the respondents to the survey population expected the increase to last for the next 12 months or even longer. Only one per cent expected a short sharp increase of less than

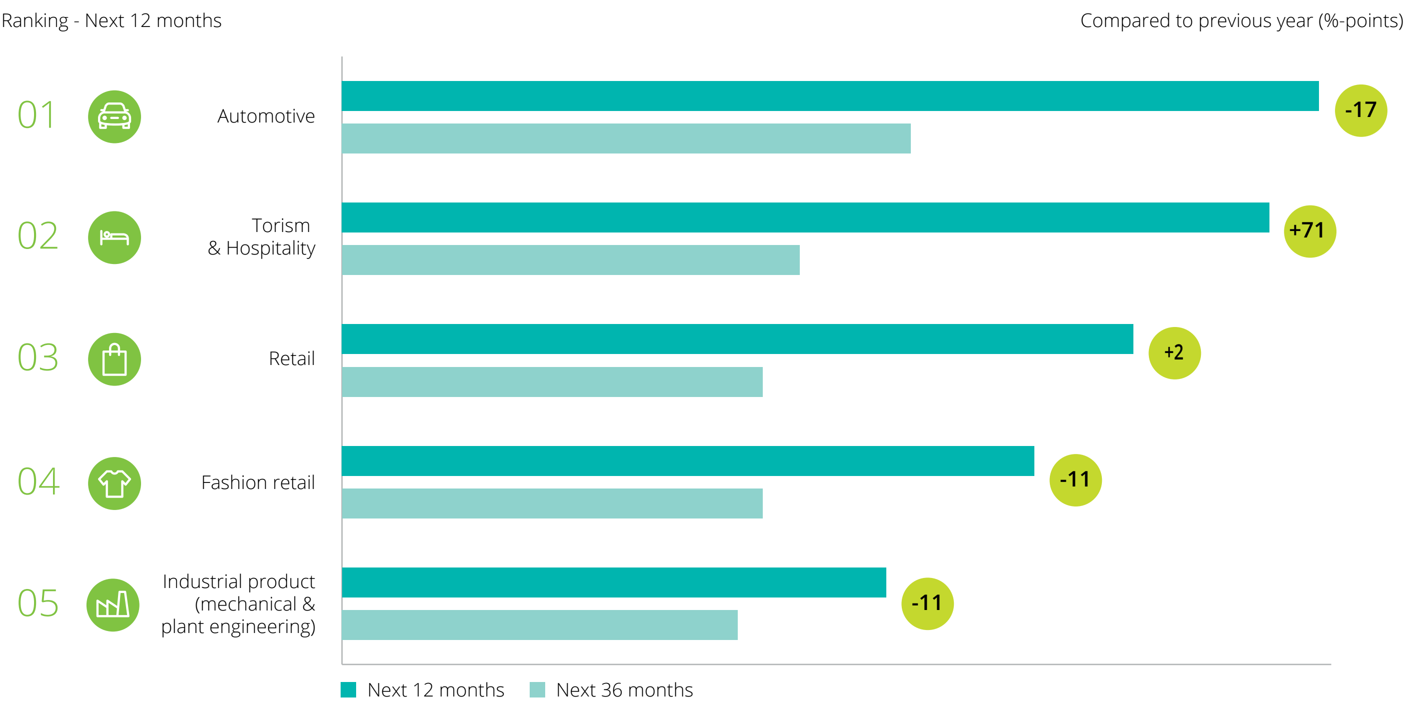
three months. Interestingly, more respondents with a private equity background (46 per cent) expected an increase for more than 12 months, compared to 18 per cent of managers.

We also asked participants in which sectors they expected distressed M&A transactions to occur. More than two-thirds of the experts expected most to occur in the automotive sector. As well as retail and fashion followed closely.

