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2015 was a year to forget for most distressed investors. It started off with great hopes that it would bring a plethora of opportunities, but few materialised as the long-awaited wave of European high yield restructurings showed no signs of emerging. Austria aside, European banks proved to be far more resilient than expected, Greece’s spell on the edge of default was far less intimidating the second time round and a weak but accelerating European recovery took hold.

With a debt pile that gets bigger by the day, the implosion of Spanish clean tech engineering conglomerate Abengoa provided plenty of activity for hedge funds who smelt a rat over the group’s opaque accounting, but few other large-scale restructurings materialised. Looser than ever loan documentation and the shift of loan to bonds had removed nearly all triggers other than liquidity shortfalls on many deals, keeping distressed opportunities in check. And in the cases where liquidity needs emerged, they looked too big and too late to address, even for the bravest.

Many distressed players also got burnt by getting involved too early on in some situations, notably the oil & gas sector, which caused a wave of hedge funds to nurse heavy losses by the middle of the year when oil prices moved another leg lower. Whilst the European oil production sector is tiny compared to the US, it will likely feed the restructuring pipeline in this year with service providers to the sector looking especially vulnerable. Other commodities prices also came under the wheels, suggesting more victims will surface.

European high yield has been a sweet spot for buysiders over the last few years, and investors polled by Debtwire still expect it to be the most popular asset class in 2016. But 84% of those polled said they boosted their asset allocation to distressed investing in the last year, up from 75% in the previous edition of this survey. That suggests the market increasingly expects stressed credits will no longer be able to kick the can down the road and will have to face reality. Interest rates in Europe show few signs of being in danger of hikes, but China’s uncertain transition to a consumption-led economy and a seemingly hard sell to keep the UK in the EU could provide further macroeconomic shocks.

Southern Europe, led by Spain, will continue to offer most opportunities. And while investors polled acknowledged the efforts of the country, and its peer Italy, to improve their domestic legal frameworks by offering a broader range of restructuring tools, this has not translated into a better outcome for creditors just yet, leaving the UK, Germany and the Netherlands the most favoured jurisdictions for workouts.

Chiara Elisei
Co-Deputy Editor
Debtwire Europe
Europe in 2015 was characterised by the steady fall in oil and other commodity prices and increasing uncertainty around a fragile global economy. Strengthening domestic dynamics, particularly private consumption – which benefits from low oil prices and quantitative easing, were set against a difficult backdrop of global headwinds; including Chinese stock market volatility and the ongoing deterioration of many major emerging economies. Overall this resulted in capital markets in 2015 being more subdued than in 2014, but remaining sufficiently buoyant to continue to facilitate refinancings, amend & extend transactions and M&A in circumstances where some may have anticipated a restructuring.

2015 was after all a year which experienced the largest volume of M&A transactions on record ($5.03t).

An obvious focus for 2016 remains the slew of covenant-lite European high yield bond financings originated in 2013/14/15. These will prove to be increasingly interesting capital structures with 1/7 US high yield names yielding over 10% and the European high yield universe close behind. The absence of covenants will cause some delay on restructurings emerging from this asset class until payment default looms. The largest opportunity set has so far been provided by the oil & gas sector and interestingly exchange offers, which have been a staple in the US, are now making a return in Europe.

Central bank policies have played a key role in maintaining liquidity in the European market. However, a number of factors may yet drain this liquidity: early signs of capital withdrawal away from alternative capital and special situations funds; the Fed’s hawkish outlook raising questions over long-term rates; and the geo-political landscape looking to be increasingly uncertain. These were particularly topical issues towards the end of 2015, giving some encouragement to market participants focused on distress that the coming year will yield more opportunity. Given the liquidity in the market, 2015 proved to be a constrained playing field for many distressed investors driving the yield opportunity to some jurisdictions and sectors that are much more challenging (e.g. oil & gas/Ukraine/mining in Africa). 2015 was after all a year which experienced the largest volume of M&A transactions on record ($5.03t).

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2016 will likely see the uncertainty which emerged in 2015 amplified: further volatility; a more uncertain political landscape; uncertainty around Brexit; worsening macroeconomic conditions and an indication that credit markets are approaching another peak. The macro picture is undeniable: China is slowing down, Russia is under sanctions, and growth in Brazil has reversed. Additionally, the rate rise in the US has forced many European investors to ask when the Bank of England (and, probably later, the ECB) will follow suit. These uncertainties should result in more opportunity for distressed investors through the year.
### The world leader in financing advisory

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<tr>
<td>Four Seasons (Current)</td>
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Image: detail from a bond issued by Rothschild for the 1900 4.5% Coquimbo railway loan, Chile (The Rothschild Archive)
Since the credit crisis, market participants in the restructuring space have felt a sense of unfinished business. The era of refinancing, extending and amending debt has led to the feeling that Europe has a large number of “zombie companies” which have not truly dealt with “over-leverage” and, that the problems have spilled over into increased levels of sovereign debt. Leverage in Emerging Markets shot up too since the credit crunch. This year, participants in the European Distressed Debt Market Outlook are expecting a marked increase in restructuring activity and there are plenty of signs that this expectation may well translate into reality.

The year has opened with significant stock market declines and a sense of economic anxiety. For those of a bearish disposition looking for reasons to short the markets generally, there are plenty of reasons to point to. Middle Eastern tensions, the East-West discord, commodity price falls, Chinese Stock market woes and weakening growth in some of the Emerging Markets are all feeding into the sense of foreboding.

On a less-significant scale, but perhaps an indicator of a tough regulatory mindset, the Portuguese authorities transferred certain senior bonds of the so-called “Novo Banco” (the good bank) back to Bank Espirito Santo (the bad bank) just before the New Year. EU Member States are, as of 1 January 2016, required to implement the “bail in” tool under Article 55 of the Bank Resolution and Restructuring Directive which will allow the resolution authorities to write down debt of banks or convert debt into equity.

Conversely, the economic data from the US has been strong. European growth has been strengthening (supported by ECB and its asset price-boosting QE policy) and, in its latest Global Economic Prospects Report, the World Bank declares “global growth is poised to recover modestly, by 2.9 per cent, in 2016, after [once again] falling short of expectations at 2.4 per cent in 2015”. Price falls will be a significant boost for consumers in oil-consuming nations.

The mantra of “Lower for Longer” in the oil sector will continue to be a key theme in 2016. The number of high yield (HY) bonds trading at distressed levels is higher than it has been for some years and it is only to be expected that HY restructurings will significantly tick up from the low levels of previous years. When, or if to invest in the commodity sector is the question on investors’ minds this year. The desire not to catch the falling knife is an oft-heard refrain. The example of the failure of Afren plc, where many bondholders followed their money into “super senior” bonds, was not a happy one.

Gradually European insolvency regimes have been improving with reforms in Italy, Spain and France coming into force in 2014 and 2015. In the UK, the nature of how far the UK’s scheme jurisdiction extended was in question in 2015. Adherents of schemes were given a boost by the decision in the restructuring of a Spanish company, Codere, where the judge’s initial worry of “extreme COMI shifting” did not prevent the scheme from being sanctioned. This comes after Mr Justice Snowden appeared to be rowing back in the Van Gansewinkel case. Given how multinational many oil and oil service companies are, we also expect to see US Chapter 11 practitioners wake up from their hibernation too.

2015 was not a happy market for the credit markets. Many hedge funds suffered poor returns. A number closed their doors and began giving back their money to investors. We expect that 2016 might be another “year of volatility”. Happy is the trader who calls it right.

Saam Golshani
European Co-Head of the Restructuring Practice

Stephen Phillips
European Co-Head of the Restructuring Practice
For major financial, commercial and industrial institutions debt restructuring is about adapting to thrive and not just survive. With experienced restructuring practitioners in France, Germany, Italy, Russia, UK, US and Asia, Orrick has a strong track record of crafting solutions in difficult circumstances. Orrick assists lenders, bondholders committees and debtors with the right advice to achieve successful restructuring outcomes.

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What will the Chinese economy grow by in 2016?

Respondents’ expectations for economic growth in China are fairly conservative. The largest percentage of those polled (46%) expect the rate of economic growth to be lower than 7.5%, while 43% predict 7.5% exactly. The remaining 11% are more bullish in their estimates, anticipating that the growth rate will exceed 7.5%. As a point of reference, Chinese GDP growth stood at 6.9% in 2015 and has been declining steadily since 2010, when the GDP growth rate was as high as 10.6%.

“Persistent sluggish growth in China will likely further impact the commodities and natural resources sectors throughout 2016, and companies exposed to them.”

—Andrew Merrett, Rothschild

In the final quarter of 2015, Debtwire canvassed the opinions of 100 hedge fund managers, long-only investors and prop desk traders in Europe.

