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# EUROPEAN DISTRESSED DEBT MARKET OUTLOOK 2012

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JANUARY 2012





# FOREWORD

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2011 is best described as a game of two halves. The first six months built on a solid recovery in 2010, but rising concerns over Greece's rapidly deteriorating credit profile soon spread contagion market-wide. By the end of August, global markets were tugged down by the eurozone's escalating sovereign debt crisis, stemming growth and reversing progress achieved in the first half of the year.

European high yield bond issuance hit a record €28.6bn in H1 2011, but primary loans and bonds found few buyers in the last six months of the year. Issuance came to a shuddering halt, and the market never fully re-opened in 2011 as colossal sell-offs in eurozone sovereign debt spilled over into alternative asset classes.

With refinancing options off the table for the foreseeable future, companies rubbing against covenants and tackling a maturity wall are running short of funding alternatives. This sets the scene for more creditor negotiations in 2012. Europe faces limited growth prospects at best as long as the monetary union holds together, which will in turn drive a rise

in distressed debt opportunities and balance sheet restructuring, according to survey respondents.

Debtwire's European Distressed Debt Market Outlook has entered its eighth year of production, presenting detailed results of a survey questioning 100 European hedge fund managers, prop desk traders and long-only investors on the outlook for the European distressed debt market in 2012. The report also presents insight from 30 private equity practitioners. We hope you continue to find it a useful resource on sentiment in the distressed debt market.



**Robert Schach**  
Deputy Editor,  
Debtwire Europe  
robert.schach@debtwire.com

# EXECUTIVE SUMMARIES

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## Rothschild

We enter 2012 with greater uncertainty regarding economic outlook than any other year since the credit crunch in 2007. In addition to the lingering eurozone crisis, we have a number of elections this year, the USA debt ceiling, the continuing story of the Arab Spring and slowing China. The symptoms are apparent in anaemic growth, market indices and general sentiment but the outlook is clear amongst the respondents to this report: there will be more restructuring this year than last and it will be a tougher environment for companies to access capital.

The first half of 2011 proved very different. The leveraged loan and high yield markets opened up leading to many speculative grade companies seizing the opportunity to refinance or to amend-and-extend. The eurozone issues brought this window to an abrupt close over the summer. It is difficult to accurately predict when the markets will re-open, but companies need to be ready to act quickly as any new window may be short-lived.

This brings the maturity wall back on the agenda. If the lack of liquidity in the traditional loan and bond markets persists, and as existing CLO investment windows close, we can expect to see a rising need for alternative sources of financing. This will provide an opportunity for investors as traditional capital suppliers may be disintermediated in 2012.

Overshadowing many of these themes is the desire for greater clarity on how European governments propose to deal with eurozone issues. Having already used most of the fiscal and monetary levers to stimulate economic growth in the past four years, and with many governments having started to apply austerity measures to reduce their deficits, this leaves few obvious catalysts for stimulus. This will persist in 2012 offering little comfort to many weaker credits which are on the course to restructuring – weaker than expected trading experienced by many companies in the second half of 2011 is starting to translate into LTM covenants for the first two quarters of the year. Private equity funds reaching the end of investment periods may not be able to provide new money to troubled investors.

Some high yield structures recently put in place are already finding their way to discussions with their creditors. CMBS renegotiations will be another big theme for the year. The list of potential sources of distress goes on ... the solutions will lie in old and new restructuring technologies, but this time around expect stakeholders to be more focussed on proper balance sheet solutions rather than some of the “thin-air-for-equity” swaps of the recent past.



**Andrew Merrett**  
European Head of Restructuring  
Co-Head Financing Advisory – London  
Rothschild  
andrew.merrett@rothschild.com

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## Cadwalader, Wickersham & Taft LLP

After a relatively quiet 2011, the responses to this year's Debtwire Distressed Debt Outlook market survey suggest that 2012 will be much busier on the restructuring front. The driving force behind this upturn in activity is the European sovereign debt crisis, which has disrupted credit markets and has now pushed members of the eurozone into what promises to be a deep and sustained recession. Responses to the survey highlight that uncertainty over the future of the euro and the solvency of Europe's banking sector are clearly framing all investors' views of the market.

Since 2009 European debtors have avoided biting the "deleveraging bullet" as expansionary monetary policy implemented by European governments to minimise the duration of the post-Lehman recession boosted consumer demand, and liquidity in the high yield market allowed for the refinancing of maturing sub-investment grade bank debt. However, as 2012 begins, we are seeing European governments taking money out of their economies and little (if any) capacity or appetite in the market to take Europe's banks out of their riskier assets.

Given those pressures, we foresee that European debtors, squeezed by both a lack of consumer demand and dearth of credit, will be forced to find a more substantive fix for their capital structures than the "extend and pretend" stopgaps that have been so prevalent in the market in the past two years. The only question will be how deep the deleveraging throughout Europe will have to be. The markets are anticipating strong medicine. Respondents' preference for senior debt reinforces the view that value will increasingly break higher and higher in the capital structure.

2012 is therefore likely to see the surge in restructuring opportunities that market participants have been predicting over the past two years. That assumes an orderly resolution of the eurozone crisis, with only inevitable and hence predicted side effects (shortage of both credit and private demand, due to prescribed austerity). If politicians and central bankers lose effective control of the crisis, then collateral damage (to stressed but sound debtors, for example) flowing from a disorderly sovereign default (or defaults), or implosion of the European monetary union, means that all bets are off.



**Richard Nevins**  
Partner,  
Cadwalader, Wickersham & Taft LLP  
richard.nevins@cwt-uk.com



**Greg Petrick**  
Partner,  
Cadwalader, Wickersham & Taft LLP  
greg.petrick@cwt-uk.com

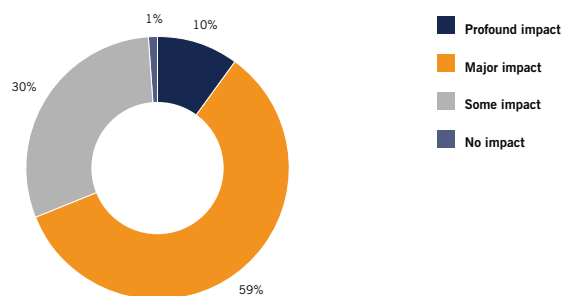
# DISTRESSED INVESTORS SURVEY

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In the final quarter of 2011, Debtwire canvassed the opinions of 100 hedge fund managers, long-only investors and prop desk traders in Europe.

Interviewees were questioned about their expectations for the European distressed debt market in 2012 and beyond. The interviews were conducted over the phone and the respondents were guaranteed anonymity. The results are presented in aggregate.

1a. What do you feel will be the impact of the eurozone and sovereign debt crisis on private credit markets?



The majority of investors believe the sovereign debt crisis in the eurozone will have a significant impact on private credit markets, although there is no clear view on what the outcome will be. Close to 60% expect the crisis to have a “major impact” and 10% predict a “profound impact.”

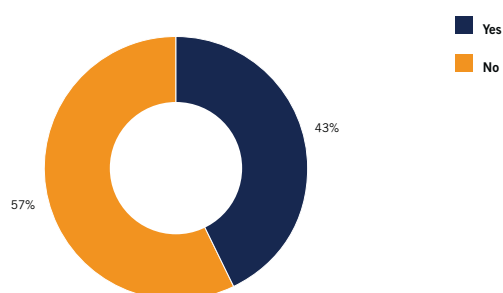
“Things could become difficult if banks aren’t lending any more to investors,” one hedge fund manager commented.

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*“Europe wide austerity measures, implemented in the wake of the sovereign debt crisis, are draining liquidity from the European economy. Europe’s banks, already burnt by their exposure to sovereign debt and holding €1.7 trillion of non-core and non-performing assets on balance sheets, are unlikely to expand, or even maintain, private lending. This will create a damaging feedback loop, reducing economic activity as private borrowers, starved of credit and squeezed by government austerity measures, scale back operations and cut employment, hurting tax collections, leading to further austerity. With lenders competing to reduce riskier loans, restructurings will become ‘harder’ (equitisations, administrations) not ‘softer’ (extend and pretend).”*

Richard Nevins, Cadwalader, Wickersham & Taft LLP

1b. Do you expect Greece to be cast out of the eurozone?

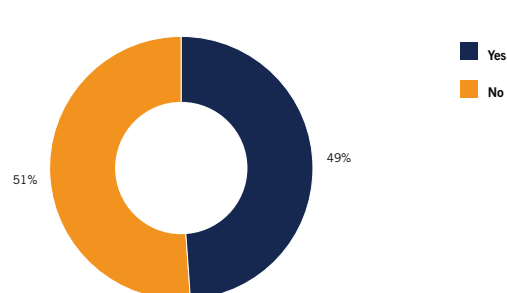


The majority of the respondents believe Greece will not be ejected from the eurozone, but 43% expressed doubt over the beleaguered sovereign's ability to remain a member. Some participants think it could leave the monetary union but remain in the EU.

"The general feeling is that it would be a drastic measure, and rash to throw them out," a prop desk trader commented.

"If you let Greece out, the problem is this what happens to Portugal, Spain, Ireland and Italy?" a hedge fund manager added. "If one of these countries leaves the currency union then you could end up with a situation where others do the same, and then it's no longer a problem you can handle."

1c. Do you believe the single currency will fail in its current form?

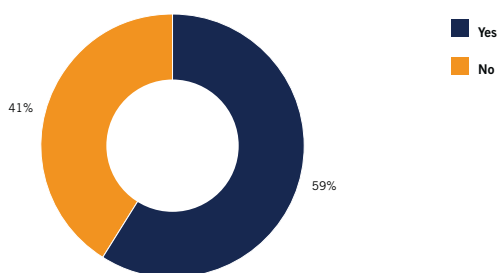


Almost half of all survey respondents (49%) believe the single currency will fail in its current form. The main reason for the creation of the euro was to unite Europe, one hedge fund manager says. "It might make sense from an economic perspective to exclude some countries from the euro, but there just isn't the political will to do so."

"It will not survive in its current form," a second hedge fund manager predicted.

# DISTRESSED INVESTORS SURVEY

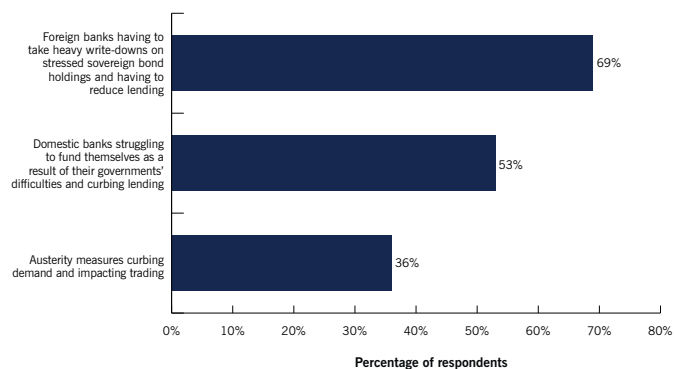
1d. Do you expect the eurozone to opt for eurobonds/fiscal union?



The majority (59%) of those surveyed believe the eurozone will end up either issuing joint eurobonds or becoming a fiscal union in order to resolve the sovereign debt crisis.

“Eurobonds would be a good solution, but not a final solution to the crisis and any fiscal integration would mean a strong loss of sovereignty for each government,” a prop desk trader commented.

2. What will be the cause of the restructuring resulting from sovereign risk issues?



Respondents are clearly concerned over the impact the sovereign debt crisis is having on European banks. Over two-thirds expect write-downs on holdings of stressed sovereign's bonds to impact banks' ability to lend, and just over half think that in countries struggling to fund themselves domestic banks will suffer a knock-on effect in terms of raising capital that will lead them to curb lending, both of which will trigger corporate restructurings.

“Liquidity from domestic banks is drying up and this is having an impact on us,” a prop desk trader commented.

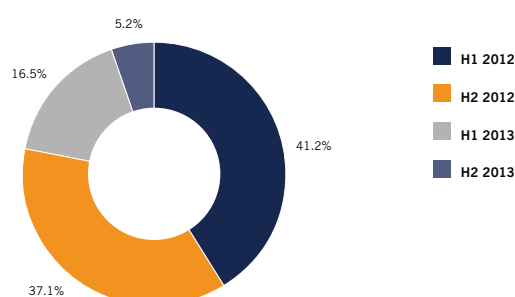
“Financing of the economy is beginning to shift from financial institutions to industry,” a hedge fund manager noted. Companies have lots of cash, so they will probably take over the financing role. For example, Siemens and other big companies are already placing their money with central banks.”

Heavy sovereign bond write-downs will also impact institutional investors, not just banks, according to a second hedge fund manager. Pension funds with a limited ability to hold equities are unable to achieve their targeted 4% returns by buying safe bonds like German bonds, which has forced them to take on Greek, Portuguese and Irish risk, he stated. “The whole haircut debate will be a real issue for them and will impact the real economy very heavily.”

*“It is clear from survey responses that European corporates will be hit from all angles during 2012. As highlighted by previous charts, liquidity available in the market will be markedly reduced – not just in the form of bank debt but also HY bonds. Further, austerity measures and the resulting Europe-wide recession will impact negatively on corporate financial performance. The effects of this are already being seen in the UK retail sector.”*



### 3. When do you expect the volume of European restructurings to hit its next peak?



Survey respondents remain divided over how long it will take before European restructurings reach their next zenith. Some 41% predict restructurings will peak in the first half of 2012 and 37% think it will be in the latter half of the year. Approximately 22% of those asked said that European restructurings would not reach their peak until 2013.