Figure 13. Expected increase in the number of distressed M&A transactions in the next 12 months

Top 5 (Feedback in %; multiple choice possible)

Figure 13. Expected increase in the number of distressed M&A transactions in the next 12 months



Source: Distressed M&A Study 2021 (Deloitte 2021)

Orchestrating the Recovery from COVID-19

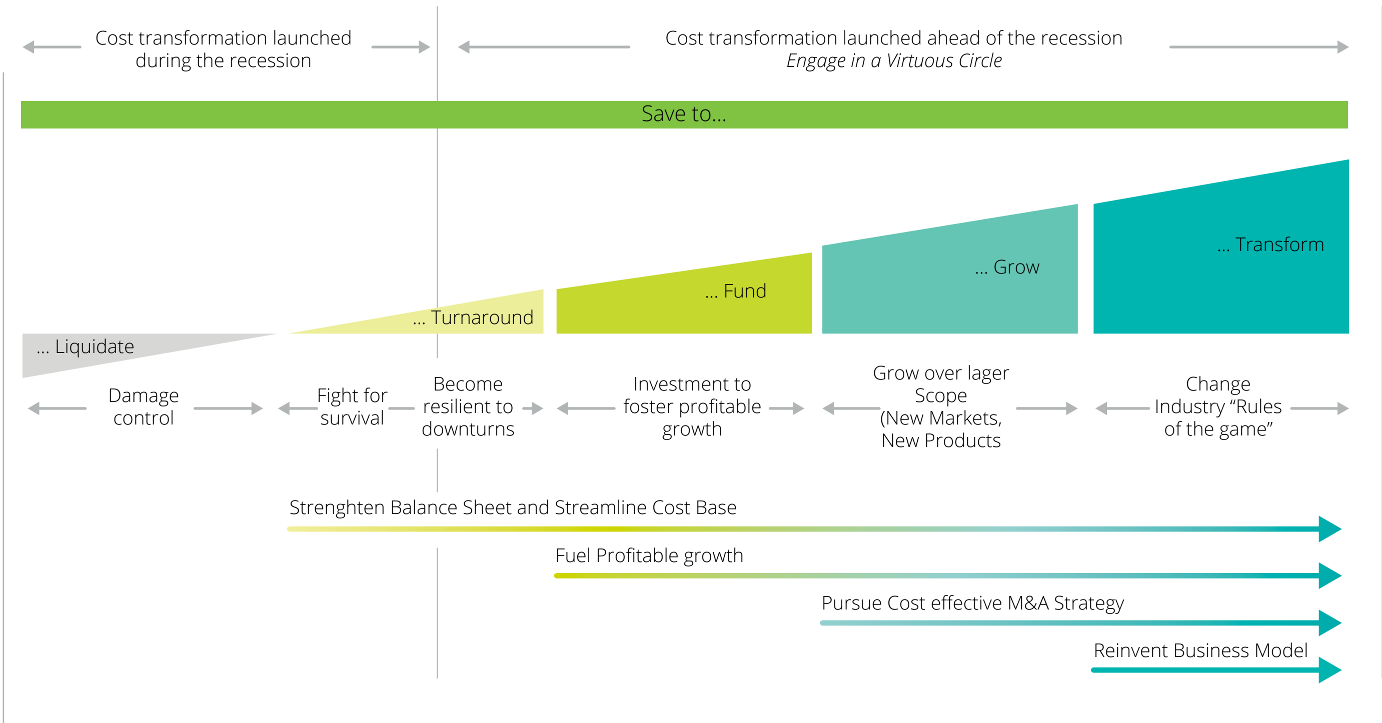
The priority of business leaders at the outset of the COVID-19 pandemic was focused almost exclusively on how to respond. However, given the prospect of emerging eventually from the crisis, leaders have had to consider all three time frames: respond, recover, and thrive, and allocate resources accordingly. Many companies established a central team or crisis management centre during
the response phase to assess the immediate impacts and provide directions and information to employees, customers, suppliers, and broader ecosystem partners about immediate actions to mitigate risks. However, resilient organisations have gone further and have looked for clues about the shape the recovery could take and have established flexible plans for the recovery. When the company prepares for and shapes the 'next normal' it has the potential to thrive again.

To plan for the recovery, companies have dealt regularly with business units individually and laid down a cost transformation programme in response to the pandemic and sets the basis for the recovery and thrive stages, as depicted in Figure 14.

