In the fourth quarter of 2017, Debtwire canvassed the opinion of 80 distressed debt investors and 50 private equity executives in two separate surveys to gain insight into their views on the European distressed debt market in 2017 and expectations for the market in 2018 and beyond.

The interviews were conducted by phone and respondents were assured anonymity. Results are presented in aggregate.
FOREWORD

2017 was a year of political earthquakes largely ignored by credit markets. Bolstered by continued central bank support-driven liquidity and low default rates, European leveraged finance markets continued to grind tighter. That enabled many stressed credits to pull off refs, often lowering funding costs and creating a virtuous circle, which limited distressed opportunities. However, the year ended with an uptick in activity, with Carillion and Steinhoff lighting up traders’ screens.

Cheap funding costs injected some froth into M&A activity and valuations, which also resulted in diverting some opportunities away from distressed debt investors last year. Over-levered pharma producers and specialist packaging firms fell off hedge funds’ radars after being put up for sale by the sponsors.

That left the distressed debt community mainly working its way through residual struggling energy credits, such as Seadrill, Explo and Premier Oil. Many funds also looked at stressed financials, such as struggling Spanish, Italian and German banks, as well as some of the NPL sales coming out of the sector.

But distressed debt markets experienced a notable surge in activity as the year came to an end with first UK construction group Carillion and then South Africa/Germany listed retailer conglomerate Steinhoff imploding. 2018 does not immediately look like delivering a massive rebound in distressed activity, with many of the respondents surveyed expecting sourcing to become even harder. The European recovery looks to be gathering pace, and even Brexit uncertainty-hobbled Britain is still growing. But this in turn is hastening the end of the ECB asset purchase programme and building the case for rate rises, which could translate into higher funding costs and tip some companies into distress.

According to this year’s survey, property and construction, oil and gas, transport, energy and the auto sector will represent the biggest opportunities for distressed players in 2018. That is already being borne out by Carillion and several Italian construction names under pressure, while transport, and especially shipping, will struggle to absorb the recovery in oil prices.

But higher oil prices are also feeding through into surging input costs for a range of industries, especially in the chemicals, packaging and related sectors, pressuring margins of companies without robust pass-through mechanisms.

Lastly retail, a sector long expected to throw up more casualties, is starting to bear out some of the concerns despite many historically stressed retailers managing to stage modest recoveries that enabled them to get refs over the line last year. New Look looks finally ready to engage with bondholders after running low on liquidity, with more UK retailers set to follow.
**EXECUTIVE SUMMARY: GREENHILL**

2017 was a fantastic year for European corporates: growing economies, bullish stock markets and increasingly cheap credit. We entered the year with considerable political uncertainty and quickly realised that the markets didn’t really care.

Many sub-investment grade companies, and in particular sponsor-led corporates, have taken advantage of these market conditions to lower funding costs, improve flexibility and extend maturities, pushing the maturity wall to 2021 and beyond. The liquidity in the market has facilitated a lot of covenant resets and extensions at private equity companies, which mainly happened under the radar.

The combined volumes of leveraged loans and high yield bonds in Europe have passed the 2007 peak with more than €200bn in total issuances (€350bn depending on the definition), mainly used to reprice or refinance existing indebtedness. These volumes have been issued at unprecedented levels with triple-C yields in the 5-6% range (the triple-C index dipped below 5% in Q4 2017) and single-B below 3%, evidently high yield only in name. Perhaps even more importantly, this avalanche of debt has come to market with very borrower-friendly terms, with only the most aggressive language being pushed back by investors scared to miss out.

Even in such a benign environment, some large restructurings have taken place, and some public companies have ended up in administrations or even liquidation. These rare events were cautionary tales for corporates and investors that, despite the market, it is critical to have an underlying viable business and to tackle capital structure problems in time.

Distressed investors had to roll up their sleeves to find attractive investment opportunities and will need to continue to do so until markets normalise. We have witnessed first-hand the creativity of some of these funds that have been able to find value where plain vanilla credit was not available.

Restructuring activity has concentrated in certain sectors that faced economic headwinds even in this market and with corporates that created their own challenges. Furthermore, there has been a significant volume of non-performing loan activity in Southern Europe in general, with a specific focus on Italy.

We enter 2018 with eyes wide-open but the sense is that we might see these trends continue, absent an exogenous shock or a return of inflation. Junior debt has not made a big comeback yet and appetite for yield will likely bring PIK Toggle notes and other junior debt instruments back to the market. Sponsors might see it as a good alternative to an exit (especially when there is a lack of affordable new opportunities) and hedge funds as a way to put money to work at acceptable returns.

We invite our corporate clients to proactively address their capital structure and take advantage of such a benign environment and use the flexibility to fix their businesses. Famished distressed investors will leave no stone unturned.

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A Unique Investment Banking Firm
Greenhill is a leading independent investment bank focused on providing financial advice globally on significant mergers, acquisitions, restructurings, financings and capital advisory to corporations, partnerships, institutions and governments.

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• No Products to Sell / No Conflicts

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• All Major Industry Sectors

We Have Substantial, Senior Teams In All Major Markets
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• Managing Directors Average 25+ Years of Experience

Our EMEA Financing Advisory and Restructuring team has advised corporations and their shareholders on c.$50bn of transactions since 2010, complementing our market-leading global franchise with a holistic approach that allowed us to implement creative solutions that were believed not to be possible.

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Lansdowne House, 57 Berkeley Square, London W1J 6ER
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EXECUTIVE SUMMARY: ORRICK

Interest rates across Europe have been set at historically low levels for so long that there are many business professionals and homeowners who have never experienced a rise – or if they have, the memory is somewhat distant. In the years since the global financial crisis, the world of low (or even negative) interest rates, and quantitative easing (QE) has resulted in low corporate default rates and correspondingly low business failure rates, which are almost unprecedented.

Led by the US Federal Reserve, and followed by the Bank of England with a small base rate rise in November 2017, the interest rate cycle has pivoted. Barring external shocks, it appears we are at the beginning of the end of the experiment of extreme monetary easing.

The normal corporate failure rate, or what Joseph Schumpeter grandly called, the “Creative Destruction” inherent in the capitalist system, has, with certain key exceptions (and in certain industries such as oil) been extremely low. However, the recent well-documented problems at Carillion and the collapse of Steinhoff demonstrate that there is always some degree of distress or failure in the market, no matter how benign conditions appear to be.