Interviewees were questioned about their expectations for the European distressed debt market in 2016 and beyond. The interviews were conducted over the phone and the respondents were guaranteed anonymity. The results are presented in aggregate.
Q When do you expect the volume of European restructurings to hit its next peak?

Close to half of respondents (48%) predict that European restructurings will peak in H1 2017, while 38% expect that the largest number of restructurings will be in H2 2016. Remaining respondents are divided fairly evenly across H2 2017 (8%) and H1 2016 (6%).

Respondents believe that shareholder activism will be one of the foremost drivers of restructurings in the near term. One respondent, a UK-based proprietary trader, expects restructurings to peak in H1 2017 as companies come under “immense pressure” from shareholders to “recoup their financial strength”.

“The sheer number of factors driving uncertainty in the market (macroeconomic and monetary policy alike) will likely result in a gradual increase in restructurings through 2016.”
—Glen Cronin, Rothschild

Q Which forms of debt renegotiation do you expect to be most, and least, prevalent in 2016?

Break-ups and asset disposals (41%) and amend & extend (35%) are expected to be the most common debt renegotiation strategies in 2016. All other options were chosen by less than one-tenth of those polled, including full or partial debt equitizations and exchanges (9%); forward start facilities or new money injections, each chosen by 6% of respondents; and debt buybacks (3%).

Faced with the opposite question of which forms of debt renegotiations would be the least popular in 2016, more than a third of respondents picked debt buybacks, followed by forward start facilities (23%) and debt for equity swaps or debt exchange offers (18%).

“It doesn’t surprise me that asset disposals get such a high rating. In the oil and mining sectors in particular we are expecting 2016 to be the year of distressed M&A sales.”
—Stephen Phillips, Orrick Partner, Restructuring, London
Southern Europe remains at the top as the region generating the highest level of debt restructurings in 2016, according to 91% of those polled. All other regions trail far behind, with Northern Europe and Western Europe coming in as the second busiest restructuring geographies for about one-third of respondents. Eastern Europe was chosen only by 27% of those polled. Still, many respondents say Eastern Europe is ripe with distressed opportunities for those who are brave enough to face the area’s lingering uncertainty. According to one respondent, international investors’ risk aversion for the region may actually be pushing prices further down, creating more attractive distressed opportunities later on: “Political and economic unrest in the entire Eastern European region has pushed corporates into vulnerable situations, but international buyers are avoiding investments here for the time being, which means the companies are forced to divest their assets at a discount.”

“Our sense is that Spain has been significantly ahead of Italy in the restructuring cycle. Italy has been quietly reforming its insolvency laws and ramping up its NPL market. Whether 2016 is the year the dam breaks remains to be seen.”

—Daniela Andreatta, Orrick Partner, Restructuring, Milan

Q: What proportion of sub-investment grade companies do you believe are likely to face debt restructurings in 2016?

The vast majority of respondents (86%) believe that more than 10% of sub-investment grade companies will face debt restructurings in 2016, with a variety of catalyst events. A Netherlands-based proprietary trader says hedge funds will be partially responsible for fuelling this activity: “Hedge funds are getting more and more involved in supporting companies and taking relatively higher risks, suggesting over 5-10% of these companies are likely to restructure their debts successfully this year.”

Hedge fund-driven restructurings may be common in 2016, but this does not mean they will be easy, as the managing director of a German hedge fund highlights: “Balance sheet reworks will be more difficult for sub-investment grade companies as they will be in a weaker position to negotiate. Nonetheless the number of those restructurings will increase, due to the urgency of recovering financial soundness.”

“High yield bonds will take the lion’s shares of sub-investment grade restructurings, led by the oil & gas sector.”

—Tom Smyth, Rothschild

Q: Where do you expect most European debt restructurings to originate from? Rank the following regions from 1 to 4 where 1=most debt restructurings

Southern Europe
- Percentage of respondents
- 91%

Eastern Europe
- Percentage of respondents
- 27%
- 43%
- 26%

Western Europe
- Percentage of respondents
- 32%
- 35%
- 30%

Northern Europe
- Percentage of respondents
- 32%
- 22%
- 44%

Key:
- 1
- 2
- 3
- 4
Please rank the following countries from 1 to 6 where 1=most debt restructuring

In line with respondents’ bullish predictions for Southern Europe, Spain remains at the bottom of the league, with roughly half of respondents (51%) indicating it as the country that will see the highest volume of restructurings in 2016. The gap with second-in-list Italy remains relevant, as the latter is chosen by close to one-third (31%). However, adding up the number of respondents who consider Italy to be the busiest (31%) or second busiest (42%) country for restructurings next year, the gap with Spain is almost void (a combined 74% versus 73% of Italy). Ireland is surprisingly low on the list: just 12% of respondents overall expect Irish restructurings to be prominent in 2016.

“There are three or four significant French restructuring deals we are anticipating this year. Not a record-breaking year in prospect by any means but not quiet either.”
—Saam Golshani, Orrick Partner, Restructuring, Paris
Where do you expect to find the best distressed opportunities going forward? (Select one option)

Europe is expected to be busier than other regions in terms of debt restructuring activity in 2016 for 60% of those polled, followed by 24% who identified Asia and 16% who indicated North America.

Drivers behind European restructuring in 2016 will be largely the same as in 2015, including economic instability, low commodity prices, regulatory uncertainty, and reduced capital availability. North America will also see a fair amount of restructurings due to the number of oil & gas opportunities it offers, as one respondent points out: “The USA and Canada have been impacted by oil & gas price volatility, which has resulted in advantages for international investors looking for distressed opportunities in 2016.”

“It is interesting how low North America ranks. Given the oil distress, many of our fund clients have been focusing their oil efforts on North America due to the depth of the HY market and its exposure to oil.”

—Ron D’Aversa, Orrick Partner, Restructuring, New York
Which macroeconomic factors will drive a European restructuring wave next year? Please rank from 1 to 5 where 1=most important driver.

Key:

- 1
- 2
- 3
- 4
- 5

The top two macroeconomic drivers of European restructurings will likely be rising interest rates and sovereign bond defaults, followed by deflationary pressures in the Eurozone. Only 11% of respondents overall expect the credit crunch in China will be the first or second most significant driver, while geopolitical events such as the Syrian conflict rank lowest on the list.

One respondent notes that all of the above challenges are having unique but simultaneous effects. Elaborating on the specific but equally important effects that the above factors will have on European restructurings, one respondent says: “Geopolitical problems as seen in Ukraine and Russia, as well as law and policy changes made by the EU will affect companies and the way they restructure. Separately, the credit crunch in China will add pressure, and potential sovereign bond defaults can cause problems across all economies.”

“The Fed interest rate rise in December may trigger difficulties for some sovereigns and corporates to refinance, potentially leading to defaults.”

—Arnaud Joubert, Rothschild
Please rate the following in terms of the opportunities they present for distressed investors in 2016.

The oil & gas sector (94%) and the transport sector (90%) will offer the highest number of restructuring opportunities in 2016, followed by the financial services sector (81%). Infrastructure and energy were chosen by 76% and 72% of respondents, respectively. Five additional sectors were selected by more than half of respondents as providing the largest potential for distressed investors next year: chemicals and materials, property and construction, automotive and auto parts, mining and minerals, and media.

Compared to last year’s survey, the consumer sector has been shaping up, as the number of respondents considering it the sector that would produce the most significant distressed opportunities has more than halved to 31% versus 65% for 2015.

On the flipside, transport and financial services have jumped up to the top of the list for next year, while last year a remarkably small percentage of respondents (52% and 48%, respectively) had picked them.

“The focus on oil & gas and shipping is hardly surprising. We also expected mining to rank higher than it did.”

—Anthony Riley, Orrick Partner, Corporate, London

Key:

- Significant opportunities
- Some opportunities
- Few opportunities

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<thead>
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<th>Sector</th>
<th>Percentage of respondents</th>
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<tbody>
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<td>Oil &amp; gas</td>
<td>94%</td>
</tr>
<tr>
<td>Transport (incl. Shipping)</td>
<td>90%</td>
</tr>
<tr>
<td>Financial services</td>
<td>81%</td>
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<tr>
<td>Infrastructure</td>
<td>76%</td>
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<tr>
<td>Energy</td>
<td>72%</td>
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<td>Chemicals and materials</td>
<td>58%</td>
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<tr>
<td>Property &amp; construction</td>
<td>56%</td>
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<tr>
<td>Auto / Auto parts</td>
<td>54%</td>
</tr>
<tr>
<td>Mining &amp; minerals</td>
<td>53%</td>
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<td>Media</td>
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<td>Telco / Cables</td>
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<td>Business services</td>
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<tr>
<td>Consumer / Retail</td>
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<tr>
<td>Leisure</td>
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<tr>
<td>Renewables</td>
<td>19%</td>
</tr>
<tr>
<td>Recycling</td>
<td>12%</td>
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Percentage of respondents
Q. Which oil & gas sectors offer the best opportunities?