"Given that restructurings are going to peak for Greece in December, I expect Europe to peak in the first half of 2012," a prop desk trader commented.

"I think restructurings will continue for a long time," a hedge fund manager added.

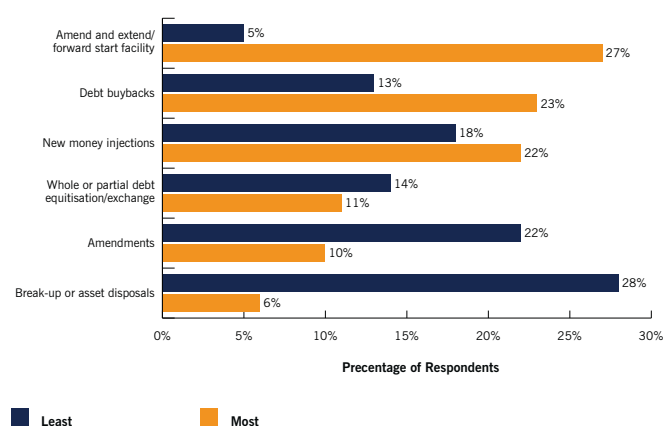
*"There should be a steady stream of restructurings throughout 2012 and beyond as companies are required to refinance indebtedness for which there is no longer a market, or simply run out of cash."*

Richard Nevins, Cadwalader, Wickersham & Taft LLP

*"Softer trading performance as GDP growth in Europe has slowed through 2011 is resulting in tight covenant forecasts for Q1 and Q2 2012 as this translates into full 12 months of weaker than expected trading."*

Arnaud Joubert, Rothschild

### 4. Which form of debt renegotiation do you expect to be prevalent in 2012?



Amend and extend and/or forward start facilities will be the most frequent form of debt renegotiation during 2012, according to 27% of those surveyed, the largest single group of respondents. Some 23% expect debt buybacks to be the most prevalent, while 22% of the respondents tip new money injections as the most widely used form of debt renegotiation next year.

Company break-ups and asset disposals will be the least likely solution to debt renegotiations, according to 28% of respondents surveyed.

*"A revealing question, perhaps speaking more to respondents' hopes (as opposed to expectations): asset disposals (by troubled borrowers) are seen as less likely (presumably due to a shortage of investment capital), but debt buybacks and new money injections (requiring access to new cash) are seen as more likely. At the same time, transactions that immediately and significantly aid debtors (equitisations) are seen as less likely (when constrained liquidity indicates they should become more likely), perhaps due to the sharp sacrifice they require of creditors."*

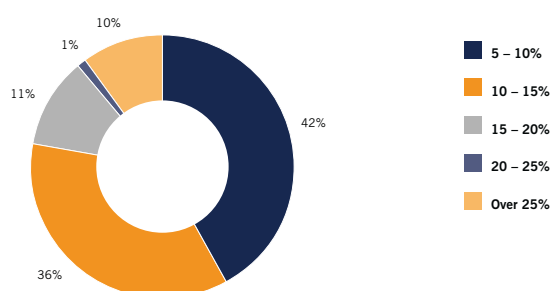
Richard Nevins, Cadwalader, Wickersham & Taft LLP

*"Performing companies that have, however, hardly deleveraged over the past 3 to 5 years and which bear a large quantum of debt will face greater reluctance from their creditors to extend their maturities, potentially leading to break-ups, forced selling or even restructuring."*

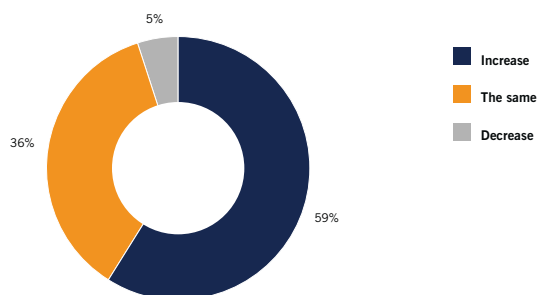
Arnaud Joubert, Rothschild

# DISTRESSED INVESTORS SURVEY

5a. What proportion of sub-investment grade companies do you believe are likely to face debt restructurings in 2012?



5b. Does this represent an increase or a decrease from 2011?

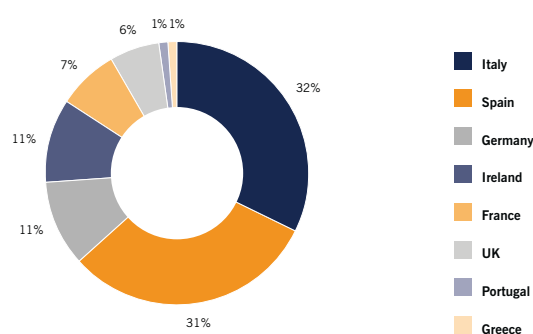


Respondents are wary over 2012, with over half expecting more than 5-10% of speculative grade European issuers to undergo a debt restructuring in 2012, followed by 36% who think the number could be 10-15%. Some 10% of those surveyed anticipate a doomsday scenario of more than 25% of sub-investment grade companies having to rework their capital structures this year.

Some 60% of respondents expect the number of restructurings in 2012 to rise versus 2011, which reflects the gathering pessimism over stalling global economic growth and adverse impact of the sovereign debt crisis. However, at 36%, a still sizeable number of those surveyed think the ratio will likely remain the same, implying they see few near-term triggers, such as upcoming maturities in 2012.

“Because of what’s going on in Greece, Spain and France a lot of companies are going get into trouble and I think it will be more severe compared to 2011,” a prop desk trader said.

### 5c(1). In which country do you expect most European debt restructurings to take place?



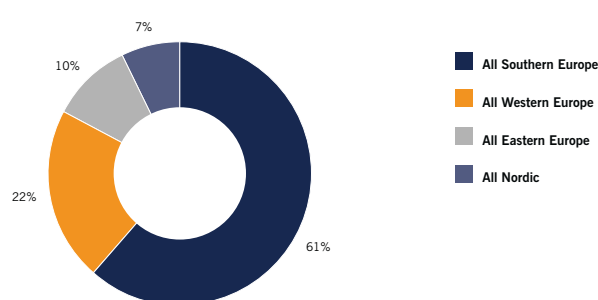
Spain and Italy have displaced the UK as countries in which survey respondents expect the highest number of restructurings to take place over the coming downturn. Some 32% expect Italy to account for the largest share of corporate workouts, followed by Spain with 31%, Germany with 11% and France at 7%. Just 6% of those surveyed think the UK will lead in terms of restructurings, a sharp reversal from last year's survey in which the UK took top spot with 39%.

"Financing rates in Italy are unsustainable, and they will increase even further," a hedge fund manager commented.

*"A key theme for Italian corporates in 2012 will be the availability of credit as bank debt represents two thirds of total existing debt and 60% of it has a maturity not exceeding two years. With the international banking system under pressure, there is fear that liquidity in the market will remain tight notwithstanding the massive injections from the ECB. This would translate into further restructuring despite the continuing effort to postpone refinancing cliffs through amend and extend transactions and issuance of high yield bonds."*

Alessio De Comitè, Rothschild

### 5c(2). In which region do you expect most European debt restructurings to take place?



With the crises in Greece, Spain and Italy escalating, the majority of debt restructurings in 2012 are now expected to take place in Southern Europe, rather than Western Europe. The level of respondents tipping Eastern Europe has remained unchanged at 10%, and unsurprisingly just 7% expect the Nordic regions to lead in terms of corporate restructuring.

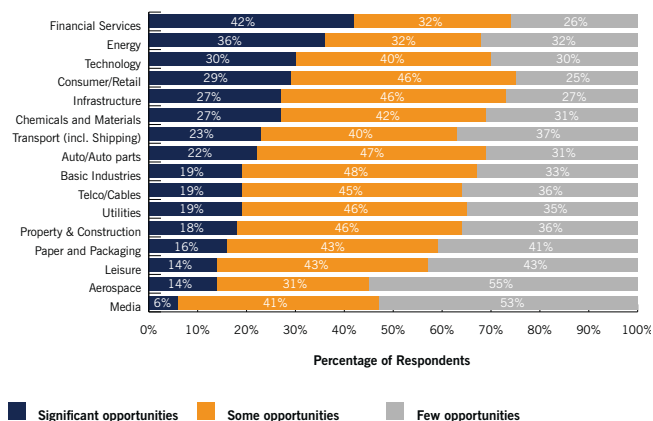
"I think Southern Europe, especially Italy, has the weakest governments," a prop desk trader said.

*"Southern Europe is the obvious answer to this question, as it is clear that Spain and Italy in particular face significant structural challenges and are likely to experience deep recessions. However, the lack of liquidity will have a knock-on effect throughout the region."*

Greg Petrick, Cadwalader, Wickersham & Taft LLP

# DISTRESSED INVESTORS SURVEY

6. Please rate the following in terms of the opportunities they present for distressed investors in 2012.

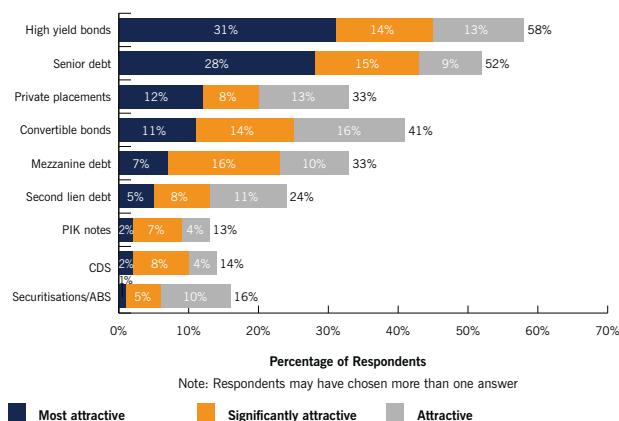


The impact of the burgeoning sovereign debt crisis on banks has elevated financial services to top spot from second place last year in terms of significant opportunities for distressed investors. Respondents also see significant opportunities in the energy sector, followed by technology and retail. Property and construction workouts seem to have played out, with the sector slipping down the rankings for distressed opportunities to tenth place compared to first place last year.

*“Consumer facing businesses with upcoming maturities throughout the eurozone face the double whammy of reluctant lenders and frightened consumers who are paring back household expenditure at every opportunity.”*

Dacre Barrett-Lennard, Rothschild

7a. Out of the following, please rank the three instruments that you think will offer the most attractive investment opportunities in 2012.



High yield bonds, picked by 31% of those surveyed, replace senior debt as the most attractive investment opportunity for the year ahead. Private placements move to third place from fourth, while convertible bonds leapfrog into fourth place from seventh last year as mezzanine debt slips to fifth place from third. ABS debt lost some of its appeal, dropping to ninth place from sixth last year, while PIKs remain among the least favoured debt instruments.

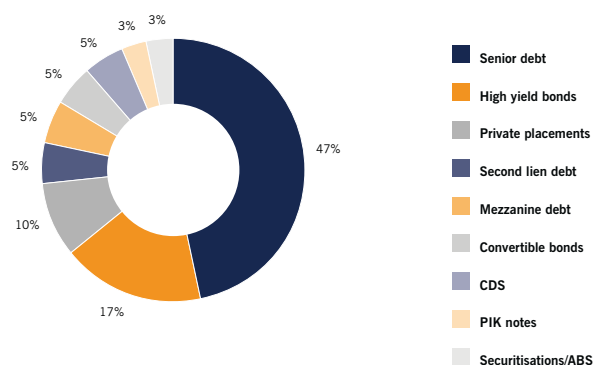
*“High yield bonds appear to have confirmed their prominence in the European leveraged landscape, as the instrument of choice both for refinancing (mostly of bank debt) and restructuring (as the ‘fulcrum’ security in the debt capital structure, where risk, and hence potential reward, is highest).”*

Richard Nevins, Cadwalader, Wickersham & Taft LLP

*“High yield issuance dominated the first half of 2011. Many speculative grade credits capitalised on this window – but some of the weaker high yield credits will be back and need to restructure, with bank-bond deals likely to be first up.”*

Glen Cronin, Rothschild

7b. Which instrument is most likely to be attractive as a means to secure control of a credit in 2012?



Senior debt remains the most attractive instrument for obtaining control of a credit going forward, with 47% of the respondents identifying it as their preferred route to take over a distressed company. Mezzanine is displaced as the second best option by high yield bonds, slipping to fifth place. Private placements increase in importance, jumping to third place from sixth in 2010.

Senior debt typically includes a security package that enables creditors to obtain control of a company, a prop desk trader notes.

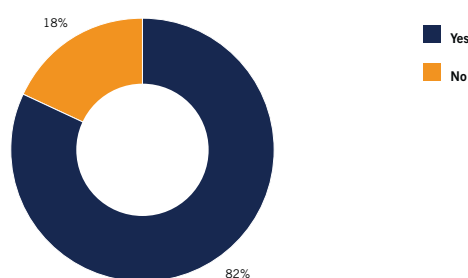
*“Senior bank debt will remain the most attractive means to secure control because even in post 2009 split bank debt/secured HY bond structures, the bank lenders will control enforcement of security.”*

Alex Kay, Cadwalader, Wickersham & Taft LLP

*“Incumbent lenders in restructuring situations are likely to continue to rely on transparent M&A processes/market testing to assure themselves that they are receiving best value.”*

Dacre Barrett-Lennard, Rothschild

8a. Do you expect to witness more in-court debt restructurings in 2012 than during 2011?



