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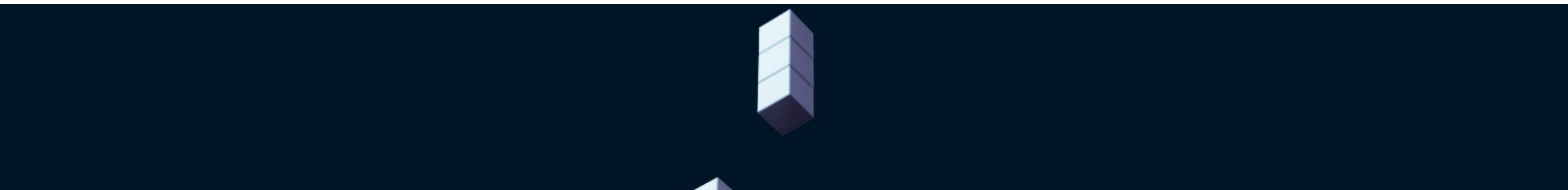
Road to recovery: The state of corporate restructuring in Europe

As the next normal draws nearer, trends in corporate restructuring are coming into focus. Here's how organizations can prepare.

This article was a collaborative effort by Julian Gething, Sam Hodgkinson, Richard Hudson, Matt Johnston, David O'Neill, and Marta Wlodarz, representing views from McKinsey's Transformation Practice.



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As the COVID-19 pandemic continues to threaten lives and livelihoods, many hard-hit European companies face an uncertain future. Their profitability has declined as a result of significant market disruption during the pandemic. At the same time, they have taken on massive amounts of debt to offset the loss of cash flow. Globally, corporate debt issuance reached a record \$5.4 trillion last year (a 20 percent increase from 2019), with another \$3.5 trillion from syndicated loans.[1] European Union data shows that European companies added more than €400 billion in debt over the first half of 2020, compared with €289 billion in the whole of 2019.[2]

Many struggling organizations will have found some stability through government aid. The fiscal response to the COVID-19 crisis was three times bigger than seen for the 2008–09 financial crisis, with fiscal packages estimated at more than \$10 trillion in the G-20. Western European countries alone have allocated close to \$4 trillion, an amount almost 30 times greater than today's value of the Marshall Plan.[3] But, when the support ends, companies with reduced profitability or unsustainable debt-service costs will face a looming concern: Will they be able to survive?

One solution for debt-saddled firms will be to reduce their debt by restructuring their balance sheets, opening the pathway for them to recover from the crisis and position their organizations to thrive in the next normal. As organizations look to restructure, we surveyed 114 European restructuring experts to forecast trends for the coming year across sectors, geographies, and solutions. Not surprisingly, 92 percent of respondents expect to see overall restructuring activity rise over the next 12 months, with leisure, transportation, and retail sectors ranking highest among industries for expected restructurings. Indeed, we have already seen increased refinancing, restructuring, or insolvency of organizations in these industries.

In this article, we share trends that emerged from our recent survey and explore the primary actions that organizations can take today to prepare for a potential restructuring.

Why restructuring activity is expected to rise across Europe in 2021

Much has been written about the fiscal response to the COVID-19 crisis. Along with the European Union as a whole, many national governments have provided a temporary respite for struggling organizations and individuals through fiscal packages, often borrowing heavily to finance the relief. That has led to high levels of government debt. In the United Kingdom, for example, government debt rose to more than £2 trillion, a record and more than 100 percent of the nation's GDP (a ratio not seen since 1963). In the eurozone, the combined budget deficits in October were 11.6 percent of GDP, compared with 2.5 percent in the first quarter of 2020; total debt hit a record 95.0 percent of GDP.

As the pandemic recedes, government support and furloughing schemes will inevitably end as progress allows and to avoid negative effects on sovereign credit ratings. For companies needing cash, this reckoning could be painful. These organizations have been borrowing at record levels, while shrinking their working capital. At the same time, profitability has declined for many amid the significant market disruption caused by the pandemic. It may take years for certain markets to recover to pre-COVID-19 levels. Our modeling shows airline travel, for example, may not recover to prepandemic levels until 2023. Businesses that do not prepare for the end of support schemes and quickly return to their pre-COVID-19 steady state may find themselves in a vulnerable position. Even if the business recovers quickly, working capital will still need to be rebuilt.