A closer look at the oil & gas sector reveals that some of its subsectors will be more appealing than others. Oil services was selected by close to half of respondents (48%) as the subsector that will provide the most profitable opportunities, followed by rigs (22%) and subsea (15%). Lowest on the list are OSV (10%) and seismic (5%).

"Servicing companies currently offer the best distressed O&G opportunities, although there is an over-supply of vessels and drilling rigs these are ultimately asset backed companies. The E&P sector presents greater challenges in that enforcing security over licenses is uncertain due to multiple stakeholder interests e.g. JV partners, host governments and regulators."

— David Hemmings, Rothschild

"This is consistent with our discussions with our fund and strategic clients. No surprises that investments related to new exploration spend, such as seismic and drilling companies, are seen as unattractive in this part of the cycle."

— Colin Graham, Orrick Partner, Energy & Infrastructure, London
Are you considering distressed oil & gas opportunities in the larger, more liquid US market?

Most respondents (82%) are not considering distressed oil & gas opportunities in the US market. These numbers show respondents’ risk aversion, as many say they will hold off on investing until the outlook for the industry is clearer. One respondent, however, is sceptical as to whether certainty will come any time soon: “We do not think oil prices will really recover in the coming few years and we do not want to invest our capital for such a long time in an industry where we may face losses.”

Afren’s failed restructuring also appears to have affected respondents’ appetite for the sector. One Sweden-based hedge fund manager explains: “Our interest for investing in oil & gas deals has cooled down as a result of Afren and we will only invest in businesses that can provide us clear and transparent financial statements.”

What is the best way to invest in distressed oil & gas situations?

Buying into equity (26%) or into bonds (25%) are considered the best strategies for investing in distressed oil & gas situations. Buying into loans is considered the most effective approach by one-fifth of respondents, followed by buying assets out of insolvency (16%). The least effective strategies include refinancing RBL claims with second lien debt (10%) and buying up RBL claims (3%).

One respondent sheds light on the different factors that investors consider when planning their oil & gas investments: “Buying into the company by acquiring its stocks and equity would be the cheapest way of investing. The stock market prices are low, because these companies have been very badly affected by current economic conditions.”

“It is interesting that a lot of our distressed debt clients have been concerned that direct investments in oil companies are simply a bet on the oil price – which is not really their remit. Some have dealt with this by focusing on oil services companies, a step removed from the E&P sector.”

—Stephen Phillips, Orrick Partner, Restructuring, London

“We have spent a lot of time discussing the differences between US structures and structures in EMEA. The legal differences in how security is taken, and how this operates in practice are significant.”

Out of the following, please rank the three instruments that you think will offer the most attractive investment opportunities in 2016.

The results of this year’s survey show some major shifts in respondents’ instrument preferences. Close to one-third of respondents (31%) identify convertible bonds as the most attractive instrument for 2016, compared to just 10% last year. Meanwhile, the percentage of respondents selecting high yield bonds as the most attractive instrument has decreased from 31% last year to 21% this year. Other top picks for 2016 were more or less consistent with last year’s results. Senior debt (21%) and mezzanine debt (14%) are still among the four most popular, while equity, securitisations, and second lien debt remain lower in the list.

“Convertible bonds and senior debt could prove attractive in 2016 and although HY bond restructurings will be a rich source of opportunity, the absence of triggers and rise of coercive exchanges will pose a risk.”

—Alessio De Comite, Rothschild
Q. Which instrument is most likely to be attractive as a means to secure control of a credit in 2016?

Senior debt and convertible bonds were both chosen by 27% of respondents as the most attractive instrument for securing control of a credit in 2016, followed by mezzanine debt (19%). Comparing these results against the 2015 survey, the percentage of respondents identifying senior debt as the most attractive tool for credit control has decreased from 34% to 27%, while the percentage selecting convertible bonds has risen from 20% to 27%.

“I see this as a proxy for where the market thinks the value will break at the moment in a restructuring. During the credit crunch no one wanted to be in the mezzanine whereas, whilst the senior is still seen as more attractive, it’s reflective of an uptick in valuations in recent years that bonds and mezzanine debt rank highly.”

—Saam Golshani, Orrick Partner, Restructuring, Paris
The majority of respondents (78%) continue to anticipate a wave of high yield-related restructurings in the next 18 months. Across the board – regardless of industry or their role – respondents tend to believe that companies will eventually have to restructure their high yield bonds.

“In line with these market expectations we expect an uptick in liability management exercises. Deeper restructurings involving schemes or formal processes are on the cards too in the resource sector, but the first step is usually to consider consent solicitations and exchange offers before formal processes such as schemes.”

— Nell Scott, Orrick Partner, Corporate, London

There is some consensus on the impact that weak covenants will have on the restructuring landscape in 2016. Forty-three per cent of respondents believe covenants have become so weak that liquidity events will be needed to trigger a restructuring, while 45% take a neutral position. Only 12% disagree.

A UK-based respondent says the consequences of weak covenants have been noteworthy: “Covenants have become in recent years as loose as they were back in 2007, and we now have to invest more money to actually enable companies to restructure their debt.”

— Stephen Llewellyn, Rothschild
Rate the following bankruptcy jurisdictions on a scale from 1 to 5. (1=avoid at any cost, 2=avoid if possible, 3=average but not ideal, 4=acceptable, 5=1st rate)

As far as the most favourable European bankruptcy jurisdictions are concerned, responses to this year’s study reveal a shift in the opinions of those polled. Whereas last year the UK and Germany ranked first and second, respectively, this year Germany comes first followed by the Netherlands, with the UK only third. Spain and Italy have both moved up in terms of favourability, while France has been downgraded to the last position.

Looking more closely at the specific features of the various jurisdictions, there is a difference between the quality or sophistication of a bankruptcy legal framework and the results those jurisdictions yield for investors. Spain and Italy both rank noticeably lower in terms of outcome than for the range of available options they offer, suggesting that improvements to their insolvency laws have not necessarily translated into better results for distressed investors.

“The key question is whether the Netherlands will now become a target for forum shopping in the same way the UK has for the last 15+ years.”
—Henning Block, Rothschild

“This is a very interesting result; Germany ranking above the UK is unexpected. Will the market want to see COMI shifts of English companies to use German procedures?”
—Stephen Phillips, Orrick Partner, Restructuring, London
The majority (80%) of those polled expect primary market liquidity will increase in 2016, representing a significant surge from the 53% of respondents who expected the same in 2015.

Some respondents maintain that it is difficult to predict primary market conditions in the current circumstances, as so much depends on whether banks will be able to cope with new regulations and capital requirements. One hedge fund respondent based in Spain points out that primary market liquidity could be curtailed by “regulatory pressures”, making it hard for banks to lend money, while another respondent from the same country concurs that “new regulatory policies and market unpredictability” are the main external factors hampering primary market liquidity.

When asked to give more detailed predictions on primary market liquidity next year, most respondents (71%) say they are expecting liquidity to increase by 10-19%, while 28% have more bullish predictions for an increase in the 20-29% range.

It is worth noting that the percentage of respondents predicting an increase by the highest possible 20-29% range has risen from about one-tenth last year to more than one-quarter (28%) this year.
Q What will be the key driver behind primary market activity in 2016?

In line with the last edition’s findings, M&A remains the number one driver of primary market activity, but is down on last year. In the current survey, 44% of respondents identify M&A as the top driver, compared to 62% in 2015. Refinancings are identified as a major driver by more than a quarter of those polled (28%) while dividend payouts/recaps (15%) and LBOs (13%) are considerably less popular among respondents.

Nonetheless, comments from the 13% minority indicating LBOs as a driver for primary market activity in 2016 suggests that leveraged buyouts are indeed coming back into fashion. One UK-based hedge fund manager says: “The overall volume of LBOs is increasing, greatly boosting the level of activity within the investor market.” This trend suggests the stigma attached to LBOs since the financial crisis may be lifting as these deals are back in favour with distressed investors.
Who will be the players behind primary market liquidity in 2016?

This year’s results suggest a change in the hierarchy of primary market players. Mutual funds, insurance companies and pension funds (94%) are expected to be the biggest primary market players by far in 2016, followed by hedge funds (70%). Last year, the order was reversed: hedge funds ranked first with 83% of respondents, while mutual funds and the like followed second with 67% of respondents. CLOs have also seen a major uptick. Roughly half of respondents identify CLOs as a major player in the primary market for 2016, compared to just 15% in 2015.

One respondent says the rising profile of pension funds and mutual funds is already undeniable: “Active investments from pension funds and mutual funds are already increasing the level of liquidity available in the primary market. If we look at the allocation of funds by these institutions we can clearly see a high proportion of investments in the stock and bond market.”

