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Political instability in the Middle East, Russia’s involvement in Ukraine and the subsequent sanctions, and the threat of a global pandemic all contributed to general macroeconomic uncertainty in 2014. By year end, oil prices falling by 50% and a new Greek political tragedy added fuel to the fire. Primary markets were very strong in the first half of 2014, especially on the bond side. But increasing pessimism contributed to a partially shut bond market and fuelled a re-allocation of risk among large fund managers, which caused a massive sell off. The demise of UK retailer Phones 4u reminded many funds that high yield is a risky asset class.

This year will likely be one of slow growth and stagnation in the eurozone, with deflationary pressures providing new challenges to central banks. Economic forecasts are now suggesting even the strong growth in the UK is set to peter out.

But the music will not stop.

According to investors polled by Debtwire, a new string of high yield restructurings will increasingly dominate the workout arena, with liquidity becoming a more common trigger. In-court processes will become more common with the UK and Germany remaining the preferred bankruptcy destinations, maintaining a trend witnessed over the last couple of years.

Allocations to distressed investments are set to increase this year compared to 2014 with more and more funds pouring money into Europe. Direct lending will continue to grow as hedge funds eager to put money to work will fill the gap left by banks’ withdrawal from certain areas of lending.

Mario Oliviero
Deputy Editor, Debtwire Europe
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Europe in 2014 was characterised by a new wave of volatility. Capital markets remained strong over the first nine months of the year despite the Crimean war, the Scottish referendum, the AQR and falling commodity prices. However, jitters started to emerge in Q4 and a subdued capital market is expected in the first part of 2015.

Central bank policies have remained accommodating, with abundant liquidity that has sustained refinancings and amend & extends. Despite this, Europe continued to deliver opportunities to distressed investors thanks to more sophisticated capital structures and banks deleveraging ahead of the AQR.

While new large-scale restructuring volumes have remained subdued, the attention has focused on the high yield bond market. The collapse of Phones 4u has shown how quickly high yield deals can unravel. This is in line with investors’ view that high yield bonds will be the main driver of the next wave of restructuring.

Market conditions in Europe’s larger economies have seen a resurgence of M&A activity, which has seen a record year since the crisis. As a result, many troubled situations were solved through asset disposals/break-ups, avoiding a fulsome restructuring.

Looking forward, expectations around the timing of interest rates rising, the falling oil price, the future of Greece within Europe and the UK general election will all be key determinants of the restructuring pipeline over the medium term.

Andrew Merrett
European Head of Restructuring
Co-Head Financing Advisory – UK
Rothschild
The world leader in financing advisory

Towergate (Current)
- Advising on strategic options

Sorgenia (2014)
- Adviser to creditors on €2.7bn restructuring

Punch Taverns (2014)
- Adviser to ABI Committee on £2.6bn debt restructuring

Budapest Airport (2014)
- Adviser on €1.4bn refinancing and its €1.1bn swap notional restructuring

Vivarte (2014)
- Adviser on its €2.8bn debt restructuring and €500m new money issuance

PHS (2014)
- Adviser on the restructuring of £945m debt facilities

Hellenic Republic (2014)
- Adviser on the €8bn restructuring of four Greek motorway concession projects

Al Jaber (2014)
- Adviser on the restructuring of its US$4.5bn financial indebtedness

Frans Bonhomme (2014)
- Adviser to senior lenders on €570m debt restructuring

Solocal (2014)
- Adviser on €1.3bn restructuring

Tele Columbus (2014)
- Adviser on €600m amendment and extension of its indebtedness

Endemol (2014)
- Adviser to a group of senior lenders on the €2.1bn restructuring

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Image: detail from a bond issued by Rothschild for the 1900 4.5% Coquimbo railway loan, Chile (The Rothschild Archive)
We open the year with the spectre of significant oil price falls, prominent geopolitical risks, a ‘new normal’ in China implying a lower level of trend growth, a deflationary environment in much of Europe, a possible inflection in US rates, and an upcoming election in the UK which is expected to be closely fought. Given this backdrop, we cannot imagine that 2015 will be anything other than interesting.

Looking back at 2014, the availability of a ‘wall of capital’ was the consistent theme. Banks are continuing to be burdened with regulatory demands which will depress lending, but, by contrast, the shadow banking system is providing increasing liquidity in some of the market sectors previously dominated almost exclusively by banks. October’s market adjustment saw investors become reacquainted with risk, and the market volatility has continued into the New Year.

Another theme in the credit markets has been the ongoing rise and rise of high yield bonds and the demand, mainly from US-based investors, to invest in the high yield product across a wide range of geographies and industries. For many of us looking at the market with a long-term perspective, the debt market is beginning to look a lot like it did in 2007. Concepts such as ‘cov-lite’ loans and other top-of-the-market features have returned in recent years. Debt in a near-zero interest rate environment remains largely sustainable, however, and whilst restructuring activity has been strong in certain sectors and geographies, overall activity levels in Europe were concentrated in Southern Europe and Ireland in 2014.

Restructuring activity was prominent in France last year. There has been welcome ongoing success in the sale of European non-performing loans to international fund investors, particularly in Ireland and Spain. Many market participants will be hoping for an acceleration of the sales of NPLs by Italian banks in 2015, given the reported €250bn-worth of NPLs thought to be in existence. The market is also looking to see if geopolitical tensions are going to result in a spike in the default rate in Ukraine and Russia. Governments in austerity mode have been taking certain decisions, such as the recent retroactive tariff changes in the renewables sector in Spain and Italy, which are likely to lead to a need for a restructuring of the sector in 2015. Expect more investor pain driven by these types of political decisions in the coming years.

Finally, insolvency systems remain in flux in Europe. We have seen revolutionary changes to the insolvency systems of all the major eurozone economies in recent years, with significant adjustments to the Spanish and French regimes in March and July of last year, respectively. The UK has seen no such major change, although there has been a number of case law developments which have shown that the UK High Court will adopt a liberal approach to taking jurisdiction in respect of UK schemes of arrangement for foreign companies. The failure of a number of European banks, with Banco Espirito being the most prominent, shows why insolvency reform for banks remains high on the European Union’s agenda. Europe now has a comprehensive set of tools which enable relevant authorities to take early and decisive action in relation to failing financial institutions. This common framework, the European Bank Recovery and Resolution Directive (“EBRRD”), was adopted by the European Parliament on 15 April 2014. The provisions relating to the ‘bail in’ of subordinated creditors by conversion of debt to equity and write-down do not become mandatory until 1 January 2016. Accordingly, the ‘too big to fail’ problem is being addressed. It remains to be seen whether the EBRRD will be tested in 2015.

Saam Golshani
European Co-Head of the Restructuring Practice

Stephen Phillips
European Co-Head of the Restructuring Practice
FOR A BUSINESS THAT COULD BE IN A BETTER SHAPE

RESTUCTURING MAY BE THE ANSWER

For major financial, commercial and industrial institutions debt restructuring is about adapting to thrive and not just survive. With experienced practices in the UK, France, Germany, Italy and Russia, and a strong track record of crafting solutions across the full range of restructuring related legal services, Orrick assists lenders, creditor committees and debtors with the right advice to achieve successful restructuring outcomes.

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In the final quarter of 2014, 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 2015 and beyond. The interviews were conducted over the phone and the respondents were guaranteed anonymity. The results are presented in aggregate.

High growth levels are not expected to reach European Union (EU) shores anytime soon. In the next two years, the majority of respondents (64%) expect the EU economy to experience low growth, while 23% expect it to be stagnant during this time.

Only one in ten forecast a gradual decline (10%), which does not compare favourably with the 2014 survey results, where just 5% of respondents predicted a gradual decline. Only 3% felt there would be high growth.

One of the reasons the EU could enter a phase of gradual economic decline is its inability to welcome investments, according to a hedge fund manager based in France: “In the last two years, investors have shown a certain amount of interest in the European economy but businesses failed to meet their expectations. The resulting loss of investor appetite will be reflected in economic decline in the coming years.”
When asked which debt renegotiation instruments would be most widely used in the upcoming year, the majority of respondents cite amend & extend (48%) and debt buy-backs (24%). Forward start facilities (28%), whole or partial debt equitisations/exchanges (23%) and new money injections (18%) will be least popular during this period.

A London-based proprietary trader feels that the challenges in accessing new capital will result in asset disposals (highlighted by 18% when asked about debt renegotiation instruments): “New money injections are really difficult, as businesses have no source of capital either through investors or existing cash reserves. Non-core asset disposals will be prevalent in debt renegotiations, as certain business units will be shelled off to lower the debts associated with them.”

