Corporate Debt Restructuring

Restoring distorted capital structures

Milan, February 28th, 2014

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The Capital Structure

Capital Structure refers to the way a company finances its assets through some combination of debt and equity

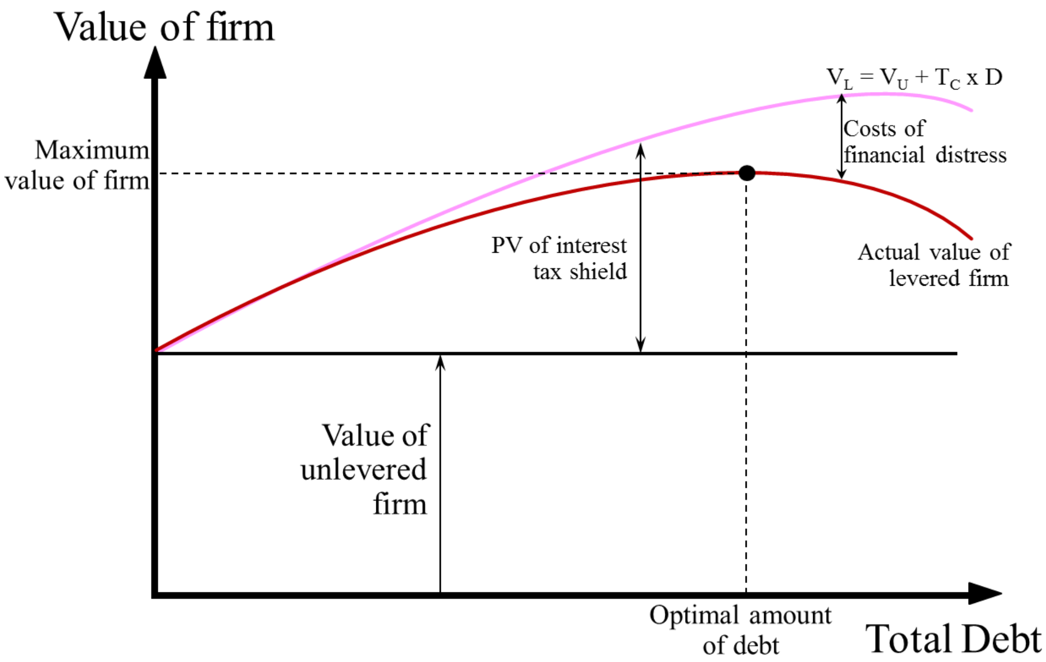
The capital structure of a company is the composition, the structure of its liabilities.

The great contribution of the Trade-Off theory of Modigliani-Miller and their followers is that these models identify the specific benefits and costs of using debt (i.e. the tax effects and the costs of financial distress).

A company will choose how much debt and how much equity should finance its investments by balancing the relevant costs and benefits.

The **Trade-Off theory** of capital structure basically entails off-setting the costs of debt against the benefits of debt.

Tax benefits must be measured in relation to the bankruptcy and non-bankruptcy costs of debt



The marginal benefit of further increases of debt declines as debt increases, while the marginal cost increases.

Bankruptcy costs of debt:

- costs of the bankruptcy procedure
- haircut for creditors.

Non-bankruptcy costs of debt:

- staff leaving
- suppliers demanding less favorable payment terms
- bondholders fighting with stockholders
- transfer of ownership of the company.

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The costs of distress

There are costs associated with a state of distress of the company:

- for the banks that provided the financing – because they will have to face losses in case of non collection of the debt or in case of restructuring with a reduction of the value of the borrower’s assets
- for the community – in terms of social consequences, that will be proportional to the size of the company
- for the creditors – who will lose a portion or all of the amount they’re owed
- for the other companies that will ask for debt – as the bank’s losses will have negative influences of the banking sector and will likely deteriorate the conditions to tap the market.

In order to minimize/reduce these costs, restructurings are deployed

The costs of distress

A financial restructuring becomes necessary when the capital structure of a company has been distorted or broken

A distortion of the capital structure of a company, leading to its financial crisis, can be originated by many factors:

- inability of the company to react to its competitors, or increase in the number of competitors in the same market
- lack of innovation
- lack of programming/planning
- pursuing too aggressive growth strategies.

