Thesenpapier

The renaissance of radical operational restructuring?

Post Corona: 7 Predictions for the German Turnaround Industry

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INTRO DUC TION

Within a matter of a few weeks, the Corona virus epidemic developed from a local crisis in China, to a worldwide pandemic that has brought the world's economy to a virtual standstill.

From a business perspective, this means that many companies are not only facing an existential crisis, but that they have skipped all the classic crisis stages (stakeholder, strategy, sales, profitability and liquidity crises) on their way there.

While in some places we are beginning to see some light at the end of the tunnel, the far reaching effects have yet to be seen. For the restructuring community, this is especially disconcerting. The meat of our work, finding and implementing a sustainable business model for distressed companies, is based upon assumptions of how the overall market will perform in the next 18–24 months.

For that reason, and in order to help you develop a better understanding of what the Corona Pandemic will really mean for the turnaround management community, we have developed a set of 7 predictions of how we see the German turnaround environment moving forward.

THESIS 01

EXTENDED RECESSION

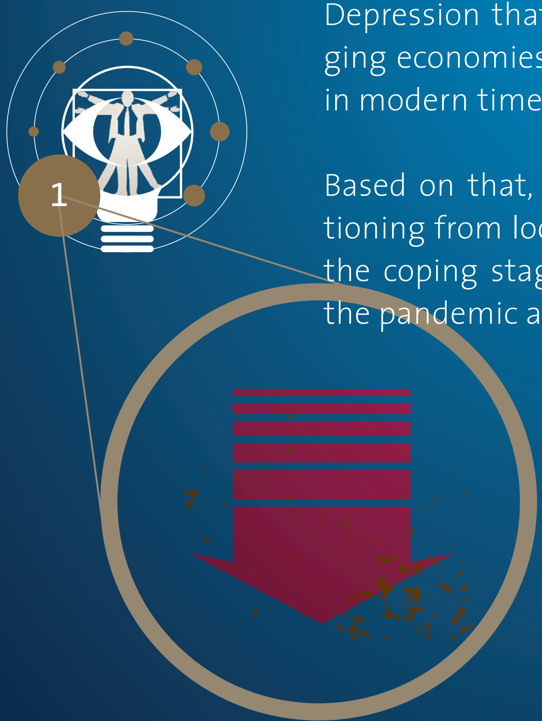
Due to the extent of the effects of the pandemic on global supply and demand, this crisis will last much longer than previous recessions.

The effects of the Corona crisis have been truly global, effecting much more than a single industry or region.

On the supply side, we see longer delivery times and slower production rates caused by production stops both inside Germany and internationally. As the pandemic grows, quarantines as well as sick leave also will slow production.

On the demand side, consumption has dropped significantly at all of Germany's major trading partners. This is compounded by the uncertainty as to whether it will continue to drop or when it will start increasing again. The Corona crisis is the first time since the Great Depression that both the industrialized western world and the emerging economies have simultaneously been hit with a recession, which in modern times average about 11 months (US NBER).

Based on that, over the next 18–24 months we see the crisis transitioning from lockdown to coping and finally back to growth. How long the coping stage lasts will be dependent both on any resurgence of the pandemic and our society's/government's reaction to that.