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[1] Eric Platt, "Distressed debt specialist Howard Marks warns on corporate borrowing burden," *Financial Times*, January 5, 2021, ft.com.
[2] William Horobin and Alexander Weber, "Europe's corporate debt binge risks years of pandemic pain," Bloomberg, November 22, 2020, bloomberg.com.
[3] Ziyad Cassim, Borko Handjiski, Jörg Schubert, and Yassir Zouaoui, "The \$10 trillion rescue: How governments can deliver impact," June 2020, McKinsey.com.

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Corporate creditworthiness has been compromised because of the crisis, with S&P Global predicting European default rates will rise to 8.50 percent by June 2021 from 3.35 percent in June 2020. Nearly 90 European companies (three times the norm) are currently in an "unstable" or at-risk state, with either a negative or long-term debt rating of B– to CCC–, according to S&P Global. If the past is prologue, these companies are approaching a critical point. Default rates peaked 12 to 18 months after the 2008 financial crisis; the pandemic started hitting European concerns in the first half of 2020.

That means debt-saddled firms may soon have to make a choice: execute a swift corporate restructuring or, at best, grind on hoping business performance picks up sufficiently to allow them to service their debt over many years. At worst, these companies can become zombie-like—existing in a never-ending cycle of cost-cutting and inadequate investment while their top lines stagnate—or even decline, leaving little hope of being able to repay their debt in full.

The most vulnerable business sectors

While the advent of various coronavirus vaccines could boost economic activity, some sectors will be harder hit than others, as always occurs when there are seismic disruptions. The travel, leisure, and tourism sector and the consumer sector have borne the brunt of continuing localized lockdowns and travel restrictions throughout Europe. Already, prominent leisure, transportation, and retail groups have had to be recapitalized or placed into insolvency. These sectors are singled out for expected restructurings at a much greater rate in our survey.

Survey respondents did not find a consensus in addressing the likelihood of restructuring activity in other sectors, though the oil and gas and manufacturing industries appear to be vulnerable too, according to respondents. The pandemic has been a considerable setback for the European automotive sector, with new vehicle registrations, for example, declining about 25 percent last year across the continent's five biggest car-buying nations: Germany, the United Kingdom, France, Italy, and Spain.

That said, the pandemic's effects are highly varied. There could be companies that find themselves in distress even within sectors that have been relatively spared from pandemic disruption as compared with the last recession. We will be publishing more on the implications for the higher-risk sectors highlighted by our survey over the coming weeks and months.

Companies have many restructuring options at their disposal

Whereas an uncontrolled insolvency causes a loss in economic value for a business and its stakeholders while threatening jobs, a successful balance-sheet restructuring ensures the business's long-term survival by freeing it from the stifling impact of debt encumbrances.

In our recent survey, just more than half of the respondents said insolvency would be among the three most likely restructuring solutions to be deployed to tackle poor trading performance and unsustainable debt levels. But a wide array of non-courtroom restructurings is expected as well, including debt-for-equity recapitalizations and fund injections principally from distressed-debt investors, private equity, and, in the short term, government support.

New restructuring tools available in many jurisdictions will support this trend—including new "cramdown" tools[4] introduced in Germany, the Netherlands, and the United Kingdom—particularly as a stick to drive consensual, noninsolvency solutions. In Europe, €76.7 billion of private-credit dry powder is available to companies as they restructure and seek to avoid the worst case: insolvency.[5] In 2020, many companies received liquidity bridges through the pandemic crisis, and the vast amount of private capital available alongside continued government support in the immediate future will likely delay a big wave of restructuring activity or insolvencies in 2021, though it won't forestall the inevitable for some.

Other tactics include the use of "amend and extend" of debt facilities or covenant resets to provide companies with more time, as well as mergers and acquisitions. One or two big deals could signal a wave of consolidation as stronger competitors capitalize on depressed asset values by seeking to expand share or move into adjacent business lines, while private-equity and distressed-debt investors look for value in turnarounds (60 percent of survey respondents said such investors would be one of the top three choices of funding).

No self-help solution is likely to be off the table. The survey respondents expect companies to tap shareholders to address funding gaps. Debt-for-equity swaps are likely to be used to a sizable degree. In fact, various major restructuring agreements announced during 2020 already featured some of these solutions.