Monetary easing has generally led to high valuations in most asset classes and buoyant debt and equity markets. The world is awash with liquidity, with investors in the debt markets hungry to find high yielding investments in a low interest rate environment. Corporate borrowers have been able to find finance fairly easily including from private debt funds, the private placement note market, the high yield bond market, online lenders and via the syndicated loan market. There has been an explosion of funding options available to borrowers, even to borrowers of marginal creditworthiness. As a result, lending standards have been in decline. Cov-Lite deals for non-investment grade companies are now the norm. Overall, the trend towards ‘normalisation’ of monetary policy is likely to see a return to more historically standard default levels.

Reversing QE and raising rates at the same time is fraught with risk, particularly where global debt ratios remain elevated. A number of issues, particularly in Southern Europe, are yet to be fully dealt with, including in the European banking system where the legacy of the global financial crisis still resides. We saw a fairly divergent approach to bank resolution in 2017, notwithstanding that the EU wants to see bank resolution occur in a more uniform (and taxpayer-friendly way) under the aegis of the Bank Recovery and Resolution Directive (BRRD). For example, the sale of Banco Populare for €1 in 2017 by Santander involved no taxpayer injection whereas the bail out of Monte di Paschi involved injections from the Italian government.

The key point is that notwithstanding the uneven pace of implementation and the divergent strategies employed, the clear up of European bank balance sheets is well underway. Survey results point to Italy as a clear target for more activity this year, whether by banks implementing NPL sales in large blocks or sales of individual exposures to hedge funds looking to undertake single-name restructurings. We also think that, this year, the focus of the NPL market may move to other areas in Southern Europe.

We cannot end our commentary without mentioning Brexit which, understandably, features heavily in the report this year. The recent decision to upgrade talks to the next level is to be welcomed. Brexit has the potential to do a lot of damage to the European economy and it is hoped that the parties resolve a mutually amenable deal. It is naïve not to expect some fallout for the UK given the political uncertainty. On a more granular level, we are already seeing signs of distress in the UK retail and casual dining sector. It is fascinating to see that UK-based survey respondents are more bullish on the UK’s economic prospects this year compared to those based outside. A majority of respondents are expecting some kind of recession in the next two years in the UK.

UK insolvency/scheme procedures have been used extensively in some of the bigger ticket European restructurings over the past few years and the survey results show that the market believes that some kind of deal on mutual recognition of judgements/insolvency procedures will be possible. Are we going to see a Brexit which bears out Giuseppe Tomasi di Lampedusa’s famous line in one of the great Italian novels, The Leopard; “If we want things to stay as they are, things will have to change”, or will Brexit send the UK off on a path which diverges greatly with EU member countries? 2018 could well be the year when we receive the answers to these questions.

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Saam Golshani
European Co-Head of the Restructuring Practice, Orrick
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Is this the beginning of the end?

Commentators predict the end of a 38 year Bond Bull Market.

Tightening credit conditions will create both challenges and opportunities. Our experienced team is ready to craft innovative solutions in difficult circumstances to help you adapt or survive.

Our global restructuring practice operates as an integrated team across Europe, the US and Asia assisting lenders, bondholders, insolvency practitioners and debtors achieve successful outcomes.

Our track record speaks for itself.

Global Finance Deal of the Year 2017 for African Insolvency and Restructuring
American Lawyer

Recognized in FT Innovative Lawyers Report Europe 2017
Financial Times

http://blogs.orrick.com/distressed-download/
Views on Brexit diverge but UK-based respondents are more optimistic. Private equity players are wary of fallout but distressed investors scent opportunity.

As 2017 was coming to a close, the International Monetary Fund (IMF) trimmed its forecasts for the UK to 1.6% from 1.7% with 2018 coming in at around 1.5%. It stated that the uncertainty over Brexit was taking its toll as evidenced by a weaker pound, rising inflation, stagnant wage rises and lower investments.

This is in sharp contrast to the IMF’s more bullish outlook on the eurozone area, which ended 2017 on a high note of 2.2% growth. This is a significant jump from the initial 1.7% forecast made in the spring. The EU economy as a whole is also set to exceed expectations with real GDP growth of 2.3% in 2017 and 2.1% in 2018. This is due to a mix of falling unemployment, strong consumer spending and a loose monetary policy stance that will continue to underpin domestic demand going forward.

Although the consensus is that, overall, Brexit will have a negative effect, it is fascinating to see how stark the divide is between the thinking of the non-UK-based participants versus UK participants. For non-UK participants, there is an overwhelming sense that Brexit will be negative for the UK. For example, 71% of UK-based survey participants do not envision a Brexit-triggered recession over the next two years compared with only 33% of non-UK-based respondents.

“With political instability creeping up in the UK and the constantly changing situation in Europe, there are real chances of the UK seeing the beginning signs of recession early in 2019,” says a partner from a UK private equity firm.

The projections represent an upward revision to GDP of 0.5 and 0.2 percentage points, respectively, from forecasts earlier last year.

**UK recession-bound?**

Greenhill’s Carlo Bosco, believes that 2018 will be an absolutely critical year for Brexit negotiations. “This year, we will likely find out what Brexit actually means in terms of trade-offs between the status quo and the new role the country will play once Brexit is implemented,” he says. “It looks like the British economy is already suffering its effect with higher inflation, lower consumer spending, in particular around the Christmas trading period, and growth rates well below other developed economies.”

Overall, the bulk of both PE and distressed investor respondents in our study expect the UK to fall into recession over the next two years, with a slightly higher proportion of distressed investors expecting this to occur comparatively sooner, in 2018 rather than 2019.

However, the views are split depending on location and political bias. For example, 71% of UK-based survey participants do not envision a Brexit-triggered recession over the next two years compared with only 33% of non-UK-based respondents.

“Will the UK enter into a recession in the next two years?”

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<td>Distressed investors</td>
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Saam Golshani, M&A Partner, Paris, Orrick
Benefits of Brexit?
Opinions are also mixed over the advantages of Brexit. On the UK-based side, a sizeable proportion (61%) envisage benefits such as improved trade deals or less bureaucracy and red tape. Meanwhile, a notable majority (75%) of those located outside the country don’t see such advantages.

A director of investment at a German hedge fund says: “It could go either way, it’s impossible to project but, in my opinion, it won’t be a great option for the UK as it is going to miss out on the bigger and more developed market in Europe while it tries to manage itself.”

Stephen Phillips of Orrick’s Restructuring division in London is more sanguine about the situation. “It seems that the negative view of the UK’s prospects is being set against survey participants’ benign view of the economic picture in other areas in the world, particularly Europe,” he says. “Perhaps there is a view that while Brexit-related anxiety will impact growth, the wider economic trends may help the UK avoid a hard reckoning.”

These divergent perspectives are colouring investment decisions. Distressed investor respondents believe there could be a crop of new opportunities in the UK due to reduced valuations. As a result, three-quarters are either as inclined or more inclined than they were 12 months ago to invest in the country.

