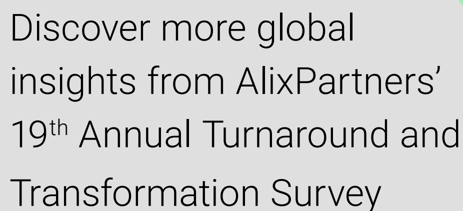
AlixPartners

Liability management

Securing stability with a turnaround mindset

October 2024



Discover more global insights from AlixPartners' 19th Annual Turnaround and Transformation Survey

Read more

When it really matters.sm

Liability management is becoming the go-to option for companies in search of a lifeline, looking to capture a discount or seeking to avoid formal restructuring.

Once seen as novel, transactions that leverage flexibility within existing debt documents to create refinancings, unlock fresh capital, and take advantage of other opportunities, are now familiar in the U.S. and no longer uncharted territory in Europe.

With techniques such as the double-dip, drop-down, and uptier exchange becoming well entrenched, the nature of the conversation is changing. Companies and lenders that have made a success of liability management increasingly recognize that securing an extension of runway is not an end in itself. Instead, it is best deployed as part of a holistic exercise that aims to resolve – rather than paper over – the underlying causes of financial pressure as part of a comprehensive turnaround or transformation.

But why the rise in popularity? Is liability management significantly different from other financial management strategies deployed over the years? And how can true business benefits be realized, beyond merely extending maturities and re-carving up an existing capital structure?

Why is liability management on the rise?

In broad terms, Liability Management Exercises (LMEs) see leveraged companies secure fresh capital to support the transformation of the business, at times over the objections of some creditors.

This might involve, for example, the drop-down of assets into an unrestricted subsidiary that issues new debt, or the amendment of financing agreements to permit additional senior debt incurrence. Different transactions will suit different companies, depending on their particular needs, capital structures and stakeholder profiles.

In AlixPartners' 2024 Turnaround and Transformation Survey, we asked turnaround executives what liability management techniques they expect to see activated in the next twelve months:

72%

cited changes to capital structure or movement of assets

40%

anticipated increased monitoring of liabilities and risk

41%

expected creditor co-operation agreements as a response among lenders

26%

pointed to uptier exchange transactions

> "Different transactions will suit different companies, depending on their particular needs, capital structures and stakeholder profiles."

Such exercises often involve the cooperation of at least some existing lenders. Several factors explain existing lenders' willingness to participate, despite the potential for conflict up to and including litigation (particularly in the U.S.) either in connection with the transaction or down the road if more funding is required or an insolvency proceeding subsequently ensues. First, the increased cost, time, and perhaps risks attendant to bankruptcy protection makes out-of-court transactions more appealing. Second, liability management frequently allows participating creditors to improve their position in the capital structure in exchange for providing incremental liquidity, providing greater protection if bankruptcy was to follow. And third, some lenders want to avoid taking ownership of certain distressed businesses.

The benefits for existing equity of liability management are obvious, and significant, too. Raising incremental debt capital while avoiding restructuring permits shareholders to retain all or a substantial portion of the company's equity and buys time for a business to turnaround.

The spread of liability management from the U.S. into Europe has been a relatively slow burn. This is partly down to differences in business culture. With fewer market participants, the risk of aggravating non-participating creditors who find their grip on collateral loosened is seen as higher. That said, a number of European sponsors have U.S. style covenant packages, and it is common for the security packages in European deals to be looser, which may create more future LME opportunities.

