Turnaround Management

Turnaround management in south-eastern Europe

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In the summer of 1931 a Swiss newspaper reported that a prominent German bank was on the verge of collapse. On 6 July 1931 Germany's third largest bank, the Danatbank, denied it was having any financial difficulties but two days later conceded that it could no longer meet its liabilities. Danatbank closed its doors on 13 July 1931, only two months after the May 1931 bailout of Creditanstalt, the largest bank in Austria.

By 14 July 1931 the great banking house of Lazard Frères was in serious difficulties. A rogue trader made a wild bet on the collapse of the French franc and lost almost twice the bank's capital. The Bank of England agreed to bail out Lazard, as well as two other leading British investment banks – Schroders and Kleinworts.

That same year, Andrew Mellon, United States Secretary of the Treasury, advocated weeding out weak banks as a harsh but necessary means to the recovery of the US banking system. This "weeding out" was accomplished through refusing to lend cash to banks and by refusing to put more cash in circulation.

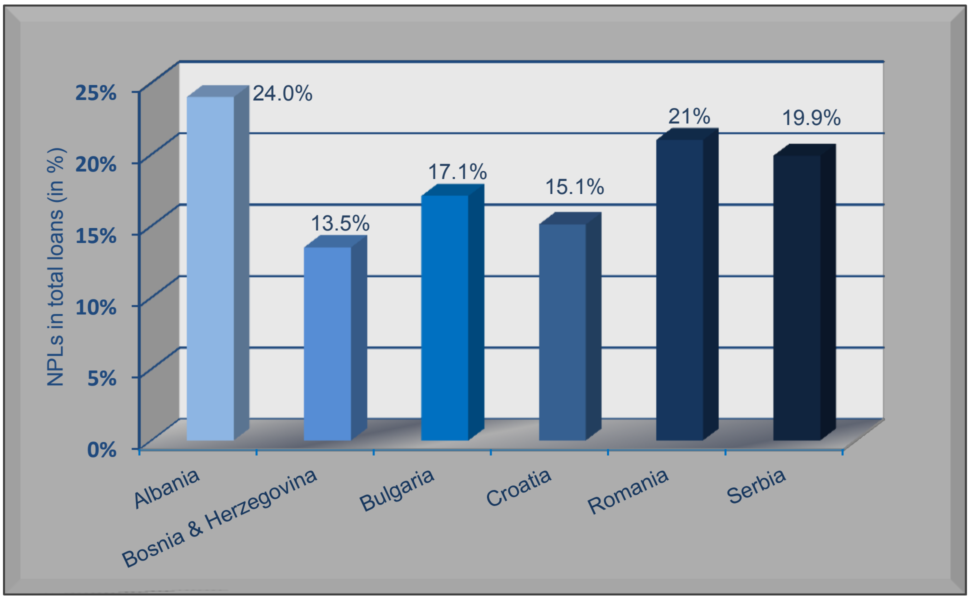
Fast forward to 2008 when fears about the collapse of Europe's banks dominated newspaper headlines. Heavy exposure to emerging eastern and southern European countries by banks nearly led to an unravelling of the European Union, as EU members fought over who should bail out the banks.

Today, in the aftermath of the financial firestorm that swept through Europe, banks are faced with weak loan demand, high levels of non-performing loans (NPLs), and the threat of deflation. Given this uncertain outlook, many foreign banks are rationing capital into south-eastern Europe (SEE), and instead allocating more capital to other higher-growth areas of Europe.

The banking problems besetting SEE countries will not be easily solved by sales of NPL portfolios. Unlike Ireland and Italy, many NPL portfolios in the SEE region are too fragmented to attract large-scale buyers like KKR, Apollo, Lone Star and Oaktree. And there are vast differences in NPL standards within SEE countries for loan documentation and sector concentration. According to Andi Ballta, Office Head for Western Balkans and Greece at NCH Capital, a US$ 3 billion fund, "The NPL issue is a big concern. In most Western Balkans countries the banks are not acting – they are simply waiting and praying for better days, and paralysing their banking system. At this pace, it will take them another five to seven years to improve the NPL situation."

Chart 1 illustrates NPLs as a percentage of total loans, according to the CESEE Bank Lending Survey, conducted by the European Investment Bank (EIB) in December 2013.

