

DISTRESS

Financial restructuring and distressed investment opportunities in Asia Pacific

BY PAULINE RENAUD



The distressed financial environment, tight credit conditions and scarce liquidity have forced many companies around the world to either restructure their operations or file for bankruptcy. The Asia Pacific region has not been immune to the current global slowdown, and even good companies in the region may have to reorganise their businesses in the coming months. But in crisis lies opportunity, and a dynamic distressed investing market has already begun to emerge in the Australasian countries. In particular, rich pickings are available in the REIT sector, retail, auto, consumer goods manufacturing and property and construction. But challenges still exist. The market for distressed debt is complex and there are a number of risks associated with making such investments, particularly when investors are unfamiliar with the region.

Corporate defaults on the rise

No country in Asia Pacific has proved resilient to the financial crisis, and this has been particularly true for China, which has seen real growth decline for the first time in seven years. Furthermore, the outlook for foreign and domestic demand is not encouraging. Sustaining growth and conducting business in Asia, as a whole, has run into difficulties. "The Asian economy has grown in recent years via a wave of debt," explains Mark Chadwick, a partner at the Shanghai office of Ferrier Hodgson. "Asian corporates are generally highly

leveraged and, over the last several years, the concept of debt amortisation has, for the most part, been non-existent, given the ease of being able to refinance. Unfortunately, the days of being able to rely on financing are over and funding options for maturing debt are increasingly limited." As a result, default rates across Asia Pacific are up. In Australia, for example, the Australian Securities Exchange (ASX) top 200 listed corporate debt maturities are worth A\$50bn in 2009 and 2010. With foreign banks representing 25 percent of that debt limiting their exposure to Australia, there has been an obvious and immediate financing shortfall.

This has affected almost all sectors, but notably those that are both capital intensive and heavily exposed to the current financial conditions. For example, consumer goods manufacturers have been hit hard, with about 70,000 factories closing down this year in China alone, according to government statistics. Retailers, the base metals industry and the automotive sector have also been casualties. "The property and construction sector is also facing a great deal of demand contraction," highlights Mr Chadwick. "We've seen declines in average monthly revenues of as much as 70 percent for some distressed property and construction companies. This has had a trickle-down effect on construction material suppliers, particularly those in the steel, metal and cement industries. Combine this with the fact that many of the participants in these in-

dustries are highly leveraged, and it becomes pretty plain to see that a great deal of financial re-engineering is required," he says. This is also true for the financial industry, where non-deposit financial institutions and the REIT sector have also been affected. Indeed, the latter has seen equity valuations plummet, and is feeling the effects of the banks' conservative approach to rationing credit. As a consequence, most companies need to undertake some kind of financial restructuring.

Businesses can choose to restructure under court supervision or outside of court in consensual restructuring negotiations. The second option is generally preferred, but Mr Chadwick warns that restructurings in Asia are often hampered by a lack of transparency, an unwillingness to engage with stakeholders and a failure to address core problems linked to the business. But this has not prevented some companies from undertaking successful restructurings, particularly where secured lenders are happy to renegotiate covenants or extend maturities to deal with short-term cash flow issues. Furthermore, experts have noted that there is currently a wave of discounted tender and exchange offers for bonds and convertible bonds, a sign that companies are looking to reduce their debt, obtain significant buy-back discounts and/or restructure poor capital structures. For example Nine Dragons, China's biggest paperboard producer, recently bought back \$160m of its \$284m outstanding 2013 bonds, at 53 cents to the dollar. Similarly, ProMOS Technologies, Taiwan's third largest DRAM maker, said a few months ago that about 80 percent of investors in its convertible bonds had agreed to accept its offer to buy back at a discount, or withdraw their redemptions of the bonds. But not all cash tender offers are successful. Hong Kong-listed Asia Aluminium recently withdrew its tender offer after failing to gain support from the holders of the bonds and notes that it was seeking to buy back. The group was therefore put into provisional liquidation.

Ultimately, the company must have either cash or the means to raise cash in order to launch a cash tender offer. However, this not the case in most distressed restructurings, points out Jim McKnight, head of APAC Restructuring for UBS. "Situations can become

problematic when companies are required to raise fresh equity as a pre-condition to restructuring. Larger, more liquid, listed companies have windows of opportunity to access the equity markets at short notice and issue fresh equity to existing holders – albeit sometimes at large discounts. For smaller, illiquid, listed companies in the region, particularly stressed or highly levered credits, public equity and equity-linked markets are typically closed,” he explains. Private companies are facing similar difficulties accessing external capital. Therefore, some businesses are turning to other sources of funding, such as distressed funds or private equity. Debt funds will often prefer to take the most senior position in the capital, while private equity will usually structure an investment as debt or equity, with additional control and corporate governance requirements. But capital is expensive, and only the best companies will be able to access it. Alternatives include asset sales and debt-for-equity swaps, which may be the only way for these companies to avoid bankruptcy.