A company's crisis is often generated by too aggressive growth strategies which are mainly financed with short term debt. Such scenario can expose the company to the risk of not being able to service the debt repayment, especially if there is any unforeseen event in the implementation of the growth process or in case of change in the economic context.

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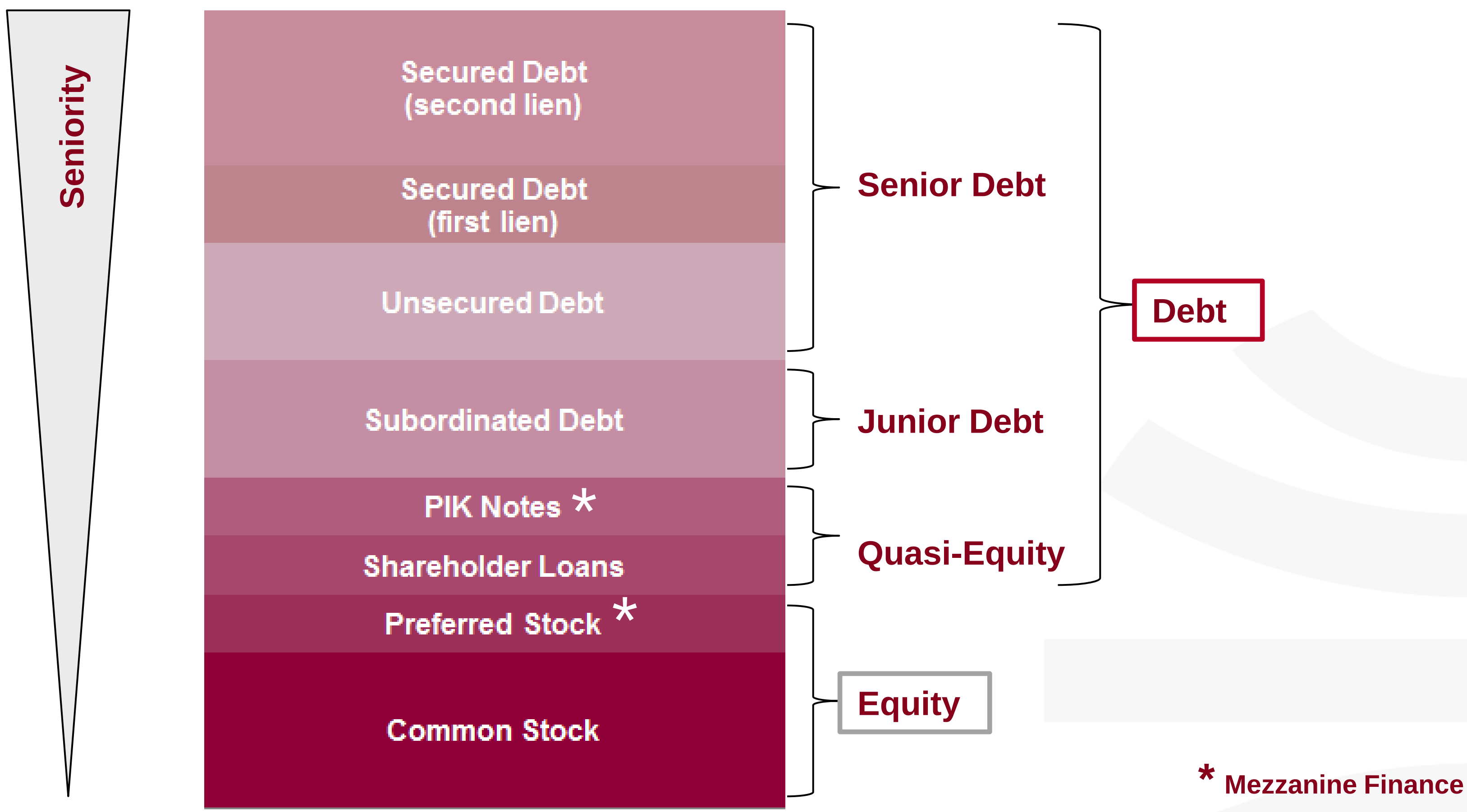
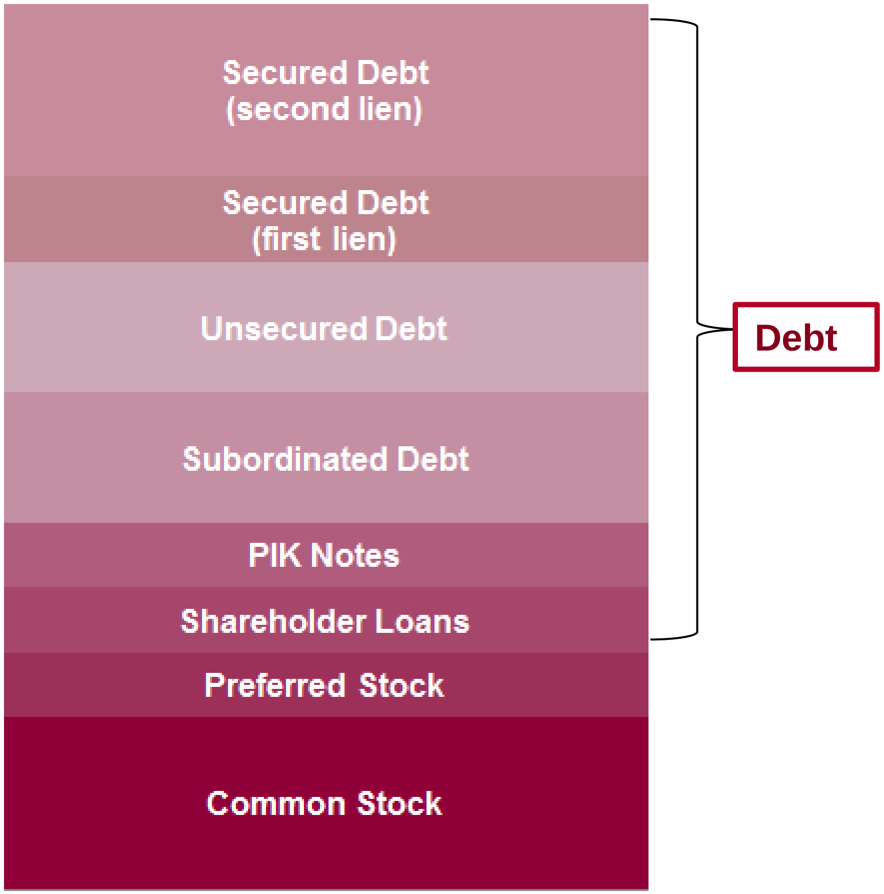
The typical debt structure of a company has been changing with time