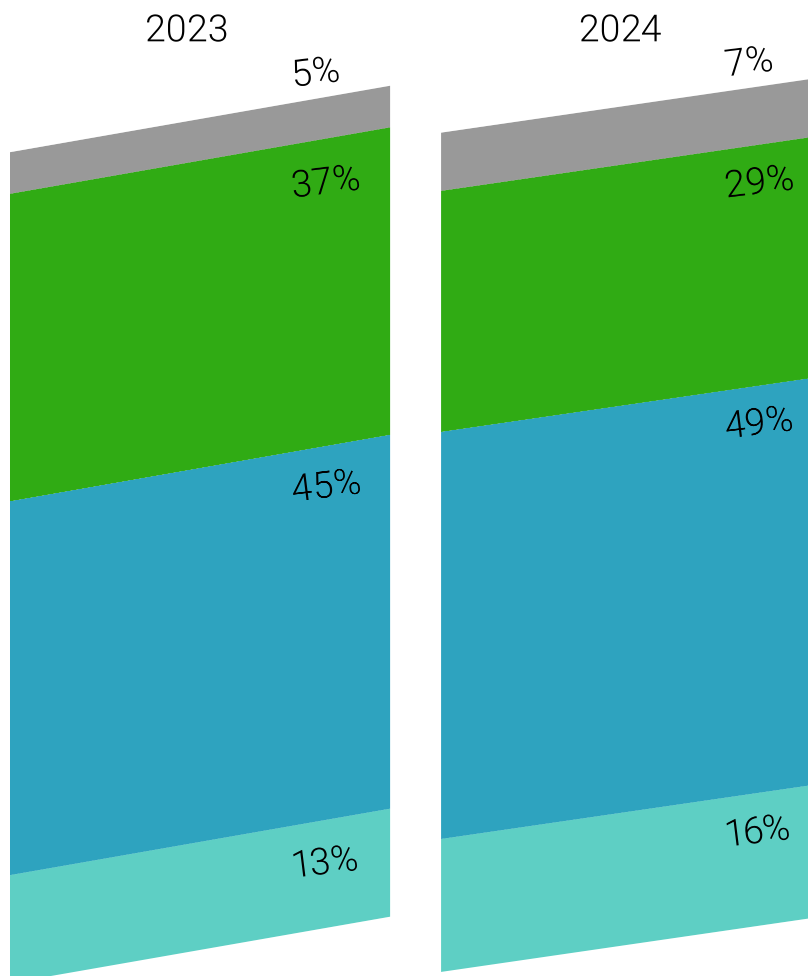
European regimes offer other important tools, too. Schemes of Arrangement and the Restructuring Plan, the latter of which came into force in June 2020 in the U.K., are effective means of achieving "cram down" of dissenting creditors, thus displaying some similarities to the U.S. Chapter 11 regime. Insolvency options continue to exist across Europe providing business with a range of tools to manage debts. The impact and process will, of course, differ from jurisdiction to jurisdiction.

As our survey results indicate, liability management is expected to remain a factor on both sides of the Atlantic for the foreseeable future. In an era in which both interest rates and the availability of private credit remain relatively high, it is hardly surprising to see companies grasping at opportunities to stave off liquidity crunches, should they be facing them. And for private equity sponsors for whom a company in bankruptcy is a reputational risk, the ability to keep matters out of court is an important feature.

That being said, those existing lenders excluded from participating in these transactions often take the position that the credit agreements don't permit such activity. This may lead to a significant amount of litigation, which companies and their capital partners need to be well attuned to and advised on, as many of these liability management tools have not been fully tested by the courts.

What percentage of distressed companies that extended their liquidity runway through "amend & extend" approaches or by raising additional capital in 2023 and into 2024 will end up distressed again in the next 3 months?

Substantially all · 50%-75% · 25-49% · Less than 25%



Embedding liability management in the business plan

Liability management responds to a liquidity crisis but does not solve the underlying issues creating the unanticipated situation.

It is therefore tempting to view these as separate processes. That would be misguided.

Successful execution of a new debt offering buys time to address underlying performance issues. And a truly successful liability management exercise cannot be conducted in isolation from an operational transformation, but rather must be embedded in a credible business plan that identifies what the future looks like and the precise role that fresh capital can play in enhancing the business and enterprise value.

Put another way, the goal of liability management is to ensure with some confidence that a transaction is a means to an end as opposed to a road to nowhere. We are only beginning to see in the U.S. the fallout from failed LMEs. As these situations play out, it is becoming more important that LMEs are grounded in a credible plan that likely leads to resolution of the company's current challenges.

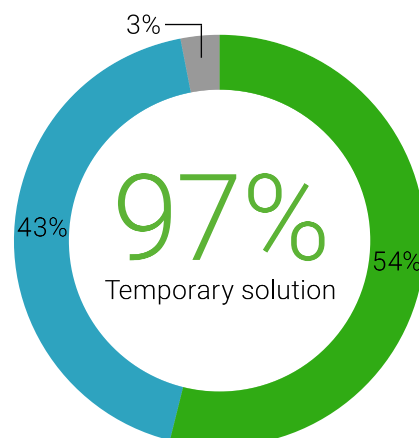
This is especially true due to the often-demanding nature of the exercise. Liability management is typically a complex legal process commanding significant senior management time and attention. Properly integrating this effort within the overall turnaround strategy reduces the risk of leadership losing focus on the business plan and operating model.