The overwhelming number of respondents (82%) expect in-court restructurings to increase next year versus 2011. This is a sharp tack in attitudes from last year, when survey respondents were almost equally split on the issue.

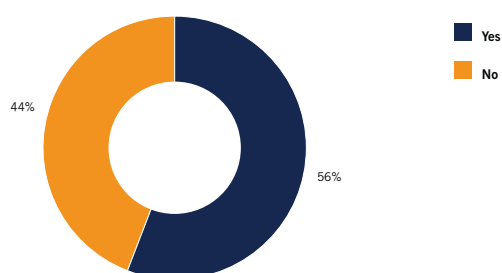
“The overall credit situation is getting more critical,” a prop desk trader commented.

*“Expect banks to be very reluctant extenders of credit at maturity. There will be little choice for them but it’s going to make negotiations tougher.”*

Richard Millward, Rothschild

# DISTRESSED INVESTORS SURVEY

8b. Do you expect to see an increase in the number of companies moving their centre of main interest (COMI) to the UK or US to transact restructurings via a court-driven process?



A small majority (56%) expect an increase in the number of companies switching their COMIs to the UK or US to complete restructurings. The six percentage point rise from last year likely reflects the expected increase in in-court restructurings.

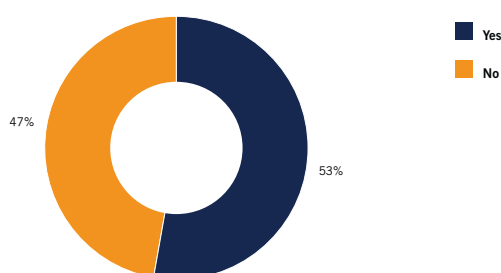
It is no longer necessary for companies to resort to US or UK courts following legal reforms in many European jurisdictions, one hedge fund manager highlights. But the US and UK processes remain more effective, a second fund manager counters.

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*“A number of European countries have rewritten their insolvency laws in the recent past in an attempt to make them more attractive to creditors. However, these insolvency regimes are generally untested from a cross border restructuring perspective and often contain idiosyncrasies that preclude restructurings being effected in an efficient and value maximising manner. Practitioners, prizing predictability, will continue to advise, where feasible, corporate migration (or connection) to the UK or the US to implement restructurings.”*

Greg Petrick, Cadwalader, Wickersham & Taft LLP

9a. Do you expect liquidity in the primary market to improve in 2012?



While the respondents are marginally more optimistic than negative on the outlook for liquidity in the primary market in 2012, the share of those expecting an improvement dropped to 53% from 82% last year, likely reflecting shrinking bank balance sheets and the structural decline of the CLO market.

One bullish hedge fund manager predicts improved visibility and a lot of new issues. “In 2012 there will be more confidence and companies will be more active in issuing debt.”

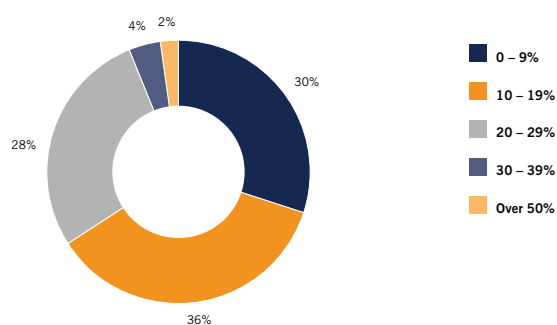
“I don’t think liquidity will increase in the beginning of the year, that’s certain, however by the end of 2012 it should,” a second hedge fund manager added.

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*“Solutions to eurozone woes in 2011 now look like Botox economics – short term fixes which could not hold off the effects of bad news coming from weaker Eurozone sovereigns – a similar approach in 2012 will result in pockets of liquidity opening and closing through the year. Companies are best advised to get ready now to capitalise on these pockets of liquidity as they appear – liquidity windows may be short.”*

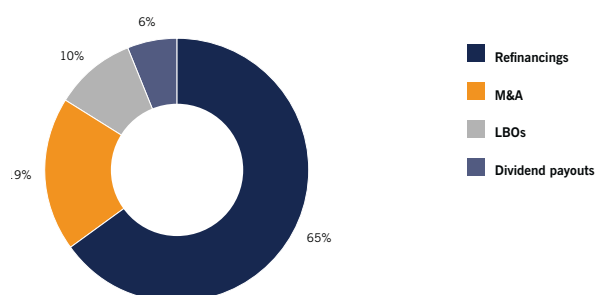
Glen Cronin, Rothschild

9b. In percentage terms, how much will liquidity improve in the primary market in 2012?



Out of those respondents expecting liquidity in the primary market to improve next year, some 36% think it will increase by 10%-19%, in line with last year's forecasts. Just 6% of survey respondents expect liquidity to improve by more than 30%, compared with around 10% of respondents last year.

9c. What will be the key driver behind primary market activity in 2012?

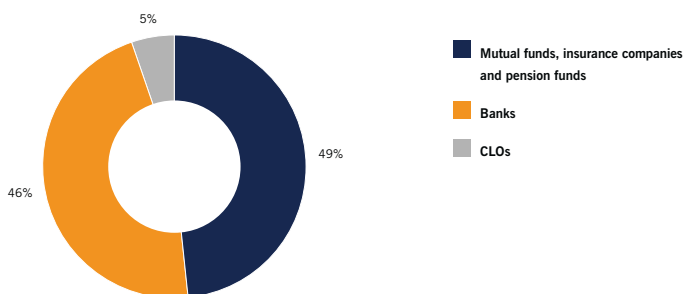


Refinancing will remain the key driver for new deals, with 65% of respondents citing it as the main reason for companies to tap the debt capital markets in 2012. Funding M&A was in second place, LBOs in third with dividend payouts considered the least likely driver of the primary market next year.

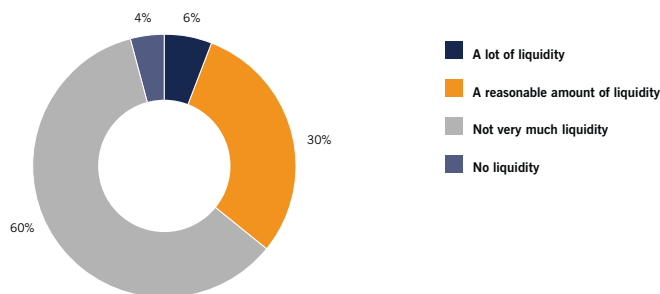
"Some companies have very attractive valuations right now, and other companies are generating a lot of free cash flow so have enough cash to buy a competitor and increase their market share," said a hedge fund manager expecting M&A deals to lead issuance.

# DISTRESSED INVESTORS SURVEY

9d. Who will be the players behind primary market liquidity in 2012?



10a. How much liquidity is there in the high yield bond secondary market in Europe?



The survey uncovers a substantial shift in expectations of the players providing primary market liquidity in the year ahead. Almost half the respondents think funds will be the main providers of liquidity in 2012, edging out banks, a reversal of last year's expectations when over 60% expected banks to be the key providers and just 30% tipped funds. Just 5% expect CLOs to be the main liquidity providers, down from 8% last year, further highlighting the structural decline of the CLO market.

"Mutual funds, insurance companies and pension funds have lots of money they will put it into the market," one hedge fund manager commented.

"Banks [will be the main liquidity providers], because the system is supposed to be run in this way," a second fund manager countered, while a third predicts a recovery of the banking system.

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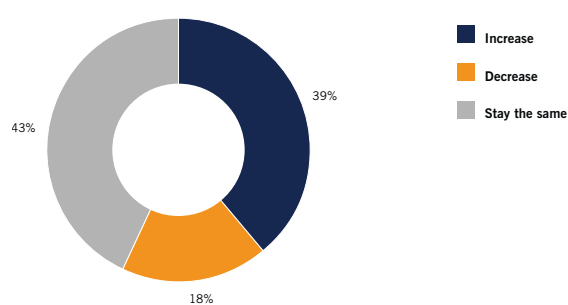
*"Disintermediation is on the agenda as questions are raised on whether capital markets will be there to absorb reduced bank and CLO issuance."*

Andrew Merrett, Rothschild

Liquidity has dried up in the secondary high yield cash bond market, with 60% of respondents seeing very little and just 30% experiencing a reasonable amount of liquidity. This time last year some 60% of respondents felt there was a reasonable level of liquidity in the secondary market, and just 16% thought there was not very much.



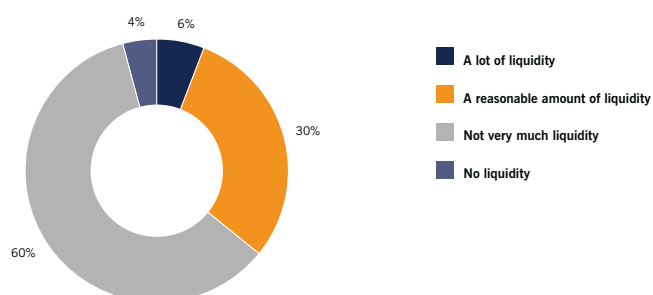
10b. Do you think that this level of high yield liquidity will increase, decrease, or stay the same in 2012?



The largest group of the respondents (43%) expect liquidity in the secondary market to stay the same next year, while some 39% expect it to improve – more than twice as many who expect liquidity to deteriorate.

“Risk appetite will get back to normal,” said one hedge fund manager.

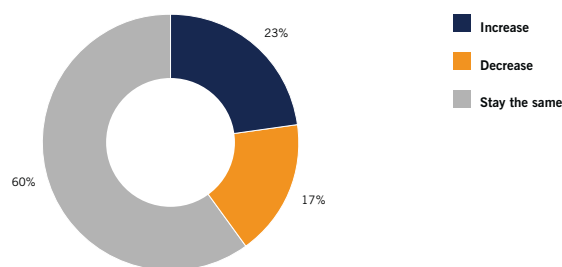
11a. How much liquidity is there in the secondary loan market in Europe?



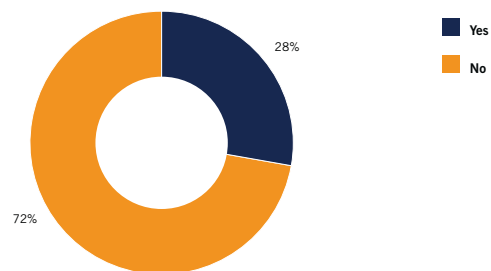
Respondents' experience of liquidity in the secondary loan market echo those on the high-yield bond side, with 60% saying liquidity is scarce, and just 30% experiencing reasonable levels. Last year 53% of respondents felt secondary liquidity in the loan market was reasonable, and just 35% said there was not very much.

# DISTRESSED INVESTORS SURVEY

11b. Do you think that this level of loan market liquidity will increase, decrease, or stay the same in 2012?



12. Have you increased your asset allocations to distressed investing in the last twelve months?



The majority of respondents expect the level of liquidity in the secondary loan market to stay the same, but 23% expect it to improve, outnumbering the 17% who think it will dwindle further.

“I expect it to increase because the European Central Bank is acting to provide some liquidity [to banks],” a prop desk trader commented.

“There will be consolidation in the markets and a shift from debt to equity so liquidity will remain [weak],” a more downbeat hedge fund manager countered.

Nearly three-quarters of the respondents (72%) say they have not increased their asset allocation to distressed investing in the past twelve months, suggesting that they expect things to get worse before they get better.

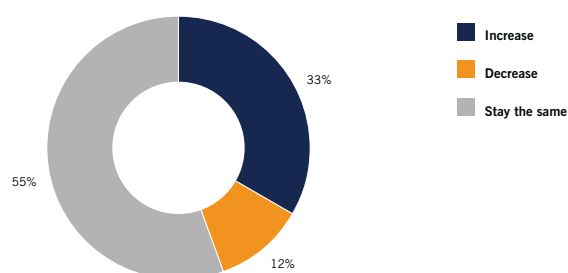
“The risk is too high,” said one prop desk trader.

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*“A fascinating contrast with the responses to question 4; there, respondents thought (potentially) ‘creditor friendly’ outcomes (including debt buybacks (for cash)), new money injection (bespeaking sponsor confidence) and ‘amend and extends’ (avoiding immediate write-offs) were most likely. However, when it came time to place their bets (in terms of 2012 asset allocations), outcome risk was by contrast seen as overly high (suggesting actual fear of more ‘robust’ restructurings, where new money is not to be found, and significant creditor ‘contribution’ becomes inevitable).”*

Richard Nevins, Cadwalader, Wickersham & Taft LLP

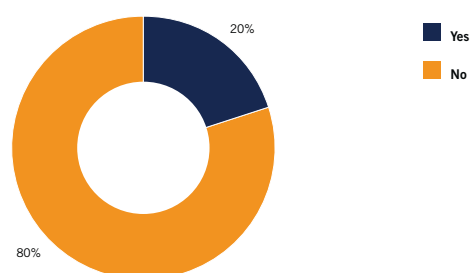
13. What do you expect to happen to your distressed allocations in 2012?