In percentage terms, to what degree do you think banks’ ability to lend new money or extend existing debt facilities has diminished as a result of Basel III rules?

It is clear that Basel III rules have affected the European lending environment, but responses are not universal as to how much. According to 72% of those polled, banks’ ability to lend new money or to extend existing debt facilities has changed by about 0-25% as a result of Basel III, but the remaining respondents (28%) say the change has been more dramatic, in the 25-50% range. Last year, respondents were more likely to expect a significant 25-50% cut of banks’ lending abilities, reflecting early-stage uncertainty about the impact these regulatory changes would have.
Q. How long do you have capital locked up for?

Most respondents (70%) say that they have capital locked up for between one to three years, while remaining respondents cite time ranges of six months to one year (20%) or more than five years (10%).

“Lock-up periods are getting longer – flexible capital is proving key particularly in light of liquidity and the time it takes to execute a restructuring.”

—Vincent Danjoux, Rothschild

“We have seen a couple of funds close their doors this year, hit by short-term volatility in the fixed income distressed asset space. It’s vital that distressed debt funds can ride through these inevitable periods of volatility.”

—Ron D’Aversa, Orrick Partner, Restructuring, USA

Q. Do you think this level of liquidity will increase, decrease, or stay the same in 2016?

Respondents are noticeably more optimistic about liquidity this year than they were before: the majority (57%) expect liquidity to increase in 2016, compared to 29% predicting an increase in 2015. The percentage of those foreseeing a reduction has accordingly declined from 21% last year to 7% this year. Respondents who expect liquidity to increase tend to cite solid returns and profits in 2015 as evidence that more money will become available over the course of 2016.

“We continue to see new funds set up lending platforms and this is consistent with the predicted rise in liquidity.”

—Michael Crosby, Orrick Partner, Banking, London
Where did you deploy your capital in 2015? And where do you expect to allocate your capital in 2016? (Showing means)

As far as capital deployment is concerned, respondents are most likely to maintain their 2015 habits in 2016. The mean allocation to the primary high yield bond market remains consistent from 2015 to 2016 (35%), as does the allocation to listed corporate equity (30% in 2016 versus to 31% in 2015). Distressed debt seems slightly more popular, as this class has increased from 28% in 2015 to 31% in 2016.

“Increased asset allocation to the distressed debt market mirrors the recent increase in the number of global defaults.”
—Dacre Barrett-Lennard, Rothschild
Q: Do you invest in NPL portfolios?

76% No
24% Yes

Q: Are you actively raising long-term capital for direct lending?

53% Yes
47% No

As was the case last year, most of those polled for this survey (76%) do not invest in NPL portfolios. One respondent describes NPLs as “risky investments” that “will not get the returns we are looking for in the future”. Respondents are not dismissing NPLs as an option entirely, however. Firstly, the percentage of respondents who do invest in NPLs has increased from 17% last year to 24% this year, and many within this group say NPLs can offer excellent opportunities when handled carefully.

A UK-based hedge fund manager says: “When it comes to NPLs, we invest in those areas where we are sure we can make the investments work again. We make a short list of assets that have the potential to provide us good returns in the future, and we make decisions based on each asset’s potential.”

“We continue to expect a flow of NPL transactions across Europe with Italy being one of the most prominent markets this year.”
—Patrizio Messina, Orrick Partner, Structured Finance, Rome

More than half of respondents (53%) are actively raising capital for direct lending in 2016, marking a decline from the nearly three-quarters of respondents (73%) who were doing the same last year.

The CIO of a hedge fund based in the UK provides some insight into the due diligence and planning required for direct lending in the current market: “We are currently raising capital for direct lending because it will allow us to get higher margins, and it also gives us more control of the company we are lending to.”

“I am surprised that the direct lending strategy appears to have declined in comparison to last year’s survey. It still seems to be a growing area, and many of our clients are looking to add to their existing resources and have only just got going.”
—Michael Crosby, Orrick Partner, Banking, London
Q Have you increased your asset allocation to distressed investing in the last 12 months?

- 84% Yes
- 16% No

Eighty-four per cent of those polled say they have increased their asset allocation to distressed investing in the last year, up from 75% who did the same in 2015. While some sectors and countries are more primed for distressed opportunities than others, respondents overall believe distressed opportunities can be found across all European countries. A UK-based hedge fund manager points out: “We have increased our allocations to distressed, especially in Europe. We feel European markets will do well in the future and prices are quite low now. It is an investment that will get us the returns we want in the future.”

Q What do you expect to happen to your distressed allocation in 2016?

- 61% Increase
- 35% Stay the same
- 4% Decrease

Most respondents (61%) expect their distressed allocations in 2016 to represent an increase from 2015. It is worth noting that just 44% of respondents cited an increase in the 2015 edition of this study.

Plans for 2016 allocations will be largely determined by investors’ willingness to take on risk. Commenting on the current market, one respondent suggests that the best time to invest is when others are “panicking”: “We will increase our allocation to event driven and distressed debt opportunities in 2016. We see market volatility impacting businesses, and opportunities will arise in our domestic markets where we can acquire targets that are undervalued due to a panicking mode.”
Q  Are you actively raising funds to invest in distressed debt?

More than half of respondents (57%) are actively raising funds to invest in distressed debt while 43% are not. These results indicate a decline in distressed debt fundraising versus 2015, when a significantly larger 82% of respondents said they were actively raising distressed-focused funds.

Q  Do you anticipate tougher fundraising conditions in 2016?

Given the decrease in distressed debt fundraising from 2015 to 2016, it is somewhat surprising that respondents’ view of the lending environment has become more favourable. The percentage of respondents predicting tougher fundraising conditions has declined from 81% last year to 54% this year.

Many respondents say the difficult lending environment partly reflects lenders’ protracted prudence since the financial crisis. According to the managing partner of a UK-based hedge fund, companies are not able to secure loans easily, and they are subject to more scrutiny once those loans are provided: “The market is quite volatile, and investors are slightly sceptical, so it will be difficult for us to reassure them and offer desired returns.” Even respondents who believe fundraising has become easier acknowledge that satisfying lenders’ appetite for control and transparency takes extra work in the current market: “For us, the fundraising environment will not get tougher – but this is because we have ensured our investment goals and objectives through proven strategies and proactive risk management,” says one UK-based prop trader.
Q Which source do you expect to represent the largest investment in distressed funds in 2016?

The greatest contributors to investing in distressed funds in 2016 will be funds-of-funds (33%) and insurance companies (32%). The popularity of nearly all categories has remained consistent since last year’s study, except that insurance companies’ appeal is on the rise as the percentage of respondents citing insurance companies as the largest distressed investors has seen an increase from 27% last year to 32% this year.

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage of Respondents</th>
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</thead>
<tbody>
<tr>
<td>Funds-of-funds</td>
<td>33%</td>
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<tr>
<td>Insurance companies</td>
<td>32%</td>
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<tr>
<td>High-net-worth</td>
<td>17%</td>
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<tr>
<td>Pension funds</td>
<td>17%</td>
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<tr>
<td>Family offices</td>
<td>1%</td>
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Q Do you expect it to be more or less difficult to source distressed opportunities in Europe in 2016?

Respondents are completely divided on the difficulty of sourcing distressed opportunities in 2016. Half of respondents expect it to be more difficult to source distressed opportunities in Europe in 2016 while exactly half disagree.

One possible reason for this dichotomy is the increased competition. Distressed opportunities may abound, but stronger competition may make it difficult for investors to catch them. According to a Germany-based prop trader: “It will be more difficult to source distressed opportunities as global businesses and private equity players will compete for opportunities, and may capture deals before they are announced through strategic sourcing techniques.”

“China will likely export deflation to Europe which should create new distressed opportunities in metals and commodity-related industries and retail due to the already tight margins and intense competition.”

—Beltran Paredes, Rothschild
Do you expect to invest in out of the money swaps?

Just over a quarter of respondents (27%) will likely invest in out of the money swaps in 2016, marking a decline from the 34% who planned to do so last year. As was the case in the 2015 study, this year’s respondents say their resistance to out of the money swaps is consistent with continued risk-aversion among European firms.

If yes – what strategy are you pursuing?

Among the respondents who do plan to invest in out of the money swaps in 2016, most (74%) will pursue a loan-to-own/control strategy rather than par repayment (26%). Again, it seems that respondents’ strategies for distressed debt investing will be largely driven by their intention of having control over their investments.
What percentage return do you expect when investing in distressed debt in 2016?

About three-quarters of respondents to this year’s study expect returns in the 16-20% range when investing in distressed debt, while the remaining 27% of respondents are predicting more conservative returns of between 10% and 15%. A hedge fund respondent illustrates these figures by explaining that his firm is not anticipating blockbuster returns for some time: “We are not expecting very high returns from our investments in distressed debts in 2016. We have invested into markets that are not doing well at present but will improve and generate higher returns in the future.”