Relatedly, liability management transactions can have implications for the substantive running of the day-to-day business. Asset sales or asset segregation through drop-down can trigger operational changes, creating the need for a wider assessment of people, contracts, intercompany obligations, and intellectual property usage. Without careful planning, a company that divests or spins out assets can find itself at cross purposes – particularly in more service-oriented, people-focused businesses with the transaction itself hindering operational performance.

Burnt bridges are a further consideration. By its nature, and despite the cyclical rotation of personnel in the capital markets and incentive structures within funds and banks, a liability management exercise involves elevating levels of security – and added control – for some lenders and not others. The alienation of non-participating creditors could reduce future flexibility to raise capital, meaning that the company is more reliant on the creditors and sponsor with whom it has concluded the deal. If the new money proves insufficient to kick-start the turnaround, securing further funding may prove more difficult. This makes it essential for capital requirements to be accurately sized from the outset.

In your experience, how successful have amend & extends or liability management efforts been in the past 12 months?

- A temporary solution that doesn't ultimately resolve the fundamental issues
- A temporary solution granting time to turnaround or improve operations
- A permanent fix that enables the company to rebuild enterprise value



The right advice, at the right time

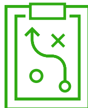
In our experience, successful liability management is multidisciplinary.

Liability management is often spearheaded by the investment bank tasked with financing, valuation, and divestiture strategies. An external law firm leads the legal tactics, implementation strategy, litigation risk assessment and mitigation strategies, and often stakeholder negotiations. Turnaround advisers work with management to devise a credible transformation plan, global liquidity forecasting, business planning, and support operationalizing the transformation. And communication professionals assist as needed with how the transaction will be perceived in the marketplace.

The task for turnaround professionals is to advise management and the board on the viability of the underlying turnaround plan that a liability management transaction is intended to facilitate. This advice is an important part of establishing a sound record for boards of directors to approve implementing the liability management efforts. In addition, professionals help to bridge information and trust gaps among constituents; their "repeat player" status, independent judgment, and long-term dependence on reputation become key.

Other financial professional tasks include ensuring that the company has a clear plan for putting new borrowings to work:

Checking that a sufficient portion has been allocated to support necessary capital expenditures or investments to drive revenue growth



Scenario planning to risk assess whether the new debt will prove sufficient in the event of a market downturn

Revisiting the company's cost base to ensure it remains fit for purpose

> "Grounding liability management in the context of a turnaround plan provides boards with enhanced protection in the event of a bankruptcy down the road."

Grounding liability management in the context of a turnaround plan provides boards with enhanced protection in the event of a bankruptcy down the road. Proper assessment of how the transaction contributes to a recovery strategy helps to create a record of appropriate decision-making at the board level.

Considerations for lenders: positioning to participate

For the creditors we advise, a running theme is ensuring that liability management doesn't happen around you, but runs through you. Lenders need to consider where they sit in the stack, the relative size of their position, and the propensity of fellow creditors to engage in "lender-on-lender violence" – all of which will bear on whether an exercise is likely and who might be invited to participate. The relationship with sponsors, who often push for liability management measures as a substitute for restructuring, can be a critical factor in determining whether or not a lender ends up inside the tent.

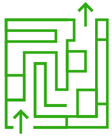
Where liability management is likely, lenders may need to deploy countermeasures if necessary to ensure transactions are not done around them. Over 40% of our survey respondents expect to see further creditor co-operation agreements activated in the coming year. Lenders who pledge themselves to present a common front in the face of liability management efforts create a greater likelihood of maintaining a seat at the table. But enforceability of creditor co-operation agreements remains open to question in European jurisdictions, making contingency planning for non-participation scenarios all the more important.

More than 40%

of our survey respondents expected to see creditor co-operation agreements activated in the coming year.

"The relationship with sponsors, who often push for liability management measures as a substitute for restructuring, can be a critical factor in determining whether or not a lender ends up inside the tent."

