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Restructuring Services
Corporate Advisory

Ten lessons from ten years
Celebrating our first decade

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Contents

Introduction	1
Lesson 1: First find a client	2
Lesson 2: Look past the flag pole	3
Lesson 3: Learn to be a psychiatrist	4
Lesson 4: Private, not public	5
Lesson 5: Don’t expect lucky breaks	6
Lesson 6: The devil is in the detail	7
Lesson 7: What do you mean, “CRO”?	8
Lesson 8: Nearly everyone is logical	9
Lesson 9: Welcome the hedge funds (sometimes)	10
Lesson 10: Agree at the outset what success looks like	11
Restructuring Services Corporate Advisory team	12

Introduction

Ten years ago, Jas Sahota and Henry Nicholson formed Deloitte's Restructuring Services Corporate Advisory team. In those days we offered 'Debtor-side Reorganisation Services', but somewhere along the line *Reorganisation* became *Restructuring* (largely to avoid unwelcome parallels with removal men), and since no-one except accountants understood what debtors were, we re-badged ourselves *Corporate Advisory* to be clear that we intended to advise companies and their Boards, rather than lenders.

In truth, back in 2003 it was pretty much a team of two. Jas had just been made up to partner, having trained and started in restructuring at Arthur Andersen. Henry came to us via McKinsey, having previously been in restructuring at Coopers & Lybrand. Gerry Loftus's recruitment pitch to Henry was (for those who know Gerry) characteristically straight-talking: "We have a good restructuring business but are doing an increasing amount of work Company-side. We need someone who understands restructuring and strategy to help Jas grow it – and quite frankly we don't know anyone else".

With this ringing endorsement from the best in the business, Jas and Henry set about building a company-side restructuring advisory team by trial and the occasional error. Growth was supported in part by market conditions in the form of a spectacular boom and subsequent bust in leveraged finance, and today Deloitte has a nationwide UK team with 6 partners and 30 staff which is almost unique in the market in being dedicated to serving only companies in distress. In 2012 the team was involved in 5 of the 10 major UK restructurings in Debtwire's Advisory mandates table, and in the past 24 months has been involved in some of the most high-profile assignments in the market including Biffa, Travelodge and National Car Parks.

Restructuring is a serious business. It is also an acutely truthful business in which the natural ebullience, ambition and gloss of the mainstream corporate finance market are replaced by the gritty realities of corporate survival and personal reputational risk. The ten lessons which follow embody many of the truths uncovered during a decade's experience, and reflect all the frustrations, idiosyncrasies and occasional humour of this difficult, essential, compelling business.

We hope you enjoy reading them.

We need someone who understands restructuring and strategy to help Jas grow the business – and frankly we don't know anyone else.

Henry Nicholson

Jas Sahota

Lesson 1: First find a client

The traditional route to becoming a lender-side advisory partner in a restructuring practice is clear. You cut your teeth on cases by meeting banks, funds and lawyers, and if you're lucky you might be sent on secondment to a lender. Over time you build a reputation as a good adviser and deepen your relationships with a group of institutions who are repeat buyers of your services. As you get promoted through to partner, those lenders start to provide you work which gives you the opportunity to reinforce your reputation. The lender community is not as small as it once was, but your reputation will still spread quickly amongst the decision-makers that matter.

We soon realised that building a corporate client base was much harder for four reasons:

- If you do a company-side job well, you will have restored your client to sustainability for the long term – i.e. the better you are, the less likely you are to get repeat business.
- Your target audience potentially includes all stressed corporates – a much larger and more diffuse group than, say, the target audience for lender-side advisers.
- No client will thank you for publicising your involvement in their problems for your own PR purposes. As many deals are done quietly/privately, there are real constraints on the extent to which you can trade off your track record.
- Companies frequently don't want to buy restructuring services, either because they don't recognise their problems, or they believe they can find a solution by themselves. If you doubt this little homily, as an experiment try and approach a Board on the verge of financial difficulties (or indeed its private equity sponsor) with the well-worn ice-breaker, "Hello, I'm a restructuring professional and I think you are in trouble". Remember to step back quickly before the door is slammed firmly in your face.