While just over half the respondents plan to maintain their allocation to distressed debt next year, a third expect to increase it. Just 12% say they will reduce it.

Opportunities in the distressed market are on the rise, hedge fund managers say. "It [our distressed debt allocation] will increase, because some companies have suffered a lot and we can follow distressed strategies," one of them adds.

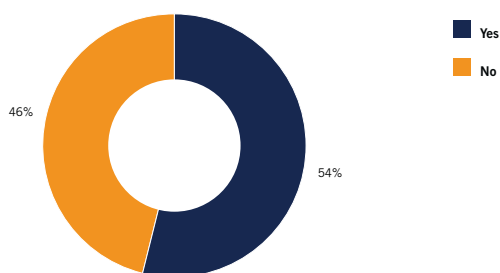
14a. Are you actively raising distressed funds?



Just 20% of the respondents surveyed are in the process of actively raising funds for distressed debt opportunities, slightly down on the same time last year, when 26% of those surveyed were raising money to invest in distressed situations.

# DISTRESSED INVESTORS SURVEY

14b. Do you anticipate tougher fundraising conditions in 2012?

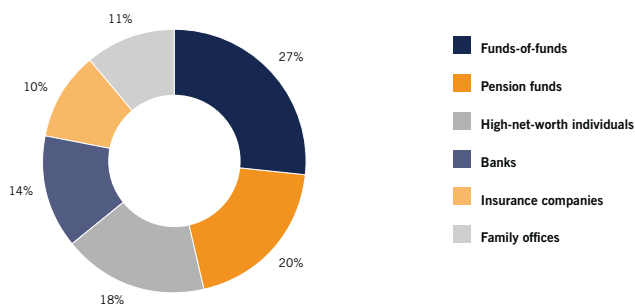


Raising new money has become significantly more difficult, according to respondents. Just over half (54%) anticipate tougher fundraising conditions next year, a notably more pessimistic view from a year ago when just 33% expected it to become more difficult.

*“2011 can be summed up as the year where volatility accelerated. The euro crisis remained open for resolution and only strong credits remained immune from funding challenges.”*

Richard Millward, Rothschild

14c. Which source do you expect to represent the largest investment in distressed funds in 2012?



Funds-of-funds will likely provide the largest investment in distressed debt funds next year, according to 27% of respondents, the largest single block of the survey pool. Pension funds – last year’s top pick as a source of new money – have dropped to second place. High net-worth individuals have moved into third place, while banks have dropped to fourth, again reversing last year’s order.

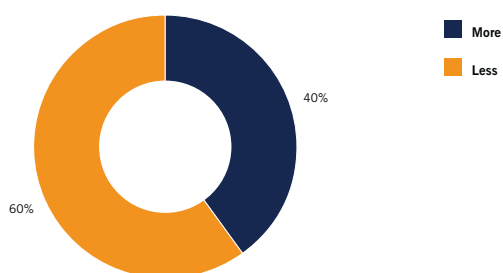
“High-net-worth individuals seem most likely to invest in distressed funds, as others do not have that much money to invest right now,” stated one prop desk trader.

“I think high-net-worth individuals are more flexible compared to other investors in this environment,” agreed one hedge fund manager.

*“Banks are having to review their appetite for crystallising losses on disposal on a quarterly basis; inter alia, this is dependent on both internal and external factors which affect the level of provisions which can be utilised to cover losses.”*

Hamish Mackenzie, Rothschild

14d. Do you expect it to be more or less difficult to source distressed deals in Europe in 2012?

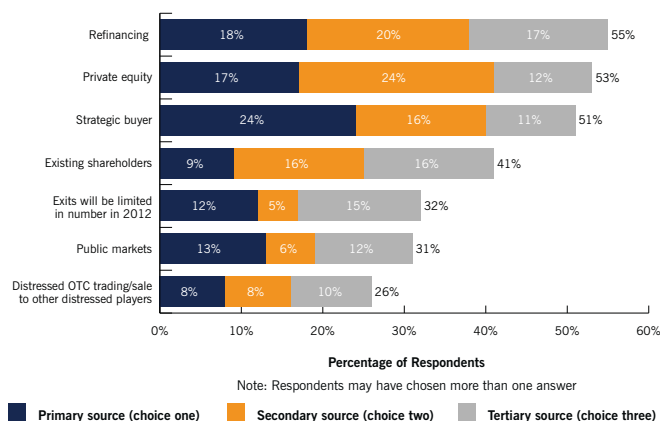


A clear majority of the respondents (60%) expect it to become easier to source distressed deals in Europe next year, an increase of four percentage points versus last year.

*"Market consensus is that increasing numbers of European companies will be in distress in the coming year; indeed, recessionary conditions are already apparent in Southern Europe, and unresolved sovereign debt and currency union problems strongly suggest Europe will drive the next wave of corporate restructuring."*

Greg Petrick, Cadwalader, Wickersham & Taft LLP

15. What do you expect to be the primary source of liquidity for long-term exits from European distressed debt? (Please rank the top three.)

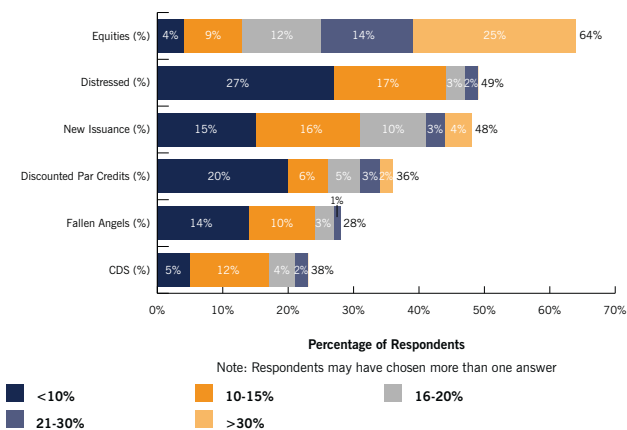


Strategic buyers will likely represent the key source of liquidity for long-term exits from distressed European deals, according to 24% of respondents' first choices, followed by refinancing with 18% and private equity buy-outs on 17%. But when adding first, second and third choices together, some 55% expect refinancing to offer the most likely exit route from distressed debt investments, ahead of 51% plumping for strategic buyers.

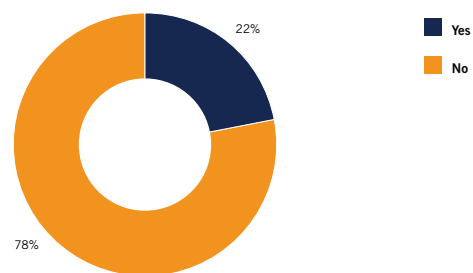
Encouragingly, just 12% of respondents, in terms of first choice, and 32% on a total basis, expect a limited number of exits in 2012.

# DISTRESSED INVESTORS SURVEY

16. What proportion of your investments in the past twelve months have you allocated to the following?



17a. Are you actively seeking direct new money investments in stressed scenarios?



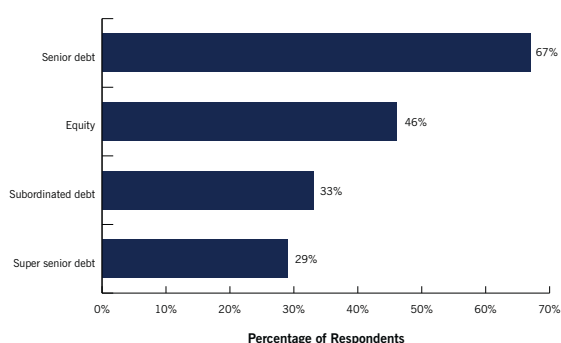
Equities made a comeback in the past twelve months, with almost a quarter of the respondents having allocated more than 30% of their investments in the past year to the asset class, up from just 9% in last year's survey.

New issuance represented a 30% plus share of new investments in the portfolios of 4% of those surveyed and discounted credits in 2%. Distressed debt has been sidelined in the past twelve months, with just 2% of respondents having allocated more than 21% to the asset class.

"We allocated 95% [of our investments] into refinancing new issuances," said one prop desk trader.

Just over one-fifth (22%) of the respondents are seeking direct new money investments in stressed scenarios at this point. Last year, about a third of respondents were actively seeking opportunities in underperforming companies.

17b. If yes to the preceding question, in what form?

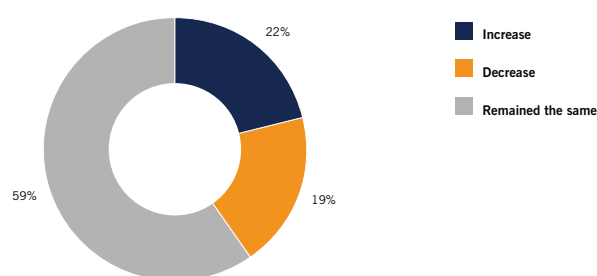


Note: Respondents may have chosen more than one answer

Senior debt remains the most popular entry point for investment in stressed situations, with 67% of the respondents preferring this route. Equity is the second most favoured form at 46%, overtaking super senior debt which has slipped to fourth place with 29%. Subordinated debt moved into third place from fourth last year as the preferred debt instrument for investing in stressed scenarios for 33% of respondents.

“We expect to invest in bonds from core Europe, nothing from Southern Europe,” one hedge fund manager commented.

18. Has your appetite for committing fresh cash to a situation to buy out other creditors increased, decreased, or stayed the same?

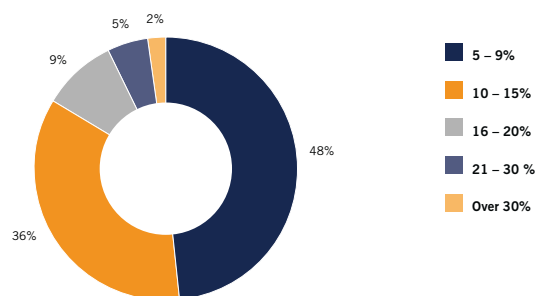


There has been little change in appetite for committing fresh funds to buying out other creditors, with 59% of respondents saying their attitude remains the same. But at 22% the number of respondents with an increased willingness to buy out fellow creditors was marginally ahead of those showing a decreasing willingness to add exposure.

“We think at this moment we should not take added risk into our portfolio,” stated one hedge fund manager.

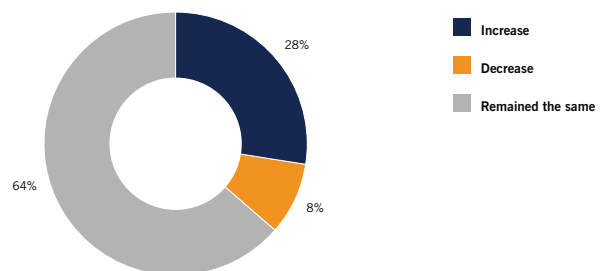
# DISTRESSED INVESTORS SURVEY

19a. What percentage return did you target in 2011?



Roughly half of the respondents (48%) targeted returns of just 5-9% in 2011, 36% expected to generate 10-15% and 9% aimed for 16-20%. Only 2% were hoping for 30% plus returns.

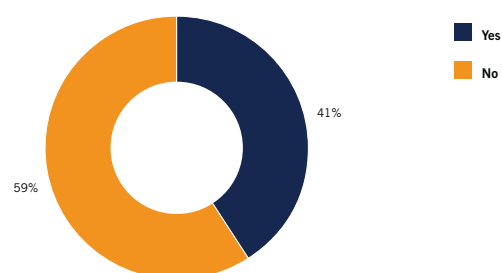
19b. Has this return increased, decreased or stayed the same?



Roughly two-thirds of the respondents say their expectations are unchanged on the previous year. Around 28% targeted higher returns, while 8% decreased their expectations.

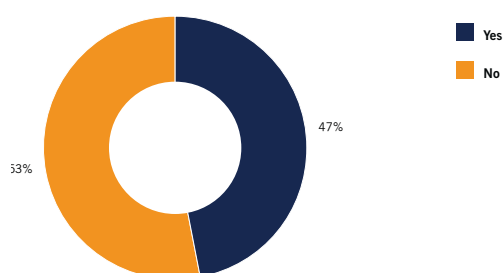


20a. Do you seek equity control of companies via a “loan-to-own” strategy?



The majority of respondents (59%) do not seek to gain control of companies in which they invest via a loan-to-own strategy, however, the number of respondents that do (41%) has increased slightly from last year (38%).

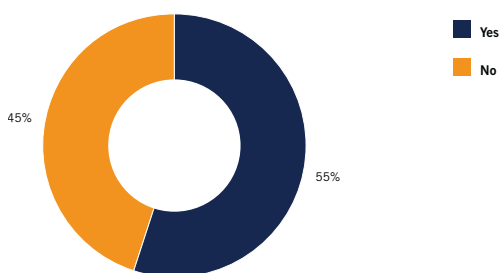
20b. Do you think acquiring a blocking stake will be the key to loan-to-own strategy in 2012?



At 47%, almost half of all respondents expect blocking stakes to be the key to loan-to-own strategies in 2012, a slight drop from 53% in 2010.

