Global Focus: European Distressed Debt Market

November/December 2005

Adam Plainer

The distressed debt market is a rapidly growing market with increasing importance in large-scale restructurings in Europe. With non-performing loans ("NPLs") playing a large role in an overall bank restructuring initiative, distressed debt has become the latest hot topic with financiers.
In 2003 alone, the high yield debt sold by European issuers topped £18.6 billion. It is not just distressed debt that is on the increase either, the secondary market overall is also growing rapidly and experienced a 29 percent increase between 2003 and 2004. This growth is attributable to multiple factors including increased liquidity in the market (with more investors being attracted daily to this relatively new area of investment with such large potential returns), a significant reduction in equity contributions and the resulting increase of leveraged multiples.

Recent Key Deals

Even though this is a relatively new market in Europe, there are already several cases that demonstrate the potential numbers involved in the trade of distressed debt, which in turn begin to explain the reason for the market's steady growth in recent times.

The collapse of Parmalat in December 2003 for example has already made some investors (who bought much of Parmalat's debt at discounts of up to 90 percent) lose three times their money after the price benchmark of the bonds rose significantly over the last two years, and the company is currently in negotiations with its bondholders and creditors regarding a debt-equity swap (the vote closed on August 25, 2005).

At the beginning of 2005, British Energy’s lenders were reported to have made almost £1 billion when the company was re-listed on the London Stock Exchange and its debt was exchanged for new shares and bonds. When British Energy had initially suffered its collapse, the creditors agreed to swap £1.2 billion in debt for £425 million in bonds and 97.5 percent of new shares. When the company was re-listed, it was thought that this debt package would be worth somewhere in the region of £2.03 billion.

In Germany, however, the distressed debt market is really booming as a result of an unprecedented push by the banks to sell off large proportions of their NPLs. In the NPL market, returns come not only from restructuring but also from realizing collateral that often makes insolvency a strategic decision to realize value. In Germany last April, Frankfurt and London Goldman Sachs entered into exclusive talks to acquire a €2 billion portfolio of bad loans with Delmore, a specialist bank. Earlier in the year they also bought €350 million of NPLs from Commerzbank. The biggest loan sale to date in Germany was the €3.6 billion sale by mortgage bank Hypo-Real Estate in 2003 to the US fund Lone Star. This sale confirmed analysts’ views that Germany is the biggest potential market for distressed debt in Europe. With Eurotunnel, Euro Disney and Parmalat all in play, the market is forecast to grow throughout Europe in the coming years.

That said, the expansion of the distressed debt market is still taking time to entice some investors. Eurotunnel’s approximate debt of £6.4 billion is spread among 200 creditors, a small proportion of which are secondary holders. The talks of a debt-equity swap, however, have got off to a slow start as the management is proposing a write-down of £4 billion that is currently being met by indignation and frustration from the creditors. Further, the European market would be wise to take stock of the US markets' experiences over recent months. As a result of $200 billion of General Motors debt being unleashed on the market in May, the US junk bond market found itself in chaos and dealing came to a standstill, unable to cope with the sheer volume of deals. The European market must be mindful of potential volatility and would do well to try to alleviate, or at least minimize, the chances of such chaos occurring in Europe.

Effect of Insolvency Rules on the Distressed Debt Market

Analysis of a country's insolvency regime is key when evaluating a prospective credit. Currently, insolvency law differs widely in each of the 40 plus jurisdictions across Europe and, in general, such laws favor the creditors, which does not lend itself to the growth of the distressed debt investment market. There is a general desire, however, to change this approach and countries are slowly attempting to simplify their insolvency laws and make them more flexible and pragmatic, with a knock-on effect to the market.

In France, a draft law has proposed a significant change to the insolvency procedure, whereby debtors, even before entering into an insolvency situation, may be granted an automatic stay of creditors' claims. In such circumstances, the commercial court, which has a supervisory role over the proceedings, appoints an administrator, but the significant development is that the debtor retains management control over the company. This proposal is a move in the direction of the chapter 11 procedure, as used in the USA, and rehabilitation plans are then negotiated with the creditors. A large degree of control still remains with the court, however, and the court may still reject any rehabilitation plans suggested, even if agreed between the parties.

Germany is moving in a similar direction to France. The first question the court asks is whether the company can be rehabilitated. If so, a process similar to that of chapter 11 is then implemented and the debtor is able to achieve restructuring on a going-concern basis by means of an insolvency plan approved by the majority of creditors.

