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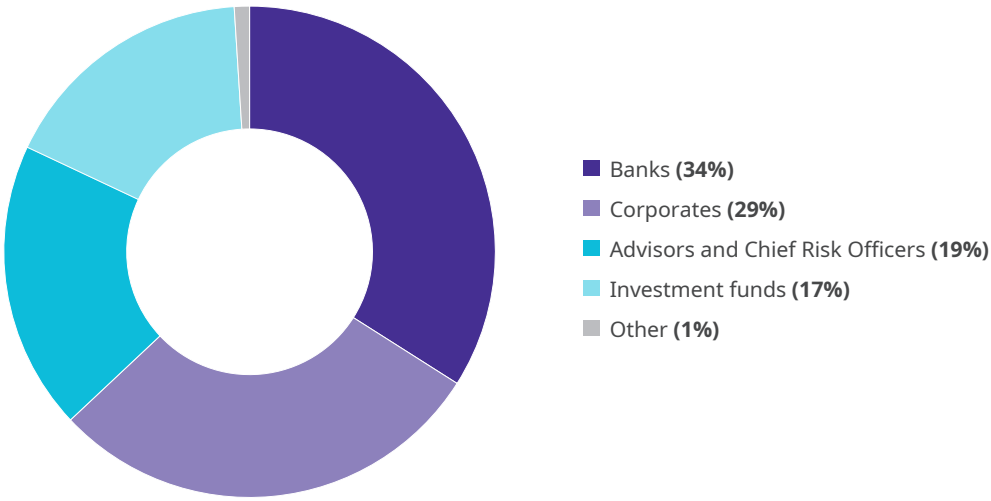
Successful restructuring in times of uncertainty

Lutz Jaede

SUCCESSFUL RESTRUCTURING IN TIMES OF UNCERTAINTY

The COVID-19 pandemic has brought about a period of prolonged uncertainty that is set to continue, perhaps for years to come. Within corporate restructuring there are many lingering questions and implications. For this reason we asked 150 restructuring experts for their opinion about how to move forward during uncertain times.

Exhibit 1. Structure of survey participants
In % of total participants



Source: Oliver Wyman Restructuring Survey 2020

64%

of banks surveyed will try to sell off their loans if they do not trust in their lenders in uncertain times

INTRODUCTION

Dear reader,

Uncertainty is an inevitable element of business. The COVID-19 pandemic hit the world almost overnight, but even before this event, many industries faced looming downturns or disruptive changes. The electrification of the automotive powertrain, the rise of the Industrial Internet of Things (IIoT), and fundamental changes of consumer buying habits are just a few examples of such developments disrupting many industries.

Lutz Jaede | Head of Corporate Restructuring

In these uncertain times, there are many lingering questions for corporate restructuring. Will banks need to be ready to take on more risk or will restructuring cases with uncertain perspectives require a stronger engagement of investment funds? Which challenges will become more acute for the management of distressed companies? And how should turnaround concepts and the restructuring process be amended to cope better with uncertainty?

These are the questions we address in this year's *Restructuring Report*. It is based on a survey of 150 restructuring experts across Europe, complemented by Oliver Wyman's own analysis and published insights.

We hope you find it an interesting read.

Sincerely yours,

Lutz Jaede

CONTENTS

MANAGEMENT SUMMARY

If you cannot predict the future, shape your own one

Prompt downturns or fundamental industry changes can happen suddenly and unexpectedly. This is true of the COVID-19 pandemic and other major crises. These are usually driven by external forces and are extremely difficult to predict or avoid. As uncertainty cannot be avoided, it is very important to be properly prepared.

Being bold and building trust

Companies who manage to be successful during uncertain market developments show similar characteristics. They act without hesitation and do not shy away from ambitious transformation or restructuring, which they also approach in a rapid manner. This helps them to avoid financial distress and may even allow higher profits after a successful transformation.

Financial support is available to help along the way. The willingness of investment funds to support a distressed debtor often increases when the situation is uncertain. The reason for this is the potential upside that investment funds see in situations where banks or other lenders may be unwilling to take risks.

If financiers are not confident of a successful turnaround, however, their readiness to withdraw their support also rises in line with the level of uncertainty they face. When we asked the study participants which mistake they deem to be dangerous for a company in times of uncertainty, they rated losing trust from the lenders as most critical.

Commitment requires information and involvement

Often, there is a clear correlation between a stakeholder's ability to deal with uncertainty and their proximity to management's decisions. Informing banks and other lenders better about the rationale and goals of a restructuring will improve their capability to understand and endorse the turnaround plan.

To achieve this, restructuring concepts need to put a particular emphasis on the market environment, the target picture for the turnaround, and the planned restructuring actions. Backward looking information is less important and digital tools do not help to set the right direction.

In this situation, it is important that top management displays a united front, shows confidence in the chosen target picture for the business, and works closely with middle management to execute the turnaround. This increases the odds for success even in uncertain times.