# DISTRESSED INVESTORS SURVEY

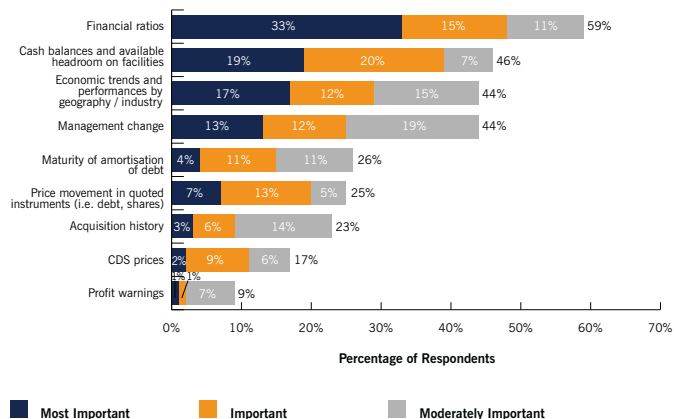
20c. Do you expect an increase in the number of investors intent on acquiring control through equitisation in 2012?



Around 55% of the respondents expect equitisation as a means of gaining control of companies to become more prevalent in 2012.

“There will be an increase in this type of strategy because the M&A market will increase in size,” explained one hedge fund manager.

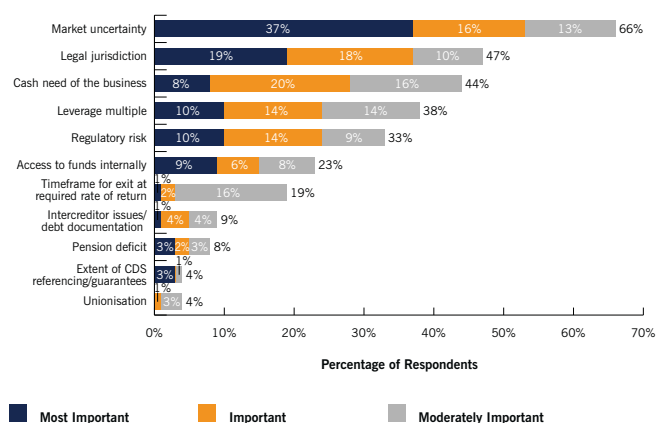
21. What are the key metrics you are tracking to determine potential investment opportunities? (Please rank the top three.)



Financial ratios remain the most tracked metric to determine potential investment opportunities amongst those who took part in the survey. The respondents also rate cash and covenant headroom, economic trends and geographic performance, as well as management changes as key metrics.

“Performance in key markets will always drive the company to go forward, leverage will indicate whether or not a company might need capital in the near term, profit warnings give you an indication that it is a good time to try to do something with the company,” according to one hedge fund manager.

22. What are the main issues preventing your investment in distressed businesses?  
(Please rank the top three.)



Market uncertainty remains the biggest deterrent to investing in distressed opportunities, with 37% of those surveyed citing it as a key concern. Respondents are increasingly concerned with legal jurisdictions, with 19% calling it the most important issue, up from just 9% last year. Leverage multiples are also an obstacle, followed by regulatory risk. Just 8% consider cash needs of a business the most important issue preventing an investment, but almost half the respondents considered it important.

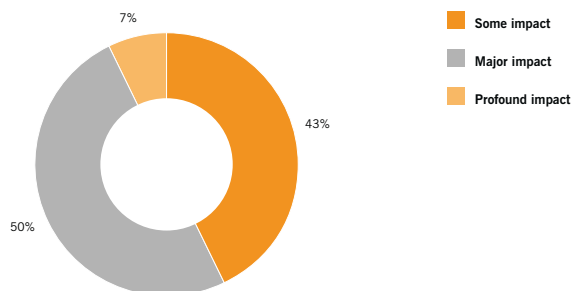
# PRIVATE EQUITY SURVEY

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In the fourth quarter of 2011, Debtwire canvassed the opinion of 30 private equity investors to gauge their views on restructuring and the state of the market.

The interviews were conducted by telephone and the respondents were guaranteed anonymity. The results are presented in aggregate.

## 1a. What do you feel will be the impact of the eurozone and sovereign debt crises on private credit markets?

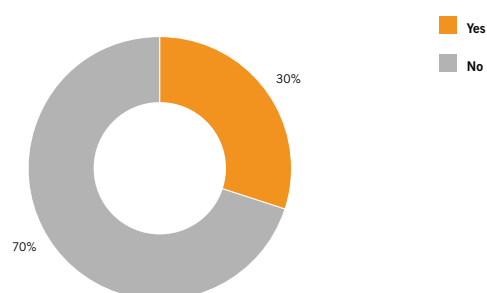


Private equity funds seem slightly less concerned about the eurozone sovereign debt crises than investors, with just half of respondents predicting a major impact on private credit markets, and 7% expecting the impact to be profound.

“There are mainly two reasons [why the crisis will have an impact]; one is regulatory risk and banks will require more equity. The second is some of the industries or companies especially [those] which are exposed to Southern Europe will be negatively impacted,” an associate in Germany said.

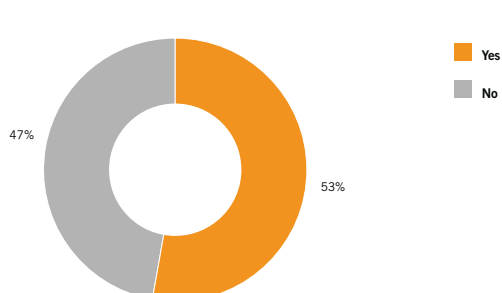
“The credit markets are [effectively] shut right now,” a UK principal added.

1b. Do you expect Greece to be cast out of the eurozone?



The overwhelming majority (70%) of respondents do not believe Greece will be forced out of the eurozone.

1c. Do you believe the single currency would fail in its current form?

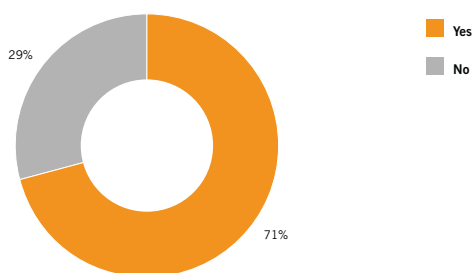


Views on the longevity of the single currency among private equity investors are slightly more negative than those among investors, with a small majority (53%) expecting the euro to fail in its current form.

“The euro won’t vanish,” a Norwegian associate commented. “I think it will stay in its current form as there is a need for economic interactions across Europe.”

# PRIVATE EQUITY SURVEY

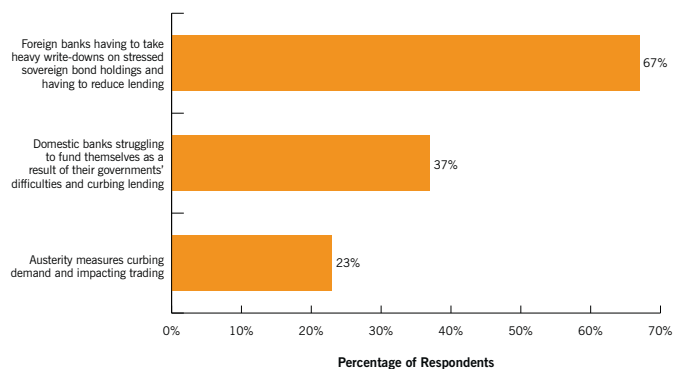
1d. Do you expect the eurozone to opt for eurobonds/fiscal union?



A clear majority (71%) of the respondents believe the sovereign crisis will force the eurozone into adopting some form of coordinated fiscal policy either in the form of eurobonds or fiscal union.

"It's a problem for Germany and it will be a challenge, but it's a good option to solve the current situation," a Norwegian associate said.

2. What will be the cause of the restructuring resulting from sovereign risk issues?



Over two-thirds of respondents expect reduced lending from foreign banks forced to take heavy write-downs on sovereign notes to trigger restructuring in the year ahead. Some 37% expect knock-on funding gaps amongst domestic banks to spark restructuring, and 23% cite suppressed demand as a major cause of restructuring.

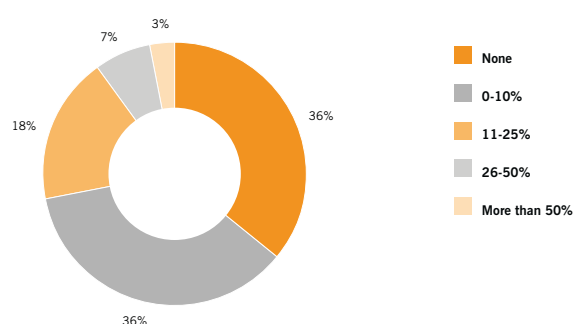
*"The squeeze applied to banks worldwide will cause an acceleration of restructurings. The European sovereign issues only serve to exacerbate that squeeze. Combined with low levels of growth, relative to the BRICs and even the US, European corporates figure to be the worst affected borrowers."*

Richard Nevins, Cadwalader, Wickersham & Taft LLP

*"The Euro-Sovereign problems will translate into continued anaemic growth through 2012 – many governments will be fighting the tide of rising unemployment/potential further bank bail outs."*

Vincent Danjoux, Rothschild

3a. What percentage of your portfolio underwent a covenant reset, covenant amendment or maturity extension in 2011?



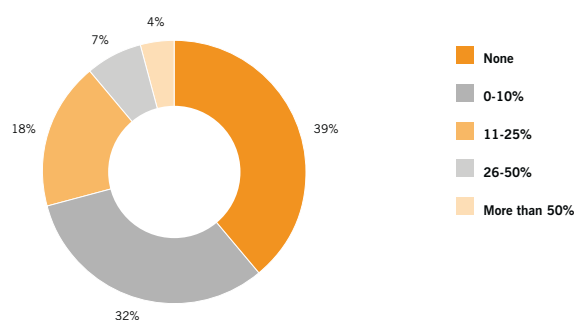
Just 28% of the private equity investors surveyed say more than 10% of their portfolios underwent covenant resets, amendments or maturity extensions in 2011, a big improvement from 2010 when half the respondents resorted to one of these measures in more than 10% of their investments.

More than a third (36%) of the respondents did not experience any of these actions, while an equal number had to take one of these actions in up to 10% of their portfolios.

*“European CMBS restructuring transactions will be front and centre in 2012. There are a very high volume of loans which are expected to default, and creditors, borrowers and servicers/trustees are seeking more creative solutions, particularly as the bank market has weakened substantially.”*

Nigel Das, Rothschild

3b. What percentage of your portfolio underwent some form of financial restructuring in 2011?



Less than 30% of the respondents say that more than 10% of their portfolio companies underwent a balance sheet work-out in 2011, a sharp improvement on 2010 when 65% of respondents had to restructure more than 10% of their investments.

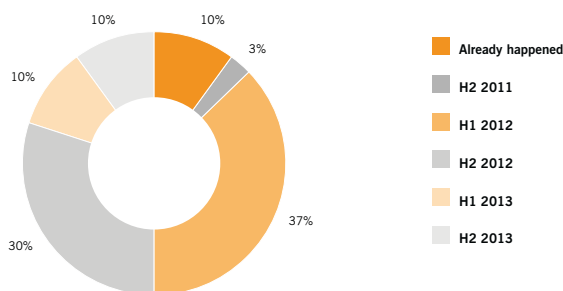
The portfolios of almost 40% of the respondents did not undergo any financial restructuring, and 32% had to restructure less than 10% of their portfolio companies.

*“The high volumes of commercial property portfolio restructurings both asset based and operating businesses, will continue throughout the eurozone in 2012 with an absence of new lenders and continued pressure on values, in many cases extinguishing what equity value previously remained.”*

Dacre Barrett-Lennard, Rothschild

# PRIVATE EQUITY SURVEY

4. When do you expect the volume of European restructurings to hit its next peak, or has this already happened?

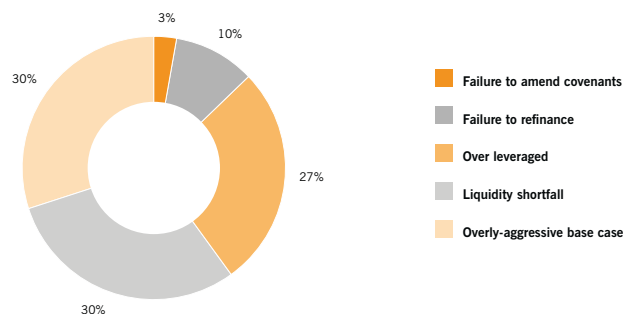


More than two-thirds of respondents expect European restructurings to peak in 2012, with 37% tipping work-outs to reach their zenith in the first half and 30% in the second half.

“The current situation of instability will be solved by June this year,” a Spanish associate predicted. “It’s not good for the economy for things to remain as they are.”

That looks optimistic according to a Czech associate who does not expect restructurings to peak until the second half of 2013. “The economy is like a living organism and will not change daily, it will take time.”

5. What do you expect to be the single largest contributing factor to trigger restructurings for private equity portfolio companies?