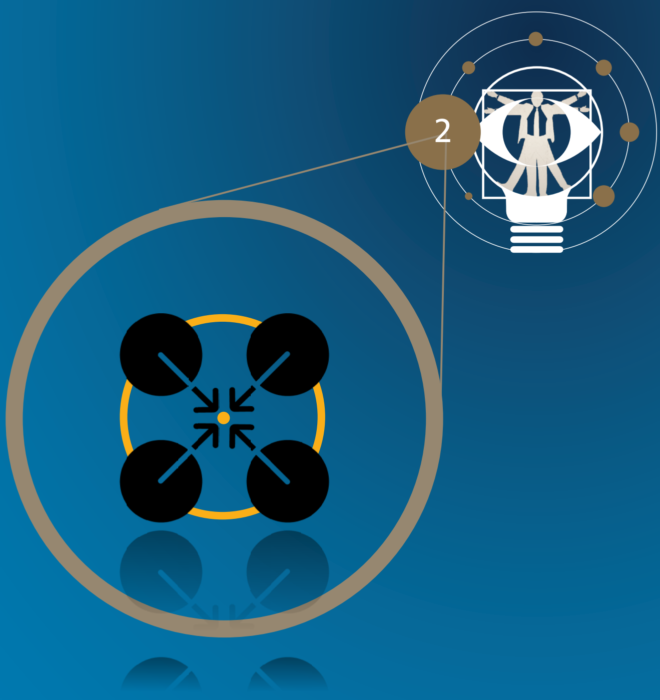
THESIS 02

SUPPLY CHAIN RESTRUCTURING

Over the long term, companies will reevaluate their global sourcing strategies and reduce their risk by increasing the amount of local sourcing.

The Corona crisis has hit the Achille's heel of our global economy: A tight, highly optimized, global supply chain integration.

Many companies are realizing just how susceptible their global supply chains are to the failure of one or more links in the chain. We expect that the perfectly "tuned" value chains of industries like automotive or industrial machinery will be revamped with a particular focus on resilience. This will mean companies finding a balance between minimizing costs and redundancy and in some cases may require rethinking parts of their business model.



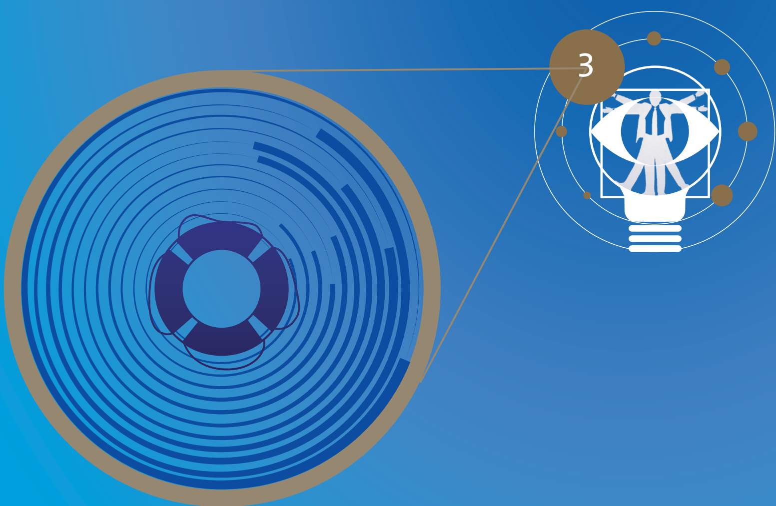
THESIS 03

LOST OPPORTUNITY

Government stimulus programs have been primarily used to keep companies out of bankruptcy while the opportunity to improve competitiveness is being lost.

Both the "Corona Shield" and the special loan programs of the KfW (Kreditanstalt für Wiederaufbau, Germany's state-owned development bank) offer companies the possibility to finance both capex and operating costs. Nonetheless, most companies have focused on attaining immediate liquidity to avoid insolvency rather than on investments.

While this is understandable given the current economic environment, with the higher debt loads they are taking on, the only companies that will successfully prosper over the longer-term are those that invest in increasing productivity.



THESIS 04

MARKET CONSOLIDATION

As we transition out of crisis mode, many companies will be so debt laden that they turn into „zombies". They will be able to service their debt, but over time will not be able to keep up with the market because of their lack of investment capital. This will cause a consolidation in more than one industry.

While from a political and ethical standpoint "doing nothing" was out of the question, industry experts have expressed valid concerns over how effective government stimulus programs truly are over the mid- to long-term.

For many ailing companies, those with a poor capital structure or business model, and most especially those who were already in restructuring, the crisis will end in insolvency.