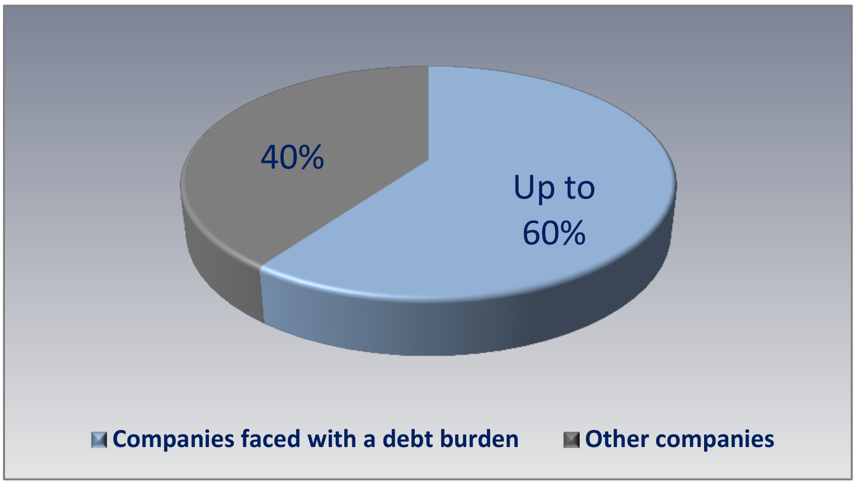
Chart 1: Non-performing loans as a percentage of total loans (as of Q2 2013) in south-eastern Europe



Source: CESEE Bank Lending Survey, EIB, December 2013.

According to the EBRD's May 2014 Working Paper[1], in Slovenia, "between 10,000 and 13,000 out of 23,000 companies (that is, between 44 and 60 per cent of all companies) are faced with a debt burden that will require some sort of debt restructuring" (see Chart 2).

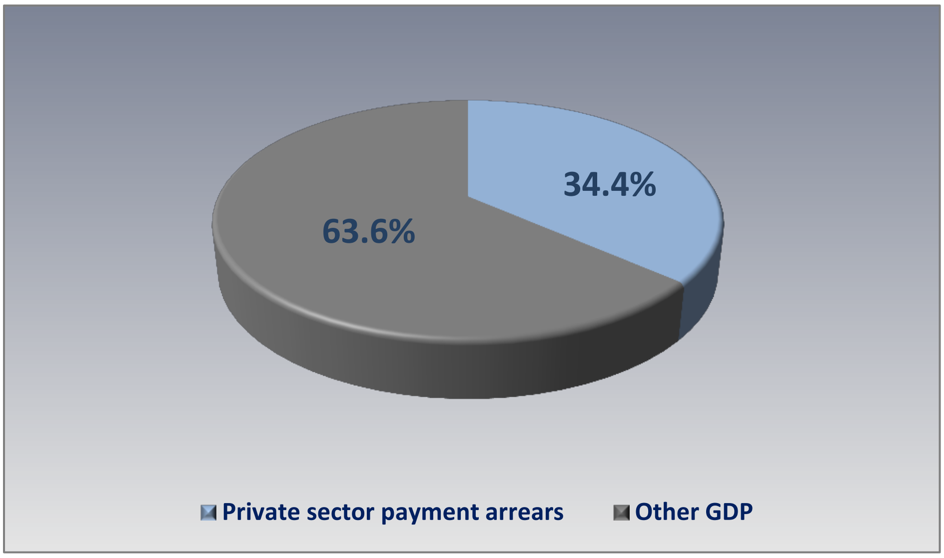
Chart 2: Companies in Slovenia faced with a debt burden requiring restructuring



Source: EBRD Working Paper No. 168, May 2014.

In addition, a recent World Bank report[2] found that, "private sector payment arrears (including non-performing loans, blocked bank accounts of private and legal entities, tax and related arrears to the government), amounted to 34.4 per cent of the GDP" in Montenegro, in the fourth quarter of 2012 (see Chart 3).

Chart 3: Private sector payment arrears as a percentage of Montenegro's GDP



Source: World Bank, Finance and Private Sector Development, June 2014

Many companies in south-eastern Europe are facing severe banking or liquidity constraints, which have hampered investments in new products, factories, supply chains and people. Companies have experienced blocked bank accounts, and some are barely surviving in the twilight zone of insolvency.