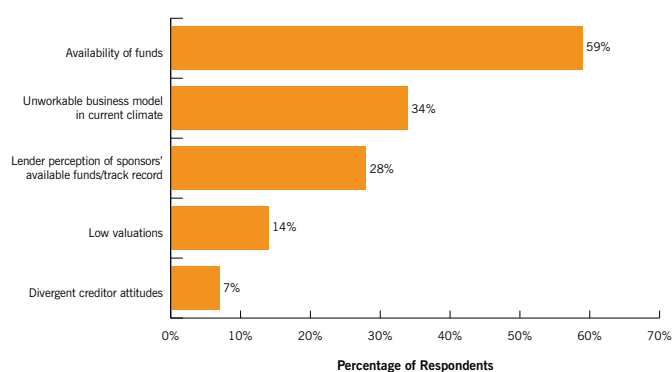
Respondents cite aggressive base cases (30%), liquidity shortfalls (30%), and overleveraged structures (27%) as the three largest contributing factors to portfolio company restructurings. Difficulties amending covenants were not considered key factors in triggering restructurings.

“You can’t refinance if you are overleveraged,” a UK managing partner commented.

“Working capital is increasing, the government is not [supportive] and the short term bank finance is not available,” a Spanish vice president concerned over liquidity shortfalls added. “Companies will suffer from these issues for at least another 7-8 months.”



## 6. What are the greatest challenges to completing financial restructurings?



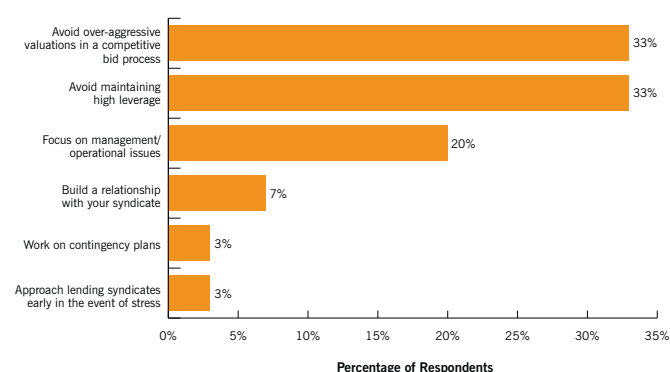
The majority of respondents (59%) cite availability of funds as the greatest challenge to completing financial restructurings. This contrasts to the 2011 survey when divergent creditor attitudes, now viewed by just 7% as pivotal, were viewed as the number one restructuring stumbling block. Business models unworkable in the current climate are also a key concern for respondents (34%), another reversal from last year when the issue was considered the least important obstacle to balance sheet work-outs.

"Neither banks nor the businesses themselves know what their performance will be like over the next 12 months," a Spanish vice president commented.

*"The responses here, as compared to last year, indicate the value of cash in the current climate, together with greater appreciation of the value that creditors are able to bring to a restructuring."*

Greg Petrick, Cadwalader, Wickersham & Taft LLP

## 7. What is the most important lesson the private equity industry has learned from restructurings completed in 2011?



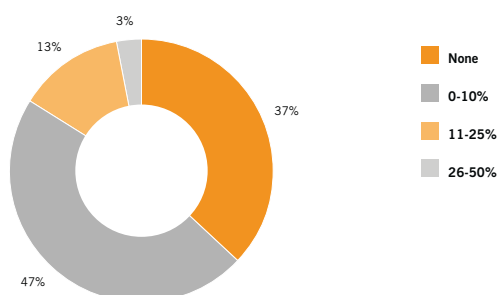
The key lessons private equity investors took from restructurings completed in 2011 was not to overheat valuations during competitive auctions and to tackle sustained high leverage, respondents say. Focussing on management and operational issues, last year's key lesson, slipped to third place in terms of priorities.

"Avoid over-aggressive valuations in a competitive bid process," a UK principal said. "If there is no leverage you lose flexibility."

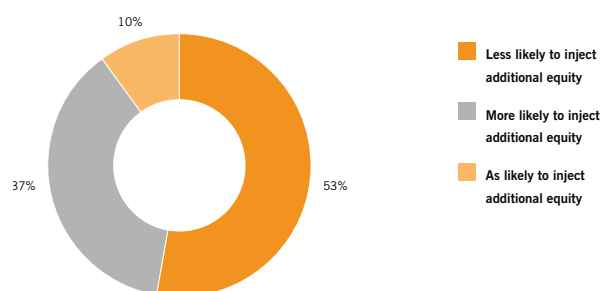
However, if sponsors do not delever their portfolio companies, they will struggle to get their dues funded and risk facing increased difficulties in a restructuring, a UK managing partner adds.

# PRIVATE EQUITY SURVEY

8a. What percentage of your portfolio companies will you have to consider injecting additional equity into in 2012?



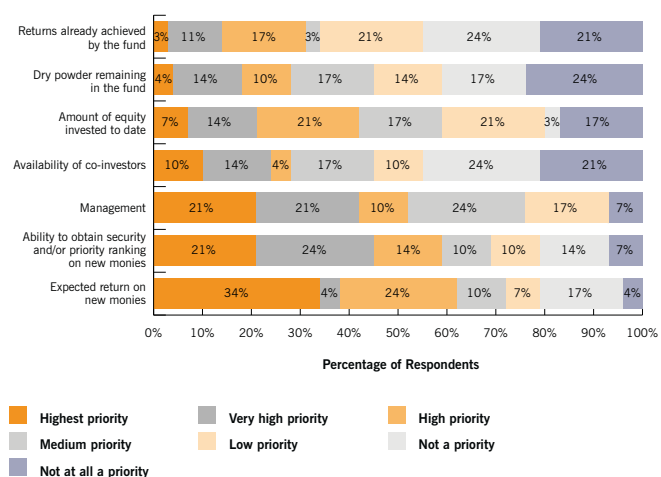
8b. Are you more or less likely to consider injecting additional equity in portfolio companies this year compared to last year?



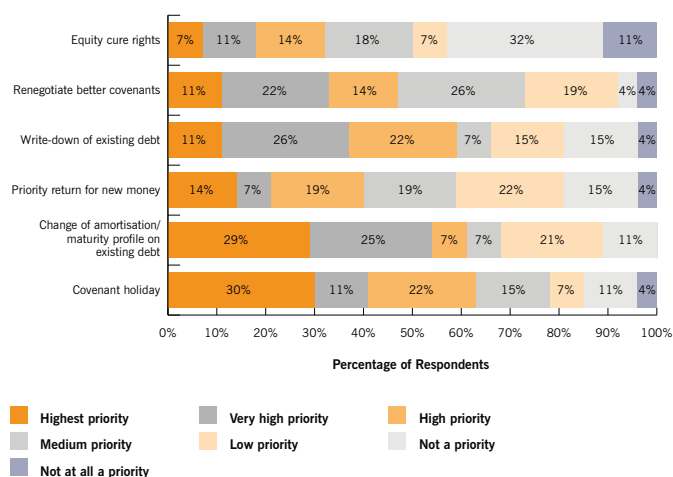
Around 37% of sponsors do not expect to inject any additional equity into their portfolio companies in 2012, and 47% think they will need to put new money into up to 10% of their investments. Some 13% expect to have to stump up cash for as much as 11-25% of their portfolios.

Just over half the respondents (53%) say they are less likely to inject additional equity into their portfolio companies than they were a year ago, while 37% indicate they are more likely to stump up new money.

9a. In a restructuring scenario, what are the main considerations when you review new investment in portfolio companies?



9b. What leniencies do you expect from lenders in return for new money injections?

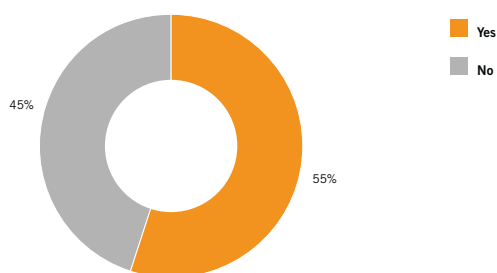


Expected returns is the most important consideration when reviewing new investment in portfolio companies for 34% of the respondents, followed by the ability to obtain security or priority ranking (21%) and management (21%), according to those surveyed. The availability of co-investors, considered the least important in last year's survey, moved into fourth spot as the key priority for 10% of respondents.

Almost one-third (30%) of respondents expect a covenant holiday from lenders in return for new money injections, with 29% expecting a change of the amortisation/maturity profile on existing debt. Renegotiating better covenants, the highest priority concession in last year's survey, dropped to fifth place with just 11% citing it as the most important leniency.

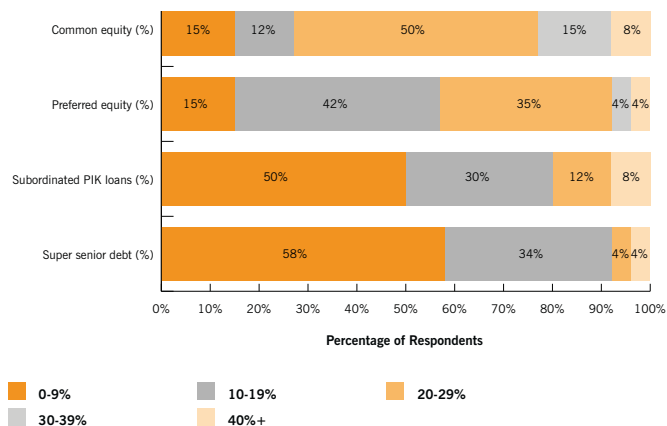
# PRIVATE EQUITY SURVEY

9c. Do you expect lenders to be more open to write downs/equitisation in 2012 vs. 2011?



Just over half (55%) of the private equity investors surveyed think lenders will be more likely to accept debt write-downs or equitisation in 2012 than in 2011. This marks a major shift from last year, when just 37% of respondents expected lenders to be willing to take haircuts in 2011.

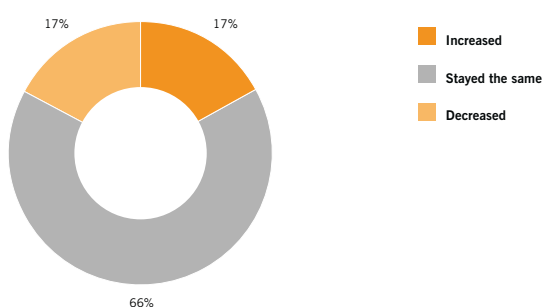
10a. When allocating new money in a restructuring scenario, what percentage in annual returns do you expect from investment in the following instruments?



Private equity investors expect to make the highest returns investing in common equity, with 73% of the respondents targeting returns greater than 20%, and 23% aiming for returns above 30%. At the other end, super senior debt will likely yield the lowest returns, with 58% of respondents anticipating returns of less than 9%.

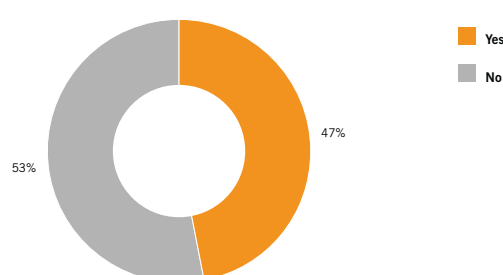
The findings mirror last year's trend but are far less bullish, with just 8% of respondents expecting common equity to yield more than 40% returns, down from 43% in the previous survey.

10b. Has the return you require on new money injections increased, decreased, or stayed the same from last year?



The majority of respondents (66%) target the same returns from new money injections as the prior year, while the rest were equally split between investors wanting higher and those accepting lower returns. The results mark a more downbeat shift in expectations from last year, when 60% kept their requirements the same and 40% increased them.

11a. Do you expect that you may need to restructure one or more of your own portfolio companies in the next twelve months?



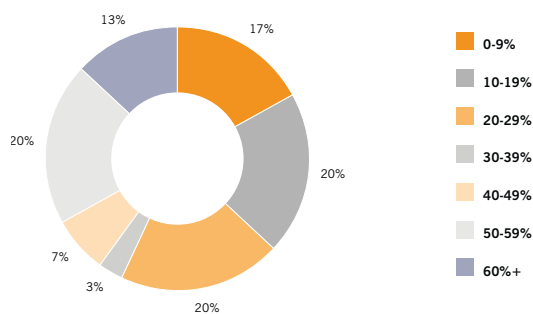
Almost half the respondents (47%) think they might need to restructure one or more of their portfolio companies in the next twelve months, up from 30% during last year's survey.

*"M&A is returning as part of the restructuring solution – trade bidders seeing value, but also private equity looking at deleveraging disposals or a full exit early on to avoid the default scenario entirely."*

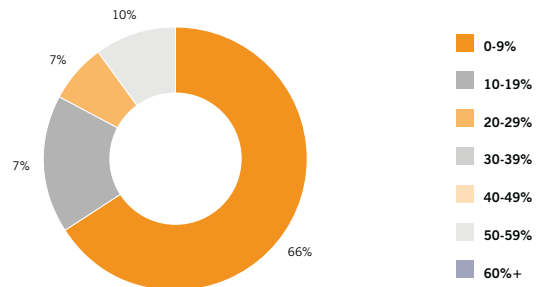
Andrew Merrett, Rothschild

# PRIVATE EQUITY SURVEY

11b. What percentage of your portfolio is performing below the level of the acquisition business plan?