As a result, we have built up our routes to market by recognising that direct requests for help from Boards are rare, and that you often need to be introduced to a situation by an influencer or an existing trusted stakeholder:

Getting hired

Stakeholders	Lenders	Shareholders	PE Houses	
Influencers	Non-Executives/CROs	Advisers (Lawyers, Brokers)	Banks/Lenders	Internal
Clients	Listed companies		Private companies	

Good relationships with the major law firms are crucial. But the best answer of all is to have colleagues with strong, trust-based, board-level relationships who are prepared to introduce you at the appropriate time. This explains the importance of having strong debt advisory and M&A teams sitting alongside a restructuring practice.

Companies frequently don't want to buy, or be seen buying, restructuring services… remember to step back quickly before the door is slammed firmly in your face.

Lesson 2: Look past the flag pole

So how do you identify a prospective client in trouble?

There was an old joke that if you wanted to spot the client requiring restructuring, look for the flagpole, fountain and flashy CEO whose eye is no longer on the detail. Memorably in 1994 we started a major restructuring only to find that the first four speed dials on the CEO's office phone were Aston 1, Aston 2, Plane, and Yacht, which probably told you all you needed to know.

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The world has moved on; these days the blame for a corporate crisis does not necessarily lie with management. In the past ten years we have observed two new issues which have started to determine which companies get into difficulty:

- The leveraged finance boom between 2005–08 resulted in fundamentally good companies producing strong cash flows getting into difficulties. This has had a profound effect on restructurings by rebalancing the demand from operational turnaround to debt restructuring. As a consequence, restructuring teams have had to adapt their skills, as the importance of understanding insolvency and the relative positions of different stakeholders has become increasingly important.
- The sale-and-leaseback boom of the 1990s and early 2000s created a number of companies with substantial lease obligations on upward-only rent reviews. As recession hit and profits flatlined or fell, many of these operationally-geared structures have literally not been able to pay the rent. This has been a particular issue for the retail sector and has given rise to the use of pre-packaged administrations and CVAs to force opco lease restructurings. In a few cases like NCP, consensual lease restructurings have been achieved, but normally landlords have been forced to the negotiating table via some kind of formal process.

We're not suggesting that there has been a sudden transformation in the calibre of management teams over the past decade; companies continue to suffer from poor management information and weak cash flow practices, and many are failing to flex their operating models to respond to rapid technological or social/behavioural changes in their core marketplaces. Such issues can normally be fixed with management change, improved governance and specialist advice. But one important lesson from this latest cycle is that there are many sound businesses run by excellent management teams whose ability to keep up with their less-leveraged competitors is fundamentally undermined by their legacy capital structures and lease commitments.

Lesson 3: Learn to be a psychiatrist

If you advise lenders on a restructuring, the individuals involved are normally dispassionate and objective. Frequently they didn't make the original loan themselves, as it will have been moved out of the main portfolio and into a specialist team for the duration of the restructuring, and as they are workout specialists they have generally seen it all before.

If you work with Boards and management teams more used to running hotels, factories or media businesses, the opposite is usually true:

- Hopefully management teams only go through a financial restructuring once in their career. That makes it easier for the advisor to sound knowledgeable based on experience, but much harder insofar as everything is new to the client and requires them to adapt behaviourally and emotionally to the new reality.
- Managements' jobs are frequently on the line in a restructuring, which makes the whole affair much more complex and dynamic. Inevitably, one of the lenders' first judgements is whether they should back the incumbent management or change/strengthen the Board.
- Opening expectations of management and staff can often be confused, ill-informed and unrealistic. Rebasing stakeholders' perceptions of management teams can be an important part of an advisor's role.
- Sometimes companies get into difficulty because of management divisions and Board-level conflict. As a restructuring professional, you walk into the middle of this and are expected to defuse the situation.