The journey will depend on the company's natural business cycle and the effectiveness of its cost transformation measures.

- **Liquidate:** The business unit is no longer a strategic priority and/or the benefit from the business is greater than from implementing a turnaround and potential sale.
- **Turnaround:** The business unit is fighting for survival or to become resilient to the downturn via a stronger balance sheet and streamlined cost base.
- **Fund:** The business unit has achieved a streamlined cost structure and can deploy capital in strategic assets to fuel profitable growth of existing operations.
- **Grow:** The business unit has enough liquidity to enter new markets or expand the product portfolio, and increase the scope of business operations via a cost-effective M&A strategy.
- **Transform:** The business unit is in a position to take on higher risk and test new business models that can change the 'rules of the game' of the industry.

Figure 14. Cost transformation programmes



Source: Business in Volatile Times | Recession or not: Are you ready to thrive? (Deloitte 2019)

At the height of the pandemic the businesses most affected quickly found themselves in a turnaround scenario, in which it was crucial to act quickly to ensure focus and secure financing.

Despite the uncertainty resulting from the pandemic, management teams have required a sound basis for decision-making and a strategic options review proved to be an effective tool for crisis management.

Strategic Options: Fix, Sell or Close

A strategic options review entails a detailed assessment of the opportunities available for a distressed company, their implications, and a recommendation or decision by management. The review is undertaken in close consultation with clients to determine the optimal way forward, but at the same time retaining an independent and objective perspective.

Having defined the criteria for success the options are assessed on the basis of timing, resources, cost, liquidity, liabilities and the risk involved along several dimensions, such as operational, commercial, financial, tax and legal, reputational, and regulatory. The recommended option will include preliminary contingency plans for the key risks, outline indicative timelines and resource requirements, and assess the implications of choosing the option from a liquidity and financing perspective.

The strategic options comprise:

- Restructuring option: Fix the business
- Divestiture option: Sell the business or parts of it
- Close option: Wind-down or liquidate
- Source: Deloitte analysis

Unfortunately, we have seen many cases where the options are considered and executed in sequence. Initially, the company tries to restructure its distressed business. Soon after, it then explores M&A options. And if that fails, winding down or liquidating the asset is the only remaining option. Such a process not only leaves money on the table, but also occupies management attention for a long period of time. It is therefore best practice to assess and evaluate all the options prior to making any decision.

Figure 15. Strategic options

Strategic options review

Based on strategic directions, assessments will be performed for the best solution for each business

01. Restructuring
Is there a way to resolve financial or operational stress factors?

02. Divestiture
Can part of the business be sold and which is the optimal portfolio

03. Wind-down
Plan B, if no M&A can be identified?

Fix the business

Operational and Financial measures to turnaround the busine

- Key to address the root-1uses of performance, e.g. cost and revenue issues vs financing & cash requirements
- Right-sizing of the business
- Benefits Identified and partially implemented will improve the likelihood of a transaction

Privatize the busineu

Share or Asset sale to (or JV with) an existing player in the value chain

- Key to evaluate business in parts and as 21 whole to determine right combination ror maximum value
- Existing players in the value chain may be interested in a Joint Venture
- Transaction at low/negative consideration to achieve a share deal

a) Solvent wind-down

Wind-down as last option for certain parts of the business

- High-level plan of wind-down and it's costing allow to determine lowest price acceptable from an M&A perspective
- Asset deal with subsequent wind-down of the remaining activity, If no other solution can be identified

b) Insolvency

An insolvency administrator takes full control over the insolvent comapny

- Feasibility, benefit, costs and the Insolvency process Is highly dependent on local Jurisdictions
- Local experts are required to assess Insolvency options, but it would lead to a loss of control

Deloitte analysis

Restructuring Option – Fix the Business

The restructuring option entails operational and financial measures to turn it around and right-size the business by addressing the root causes of poor performance. The aim is to fix the business and initiate a recovery and drive the transformation or to prepare it for divestment in the case of a non-core asset.

