THE 2022 RESTRUCTURING HORIZON

Many businesses have emerged from the recent enforced constraints but are facing into the early vernal headwinds of increasing inflation, supply chain challenges, the costs of adopting new business models while wrestling with working capital/refinancing issues. Apart from consumer related restructurings in 2021 many market commentators are hedging their views on whether 2022 will lead to a significant increase in deeper restructurings or insolvencies in various jurisdictions, using newly introduced restructuring procedures, while high levels of liquidity remain to be deployed by debt investors.

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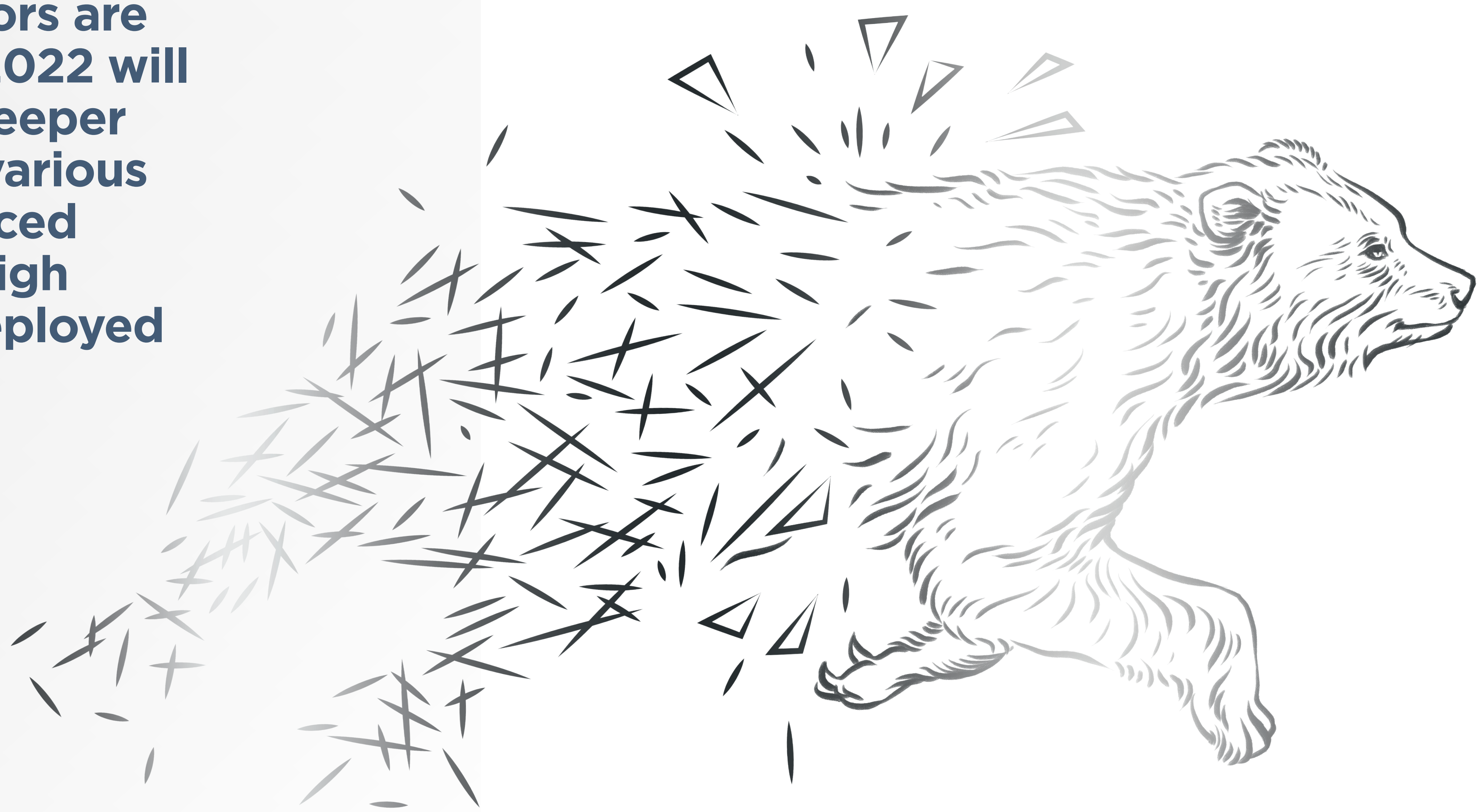
MORE IMAGINATION MORE IMPACT



1 THE LTM PERSPECTIVE

Throughout 2021 a number of high profile CVAs and restructuring plans continued to be deployed in consumer facing sectors in the UK, typically to the detriment of landlords and/or junior financiers. This reflected the 5-year trend in the retail and casual dining sectors as consumer patterns changed but often these never addressed more fundamentally unsustainable debt capital structures. Government support packages and creditor forbearance (or statutory curtailment of their rights) prevented many businesses from suddenly failing in the last twelve months but these elements have largely now ceased to apply so many debt advisers and investors are analysing which debtors have not yet undertaken a more fundamental balance sheet adjustment. Indeed, official figures for January 2022 demonstrate that insolvencies in England and Wales are back at the levels last seen in January 2020, but with many more now initiated by directors who have reluctantly concluded that their companies have run out of road with no reasonable prospect of rescue or recovery. A relatively small number of 'pre-pack' insolvency sales have been concluded in the last twelve months where stronger businesses acquire the relevant assets and undertakings of failed enterprises, these have most often featured the construction, leisure, energy or casual dining related sectors.