This is a sharp jump from last year’s 54% figure. The sentiment is the reverse for private equity respondents, where there is a decrease in investment appetite in the country from 12 months ago. Only 66% show similar or increased interest versus 80% at the beginning of 2017. Recently, a report in the Financial Times said that investors have been demanding that private equity funds restrict UK investments due to ongoing ambiguity relating to Brexit.

Scott Morrison of Orrick’s Restructuring division in London notes: “One family office client told us that Brexit provides his fund with the opportunity of a lifetime. Another client told us that she foresees an extended six-year recession in the UK as a result of Brexit. Opinions and emotions are divergent and strongly held. Our view is that reduced valuations will generate interest in UK assets both in the distressed and in the PE space and we are more inclined to see the opportunity aspects of Brexit.”

Despite the undeniable impact of Brexit on the attractiveness of the UK as an investment destination, dealmakers will continue to look beyond the uncertainties of Brexit and continue to invest as changes in US corporate taxes, a favourable European economic outlook and the fall in sterling give rise to new cross-border opportunities.

Pieter-Jan Bouten, Managing Director, Head of UK, Greenhill

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**Will the UK enter into a recession in the next two years? (UK-based respondents, DI and PE aggregated)**

- Yes, in 2018: 21%
- Yes, in 2019: 8%
- No: 71%

**Will the UK enter into a recession in the next two years? (non-UK-based respondents, DI and PE aggregated)**

- Yes, in 2018: 43%
- Yes, in 2019: 24%
- No: 33%

**Are there any benefits for the UK from Brexit? (UK-based respondents, DI and PE aggregated)**

- Yes: 61%
- No: 39%

**Are there any benefits for the UK from Brexit? (non-UK-based respondents, DI and PE aggregated)**

- Yes: 25%
- No: 75%
Are there any benefits for the UK from Brexit?

Key:
- Private equity
- Distressed investors

- Yes: 64%
- No: 36%

Are you more or less inclined to invest in the UK than 12 months ago?

Key:
- Private equity
- Distressed investors

- More: 26%
- The same: 40%
- Less: 34%
Are you planning to relocate any activities as a result of Brexit?

**Key:**
- Private equity
- Distressed investors

**Should I stay or should I go?**
Concerns over Brexit have also left firms considering options around the relocation of their offices. To date, the activity seems to be most pronounced in the investment banking sector, with heavyweights such as Goldman Sachs, JPMorgan, HSBC and Morgan Stanley as well as regional players such as Japan’s Nomura and Daiwa and the UK’s Standard Chartered all announcing plans to establish new bases on the continent.

So far, private equity firms and distressed investors are staying put with 58% and 66% of respondents respectively saying they do not intend to relocate any activities as a result of Brexit.

“As a funds-orientated practitioner, I haven’t seen too much sign of impetus for relocation,” says Dominic O’Brien of Orrick’s Banking division in London. “However, I expect the key decisions for the banks are going to be made in the first half of 2018.”

For those considering a move, Frankfurt has emerged as the frontrunner. Not only is it a large and thriving city, in Europe’s biggest economy, but it is also the financial capital of the region, home to the European Central Bank and sits in a favourable time zone for international businesses. There is a large English-speaking population, good transport links and family-friendly suburbs. Amsterdam, Paris, and Milan are all jostling for the runner-up spot, according to our survey.
While Frankfurt is guaranteed to take the biggest share of London’s business, I do not expect Brexit to spark as big of an exodus as the press reports.

Anthony Samengo-Turner, Co-Head of DACH Region, Greenhill

It would appear that Frankfurt has been the winner in terms of relocation with other locations such as Amsterdam, Paris, Milan and Dublin winning some additional functions as well. However, we don’t see Frankfurt, or any other European city for that matter, replicating London’s scale any time soon.

Thomas Schmid, M&A and Private Equity Partner, Munich, Orrick
Exploring UK and EU insolvency policies, highlighting private equity and distressed debt investor views on the EU Insolvency Directive and Chapter 11

There has been a great deal of debate and discussion about the European Union Insolvency Directive (EUID), which is still working its way through the EU regulatory approval maze. However, few would be averse to see harmonisation across the patchwork of national bankruptcy laws in a region where business failure is a major issue. In Europe, 50% of entrepreneurs experience economic failure in the first five years of activity, according to figures from the European Economic and Social Committee (EESC).

One of the proposals, which has been long promulgated by Brussels, is to replicate the Chapter 11 framework of the US bankruptcy laws, a provision that many in the EU government see as taking the pain out of bankruptcy and promoting a more dynamic economy. The plans are also inspired by regulations in some EU countries that facilitate early corporate restructuring, such as the UK’s “schemes of arrangement”.

Under the EU insolvency proposals, a business would be able to avoid creditor demands to close shop while it seeks to negotiate a voluntary debt restructuring. The protection would initially last four months but courts could extend it up to a year. The new rules would prevent a small minority of investors from delaying restructuring agreements, with safeguards to ensure ‘legitimate interests’ are protected.

Impact of the directive

Our survey shows that a majority of both PE (88%) and distressed debt investors (80%) expect the directive to fundamentally alter European restructurings.

“The directive could have a major impact,” says the director of a private equity firm in Germany. “Companies will be given a chance to try and restructure and reform their businesses to achieve stronger results in the future.”

It also shows that 62% of PE investors and 66% of distressed investor participants think that the remaining EU member courts will continue, for now, to recognise UK insolvency processes, but this is a slight dip from the respective 66% and 70% of last year.

In terms of countries, roughly half of respondents (52% PE and 50% distressed investor) expect France to make the most use of the incoming directive.
Do you think the remaining EU member courts will stop recognising the UK insolvency processes?

Key:
- Private equity
- Distressed investors

“Do you think the remaining EU member courts will stop recognising the UK insolvency processes?”

A higher percentage of distressed investor respondents (72%) compared with private equity respondents (58%) expect more US companies to take advantage of schemes of arrangement which is prevalent in the UK.

Any effort aimed at standardising bankruptcy proceedings across the EU and facilitating cross-border bankruptcy should be welcomed. In the last few years, there has been an improvement in the legislation of many continental jurisdictions, and any continuation of this trend should facilitate transactions. Chapter 11 is a great option to resolve complex capital structures, but it is also an expensive one. It can be used to convince stakeholders to use more cost-effective tools, so it is critical for a corporate to have advisors that can operate on both sides of the Atlantic and credibly implement a number of restructuring options. We execute deals from Europe, but, in large and complex transactions, always have our team in NYC standing by.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill

There may be some political resistance to attempts to maintain the status quo. However, given that the recognition of judgements (currently governed by the Recast Brussels Regulation) and insolvency processes (currently governed by the Recast European Insolvency Regulation) have been highly beneficial for businesses and creditors alike involved in cross-border disputes/insolvencies, it is to be hoped that cooperation on recognition should be an area of focus in the upcoming negotiations.