As a consequence, the level of emotional intelligence required for company-side work is definitely higher. Over time you learn that being very clear and logical in your explanations, always being available to discuss, and not being too forceful in manner are key to building those trusted client relationships.

The level of emotional intelligence required for company-side work is definitely higher.

One of the hardest parts of being the company's adviser is management change. Investors, lenders and the Chairman/CEO will usually ask you for your personal and professional opinion on an individual. Thankfully one of the features of this recession is that as leverage rather than under-performance has been key, there has been rather less management change than might be expected.

Lesson 4: Private, not public

A frequent question is: would you rather work on the restructuring of a listed company or a firm under private equity ownership? Both bring their own unique challenges, but on the whole private companies are probably easier.

The benefit of a public company is that the shareholders are less visible or directly engaged at Board level, so the directors find it easier to make the transition to acting in the interests of all stakeholders and balancing the interest of creditors vs. equity holders. The very significant downside is that the Listing Rules exacerbate the complexities of restructuring processes:

- The need to keep the market informed means that your problems can get played out in public, thus alerting creditors and customers to the prospect of major problems can and potentially undermining confidence in the business.
- Raising new equity is complex, slow and uncertain given the dispersal of shareholders and the pre-emption rights designed to protect minority shareholders.
- The fact that even small disposals frequently become class transactions requiring working capital statements makes generating cash quickly tough.

With a private company, and particularly a private equity-owned company, the challenges are different. The obvious benefit is that you have fewer disclosure and public reporting obligations. Furthermore you potentially have an equity holder who is more easily able to commit to providing new money quickly and decisively to the situation.

The challenge of a private equity-backed situation is that the shareholder is much more visible at the Board table. Whilst this makes for a stronger debate, striking the balance between equity and creditor interests can be harder. Investor-directors will face personal career pressure to protect the equity holders' interests, which may conflict with their fiduciary responsibilities as company directors.

Experience shows that there is much more tactical planning before the first approach to lenders in a private equity owned situation.

In practice, we have found from experience that there is much more tactical planning behind the scenes before the first approach to lenders in a private equity-owned situation, reflecting the fact that the sponsor will be trying to stay several steps ahead by anticipating the concerns, preferences and options of the company's other stakeholders.

Lesson 5: Don't expect lucky breaks

One thing that hasn't changed over the years is that companies under financial pressure rarely get lucky breaks. This is typically because:

- With non-distressed companies small issues can be covered up and dealt with; but with distressed companies, particularly where liquidity is tight, every small issue becomes significant.
- The publicity around distress causes creditors, customers, employees and particularly credit insurers to become concerned, and can cause companies to lose out on new contracts or come under unexpected liquidity pressure. Trade credit insurance has proven to be one of the biggest issues – the moment companies really need it, they tend to find it has been withdrawn.
- Decision-making comes under much more scrutiny because of directors' individual responsibilities. This can be particularly true in groups where directors are used to thinking at a group level but suddenly have to think at a legal entity level.

Prepare for the worst, as things rarely get better during restructuring processes.

As for salvation via M&A, be sceptical: relatively few situations have been resolved by selling divisions prior to a restructuring.

Consequently, things rarely get better during restructuring processes. As a rule we advise companies to prepare business plans they have a fair chance of hitting (a 'P70' case, or a 70% probability). This is to allow for natural optimism, the unintended bad event and recognition of the fact that the plan is being used for restructuring a debt facility, not just a budget. Compare that to an M&A situation, where you typically base off a plan that you have a lower probability of hitting.

Similarly, at the early stage of a distressed situation management will frequently assume that they can sell divisions to reduce debt and raise funds. Experience dictates that M&A is much harder when you are dealing with distressed businesses as buyers are much more wary and less prepared to pay the full price. As a consequence there are relatively few situations that have been materially resolved by selling divisions prior to a restructuring.