“Amend & extend will continue to be a key feature of deals in Europe – but fixed income deals are going to lead to more debt buy-backs, exchange offers and more scope for ‘right-sizing’ equitisations.”

Glen Cronin, Rothschild

Overall, respondents feel there will be an increase in European restructuring activity. When asked to estimate the peak of this activity, most respondents point to the second half of 2015 (42%) or the first half of 2016 (33%). Remaining respondents tend to expect restructurings to peak sooner rather than later: 15% say activity will peak in the first half of 2015.

“Respondents are expecting an increase in the restructuring activity in the 12-month period starting in June 2015 when the effects of sluggish economic growth, geopolitical worries, weaker high yields, and the current oil and gas situation create a perfect storm.”

Andrew Merrett, Rothschild

“Whether 2015 becomes a banner year for European restructuring activity is dependent on how the big macro factors play out, such as low oil prices, slowdown of Chinese growth, fallout from recent events in Ukraine and the possibility of Euro-related turbulence. If all these risks play out adversely, we could see a serious spike in activity, albeit starting from a low base.”

Stephen Phillips, Partner, Orrick
What proportion of sub-investment grade companies do you believe are likely to face debt restructurings in 2015?

<table>
<thead>
<tr>
<th>Percentage of respondents</th>
<th>0-5%</th>
<th>5-10%</th>
<th>10-15%</th>
<th>15-20%</th>
<th>20-25%</th>
<th>Over 25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of respondents</td>
<td>4%</td>
<td>2%</td>
<td>2%</td>
<td>21%</td>
<td>31%</td>
<td>41%</td>
</tr>
</tbody>
</table>

Does this represent an increase or a decrease over 2014?

- Increase: 60%
- No Change: 35%
- Decrease: 3%

On the whole, nearly three quarters of respondents believe that 10% to 20% of sub-investment grade companies will face debt restructurings in 2015.

"High yield restructurings will very likely be the upcoming trend within the distressed debt space, as we have started to notice in 2014. High confidence and liquidity in the capital market enabled many corporates to refinance highly leveraged capital structures in 2014 but these may not be sustainable in the medium term, especially in some more difficult sectors such as retail."

Arnaud Joubert, Rothschild

"The findings are consistent with the market’s view that there will be an increase in restructuring activity – if this happens, then it is to be expected that much of the activity levels will be in sub-investment grade credits."

Saam Golshani, Partner, Orrick
Most respondents (52%) expect the majority of debt restructurings to originate from Southern Europe. About one fifth expect the same of Eastern Europe and Western Europe. Only 7% expect restructurings to originate mostly in the Nordics.

“Whilst the findings show an expectation of current trends, namely that many restructurings have a Southern European or Eastern European focus, we would not be surprised to see an increase in Nordic restructurings given oil price and commodity price falls in recent times.”
Scott Morrison, Counsel, Orrick

“Recent improvements in legislation and banks deleveraging make Italy and Spain attractive markets for investors, as other European economies are recovering faster. However, if the downward pressure on oil prices continues, the Nordics may offer many distressed opportunities in the oil and gas sector.”
Alessio De Comite, Rothschild

When we break it down to a country level, Italy (39%) and Spain (29%) rank highest on respondents’ list of the countries most likely to witness heavy volumes of debt restructurings in the year ahead. This matches responses to the previous question, which identified Southern Europe as the most active in terms of restructurings. Remaining respondents were most likely to cite Ireland as a hub for upcoming debt restructurings in the coming year.

Two of the largest economies in Europe, the UK and Germany, gained only 3% and 2% of responses. The head of a Norwegian proprietary trading desk focuses specifically on the strength of the UK in stating: “The UK, in particular, has shown high economic growth and business development, so investments made in this market are robust and are sure to deliver high value to investors, unlike other distressed regions.”

“It is interesting to note how much restructuring activity is expected in Ireland and Spain. We think that the focus could well move to Italy in 2015.”
Daniela Andreatta, Special Counsel, Orrick
With most of its economies still struggling, Western Europe remains the area of the world where investors expect to find the best distressed opportunities in 2015. This is the case for 51% of respondents, while others expect Eastern Europe (23%) and Asia (18%) to be more attractive. North America and the Middle East and Africa rank lower on the list.

“The best distressed opportunities will be found in Western European countries, which show more certainty of an improvement in the longer term. This will attract more investors, as will employee skills and the technological know-how of Western European businesses,” the managing director of a German proprietary trading desk notes.

Other respondents disagree, however, as they see the focus shifting toward emerging markets. A UK-based prop trader explains: “Opportunities in Europe aren’t strong enough to attract investors who are already investing in growth markets like Asia-Pacific, Africa or Latin America. European opportunities will only catch up with these markets if European businesses show resilience.”

Respondents are split as to whether the European Central Bank’s AQR, which involved the stress-testing of 130 European banks, will create distressed opportunities in the near term: 43% of respondents say it will, but 57% disagree.

“Initial reactions to the AQR were muted – as it was well trailed – but it has nonetheless helped influence the deleveraging of banks, particularly in respect of NPLs.”

Glen Cronin, Rothschild

“There were expectations last year that the AQR process would cause the banks to take more proactive steps to sell loans. We think this is happening albeit at a rather measured pace.”

Saam Golshani, Partner, Orrick
If yes to the previous question, where do you think the opportunities would be generated?

Most of the distressed opportunities triggered by the AQR are expected to be corporate opportunities (60%) or direct lending opportunities (33%). Remaining respondents expect opportunities to take the form of financial institutions’ Tier 1 or Tier 2 debt (5%) or non-profit loan (NPL) portfolios (2%).

“We see an ongoing continuation of the trends which were evident in 2014 and before: direct sales of non-core and distressed loans by banks alongside the shifting of lending activity from banks to the alternative credit providers.”

Michael Crosby, Partner, Orrick

How likely do you see the following macroeconomic factors which may drive a European restructuring wave next year?

The macroeconomic factors most likely to drive European restructuring in the coming year include the credit constraints driven by bank stress (55%) and possible sovereign bond defaults (46%).

Lower down the list but still significant are the credit crunch in China – more than half of respondents overall see this as a highly likely or moderately likely driver of restructurings next year – and deflationary pressures in eurozone economies.

“The top ranking given to the risk of a further credit crunch is notable. Does this suggest that the market is sceptical of the efficacy of recent bank stress tests and the asset quality review?”

Stephen Phillips, Partner, Orrick
DISTRESSED INVESTORS SURVEY

The consumer (65%), transportation (52%) and financial services (48%) sectors are expected to produce the most significant opportunities for distressed investors in 2014, followed by energy, technology, and oil and gas. The appeal of the consumer sector can be attributed mainly to declining sales and related distress. As one Austria-based hedge fund manager says: “Department stores and retail chains are experiencing negative sales and low net sales revenue due to the rise in online shopping and lack of marketing strategies to retain customers. Investors can take advantage of this by improving their efficiencies and marketing strengths to bring back profit levels.”

Another sector that garnered a significant amount of commentary is the financial services sector. Many respondents believe that distressed investors will continue to flock to this space as it struggles to navigate new regulatory challenges. As one EU-based proprietary trader explains: “Banks offer some of the best opportunities in the entire EU. New requirements and guidelines have hampered the credit lending facilities of the financial institutions and this, in turn, has reduced their overall profitability.”

After 2014, when investors poured cash into an expanding European high yield bond market, it seems 2015 will not be different. High yield bonds (34%) are identified as the most attractive investment opportunity for 2015, followed by senior debt (18%), convertible bonds and mezzanine debt. Less appealing instruments include private placements, second lien debt, CDS and PIK notes. These results show a change in respondents’ tastes from last year. Since the 2014 edition of this survey, high yield bonds, mezzanine debt and senior debt have all markedly increased by up to 13 percentage points.

Respondents who selected equity stakes and convertible bonds were surprisingly vocal about the benefits of these instruments. A hedge fund manager based in Italy states: “Equity investments are going to be most attractive in 2015, as more investors are seeking decision-making powers in their portfolio companies and are stressing improvements in productivity that will increase net earnings.”

Others comment on the appeal of low-risk convertible bonds. “In the current economic climate, companies are offering their convertible debts at lower or near-normal costs. These securities are attractive and promise high growth in the future,” says a Netherlands-based hedge fund respondent.
Which instrument is most likely to be attractive as a means to secure control of a credit in 2015?