Six questions when considering liability management



While there will be differences of emphasis among the different stakeholders, certain objectives and end-result goals are common to all stakeholders: ensuring a company emerges with a healthy balance sheet, growth in enterprise value, overall alignment on a plan to deliver improved performance and sufficient liquidity to deliver on that plan.

Both companies and lenders considering liability management proposals should therefore ask themselves broadly whether the road they are being asked to travel leads to the correct destination.
In particular:

1. Is there sufficient near-term liquidity to fund the completion of the transaction? Do lenders involved fully appreciate the (often constrained) timeline? This requires a careful and comprehensive analysis of a company's liquidity profile and runway, including working capital needs, debt service obligations, and liquidity levers that can be pulled.

2. Does the exercise likely provide the necessary runway to execute a turnaround plan without further recourse to the market? Sensitivities should be run to stress test assumptions and the potential operational improvements needed to validate that the funding secured should be reasonably sufficient for the organization's ongoing needs.

3. Is the underlying turnaround and business plan credible? Is the path from point A to point B passable? Advice to the board from turnaround advisors is an essential input to the board ratification process.

4. Have the implications of the transaction on the business and, subsequently, the ability to operate and achieve the turnaround been fully assessed? For example, complex transactions involving a drop-down or carve-out may have implications for vendor contracts that bar transactions between affiliated entities, requiring renegotiation of agreements.

5. Has the litigation risks been fully vetted and discussed with relevant parties? Is the potential for lender-on-lender violence likely and, if it were to occur, is the antagonism going to negatively impact the business? If so, the company is going to need a robust and credible turnaround story to reassure and retain the support of the key operating stakeholders.

6. If the LME fails and a subsequent formal restructuring occurs, has a good record been established that the transaction was a reasonable course of action to take? Establishing a solid record that drives the decision to implement an LME is essential to protect the potential downside of the transaction not working and being subsequently investigated as part of a formal insolvency proceeding.

Sticking to the fundamentals amid uncertainty

The longer-term outlook for liability management techniques remains uncertain.

Much depends on the development of case law in the U.S. and the outcome of high-profile transactions in the EU. Even without a major adverse event, liability management is a finite resource: lenders who feel they have been burned once will demand protection against such transactions in future deals. We expect the market to move to more robustly protective documentation that will reduce the scope for liability management available in individual cases, albeit slowly over time.

In the meantime, considerable scope remains for liability management transactions – particularly given the deep pools of private credit on the market. Funds remain under pressure to deploy capital without necessarily including the debt covenants that a traditional bank might require. And, in this environment, boards are in a position to delever balance sheets and reduce downside risks through liability management transactions – provided they are grounded in the fundamentals of company turnaround.

> "We expect the market to move to more robust documentation that will reduce the scope for liability management in individual cases, albeit slowly over time."

Authors

Ben Browne

Partner & Managing Director, London

bbrowne@alixpartners.com

Randall Eisenberg

Partner & Managing Director, New York

reisenberg@alixpartners.com

Clare Kennedy

Partner & Managing Director, London

ckennedy@alixpartners.com

About us

AlixPartners offers a holistic suite of integrated Liability Management Exercise (LME) services.

Liability management transactions require a path to operationalize and an understanding of the long-term implications to the operations and cash flows of the business. Our team of restructuring experts is called in by companies, investors, creditors, law firms and governments to solve complex problems and preserve value in urgent situations. We have a track record and reputation as a world-class firm that brings the experience and expertise to lead stakeholders through these complex, time pressured scenarios and drive a business to a successful outcome in any circumstance.

For more information, please contact the authors.

The opinions expressed are those of the authors and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective professionals or clients.

This article: Liability management, was prepared by AlixPartners, LLP ("AlixPartners") for general information and distribution on a strictly confidential and non-reliance basis. No one in possession of this Article may rely on any portion of this Article. This Article may be based, in whole or in part, on projections or forecasts of future events. A forecast, by its nature, is speculative and includes estimates and assumptions which may prove to be wrong. Actual results may, and frequently do, differ from those projected or forecast. The information in this Article reflects conditions and our views as of this date, all of which are subject to change. We undertake no obligation to update or provide any revisions to the Article. This Article is the property of AlixPartners, and neither the Article nor any of its contents may be copied, used, or distributed to any third party without the prior written consent of AlixPartners.

AlixPartners

AlixPartners Turnaround and Transformation Survey 2024 |
Liability Management