Spain, it could be argued, is not perhaps progressing as quickly in this area as some of the other European states. In this jurisdiction, a commercial judge decides if the administrator, who is court appointed, should take over the management of the company or leave it in the debtor's control. Spain does not, therefore, go as far as the French reforms in that respect, which allow the debtor to maintain control. The Spanish administrator, however, can then attempt to reach an agreement between the creditors and the debtor on the restructuring, if it feels such an agreement is a viable option.

In the UK, the Enterprise Act of 2002 is aimed at streamlining insolvency rules and, in the main, brought about the end of administrative receivership. Ring-fencing for unsecured creditors was introduced along with the abolition of the preferential status of the Crown in respect of pay-as-you earn tax, national insurance contributions and value added tax. It is also possible to use a new out-of-court procedure to initiate administration, but this process is only open to holders of qualifying floating charges, the debtor and its directors. Further, in 2000, the government reformed Company Voluntary Arrangements, imitating chapter 11, and providing a procedure whereby creditors could be "crammed-down," effectively paving the way for bondholders to reap the rewards.

This general move towards a chapter 11 approach is beneficial to the distressed debt market in that the emphasis is shifted from bankruptcy proceedings to actually attempting to save the company. As a result, bondholders are an essential part of the restructuring process that will subsequently lead to a growth in the market.

Basel II

The introduction of the Basel II Rules will also influence the future growth of the distressed debt market. In July 2004, the European Commission adopted a directive proposal, the Capital Requirements Directive, for a new capital requirements framework for institutional investors. The Basel Committee on Banking Supervision wished to introduce new capital requirements for banks and investment firms to ensure coherent applications throughout the European Union. The Committee aimed to ensure that the financial institutions' capital in the future would be more closely aligned with the risks that they face. Lending will become a far more risk-sensitive area as a result. Such an approach will mean the introduction of new standards for establishing minimum capital requirements for banks, which will in turn mean that banks will be forced to start getting rid of NPLs in order to ensure they have adequate capital to support their risk. This move will have the knock-on effect of increasing the level of distressed debt available to the market. These new capital requirements may be brought in towards the end of 2006, but the more advanced changes will not be implemented until the end of 2007.

The Future for the Distressed Debt Market

It is predicted that, as a result of these reforms, on a national level in the UK as well as on the pan-European level, the rights of senior lenders will continue to be eroded and more rights will be given to bondholders. The emphasis will be on saving the debtor by way of restructuring, with the aim being to create a pan-European restructuring process in the future. There has already been a suggestion of this pan-European approach in the UK, with administration orders being made against the entire Crisscross Group despite eight companies of the group having assets and creditors registered in other jurisdictions. Latterly, the same approach has been adopted in Collins & Aikman. This approach is likely to be increasingly taken up across Europe.

Investors appear to be focusing on pan-European industries with weak fundamentals rather than tracking single-deal opportunities, the net effect being that the European distressed debt market will continue to grow over the coming years. Some sectors, particularly automotive, retail and the airlines are predicted to experience dramatically increased opportunities. Bank debt is also likely to become the most attractive product in terms of investment opportunity in the light of the shift in market supply, with opportunities in public debt and bonds now insufficient to deal with the available capital of investors in the market. Traditional clearing banks are beginning to embrace the concept of selling their debt and seem to have overcome concerns about protecting their brand. Distressed debt investors, particularly hedge funds, may be a source of new financing when it is needed as part of the reorganization plan, again replacing traditional clearing banks but this time in the provision of new money as well as in buying their existing exposure during the restructuring process.

In addition, the move towards a chapter 11 procedure, whereby the debtors remain in possession and the creditors merely have a voice when negotiating the methods of rehabilitation, will further assist the growth in the distressed debt market by further encouraging the rehabilitation and restructuring of debtors as opposed to promoting their bankruptcy. As excess market liquidity chases the (fewer) available opportunities in the European distressed debt arena, however, each asset class becomes more widely held across different types of creditors. Having diverse creditors (*e.g.*, par and sub par investors) within an asset class as well as across the capital structure will make reaching a consensus outside a formal reorganization process more challenging and may force more companies into an insolvency process as a means of dealing with diverse creditor constituencies. Companies and creditors will be assessing insolvency as a tactical move in the absence of established precedent in many European jurisdictions.