High yield bonds are considered the top instrument for securing control of a credit by 34% of respondents, followed by mezzanine debt (21%) and convertible bonds (20%). Remaining respondents are split between senior debt and private placements.

A proprietary trader based in Italy says senior debt will be most attractive because it leaves “no doubt that creditors are secured, and the credit agreements between company and lenders ensure adequate control and security.”

Other respondents commented on the attractiveness of mezzanine debt and convertible bonds, both of which allow a degree of flexibility for investors. One Italy-based hedge fund manager is a big proponent of mezzanine debt: “It is the most attractive means to secure control of a credit because, being a hybrid model, it ensures balanced risks and rewards and also strengthens investor morale by providing high control over the credit provided.”

Another respondent praises convertible bonds for similar reasons: “Convertible bonds are the most attractive means to secure control of a credit, as these bonds are more flexible. Bond-holders can trade shares or bonds as per the fluctuating prices in the market, and this gives the investors higher chances of securing investments through low-risks portfolios.”

Which instrument will most likely need to go through restructurings in 2015?

Restructurings in 2015 will most likely centre on high yield bonds, according to 39% of respondents. This is followed by senior debt (24%) and convertible bonds (23%). Mezzanine debt was chosen by just 12% of the respondent pool.

“High yield bonds are attracting a lot of attention currently in restructuring, following the record levels of issuance over the last few years. However, the covenant-lite nature of the instruments means that full restructurings are triggered by liquidity issues.”

Stephen Llewelyn, Rothschild

“It’s undoubtedly the case that a number of high yield bonds issued in a benign environment will become restructuring cases in the fullness of time. Many distressed debt specialists include a significant number of high yield bonds on their watch lists.”

Stephen Phillips, Partner, Orrick
The large majority of respondents (85%) predict an increase in high yield restructurings over the course of the next year – a noteworthy jump from the 73% of respondents who predicted the same in last year’s survey.

As one respondent explains: “High yield restructurings in the next 18 months will present good opportunities to investors who are focusing on refinancing, resolving liquidity challenges and maintaining heavy cash-flows. These opportunities will increase the volume of issuance over the years.”

The majority of respondents (81%) expect to see more in-court workouts in 2015 than they did in 2014. In-court restructurings, according to several respondents, will be appealing to companies that are eager to resume their normal operations. As a trader at a London-based prop desk explains: “Crashing businesses will rely on in-court settlements and negotiations. They will want organised processes and valuations.”

Those respondents who disagree, however, are quick to point out that the rigidity of in-court proceedings could deter some business owners. One respondent – a managing director at a Switzerland-based hedge fund – says: “Out-of-court restructurings will be more common in 2015, as distressed European businesses are looking for more flexibility and more momentum than rigid in-court frameworks can offer.”

“The desire not to be left behind and to be seen as a good jurisdiction for restructurings was evident in a number of European insolvency reforms last year, particularly in France, Italy and Spain. In France, we expect to see an increased use of sauvegarde in the coming years, particularly following the improvements to the French insolvency regime of July 2014.”

Saam Golshani, Partner, Orrick
Quality of jurisdiction aside, the overwhelming majority of respondents (91%) expect to see increased interest in Southern European debt and assets over the next year.

This finding aligns with last year’s survey, in which 73% of respondents said they expected Southern European countries to account for the most substantial portion of debt restructurings in Europe in the year ahead.

A hedge fund respondent based in the UK says investors will be drawn to the Southern European region because “the assets will be valued low and gaining entry will be swifter.”

The bankruptcy jurisdictions of the UK and Germany rank highest for quality across the board. Both countries are thought to have the widest range of options, the best outcomes, and the greatest efficacy. The Netherlands is also thought to have a favourable bankruptcy jurisdiction, especially when it comes to speed and available options.

Italy and Spain are considered significantly less favourable. Outcomes in Spain and Italy are among the issues cited by respondents, followed by speed.

It is also worth noting that respondents consider Spanish bankruptcy proceedings to be slightly less effective than Italian proceedings, albeit by a small margin. A German respondent with experience of the Italian system expands on these findings by stating: “Italian bankruptcy jurisdictions are insufficient to address the critical issues pertaining to insolvency cases. Most of the parties there try to make out-of-court settlements and debt restructurings to avoid lengthy proceedings and unviable judgements.”

“We note how well regarded the German system comes out – it seems the market has responded positively to the 2012 reforms of the German Bankruptcy code.”

Benedikt Burger, Partner, Orrick
There is pretty much an even split when respondents were asked what investors would be mostly looking at in Southern Europe. They believe that investor appetites will be directed at the financial sector (29%), asset sales or privatisations (27%), and direct lending (26%). Sovereign debt-related opportunities came in fourth but still garnered 18% of responses.

This even spread marks a shift from last year’s survey, in which more than half of those polled (51%) expected most investors to target sovereign debt opportunities. The percentage of respondents selecting the financial sector has remained relatively steady from last year’s survey to this year’s, but the percentage of respondents predicting increased interest in direct lending has increased from just 5% last year to 26% over the same period. The percentage of respondents expecting increased interest in asset sales also increased to 27% from 18% last year.

Looking more specifically at Southern European countries, respondents expect Spain to be the most interesting investment destination for those targeting debt and assets, followed by Portugal (29%), Italy (22%) and Greece (10%).

Even though respondents do not rate the Spanish bankruptcy system highly in terms of ease and sophistication, these results suggest that the opportunities for distressed investors are significant enough to make the legal and bureaucratic stresses worthwhile. Several respondents point to low valuations and a slightly greater degree of stability this year compared with last year as factors drawing distressed investors to the country.
When asked to give more detailed predictions on primary market liquidity, respondents were most likely to predict an increase in the 10% to 19% range (47%) or in the 0% to 9% range (40%). Remaining respondents are more optimistic, predicting an increase of 20% or greater over the course of 2015.

A UK-based hedge fund respondent says: "Liquidity will be balanced in the primary market. The stability and performance of the stock exchange has accrued a high volume of investments from private and institutional investors. Funds will be very liquid, and we will witness heavy trading of shares and equities."
What will be the key driver behind primary market activity in 2015?

M&A will be the main driver of primary market activity in 2015, according to 62% of respondents, followed by refinancings (22%) and dividend payouts (16%). The importance of M&A can be explained by an overall desire on the part of European businesses to rebuild themselves from the inside out with the help of strategic investors.

“Strategic buyers will be the source of liquidity for European distressed debt. Businesses have an immense need for capital, but they also demand external expertise and efficiencies to rebuild or return to operational excellence,” says a hedge fund manager based in Germany.

Who will be the players behind primary market liquidity in 2015?

The majority of respondents (83%) say hedge funds will be the main players driving liquidity in the primary markets this year, followed by mutual funds, insurance companies and pension funds (67%). This marks an interesting reversal from last year’s findings, in which 92% of respondents expected the latter group of investors to be the most significant drivers of liquidity, while just 63% expected hedge funds to be most significant.

As in other parts of this year’s survey, respondents consistently link hedge funds’ predominance to regulatory constraints on banks. A proprietary trader based in Sweden describes hedge funds as opportunistic players in today’s market: “Financial institutions are tied up with stringent regulations that have restricted their lending abilities and discretionary powers, but the hedge funds have outsmarted these institutions and have become the most active investors in the European 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?

![Chart showing percentage of respondents' views on the impact of Basel III on bank lending activity.]

- Between 0-25%: 27%
- Between 25-50%: 31%
- More than 50%: 2%
- Between 0-25%: 67%
- Between 25-50%: 31%
- More than 50%: 2%

When asked about the impact of Basel III on bank lending activity, most respondents (67%) say banks’ ability to lend new money or to extend existing facilities has diminished by between 25% to 50%. About one third of respondents are more optimistic, citing the 0% to 25% range, while a very slim majority believe bank lending has been cut in half or more, as a direct result of Basel III.

“Whatever the exact percentage, lending by alternative credit providers continues to be on the increase and is here to stay.”

Michael Crosby, Partner, Orrick

Do you expect hedge funds to fill the lending gap?

![Chart showing percentage of respondents' views on hedge funds filling the lending gap.]

- Yes: 73%
- No: 27%

The lending gap created by Basel III regulations is expected to open the door for hedge funds next year. A substantial 73% of respondents expect hedge funds to fill the lending gap in 2015, and many explicitly link this trend to new regulations.

One London-based hedge fund respondent says that: “Large investments are coming in from hedge funds because banks have limited their investments.” Another explains: “Hedge funds are enthusiastically investing in underperforming businesses right now. Basel III regulations have laid down critical guidelines for lending for banks and financial institutions, so credit powers are more with the hedge funds.”