“2015 has been a challenging year for distressed returns; the general view is that 2016 will bring greater opportunity.”

—Glen Cronin, Rothschild

What percentage of return did you achieve in 2015?

To better understand how closely 2016 expectations match 2015 results, it is worth looking at exactly what percentage returns respondents achieved in 2015. The largest portion of those polled (39%) report returns of 15% while 23% report returns of 14%. Fifteen per cent of respondents apiece saw returns of either 16% or 17%. The outliers tend to fall on the lower end of the spectrum, with 7% reporting returns of 13% and only 1% reporting returns of 18%.

These results correlate with those of the 2015 report: the majority of respondents (60%) reported full-year returns in the 10-15% range for 2014 and the majority (60%) likewise predicted returns in the 10-15% range in 2015.
Do you seek equity control of companies via a 'loan-to-own' strategy?

Fifty-seven per cent of respondents say they seek equity control of companies through a loan-to-own strategy, down from the 70% majority of respondents who pursued a loan-to-own strategy according to the 2015 edition of this survey.

A common trend emerging from respondent commentary is that the loan-to-own approach will gain popularity again because it offers investors the security that they require at this point in time. Speaking for the majority, a UK-based proprietary trader highlights: “Investors may feel more confident and safe when they hold equity positions in the business, so their plans to acquire control through equitisation will increase in 2016.”

Do you think acquiring a blocking stake will be the key to loan-to-own strategies in 2016?

The majority of respondents (59%) say that acquiring a blocking stake will be the key to successful loan-to-own strategies in 2016, including one hedge fund manager who says the appeal of this approach lies in the transparency it offers to investors: “Building a blocking position in the loans means we can have a certain amount of control over them.”

“Blocking stakes give negative control rather than an ability to ensure the success of a loan-to-own strategy. Presumably the thinking is that by securing such a stake an investor can usually stop anyone else taking control.”

—Stephen Phillips, Orrick Partner, Restructuring, London
Do you expect an increase in the number of investors intent on acquiring control through equitisation in 2016?

The overwhelming majority (90%) expect an increase in the number of investors seeking control through equitisation in 2016. A hedge fund respondent based in France believes debt for equity swaps will surge as they grant investors more access to companies’ business strategies: “Investors will increasingly seek control through equity positions in 2016. Past failures and a lack of good returns have pushed investors to take an active role in companies’ management and keep a close eye on their operations and finances.”

“Longer fund lock-up periods, combined with the expected increase in default rates and more banks selling paper will likely bring more loan-to-owns in Europe.”

—Dacre Barrett-Lennard, Rothschild

What are your key sources of origination for distressed debt opportunities?

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Direct contacts with corporate</td>
<td>75%</td>
</tr>
<tr>
<td>Independent originators</td>
<td>66%</td>
</tr>
<tr>
<td>Broker/dealer</td>
<td>41%</td>
</tr>
<tr>
<td>Advisers</td>
<td>39%</td>
</tr>
<tr>
<td>Press/public sources</td>
<td>25%</td>
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</tbody>
</table>

Percentage of respondents

When asked about the most effective sources of origination for distressed debt opportunities, three-quarters of those polled say direct corporate contacts are the most important avenues, followed by 66% citing independent originators. Other sources – broker/dealers (41%), advisers (39%), and press/public sources (25%) – are considered less rewarding.

Several respondents commented on the importance of personal relationships, with many noting that their firms keep a running list of corporate contacts that is carefully maintained and regularly updated. Respondents also mention that it is important to keep tabs on international, industry-specific media outlets to ensure that all opportunities are being captured. Many of those polled note their firms have teams of analysts dedicated to doing exactly this.
Q. What are the key metrics you are tracking to determine potential investment opportunities? Please rank the top three, where 1=most important.

When asked to name the specific metrics they use to track potential opportunities, the largest proportion of respondents cite financial ratios (58%), followed by economic and industry trends (55%). Cash balances and available headroom on facilities was the third most popular choice, with 39% of respondents viewing it as one of the most important metrics.

One respondent says financial ratios and debt amortisation are his firm’s top two priorities when eyeing new opportunities: “We check the amortisation of the debt to see how much time we have to negotiate with the creditors and meet the debt obligations.”

Key:

Financial ratios
- 13% 20% 25%

Economic trends and performances by geography / industry (including competitors)
- 20% 22% 13%

Cash balances and available headroom on facilities
- 9% 16% 14%

Maturity of amortisation of debt
- 10% 10% 15%

Price movement in quoted instruments (i.e. debt, shares)
- 15% 11% 9%

Management change
- 12% 11% 9%

Profit warnings
- 12% 3% 4%

Acquisition history
- 3% 4% 8%

CDS prices
- 6% 3% 3%
What are the main issues preventing your investment in distressed businesses? Please rank the top three, where 1=the top main issue.

Market uncertainty, cited by 68% of respondents, was the issue most likely to impede respondents’ investments in distressed businesses. Following some way behind was the timeframe for exit and the cash need of the business (both on 43%). Other important factors were the legal jurisdiction (cited by 37%), regulatory risk (32%) and the leverage multiple (30%).

“Legal jurisdiction can often create the largest, binary uncertainty in the ultimate outcome of a restructuring situation.”
—Alessio De Comite, Rothschild
In January 2016 the BRD comes into effect, providing European regulators with a bank resolution tool. Do you expect to see a rise in bail-ins?

Respondents almost unanimously agree that the European Commission’s Bank Resolution Proposal (BRD) coming into effect in January 2016 will ignite a rise in bail-ins. Originally proposed in 2012, in response to a number of large international banks being bailed out by public funds, BRD aims to reduce the potential public cost of possible future financial crises. It remains to be seen how effective or common BRDs will be over the course of the next few years.

What level of yield do you consider “distress”?

Most respondents (63%) define “distress” as 15-20% yield while 31% consider “distressed” to be anything above 20% yield. Only a small 6% minority of respondents categorise “distress” as the lower 10-15% yield range.
Most respondents (86%) do not expect the UK to exit the European Union, and many voice their concerns about the consequences that such a move would entail. As the CEO of a Spanish prop desk points out: “The European Union is dependent on UK for growth, the UK holds trade relations and agreements with several other countries. The consequences of exiting could be disastrous, which is why I do not expect it to happen.”

Others within the 14% minority feel differently, however. A hedge fund manager based in the UK reckons that Britain can remain independently strong: “We feel Great Britain will ultimately leave the EU. They have nothing to lose by not being part of the EU. The UK by itself has a strong economy. Many industries of Britain have taken a beating in the past when they did become a part of the EU, and leaving it would be good for them.”

“It is a decision about hope over experience but ultimately the uncertainty will be the most damaging in the short term.”
—Christian Savvides, Rothschild

Sixty-three per cent of respondents say that current credit conditions mirror those of 2006. Remaining respondents are somewhat evenly divided: one-fifth say current conditions resemble 2005 while 17% say current conditions are similar to those of 2007.

Of course, it is important to bear in mind that respondents’ views of 2005, 2006 and 2007 vary and that differences in perception can skew these results. Two respondents from the UK illustrate this point. A hedge fund manager describes current conditions as positive and similar to 2006: “Market conditions are improving, there is a lot of capital available and plenty of investments offering strong returns as we had only seen before the financial crisis.” Another respondent, a UK-based prop trader, argues that there is actually “too much” capital in the market presently and this is distorting investors’ views: “Market conditions are similar to those of 2005 in that there is a lot of capital and many areas to invest into. But these factors are fuelling unrealistic expectations for returns.”
What will the Chinese economy grow by next year?

Private equity respondents are more bullish on economic growth in China than hedge fund and prop traders. Twenty-three per cent of private equity respondents expect the Chinese economy to grow by more than 7.5% next year, compared to just 11% of hedge fund and prop trader respondents. However, half still believe growth will be below 7.5%.

One respondent – a partner at a UK private equity group – thinks low economic growth in China will directly impact the European restructuring market: “The slowdown of activity in China will cause investors to migrate their investments to Europe with a focus on consolidation. This, in turn, will feed into the European restructuring wave.”

“Growth in China has tailed off in the past three years as the government seeks to change the economic model from an investment-driven one to an economy more reliant on consumer spending. So far a hard landing has been avoided, but the stock market is likely to be volatile as this transition occurs.”

—Edwin Luk, Orrick Partner, Capital Markets, Hong Kong
What percentage of your portfolio underwent a covenant reset, covenant amendment or maturity extension in 2015?

Forty-one per cent of respondents reported that fewer than 5% of their portfolio companies underwent a covenant reset, an amendment or maturity extension in 2015. Roughly one-third of those polled (34%) said between 5% and 20% of their portfolios underwent at least one of the three. One-quarter of respondents cited a higher range of between 21% and 40%.