Stephen Phillips, Restructuring Partner, London, Orrick

“It’s very interesting to see France at the top of this list,” says Alexis Hojabr of Orrick’s M&A, Private Equity and Restructuring division in Paris. “Does this suggest respondents are jaded by the current insolvency regime currently in place in France? Regardless, the proposed EUID is to be welcomed with its emphasis on early intervention, giving entrepreneurs a second chance and minimum standards throughout Europe. In fact, we see it being most helpful for some of the states which have more recently acceded to the EU given that some of the more established countries, such as Germany, France, Italy and France, have already undertaken extensive insolvency reform in recent years.”
Which countries do you expect to make use of the tool the most? (Select top two from list of EU countries)

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Key:
- Private equity
- Distressed investors

Chapter 11 continues

The bulk (92%) of PE respondents predict more European companies will use Chapter 11, although half believe this will be the case for cross-border issuers only. This view is shared by a majority (64%) of distressed investor respondents. Recent examples include privately-held UK oil and gas group Expro Holdings, which filed for Chapter 11 protection with the US Bankruptcy Court in the Southern district of Texas in late December 2017. The process allows for reorganisation without the approval of some classes of credit investors.

“We see Chapter 11 as a viable option in some cross-border cases given the power of the automatic stay, the deference given to the US bankruptcy courts by many multinational corporations and the possibility, in certain circumstances, of cramdown of dissenting creditor classes,” says Raniero D’Aversa of Orrick’s Restructuring division in New York.

The requirement for shareholders to consent within French safeguards is one of the reasons why Chapter 11 proceedings could prove to be popular for French corporates such as CGG. Out-of-the-money shareholders in a French safeguard proceeding would need to approve any deal, while out-of-the-money shareholders in a Chapter 11 can just have a plan crammed down on them by way of a creditor vote.

Charles Pontvianne, Greenhill
Do you expect more US companies to take advantage of schemes of arrangement?

Key:
- Private equity
- Distressed investors

Do you expect more European companies to use Chapter 11?

Key:
- Private equity
- Distressed investors

- A: Yes, for both domestic and cross-border issuers
- B: Yes, but only for cross-border issuers
- C: No
It is likely that Chapter 11 will continue to be a predominant restructuring regime for multinational companies with substantial connections to the US. However, we have come to appreciate certain advantages of scheme of arrangement proceedings (whether under UK law or similar laws in other jurisdictions) in situations where the connection to the US is limited to the company having accessed the US capital markets or is otherwise minimal.

Evan Hollander, Senior Partner, New York, Orrick
MARKET OUTLOOK: INVESTMENT OPPORTUNITIES

Our survey reveals investment opportunities in 2018 and challenges including regions, sectors and instruments

Last year was not easy for many distressed debt investors, with continued loose monetary and red-hot primary markets maintaining easy refinancing conditions and a frothy M&A market, which enabled a number of stressed companies to escape restructuring and inflated valuations in secondary markets.

The majority (65%) of distressed investors believe that market conditions will be as challenging in 2018 as in 2017. In other words, there will still be too many investors chasing too few deals.

“This is driving prices up,” says Greenhill’s Carlo Bosco. “In this market, a company with securities trading with high-single-digit yields are now considered distressed. So I think that’s the main challenge.

Sourcing distressed debt opportunities was difficult for investors in 2017 and will continue to be so until credit markets normalise. Last year, a total of €214bn of leveraged loans and high yield bonds were issued in Europe vs. €123bn in 2016, a 74% increase. Even more interestingly, this volume is 13% higher than 2007.

The impressive liquidity available pushes investors to be more creative and look at opportunities in more complex sectors and geographies. For corporates, it is a great time to get additional liquidity and extend maturities at advantageous rates and conditions.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill
What do you expect to happen to your distressed allocation in 2018? (DI respondents only)

- Increase: 66%
- Stay the same: 34%
- Decrease: 0%

Did your increase your asset allocation to distressed investing in 2017? (DI respondents only)

- Yes: 78%
- No: 22%
Oil field services (OFS) companies have undergone significant cost cutting but have yet to materially reduce the supply of vessels and rigs, increasing the need for consolidation in the industry. The recent crude price rebound is unlikely to help OFS and offshore services companies in the near term and we should thus expect 2018 to be another painful year.

Steve Conner, Head of OFS, Greenhill

Given the pressures on retail, casual dining and the care homes sector in the UK, we expect to see a knock-on effect on real estate financing and real estate securitisation structures.

Sushila Nayak, Orrick, London

**Region and sector outlook**

Western Europe remains the most attractive region in terms of distressed opportunities, according to 86% of the respondents, followed by Eastern Europe with 58%.

“Eastern and Western Europe have the largest concentration of distressed debt,” says a managing director of a UK-based hedge fund. “Sectors such as industrials, and oil and gas provide excellent opportunities for us.”

Property and construction are expected to provide the best opportunities in 2018 say 71% of respondents, followed by oil and gas (70%) and transport, including shipping (66%).

Carillion seems to bear out the results. The listed UK construction services group, which had close to around GB£1bn of debt, hit headlines with a profit warning in July 2017, launched restructuring talks soon after and filed for insolvency last month.

This line-up is distinctly different from 2017. Opportunities in the telecommunications, cable and technology industries have diminished with only 15% to 16% stating there will be significant distress, compared to 54% the previous year.

Some respondents also believe that retail will see its fair share of activity – despite its lowly position in the table. Many former stressed retail names such as Hema in the Netherlands, Takko in Germany, Cortefiel in Spain and Matalan in the UK have bounced back and managed to refinance in the last 12 months, but there are still plenty of struggling retailers, such as value fashion group New Look or department store House of Fraser.

“We were surprised to see low retail rates on the list for distressed debt opportunities,” says Orrick’s Scott Morrison. “We have seen an uptick in distress in this area and I wonder if respondents may have responded differently if the issues relating to Steinhoff had been public at the time of the survey.”

South African retail conglomerate Steinhoff, which owned assets in the US and across Europe, is facing liquidity issues after disclosing accounting irregularities.
Please rate the following in terms of the opportunities they present for distressed investors in 2018? (Please select top two)

(DI respondents only)
Non-performing loans
In part, the interest in property is being driven by the almost €1tn worth of non-performing loans (NPLs) that are sitting on the balance sheets of weaker continental banks.

