The Governance Issues in Distressed Companies
Rome, 3 May 2016
The Governance in Distressed Companies

- Relevant stakeholders and the “reality gap”

- Conflicts Outside the “Board Room” and “Value Break”

- Conflicts in the “Board Room” and on the “Executive Floor”

- The role of the CRO
In a distressed scenario, governance issues arise at various levels

- Among stakeholders with a say on restructuring, liquidation or bankruptcy alternatives
- Among stakeholders with shareholder's meeting voting power
- Within the Board of Directors
- Between Board of Directors and Shareholders
- Between Board of Directors and CEO
- Between CEO/BoD and Management
- Between Management, Employees and their representatives
The reason behind conflicts should be that…

in a distressed scenario, interest of various stakeholders tend not to be anymore aligned

But is it true? Experience says that this is generally not the main reason behind conflicts, as value preservation and enhancement remains paramount interest for all stakeholders, as in most well performing enterprises.

The real reason should be searched in …
The Reality Gap

Net assets

- Actual
- Reported
- Reserves accumulating
- Reserves released

Time

- The reality gap

X

Y

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The Fog Index

Fog Density %

- Executive Directors
- Banks
- Suppliers / Customers
- Employees
- Non Executive Directors
- City Analyst
- Independent Shareholder

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Conflicts arise among stakeholders with a say on restructuring, liquidation or bankruptcy alternatives ….
- Holders of various classes of shares
- Mezzanine and other quasi equity providers
- Secured, unsecured lenders, bondholders etc.

…. and stakeholders with shareholder’s meeting voting power
- Various classes of shareholders
- Lenders with voting rights, pledges and or negative pledges

The main reasons being that some parties feel protected also in a liquidation scenario, other only by a restructuring plan and others, being out of the money in all scenarios are willing to sell an option.
Restructuring negotiations becomes harder when value breaks well below equity

<table>
<thead>
<tr>
<th>Book value</th>
<th>Value break</th>
<th>Issues</th>
<th>Typical dynamics</th>
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</table>
| Equity     | On the cusp of value brake | • Equity out of the money but still deeply involved  
• Yet limited pressure from liquidity | • Shareholders reluctant to let the business go  
• Covenant reset and/or debt rescheduling with banks asking for equity injection  
• Working capital facilities could be provided |
| Sub debt   | Out of money | • Equity “sitting on the fence”  
• Banks suffering losses  
• Many parties joining the table  
• Pressing urgency from liquidity needs | • Subordinated debt holders with limited options, senior debt holders try to minimize write offs  
• New money as new investment and financing only super senior |
| Senior debt | Sticking plaster | • Equity managing it’s “option”  
• Bankruptcy value destruction looming | • Fierce discussions on recovery and potential litigation  
• Bankruptcy proceeding likely alternative to debt restructuring |
Today the key requirement for a successful restructuring process is to provide evidence that value can be enhanced

<table>
<thead>
<tr>
<th>Priority 1</th>
<th>Priority 2</th>
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<tbody>
<tr>
<td>Increase / protect company value</td>
<td>Negotiation with stakeholders</td>
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- Approach prevailing starts from financial restructuring based on expected performance ...
- ... while its key to assess and start performing at sustainable rate to avoid surprises later
“Cake size” must be firmly grounded in facts and identified actions, organized in an achievable path

Jewelry manufacturer production volume
2000-2009, Tons of pure gold

- Despite an underlying market decline, all business plans implied a sharp change in trend
- Significant gaps already from the first year
- Plans developed by strategic management consultants proved to be particularly unrealistic

Source: business plan documents, AlixPartners analysis
Traditionally you first define a business model, than you renegotiate the capital structure and finally you can implement the plan.

Traditional Golden Rules apply:

- Keep it simple
- You can analyze anything in 6 weeks
- If you cannot implement it in 18 months, you simply cannot implement it
- Focus on short term….

financial restructuring based on expected performance …
Holistic Turnaround implies upfront operational effort to optimize cash and operations, then negotiate support and implement initiatives.

Immediate focus on cash and operational restructuring allows:
- to preserve asset value for the benefit of all stakeholders
- to fully understand the company before working on a comprehensive plan
- to become a credible broker for all stakeholders gaining their cooperation
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Conflicts in the “Board Room” and on the “Executive Floor”

- Between Board of Directors and Shareholders
- Within the Board of Directors
- Between Board of Directors and CEO
- Between CEO/BoD and Management
Governance Issues at Board level strongly depend on proprietary model

- **Public Companies**
  - The Seat Pagine Gialle case

- **“Strategic” owner**
  - Operational approach
  - Fix or close
  - Adverse to any insolvency procedure

- **Family owned**
  - From injecting the last penny to “milking” the last penny

- **P/E owned**
  - Financial approach: “never inject good money behind bad money”
  - There is no money available for rescue, while there is always for a good investment
  - The conflict of interest of the Management Company’s Partners when they are (or have been) also Directors of the distressed Company … at risk of insolvency
Role of the Turnaround Leader

- Acts for the company to maximise value
- Full respect of “restructuring in the zone of insolvency” rules (laws)
- Defined scope and time
- Interface with all other stakeholders
  - Communicates regular, transparent information on the Company
  - Understands the mind-set and information needs of stakeholders
- Situational expert
  - Consensual restructuring
  - Liquidity protection
  - Significant operational issues
  - Profit / liquidity trade-off
  - Asset disposal programme
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The players

- Agent Bank
- Co-Com
- Instructing Group
- Co-Com Brokers
- Board
- CEO
- CFO
- CRO
- Banks
- Pensions
- Company
- Equity
- Bond Holders
- CRO
- Financial Advisors Reporting Accountants Lawyers
- Financial Advisors Reporting Accountants Lawyers
- Pension Trustees
- Financial Advisors Lawyers
- Brokers
- Lawyers Accountants
- Financial Advisors Lawyers
- Financial Advisors Reporting Accountants Lawyers
Four Objectives and Seven Key Ingredients

Take Control
- Crisis stabilization
- Leadership

Resolve Future Funding
- Financial

Rebuild Stakeholder Support
- Stakeholder management

Fix the Business
- Strategic focus
- Organizational change
- Critical process improvements
Mitigating CRO risk

- Highly experienced practitioners
  - Risk mitigated through CRO’s day to day actions

- Regular, full communication with management team
  - Ability to propose a change to management team if more support required

- Actions approved by the Board of Directors
  - In line with Corporate Governance best practice

- Does not act alone – typically works with a supporting ‘CRO team’
  - Ensures decisions are made on sound analysis

- Typically require Company to include CRO in D&O Insurance policy

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