“Funds have been filling the lending gap this year and, if anything, the competition for deals has been tough, and returns have been driven down too much.”

Saam Golshani, Partner, Orrick
Three quarters of respondents believe there is a reasonable amount of liquidity in European secondary debt markets right now, while 21% say there is not much liquidity at all. Only a slim portion (4%) of overall respondents believe there is a lot of liquidity in the market right now.

These conservative predictions can be explained in part by conditions in the secondary market, and by an underlying resistance on the part of major investor groups. A hedge fund respondent says of these twin factors: “The secondary debt market in Europe will struggle due to liquidity issues. Private equity firms and corporate investors are holding back their investments and so there will be a lower volume of activity in the coming year.”

When asked for a higher level view of secondary market liquidity, half of respondents say liquidity is likely to remain at its current levels while remaining respondents are fairly evenly divided between a decrease (21%) or an increase (29%).

“In recent times in the US and Europe, any negative credit event seems to have led to a greater price fall compared to a similar event in the past. The broker dealers seem to hold less inventory these days and their 'shock absorber function' has been significantly reduced as a result.”

Raniero D’Aversa, Partner, Orrick

“In 2015, problems in the eurozone are likely to again be the key driver of liquidity. The ECB’s quantitative easing programme could have a positive effect, but deep-rooted structural problems in much of Europe are likely to mean we will see little improvement in liquidity.”

Dacre Barrett-Lennard, Rothschild
Distressed Investors Survey

Respondents do not expect any major changes to their capital allocation in 2015. In 2014, about one third of respondents deployed most of their capital to distressed debt investments and about one third expect to allocate to distressed debt in the coming year. Respondents investing in listed corporate equity, direct lending and secondary bond/loan markets will remain consistent too.

However, there is a slight change in the high yield bond market. More than one fifth of respondents (22.6%) will deploy capital to the high yield bond markets this year, compared to just over 20.7% last year.

“Given the high levels of NPLs, particularly in Italy, we expect that the portion allocated to NPL portfolio purchases will inevitably increase considerably in the next few years.”
Patrizio Messina, Partner, Orrick

“Focus on liquid names can be damaging to the market – everyone seems to be looking to invest in the same liquid trade which inevitably means many credits are overpriced. Those funds which are less vulnerable to possible broker margin calls and short-term investor outflows are in a far better position to look at less liquid situations which will be more competitively priced than the liquid names.”
Raniero D’Aversa, Partner, Orrick

The majority of respondents (61%) lock up their capital for one to three years, while the remaining respondents hold it for six months to one year. Respondents in both camps are careful to stress the importance of flexibility.

One respondent explains that his firm – a Switzerland-based hedge fund – locks up capital for six months to one year in order to remain flexible: “For all of our portfolios within the European Union, we intend to keep our investments mobile so that we can divert it as we get different options.”

“Lock-up periods have increased. This is partly the result of distressed situations taking time to play out, as well as being driven by the need for longer investment periods resulting from an increasing number of competitors investing across a diminishing universe of opportunities.”
Hamish Mackenzie, Rothschild

Where have you deployed your capital in 2014? Where do you expect to allocate your capital in 2015?

How long do you have capital locked up for?

- 6 months–1 year: 39%
- 1–3 years: 61%

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“Focus on liquid names can be damaging to the market – everyone seems to be looking to invest in the same liquid trade which inevitably means many credits are overpriced. Those funds which are less vulnerable to possible broker margin calls and short-term investor outflows are in a far better position to look at less liquid situations which will be more competitively priced than the liquid names.”
Raniero D’Aversa, Partner, Orrick

Respondents do not expect any major changes to their capital allocation in 2015. In 2014, about one third of respondents deployed most of their capital to distressed debt investments and about one third expect to allocate to distressed debt in the coming year. Respondents investing in listed corporate equity, direct lending and secondary bond/loan markets will remain consistent too.

However, there is a slight change in the high yield bond market. More than one fifth of respondents (22.6%) will deploy capital to the high yield bond markets this year, compared to just over 20.7% last year.

“Given the high levels of NPLs, particularly in Italy, we expect that the portion allocated to NPL portfolio purchases will inevitably increase considerably in the next few years.”
Patrizio Messina, Partner, Orrick

“Focus on liquid names can be damaging to the market – everyone seems to be looking to invest in the same liquid trade which inevitably means many credits are overpriced. Those funds which are less vulnerable to possible broker margin calls and short-term investor outflows are in a far better position to look at less liquid situations which will be more competitively priced than the liquid names.”
Raniero D’Aversa, Partner, Orrick

“The major change in the expectation of asset allocation is in the HY bond space. This is due to an increase in HY bond supply and, in part, a lack of growth prospects in global equity markets.”
Arnaud Joubert, Rothschild
DISTRESSED INVESTORS SURVEY

Do you invest in NPL portfolios?

- Yes: 17%
- No: 83%

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

- Yes: 27%
- No: 73%

NPL portfolios are out of favour with the majority of respondents. The survey shows that 83% of respondents do not invest in them.

One respondent expands on this relatively low percentage by stating: “It is very complicated to manage the NPL portfolios. Complex regulatory and tax structures are reducing the demand for NPL portfolios. Buyer/seller disagreements are most common in these portfolios and so it is riskier.”

“NPLs are not for everyone, the barriers to entry are high and to date many banks have had unrealistic pricing expectations. For a select number of institutions, however, we expect this asset class to be a key strategy, particularly in Italy, and it is certainly less crowded than the well known distressed debt credits.”

Patrizio Messina, Partner, Orrick

Close to three quarters of respondents (73%) are actively raising long-term capital for direct lending in 2015, which is roughly in line with the 68% of respondents who reported the same last year.

However, in our survey, the respondents in the minority are the most outspoken, with many stating that uncertainty about European businesses’ long-term stability has dissuaded them from lending.

A Germany-based hedge fund respondent says: “Our allocations are more towards distressed debt than direct lending, as the economic conditions are not favourable for European businesses and the risks are high. We are not confident in the businesses’ performance so we are focusing mostly on investing in distressed debt.”

“It will be interesting to see if there are enough opportunities to go around; not only are existing funds raising additional funds but we are seeing participants join the market almost on a regular basis.”

Michael Crosby, Partner, Orrick
As was the case last year, 42% of respondents expect distressed allocations to stay the same in 2015 when compared with 2014. Remaining respondents are more likely to foresee an increase (44%) in their distressed allocations than a decrease (14%), marking a switch against last year’s results, which showed 35% expecting a decrease and 23% expecting an increase.

Respondents’ continuous focus on distressed investing reflects the ongoing opportunities coming out of the European market. One partner at a UK-based hedge fund says that European businesses were under “high pressure due to a low availability of finances and increased cost pressures in 2014, so in 2015 more distressed opportunities will be sourced from the European market.”

Another respondent from a Sweden-based hedge fund says: “Negotiations have become less difficult since the companies are ready to quickly dispose of assets to generate working capital reserves.”
Eighty-two percent of respondents to this survey are actively raising funds to invest in distressed debt – almost double the 42% who were actively fundraising this time last year.

Some respondents elaborated on their answers by explaining that market conditions are allowing them to fundraise more confidently. As one hedge fund respondent explains: “Western Europe is being recognised by its investors as businesses there are improving performance. They have the talent to construct appropriate strategies to facilitate growth and so countries like France and Germany will start to witness new ventures.”

Eighty-one percent of respondents expect the financing environment to become more difficult in 2015 than it was last year, representing a significant increase over the 52% of respondents who expected the same for 2014.

Of course, fundraising difficulties are nothing new. The effects of the financial crisis have been unfolding for nearly seven years. But several respondents believe this year will be uniquely difficult thanks to Basel III policies and a shift toward other markets.

As one respondent – a proprietary trader based in the UK – explains: “Investors have been focusing on other markets like Asia and Africa to capture distressed businesses, and the fundraising environment within the European economy is getting tougher as banks and other financial institutions have tightened their lending policies to adhere to new regulations.”
Respondents are largely optimistic about sourcing distressed opportunities in Europe in 2015. The overwhelming majority of respondents expect the process to be easier than it was last year.

