

“Loan-to-Own”: Europe’s Latest Acquisition Strategy?

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WHAT IS “LOAN-TO-OWN”?

“Loan-to-own” is the process by which investors buy into a piece of distressed debt (that is, debt trading at a discount because the market considers that the debt is unlikely to be repaid in full and on time) with a view either to: (i) swapping the debt for a potentially more valuable equity stake in the company; or (ii) enforcing security over the company and/or its assets, with a view to taking control of the company as part of a debt restructuring. A distressed company which is over leveraged but has a viable underlying business (good business, bad balance sheet) makes for the ideal target.

Typically the loan-to-own strategy has been more prevalent in the United States than it has been in Europe. There are a number of features of the Bankruptcy Code’s Chapter 11 regime which make the business of distressed investment appealing and serve to encourage loan-to-own transactions. Chapter 11 allows a business to continue operating whilst a plan of reorganisation is formulated under court supervision. If a company commences a Chapter 11 case, a secured creditor can participate in an auction of the company’s assets by credit bidding the full face value of its allowed secured claim as opposed to the discounted purchase amount of the claim. There is the ability to provide debtor-in-possession (DIP) financing resulting in super priority claims and liens once approved by the court, and DIP lenders can have a significant amount of influence over any potential

plan of reorganisation or asset sale. An investor can participate in a rights offering to increase its holding in the new equity of a reorganised company either as part of the Chapter 11 process or before, in the context of a pre-packaged bankruptcy. An investor may also opt to be a plan sponsor, agreeing to contribute liquidity to enable the company to make distributions under its Chapter 11 plan.

Europe, by comparison, has historically seen less loan-to-own activity, possibly owing to its divergent (and sometimes inflexible) insolvency laws and procedures. What little loan-to-own activity there has been has, until more recently, been primarily the preserve of specialist debt investors. However, faced with limited M&A opportunities in the current economic climate, it is perhaps unsurprising that more investors are now looking at investment in financial assets which could in due course transform into a new addition to their equity portfolio.

RECENT EUROPEAN EXAMPLES

The first significant loan-to-own transaction in Europe in the current downturn concerned Countrywide, the UK’s largest estate agency group. The financial crisis and consequent decline in residential housing transactions had put the group under pressure. As of March 2008, the company’s debt and loan notes were trading in the secondary market at levels as low as 30 per cent. of face value. In May 2009, Oaktree took advantage of this discount to build up a stake in Countrywide’s debt, before successfully launching a restructuring proposal which saw them, alongside incumbent sponsor Apollo Management and co-investors Alchemy Partners and Polygon Investment Partners, investing £75 million in return for 60 per cent. of the new equity post restructuring.

The existing equity sponsor may not always be so willing or able to write an equity cheque of sufficient amount to win the support of creditors. Whilst Countrywide is illustrative of the loan-to-own strategy resulting in a collaborative exercise as between the existing sponsor and loan-to-own investors, the strategy may actually displace the existing shareholders altogether, as illustrated by the recent example of German roofing company Monier.

In July 2009, debt investors Apollo, Towerbrook Capital Partners and York Capital Management built up around a 20 per cent. stake in Monier's senior debt in the secondary loan market. They were therefore able to propose successfully an alternative restructuring plan to that put forward by incumbent equity sponsor PAI Partners (despite the fact that PAI's offer of €135 million of new money was one of the largest recent new money bids from a sponsor to buy back a portfolio company). Whilst the Apollo led proposal left more debt in place it offered more equity – CLO managers in particular found this favourable for their portfolios. The three debt investors subsequently emerged as the three largest shareholders post restructuring. PAI meanwhile reportedly received no equity entitlement at all.

Dutch brewing company Heineken's recent arrangement with UK pub operator Globe Pub Company illustrates that it may, in certain circumstances, also be possible for trade buyers to execute loan-to-own strategies. Heineken (through its subsidiary S&N Pub Enterprises) was tied into a beer and corporate and estate management supply contract with Globe which obliged Heineken to continue providing Globe with beer and management services despite Globe's financial difficulties and even though payments to Heineken were subordinated to bondholders and lenders. When Globe ran into financial difficulties (due to factors such as the smoking ban in pubs, the credit crisis, increased beer duty and availability of cheap drinks in supermarkets) and defaulted on its debt facilities, Heineken acquired a stake of just under 50 per cent. of Globe's debt (a combination of Class A1 notes, junior bond notes and bank debt) through a series of debt purchases during April and May 2009. The acquisitions gave Heineken a blocking stake and hence a say in the restructuring.

In October 2009, an administrative receiver was appointed by the bondholders and the business sold to a new acquisition vehicle (EBP Pub Company) for £180 million. Heineken provided EBP with the funding for the acquisition; Heineken and the controlling shareholders of EBP entered into a conditional share purchase agreement giving Heineken the right to acquire full ownership of EBP in the third quarter of 2010; and Heineken continued to supply beer and corporate and management services to the group.