UNCERTAINTY IS CERTAIN

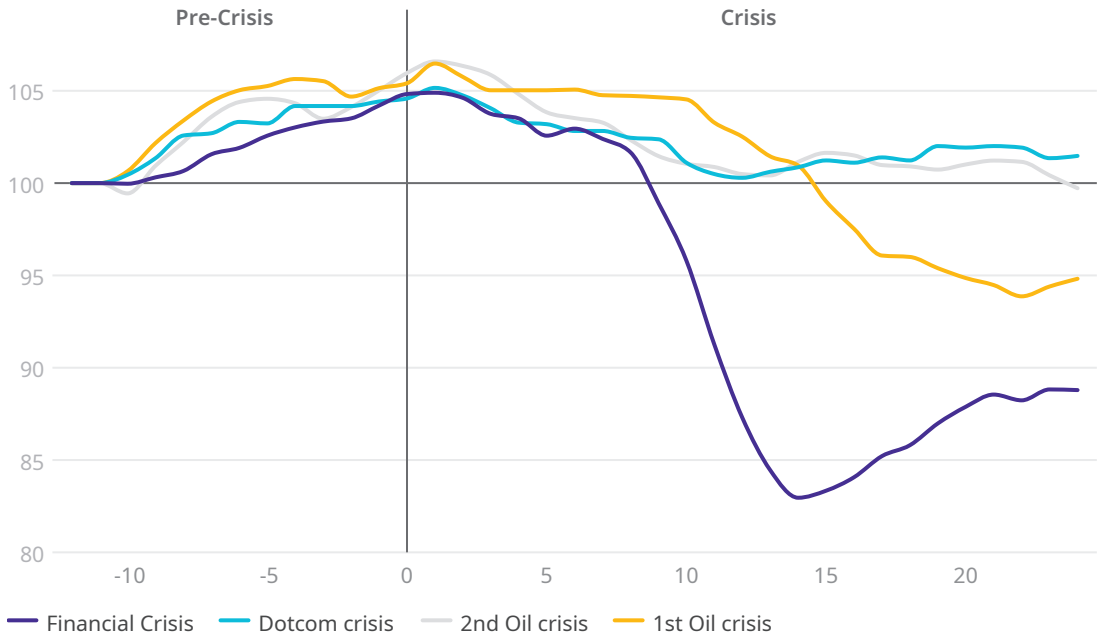
Our era is characterized by growing uncertainty. Imagine being told on New Year's Eve 2019 that a global pandemic would change our world so drastically, grounding global air traffic, with entire industry sectors being shut down by governments? And that it could be possible to reduce global CO_2 emissions so quickly? Even a few months back this idea would have seemed absurd, even preposterous. Uncertainty will no doubt continue, so it makes sense to learn to live with it.

Downturns always come unexpectedly

The downturn following COVID-19 is just another example how tides can turn in global economies. Crises, like the burst of the dotcom bubble, the financial crisis in 2008, and the oil crises, have something in common: they followed times of growth and positive sentiment. (See Exhibit 2.)

Exhibit 2. Patterns of historical crisis: Example German industrial production

3-month moving average (volume, seasonally adjusted), index peak month before crisis = 100

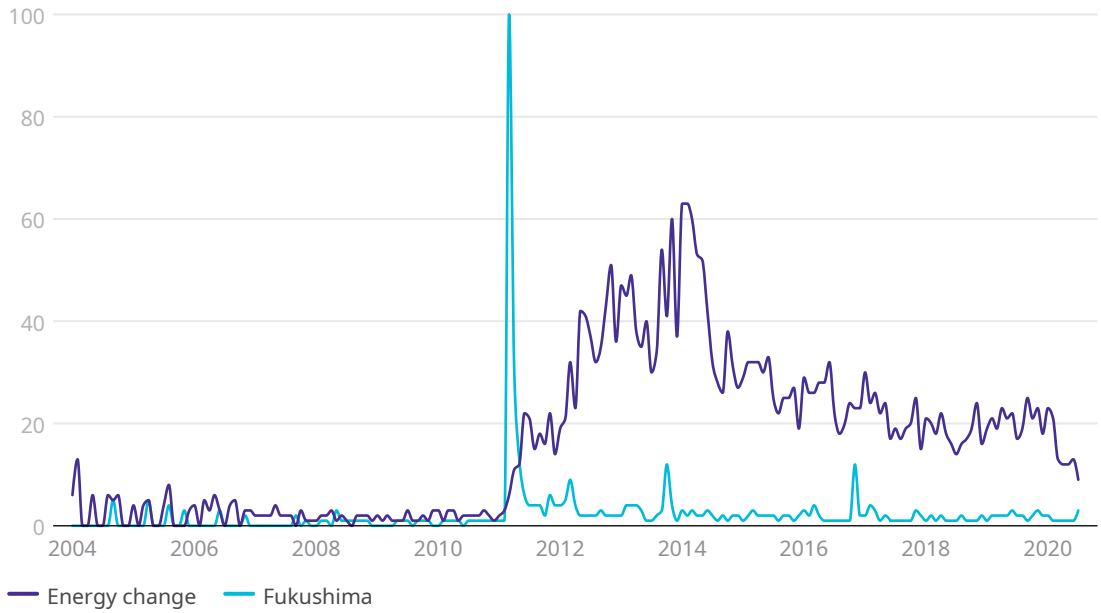


Source: Bundesbank, Oliver Wyman analysis

So, you may argue that there is no such thing as everlasting growth. Also, sudden and disruptive events can change industries quickly. Examples include the Fukushima earthquake that triggered the transformation of the energy sector (see Exhibit 3) or the rise of global positioning system (GPS)-enabled personal devices that destroyed the market for mobile car navigation devices.