Rapid Performance Improvement Framework

Typical restructuring levers are revenue growth, cost reduction, and working capital optimisation measures. These are described in the Rapid Performance Improvement framework, for example, as shown in in Figure 16. This is as an end-to-end, enterprise-wide scan and triage approach across all areas of the business, to identify and execute opportunities that drive EBITDA and cash flow on a rapid and sustainable basis.

Figure 16. Rapid Performance Improvement

Rapid Performance Improvement

An end-to-end, enterprise-wide scan & triage approach across all areas of the business to identify and execute opportunities to drive EBITDA and cash flow on a rapid and sustainable basis.

Revenue Growth	Cost Reduction	Woricing Capital Optimization
• Customer/ channel segmentation	• Cost of sales and SG&A	• Cash flow forecasting and reporting
• Go-to-market assessment	• Discretionary spend and cost management practices	• AR and AP management
• Portfolio optimization	• Zero based budgeting	• Inventory optimization
• Customer management	• Organizational restructuring	• Process re-engineering
• Sales effectiveness	• Process re-engineering	• Asset efficiency/ return on investment
• Pricing analytics		

Source: Deloitte

PE Lens

Identifying performance improvement levers can be particularly effective when applying an outside-in perspective, and looking at the mind-set of an investor, such as a private equity firm, without restricting the opportunities or challenging their feasibility with existing 'legacy' thinking. Our PE Lens approach has been developed for corporates, financial institutions and private equity (PE) – applying lessons from Deloitte's experience in working with private equity firms on value creation and strategic options.

The primary purpose of this approach is to identify rapidly the bottom-line value potential of the business, and the underlying levers to unlock that value. In a strategic options context, this rapidly establishes transparency of performance and guidance on the timeline to improving profitability – ultimately helping to accelerate decision-making about which strategic option(s) to pursue and how to maintain stability in the time available.

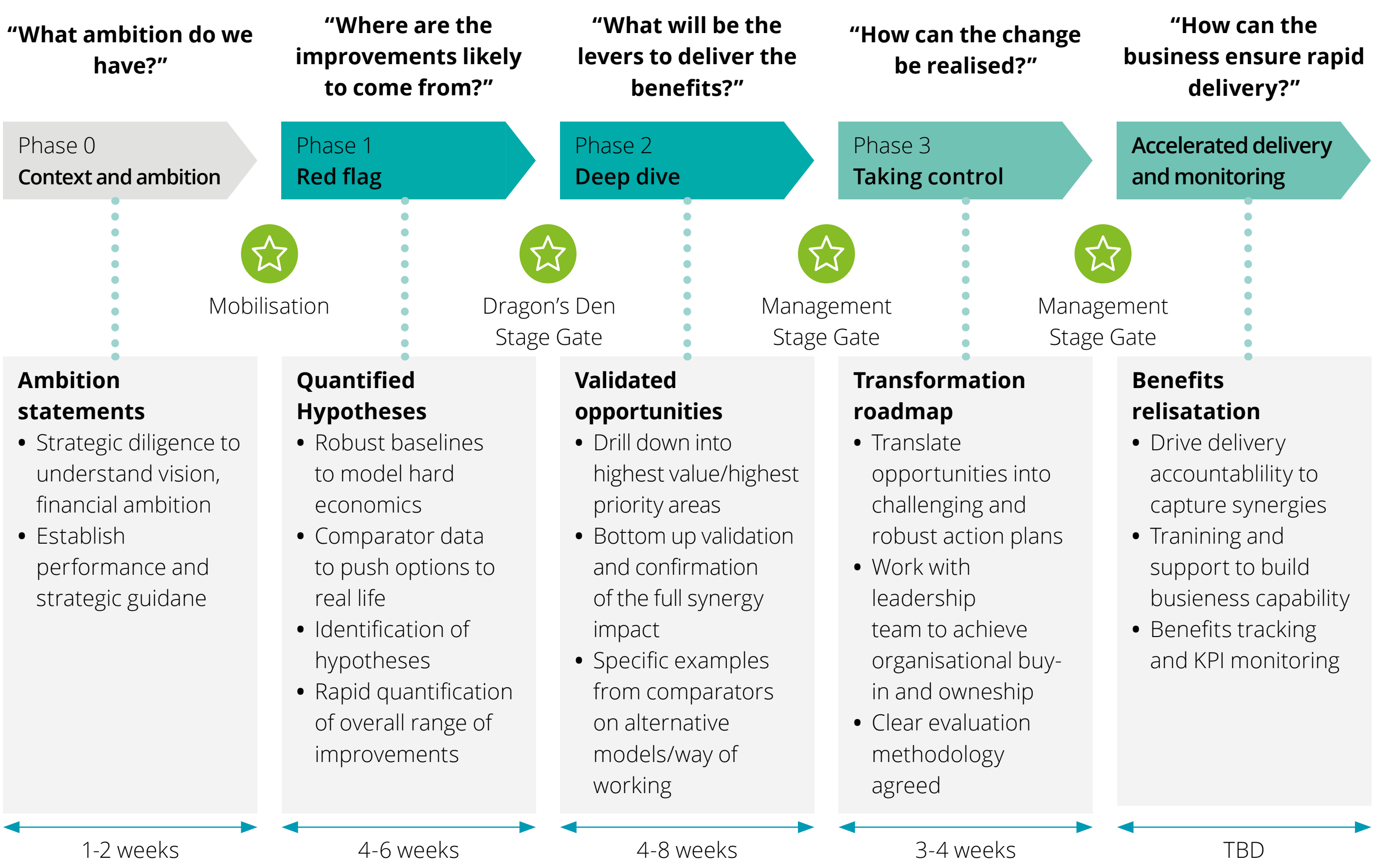
Our approach is modular, spanning from an outside-in approach to implementation and tracking (see Figure 17). In practice, the PE Lens approach provides transparency that executives, boards and investors can leverage as input into their strategic options decision-making.