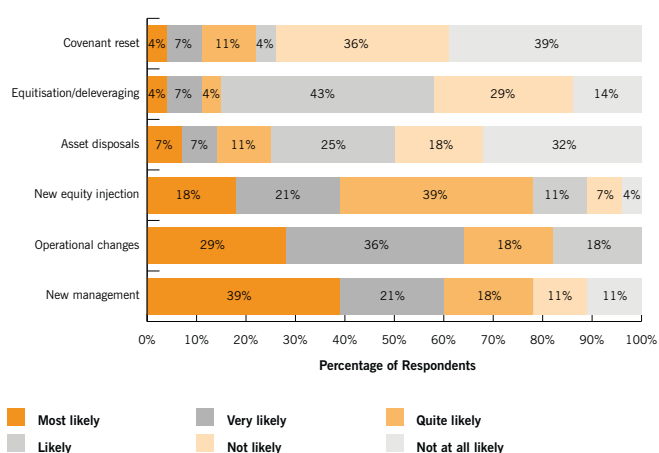
11c. How many of these underperforming portfolio companies represent potential stressed/debt restructuring candidates in the next 12 months?



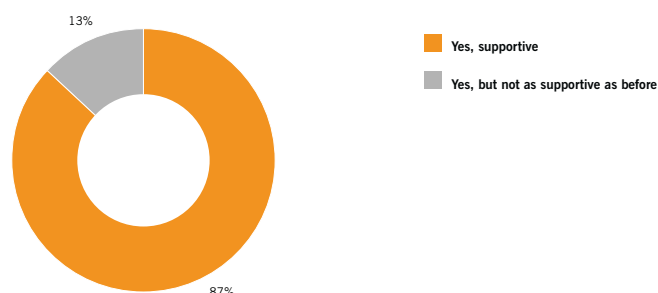
Some 63% of respondents said that more than 20% of their portfolio is underperforming their acquisition business plans, while over a third (33%) admitted that more than half of their investments were lagging behind their targets. This demonstrates a marked deterioration from last year, when 50% of respondents said that more than 20% of their portfolios were behind budget and just 14% of those surveyed missed targets on more than 30% of their portfolios.

Two-thirds of the respondents expect less than 10% of their underperforming portfolio companies to become stressed debt or restructuring candidates over the next 12 months. However 10% of the respondents expect over half of their investments' lagging budgets to turn into stressed debt or undergo balance sheet work-outs.

11d. For those companies in your portfolio which may be restructured, please rank the following method of restructuring in order of likelihoods.



12a. In a period of portfolio underperformance for many private equity funds, what has been your experience with your limited partners – do they remain supportive?

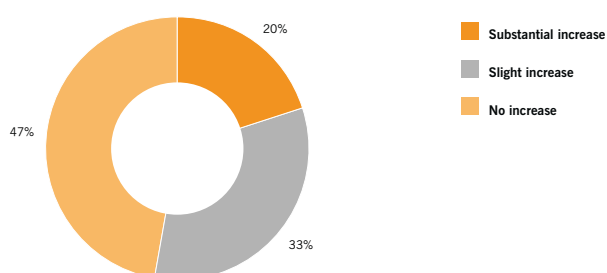


Attitudes to restructuring portfolio companies have shifted over the past year, with the largest group of respondents (39%) considering replacing the management team as the most important step, followed by operational changes (29%) and new money injections (18%). Covenant resets, which were in second place last year, are now viewed as the least likely solution to a restructuring, suggesting that private equity investors plan to deal with problems head on rather than kick them down the road.

The increasingly challenging economic outlook does not appear to be impacting the support of limited partners for private equity groups. Mirroring last year’s findings, the vast majority (87%) of respondents indicate they continue to receive the backing of limited partners.

# PRIVATE EQUITY SURVEY

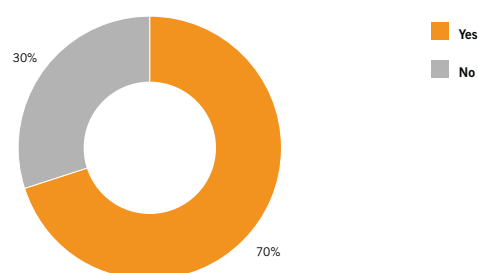
12b. Have you witnessed increased limited partner activism in 2011?



Limited partner activism is picking up, with over half (53%) of the respondents experiencing a rise during 2011, and 20% reporting a substantial increase. Last year half of the respondents noted a slight increase in activism.

"Limited partners don't become involved in underlying portfolios; they get involved in fund restructuring," a UK managing partner said.

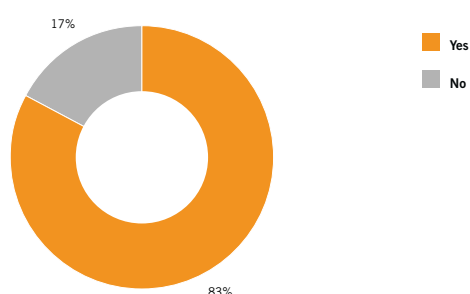
13a. Do you anticipate a tougher fundraising environment following the increased number of debt equitisations in recent years?



Fundraising is clearly becoming more challenging. The vast majority (70%) of respondents anticipate a tougher environment for fundraising as a result of the rise in equitisations in the last few years, a significant swing from last year when just 40% of respondents had a bearish outlook.

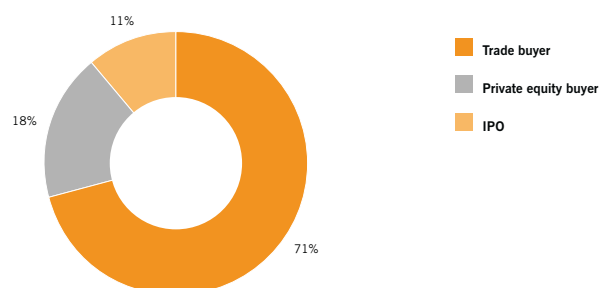


13b. Do you expect an increase in the number of private equity portfolio exits in 2012 ahead of new fundraising plans?



An overwhelming majority (83%) of the respondents anticipate an increase in private equity portfolio exits in 2012 ahead of new fundraising plans, up from 70% in 2011.

13c. What type of exit do you think will be most prevalent in 2012?



The market looks increasingly reliant on trade buyers to facilitate exits, with 71% of respondents considering it the most likely route, up from 58% last year. "Private equity guys will struggle for funding and most of the trade buyers are cash rich," a UK managing partner said.

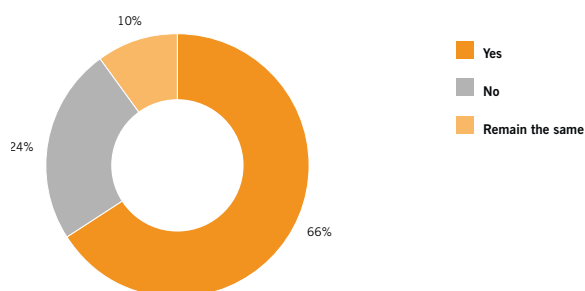
"Trade buyers will be able to take advantage of the absence of financial investors," an Italian investment manager agreed.

Despite the number of cancelled IPOs in 2011, 11% of respondents still think that IPOs will be a key exit in 2012. "IPO markets are closed and I think private equity buyers are the most desperate to make acquisitions," a UK principal said.

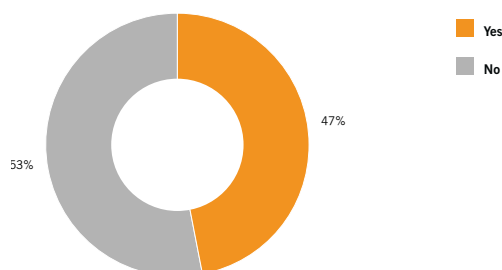
# PRIVATE EQUITY SURVEY

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13d. Do you expect the market to be more or less supportive of secondary and tertiary buyouts in 2012 relative to 2011?



14. Do you expect to play an active role in the restructuring of non-portfolio companies in 2012?

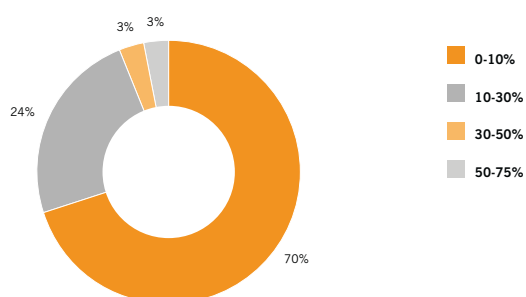


Surprisingly, two-thirds of respondents expect the market to be more supportive of secondary and tertiary buyouts in the year ahead compared to 2011, suggesting respondents anticipate a reopening of the primary markets.

“There are companies who have lots of money and will invest, and there are a few more companies that will look to exit for the purpose of raising funds,” a Spanish vice president commented.

Private equity investors expect an increase in distressed debt opportunities next year. Almost half of the respondents (47%) foresee taking an active role in the restructuring of non-portfolio companies in 2012, compared with just 20% in last year's survey.

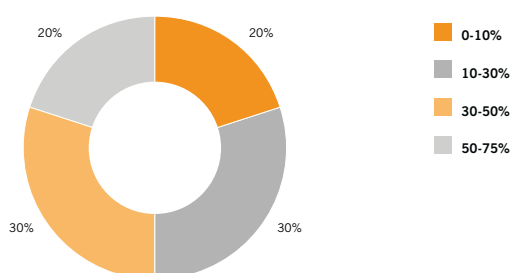
15. On what scale (in percentage terms) do you anticipate LBO deal volume to increase in 2012?



Reflecting the increased difficulty of tapping debt capital markets for funding, respondents have become more pessimistic on LBO deal activity in 2012. Some 70% expect volumes to rise by less than 10% next year, compared with 24% of last year's respondents' expectations for 2011. Just 24% think volumes could rise by 10-30%, down from 64% the prior year.

"I don't think it [LBO volumes] will increase in our region because there is a lot of drama in the mid-market," a Norwegian associate said.

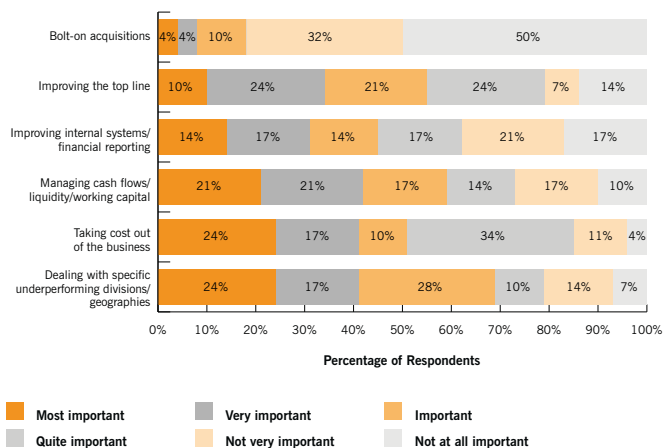
16. How many restructurings do you believe would have resolved differently if action had been taken earlier?



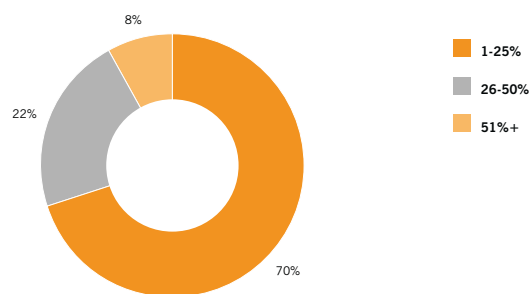
Survey respondents largely agree that earlier intervention would have changed the outcomes of restructurings, but remain divided on the number of work-outs that could have ended differently. Some 20% think that tackling the problem sooner would have produced a different outcome in between half and three-quarters of restructurings, 30% think it would change between 30-50% of cases, and 30% think it would alter 10-30% of deals.

# PRIVATE EQUITY SURVEY

17. What are your key operational priorities in managing your current portfolio?



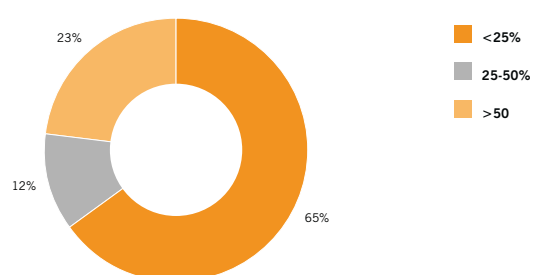
18. What percentage of activity will be devoted to developing the existing portfolio through bolt-on acquisitions rather than new investments in 2012?



Dealing with specific underperforming divisions, one of the lowest priorities for last year's respondents, was rated as the most important in this year's survey. Respondents remain focussed on taking costs out of their business, which was jointly rated in top spot, and considered the most important operational priority in last year's survey as well. Bolt-on acquisitions were the lowest priority, with half of the respondents considering them not at all important.

In line with the findings to the previous question, 70% of respondents will devote just 1-25% of their activity to pursuing bolt-on acquisitions instead of new investments.

19. In circumstances where the taxation environment is to accelerate for investment firms, what probability do you ascribe to relocating outside of the United Kingdom?



Private equity investors' willingness to relocate outside of the UK if the taxation environment were to become less favourable has increased, with almost a quarter (23%) ascribing a greater than 50% likelihood. Just 7% of last year's respondents indicated the same likelihood to relocating on the basis of taxation.

# MONETARY UNION UNDER SIEGE — THE THREAT OF A BREAK-UP OF THE EURO

The single currency faces its greatest challenge since inception. Deutsche Bank Group's chief economist Dr. Thomas Mayer discusses how the euro has worked despite its inherent flaws and the risks of its dissolution with Debtwire journalist Christopher de Vrieze.