Figures from professional services firm Deloitte show that specialised buyers of distressed assets have raised US$300bn to spend on impaired loans. In terms of the types of NPL products, commercial mortgages are the preferred option among 80% of respondents.

“Commercial mortgages that have a medium value will be good investments,” says a partner at a hedge fund in Sweden. “As businesses get stronger in 2018, there are good chances of getting higher returns from the NPLs.”

However, our survey also shows that almost half are broadening their horizons beyond property-focused debt to purchase NPLs in small-to-medium-sized enterprises.

In terms of geographies, Spain (62%) and Italy (60%) offer the most appealing hunting grounds.

“Both these countries have great opportunities in NPLs,” says the partner at a Swiss hedge fund.

This view is backed by Patrizio Messina from Orrick’s Structured Finance division in Rome. “Our workload relating to securitisation of NPLs has exploded here in Italy in recent years,” he says. “We think the banks needed to get real about selling their NPLs and cleaning up balance and this is now happening. We also expect to see increased activity in Portugal and Greece.”

Former favourite Ireland is less interesting because local banks have adopted a much more aggressive and accelerated approach in cleaning up their balance sheets.

If you invest in NPLs, what kind of NPLs do you invest in? (Select all that apply?) (DI respondents only)

- A Commercial mortgages
- B SME loans
- C Residential mortgages
- D Secured consumer credit
- E Unsecured consumer credit
In which geographies are you interested in buying NPLs? (Select all that apply) (DI respondents only)

- 31% Ireland
- 60% Italy
- 29% Eastern Europe
- 31% Portugal
- 62% Spain
- 4% Greece
Going to the source

In terms of origination, 56% think independent firms head the pack as a key source for distressed debt opportunities while 44% see direct contact with corporates as one of the main sources. These are a fair way clear of other choices such as existing lenders and press/public sources.

“Direct contacts and independent originators will be our major sources for distressed debt opportunities. We have a good mix of both these resources in the market,” says the partner at a hedge fund based in Switzerland.

Economic trends and performances by geography and industry are considered the two most important metrics followed by management change, cash balances and available headroom on facilities.

“We focus on corporates and their shareholders but interact regularly with hedge funds because they can be a force for good to raise new money and facilitate a restructuring that will create value for all participating stakeholders.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill
Opportunity knocks
When asked which instruments would deliver the most attractive investment opportunities, distressed investor respondents are divided. Almost half (45%) select convertible bonds while 41% choose deeply subordinated instruments like mezzanine debt/payment in kind (PIK) notes.

“Convertible bonds that provide ownership opportunities will be good investment instruments in 2018,” says the managing director of a UK-based asset management firm.
Some 93% of respondents consider a yield level of 14-19% to be “distress”. All respondents agree that investing in distressed debt in 2018 would generate a return of above 10%.

Around a third (36%) of respondents believe performance could be at the higher end of the 16-20% range, despite only 5% of respondents achieving this target return in 2017.

“Returns within the 15% range are expected from distressed debt,” says the managing director of a hedge fund based in Switzerland. “This is a sizeable expectation, but we also believe that some investments can generate higher returns above this if they have the right conditions.”

In terms of stumbling blocks preventing investments in distressed debt, 48% point to legal jurisdiction while market uncertainty was one of the biggest concerns for 45%.

“Market uncertainty is the biggest challenge,” says a managing partner of a hedge fund based in Austria says. “We have no control over market conditions so it’s a challenge that will always remain. Legal jurisdictions are also creating issues as many authorities have made rules stricter.”

Stephen Phillips from Orrick’s Restructuring division explains that sometimes issues with legal jurisdictions can go beyond the legislation itself.

“We often have conversations with investors where they have had a bad experience in a distressed situation which has turned them off the jurisdiction for good,” he says. “Often the complaint is not about the insolvency laws but less tangible factors such as a sense that certain jurisdictions are for ‘insiders’ and there being a lack of transparency and speed in a particular jurisdiction. However, things do change and the new European insolvency measures, will, if implemented, create a more level playing field.”

In this market, a company with securities trading with a high-single digit yield is likely distressed. This is pushing investors to use more and more leverage to reach their investment return.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill
What percentage return did you achieve in 2017? And what percentage return do you expect when investing in distressed debt in 2018? (DI respondents only)

What are the main issues preventing your investment in distressed businesses? (Please select top two) (DI respondents only)

A 0 - 5%
B 6 - 8%
C 9 - 10%
D 10 - 15%
E 16 - 20%
F Over 20%

Key
A Legal jurisdiction
B Market uncertainty
C Leverage multiple
D Cash needs of the business
E Inter-creditor issues/debt documentation
F Timeframe for exit
G Pricing
H Access to funds internally
I Extent of CDS referencing/guarantees
MARKET OUTLOOK: DEBT RENEGOTIATION

Exploring debt renegotiation and restructuring, and the challenges that firms face

Over half of respondents (56%) expect break-up or asset disposals to be one of the most prevalent forms of debt renegotiation in 2018 followed by amend and extend requests (46%).

“Assets being sold to cover debts will be prevalent in 2018,” says a partner at a hedge fund in Sweden. “Last year saw an increase in disposals and there are higher chances of them continuing and growing in 2018.”

Amend and extends will remain popular in the current environment with European companies continuing to take advantage of rock-bottom pricing to lengthen existing facilities.

Other predominant debt renegotiation strategies such as whole or partial debt equitisation/exchange are mentioned by 44% of respondents. A much lower percentage – between 26% and 28% – see new money injections and liability management as key components of debt renegotiations in 2018.

Overall, 96% of respondents believe that at least 6% of sub-investment grade companies are likely to face debt restructuring in 2018, while 39% think that over 10% of sub-investment grade companies will be affected.

Debt renegotiations are always situation-specific, driven by the numerous factors at play. Personally, I find it impossible to predict trends. Even in the dark days after the financial collapse, M&A, debt for equity swaps, amend and extends, asset sales all played a role as they will continue to do in the future.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill

The LTM S&P European Leveraged Loan Index (ELLI) closed 2017 at 1.11%, its lowest point since LCD began tracking this data in 2008.