Lesson 6: The devil is in the detail

Someone once said that every restructuring probably turned on a fact or event that was not foreseen at the start of the process. These days the old collaborative 'London Rules' approach is no longer adhered to – the reality is that each stakeholder considers its interest and its position and acts accordingly. At the start of the process those facts are not typically understood, as people don't look at healthy situations through the eyes of restructuring professionals. Getting a grip on stakeholders' respective positions is thus essential if the 'art of the possible' is to be articulated accurately at the strategy formulation stage of a restructuring process.

Common issues to arise are:

- Individual company positions become important rather than the overall group position. As a consequence, getting a proper understanding of intragroup balances and identifying where individual contracts and assets sit within the group becomes critical.
- The drafting quality of legal and commercial contracts varies widely; as a result, an individual counterparty's position is not always as people would expect.
- The tax position of companies becomes important as certain actions may incur current charges, reduce carried forward losses or increase future taxable profits.
- Enhanced diligence can lead to improved visibility over hitherto low-priority issues which may end up shaping a restructuring such as swaps, pensions, environmental liabilities, lease commitments and other off balance sheet liabilities.

Our response to these issues has been to prepare early on a stakeholder report that looks at the situation through a restructuring lens and is based on a full factual analysis of the group's contractual matrix. The stakeholder analysis considers the contractual and commercial position of each stakeholder and looks at their alternative contingency plans and options if they do not agree a consensual deal.

The reality of modern restructurings is that each stakeholder considers its interest and its position and acts accordingly – but at the start of the process those baseline facts are not typically understood.

Often this shows that (as expected) secured lenders can take control of a situation with limited impact on the wider group, but detailed diligence has often thrown out surprising answers along the way which can strengthen a company's position against precipitate action by its stakeholders.

Lesson 7: What do you mean, "CRO"?

Lenders frequently demand the appointment of a Chief Restructuring Officer ('CRO') to be their "eyes and ears in the room" and to give them confidence that someone within the senior team is really gripping the situation.

The arrival of a CRO can be an emotive subject and is frequently a very confused process. At the outset it is important to understand:

- What is the CRO's role, exactly? Is it for a non-executive to sit on the board; an executive to lead a financial restructuring or a turnaround; or an interim executive because the FD or CEO is to be replaced? It is critical to determine this at the outset, as it fundamentally influences the type of person who should be considered, and how his/her arrival should be communicated to the wider business.

From a company's point of view, one of the benefits of a CRO being appointed to the board is that they are bound by the same duties as any other director.

- Is this a board level appointment or merely an advisory role? Public companies in particular can be reluctant to appoint known turnaround people to their boards.

- What are the individual's lines of communication? We have heard lenders talk about "their man" and we have known CROs to attend lender-only meetings. That is a misconception and can cause difficulties: one of the benefits of a CRO being on the board is that it makes them bound by the same fiduciary duties as any other company director.

- Is the CRO part of a wider team or an individual? This can cause particular issues if an individual is brought in after the start of the process and want to replace incumbent advisers with their own team.

If the right individual is introduced with the right scope, a CRO can add a huge amount of value to a situation. The CRO's real differentiator is that he or she becomes a board member who can participate in board decisions and also represent the Company – as opposed to an adviser who can only advise.

Lesson 8: Nearly everyone is logical

Restructuring wisdom is that parties will be rational and follow the commercial logic for their position. If this were true, out-of-the-money creditors/shareholders should accept small offers as part of a consensual restructuring that are better than nothing received through an insolvency.

At times, people appear to act irrationally. Make sure you really understand their position, as such behaviour is usually driven by entirely rational factors.