Many respondents believe low valuations will be a key driver of distressed opportunities in the near term, including one who states: “Businesses are looking for alternative steps to development, so they are selling at low valuations and looking at the long-term benefits. European firms will look to restructuring to protect their business goals and reputation in the market.”
When it comes time to exit long-term distressed debt investments in Europe, respondents expect most of the liquidity to come primarily from private equity (PE) and strategic buyers. PE ranks highest, with 42% of respondents expecting these firms to be the primary source of liquidity and 24% expecting them to be the secondary source. Strategic buyers are more likely to be the secondary source (35%) than the primary source (15%).

Interestingly, respondents are not likely to cite the public markets, refinancings or existing shareholders as major sources of liquidity for long-term exits, though 29% of respondents do say that the public markets can be a third resource if necessary.

“A growing economy and stronger M&A volumes mean sponsors expect their distressed investments to recover to a healthier situation to attract financial and strategic buyers.”

Helier Pavely-Drage, Rothschild
The majority of respondents (71%) are actively seeking direct new money investments in stressed scenarios. Many of those respondents believe 2015 will present plenty of opportunities for investors to acquire and improve stressed companies.

According to one UK-based respondent: “Distressed scenarios are rising in Europe. Businesses are lacking the necessary capital and resources to bear the heavy burden of debts, so we are seeking direct money investment opportunities in the form of equity. We plan to make management changes and necessary restructurings to develop these businesses.”

Of the respondents who are actively looking to make investments in stressed scenarios, an even split will look at equity opportunities (41%) or senior debt opportunities (41%). Remaining respondents are more likely to consider super senior debt than subordinated debt.

Regardless of which instrument they picked, respondents consistently referred to control as a primary reason for their choice. A respondent from Germany says that 2015 will be an ideal time to “seek direct investments in distressed scenarios through super senior debts, in order to achieve maximum ownership and control.”

Meanwhile, another German respondent says of equity investments: “We are actively seeking direct investments in stressed scenarios through equity investments, in order to achieve more control over management and to streamline processes. These investments will allow us to gain maximum value from the capital invested.”
Only about one-third of respondents will make investments in out of the money swaps in the coming 12 months – while a majority 66% will not.

Respondents’ risk-aversion may help to explain their resistance to money swaps in 2015, with one London-based trader stating: “Investments in out of the money swaps are associated with high amounts of risk that are difficult to manage due to liquidity issues that are prevalent in the European market at this time. The possibility of default is higher, so we choose to pursue alternative investment strategies.”

Francois Jarrosson, Rothschild

“Investing in out of the money swaps has gained in popularity as persistently low interest rates made swaps become a debt-like item. This will remain an important topic for both distressed situations and also where bank counterparties seek to reduce costs associated with those swaps in an evermore tightly regulated environment.”

Francois Jarrosson, Rothschild

Of the respondents who expect to invest in out of the money swaps in 2015, the majority (85%) will do so via a loan-to-own/control strategy. The remaining 15% will focus on par repayment.

Again, control over companies’ internal workings is a common theme in respondents’ feedback. As the managing director of a German hedge fund explains: “Loan-to-own/control is our main strategy for investing in money swaps, as we are seeking control over the management of these distressed businesses. We believe improving the management and executive boards of these companies will be key to improving their performance.”

Stephen Phillips, Partner, Orrick

“Interest rate swap claims are often shackled by intercreditor agreements which often leave the swap providers with senior claims but few control rights; this often makes them less than ideal investments for funds which have more of a control angle.”

Stephen Phillips, Partner, Orrick
In 2014, the majority of respondents (62%) achieved returns of 10% to 15%. An additional 26% gained lower returns in the 5% to 10% range. Remaining respondents garnered returns of 16% to 20% while only a slim minority targeted returns in the highest available range of 21% to 30%.

These findings reveal a growing optimism on the part of respondents. In 2014, only 10% achieved returns of 16% to 20%; however, when asked in the previous questions about expectations for 2015, 23% expect returns in this percentage bracket.

In addition, the percentage of respondents in the lowest range of 5% to 9% has shrunk from 26% in 2014 to 13% in 2015.

“We are seeing a growing optimism in returns expectations compared to 2014. Although the majority of investments will remain in the 10-15% bracket, the bearish financial indicators (e.g. the current oil and gas situation, low expected growth in Europe, the large number of highly-leveraged refinancing undertaken in 2013/2014) are suggesting an increased number of event-driven opportunities and contributing to the increased optimism.”

Dacre Barrett-Lennard, Rothschild
Seventy percent of respondents say they actively seek equity control of companies via a loan-to-own strategy.

One of the respondents in the majority explains that loan-to-own investments are one of his firm’s primary activities, and affirms once again the importance of hands-on control in today’s market.

“Our focus is to earn greater control over companies – this is part of our strategic vision and loan-to-own fits into that vision,” he says. “Companies are failing to deal with debt pressures, and by pursuing loan-to-own strategies we can directly work on the companies’ performance and productivity. I think most investors are seeking this level of control right now, so equity control will increase in 2015.”

When asked whether it would be helpful to acquire blocking stakes in conjunction with loan-to-own strategies, 60% said this would be key and the remaining 40% disagreed.

“The need for blocking stakes is intrinsic to distressed investing. Actually there are two strategies – the blocking stake as a ‘greenmailing’ opportunity (i.e. simply forcing other syndicate members to pay you off) or defensive stakes, i.e. it is acquired to ensure no deal can happen without consent. The second is a more accepted and sustainable strategy.”

Stephen Phillips, Partner, Orrick

“Not in isolation, but blocking stakes may become more relevant in high yield bond restructurings – triggers for high yield restructurings will often comprise a payment default, giving individual lenders the right to claim their due debts. The combination of a blocking stake and a pending liquidity shortfall builds more influence.”

Hamish Mackenzie, Rothschild
When asked to identify the specific metrics used when tracking potential investment opportunities, respondents were most likely to cite price movements related to specific instruments (i.e. debt, shares) and broader economic trends and performances in the given geography or sector. Both of these factors were cited by about one fifth of respondents as most important.

The second most important factors to consider when analysing new opportunities are management changes and cash balances/available headroom on facilities. These factors were labelled second most important by 23% and 22% of respondents, respectively.

“Price movement in quoted instruments is worth tracking on a daily basis in order to identify opportunities. Movements in listed credit instruments can be quick and significant, particularly in the HY market, so funds need to be responsive. We saw some HY bonds lose 50% of their value in a few days in some of the trickier situations last year.”

Paul Richards, Rothschild
DISTRESSED INVESTORS SURVEY

When asked to specify the origin of most distressed debt opportunities, a majority of respondents cited direct corporate contacts (84%), advisors (71%) and broker/dealers (59%). All three of these sources rank higher than independent originators (21%) and press sources or public sources (7%).

Respondents offered little commentary on their firms' origination strategies, however, one respondent – a UK-based proprietary trader – comments specifically on advisors’ ability to scout cross-border opportunities: “Advisors can help firms to choose the right targets in emerging markets, where high leverage multiples are increasingly attracting foreign investors. Advisors can do the research and formulate solutions to help investors succeed.”

“Attractive distressed opportunities have been surprisingly thin on the ground in recent years and sourcing has become absolutely critical. As an advisor, we are increasingly recognising that our clients and potential clients appreciate sourcing ideas and introductions.”

Stephen Phillips, Partner, Orrick

Given respondents’ emphasis on broader economic uncertainty throughout this survey, it comes as little surprise that market uncertainty ranks highest on the list of issues preventing new investments in distressed businesses. This factor was selected by the largest group of respondents as being the most important (19%) or second most important (17%) issue impacting investments in 2015.

Two other factors likely to inhibit distressed investments include leverage multiples and exit timeframes for required rates of return. These issues are considered most important or second most important for 35% and 23% of total respondents, respectively.

Respondents’ feedback on this issue echoes feedback to earlier questions, with uncertainty being the recurring theme. A German hedge fund respondent explains his concerns about continually struggling businesses: “Even through continuous restructurings and capital investments, distressed businesses are dissolving in more debts and are losing their market share in the process. The distressed market is too uncertain right now.”
What level of yield do you consider ‘distress’?

When asked to determine what level of yield qualifies as ‘distress’, respondents were most likely to cite the 10% to 15% range (55%) or the 5% to 10% range. Only 3% of respondents cite the highest available range of 15% to 20%.

“Quantitative easing, which has led to high asset prices, has distorted pricing. The market has not reflected the underlying levels of risk for some years; this is changing, which can only be a positive for the distressed debt market.”

Raniero D’Aversa, Partner, Orrick

“As yields on all asset classes have fallen throughout 2013-14, due in part to an ultra-loose monetary policy from the Fed, ECB and BoE, the yield required for credits to be considered distressed has subsequently dropped.”