- Red Flag: This establishes the case on value potential, defines the timeframe available (cash/capital requirements, planning and stakeholder alignment), and provides a clear view of the value of the 'restructure' and 'divestment' options. The output includes financial and FTE baselines; quantified value upside based on comparator performance; and improvement hypotheses for every management function in scope.

- Deep Dive: This is a bottom-up assessment of the operational hypotheses to validate the outside-in quantification (for the prioritised strategic option(s)) and to provide clarity about the path forward once any immediate urgent problems have been resolved.

- Taking Control: This involves planning and stakeholder alignment across the business to develop practical plans and accelerate the implementation of the chosen strategic option –working directly with executive committee and board to ensure a clear plan is pursued and to provide comfort to investors and creditors.

Figure 17. The PE Lens approach



Source: Deloitte

Asset Efficiency

With the restructuring option and from an asset efficiency perspective, it is imperative to manage liquidity and address under-performing assets. A lean asset structure will drive a lean cost structure. A six-step asset efficiency approach to help companies re-evaluate and improve the performance of their entire balance sheet assets portfolio has successfully been applied in these situations
(Figure 18).

Figure 18. Asset efficiency

Asset Efficiency		
Current Efficiency		
01	**Excess cash allocation to trade working capital**	**Reallocate** Excess cash to profitable ude in current assets
02	**Trade working capital optimisation**	**Optimise** For margin, service, cost & cash
Fixed & Intangible		
03	**Choice asset intensity Capex & Opex vs Agility**	**Do the same** With less upfront capital
04	**Capacity maximisation of existing assets**	**Better use** Of existing capital assets
05	**Footprint rationalisation & stranded costs**	**Align** Assets to operations strategy
06	**Sweating the assets**	**Do more** With existing assets

Source: Deloitte

The first two steps in the approach focus on cash and trade working capital optimisation. Trade working capital is the fuel that keeps companies running; it is also the best and cheapest source of capital when the cash conversion cycle is optimised. Our experience shows that a working capital improvement programme (compliance, process, commercial, financial and structural improvements of receivables, inventories and payables) can release up to 30 per cent of the cash tied-up in business operations, much of this within three and nine months.

Steps 3 to 6 in the approach address how a company can improve its fixed and intangible assets turnover ratios.

- With regard to recent events, businesses need to reassess their fixed assets and long term leases/rental commitments against an ever-changing market. This activity should be at the core of every company's operations and commercial and financial strategy, and revisited regularly: make vs buy, own vs rent, manage vs outsource.