The chief structural impediments to the quick resolution of the NPL problem are:

- chronic inability to reduce the grip of existing owners on their companies
- unwillingness of creditors to provide new loans to owners/management who were at the helm when the business ran into financial difficulties
- mistrust of the quality of the debtor's financial statements
- holdout creditors that try to extort money
- lack of cooperation and trust among creditors
- work-out processes that are still prone to political interference.

Some owners are unwilling to give up control because they are convinced that the political environment which allowed them to amass their wealth will never exist again. On the other hand, bankers view owners as inexperienced with economic downturns, and are not confident that they possess the skills and experience required to deal with adversity. In their opinion, many oligarchs do not build their empire on hard work, focus and perseverance but through political privilege, and therefore lack the true grit to survive downturns. For example, many privatisations are the result of management buy-outs by managers who had no real external experience and had not taken significant financial risks.

One banker in Zagreb recently observed that consensual work-out is possible when two to three banks are involved, but impossible when there are more than three banks. Many companies have granted security and cross-guarantees that militate against a smooth work-out. Some owners deliberately set up complex banking arrangements on the basis that the complexity could create obstacles for banks to move against the company – such complexity then prevents banks from providing new cash to mitigate a liquidity crisis.

The issue of holdout creditors is severe in many parts of SEE. The behaviour is partially due to a lack of restructuring and a "first past the post" mentality, which favours enforcement or liquidation over work-out procedures.

Many countries have labour laws which prohibit rapid downsizing, and companies are burdened with heavy worker costs in the form of taxes and red tape. Political pressure has been an impediment to labour reform in many countries. Yet, globalisation continues its steady march and takes its toll on inflexible companies as production shifts rapidly to lowcost areas. One boat manufacturer in Slovenia commented that his costs were 25 per cent higher than competitors in Florida, and his market share was slipping rapidly.

The laws in transition

Since the crisis, enormous attention has been placed on the adoption of new, less formal, consensual resolution procedures and the use of pre-packaged plans to help accelerate NPL resolution, while trying to place more control into the hands of the real stakeholders. Insolvency procedures have been significantly improved in some SEE countries, but continue to take time and are prone to heightened regulatory risks and unpredictable outcomes.

Croatia, Montenegro, Serbia and Slovenia have pressed forward with legal reform. Montenegro has recently recognised the imperative of NPL resolution and smoother restructurings. This year, in cooperation with the World Bank, the Central Bank of Montenegro embarked on "The Podgorica Approach", which is focused on facilitating out-of-court restructurings. Montenegro's new draft law on voluntary financial restructuring (similar to Serbia's Consensual Financial Restructuring Law) establishes a framework, which encourages and supports the restructuring of economically viable companies.

Since 2011 pre-packaged plans have been commonplace under Serbia's bankruptcy law, with a "cramdown" by majority creditors on dissenting minority creditors permitted within each class. However, the process does not allow for wider cramdown across classes, as it does in the United States, and is not subject to close court scrutiny for fairness (in an economic sense). The bankruptcy judge's input is largely limited to ensuring proper procedures are followed. According to Luka Andric, Attorney at Law at Andric & Partners in Belgrade, "With the surge in pre-packaged restructurings over the past five years, no real efforts were invested by banks or incumbent owners into setting up feasible and sustainable restructuring solutions. Instead, most of these simply represented 'kicking the can down the road', which in turn over the period resulted in too many restructurings eventually failing. At this point, banks overwhelmingly do not genuinely believe in successful restructuring in 90 per cent of the cases."

In Croatia the new pre-bankruptcy legislation of 2012 was designed to encourage companies in the early stages of insolvency to file for protection against creditor actions in order to develop and negotiate a plan of reorganisation with creditors. During this time creditors can reject the plan and present a competing plan of reorganisation. However, if the debtors and creditors do not reach a settlement, then the company is forced into bankruptcy proceedings.