Many enterprises have emerged from their COVID chrysalis as clear winners while others are in acute need of working capital to recruit and re-equip themselves for newly adopted business plans, tap altered supply chains or simply to capture the re-bound in customer demand.

A small number of large cap European companies in the travel, aviation, leisure and energy sectors have sought to address unsustainable debt capital structures via powerful cross-class cram-down mechanisms (under UK restructuring plans or their EU equivalents (most notably in Germany, the Netherlands and Ireland)).

2 WHO WILL PAY THE/ANY RECKONING IN 2022?

The re-invigorated headwinds of; increasing inflation, supply chain constraints, labour sourcing and increased interest expense during 2022 mean that businesses looking to re-capitalise or refinance themselves have to assess if they are still in the right shape to be able to tap the debt markets well ahead of ensuring they can obtain a going-concern audit opinion in Q2 2022.

Many of these challenges are yet to be fully experienced by businesses and their currently spending consumers, as wage inflation had largely stayed ahead of consumer price inflation but the former is now likely to lag the latter during most of 2022. A restriction on consumer disposable incomes may bring renewed challenges for certain leisure sectors but while CPI may be at 30 year highs in some jurisdictions, any increase in current interest rates (even if doubled) would not likely have a significant impact on many but the most leveraged floating rate exposed borrowers/issuers.

Certain UK 'challenger' digital financial service providers find themselves challenged by virtue of the small scale of their operations while facing more regulatory scrutiny. There are likely to be opportunities for consolidation and distressed acquisition during the coming months in that sub-sector.

Many lenders, debt investors and corporate turnaround advisers are anticipating that corporates may well spend more money on operational turnaround/debt advisory fees during 2022, whether they are in public or private equity ownership. Many are of the view that the relatively 'subdued' level of insolvencies will remain below historically usual levels, assuming credit and equity markets continue to remain reasonably buoyant. Clearly those views may change if inflation proves to be stickier or if even just a few 'black cygnet' events occur in the world's markets (as threatened by the ongoing adjustments in the PRC RE market, geo-political risk issues and any sustained softening in technology stocks).

However, it is likely that many smaller/medium sized enterprises will suddenly enter liquidation rather than administration during 2022 as little value often remains in a business whose business plan may no longer apply to the current market and/or its resources have become depleted in the last two years. Such an environment usually favours opportunistic and special situations focused investors who in acting swiftly can acquire assets and businesses which they can recapitalise.

As with many rebounds after a prolonged recession the issue of fraud is also beginning to re-appear. This is usually twofold. First, a fundamentally fraudulently operated business model, often initially adopted to cover the loss of business itself. Alternatively, or additionally, there may be fraudulent accounting to disguise fraudulent acts or just poor business performance. Secured lenders and unsecured creditors alike are being affected by these inequities, often reputationally by association as well as financially whether by direct financial loss or by regulatory enforcement action due to their association.

Much of the unpaid multi-billion rental arrears in the UK retail sector will begin to be addressed via a statutory arbitration process from Q2 2022, with landlords and tenants vying over where the appropriate balance should be struck between their opposing interests. To date, both legislation and court decisions have broadly favoured tenants rather than their long-suffering landlords in contentious restructurings. HMRC will also return in 2022 as a significant petitioning creditor for many businesses who have benefited from prolonged deferral periods in the payment of taxation. IFRS 9 may cause certain banks to dispose of more stressed loan portfolios later in 2022 but many such institutions have also managed to reverse out earlier loss provisions so enhancing their earnings and capital base.

3 PRAGMATIC RESTRUCTURINGS AND OPPORTUNITIES

It seems inevitable that the restructuring reforms, under CIGA 2020 in the UK and under the EU Directive (2019/1023) on Restructuring and Insolvency, will be increasingly used during 2022, particularly in the large cap space where a cross-class cramdown mechanism can be used by a single creditor class to adjust the rights of multiple other classes of creditors/equity.

The UK's restructuring plan has generally only been used by larger companies with sufficient resources to retain financial and legal advisers to prepare highly detailed explanatory statements (as also typically seen on schemes of arrangement) often running to 500-1,000 pages. Other jurisdictions such as Ireland (via its Small Company Administrative Rescue Process ('SCARP') have enacted specific legislation to ensure such mechanisms can be adopted more readily by smaller companies.

Many EU jurisdictions have yet to implement these reforms or develop court practice and expertise around assessing and valuing claims and recoveries in the "next-best alternative" to a company proposed plan. Once fully appreciated by the market this pragmatic tool will provide both sponsors and many creditors with a viable alternative to a more fulsome insolvency procedure which is so value destructive in most jurisdictions. It will also provide many opportunistic debt investors with a viable route by which to adjust bad balance sheets of good businesses more readily than ever before. Ultimately it should provide a more sustainable solution across the UK and the EU for businesses in need of a truly sustainable balance sheet restructuring. The use of new moratoria procedures (to shield a debtor pending the formulation of its restructuring proposal) in various jurisdictions is still to be tested fully in the courts and may require modification if they do not provide debtors with sufficient practical breathing space or remain under-utilised.

For advice on any of the issues raised above please do not hesitate to get in touch with a member of our dedicated Restructuring team.

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If you would like a more comprehensive view of what we are seeing in the current market environment and what steps you should take to maximise your chances of success, please get in touch.

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