- Maximisation of the available capacity of existing assets should be considered next. This can take several forms: improve quality, which reduces production costs and throughput; improve cycle times, which also leads to an increase of throughput; improve scheduling and changeover times; minimise the impact of bottlenecks in factories; improve asset availability through better maintenance schedules.

- Moving on, reviewing the manufacturing footprint, repurposing facilities and factories, disposing of surplus assets, shrinking capacity or relocating has to become a business-as-usual activity.

- The final step focuses on how to 'sweat' existing assets. Excess capacity does not always have to be taken out. Sweating the assets is an area for sales teams to get creative, with tactical initiatives in order to fill the excess capacity more profitably fill, through: price points that increase both volume and contribution margin; white labelling and contract manufacturing; higher service levels such as lead time reduction; and other capacity-consuming value adding activities such as product customisation.

Divestiture Option: Sell the Business or Parts of it

The divestiture option in most cases is either a complete or a majority sale of the company or often a subsidiary or portfolio company of a larger group, to a third party. Potential buyers are typically either strategic players or financial investors. The former may be direct competitors, or other players in the value chain or adjoining sectors. Financial investors consist of (distressed) PE funds, family offices and industrial holdings. A management buy-out (MBO) can also be a valid option.

The seller may also assess the merits of setting up a joint venture with another strategic player. Joint venture endeavours should be analysed despite the fact that they are usually more time consuming, complex and risky than a straight M&A process. In many cases, when two problematic business units are merged, certain synergy cost savings are realised, but the strategic problems of the combined businesses are often not resolved.

As a first step in considering this option, the seller needs to assess whether the business unit or subsidiary is a core or non-core activity. This assessment should be made solely from a strategic point of view. This is important, because too often the decision process seems to be tainted by the current performance of the asset and all under-performing assets are automatically declared 'non-core'.

The main issues to consider when evaluating the divestiture option include:

- Buyer's universe: Who are the potential buyers?

- Equity story: Why should potential buyers be interested?

- Valuation: How much is the business worth?

Furthermore, the potential seller needs to decide on several value-influencing aspects, including:

- Scale of investor approach (Bilateral process vs broad auction)

- Timeline for transaction (Accelerated vs regular process)

- Timing of transaction (Un-restructured vs fully restructured)

One of the most challenging questions concerns the timing of the transaction. Whether to sell the business either 'as-is' or fully restructured depends on the risks of a successful restructuring and the buyer`s risk appetite.

There are generally four potential exit stages (Figure 19):

- 'Fully unrestructured' stage: Selling the company 'as-is'

- 'Initiatives identified' stage: Having identified but not implemented restructuring measures, which are integrated into the business plan

- 'Cost-saving initiatives implemented' stage: Restructuring measures on the cost side and 'quick wins' are implemented and results can be seen in current trading performance. The liquidity and operational crises have been dealt with.

- 'Business model (fully) restructured' stage: The strategic crisis of the company has been overcome by a transformation of the business model.

Figure 19. Exit stages

	Fully unrestructured	Initiatives identified	Cost-saving initiatives implemented	Business model restructured
Progress	• No initiatives • Fire Sale	• Action plan • Business plan	• Liquidity • Cost	• Product/sales • Strategy
Invest	○ ○ ○ ○ ○	● ○ ○ ○ ○	● ● ● ○ ○	● ● ● ● ●
Strategic investors	○ ○ ○ ○ ○	● ○ ○ ○ ○	● ● ○ ○ ○	● ● ● ● ●
Financial investors	● ● ○ ○ ○	● ● ○ ○ ○	● ● ● ● ○	● ● ● ● ●
Valuation level	● ○ ○ ○ ○	● ● ○ ○ ○	● ● ● ○ ○	● ● ● ● ○

Typically, it is beneficial if initial measures have been successfully implemented and contributed to the P&L

Source: Deloitte

The potential buyers of a distressed asset will increase in number the further the restructuring has proceeded. Strategic investors will normally be hesitant to invest in a fully un-restructured company, since they do not want to execute a restructuring themselves. In addition, among financial investors distressed funds will have a look at an unrestructured target.