Oleg Uskokovic, Attorney at Law at Uskokovic & Partners in Zagreb, said that the new legislation helped to highlight the real financial position of many Croatian companies, "since all the creditors' claims (even potential or conditional claims) are identified and included in financial restructuring plans. This is regardless of the fact that many of those plans are not realistic and often include future revenues from the assets that are to be foreclosed by the mortgagees, who are not even participating in the financial restructuring plan." On the other hand, the new legislation gives current owners too much leverage as it enables them "to blackmail their creditors with non-realistic restructuring plans." Uskokovic adds, "Once pre-bankruptcy settlement proceedings have been initiated by the current owner, such proceedings can end only by settlement with the creditors or bankruptcy. Knowing that the average percentage of collected receivables by the creditors through bankruptcy in Croatia is around 10 per cent, creditors are rather voting for a non-realistic restructuring plan that enables them to keep their receivables at 30 to 40 per cent of their face value for some time, rather than writing them off to 10 per cent or zero immediately."

In Slovenia, the compulsory settlement procedure is such that:

- any debtor that enters compulsory settlement is more or less forced to offer a debt/equity swap to creditors (the rule is a debt/equity must be offered if assets are valued at higher than liquidation value on the books of the debtor, which is usually always the case)

- creditors have greater powers in forcing a debt/equity swap (and wipe-out of existing equity occurs under the same rule as described above)
- creditors have increased powers to replace management (in large or medium-sized companies)
- creditors can initiate compulsory settlement (for large and medium-sized companies).

According to Grega Peljhan, Senior Partner at Rojs, Peljhan, Prelesnik & Partners in Ljubljana, "With the new compulsory settlement procedure creditors have finally gained more power, and are now even able to initiate the procedure. In principle, legacy equity should be subordinated to the claims of creditors who should have the right to decide by themselves to execute debt to equity swaps and thus eliminate the interests of former owners. In some cases, there are still holes in the legislation which can be exploited by the current owners, and which are prolonging or preventing actions of the creditors for several months."

Uros Ilic, Managing Partner at ODI Law Firm in Ljubljana adds that, "The concept of absolute priority is now included in the new legislation (not only in the bankruptcy chapter but also in the chapter on compulsory settlement), so there is more balance between the shareholders and creditors than before."

"Banking legislation in Albania is more advanced than in some other countries," notes Andi Ballta from NCH. "And there is a different concentration in Albanian NPLs compared with the rest of SEE that comes from differences in (i) the legal framework relating to consumer loans; (ii) the attitude of courts in dealing with bailiff/pre-bailiff procedures; and (iii) policy decisions at the holding level of the foreign banks. In certain Western Balkans countries, it is not possible to sell consumer debt to non-banks; in other countries, the courts are notoriously and openly favouring the borrower. Very few foreign banks in the Western Balkans have made a decision to 'clean' the balance sheet (and even less have acted), while most banks have decided to either do nothing or create sub-bad banks which have very little impact on reducing the overall level of NPLs."

The role of operational turnaround firms and private equity is the solution

In the years following the financial crisis, many companies restructured but they generally focused on re-profiling debts and reducing interest rates. Operational restructuring was not common. As a result, there were very few restructuring cases in the SEE region where new money was injected.

SEE has competitive advantages: low labour costs, a multilingual educated workforce and geographic proximity to 170 million consumers. Countries such as Albania, Romania and Serbia, with low labour costs and local currencies, can become the workshop of southern Europe by manufacturing products for high-cost countries like Austria, Germany and Italy, whereas Croatia and Slovenia have the potential to become knowledge economies.

But these transformations require financial capital, expertise in operational restructuring and the adoption of best practices. After the break-up of the former Yugoslavia, many sectors such as telecommunications, energy, transport, textiles and agribusiness became very fragmented, and in most cases, lost access to best practices as well as top tier technologies. Globalisation and EU competition are now creating the imperative of sector consolidation and vertical integration.

In the past two decades in eastern Europe, private equity (PE) funds have provided much of the capital to finance these transitions. PE firms now want to capitalise on the cycle lag between eastern Europe (which started its transition period during the early 1990s) and SEE, which is transitioning now. PE firms are awash with liquidity and are searching for yield, and as SEE countries de-leverage and transition, PE firms will play a vital role.

In many countries operational turnaround firms work closely with rescue capital PE funds on restructurings. For example, KKR and Alvarez & Marsal are cooperating on a number of Italian NPL transactions. But many PE funds need to get comfortable with SEE, and operational turnaround firms can help with this process. To invest in a turnaround, rescue capital PE firms want a clear turnaround plan to positive cash flow, and they usually want a chief restructuring officer (CRO) to execute the turnaround plan.