Charles Pontvianne, Greenhill

Which forms of debt renegotiation do you expect to be most prevalent in 2018? (Please select top two) (DI respondents only)

A: Break-up or asset disposals
B: Amend and extend
C: Whole or partial debt equitisation/exchange
D: New money injections
E: Liability management
What percentage of your portfolio underwent a covenant reset, covenant amendment or maturity extension in 2017? (PE respondents only)

- 0%
- 0% 0% 0% 0%
- 4%
- 36%
- 46%
- 14%
- 0% 0% 0% 0%
- 0-10% 11-20% 21-30% 31-40% 41-50% 51-60% 61-70% 71+

What proportion of sub-investment grade companies do you believe are likely to face debt restructurings in 2018? (DI respondents only)

- Over 10%
- 4%
- 57%
- 39%

Debt reset
Debt renegotiation was also a major theme in 2017 with all private equity respondents having had at least 11% of their portfolios undergo some sort of financial restructuring. Breaking this down, 70% report that this was the case for 21% to 40% of their portfolios, while 82% say that 21% to 40% of their portfolios underwent a covenant reset, a covenant amendment or a maturity extension.
What percentage of your portfolio underwent some form of financial restructuring in 2017? (PE respondents only)

When refinancing your portfolio companies in 2017, what percentage have you used of the following instruments? And what do you anticipate using in 2018?* (PE respondents only)

- 0%
- 5%
- 10%
- 15%
- 20%
- 25%
- 30%
- 35%
- 40%
- 45%
- 50%
- 51-60%
- 61-70%
- 71%
- 8%
- 9%
- 10%
- 11-20%
- 12%
- 14%
- 20%
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- 85%
- 86%
- 87%
- 88%
- 89%
- 90%
- 91%
- 92%
- 93%
- 94%
- 95%
- 96%
- 97%
- 98%
- 99%
- 100%

*Results show an average of the percentages given as answers by respondents

High yield hits the heights
High yield was the most commonly used refinancing instrument in the private equity toolbox last year and this will continue to be the case this year.

Nell Scott from Orrick’s Capital Markets division believes that high yield has a number of advantages as a refinancing instrument. “The high yield market has had a good year without breaking records,” she says. “Most debt raising has been devoted to refinancing (as compared to takeovers) and the high yield product lends itself to refinancing. The market is maturing in Europe and we expect 2018 levels of issuance will be similar to 2017.”

Fascinating to see that 38% of private equity respondents explained that between 31% and 40% of their portfolio underwent a restructuring. This suggests that a great deal of restructuring activity is happening quietly outside the glare of publicity given that the restructuring market, outside of a few well-known oil-related problems, has generally been considered quiet in 2017.

Scott Morrison, Restructuring Partner, Orrick, London
Regional debt restructuring
As mentioned in the investment section on NPLs, Italy and Spain will be the most active countries in restructuring their debt, with 65% and 53% of respondents choosing the countries.

“These are definitely two of the most distressed economies at the moment,” the managing director of an investment fund based in London said. “With Spain trying to deal with the issue of Catalonian independence, it’s going to get tough for the country to maintain and handle business. The businesses in Italy are also slowing down due to the lack of funds available in the country.”

Italy’s banks are finally poised to offload their NPLs in size under the GAC programme (Garanzia Cartolarizzazione Sofferenze, or NPL Securitization Guarantee) which was implemented in August 2016. Progress has been slow with only three sales totalling €2.8bn having been struck. However, JPMorgan, which, together with Mediobanca advised the Treasury on GACS, predicts the scheme will help Italian banks to offload €30bn to €40bn in bad debts in the next 12 months.

“There has been a significant uptick in single name restructurings as well as the larger NPL-type transactions,” says Daniella Andreatta from Orrick’s Milan office. “The survey results showing Italy at the forefront of expected restructurings is consistent with our experience in 2017 and expectations in 2018. We see many similar situations – corporate loans in default, the key shareholders in family companies looking for new money or new equity solutions and, importantly, the appetite for funds to act as change agents.”

Spain is farther along in its restructuring curve although there is still more work to be done. Since its inception in 2012, Spanish “bad bank” Sareb has sold a total €13.9bn of soured real estate loans out of a total €50.8bn. Last July, it launched its channel for the sale of NPLs worth €400m aimed at investors and professionals. This year, it is set to launch its Socimi Témpore Properties on the stock market, which comprises around 1,400 properties of the best rental homes in the metropolitan areas of Spain’s large capitals and other areas with high demand for rentals.

However, some, including Orrick’s Stephen Phillips, feel that the UK could be higher up than the fifth place it currently holds (22% of respondents expect to see the country with the most debt restructuring).

“We think that the devalued pound places pressure on many companies with a high import content to their components,” says Phillips. “Taken together with a number of other Brexit-related factors and the continuation of government austerity measures, 2018 will be a year where the UK may have some interesting opportunities for distressed debt and private equity investors alike. Many investors will stay away because of political risk, but the brave may see this as an investing opportunity of a lifetime.”

There will be limited sizeable restructurings in Spain in 2018, except for the ongoing one. Mid-cap opportunities will materialise in construction, engineering and industrial companies, especially those which have been hit hard by the oil and gas sector.

Alfonso Honrado, Principal, Madrid, Greenhill & Co
Private equity debt restructuring challenges

Not surprisingly, the path to debt restructuring may be bumpy this year, although there was no overwhelming consensus to determine what exact hurdles might hamper the completion of a financial restructuring. Around a third of private equity respondents expect an unworkable business model to be a major stumbling block while 22% believe it could be lenders’ perceptions of a sponsor’s available funds or track record.

The “unworkable business model” can cover a multitude of sins, according to Orrick’s Stephen Phillips. “Taking two sectors which are likely to be under scrutiny in 2018, oil and retail, we think the ‘unworkable business model’ means, in the case of oil-related companies, overly leveraged capital structures put in place when the oil price was high. In the retail context, ‘unworkable business model’ means borrowers in possession of far too many bricks and mortar sites which are unjustifiable in the digital age,” he says. “With the stabilisation of the oil price, we see a slowdown in oil-related restructurings in 2018 but the technological shift in retail is relentless. The industry is due a major structural shift which is gathering pace.”

While solutions differ depending on the circumstances, industry participants recommend that managing teams look at all the options on the table and not just rely on the traditional default options of selling assets to reduce exposure or amend to avoid taking a direct hit. The first step before taking any restructuring action is to analyse what the company needs to not only survive, but also how best it can meet shareholder’s expectations.

“With high company valuations remaining a major topic for GPs and average net debt to EBITDA ratios for buyouts exceeding 6.0X, GPs see operating leverage as key to generating returns. It is not surprising that the implementation of a workable business model is the primary hurdle to the completion of a financial restructuring.”

Briac Houtteville, Managing Director, Greenhill
When do you expect the volume of European restructurings to hit its next peak?

- 68% of distressed investors predict the peak will occur in 2019.
- 62% of private equity investors predict the peak will occur in 2019.

Barring some Brexit-related shock, we think that, while there may be a slight increase in restructurings in 2018, normalisation of monetary policy is more likely to be felt in 2019 than 2018.