Exhibit 3. Single event leading to disruptive industry change

Sudden change of interest in internet searches



Source: Google Trends, Oliver Wyman analysis

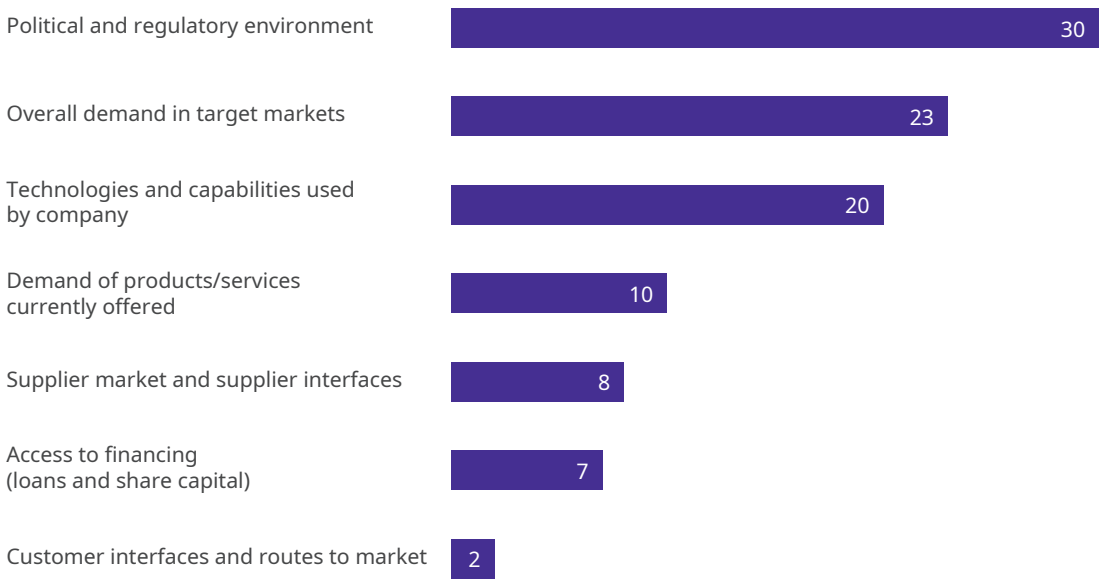
External forces drive uncertainty

In our survey, we asked for the most uncertain parts of the participants' business environment. Three areas turned out as particular uncertain across all industry sectors. (See Exhibit 4.) The political and regulatory environment was rated most often as being uncertain by the surveyed experts — certainly driven by recent developments like trade wars or regulations in the banking sector. The other two areas mentioned most frequently are overall market demand and technologies and capabilities needed to run the business competitively.

The areas of uncertainty mentioned above are driven by external forces and hence cannot be influenced by a company. The example of the COVID-19 crisis and sudden events like Fukushima also show that disruptive market changes can also not be forecasted or modelled. Therefore, uncertainty cannot be avoided, and companies need to find a way to deal with it.

Exhibit 4. Most important drivers of uncertainty

In % of total responses

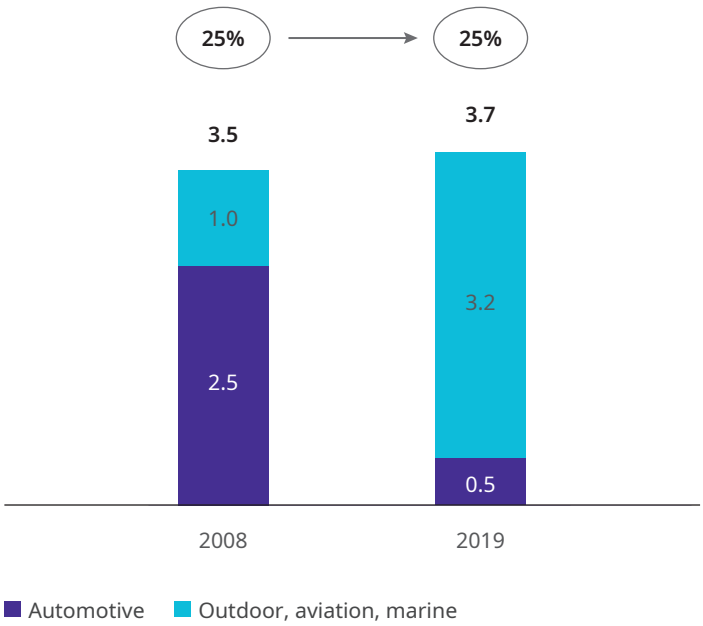


Source: Oliver Wyman Restructuring Survey 2020

TRUST IS KEY

There are ways to succeed even in uncertain times or amid disruptive events. One great case example is a major manufacturer of technology that uses global positioning systems (GPS). (See Exhibit 5.)