Alessio De Comite, Rothschild
In the fourth quarter of 2014, Debtwire canvassed the opinions of 30 private equity investors to gauge their views on restructuring and the state of the market. The interviews were conducted by telephone and the respondents were guaranteed anonymity. The results are presented in aggregate.

The majority of private equity (PE) respondents (58%) predict low growth in the European Union (EU) economy over the next several years, while 39% expect stagnation. This is roughly in line with the 64% of hedge fund and proprietary trader respondents who expect low growth in 2015. Respondents who foresee low growth tend to mention the same set of reasons for their conservatism, including constrained bank lending and the trend of investors moving toward higher growth markets. As one respondent says: “The diminishing value of European firms and the huge regulatory barriers within the region are causing investors to move out and target better performing regions for better returns.”
Respondents’ experiences with covenant resets, amendments and maturity extensions are mixed. The majority of those polled (35%) experienced adjustments in between 6% and 10% of the credits in the portfolio in 2014 and an additional 29% in between 11% and 15%.

A respondent based in Spain explains the factors that led his firm to seek maturity extensions in the first instance: “We had expected and forecasted high returns from our portfolios but the sinking conditions impacted their performance, and so our best option was to extend the maturity.”

Sixty-five percent of respondents say they restructured between 6% and 10% of their portfolios last year. Of the remaining respondents, 23% restructured more than that amount – 11% to 20% – rather than less.

Some respondents shared more detail on their firms’ restructuring activities. An Italian respondent who sought maturity extensions for 6% of his portfolio says: “We had planned a structure to follow for our investments, but the businesses could not achieve the set targets and valuations were too low for us to reap benefits from selling. Thus, we planned to hold the investments for longer and focus on restructuring.”

A respondent from the UK describes an equally difficult situation: “Eight percent of our portfolios underwent financial restructuring last year. Their performance was deteriorating, and so to avoid any future possibilities of bankruptcy or liquidation, we thoroughly identified the weak areas and reorganised assets and liabilities.”
Almost half of all private equity respondents (48%) expect European restructurings to peak in the second half of 2015. In addition, around a third expect restructurings to peak in the first half of 2016 (32%). These expectations align almost perfectly with the expectations of hedge fund and proprietary trader respondents.

The drivers of restructurings in the private equity community are mixed. However, the largest proportion (36%) feels that liquidity shortfall will be the largest single contributing factor in 2015. More than a quarter (26%) say the same of over-leveraged businesses. Remaining respondents are divided between failed refinancings (19%) and overly aggressive base cases (10%).

“As a result of the aggressive debt market and the high proportion of cov-lite refinancings occurring in recent years, it is not surprising that the two most important triggers for upcoming restructurings are liquidity shortfalls and over-leverage.”
Andrew Merrett, Rothschild

“Cov-lite structures have proliferated in recent years giving PE houses a longer option period before needing to take active restructuring steps. Notwithstanding such flexible covenant parameters most PE houses don’t wait for the deals to fall down before they take positive action.”
Shawn Atkinson, Partner, Orrick
Funds' availability is expected to be the greatest challenge to completing financial restructurings, according to 36% of respondents, followed closely by unworkable business models in the current environment (32%). Lenders’ perception of the funding or track record of private equity sponsors will be a significant challenge too, according to 16% of those polled.

“We don’t think there is a lack of new funds for distressed opportunities where debts are being ‘right-sized’ but often documentation requires 100% consent for debt reductions and European insolvency laws don’t always operate sufficiently well to eliminate out of the money claims on a timely basis.”

Michael Crosby, Partner, Orrick

How likely do you see the following macroeconomic factors which may drive a European restructuring wave next year?

When it comes to the macroeconomic factors behind European restructurings, respondents believe the credit crunch arising from bank stress will be the most significant force (61%). This is followed by the possibility of sovereign defaults in Ukraine or elsewhere. Other factors, including the credit crunch in China and the onset of deflationary pressures in the eurozone, are not expected to be as impactful.

Private equity respondents’ expectations are, for the most part, in line with those from hedge funds and prop traders, however, the private equity community does not see deflationary pressures as a major driver (13% compared to 24% of overall respondents).
PRIVATE EQUITY SURVEY

Which two main lessons has the private equity industry learned from restructurings completed in 2014?

- Focus on management operational issues: 32%
- Be flexible: 23%
- Approach lending syndicates early in the event of stress: 19%
- Work on contingency plans: 12%
- Build a relationship with your syndicate: 23%
- Avoid over-aggressive valuations in a competitive bid process: 10%
- Avoid maintaining high leverage: 6%

Looking back on 2014 restructurings, respondents say the most important lessons learned were to focus on management and operational issues (51%) and to remain flexible (42%). An additional 29% of respondents said approaching syndicates early in the event of stress was one of the most important lessons learnt.

One respondent comments specifically on the importance of flexibility, linking private equity’s reputation for inflexibility as a reason for some of their current troubles: “Companies are losing their trust in private equity groups as firms have not been very flexible when it comes to exit strategies. To increase their involvement in the market and to enhance their profile, PE houses need to display more flexibility and transparency.”

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

- Less likely to inject additional equity: 42%
- More likely to inject additional equity: 58%

The majority of respondents (58%) say they are less likely to inject additional equity into portfolio businesses this year than they were last year. However, a sizable minority (42%) are prepared to add equity if necessary. These results align with the first part of this survey, in which new money injections were identified as the least prevalent form of debt renegotiation for 2015.

Many respondents say they will resist new equity injections because they are losing confidence in portfolio businesses, including a Spanish investor who says: “We are less likely to inject additional equity this year, as we are unhappy with the actual returns and our forecasts have been high. I think the opportunities will be significant if we can locate new portfolios, so we will not take a chance with the existing portfolios.”

Another respondent describes a similarly risk-averse atmosphere at his firm: "Additional equity injections are unlikely. As an investment firm, we have strategised to remain calm for the next two years as the situations have worsened and chances of success are quite low."
Looking back at the last year, the majority of respondents (51%) have injected additional equity in up to 10% of their existing portfolio companies. Remaining respondents’ injections ranged from 11% to 25% (23%) or from 26% to 50% (13%), and an additional 13% of those polled have not made any additional equity injections at all.

“A PE house almost always needs to show its investors that new injections aren’t a matter of sending ‘good money after bad’.”

Shawn Atkinson, Partner, Orrick
PRIVATE EQUITY SURVEY

In a restructuring scenario, what are the main considerations when you review new investment in portfolio companies?

- The two most important considerations when reviewing new investments in portfolio companies under restructuring are the amount of equity invested to date (26%) and the quality of the company’s management (23%). The second most important considerations include the ability to obtain or prioritise ranking on new monies (23%) and the expected return on new monies (19%).

“It depends. Considerations range from external fundraising pressures at one end, to bottom-up detailed evaluation of the business’s prospects and the new money investment thesis at the other. Sponsors will usually explore their options well in advance of their creditors.”

Hamish Mackenzie, Rothschild

“What leniencies do you expect from lenders in return for new money injections?”

- When asked what leniencies they would expect from lenders in return for new money injections, respondents were most likely to cite priority return for new money (32%) and renegotiation of better covenants (26%) as the two most important. The second most important leniencies included write-downs of existing debt (26%) and changes to amortisations or maturity profiles on existing debt (19%).

One respondent based in the UK points to the economic benefits of offering firms more leniencies, stating: “We would expect European lenders to be more supportive of European businesses and renegotiate better covenants, so that the firms can avail convenient and flexible terms of debt. Repayment should not become a burden.”

Stephen Phillips, Partner, Orrick

“It can often be difficult for sponsors to get new money in on a super senior basis. Generally speaking, new money from sponsors tends to be part of a consensual contractual process rather than attempting to rely on ‘debtor in possession’ statutory provisions which are not always provided for in applicable European insolvency laws.”

Stephen Phillips, Partner, Orrick
Do you expect lenders to be more open to write-down/equitisation in 2015 vs. 2014?

Only 39% of respondents expect lenders to be more open to write-downs and equitisations in 2015 than they were in 2014. The majority (61%) expects lenders to be less amenable. These findings mirror those in the first section of this report, in which only 6% of respondents thought it likely that whole or partial debt equitisations or exchanges would be a common negotiation form in 2015.

However, there are a number of respondents who believe lenders’ desire for control will actually make them more amenable in the months ahead. “Lenders will be more open to equitisation in 2015,” says one respondent. “They are concerned with companies’ performance and equities will allow them to actively get involved in the management and operations of struggling firms.”