Dr. Thomas Mayer, chief economist, Deutsche Bank Group

"A euro break-up is a tail-event, but something which ultimately cannot be excluded," cautions Mayer. "That said, policymakers will do everything at their disposal to avoid such an event from occurring."

What is surprising is not the single currency's difficulties, but that it has worked for most of the ten years since its launch in 2001 despite its unusual and unique construction, such as the lack of a joint treasury, rigid social and labour market policies and inflexible intra-regional transferability, Mayer notes.

"Easy credit [from the ECB] was a substitute for the fiscal transfers that would otherwise have been needed to compensate for the insufficient fulfilment of an optimal currency area," he said. This, together with a radical narrowing of interest-rate differentials based on the assumption all currency members carried risk premiums analogous to Germany, allowed the currency union to work in its current shape and form.

But the one-size-fits-all base interest rate set by the ECB, sharply lower than pre-euro rates for many member states, contributed to the subsequent real estate bubbles in Spain and Ireland as well as unchecked public spending in Greece. Under monetary union unconstrained deficits by individual countries went unpenalised as they continued to benefit from low common interest rates. Many member states grew faster than they could sustain, causing them to build up trade deficits whilst Germany's trade surplus expanded, Mayer highlighted.

## ON THE HOOK

Once the ensuing credit crisis struck Europe and liquidity in the interbank market dried up, the ECB replaced cheap market financing with cheap credit, such as the recent three-year LTRO window for banks.

But it was the ECB's willingness to accept sovereign debt as collateral that led to a dramatic under-the-radar transfer of funds from the core to peripheral members, and meant Europe's central bank in effect serviced their balance-of-payment deficits at the expense of economically stronger economies, such as Germany and France.

The ECB periodically draws flak from hawkish finance ministers for its direct acquisition of sovereign bonds through its SMP facility to cool down escalating yields. But the €200bn plus of bonds it has hoovered up in secondary markets to date is dwarfed by the claims it has accumulated through its interbank payment system Target, Mayer said.

The EU has comfortably dealt with Greece, Ireland and Portugal's freeze-out of capital markets, opening lifelines until structural adjustments facilitate a return. But with Spanish and Italian yields at unsustainable levels and hurdles to near-term political solutions looking insurmountable, many corporates are starting to plan for the previously unthinkable – a collapse of the European monetary union.

European sovereigns' struggling to fund themselves directly in the debt capital markets are increasingly borrowing from the ECB indirectly via the Target mechanism, by selling bonds to their domestic banks, who in turn repo the debt with the ECB. This, combined with liabilities racked up via the ECB's emergency liquidity assistance (ELA) programme through which NCBs can support their banking systems, amounts to an interim and secret bailout by the Eurosystem, he noted.

"Profligate economies were given a gold credit card to overcome the flaws inherent within the Maastricht Treaty, which is buried under the ECB's Target claims," Mayer says.

To date, the Bundesbank alone has racked up €495bn of Target claims on Greece, Italy, Ireland, Portugal and Spain (GIIPS) via the ECB, notes Mayer. And this has risen further with the ECB's recent €489bn three-year LTRO. The Target balance for January will be released in March.

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*"The battle to save European monetary union is likely to be won or lost in Spain and Italy."*

Dr. Thomas Mayer, chief economist at Deutsche Bank Group

This massive backdoor financing by the ECB, funded by the central banks of stronger economies, means that Europe's core countries have a far higher exposure to the peripherals than many market participants realise. Their ability to maintain Target transfers and manage any resultant inflation will dictate the future of the eurozone, Mayer says.

The most likely outcome of the crisis is that the European monetary union (EMU) moves towards a greater fiscal and economic union, or a 'hard EMU' propped up by continued but gradually declining support from the ECB, Mayer speculates.

The GIIPS countries will need to reduce public debt levels and improve their growth prospects through internal devaluation as well as implementing credible structural adjustment programmes to restore their capital market access. While Greece has failed on this front, Portugal's response has been more convincing and Ireland has demonstrated significant progress in its internal adjustment, Mayer noted.

"But the battle to save EMU is likely to be won or lost in Spain and Italy," he noted.

At just 67% of GDP, Spain's public debt levels are relatively low, only part of its banking sector is in trouble and the new government under Mariano Rajoy is intent on making the country work in a hard currency union by reforming the labour market, recapitalising the savings banks and implementing reforms to reign in the deficit, Mayer says. But the spectre of hidden liabilities, especially at the regional level, will probably weigh on the sovereign for some time, with the new government already warning that Spain's 2011 deficit could be EUR 20bn higher and come in at 8% rather than the 6% targeted.

"In Italy the new government's job is harder as public debt is higher [at 121% of GDP], past economic performance poorer and the available time

for the government much shorter with the next elections in May 2013,” said Mayer.

Unless Italian financing costs, recently surpassing 7% for ten-year paper, move back under a sustainable threshold of 5%, the current technocratic government headed by Mario Monti is unlikely to achieve its twin goal of growth and structural reforms, he cautions. Achieving flexibility in the EMU could take more than five years and success is not guaranteed.

The EU is not yet capable of withstanding adjustment failures by member states, but a new intergovernmental agreement proposed last December for the European Court of Justice to ensure the compliance of new mandatory EU budget rules with automatic correction mechanisms is a significant step in the right direction, he added.

“Whether or not these efforts will be successful will probably be decided in early 2013 when Italy prepares for its next regular elections,” said Mayer. Encouraging results under Monti would spark confidence in the country to elect a new government with a mandate to continue the adjustment effort, and significantly increase the likelihood of a ‘hard EMU’ falling into place.

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*“Profligate economies were given a gold credit card to overcome the flaws inherent within the Maastricht Treaty, which was buried under the ECB’s Target claims.”*

Dr. Thomas Mayer, chief economist at Deutsche Bank Group

## IF THE CENTRE CANNOT HOLD..

But if austerity measures and structural adjustments in Italy and Spain prove self-defeating as in Greece, the ECB would have to continue monetising southern European government deficits. This would lead to one of two adverse scenarios, Mayer suggests.

“In the first, the ongoing monetary funding by the ECB of profligate member states as a substitute for real economic and fiscal adjustment would raise inflationary expectations, with political pressures arising by 2015,” said Mayer.

It would likely trigger the exit of inflation-averse countries led by Germany and including France, Austria, Finland, Luxembourg, Belgium as well as the Netherlands. This would result in the introduction of a ‘hard euro’ adopted by the core-EMU members, bordered by the weaker peripheral economies on a lower fixed ‘Latin euro’.

“A small EMU is more likely than a complete break-up into national currencies because of France’s insistence on the continuation of at least a core-EMU, a demand Germany cannot refuse for historical reasons,” Mayer said.

The second outcome – less likely but far more damaging – would be for the ECB to turn off the tap and discontinue funding southern members as a result of a lack of credible economic and fiscal adjustment programmes, Mayer cautioned.

Italy would be shut out of capital markets and have no choice but to reinstate the lira and re-denominate its public debt into its former currency. A domino effect across Europe would force a return to historic currencies, turning back the clock to pre-euro times. This would trigger enormous financial instability and end in a full-blown global recession, he warned.

“A euro break-up is a medium-term risk, not an immediate one given the drastic repercussions it would trigger globally,” said Mayer.

## RETURN TO THE NORTH-SOUTH DIVIDE

“In the long term the effects of a euro break-up on the corporate landscape would be dependent on the speed of the exchange rate adjustment in member countries, but the near-term effects would be very painful,” said Mayer.

Corporates located in the core ‘hard’ EMU would benefit from continued access to capital and low cost of funding, enabling them to produce higher-value capital-intensive goods, as well as invest in R&D to maintain technological leadership positions, Mayer says.

Companies stuck in the ‘Latin’ EMU zone would benefit from an initial currency devaluation boost, but facing higher funding costs would likely lag in upgrading technological practices over time, relying on depreciation to compete, he added.

“Under a shock depreciation corporates would continue to use old technologies, produce shoddy outdated products offering them at a discount as opposed to putting resources towards high value-added activities,” Mayer said. “To prevent this effect, the central bank of the country in question would have to pursue interventionist policies to contain FX volatility. Under a gradual exchange-rate adjustment, industry could upgrade to high value-added technologies, and adapt to consumer tastes.”



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For further details please contact Andrew Merrett:  
New Court, St Swithin's Lane, London EC4N 8AL  
Telephone +44 (0)20 7280 5728

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*Image: detail from a bond issued by Rothschild for the 1900 4.5% Coquimbo railway loan, Chile (The Rothschild Archive)*

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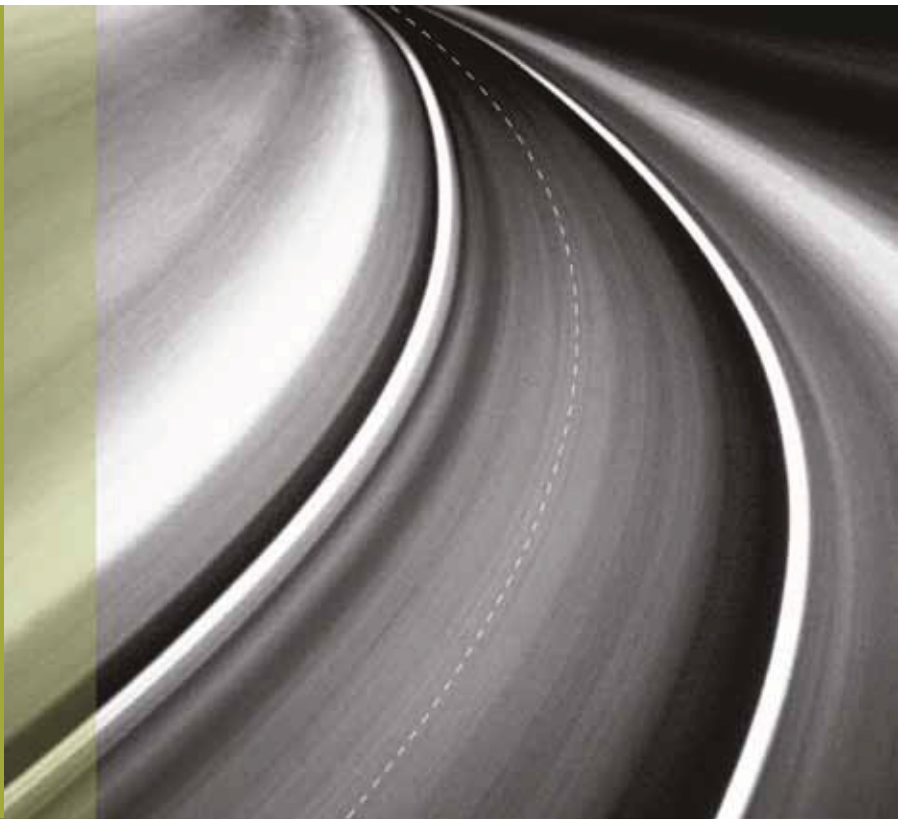
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New York London Charlotte Washington  
Houston Beijing Hong Kong Brussels

# CONTACTS

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## Cadwalader, Wickersham & Taft LLP

### Richard Nevins

Partner  
richard.nevins@cwt.com  
PH: +44 20 7170 8624

### Gregory M. Petrick

Partner  
gregory.petrick@cwt.com  
PH: +1 212 504 6373

### John J. Rapisardi

Co-Chair, Financial Restructuring  
Department  
john.rapisardi@cwt.com  
PH: +1 212 504 5585

### George A. Davis

Co-Chair, Financial Restructuring  
Department  
george.davis@cwt.com  
PH: +1 212 504 6797

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## Rothschild

### Andrew Merrett

European Head of Restructuring  
Co-Head Financing Advisory – London  
andrew.merrett@rothschild.com  
PH: +44 20 7280 5728

### Glen Cronin

Director, Restructuring  
glen.cronin@rothschild.com  
PH: +44 20 7280 5506

### Dacre Barrett-Lennard

Director, Restructuring  
dacre.barrett-lennard@rothschild.com  
PH: +44 20 7280 5717

### Hamish Mackenzie

Director, Restructuring  
hamish.mackenzie@rothschild.com  
PH: +44 20 7280 5127

### Richard Millward

Managing Director, Restructuring  
richard.millward@rothschild.com  
PH: +44 20 7280 5778

### Vincent Danjoux

Managing Director, Restructuring  
vincent.danjoux@rothschild.com  
PH: +33 1 40 74 42 43

### Arnaud Joubert

Managing Director, Restructuring  
arnaud.joubert@rothschild.com  
PH: +33 1 40 74 98 36

### Heinrich Kerstien

Managing Director, Restructuring  
heinrich.kerstien@rothschild.com  
PH: +49 69 299 884-300

### Alessio de Comite

Managing Director, Restructuring  
alessio.de.comite@rothschild.com  
PH: +39 02 7244 3338

### Beltran Paredes

Managing Director, Restructuring  
beltran.paredes@rothschild.com  
PH: +34 91 702 2573

### Paul Reynolds

Managing Director, Restructuring  
paul.reynolds@rothschild.com  
PH: +971 4 428 4320

### David Resnick

Global Head of Restructuring  
david.resnick@rothschild.com  
PH: +1 (212) 403 5252

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London, WC2R 0RL  
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