Exhibit 5. Revenue by segment and EBIT margin of a major GPS manufacturer
In $ BN and in % of revenue



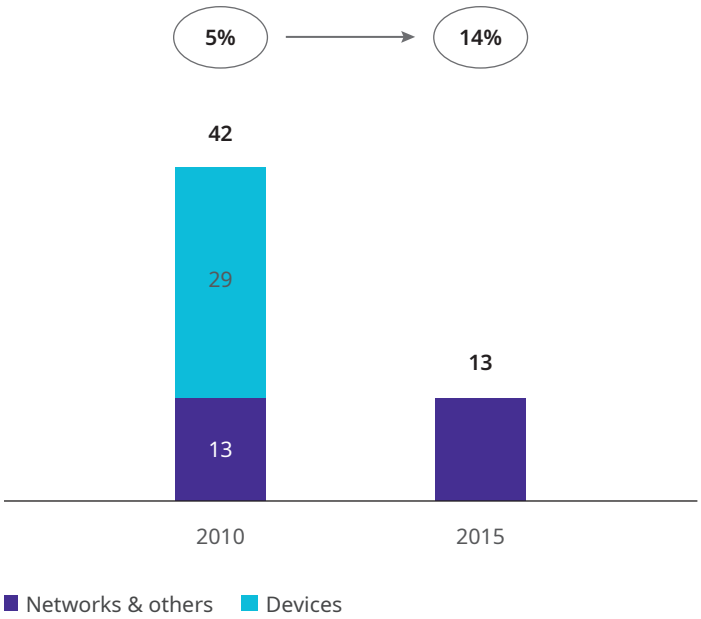
Source: Company reports, Oliver Wyman analysis

When a major tech giant entered the maps around 2008, 73 percent of the firm's revenue was from mobile navigation devices for use in cars. Their competitors tried to defend their position in automotive but ultimately lost this fight. This firm decided to leverage their understanding of how consumers use GPS devices and moved into other sectors like outdoor sports, aviation, and marine. Leaving behind your biggest business segment is certainly a bold move — but it paid off. Despite the massive restructuring of their business portfolio, their earnings before interest and tax (EBIT) margin remained above 20 percent during the entire transition. In 2019, they achieved 25 percent EBIT margin, although the share of the automotive sector had dropped to 14 percent.

Sometimes, bold moves need to happen fast. The example of a major European mobile vendor shows that determined moves may be a good strategy in changing industries. (See Exhibit 6.) After years of declining revenue and EBIT margins, this vendor sold its core business with mobile devices in 2010 — while still making profits! Only a few years later, the company looked entirely different and 90 percent of the revenue was achieved with networks. More importantly, the profitability increased by an order of magnitude with the EBIT margin rising to 14 percent. This early action may have saved the company while players who waited too long to make hard cuts may have ended up in bankruptcy.

Our survey results confirm these findings. A flexible operating model, willingness to change within the company, a strong offering, and trustful customer relations were mentioned as the most important factors that are needed to be prepared for unforeseen changes.

Exhibit 6. Revenue by segment and EBIT margin of a major European mobile vendor
In $ BN and in % of revenue



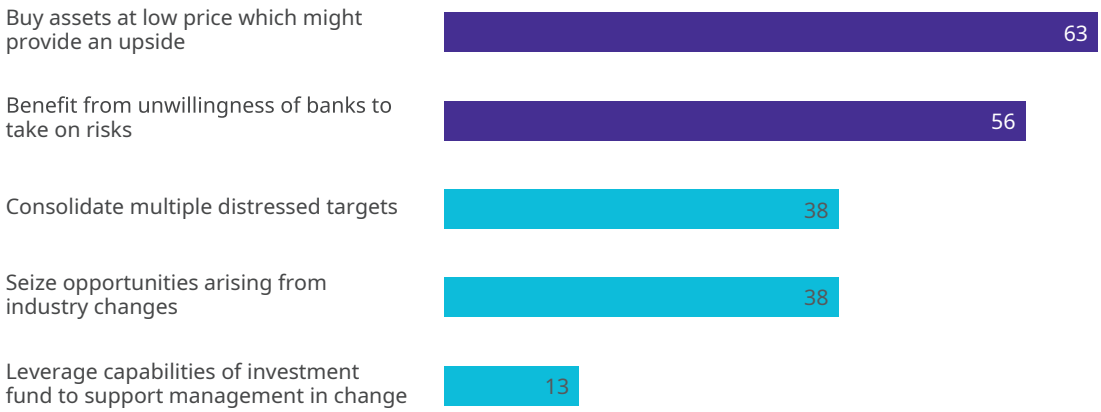
Source: Company reports, Oliver Wyman analysis

Willingness of investment funds to engage increases in uncertain times

Companies going through transformation usually require support from their financiers. Our survey also analyzed in more detail which levers might be applied to a distressed debtor in uncertain situations. (See Exhibit 7.) You can see that readiness of investment funds to engage in uncertain situations even increases in uncertain times, especially with regards to debt-equity swaps, granting participation certificates, the sub-ordination of loans in exchange for an upside, and in particular "super-senior" loans.