For many of the rest, the repayment of the debt taken on as part of the stimulus will act as a "dead weight", especially in the cases in which the money was not used for performance improvement.

As both voluntary and court ordered restructuring increase, for those that do choose to invest in performance improvement, there will be an opportunity for growth as competitors leave the market.

THESIS 05

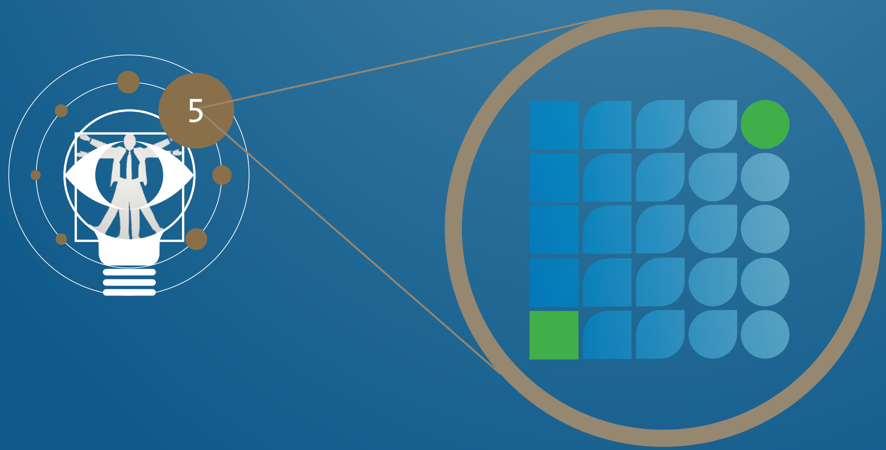
MARKET-WIDE TRANSFORMATION

The need for business transformation will hit Germany‘s privately owned, export-oriented companies particularly hard. Nonetheless this will give the initial impulse to start a wave of much needed change across industries and business models.

In addition to providing government stimulus programs, the German government passed a law (COVInsAG) temporarily suspending the obligation to file for bankruptcy until 30 September 2020. This gives businesses the chance to catch their breaths and get a grip on the multitude of problems caused by the Corona crisis.

Nonetheless, companies cannot afford to sit on their laurels, thinking “this too will pass”. Without a clear plan for the “Post-Corona” era, insolvency will ultimately only be postponed.

Nonetheless, we believe many of the traditionally innovative German “Mittelstand” will take the steps necessary to survive long-term by rethinking their business models and improving their operational structures. They will work together with experts to transform their businesses and gain market share from their ailing competitors who are unwilling or unable to do the same.



THESIS 06

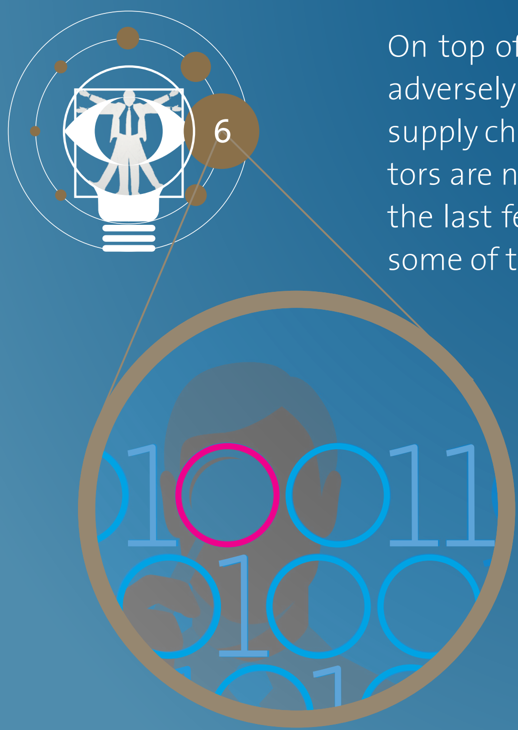
M&A: A LESS ATTRACTIVE OPTION

Because of decreasing valuations and less available capital, the common practice of using M&A as a reorganization instrument will have to be rethought.