What percentage of your portfolio underwent some form of financial restructuring in 2015?

When asked what percentage of their portfolio companies underwent some form of financial restructuring in 2015, 23% said 10-20% and another 24% said 21-30%. A further 33% cited the 21-30% range, while another 20% said 41-60%.

“2015 has seen a peak in the number of defaults since 2009. We expect this ratio and the number of restructurings to increase in 2016/17.”

—Andrew Merrett, Rothschild

“Given how high these percentages are, it seems a fair amount of restructuring activity is taking place below the radar screen with a number of non-public, discrete corporate actions which don’t hit the newswires.”

—Stephen Phillips, Orrick Partner, Restructuring, London
A large part of private equity respondents expect European restructurings to peak in either H2 2016 (44%) or H1 2017 (40%). These predictions nearly match those of hedge fund and proprietary trader respondents, with one noteworthy variation: 13% of private equity respondents foresee a very-near-term restructuring peak in H1 2016, compared to just 6% of prop traders and hedge funds.

One Ireland-based respondent sheds light on these findings by detailing the combination of factors triggering a sooner rather than later restructuring wave: “European restructurings will peak in H1 2016, as the overall economy has reached a standstill and the debt markets are more inflexible,” he says. “This will lead to a lack of capital for refinancing and less room for debt renegotiations. Companies will be forced to restructure.”

Forty-four per cent of respondents cited too high leverage as the single largest cause of restructurings among private equity portfolio companies in 2016. Other contributing factors – geopolitical/macroeconomic issues (17%), failure to refinance (13%) or amend covenants (13%) – trailed far behind.

Although failure to sell non-core assets ranks fairly low on the list, some respondents reckon that this will indeed be a major force behind restructurings next year. As one Finland-based respondent points out: “Failure to sell non-core assets will be the biggest trigger to restructurings in the private equity market in 2016. This will make the private equity management teams shift their focus towards debt restructuring through options like amend & extend or debt buybacks.”

“In most Debtwire surveys over the past five years, a significant uptick in restructurings have been incorrectly predicted in the short to medium term. The expansion cycle (even if it is seen as a little weak) has been lengthy by any historical standard and it is not surprising that the market is expecting increased activity.”

—Ron D’Aversa, Orrick Partner, Restructuring, New York

“Given the tension in the Middle East, a prickly relationship between Russia and the West, emerging terrorist threats – the stress placed on geopolitical threats seem surprisingly low. The potential for a ‘black swan’ is clearly there, but over the past few years the markets seem to have taken a lot of the negative political shocks surprisingly well.”

—Saam Golshani, Orrick Partner, Restructuring, Paris
What do you expect to be the single largest macroeconomic factor to trigger restructurings for private equity portfolio companies?

Among macroeconomic factors, rising interest rates and deflationary pressures are considered the two greatest triggers of restructurings for private equity portfolio businesses (80% of respondents each), while 60% cited sovereign bond defaults.

All these factors were considered the top triggers by prop trader and hedge fund respondents too, but with much smaller percentages. Only 35% of that pool cited rising interest rates as a top driver, and just 29% deflationary pressures in the Eurozone. Likewise, sovereign bond defaults were selected by only one-third, compared to 60% among private equity respondents.

“Anaemic trading will be the key – impacting leveraged loan and high yield structures alike.”

—Arnaud Joubert, Rothschild
What is the greatest challenge to completing financial restructurings?

Unworkable business models are considered the top challenge to financial restructurings by more than a third of those polled (34%), followed by lender perception of sponsors’ available funds/track record (23%) and divergent creditor attitudes (23%).

In their commentary, respondents consistently stress the difficulties caused by the lack of flexibility by creditors at the negotiating table.

The survey points to the need for a more liquid secondary market to emerge, particularly in non-core jurisdictions. Once lenders have sold their problem credits to the secondary market, whilst a risk emerges of an activist hold out preventing a restructuring, by and large, distressed funds are able to agree deals quicker, have less baggage and are generally better able to implement restructuring deals than par lenders."

—Stephen Phillips, Orrick Partner, Restructuring, London

“Southern European restructurings are often characterised by the diverging practices between domestic and international banks.”

—Beltran Paredes, Rothschild
Q. What lessons did the private equity industry learn from restructurings completed in 2015?

The main lesson learnt from 2015 restructurings is to avoid high leverage for a substantial 43% of the respondent pool, while 17% say the greatest takeaway is focusing on management and operational issues.

Elaborating on the risks deriving from high leverage, several respondents emphasise the importance of maintaining a low ratio especially in times of economic uncertainty. According to one respondent based in Austria, firms need to be able to act promptly in order to contain the effects of external challenges: “Private equity firms should avoid high leverage amidst the weak economic conditions while working concurrently on contingency plans to deal with uncertain events or market fluctuations.”

Q. Are you more or less likely to consider injecting additional equity in portfolio companies this year compared to last year?

The large majority of private equity respondents (83%) say they are more likely to inject additional equity into portfolio companies in 2016 than they were in 2015. This percentage represents a considerable increase from the 58% in last year’s survey.

Many respondents, however, caution that their willingness to inject additional equity will largely depend on the specific investment. For example, a respondent based in Spain says his firm will focus on “certain companies” for which equity injections will “preserve and enhance investment value” in the near term.

“In the right circumstances, additional money injected into a stressed portfolio company can be a great investment. Of course, when it goes wrong, LPs look at you and think why did you throw good money after bad?”

—Saam Golshani, Orrick Partner, Restructuring, Paris
What percentage of your portfolio companies will you have to consider injecting additional equity into in 2016?

- 26-50%: 60%
- 11-25%: 33%
- 1-10%: 7%
- None: 7%

What percentage of your portfolio companies did you inject additional equity into in 2015?

- 26-50%: 67%
- 11-25%: 13%
- 1-10%: 13%
- None: 29%

Most respondents (60%) say they will have to consider additional equity injections for between 26% and 50% of their portfolio businesses in order to strengthen the capital structure and help the companies turn around, while 33% predict a more conservative 11-25% of portfolio businesses. Less than one-tenth of those polled say they will not have to consider stumping up fresh funds at all.

One respondent based in Belgium says additional equity injections also reflect his firm’s optimism that the broader economic environment is improving: “We are more likely to inject additional equity in our portfolio companies as we see the economy and market gain pace.”

“Cov-lite financings mean that covenant breaches are becoming less relevant and sponsors can often rely on disposals to maintain liquidity.”

—Glen Cronin, Rothschild

That 60% of respondents are considering an equity injection is a strikingly high percentage; we suspect this is not driven by a concern that portfolio companies are running out of liquidity, but more that the return on an equity injection for a strategic investment such as a bolt on acquisition may be attractive.

—Peter O’Driscoll, Orrick Partner, Corporate, London

When asked what proportion of their portfolio companies received equity injections in 2015, 47% of the respondents cited the 11-25% range, while 27% selected the 26-50% range. These results suggest that a growing proportion of private equity portfolio businesses are receiving equity injections given that the same ranges were cited by only 13% and 23%, respectively, in last year’s survey.
In a restructuring scenario, what are the main considerations when you review new investment in portfolio companies? Please rank from 1 to 8, where 1 = the highest priority.

When reviewing new investments in portfolio companies undergoing a restructuring, respondents tend to prioritise three key areas: expected returns on new monies (selected as a top priority by 26%), the amount of equity invested to date (24%), and the amount of dry powder remaining in the fund (23%). The ability to obtain security and/or priority ranking on new monies – not listed as an option in last year’s study – is also considered a priority by 17% of respondents.

These results represent a shift from last year’s report. While the number of respondents prioritising the equity invested to date has remained relatively stable, the perception over other factors has changed dramatically. The percentage of respondents prioritising management has shrunk from 23% last year to a mere 3% this year, while the focus on expected returns has become key for 26% of respondents versus 16% last year. Likewise, the percentage of respondents prioritising dry powder has increased from 6% to 23%.

“Traditionally, PE clients are comfortable with equity-type instruments, but last year we saw a fair number of transactions where the ‘equity investors’ looked to use debt-like instruments for their investments.”

— Scott Morrison, Orrick Of Counsel, Restructuring, London
Q. What leniencies do you expect from lenders in return for new money injections? Please rank from 1 to 6, where 1=the highest priority

Looser covenants and changes to amortisation/maturity profiles are considered the main benefits that private equity respondents are expected to secure from negotiations with lenders – both are cited by more than a quarter of respondents.

Comparatively speaking, the percentage of respondents expecting to be granted priority return for new money has decreased from 32% last year to 17% this year, while the percentage of respondents seeking changes to the amortisation/maturity profile of existing debt has risen to 27% from 19%.
Q Do you expect lenders to be more open to write down/equitisation in 2016 vs. 2015?