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

When allocating new money to a restructuring scenario, respondents’ expectations for returns vary according to the debt instrument used. The highest expected returns are associated with preferred equity – for this instrument half of respondents expect over 15% annual returns. Common equity is expected to garner over 15% returns by 26% of respondents, while super senior debt and subordinated PIK loans are expected to generate returns of 12% and below by 90% and 80% of respondents, respectively.
The overwhelming majority of those polled (78%) expect the volume of amend & extends (A&E) to increase in 2015 from 2014. Most remaining respondents expect volumes to remain stable (16%) while only 6% expect a decline.

Commenting on the expected increase, many respondents explain that firms will see amend & extends as their only viable option. According to one UK-based PE partner: “Companies do not have many choices when it comes to negotiating, and lenders are not showing leniency in their terms, so A&E will most likely stay high.”

Other respondents second this view in stating that companies will use A&E to “relieve the burden of their existing debts”. However, a few respondents warn that firms who “approach lenders for renegotiations, expecting more leniencies” are likely to be disappointed.

Thirty-nine percent of respondents say they will require the same returns on new money injections as they did last year, and an additional 39% say they will aim higher. Slightly less than a quarter of respondents say they have lowered their expectations since last year.

Not surprisingly, respondents consistently link targeted returns to broader economic conditions. A London-based partner says his firm is always adjusting targets to match current realities: “The return required on new money injections has decreased due to currency fluctuations and weak market demand. These two factors have diminished the overall value of injections and assets introduced to our portfolio companies.”

Another respondent from the same region explores similar territory: “The returns required on new money injections has decreased from the last year because of the market volatility and unfavourable business conditions.”
Faced with maturities on your portfolio companies in 2014, what method have you used by percentage?

Respondents facing maturities on their portfolio companies in 2014 were more likely to rely on A&E than on refinancing. Sixty-one percent chose A&E over refinancing.

And what do you anticipate using in 2015 by percentage?

However, the situation is reversed when we look ahead to 2015. More than half of those polled (56%) will seek refinancing in 2015 and only 44% anticipate using an A&E.

“It comes as little surprise that the majority of respondents facing maturities in 2015 are considering refinancings rather than amend & extends. Is the era of ‘kicking the can down the road’ coming to a close?”

Saam Golshani, Partner, Orrick
PRIVATE EQUITY SURVEY

When refinancing your portfolio companies in 2014 what percentage have you used of the following instruments?

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<th>Instrument</th>
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<tr>
<td>High yield</td>
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When refinancing portfolio companies last year, respondents are most likely to use high yield instruments (31%), mezzanine debt (26%) or leveraged loans (18%). Less popular but still significant instruments include unitranche (13%) and PIK notes (12%).

Commenting on the appeal of high yield bonds, a UK-based respondent says: “In 2015, we will ensure lower risks and will procure investments in the form of high yield bonds. Even during the economic crisis, the performance of these bonds was relatively strong and less volatile than equities.”

Many respondents commented on the appeal of mezzanine financing, including a UK-based PE partner who says his firm is “trying to keep an adequate balance between the risk factors by adopting a hybrid model” so that “restructurings can be conducted with minimum defaults.” A respondent based in Germany similarly praises mezzanine financing for allowing greater “flexibility and control” than other debt instruments.

Looking ahead to 2015, respondents will rely on the same refinancing instruments as they did in 2014. High yield instruments will continue to be the most popular for 35% of respondents; mezzanine the second most popular (26%); and leveraged loans the third most popular (17%). As was the case in 2014, unitranche instruments and PIK notes both rank lowest on the list.

“Whilst we expect high yield to continue to mature in the market, it isn’t always an option for some of the smaller capital structures, and hence we would expect mezzanine, unitranche, and other junior capital products to remain an important source of liquidity for complex businesses where high yield is not suitable or for smaller capital structures which can’t justify the costs of high yield issuance.”

Michael Crosby, Partner, Orrick

“High yield bonds remain the preferred refinancing instrument, mainly due to a combination of lighter covenant structure (i.e. in most cases without any maintenance covenants, for traditional HY) and competitive pricing. The HY bond market in Europe has seen strong development over the last few years, overtaking the bank debt market as the structure of choice for eligible credits.”

Dacre Barrett-Lennard, Rothschild
Do you expect that you may need to restructure one or more of your own portfolio companies in the next 12 months?

Yes 100%

What percentage of your portfolio is performing below the level of the acquisition business plan?

- 5% or less: 39%
- 6–10%: 29%
- 11–15%: 13%
- 16–20%: 19%

Respondents unanimously agree that restructuring will be necessary for one or more of their portfolio companies over the course of the next 12 months. This is due largely to broader economic conditions, as many firms are struggling to cope with declining demand. One respondent says: “In the next 12 months, companies in our portfolios will require restructurings because they have lost their efficiency in coping with macroeconomic challenges. We will need to identify the underperforming areas and take necessary steps to modify operations.”

Other respondents are quick to add, however, that offsetting economic distress is a difficult, if not impossible, task. “Management teams might have been able to recover their respective firms earlier without restructuring, but this is only true for select firms and industries. Most companies in the European economy are suffering and restructuring due to the falling economic conditions, not their own errors,” explains a partner at a Luxembourg-based PE group.

When asked to estimate the percentage of portfolio businesses performing below the level of the acquisition business plan, respondents were most likely to say that 6% to 10% of their portfolio businesses fit this description (39%).

It is worth noting, however, that a substantial 29% of PE respondents say that less than 5% of their portfolio businesses are underperforming according to the original acquisition business plan.
PRIVATE EQUITY SURVEY

When asked to determine the most likely methods of restructuring companies, respondents identified their most likely methods as operation changes (29%) and new equity injections (29%). Installing new management also ranked highly as the top or second most likely method, followed by asset disposals.

When dealing with larger organisations – as many respondents are – it is a challenge to keep tabs on all units at once, says one respondent from a Polish private equity group: “We need to realign our resources and reduce the number of entities in our portfolio businesses in order to manage operational costs. Operational changes will be made in the portfolios that need restructuring, but reducing the number of processes and entities first is critical because some companies are sinking in debt.”

When asked for more detail on their underperforming portfolio businesses, about one fifth of respondents said that 41% to 50% of these businesses could be candidates for debt restructurings in the coming 12 months. Other respondents (16% apiece) predicted even higher ranges of 51% to 60% and 71% to 80%.

Several respondents commented that restructuring candidates may also be M&A candidates in the months ahead, if a sale proves more economical than a restructuring.

How many of these represent potential stressed/debt restructuring candidates in the next 12 months?

For those companies in your portfolio which may be restructured, please rank the following method of restructuring in order of likelihood

When asked to determine the most likely methods of restructuring companies, respondents identified their most likely methods as operation changes (29%) and new equity injections (29%). Installing new management also ranked highly as the top or second most likely method, followed by asset disposals.

When dealing with larger organisations – as many respondents are – it is a challenge to keep tabs on all units at once, says one respondent from a Polish private equity group: “We need to realign our resources and reduce the number of entities in our portfolio businesses in order to manage operational costs. Operational changes will be made in the portfolios that need restructuring, but reducing the number of processes and entities first is critical because some companies are sinking in debt.”
The large majority of respondents (87%) expect 2015 to see an increase in PE exit volumes ahead of new fundraising plans. Looking more closely at respondent commentary, however, reveals an acute sense of uncertainty about the health of the market – even for those respondents who optimistically say exits will increase. The investment director of a UK-based PE firm explains: “Valuations are bound to fall as the economy has failed to show signs of improvement. Sell-side players will experience a crunch due to the falling market value of assets and investments and I think the market will be less ripe for exits in 2015.”

As was the case with respondents to the first section of this study, the large majority of PE respondents (87%) expect 2015 to be a more difficult fundraising year than 2014. This is a slightly larger majority than the 81% of hedge fund and proprietary trader respondents who anticipated a tougher fundraising environment in the first section of this survey.

When asked to provide more detail on the reasons for poor fundraising conditions, most respondents pointed to broader economic weakness and investor frustrations. One respondent based in Germany says: “European businesses have failed to satisfy investor expectations, and have negatively affected their investment appetite. In the next year, funds will be retracted and diverted to other economies.”

Do you expect an increase in the number of private equity portfolio exits in 2015 ahead of new fundraising plans?

![Pie chart showing 87% yes and 13% no]
The majority of respondents (81%) expect the market to be less supportive of secondary and tertiary buyouts in 2015 relative to 2014. Many respondents believe opportunities for secondary or tertiary buyouts will hinge on investor appetite.