ASSESSING THE LEGAL AND COMMERCIAL VIABILITY OF LOAN-TO-OWN STRATEGIES

For a loan-to-own strategy to succeed, any investor will need to assess the viability of a loan-to-own strategy on a case by case basis. The entity's valuation, the financing structure of the relevant entity, the different classes of creditors (and potentially differing views within those classes), the rights of existing equity investors and debt, security and intercreditor terms must all be considered carefully.

With economic value breaking in the senior debt and junior creditors increasingly out of the money in many of today's leveraged deals, an investor must be sure to acquire debt at the right level of the capital structure. An investor needs to take care that it does not buy into a piece of the debt that will be wiped out or receive only a nominal amount. For example, for a loan-to-own strategy in the senior debt to succeed, the ability of senior lenders to secure a senior led proposal (over competing proposals from creditors at different levels of the capital structure) and the ability to cram down any dissenting creditor groups (such as mezzanine and other subordinated creditors) who may not agree with a senior led proposal, will be imperative.

In the UK, it is possible to propose a scheme of arrangement under Part 26 of the Companies Act, to only certain classes of creditors. It is therefore possible to develop a restructuring plan that only involves senior classes of creditors, and which combines the scheme of arrangement with a further sales process in order to 'strand' the junior debt in the rump insolvent company. A UK scheme of arrangement also affords the ability to cram down dissenting creditors within

a class (for example, a minority of dissenting senior creditors) as the scheme is binding on all creditors once the appropriate level of approval has been obtained (75 per cent. in value and 50 per cent. in number in each class of creditor). This ability to cram down dissenting creditors is not however available in all jurisdictions.

A detailed understanding of loan and intercreditor documentation will be key. For example, the terms of the finance documentation will need to be considered to see what aspects of the restructuring will require a unanimous decision, and what a majority decision. Some transactions have the concept of 'super majority' (that is, ninety per cent. of relevant lenders). 'Meaningful' restructurings with bank debt are likely to require unanimous consent as they will invariably involve deferring or rescheduling capital payments, for example by changing the repayment dates or changing the amortisation profile or converting debt to equity. Dissenting creditors can therefore have a significant amount of hold-up value absent a cram down mechanism.

The intercreditor agreement will require analysis to see whether, among other things, the senior creditors have the right to direct the security trustee on the enforcement of security and the structure enables the release of existing security in an enforcement or default context to allow assets to be sold free of existing security. If the junior and senior lenders share a security package, and the security agent requires the consent of not only the senior creditors, but also the junior creditors in order to affect a release of security, this could have the potential to hamper a senior led restructuring.

There is little to be gained if a creditor's claim has been released against the principal debtor but he is then able to immediately enforce a guarantee. A scheme of arrangement under English law does not per se deal with guarantees. Case law (most recently *In the matter of Lehman Brothers International (Europe) (In Administration) (No.2)* [2009] EWCA Civ 1161) suggests that releases of third party claims through the terms of a scheme of arrangement are permitted, at least insofar as guarantees of the debt compromised by the scheme are concerned, however the relevant

third party claims must be closely connected with the claims against the company compromised as part of the scheme. Whether such releases will be recognised in other jurisdictions will require analysis.

If the restructuring proposal requires the enforcement of security (either over shares or assets), the procedures under the relevant security documentation and local laws will be important. Events of default, and the mechanics of acceleration and enforcement (including existence of waiting periods and any requirement for public auctions in certain jurisdictions), will all require consideration. Enforcement of security over assets will generally be governed by the laws of the place where the assets are located. If, for example, the key asset of a target based in the UK is a production site in Germany, the acquiror of an English law governed loan may be faced with enforcing a German law land charge in order to become the new owner of the site.

Cross-border issues will also be at the fore if the group debt has been pushed down into operating subsidiaries in different jurisdictions. The risk that debts and liabilities compromised in English proceedings might not be regarded in other jurisdictions as having been varied or discharged will require careful analysis.

There are likely to be change of control provisions which may lead to termination of material contracts, a requirement for competition clearance, and so forth. If the restructuring does give rise to change of control concerns, the definition will require particular attention, for example, to see whether it is determined by share ownership alone or whether there is an element of economic interest too.

CONCLUSION

Of course, it may not be possible to obtain the necessary information prior to purchasing the debt as there may be confidentiality issues, such as contractual confidentiality obligations, restricting the amount of information which can be disclosed to potential debt purchasers. Securities and insider trading laws may also restrict a seller's ability to disclose information. However once the debt has

been purchased, the investor will be party to detailed information about the company and its position by virtue of its position as secured creditor.

Whilst loan-to-own may have been gaining momentum in Europe in the latest downturn, whether it will ever become as prevalent a feature of

the European landscape as it is in the United States remains to be seen. There are certainly lots of legal and commercial issues for any interested investor to grapple with and the viability of any loan-to-own strategy will always need to be considered on a case by case basis. Certainly not a strategy for the faint hearted.