Challenges in sourcing attractive deals

Nonetheless, companies in survival mode provide a wide range of opportunities for distressed investors. Direct primary investment opportunities for alternative capital and private equity sponsors should continue to improve in the Asia Pacific region as default rates increase and companies run out of financing options. In the meantime, secondary markets for loans and bonds are still attractive to distressed debt investors by offering discounted prices and high yields. “But sourcing distressed debt in secondary markets from banks has been more difficult in Asia to date,” warns Mr McKnight. Indeed, prices have yet to fall to attractive levels in some jurisdictions. “Although Australian bank bad debt levels have increased by 180 percent,

for the year ended 30 June 2008, we have not seen banks cut distressed loans, due to fear of having to re-mark other positions it holds onto. Basel II, which makes it more expensive for banks to carry non-performing loans, may eventually force some to cut positions.” He adds that foreign banks exiting Australia may provide some secondary market liquidity for impaired loans, although this remains to be seen.

Price aside, sourcing attractive deals is much easier when teamed with solid knowledge of the target country or region. Investors can also link up with smaller local investors or distressed advisory firms which have a presence in the Asian distressed situation market. Understanding the practical realities, such as exit strategies, is indeed essential, so thorough due diligence is required. This should include access to a data room and, ideally, up-to-date financials. This process is particularly important in Asia, where the economic picture is changing rapidly. “Apart from understanding the financials, you need to understand the structure that you are investing in, know who the borrowers are, and identify what areas of leverage you will possess after lending or investing. If your recourse is limited to legal avenues, in jurisdictions such as Indonesia and China, then forget it, you have no leverage,” warns Mr Chadwick.

At the moment though, the due diligence process is a vital part of asset valuation, which can often represent a tremendous challenge. As such, different methods are being employed to avoid overpayment. “Buyers of distressed securities tend to put a floor on their asset valuations,” explains Mr McKnight. “The next step is to look for value over and above the security. Key issues include whether there are any guarantees in place, the nature and extent of any underlying cash flows, the possibility of renegotiating those loans and the timing of any

formal workout process.” He adds that some distressed investors are using liquid secondary credit to set their benchmark return rate. But in Asia, these are yielding in the mid teens, with the implication that returns in excess of 20 percent per annum are required for illiquid investments – a promise which few companies can boast amid the current market uncertainty.

Some legal and regulatory issues can also arise when making distressed investments in the Asia Pacific region. In Australia, for example, the case of mining company Sons of Gwalia should be well understood by distressed investors. Ultimately, the High Court held that during the external administration of a company, claims by shareholders for the recovery of losses due to wrongdoings by the company can rank equally with the claims of unsecured creditors. This decision also acts as a warning to creditors, who could be exposed to greater risk and lower returns, as well as increased administration costs. Other legal issues include regulatory change, such as the new Bankruptcy Law in China. With 136 articles, the new law is more comprehensive and better incorporates international best practices than its predecessor. However, some analysts have said that it is still fails to address all the issues raised in bankruptcy and restructuring situations. Cross-border issues are always to be expected, because differences between insolvency laws, legal processes and transparency levels will always exist. These complexities have only been exacerbated by the financial crisis and the uncertainty it has exacted on the global markets. But well-advised, cash-rich investors need to take some risks in order to benefit from the attractive, distressed opportunities that the market has to offer in Asia Pacific. With timing and patience, assets bought at discounted levels could prove exceedingly fruitful when things improve. ■



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Mark is an executive director of Ferrier Hodgson in Shanghai. He began his career at Ferrier Hodgson in 1994 and has over 14 years of experience in the specialist fields of corporate turnaround, transaction services and forensics. Mark has gained extensive experience working on corporate assignments in Australia and Asia and has spent the last eight years working on assignments in Malaysia, Indonesia and China during which he developed a unique understanding of the diverse cultural and business practices in Asia.

In Malaysia, Mark was involved in corporate restructuring and due diligence assignments of companies operating in the areas

of banking, property development, forestry, sawmilling, hotel and resorts, tourism, oil and gas development, manufacturing and construction. After joining the Indonesia Office in 2000, Mark undertook restructuring, monitoring, financial due diligence and capital raising assignments in the fields of aquaculture, textiles, petrochemicals, property, pulp and paper, finance, timber and plywood, infrastructure, agribusiness, manufacturing and hotel operations. Mark has also completed expert witness reports on behalf of clients involved in litigation.

Since establishing the firm's Shanghai office in 2007, Mark has led numerous M&A, due diligence, business turnaround and

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Mark is able to assist clients navigate the numerous phases of a transaction cycle. In this regard, Mark has advised corporate clients on such matters as investment entry (sourcing of opportunities, due diligence, valuation, structuring and negotiation), post-deal advisory (interim monitoring/management, restructuring, corporate governance) and in some instances, developed and implemented exit strategies for investors.