The vast majority of respondents (87%) expect lenders to be more open to considering debt write downs/equitisations in 2016. Last year, only 39% of respondents anticipated more leniency from lenders, suggesting that there has been a sea change in lender attitudes (or perception of lender attitudes) over the course of the past 12 months.

Interestingly, the 13% minority fearing fewer leniencies from lenders were more vocal than the optimistic majority. According to a respondent based in the Netherlands, lenders’ continued risk aversion is leading to less flexibility in the terms and conditions of the financing: “Lenders are putting in more clauses as the economic conditions are very unfavourable, and the level of risk involved in lending is on the rise. They are not likely to be open to considering debt write downs and will strictly stick to their requirements when lending.”

Q When allocating new money in a restructuring scenario, what annual returns (%) do you expect from investment in the following instruments?

When allocating new money in a restructuring scenario, the expectations for returns vary considerably. The highest expected returns are associated with subordinated PIK loans at 14.60%, followed by super senior debt (12.97%) and preferred equity (12.63%). The expected return for common equity is at 8.57%.
Q: Has the return you require on new money injections increased, decreased or stayed the same from last year?

- 40% Increased
- 47% Stayed the same
- 13% Decreased

Close to half of respondents (47%) say they have not changed their requirements for returns on new money injections over the course of the past year. Out of the remaining respondents, 40% have increased their requirements, a percentage flat on last year’s 39%.

Many respondents say that they have kept their requirements the same to avoid putting additional pressure on portfolio companies that are already struggling to navigate through challenging market conditions. One respondent details the difficulties his firm’s portfolio companies have been facing, and the strategies they are pursuing: “Fluctuations in the market have contributed to a reduction in demand for our portfolio businesses. We have been working to improve their performance by merging them with other businesses in our network, and have managed to stabilise our returns as a result. But we are still unable to fuel further growth.”

Q: Do you think the amount of ‘Amend & Extends’ next year will...?

- 20% Decrease
- 73% Increase
- 7% Stay the same

Nearly three-quarters of those polled (73%) expect an increase in the number of amend & extends in 2016, which is roughly flat on the 78% of respondents who said the same last year. A fifth of respondents predict a decrease (up from just 6% last year).

One respondent based in Portugal says the increase in Amend & Extends will reflect companies’ continued efforts to safeguard themselves from the effects of economic uncertainty: “Businesses in the past year have not made significant progresses, mainly due to the fall in commodity prices and sluggish economic growth. Hence they are asking their investors to relax the terms and conditions on their loans, in order to buy themselves additional time to bring performance back on track.”

“With some of the 2014/15 heat expected to come out of capital markets in 2016, amend & extends will become an increasingly important part of investors’ capital structure toolkit.”

—Andrew Merrett, Rothschild
In 2015, respondents were almost equally likely to address portfolio companies’ debt maturities by refinancing (51%) or by turning to amend & extends (49%). These results represent a major change from last year’s survey, when amend & extends were noticeably more popular (61%) compared to refinancing (39%).

Respondents are fairly divided in their expectations for 2016 with a mean of 54% for refinancing and a mean of 46% for amend & extend. These results mirror almost exactly last year’s findings.

Several respondents note that their choice of refinancing versus amend & extend will vary depending on the specific situation. A respondent based in Germany explains: “We use the amend & extend route only in critical situations where we know that the ability to refinance the asset is very low.”

Another respondent based in Belgium goes into more detail on the factors that determine which avenue they will go down to address looming maturities: “In the previous year, market conditions did not support our return targets and therefore we had to amend & extend a major part of our portfolio. But now that the economy is improving and it is easier to get access to new financing we will focus more on refinancing and will seek to invest in areas with high growth potential.”

**Q.** Faced with maturities on your portfolio companies in 2015, what method did you use by percentage? (Showing mean)

49% Amend & Extend
51% Refinancing

**Q.** And what do you anticipate using in 2016 by percentage? (Showing mean)

44% Amend & Extend
50% Refinancing
Q When refinancing your portfolio companies in 2015 what percentage did you use of the following instruments? (Showing mean)

High yield (36%) and leveraged loans (30%) were by far the most widely used instruments in 2015 portfolio company refinancings. The use of high yield, mezzanine (15%) and PIK (12%) have all remained relatively stable since the publication of last year’s report, but there have been some noteworthy shifts. Leverage loans have made a strong comeback, up to a 30% share from 18% last year, while unitranche has decreased from 12% to 7% over the same period of time.

“It is interesting to note how low unitranche products rank here. That being said, we continue to expect to be working on these types of deals in 2016; the product has its strong adherents.”

—Michael Crosby, Orrick Partner, Banking, London
Q. And what do you anticipate using in 2016 by percentage? (Showing mean)

Looking ahead to 2016, respondents are most likely to use high yield (38%) or leveraged loans (26%) in portfolio company refinancings, followed by PIK (17%), mezzanine (12%) and unitranche (7%). These results more or less mirror 2015 choices, though leveraged loans may be slightly more popular in the year ahead.

<table>
<thead>
<tr>
<th>Method</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>High yield</td>
<td>38%</td>
</tr>
<tr>
<td>Leveraged loan</td>
<td>26%</td>
</tr>
<tr>
<td>PIK</td>
<td>17%</td>
</tr>
<tr>
<td>Mezzanine</td>
<td>12%</td>
</tr>
<tr>
<td>Unitranche</td>
<td>7%</td>
</tr>
</tbody>
</table>

Mean percentage

Q. Do you expect that you may need to restructure one or more of your own portfolio companies in the next 12 months?

An overwhelming majority of respondents (93%) expect that they will have to restructure at least one of their portfolio companies in 2016, and possibly more. This actually marks a decline from last year’s report, when respondents unanimously agreed that a restructuring was likely for one or more of their portfolio companies.

While respondents across the board seem to agree that challenging economic conditions will make 2016 a busy year for European restructurings, some highlight that 2016 may also be the ideal time for healthier, recently restructured companies to grow.

Out of the minority that does not anticipate any restructuring among its portfolio companies, one respondent based in the Czech Republic says: “We have already completed our restructuring phase and are now focusing on achieving greater efficiency by investing in new businesses to support our portfolio companies. Through this strategy, we will try to recover our losses by increasing the scope of our portfolio companies.”

“Potential interest rate rises, cooling off of capital markets and an increasingly unstable global macro and commodities environment will all lead to an increase in restructuring activity in the year to come.”

—Arnaud Joubert, Rothschild
Q. What percentage of your portfolio is performing below the level of the acquisition business plan?

When asked what percentage of their portfolio companies were performing below the targets outlined in the acquisition business plan, 36% of respondents cited the 11-20% range. A further 30% indicated that 21-30% of their portfolio was performing below expectations while 14% cited the 31-40% range.
How many of these represent potential stressed/debt restructuring candidates in the next 12 months?

Some 40% of respondents say that 41-70% of their underperforming businesses will be potential stressed/debt restructuring candidates in the coming 12 months. Meanwhile, just over half of respondents (52%) indicated a figure in the 21-40% range.

For those companies in your portfolio which may be restructured, please rank the following method of restructuring in order of likelihood (rank from 1 to 6, where 1=most likely)

When asked to rank the most common restructuring methods for 2016, operational changes emerged by far as the restructuring strategy most likely to be used in the year ahead. This confirms and reinforces last year’s findings, when 29% of respondents identified in operational changes their most likely restructuring method.

Asset disposals were selected by 14% as most likely for next year, followed by new equity injections at 11%, a sharp decrease on 29% last year. These same three methods were the top choices for second most likely methods as well, suggesting that other strategies – equitisation/deleveraging, new management, and covenant resets – will take a back seat in the coming year.
Did you actively look at a potential exchange offer for the bonds of a portfolio company in 2015?

- Yes: 53%
- No: 47%

Do you anticipate a tougher fundraising environment in 2016?

- Yes: 40%
- No: 60%

More than half of respondents (53%) actively looked at a potential exchange offer for the bonds backing their portfolio companies in 2015. But even respondents within this 53% say that their decision to launch exchange offers largely depends on the amount of effort and bureaucracy that the process entails.

Speaking about the cumbersome documentation involved, a respondent based in Belgium points out: “We did have the chance to opt for an exchange offer, but did not undertake it as it involved too much legislation and the process was very complex. We decided instead to dispose of the asset and allocate the capital we cashed in into the areas that needed further capital injection.”

“Exchange offers and consent solicitations are a well-trodden route to liability management. We are surprised that respondents have seen these measures as burdensome. Advisers have a sales job on their hands!”

—Nell Scott, Orrick Partner, Capital Markets, London

“Exchange offers are now making a return in Europe, and will be a key part of the next distress cycle.”