Exhibit 7. Opportunities when investing in a distressed company in an uncertain environment

In % of participants, investment funds only

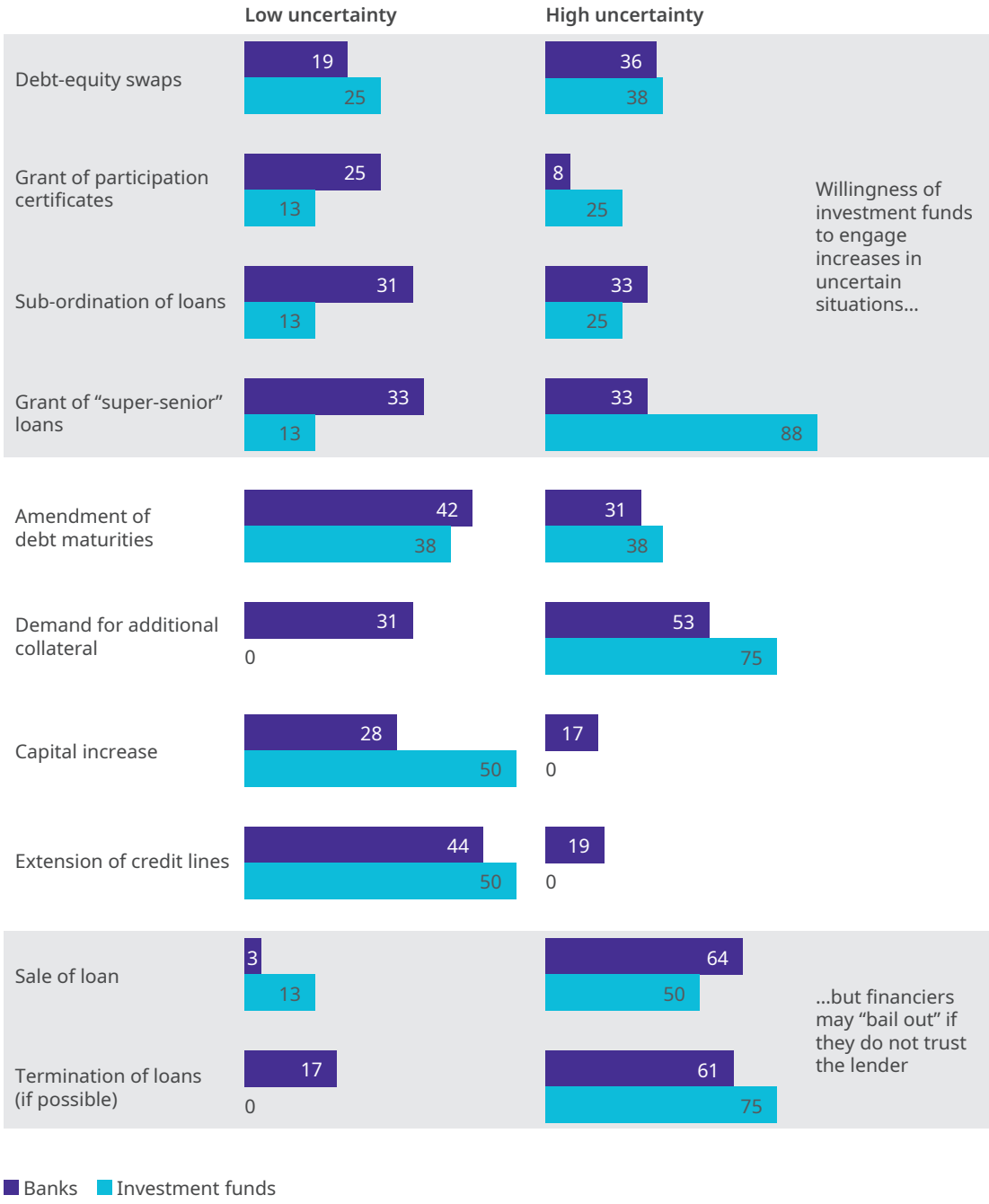


Source: Oliver Wyman Restructuring Survey 2020

Naturally, investment funds are well positioned to deal with uncertain situations. Being asked in our survey which opportunities they see from investing in uncertain situations, 63 percent of the investment managers responded that distressed companies in uncertain industries may be under-valued and can provide upsides. (See Exhibit 8.) Another 56 percent even stated that they can benefit in such a situation from the unwillingness of banks to take on risks.

