The Slippery Slope to Financial Restructuring of a Company

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These days a lot of oil service and E&P companies go through troubled times. With the low oil price, the cash flow is not sufficient to service loan payments and interest. Below we have set out (in basic and not legal terms) the various stages in how the process of financial restructuring of a company may unfold, for interested readers. The focus of this article will be on financial restructuring, which can be defined as improvements in the capital structure of the firm so that it can once again service its debt.

While a financial restructuring may be the company's first priority, it will usually also need to do an *operational* restructuring, which is the *process of increasing the economic viability of the underlying business model*. It should be noted that to do just a financial restructuring will often not be sufficient, since the business model itself will need to be adjusted in view of the changed business landscape. By the way, the expression *refinancing* has nothing to do with financial restructuring. *Refinancing* is what companies do in good times when loans are renegotiated to take advantage of better interest rates, ie on the basis of company strength. While *financial restructuring* - as we will see below - is done on the basis of weakness.

In good times the company will enjoy a healthy cash flow from operations. It will be considered as a *going concern*. At this stage all the company's stakeholders are aligned with the common goal of keeping the company going and making good money. However, with a dropping oil price and deteriorating cash flow, the first thing the company will do is to start conserving cash, i.e. delay investments, reduce the work force and cut spending in general. This may work for a while.

Still, many Norwegian companies have taken on too much debt, and the reduced cash flow may no longer be sufficient to cover debt and interest payments. The company may soon find itself in a situation where it is in breach of loan covenants. In principle any long term loans will then fall due, i.e. the banks can demand immediate repayment. The banks will also find this situation very difficult. Even though the bank has collateral for its loans, it would be problematic for the bank to take over the assets. With lots of laid up vessels and rigs any sale of collateral would probably not provide enough return on the security. Therefore, when first signs of payment trouble come up for the company, the banks will usually be quite willing to provide necessary wavers, extensions and amendments to the loan contracts. (Wavers will be that the bank accepts that the company is not able to reach various financial ratios as stipulated in the bank loans, meaning that the bank will forego its contractual right to demand payment). This is often regarded as a *soft restructuring* by the banks. The company may also have bond loans, and the process of amending such loans (in terms of extension of repayment etc) is more complicated as the company has to summon all the bondholders and have minimum 2/3s to approve the bond amendments. (This is done through Nordic Trustee, which represents all the bondholders through the bond agreements).

The real trouble starts when it is not enough to just wave/amend the loan covenants. The company's cash flow may be so meager that the interest has to be considerably reduced and deferred. The company will at this point still have a financial enterprise value (which can loosely be defined as the company's overall value of assets) that is higher than the debt, but it has no longer any capacity to service its loans, at least for a considerable period of time. At this stage more serious steps have to be taken, like having the interest costs or even the debt reduced. The company will likely terminate any debt repayments at this stage and ask all the lenders for a so-called *standstill*, where bank and bondholders are invited to discussions while they are also inquired to not demand the loans to fall due (ie a standstill).

In this dire situation the interests of the various stakeholders will really start to part ways. The various parties will take stock of the their relative positions vis-à-vis other stakeholders, ie. strengths and weaknesses (in other words a stakeholder analysis).

- Banks: To what extent do they have collateral and security? What would the assets be worth in a forced sale?
- Bondholders with security: What is this security worth for them, coming behind the banks?
- Bondholders without security: They are the ones with the most to lose.

The restructuring may now resemble a poker play, where the lack of a powerful hand of cards can be more than compensated with a better bargaining strategy.

In this situation the banks will not be interested in taking a hit, their loans are secured, and they can wait. The same goes (to a large degree) for bondholders with security. The banks will therefore expect the *unsecured bondholders* to take the largest hit (with lower interest, delayed repayments etc), these stakeholders are after all last in line for proceedings from any liquidation. However, these bondholders will usually not give in without a fight, and want compensation for any cuts in interest rates or debt owed them. They will therefore often require having their unsecured debt swapped to equity in the company. This in contrast to the banks that have loans that are secure and therefore do not want to become shareholders, as the banks want to stick to banking and not be directly involved in the company's business. Swapping debt to equity would be tantamount to exchanging a contractual right for payment with an uncertain claim on future profits, which not make sense for the banks with their secured loans. This situation is moreover posing a threat for the banks; if the unsecured bondholders take over too much of the share capital and gets control over the company, the company no longer will be under the control of industrial investors who know the business, but by financial investors (the bondholders turned into new shareholders) without any knowledge of the business. This is not at all a type of restructuring the banks would like to get into, and they would resist such a debt-for-swap transaction. At this point the enterprise value of the company will usually still be higher than if it had been liquidated, so it makes sense to keep negotiating.

As we can see, at this stage the interest conflicts are really mounting. Adding to the difficulties the board of the company has to tread carefully. If the company slips into too much debt and the business is carried out on the creditors' expense, the board may be held responsible. (The board also has to make sure that the company has sufficient equity and liquidity, and an obligation to act if there is a considerable loss of equity. Here we also see the importance of taking steps for financial and operational restructuring). From the board's point of view, however, if the initial share capital is indeed lost (which can be comparable to the enterprise value being lower than the overall debt) it makes perfectly sense to have some of the (usually unsecured) debt converted to share capital. Because this will – overnight – establish the necessary solidity to the company and lift any responsibilities the board will have regarding sufficient equity.

In a final twist to the story, the shareholders will have the final word on this voluntary restructuring. The share capital may have been wiped out and shareholders lost every penny, but they will still have to vote for the proposed restructuring if the company should remain intact as a legal entity. Hence, what the banks and bondholders propose (and agree themselves) in terms of restructuring, will still have to be approved by 2/3 of the initial shareholders. This means that the restructuring package has to offer the shareholders something in return for them to vote in favor of the debt-to-equity swap. This explains why wiped-out shareholders still get some percentage points worth of shares in restructured companies.

What we are seeing now in the Norwegian capital markets is that the restructurings may be agreed with the stakeholders to buy the company and lenders time, in the hope of having higher oil prices within 2-3 years. If the oil price does not come up, we will likely see another round of restructurings within 3-4 years where debt-to-equity swaps really have to be implemented in full force.

Epilogue

Why would not the board take the company directly to a debt restructuring (forced or voluntary) in the courts, in line with the legal requirements? Like what US companies do in a so-called Chapter 11? The reason is that the Norwegian court-led process for a financial restructuring is not flexible enough, and only a negligible amount of companies go this route. (Unless if there is no hope for recovery, since then the board of the company has no other choice than star bankruptcy proceedings through the courts). These days a panel has been appointed by the Norwegian authorities to see if the Norwegian legal bankruptcy system should be made more flexible, like more in line with the US chapter 11 system.

About the author:

Per is a State Authorized Public Accountant and joined PwC in May 2013. Prior to PwC Per worked as listing officer at Oslo Børs for several years, where he was in charge of a number of IPOs as well as the E & P companies' oil reserve reporting. He has also worked as Chief Accountant for Frontline and CFO for Northern Oil, an E&P company listed on Oslo Børs. He works as Director at PwC CMAAS and has over the years been involved in a variety of capital market transactions. He is responsible for several of PwC's internal and external publications as well as seminars covering the capital markets, including facilitating the SPE Oslo Section's full-day E & P seminar at PwC, together with Oslo Børs.