M&A is a well-tried instrument to render a company debt free and still minimize creditors losses. Unfortunately, this option is not as viable as it once was.

First of all, due to the uncertain of the current environment, less and less buyers are willing to invest in companies. Both this lack of demand and the increasing supply over the next several years will push valuations down. Financing is becoming more difficult for the same reasons. LBO's in Private Equity have become rare and alternative forms of buy-out financing are not as easy for buyers to get as in the past. For those finding financing, it will cost more moving forward.

On top of that, many PE investors have been affected by the crisis. This adversely affects market liquidity. Portfolio companies that need a global supply chain to leverage efficiency are being negatively affected. PE investors are not able to get an exit at the prices they have been used to over the last few years, and worried LP's are wary to invest additional capital, some of them are even looking to cash out.



THESIS 07

OPERATIONAL RESTRUCTING RENAISSANCE

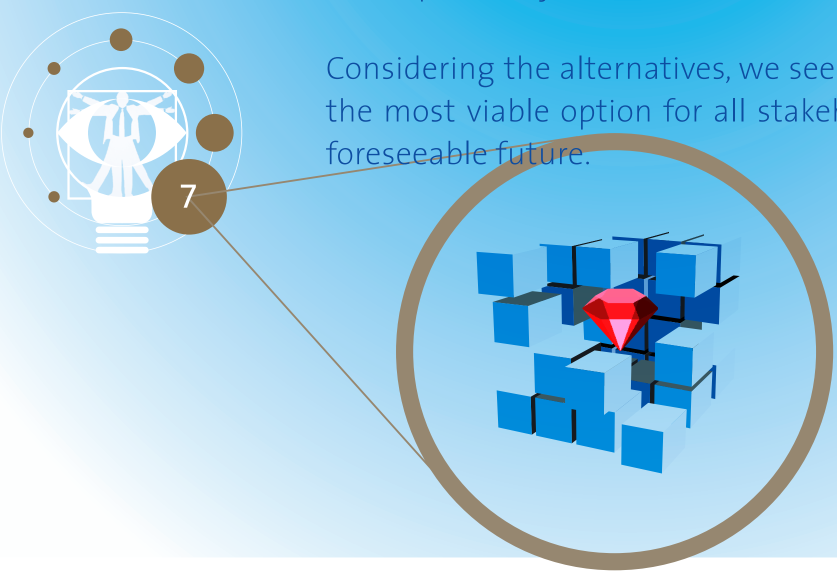
With M&A becoming less viable, and preventive restructuring more prevalent, performance improvement will become the tool of choice for restructurers.

For the reasons stated above, the sale of companies, particularly in industries hit by structural change will not be as attractive as they have been. Therefore, the increasing number of operational restructuring cases will have to be accompanied by extensive debt restructuring.

While the recently passed laws regarding preventive restructuring will bring some relief for companies going through the turnaround process, without extensive operational restructuring and adjustments in companies' business models, achieving sustainable profitability will be unlikely.

Ultimately, the two major factors determining a project's success will be the correct determination whether a company still has a viable business model, and the proper choice of the turnaround path and measures. Even then, should otherwise practicable turnarounds become hard to finance, we will get a tsunami of bankruptcies accompanied by a massive amount of defaults.

Considering the alternatives, we see operative restructuring remaining the most viable option for all stakeholders concerned, at least for the foreseeable future.



CON CLU SION

The Corona crisis has forced many companies to borrow funds just to stay solvent. This money has been used to cover losses and survive rather than transform business models or improve productivity. As a result, companies' debt has increased across the board, without creating any value.

It is to be expected that the resulting debt servicing costs can't be met over the mid-term, in particular because the global recession is just beginning and we do not know how long it may last.

The resulting defaults will significantly increase the demand for radical operative restructuring.

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