Exhibit 8. Levers considered at different levels of uncertainty

In % of participants per group, banks and investment funds only



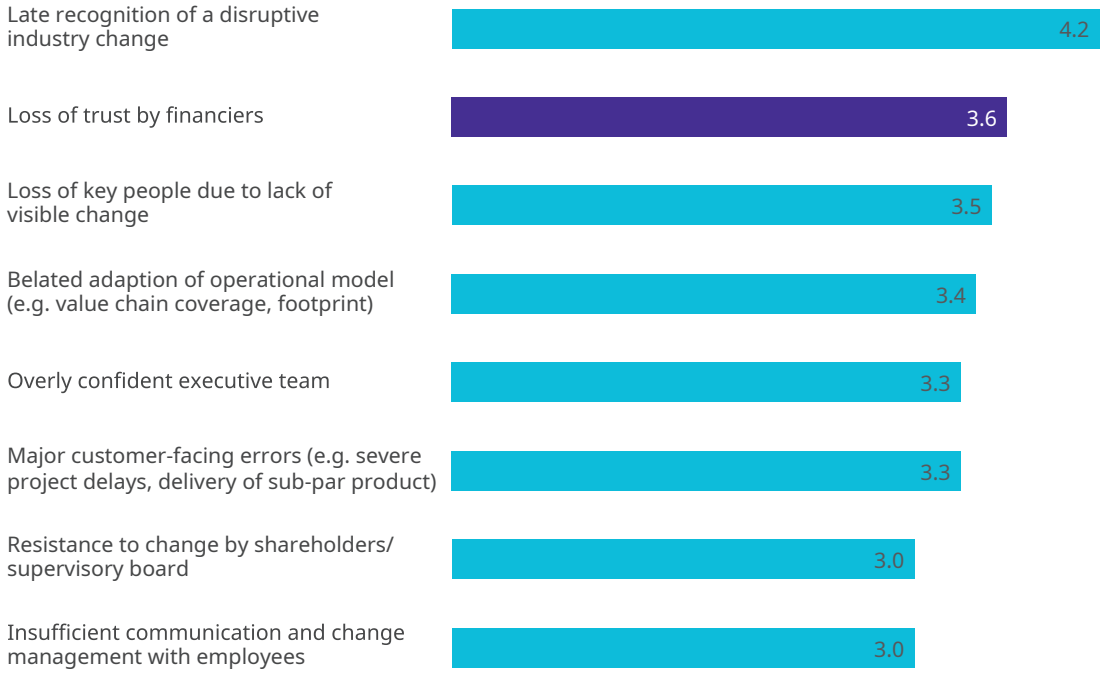
Source: Oliver Wyman Restructuring Survey 2020

Losing trust is a costly mistake

The same analysis also shows the danger associated with uncertainty. Most banks and investment funds consider actions to reduce their risk if they face an uncertain situation at a distressed debtor. At minimum, they will demand additional collateral. The majority will also contemplate selling their loan or even terminating it if possible. The key to avoiding this and benefitting from the abovementioned willingness to support is simple: you need to convince your financiers about the viability of the turnaround. Therefore, our study participants rate "loss of trust by financiers" as the second most critical mistake you can make in an uncertain situation. (See Exhibit 9.)

Exhibit 9. Critical mistakes in times of uncertainty

Average of responses, criticality rated on a scale from 1 (low) to 5 (high)



Source: Oliver Wyman Restructuring Survey 2020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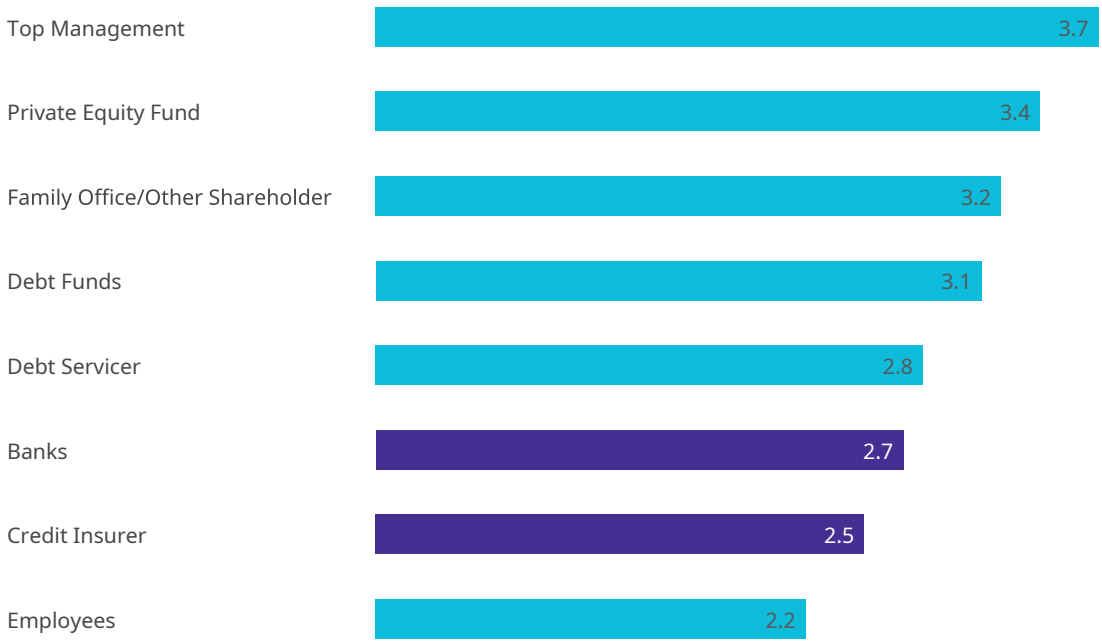
STAY ON COURSE

Information is key

So how can managers create trust with lenders and mobilize their organization to engage on bold moves in uncertain times?