Saam Golshani, M&A, Private Equity and Restructuring, Orrick
What will drive the wave?

According to both groups of respondents, one of the main macroeconomic factors that could drive the wave of restructurings is inflationary pressure in the Eurozone. The latest 1.5% level of inflation is below the European Central Bank’s target of just under 2% but manufacturing growth in the eurozone accelerated to a record high in December with the Purchasing Managers’ Index hitting 60.6. This is expected to lead to wage and price increases if the economy continues to power ahead at its current pace.

Any rise in inflation though is not expected to be accompanied by a subsequent hike in interest rates in the short term. A more likely scenario is 2019 rate rises because officials of the European Central Bank have made it clear on numerous occasions that it plans to keep rates at their current level “for an extended period of time and well past the horizon of our net asset purchases”, which are scheduled to continue until at least September 2018.

Although there has been talk of the Central Bank extending the deadline, ECB policymakers have signalled that given the robust growth outlook, the €2.55trn stimulus programme will end when planned.

More private equity firms (42%) than distressed investors (29%) view Brexit as a driver of restructuring. There are several reasons why leaving the EU could impact private equity deals. One is that many debt funds are foreign-owned and may exit the UK in the wake of the country leaving the EU.

It is fascinating to see an inflationary shock as being one of the key risks; since 2008, Europe has been concerned with the problems of deflation – is this a sign that the animal spirits will be unleashed in 2018?

Stephen Phillips, Orrick, Restructuring, London

“Following Brexit, a lot of economic changes will take place in Europe. The extent of the damage is not yet known but it could be devastating for some sectors,” a Sweden-based private equity partner said. “Along with Brexit, geopolitical conflict could also have an effect on the financial structure of European companies.”

Which macroeconomic factors do you think could drive a European restructuring wave next year? (Please select top two)

<table>
<thead>
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<th>Key:</th>
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<tbody>
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<td></td>
<td>Private equity</td>
</tr>
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<td></td>
<td>Distressed investors</td>
</tr>
</tbody>
</table>

- **A** Inflation pressures in Eurozone
- **B** Geopolitical conflict
- **C** Rising interest rates
- **D** Brexit
- **E** Systemic bank default
- **F** Political instability in Spain
- **G** Trump presidency
- **H** Political instability in Italy
- **I** Credit crunch in China
- **J** Labour election win in UK
### PE perspective

It is still too early to predict the exact outcome of the Brexit negotiations but all private equity respondents are expecting to restructure one or more of their own portfolio companies in the next 12 months. There are fairly even splits over the main triggers, ranging from companies’ failure to finance to liquidity shortfall, difficulty in amending covenants and failure to dispose of non-core assets.

In terms of the strategies that firms will employ to restructure their portfolio companies, 46% believe asset disposals and operational changes will be the main methods.

The emergence of cov-lite deals in the past few years has de-emphasised the role of financial covenant triggers as a key driver of the onset of a restructuring. The results appear to bear this out – the proportion of respondents believing that restructurings will commence as a result of failure to amend covenants has halved from 42% in the 2017 survey to 20% in 2018.

 Dominic O’Brien, Orrick, Banking, London

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**What do you expect to be the most important factor triggering restructurings for private equity companies?** *(PE respondents only)*

<table>
<thead>
<tr>
<th>Trigger</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Failure to refinance</td>
<td>24%</td>
</tr>
<tr>
<td>Liquidity shortfall</td>
<td>22%</td>
</tr>
<tr>
<td>Failure to amend covenants</td>
<td>20%</td>
</tr>
<tr>
<td>Failure to sell non-core assets</td>
<td>18%</td>
</tr>
<tr>
<td>Geopolitical/macroeconomic shock</td>
<td>16%</td>
</tr>
</tbody>
</table>

**For those firms in your portfolio which may be restructured, which methods are most likely?** *(Please select top two) *(PE respondents only)*

<table>
<thead>
<tr>
<th>Method</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Asset disposals</td>
<td>46%</td>
</tr>
<tr>
<td>Operational changes</td>
<td>26%</td>
</tr>
<tr>
<td>New equity injection</td>
<td>22%</td>
</tr>
<tr>
<td>Maturity extension/ refinancing</td>
<td>20%</td>
</tr>
<tr>
<td>Equitisation/deleveraging</td>
<td>10%</td>
</tr>
<tr>
<td>Covenant reset</td>
<td>10%</td>
</tr>
</tbody>
</table>
MARKET OUTLOOK: FUNDRAISING

Respondents reveal their thoughts on the fundraising climate for 2018

Private equity respondents have a notably more bearish outlook for fundraising conditions in 2018 than distressed investor respondents, with 94% anticipating tougher conditions compared with 70% of distressed investor respondents.

Anthony Riley of Orrick’s Corporate and M&A division in London says: “It seems that there is an almost universal belief that the private equity investment environment is going to be tough.

“This could be a result of feedback from investors, particularly in private equity funds who may be concerned that, in view of the high valuations of many businesses in the current environment, investments made in 2018 could be at the top of the cycle, and that reasonably priced bargains may be few and far between.”

“Fundraising is bound to get tougher in 2018,” a UK-based managing director of an alternative investment firm agrees. “Finding sources to raise funds within Europe will be a big mountain to climb. Depleted sources and sectors will be the main cause of this situation.”

In light of the slightly pessimistic outlook, over three quarters of distressed investors surveyed (76%) are actively raising funds.

“We are raising funds to invest in distressed debt,” says a partner at an asset management company based in Switzerland. “We have made changes to our investment strategy and bought in experts to handle debt purchases keeping in mind the high returns that can be generated.”
We continue to see a number of distressed funds raising additional equity or funds renewing their efforts with new teams being assembled.

Scott Morrison, Orrick, Restructuring, London

**Are you actively raising funds to invest in distressed debt? (DI respondents only)**

- Yes: 76%
- No: 24%

**Funding sources**

According to our survey, high-net-worth individuals will comprise the largest group of investors into distressed debt funds at 53% closely followed by fund-of-funds (39%), insurance companies (37%) and family offices (36%).

As of June 2017, data provider Preqin found that distressed debt funds have US$68bn of dry powder while direct lending and mezzanine have US$61bn and USD 51bn respectively.

Which sources do you expect to represent the largest investment in distressed funds in 2018? (Please select top two) (DI respondents only)

- High-net-worth individuals: 53%
- Funds-of-funds: 39%
- Insurance companies: 37%
- Family offices: 36%
- Pension funds: 17%
- Universities: 14%
- Banks: 4%

**Legend**

A High-net-worth individuals
B Funds-of-funds
C Insurance companies
D Family offices
E Pension funds
F Universities
G Banks
A focus on how private equity portfolio companies are performing

The survey found that private equity returns for many asset owners have failed to outperform their benchmarks. It is not a new trend but has led to some large pension funds such as the US$338.8bn California Public Employees’ Retirement System to reduce their exposure to the asset class over the past two years.

