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Corporate Finance & Distressed Investing

Market Update - September 2012

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We have outlined in this market update the state of the Finnish, Nordic and European financial markets as of September 2012 and given some prospects until early 2013. We have listed the most important regulatory developments taking place in Finland during the next year at the end of this update.

The General Trend

In general, the European banks are not selling their distressed assets – e.g. defaulting loans. However, the general view of the funds that we are familiar with is that the more the banks hold on to these assets, the more write-off we will see in the near future.

As there is ample of liquidity and several funds are looking to purchase substantial amounts of distressed assets, we need to solve two problems in creating the much-needed markets for these assets:

(i) there is a need to get the relevant parties to the negotiation table – this is not currently working adequately; and

(ii) the allocation between sales of portfolios of assets (e.g. non-performing loans) versus those of individual assets (e.g. single borrowed obligations) will have to match better between the banks and the funds and other purchasers.

Some major EU restructuring advisory firms believe that we will see a number of portfolio sales during the next year and thereafter for quite a while.

One aspect moving the trend from portfolio sales to more refined asset allocations is that the banks are becoming better in slicing parts of their assets into a smaller and more suitable assets. This should be a good piece of news for specialist funds.

Reputational Risk

One important factor limiting the number of distressed transactions results from the perceived reputational risk for the banks in entering larger distressed portfolio sales. In some occasions this has prevented some otherwise feasible transactions altogether.

The reputational risk should, as always, be balanced with the fact that some companies are facing deteriorating conditions due to lack of funding and strains caused by the existing indebtedness. As we see, there are reality checks going on in a number of financial institutions regarding the state of their portfolios. The quality of certain assets is deteriorating.

Junior Creditor Certainty

One aspect that some funds see as a major legal obstacle in carrying out distressed transactions is the uncertain state of a junior creditor in liquidation or statutory restructuring in many European jurisdictions. For the transactions to take place, it is required that:

(i) the nature of valuation should be as clear as possible. Otherwise the determination of the investment opportunity is very hard; and

(ii) the legal treatment of turnover subordination should be as secure and clear as possible in all circumstances.[1]

Real-estate Assets

The on-going trend of not accelerating real estate loans even in the case of covenant breaches if the loans are being serviced normally is continuing.

At least in Finland this trend is being enhanced by the fact that a distressed sale of a commercial real estate would most likely lead to the need of other real-estate owners in similar assets and the same area to carry out write-offs of the values of their own assets in accordance with the accounting regulations.

The above is likely to lead to a loss of equity in the company with mandatory recapitalization and possible cross-defaults. This is a difficult equation e.g. in relation to pension insurance companies.[2]

Where the Most Transactions Take Place

The volume of regular M&A transactions will remain low for the time being. We see the main reason for this being the high level of volatility in the markets.

The "sub-50 to 100 million" euros market is most likely to be the most active market both in distressed and non-distressed transactions. There are a number of distressed and other good-quality targets in this category.

Secured Financing to the Rescue

One notable aspect of the distressed companies is currently the lack of funds available for capital expenditure. This means that a few firms have been able to invest on an adequate level in order to maintain their competitiveness.

Some prevalent financiers have been instrumental in providing secured financing for corporates in need of funding e.g. for their capital investments. We see that this trend is strengthening and a positive sign of secured funding by specialist investment companies fulfilling the cap caused by withdrawal or hesitation by some of the banks.

For companies holding intellectual property as their most valuable asset, this will create a need for the parties to be better able to valuate such assets – something that has proven to be inherently difficult in practice.

What Are We Seeing in a Broader Perspective?

There is at least a 6tr€ refinancing wall (not including the distressed financing) in the medium term, which means that a number of funds, advisory firms and banks have increased notably the capabilities of their restructuring and finance teams.

Some funds see that investing in Europe is still and will be difficult not only because of the economic and market uncertainty but also due to divergent jurisdictions and their views on restructuring. They have also clearly expressed their preference of stable legal systems and countries that have remained relatively stable and on a growth path despite the recession – in Europe these are likely to be the UK, Germany, Netherlands and the Scandinavia.

At least some US funds remaining very selective in relation to the European markets – e.g. Ireland being a positive jurisdiction in this sense.

For some countries, e.g. Spain, the internal problems will most likely last at least for the

[1] We have discussed these aspects in relation to Finland in our client negotiation "Negotiating Intercreditor Agreements".
[2] It should be noted that the solvency regulations of domestic insurance companies has changed in the beginning of 2012 and there are further changes taking place at the beginning of 2013 and later on due to the EU Solvency II regime.

next 5-10 years – the questions arising with the state of the local *Cajas* (savings banks) are imminent). Some are of the view that there is a 50% overvaluation in the real-estate sector – however, this is hard to confirm, as the level of transactions is low.

In Finland, the problems are not as prevalent, but we expect that the tight lending conditions will, and have already affected quite a bit, the SME sector and its growth prospects. However, the State has been active in ensuring public funding for certain growth companies. Needless to say, this cannot replace prudent bank lending to SMEs.

What to Do to Make a Transaction Work

For example in France we have seen through our partners that the banks are only willing to extend their loans to distressed companies if the sponsor or another equity investor makes a sufficiently large equity capital injection into the company simultaneously with the extension. This has resulted in a number of companies not being able to grow adequately – thus leading to a "zombie"-type of economy. Our estimate is that we are likely to see more defaults and difficult liquidity issues also from France in the near future.

So far e.g. French banks have not carried out debt to equity swaps. In Finland, the situation was similar with certain senior bankers stating that no swaps have been made and will be made in the near future. Now the banks have eased their position and we have seen several debt-to equity swaps.

Most of our partners and contacts see that in order for a transaction to succeed, there is a growing need to carry out operational restructuring along with the financial restructuring. The markets are evolving rapidly and the lack of capital investments in some of the companies have resulted in an imminent need to update the organizational structure, products, corporate focus and management.

Legal Developments in 2012 and 2013 in relation to Finland

At least the following legal developments should be borne in mind in relation to Finland in the short term. We will prepare technical updates on these during 2012.

1. The completely revised securities laws will be adopted late 2012 and they will be most likely in force as of the beginning of 2013;

2. The laws and technical regulations in relation to alternative investment fund and managers (all other funds than the UCITS) will take effect in June 2013;

3. There have been and will be a number of changes in the solvency and capital regulations of the insurance companies. These will e.g. change investment allocation of these companies – being the largest single investors in Finland;

4. The ERISA regulation and technical standards will bring all OTC-trading into a regulated activity – also for firms entering into such contracts. This will take place most likely in the beginning of 2013; and

5. The content requirements and exemptions relating to prospectuses have changes as of 1 July 2012. E.g. the minimum threshold of securities offerings (requiring a prospectus) was raised from 100.000€ to 1,5m€, making is easier to carry out small public equity issues.

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