You can find part of the answer by comparing the perceived ability of different stakeholders to deal with uncertainty. (See Exhibit 10.) The participants in our study state that top management and equity holders are best prepared to manage uncertainty. Banks, credit insurers, and employees, however, are rated as being much less equipped to handle an uncertain situation. It seems that the closer you are to the insights and decisions of the company leadership, the better you can understand and endorse the direction the company is taking to navigate through uncertain territory.

Exhibit 10. Ability of different stakeholders to deal with uncertainty
Average of responses, ability rated on a scale from 1 (low) to 5 (high)



Source: Oliver Wyman Restructuring Survey 2020

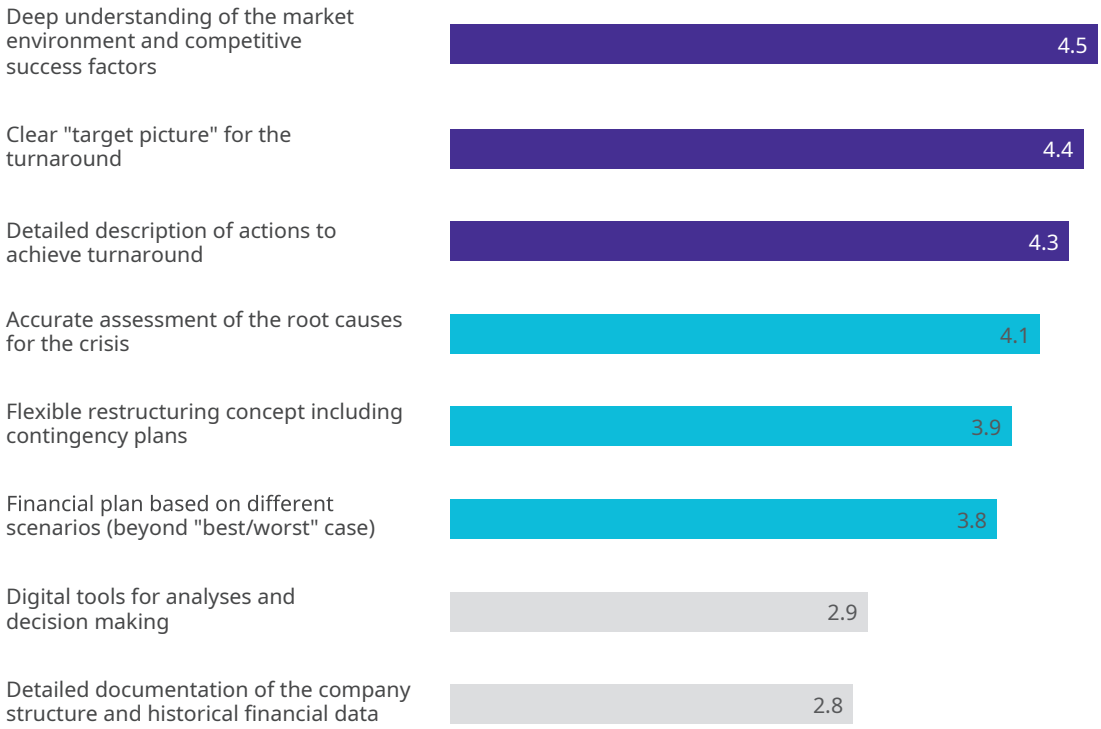
Learn, understand, act

Would the ability of banks and credit insurers to deal with uncertainty increase if they had a similar level of business insights as management and shareholders?

This hypothesis seems to be true. Exhibit 11 looks at some of the most important elements of a restructuring concept in uncertain times. These include having a deep understanding of the market environment and competitive success factors, establishing a clear target picture for the turnaround, and drawing up a detailed description of actions required. The responses to the same question also show that digital tools for analysis and decision making do not help a lot and backward-looking information like historical financial data and company structures are also deemed of less importance.