On one hand, valuation levels will increase, as the effects of a restructuring can be seen in performance figures. On the other hand, the risk of delivering a successful turnaround stays with seller. In many cases taking initial restructuring measures to obtain 'quick wins' is a preferred option.

A divestiture should not be rushed. Thorough preparation of the M&A process is value-maximising and can help filling buyer and seller expectation gaps. The required steps can include:

- Set-up stand-alone financials (historicals + business plan)

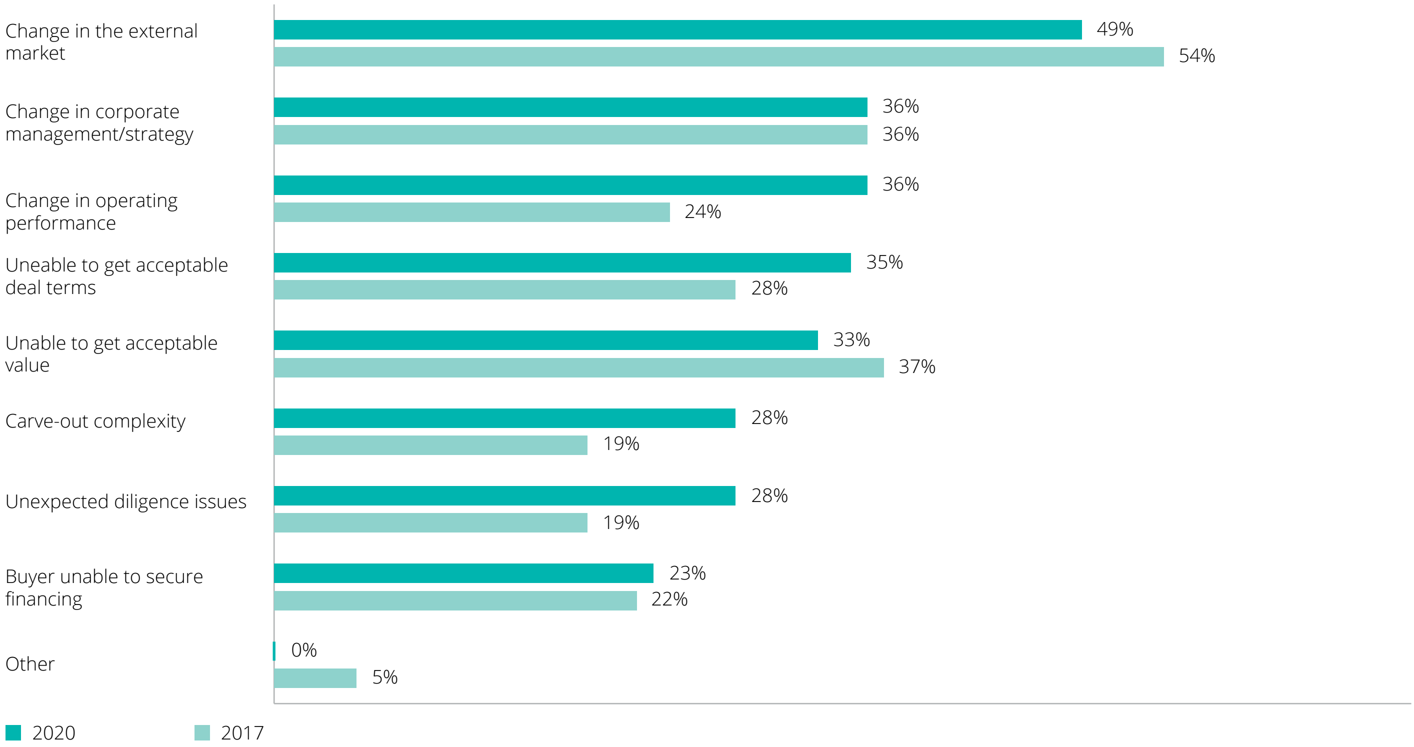
- Prepare an operational carve-out

- Collect information for the data room.