Many businesses can be saved if the corporate turnaround plan is developed and implemented as soon as warning signs appear. Financial restructuring needs to follow operational restructuring. The right side of the balance sheet cannot be properly restructured before the left side of the balance sheet is addressed. As a company shows signs of early decline, an Independent Business Review is the most common first step, to describe and map the problems. The next critical stage is to develop granular, achievable action plans in order to implement the turnaround. A turnaround needs a path to profitability that clearly eliminates unprofitable products, lines of business, facilities, customers or products. The CRO needs to identify all unprofitable activities that can be eliminated from the company over a reasonable period of time.

SEE countries have a limited number of operational turnaround professionals who can restructure companies' operations by implementing robust operational recovery plans. One obstacle to finding CRO consultants in the region is the scarcity of experienced local managers with a restructuring background. This is due to the historic economic and market circumstances of the region (centrally planned economies).

What lies ahead?

Governments in SEE countries need to intensify the implementation of robust, creditor-friendly, legal frameworks that facilitate consensual plans of reorganisation leading to restructuring and/or sale of businesses. If a consensus cannot be reached, mechanisms to facilitate competing reorganisation plans need to be implemented. Labour laws in many countries need to reform in order to expedite corporate rightsizing.

According to Danijela Vukajlovic-Grba, a World Bank consultant in Montenegro, "In light of an increased availability of PE capital on the global markets and its increased propensity to invest in SEE, central banks of SEE countries should be using this momentum to sharpen their policies aimed at downsizing NPLs in banks through loan restructuring, with a view to supporting viable companies. With their measured policies central banks have saved many banks from losses and consequent capital increase in times when capital was scarce. However, financial stability becomes less of an issue compared with the struggling economic growth. Nowadays, when capital is becoming more available, banks would need to be better motivated by the central banks to initiate loan restructuring. Loan restructuring would help promote the survival of viable debtors and consequent credit and economic growth, support of which, in prudent terms, represents one of the main tasks of the central banks, along with preservation of financial stability."

The continuing process of privatisation needs to be vigilantly managed to ensure that valuation expectations reflect market conditions. While millions have been poured into state-owned companies over the past two decades in the hope of creating national or regional champions, the market may not see eye to eye with governments on valuations of these companies.

Governments can facilitate the entry of private equity into the restructuring market in ways other than reform of insolvency and labour legislation. For example, the Croatian Bank for Reconstruction and Development has played a vital role in encouraging the development of private equity in Croatia by offering to match funds for the capital raised from limited partners. International financial institutions such as the EBRD, the International Finance Corporation and the EIB can continue to provide support to rescue capital funds such as EMSA Capital and ADM CEECAT Recovery Fund, which are focused on turnaround financing. Operational restructuring expertise will develop during the course of this economic downturn.

The three new Turnaround Management Association (TMA) chapters in Croatia, Serbia and Slovenia, and the existing Romanian chapter will help foster operational turnaround skills and expertise, and will increase investor awareness of opportunities in the region. The TMA provides an important "clearing house" function for distressed investing and lending. The 2014 Annual Conference of TMA Europe showcased alternative capital providers across the credit spectrum, and TMA's NextGen education programmes will provide practical restructuring education for young emerging professionals, which may be quite valuable in the long term.

Although considered a financial genius by his peers, Andrew Mellon will go down in history as the financial policy-maker who exacerbated the Great Depression in the 1930s. His famous phrase "squeeze them (the banks) until the pips squeak" epitomised his monetary doctrine.

Having studied the mistakes of the 1930s, central bankers have flooded today's global money markets with liquidity. As this liquidity filters into SEE, coupled with robust restructuring efforts, the region that saw unprecedented growth in the early 2000s can begin to regain its footing. The SEE region may be one economic transition cycle behind Czech Republic, Hungary, Poland and Slovak Republic, but with rigorous turnaround practices, further legal reform and fresh capital, the uplift in shareholder value of SEE companies can replicate the success of those countries.

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[1] J.P. Damijan (2014), "Corporate financial soundness and its impact on firm performance: Implications for corporate debt restructuring in Slovenia." EBRD Working Paper No. 168 (last accessed 1 August 2014).
[2] "Public and Private Sector Payment Arrears in Montenegro: Size, Composition and Policy Options for Addressing Them", World Bank, Finance and Private Sector Development, June 2014.