In short, restructuring companies have many options. There is, however, a threat that should not be lost. In the survey, many respondents highlighted the risk of loose covenants or light-touch security packages and linked these to a company's ability to survive the pandemic and avoid insolvency. These tools allow companies to delay a restructuring of their balance sheets until they run out of cash, but at that point, there can be too little time to negotiate a solution with lenders or to evaluate restructuring options that would ensure their business survives, increasing the risk of a value-destructive uncontrolled insolvency.

What's next?

Very few organizations will avoid the effects of the pandemic. Those that have been most adversely affected can turn to restructuring solutions as markets emerge from the crisis. Stronger companies, meanwhile, can begin thinking about expanding on the other side of that equation, seeking to acquire new businesses or entering new markets.

For companies concerned they may need to act to save their business, there are four key steps:

1. *Avoid denial.* To paraphrase the writer David Foster Wallace, sometimes the most obvious and important realities are the ones that are hardest to see. Accept the reality of the situation and engage honestly with stakeholders to identify and implement the correct solutions before it is too late to avoid insolvency. That includes taking the right steps to transform the business in the context of a postpandemic world. Build a robust and sustainable business plan based on realistic recovery expectations that will position the business with the right capital structure to go forward.

[4] Cramdowns enable courts to impose restructuring plans despite objections by certain classes of creditors.
[5] PitchBook.

2. *Conserve and create cash.* To mitigate the pandemic's effects, many companies refinanced during 2020, raised new equity capital, and announced cost-reduction plans with an initial focus on low-hanging fruit. These moves were based on the assumption of eased lockdown restrictions and restored growth by the end of the year, even if trading had not yet rebounded to pre-COVID-19 levels. With lockdowns reintroduced around the world, new restrictions imposed on mobility, and the emergence of new strains of the virus creating further uncertainty, these initial assumptions are coming under strain, with recovery in trading expected to take longer.

   There is an imperative then for companies to continually reassess their business plans and potential downside cases with a view toward identifying their liquidity requirements and the actions needed to return financial performance to sustainable levels. Many organizations took drastic measures to conserve cash in their initial response to the pandemic, but with the recovery taking longer than expected, companies should continue to focus on both short-term tactical and longer-term structural self-help solutions that free up or otherwise optimize cash and business performance.

   Moreover, companies can build the current focus on cash into long-term cash excellence by establishing a "cash culture" across the organization, where preserving cash is a fundamental part of ongoing operations. With more cash headroom, companies can begin to consider allocating capital to future growth opportunities.

3. *Embrace transformational change.* As the post-pandemic economic recovery slowly takes hold, now is the time for companies to embrace more holistic and radical transformational change to emerge stronger for the next normal. The key will be to balance this within any liquidity constraints and achieve a position where the transformation is self-funding very early on. Companies can take the following steps:

   - *Reimagining their purpose and value agenda.* The COVID-19 crisis has spurred organizations to consider several big questions to better meet customer and employee needs: Who are we? How do we operate? How will we grow? The answers to these questions will help shape how companies will look in the post-pandemic future.

   - *Innovating their products and services and the markets they operate in.* By doing so, companies can meet new trends and changes in consumer behavior (as a result of both the pandemic and pre-COVID shifts) while also divesting noncore businesses to raise funds and reposition the business's focus.

When businesses are in distress, retaining top talent becomes extremely challenging. But without talent, sustaining performance or restarting growth becomes all the more difficult.

- *Radically changing how they operate* to reduce structural complexity and increase speed—getting things done well and fast. That includes developing a bias to action while retaining and developing the right talent to deliver on the value agenda.

4. *Retain talent.* When businesses are in distress, retaining top talent becomes extremely challenging. But without talent, sustaining performance or restarting growth becomes all the more difficult. Now more than ever, companies are reimagining their personnel practices to build organizational resilience and drive value.

The coronavirus pandemic has wreaked havoc on key sectors of the European economy, particularly those facing consumers. As a result of this seismic disruption, many companies are left with their cash stretched thin and debt that cannot be fully serviced. For these companies, a debt restructuring may at some stage be necessary to ensure they survive. Regardless of loose financial covenants, companies need to be realistic and proactive in all matters, retaining control of the process and their destiny by acting while there is sufficient runway to implement a solution can reduce the risk of an uncontrolled insolvency.

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