At times, though, people appear to act irrationally. This is usually driven by one of the following – entirely rational – factors:

- The party has an entirely different starting position. The obvious example is a par lender who will feel very differently to a distressed fund who has bought into the debt at a substantial discount. For example, an offer of 55p vs. 60p may not be a significant change for a par lender, but is material for a hedge fund who bought in at 57p.

- The party may be acting irrationally compared to another, but for a different reason. For example, a small lender may block a transaction with the intention of being quietly bought out on the side in a way that a major lender never could.

- The party may be regarding the interaction as one part of a multi-round negotiation. In this situation it may pay to act irrationally in one situation to avoid setting precedent or displaying weakness, thereby gaining an advantage in a subsequent round based on "reputation". Some distressed investors have made a regular habit of this.

Of course, there is always the risk that the party does not understand the position properly, or their inherent bias is clouding their judgement. This is becoming less frequent but can cause real problems. Luckily the use of UK schemes of arrangements has made it harder for a minority lender to hold out against a group as a ransom creditor, but schemes are costly and require time to prepare and implement.

Lesson 9: Welcome the hedge funds (sometimes)

Over the past 10 to 15 years, the ability to trade debt has increased significantly as the number of buyers has multiplied and the banks have become more willing sellers.

The default position of companies is to be deeply suspicious of hedge funds and other "opportunity investors", particularly those with a reputation for executing "loan to own" strategies. But as time has passed it has become recognised that debt trading can sometimes be of significant benefit in a distressed situation where the new fund is prepared to:

- Drive consolidation in fragmented syndicates that can otherwise be unwieldy to herd together;
- Act as a source of liquidity to remove lenders who either are unable to take decisions or provide new money;
- Bring in other new parties with a significant appetite for higher-risk new money which may not be deliverable by traditional par lenders;
- Force a larger debt write-off than would be achieved with incumbent lenders who want to hold value as debt rather than equity; typically funds are more able to hold a variety of interests across the capital structure.

Contrary to popular belief, debt trading can sometimes be of significant benefit in a distressed situation.

Debt trading is not always a good thing, especially if you start with a well consolidated syndicate. If the incumbent lender group can be stabilised and remains constructively engaged with the company, it generally provides a better platform for the company to achieve its desired outcome.

Lesson 10: Agree at the outset what success looks like

You may have noticed that restructuring professionals generally describe their contingent fees as 'transaction' fees rather than 'success' fees. This is for two reasons:

(i) Lenders understandably tend to get upset when a substantial debt write-off is characterised as a 'success';

(ii) It is often difficult to reach agreement on what success looks like in many of these complex situations.

Lenders generally assess the success of a restructuring on the quantum and timing of their economic recoveries. Companies are different, and as a restructuring professional you can take different measures of success – for example, success is often defined as completion of a transaction in which the underlying business (as opposed to specific legal entities) continues to trade as a going concern.

As restructuring professionals, we want to advise on difficult and high profile mandates because they are the most interesting jobs that motivate our teams. But we also want to achieve an outcome that sees a company restructure its debts, improve operating and financial performance, shield its supply chain and commercial counterparties from unnecessary collateral damage, and provide compelling future prospects for its employees.

Lenders assess the success of a restructuring on a single measure – economic recovery. Companies' objectives are different.

We would prefer to achieve that outcome consensually as we believe that it always offers a better platform for the company. However, it may be that a CVA or an insolvency procedure such as a pre-packaged administration is part of the process for implementing such a solution, for example to exit onerous contracts or obligations, or to disenfranchise a non-supportive stakeholder.

Ultimately success is a very personal concept but in the course of a restructuring you tend to build strong relationships with management teams and fellow advisors. When things are inevitably going wrong those relationships hold the project together and bring the team through. Probably the greatest satisfaction comes from walking away knowing that you have helped protect the jobs of the management team and their staff.

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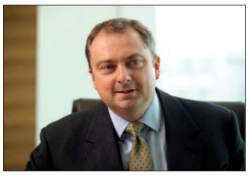

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