Bankruptcy Part 2: Recovering

an eprentise white paper

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The previous article talked about the types of bankruptcy in the US and the options for restructuring. This whitepaper elaborates on restructuring in a Chapter 11 scenario. The initial turnaround plan considers an extensive analysis of what is working, and what is not working. Essentially, there are five components to this plan: debt restructuring, organization restructuring, cost reduction, revenue improvement, and evaluating divestiture or acquisition options. The plan must evaluate the risks of each component, the resources needed, and the expected results.

Debt Restructuring

The goal of debt restructuring is to settle and consolidate as many debts as possible by working with creditors. This typically involves taking a new loan to pay off a variety of creditors. Ideally, the terms of any debt restructuring deal should be advantageous to the company, reducing the total of amount of monthly payments and/or the total amount of principal and interest to be paid over time. Depending on the company's current situation, there are many different options for debt restructuring: [1]

- **A waiver or amendment of debt agreements.** Typically, the first step in a restructuring, particularly if the symptoms of distress are less severe, is to seek temporary relief from certain covenants in the company's debt agreements or to recontract with debt holders within the structure of its existing obligations, with the goal of modifying key terms in its agreements. This may provide relief from maintenance covenants (the obligation, for instance, to maintain a given debt-to-EBITDA ratio**)** or allow an increase in any limits on the amount of new debt the company can take on.
- **Debt-for-debt exchange.** When waivers or amendments are not possible, a debt-for-debt exchange can be a powerful tool to facilitate material change to a capital structure. It works like this: The company agrees with its debt holders to exchange existing obligations for new ones that have a lower principal amount, a lower interest rate interest burden, or a longer maturity (or some combination of these). These exchanges often involve both a carrot and a stick. New debt with a longer maturity could, for example, have priority over the old debt it's exchanged for in the event of a bankruptcy.
- **New debt or equity financing**. With the Fed's recent intervention in debt markets, many companies have been able to restructure by raising new debt capital to meet their liquidity needs. This has exacerbated their leverage problem but has had the benefit of preventing dilution to shareholders. The company can also raise new equity to pay down debt or fund business obligations, which dilutes the interests

[1] https://silo.tips/download/restructuring-strategies-and-post-bankruptcy-performance

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of current shareholders unless they participate in the new equity. Alternatively, companies may issue a "hybrid" instrument, such as a bond convertible into equity. With instruments of this kind, the amount of equity dilution to existing shareholdings will be less than if new capital were raised through an issue of common stock, due to the benefits of interest payments and seniority offered to investors.

- **Deleveraging through debt repurchase.** Instead of simply injecting more capital into the company as cash, shareholders can instead agree to repurchase the company's debt, usually at a discount to the debt's face value, and then cancel it in exchange for additional equity, thereby deleveraging the company and allowing it to use the interest payments saved to fund operations.
- **Debt-for-equity swap.** Certain debt holders could agree to convert all or a portion of their debt obligations into equity instruments, which would have the same deleveraging effect on the company as debt repurchases but would dilute the ownership of existing shareholders.

Organization Restructuring

Organization restructuring involves personnel and infrastructure. It may mean eliminating or changing management, or combining resource-heavy functions into a shared services center. Organization restructuring may involve consolidating distribution centers or warehouses, plants, or even office facilities. For many companies, Work-From-Home (WFH) is now the new normal, and offices and conference rooms are no-longer needed. From an IT perspective, systems can be consolidated and licenses and interfaces significantly reduced.

Cost Reduction

For a company who has filed for Chapter 11, a critical success factor is reducing costs by developing a monthly and yearly budget that limits unnecessary spending while maximizing profits. All contracts including supplier contracts, benefit contracts, joint-venture agreements, payment terms, and discounts for customers and suppliers may be reevaluated to determine most favorable terms and conditions, best discounts, and leverage the buying power of the organization and increase the cash flow of the organization.

Revenue Improvement

Revenue improvement can result from identifying new markets or products or rebranding existing products for changing market conditions. During the 2020

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pandemic, in order to survive, restaurants moved to take-out and delivery services, grocery stores moved to prepared meals, automotive manufacturers began to build ventilators. For many companies, the customer base changed, and the profile of opportunities for growth expanded. After a Chapter 11 filing, companies were able to improve their bottom line by looking at cost recovery opportunities including finding duplicate invoices or evaluating discounts and prices paid to suppliers. These cost recovery opportunities were the equivalent of 10 times the revenue received by direct sales because there is no cost of sales (A dollar recovered is equivalent to $10 in new sales).

Divestiture and Acquisition

Companies that are more active in M&A activities, including the acquisition or sale of (parts of) businesses after emerging from bankruptcy, exhibit a higher success probability. By evaluating those parts of the business, and the assets that are not essential to a company's future business plan, the company can sell the asset or business and use the proceeds to leverage the company or provide cash for use in the business. While under Chapter 11 protection, successful firms might thus be able to avoid divestments at fire-sale discounts.

Sale or Merging of the Company

Finally, a board may determine that the best way to maximize value and access liquidity is to merge the company with a third party who possesses more resources, and potentially synergies, with which it can achieve superior value for stakeholders than the company could achieve on its own. Private equity funds, which currently have fairly sizable funds to invest, are potential purchasers in these situations. Sometimes, it is also beneficial to acquire a company that has a complementary product or market strategy. It is a risky strategy, and may not realize the envisioned synergies. Many commercial buyers, however, might themselves be too strapped for cash in the current environment to take advantage of the opportunities afforded by the crisis.

Benefits of filing for Chapter 11[2]

There are many potential benefits to a Chapter 11 filing:

- Gives a bankrupt firm time to negotiate restructuring with its creditors while the firm's going concern value

[2] https://silo.tips/download/restructuring-strategies-and-post-bankruptcy-performance

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- Provides a unique opportunity for firms to establish a new and, presumably, more suitable capital structure
- Results in comprehensive restructurings or triggers a change to corporate strategy that can increase the firm's value.

Curious?
For more information, please call **eprentise** at **1.888.943.5363** or visit **www.eprentise.com.**

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