The largest share of private equity respondents (58%) say that between 21% and 30% of their portfolio companies are producing sub-par performance – up from 40% in last year’s survey. However, while nearly a third note that 31% and above of their portfolios are not hitting their marks, only 2% state that 41% and above are underperforming – down from 7% last year.
While the private equity asset class has outperformed public markets and become an increasing part of investors’ portfolios, the asset class is still characterised by a significant dispersion in returns (industry mean deal return is 1.4x while the top-quartile mean is 2.2x), illustrated by the proportion of portfolio companies performing below initial projections.

Briac Houtteville, Managing Director, Greenhill

Private equity injections
Equity injections are expected to decline this year with 66% of PE respondents signalling they expect to have to provide additional cash to between only 11% and 25% of portfolio companies in 2018.

This compares to 56% infusing new capital into between 26% and 50% of their portfolio companies last year. When surveyed last year about their 2017 intentions, the percentages match very closely: 58% said they would be considering injecting extra equity.

“A quarter of our companies have been given an extra dose of equity in the current year to try and keep up with the market and not fall behind,” says a UK-based managing director. “The current addition is serving us well and we do expect better returns by doing this.”

Ylan Steiner in Orrick’s Corporate and M&A division in London feels that it makes sense for firms to inject extra equity in the current climate. “There’s the obvious consideration of making defensive additional equity injections in a possible covenant breach scenario, given that there haven’t been too many new cheaply priced investment opportunities in the market, it makes sense for private equity houses to inject further monies into their existing portfolio companies where there may be opportunistic growth-related investments such as bolt-on acquisitions.”

The responses also vary as to what percentage of these companies represent potential distressed/debt restructuring candidates in the next 12 months. Some 32% say that between 51% and 80% of these low-performing companies represent potential restructuring candidates, and only 16% say that 30% or less of their companies are distressed candidates.

“Looking back over respondents’ answers to this question in previous years (and this year is no exception), it is striking that respondents consider that a significant portion of their portfolios are underperforming and possible restructuring candidates,” says Saam Golshani of Orrick’s Paris office. “These gloomy prognostications have often been at odds with the low default rate and relatively low levels of activity – will 2018 be different? I expect to be doing more M&A than restructuring in France and I think it’s a similar picture in mainland Europe.”
Happy returns
The main drivers behind any new investments, according to 60% of PE respondents, are the returns being achieved by the fund. Other main considerations include expected return on new monies (42%) and the ability to obtain security and/or priority ranking on new monies (32%).

Respondents are more mixed regarding which leniencies they expect. The most common cited by 48% is priority return for new money while 38% mention the ability to better negotiate covenants.

When injecting new money, the position is likely to start with all of the ‘leniencies’ mentioned but it is interesting to see which factors respondents emphasise as the key likely requests to lenders.

Stephen Phillips, Orrick, Restructuring, London

New money is a very effective way for sponsors to drive and retain control of a restructuring although in this market, the same result can be achieved with third party capital.

Carlo Bosco, Head of Financing Advisory and Restructuring, EMEA, Greenhill

In a restructuring scenario, what are the main considerations when you review new investment in portfolio companies? (Please select top two) (PE respondents only)

- A  Returns already achieved by the fund
- B  Expected return on new monies
- C  Ability to obtain security and/or priority ranking on new monies
- D  Availability of co-investors
- E  Dry powder remaining in the fund
- F  Constraints of fund structure
- G  Amount of equity invested to date
- H  Management
What leniencies do you expect from lenders in return for new money injections? (Please select top two) (PE respondents only)

A. Priority return for new money
B. Renegotiate better covenants
C. Write down of existing debt
D. Change of amortisation/maturity profile on existing debt
E. Equity cure rights
F. Covenant holiday

- A: 48%
- B: 38%
- C: 36%
- D: 30%
- E: 24%
- F: 24%
Exploring respondents’ attitudes to private debt provision and direct lending

Over the past few years, banks have withdrawn from private lending due to stricter leverage and liquidity requirements. Increasingly, private debt funds are closing the gap, drawn to these types of investments by the risk-adjusted double digit returns and low correlations to public markets in the prolonged low interest rate environment.

Research from Preqin shows that, on average, direct lending funds have the highest horizon internal rate returns across the one-, three- and five-year periods with mezzanine strategies out in front as the strongest performer. The asset class boasted a five-year horizon internal rate of return (IRR) of 12.2% to September 2016.

Assets under management

In terms of investing, distressed investor respondents in the survey say that 84% of their assets under management are currently invested, and this is set to rise to 94% in the next 12 months.

Notwithstanding concerns with high valuations at the moment, given what appears to be a relatively benign economic environment, our clients are telling us they have a good appetite for new deals and the survey’s results [which show a 10% increase in AUM in 12 months’ time] bear this out.

Jinal Shah, Corporate and M&A Partner, Orrick, London

What percentage of your assets under management are currently invested and expected to be invested 12 months from now? (State percentage) (DI respondents only)
Direct lending appetite

The appetite for direct lending among distressed debt investors is on the rise. Almost three quarters (73%) are actively raising long-term capital for direct lending – up from 66% last year – and of those, 86% are planning to offer tickets of between €10 million and €30 million.

“Direct lending is where our portfolio is going to expand in the next quarter and we have already begun raising capital for this lending purpose,” says the director of investment for a hedge fund in Germany.

Dominic O’Brien of Orrick’s Banking division in London is not surprised by the rise in direct lending intentions. “The rise of these types of funds is well commented upon,” he says. “The range of activities such funds are looking to undertake is now wide ranging and extensive.”

Where did you deploy your capital in 2017? And where do you expect to allocate your capital in 2018? (DI respondents only)

How long do you have capital locked up for? (DI respondents only)

Are you actively raising long-term capital for direct lending? (DI respondents only)

If yes what kind of ticket sizes are you planning to offer? (DI respondents only)
The PE perspective – credit solutions and private debt

On the private equity front, only 12% of survey participants are uncomfortable with the increasing number of sponsors providing credit solutions. However, most have not yet entered into financing arrangements with other sponsors, and a higher number (76%) have financed as least 16% of deals with private debt/alternative capital.

When asked about the percentage of deals financed by private debt or alternative capital, 54% say that they financed between 16% and 20% of deals. An additional 22% say that they have financed more than 21% or more of deals this way – an increase of 4 percentage points on last year.
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