—Stephen Llewellyn, Rothschild

The majority of respondents (60%) do not anticipate a tougher fundraising environment in 2016 compared to 2015 – but this is a significantly smaller majority than last year’s 87%. Such change in perception can be part explained by investors’ time-tested faith in the private equity industry.

Indeed, respondents from a variety of regions believe investors are more confident in private equity than most other asset classes. According to a respondent based in the UK: “Investors find more reliability in private equity funds over corporate bonds, due to the excellent track record of some private equity firms. Because of this (and because the regulatory environment is more stable now) private equity investors will not face any major challenges in fundraising next year.”
Do you expect an increase in the number of private equity portfolio exits in 2016 ahead of new fundraising plans?

The majority of respondents (87%) expect an increase in the number of portfolio exits in 2016 ahead of new fundraising plans – which perfectly matches last year’s results. Many respondents think there is an appetite for private equity assets in the current market, and a respondent based in Italy notes: “Asset valuations have appreciated and there are great opportunities for private equity firms to exit their investments, with strategic players definitely keen to acquire those assets.”

“I agree with the Italian respondent that there are some interesting opportunities available in Italy in 2016 after a fairly quiet past few years. Valuations are ticking up. We have plenty of family-run companies in Italy where the founder is looking to exit after building the business.”

— Guido Testa, Orrick Partner, M&A/Private Equity, Milan

What type of exit do you think will be most prevalent in 2016?

Respondents’ expectations for the most prevalent exit types in 2016 reveal significant shifts since the 2015 edition of this report. Approximately three-quarters of respondents (73%) expect trade buyers to dominate the exit market in 2016, compared to 20% who predicted the same for 2015.

Refincings are expected to be the most popular exit type by 17% of respondents, down from 23% last year, while private equity buyers – identified by nearly half of respondents (47%) as the most likely exit route as 2015 – are considered the most popular by less than one-tenth (7%) of those polled. The percentage of respondents indicating IPOs as the most popular exit route has likewise reduced from 10% last year to a mere 3% this year.

“It is perhaps understandable why respondents are bearish on IPO exits. Last year saw a declining number of IPOs, particularly on AIM. We also saw a declining number of US IPOs, particularly in the tech sector, as many companies opted to stay private.”

— Hilary Winter, Orrick Partner, Capital Markets, London
Q. Do you expect the market will be more or less supportive of secondary and tertiary buyouts in 2016 relative to 2015?

The overwhelming majority of respondents (90%) expect the market to be more supportive of secondary and tertiary buyouts in 2016 compared to 2015, up from just 19% in last year’s survey.

Echoing comments made earlier about the trustworthy reputation of private equity as an asset class, a respondent based in Germany says: “Private equity deals will be more supported by the market in 2015. Over the years, the entire private equity industry has earned goodwill through continuous returns and portfolio success, so the debt market and the investors will actively invest in this segment.”

Q. Do you expect to play an active role in the restructuring of non-portfolio companies in 2016?

The majority of those polled (63%) do not expect to play an active role in the restructuring of non-portfolio companies in 2016. This is due mainly to the fact that respondents are more focused on maximising the value of their own portfolio companies.

The general sentiment is that private equity players have too much to worry about within their portfolio to get involved in other troubled assets.

A respondent based in Germany says: “We will not play an active role in restructuring non-portfolio companies in 2016, as we already have our strategies lined up for our portfolio companies and we need to focus our attention there. We cannot neglect any opportunities to boost our portfolio value.”
In the wider European market, please rank these financial restructuring outcomes as most (6) and least common (1) in 2016.

There is no clear consensus as to the most common outcomes for European restructurings. Respondents are most likely to expect equity dilution (20%), amend & extends (20%), and new money/refinancings (20%).

Covenant resets were also a top choice, selected by 17% of respondents. It is worth noting that incremental investments (new money) and amend & extends were selected by a much larger percentage (48%) in the 2015 edition of this report, while equity dilution has risen in popularity from last year’s 13% to this year’s one-fifth.
Do you anticipate LBO deal volume to increase or decrease in 2016?

Q

Regardless of whether respondents are expecting an increase or a decrease, the general sentiment is that LBO volume will experience a 10-30% change in 2016. One-tenth of respondents expect a more dramatic change of 30-50% while only 3% of respondents expect a limited change of 0-10%.

Comparing these results against last year’s study shows that the percentage of respondents predicting a 0-10% change in deal volume has shrunk from 23% to just 3%, while the percentage of respondents expecting a 10-30% change has remained stable at 10%.

On what scale (in percentage terms) do you anticipate LBO deal volume to increase (or decrease) in 2016?

Q

Respondents are quite divided as to the direction the LBO market will take in 2016. Slightly more than half (53%) expect LBO deal volume to increase in 2016 while a comparable 47% predict a decrease. Last year, a much smaller percentage (33%) of respondents anticipated a rise in the number of LBOs.

The lack of consensus is reflected in respondents’ mixed comments. A partner at a private equity firm in France believes current market conditions do not favour LBOs: “I think the market has not performed up to expectations in the recent past. There have been a number of covenant defaults resulting from the sluggish growth environment, and the availability of new debt is low. This is causing a decline in the use of leverage to back private equity transactions.”

However, a respondent based in Norway takes a different view: “LBO deal volume will increase in 2016, as there are better opportunities to use financial leverage as a strategy to acquire quality businesses and debt providers are more supportive.”
Q. What are your key operational priorities in managing your current portfolio? Please rank from 1 to 6, where 1=most important

Respondents’ top priorities when managing existing portfolios include improving internal systems/financial reporting (33%) and reducing costs (23%).

Taking cost out of the business is also considered the second biggest priority by 43% of the respondent pool, making it the highest or second-highest priority for 66% of respondents in total. This represents an increase from the 49% of respondents who considered this the highest or second-highest priority in 2015.

Other priorities include managing cash flows, liquidity, and/or working capital (selected as a first or second priority by a combined 28%) and improving the top line (selected as a first or second priority by 34% in total) – but both rank slightly lower on respondents’ list of priorities than last year.

Key:

1 2 3 4 5 6
Q What percentage of activity will be devoted to developing the existing portfolio through bolt-on acquisitions rather than new investments in 2016?

When asked what percentage of activity would be devoted to growth via bolt-on acquisitions (rather than new investments) in 2016, 40% of respondents cite a figure in the 20-25% range. Meanwhile, half of respondents pointed to a figure in the 26-40% range, while one-tenth of respondents predict that more than 41% of activity will be devoted to this end.

Q Do you expect dividend recaps to increase in the coming months?

More than three-quarters of respondents (77%) expect the volume of dividend recaps to increase in the months ahead, down from 84% of respondents who expected the same in the 2015 edition of this survey.

Many respondents in the majority cite pressure from shareholders as the primary cause for the increase in dividend recaps over the next 12 months. As a respondent based in Norway points out: “Shareholders are quite demanding and the dividend payments that are pending need to be paid off to stay away from conflicts. Companies will approach the debt market for recapitalising, to avoid tensions with shareholders.” Other respondents mention deflationary pressures and low interest rates as major reasons behind firms’ decisions to incur additional debt for the purpose of paying dividends.
In percentage terms, to what degree do you think banks’ ability to lend new money or extending existing debt facilities has diminished as a result of Basel III rules?

<table>
<thead>
<tr>
<th>Percentage of respondents</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>0-25%</td>
<td>63%</td>
</tr>
<tr>
<td>25-50%</td>
<td>33%</td>
</tr>
<tr>
<td>Unchanged</td>
<td>4%</td>
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</tbody>
</table>

Do you expect hedge funds to fill the lending gap?

- Yes: 83%
- No: 17%

Sixty-three per cent of respondents believe that banks’ lending abilities have diminished by up to 25% as a result of Basel III. About one-third of respondents say lending abilities have been cut by a more drastic 25-50%, and only 4% of respondents believe lending abilities have not changed at all.

These results suggest that private equity respondents view the effects of Basel III differently than hedge fund and prop trader respondents. Only 28% of the latter group said banks’ lending abilities had been cut by 25-50%, suggesting that the private equity community is feeling the effects of constrained lending more acutely than other financial services or investment firms.

The majority of private equity respondents (83%) expect hedge funds to fill the lending gap left behind by constrained bank lending. This represents an increase from the 73% of private equity respondents who expected the same last year. These results coincide with comments made by respondents throughout the first half of this survey, in which hedge funds were identified as major players in the current restructuring market.

“The bid-ask between borrowers and alternative capital providers has narrowed in many European jurisdictions. Spain, Italy and Germany now provide a much broader opportunity set for direct lenders.”

—Glen Cronin, Rothschild

“This is consistent with our experience; there are a plethora of options for borrowers. Lending by banks has revived since the credit crunch but the liquidity being offered by alternative credit providers is significant (and growing).”

—Michael Crosby, Orrick Partner, Banking, London
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