Exhibit 11. Most important elements of a restructuring concept in uncertain times

Average of responses, importance rated on a scale from 1 (low) to 5 (high)



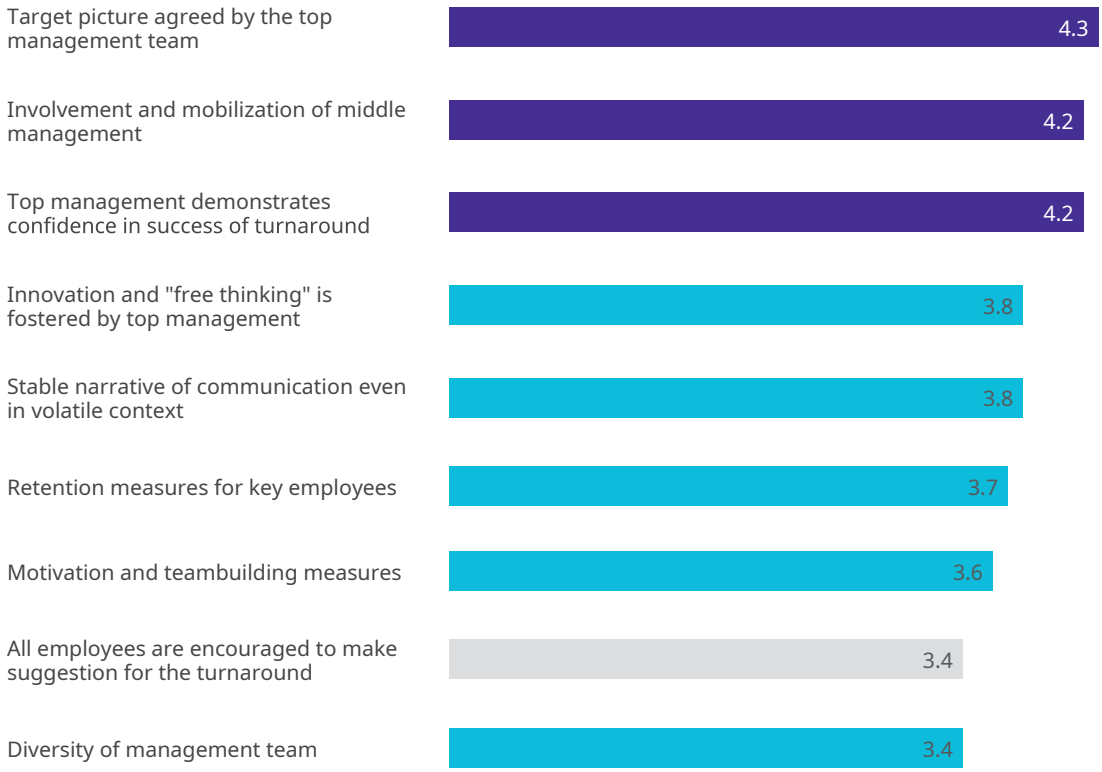
Source: Oliver Wyman Restructuring Survey 2020

Lead with confidence

The most important success factor to master a crisis in uncertain markets is leadership! (See Exhibit 12.) This starts with the senior management team agreeing how the target picture should look like. A lack of alignment or even hidden agendas in the company's leadership team is a recipe for failure. Also, the middle management needs to be mobilized and encouraged to embark on a journey with uncertain outcome. This will only work if they trust the course set by the leadership team. And this in turn requires that management teams demonstrate confidence in the success of the turnaround — even in times of uncertainty and amid setbacks which may happen along the way.

Exhibit 12. Most important requirements on the executive team to master uncertainty

Average of responses, importance rated on a scale from 1 (low) to 5 (high)



Source: Oliver Wyman Restructuring Survey 2020

FINAL THOUGHTS

Corporate restructuring requires a fine balancing act in any environment, and post COVID-19 it is likely to become harder. Uncertainty is pervasive. It cannot be avoided, modelled, or mitigated, therefore firms must work out the best strategies to be aware and prepared. It is therefore important that business leaders recognize the importance of this turning point and take decisive action. Waiting for the future to become more certain may waste precious time to act.

Business leaders must prioritize collaboration and accountability, with their own teams and external parties. They should treat lenders like shareholders, communicate early and comprehensively with financiers, who after all will only support a company through uncertain territory if they understand the need to act and the course ahead.

COVID-19 is unprecedented in its size, speed, and scale, therefore many executives may be experiencing self-doubt, being unable to rely on gut intuition honed by years of comparable experience. This feeling is natural but should not be an excuse to put off making big decisions. If you do not know where to go — just pick one of the options and move.

Above all, lead by example. Once they have chosen a path for the turnaround, firms must demonstrate alignment and confidence with their decision. Equally invest time to ensure that middle management is willing and able to follow. Many businesses may be struggling now, but can also take comfort in the fact they can capitalize on new opportunities for innovation as they rebound.

RESTRUCTURING WITH OLIVER WYMAN

Backed by years of experience, Oliver Wyman acts as a trusted advisor to banks, investment funds, and distressed corporates as they take on the challenges of strategic, operational, and financial restructuring.

We support commercial banks by providing solutions for their book of non-performing loans (NPLs), leveraging our deep understanding on the financial services industry and world-leading expertise in finance and risk. At the same time, we work with the world's biggest investment funds and advise them on investments in distressed debt and equity.

When working with distressed corporates, we place a priority on developing sustainable restructuring concepts that address the market and the competitive environment, as well as specific factors for achieving operational excellence. Oliver Wyman acts as a coordinator for restructuring processes, an objective expert, and a neutral third party who provides quantitatively supported advice to address the interests of management, shareholders, lenders, and other stakeholders.

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