According to the Deloitte 2020 Global Divestiture Survey (Figure 20), after changes in market environment and corporate strategy, the biggest hurdles to divestitures that respondents anticipated in 2020 were changes in operating performance (36 per cent), inability to negotiate acceptable deal terms (35 per cent), and inability to obtain acceptable value for their assets (33 per cent).

Further, on the basis of the transaction experience gained by Deloitte over the years the expectation gaps between buyer and seller are generally caused by additional challenges such as lack of clarity about manufacturing services agreements, transition services agreements, and working capital in purchase agreements. While many believe that these agreements can be completed close to signing, a seller would benefit by aligning them internally and build a supporting narrative well in advance.

Figure 20 Biggest hurdles in the context of divestitures



Source: Deloitte, 2020 Global Divestiture Survey and 2017 Corporate Divestment Strategy Survey

Close option: Solvent wind-down or Insolvency

The wind-down or liquidation option must be considered as the last resort. This option should be included in the strategic option review, since there are cases where this is (unfortunately) the only rational solution. However, having developed an understanding of the expected wind-down costs informs the M&A negotiations and the decision making on whether or not to move forward with a transaction.

Generally, the following options can be considered for a wind-down:

- Solvent wind-down
  - by the original owner of the company
  - by a third party after a sale to a buyer that will liquidate the company (also known as 'paid funeral')
- Insolvency

Solvent Wind-down

The winding process usually starts with a comprehensive plan, with the following components:

- Operational closure strategy, including employee considerations, asset realisation and customer retention
- Detailed Day 1 communication plans (media, PR and reputational issues)
- Stakeholder management, e.g. clients, employees, suppliers
- Wind-down financial forecasts and baseline, including actual and contingent liabilities as well as cash and trading forecasts, and working capital projections
- Tax reglatory and legal implications
- Solvent liquidation of legal entity
- Detailed wind-down plans with key actions and milestones, and
- Set up PMO and internal reporting.

A solvent wind-down can be more complex than expected in light of the myriad issues that need to be addressed, as shown in Figure 21.

Figure 21. Factors defining the complexity of a wind-down plan

Source: Deloitte

Paid Funeral

A so called 'paid funeral' may be another option. With this option, the company is being sold 'as-is' to a buyer, who will continue the loss-making activities for a certain time before putting it into liquidation. The advantage of such an option for the seller is that it will not have to undertake the often complicated wind-down process itself. However, this benefit comes at a price: the buyer usually expects a negative price that covers the expected losses as well as the liquidation costs. Furthermore, the buyer usually expects its
'services' to be covered, together with a risk premium, making this alternative unattractive in many cases.

Insolvency

An insolvency should also be considered. With this option, the company is placed in a formal insolvency or bankruptcy process. Since the details of this option depend on the insolvency legislation in each country, we discuss this option here only in general terms.

The appeal of this option from a shareholder perspective might be that losses are cut with immediate effect. For this reason larger corporates consider this option — before discarding it after a more careful thought. There are several reasons why we see hardly any insolvencies of subsidiaries:

- The administrator takes full control over the insolvent company and decides on continuation or cessation of the business (unless the process is done under self-administration as referred to below).
- There is a risk of clawback of repayments of shareholder loans prior to the filing for insolvency.
- Corporates often see reputation risk affecting stakeholders such as employees, customers, suppliers, banks and other financing partners.

From a legal viewpoint, during 'self-administration' the debtor retains possession of the assets while the business undergoes reorganisation. The aim of self-administration proceedings is to retain the responsible and capable management of the organisation and to minimising outside interference. Self-administration proceedings are normally used in the context of a restructuring, driven by a court's insolvency process. In these situations, the management remains in place, in order to maintain relationships of trust with customers, suppliers and employees. This is essential to make a restructuring successful[6].

Outlook

In recovering from the COVID-19 crisis, difficult decisions and choices will continue having to be made. There may be a lack of clarity about options for the way forward, and the framework and approaches illustrated above will support management teams, board members and shareholders alike to consider a full range of options for dealing with the challenges around underperforming or distressed companies that exist, making crucial decisions, and implementing them rapidly.

6 Source: Clifford Chance LLP

Deloitte.

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