According to a PE partner at a London-based firm: “The markets will be less supportive to secondary buyouts in 2015, as the valuations have gone too low. European assets have lost their significance in the eyes of investors, and buyers will increasingly divert to high-yielding economies.”

“Given general market expectations of excess public equity returns driven partly by a pick-up in European M&A activities, this paints a gloomier picture than we expected.”

Shawn Atkinson, Partner, Orrick
Restructuring non-portfolio businesses will understandably be less of a priority than restructuring portfolio businesses in the coming 12 months. Sixty-one percent of respondents say they will not be actively involved in restructuring non-portfolio companies in 2015, while the remaining 39% say they will.

Not surprisingly, many respondents say their decision to stay out of non-portfolio company restructurings will reflect the urgency of restructuring their own portfolio businesses. One respondent says he will focus only on his firm’s “existing portfolios” and avoid non-portfolio matters “as this will involve extra finance and attention.” Another respondent similarly states: “Right now, we are focusing only on the performance and restructuring of our portfolio companies. We need to achieve our expected returns and to develop our firm more in the coming years.”

“Restructuring can be a resource intensive occupation and the answers appear to indicate that PE houses will prioritise fixing their own ‘problem children’ rather than seeking new restructuring investments.”

Saam Golshani, Partner, Orrick

By some distance, the most common restructuring outcome in 2014 was incremental investments (new money) related to amend & extend (48%). This was followed by refinancing with 23%. An additional 13% and 10% of respondents, respectively, cited equity dilution and covenant reset as the two most common outcomes.

“Incremental investments to facilitate amend & extend restructurings are popular mechanisms for sponsors to retain control of their assets when they see some real turnaround potential. As the supply of financing was abundant in 2014, sponsors also pursued debt refinancing (with third party or existing lenders) as a powerful strategic action. Separately, we also saw massive debt for equity swaps where incumbent sponsors have preferred handing over companies to their creditors rather than pushing the can down the road another few years. This trend has been supported by more banks accepting booking their loss, selling their loans at a discount and moving on.”

Arnaud Joubert, Rothschild
PRIVATE EQUITY SURVEY

On what scale (in percentage terms) do you anticipate LBO deal volume to increase in 2015?

What percentage of restructurings do you believe would have resolved differently if action had been taken earlier?

When asked about the percentage increase in LBO activity for 2015 sixty-eight percent expect there to be a decrease in LBO volume while remaining respondents are divided between an increase of 10% or less (23%) or an increase of 10% to 30% (10%).

“There is still a fair chunk of dry powder out there and many PE houses are keen to invest. That being said, the results seem to show a fairly negative sentiment on deal volumes.”

Shawn Atkinson, Partner, Orrick

“Unlike M&A activity, the volume of LBOs in 2014 has collapsed. Instead of doing other LBOs, PE firms, encouraged by high valuations and a hot equity market, preferred off-loading their previous investments to the public via IPOs or selling them to corporates. With the equity markets cooling off and a less buoyant credit market, I would expect LBO volumes to remain subdued.”

Alessio De Comite, Rothschild

More than half of respondents (55%) believe that 10% to 30% of restructurings would have been resolved differently had action been taken earlier. This aligns with previous findings, in which 39% of respondents said that 2014 experiences with restructuring taught them the importance of approaching lenders early on in the event of stress.

Respondents across the board believe planning and preparedness could lighten the burden on distressed companies. A Luxembourg-based PE investor says: “Anticipating economic distress, companies could have taken steps to either conduct early restructurings or to focus on the rationalisation of entities. This would have ensured resilience in the longer run. Instead, a lack of proactiveness among European firms has resulted in greater distress.”

A Switzerland-based respondent takes a similar stance in stating that “businesses should have planned rescue strategies earlier, either by limiting debts or selling non-core assets.”
Respondents’ operational priorities cover a wide spectrum of activities. Respondents were most likely to prioritise taking costs out of the business – this was a first or second priority for more than half of those polled. This was followed by improving the top line (a top priority for 23%), and improving internal systems and/or financial reporting (a top priority for 19% and second most important priority for 19%). An additional 23% of respondents prioritise dealing with underperforming divisions or geographies.

Several respondents point out that when dealing with multiple business units, cost cutting, streamlining operations and improving management are all interconnected efforts. One respondent says: “We are monitoring the performance of our various divisions and are undertaking necessary steps to improve them. Our focus right now is to either improve the management efficiency or change the management to ensure efficiency.”

When asked about the percentage of activity that would be devoted to bolt-on acquisitions, there is an even three-way split. Twenty-six percent of respondents said they would spend less than 5%, between 6% and 10% and between 11% and 15%. Only a slim 3% of respondents expect to spend between 21% and 25% of their time on bolt-on acquisitions as opposed to new investments.

Respondents have no doubt that bolt-on acquisitions can fuel growth, but many doubt whether bolt-on opportunities will be readily available in the coming months.

As one respondent explains: “Our firm is currently strategising bolt-on acquisitions for around 10% of our portfolio companies. These deals would increase technological capabilities, improve infrastructure and add new resources. However, the availability of such businesses is low, so the percentage of bolt-on acquisitions this year will be low too.”

Another respondent refers specifically to the difficulty of cross-border bolt-ons: “It is difficult for distressed European companies to identify opportunities and collaborate with potential targets, as many foreign firms are avoiding an entry into this zone. We do not have many options available for bolt-on acquisitions right now.”
The large majority of PE respondents (77%) will seek a dividend recap for at least one of their portfolio companies during 2015, hinting to an increased presence of distressed businesses during this time.

Several PE respondents shared their opinions on the underlying drivers of dividend recaps in 2015. Investors’ impatience and desire for returns is a common theme within respondents’ commentary, with one UK-based practitioner stating: “Increased shareholder activism is putting pressure on companies to generate returns. Investors are extremely rigid when it comes to returns and are unlikely to lower their demands. Such investors give businesses no other option than dividend recaps in the following months.”

A respondent from a Swiss PE firm describes a similar scenario in stating: “Private investors have been more aggressive in demanding dividends from their portfolio companies. This will cause dividend recaps to increase in the coming months, and will force businesses to incur new debts.”

Michael Crosby, Partner, Orrick

The majority of PE respondents (84%) expect dividend recaps to increase in the coming months. This is driven by a combination of cost pressures on the part of individual companies and broader economic challenges.

“Private equity investors who have held investments for a number of years will still seek a return on investment and a recap is often the easiest way of achieving this where other exit scenarios are not available. The results also reflect the ready availability of new money to support dividend recaps. In circumstances where the underlying portfolio business has met or exceeded the agreed base case model, many credit fund investors feel comfortable lending to such businesses with such a proven track record.”

Michael Crosby, Partner, Orrick
PE respondents are divided as to whether hedge funds will be able to fill in the lending gap. Fifty-two percent of respondents believe hedge funds will step up to the plate in 2015, while the remaining 48% disagree. These expectations are a sharp contrast to the expectations of hedge fund and prop trading respondents: 73% of these respondents expect hedge funds to fill the lending gap in 2015, making them far more bullish on this issue than their PE peers.

PE respondents from various regions describe hedge funds as opportunistic and aggressive players in the current market. “Hedge funds have taken advantage of the limitations of the banks’ lending policies and have invested in companies that are considered risky in order to gain quick growth among the competitors,” says the managing director of a Swedish PE firm.

Another respondent who believes lending abilities will be curbed by 25% to 50% seconds this view by stating that the experience of being under constant “close scrutiny” will make financial institutions less willing to lend.

About half of respondents (52%) believe that banks’ ability to lend new money or extend existing debt facilities has been curtailed by between 25% and 50% as a result of Basel III regulations. A smaller but still substantial 45% expect banks’ lending abilities to diminish by 25% or lower. These figures are for the most part in line with hedge fund and prop trading respondents, and for each respondent group the percentage of respondents expecting lending abilities to be cut by more than half stands at just 3%.

One of the more bullish respondents who selected the 50%+ range explains the reasons behind his choice, stating that Basel III regulations have affected the entire financial services landscape: “Basel III norms present the most significant challenges to the banking and insurance sectors. Financial institutions are facing higher pressure from regulators and lending leniency has been curbed, so I think the impact is definitely more than 50%.”

Another respondent who believes lending abilities will be curbed by 25% to 50% seconds this view by stating that the experience of being under constant “close scrutiny” will make financial institutions less willing to lend.
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