Prior to the late 1980s, most enterprises were funded through bilateral lending, often by a single lender with a heavy domestic focus.
From mid-1990s onward, multi-bank, syndicated facilities provided by lenders and investors from many different domiciles became common, together with an increase in publicly traded debt (both investment grade and high yield/junk) and privately placed mezzanine debt and other instruments.
A complex structure is not uncommon today, fuelled in part by the rise in leveraged buy-outs and in part by the over-supply of liquidity (nowadays in a reduced manner), which has contaminated even smaller companies.
The restructuring process become considerably more complicated as companies grow and more financial stake-holders are involved in multi-level capital structures.

Debt: definitions

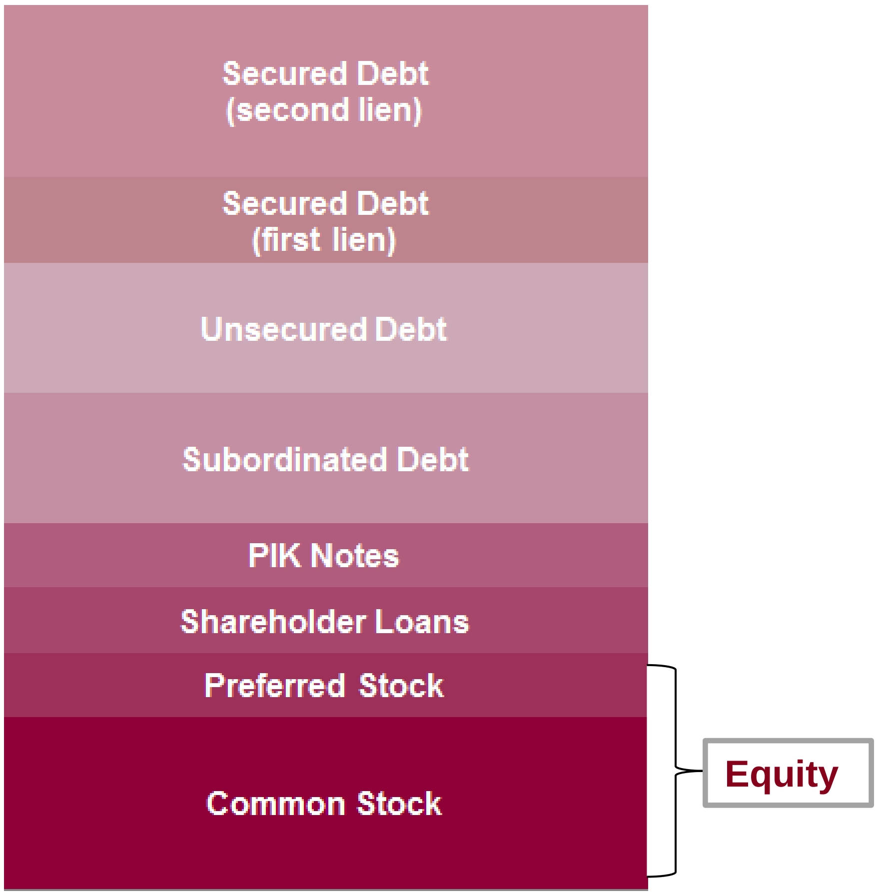


Debt: definitions



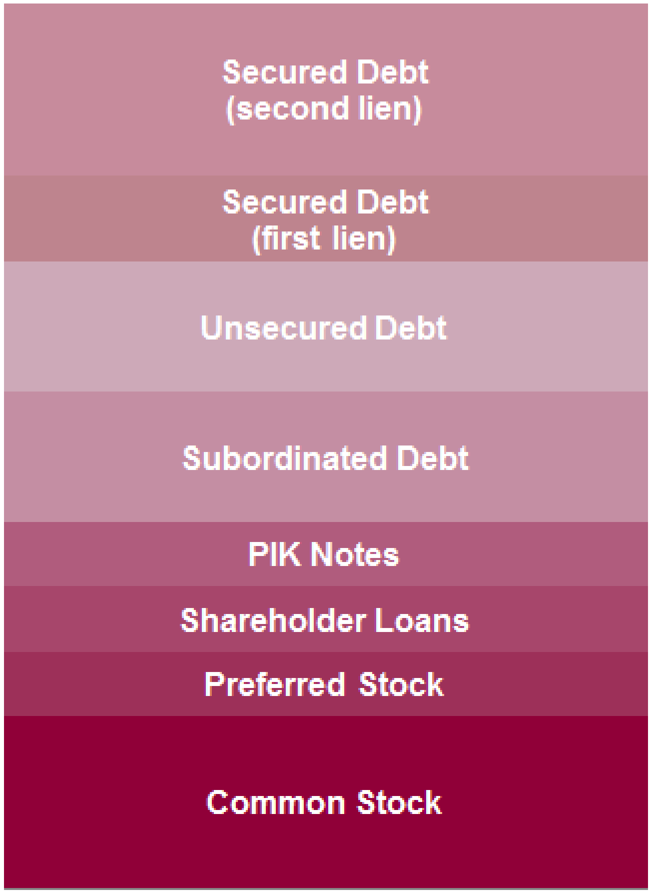
- Debt is a more versatile form of financing than equity as it can be modulated differently according to its type, to the repayment period, to the amount, to the hybridization with other financial instruments.
- Debt is also cheaper than equity: the expected return for the lender is lower that the expected return for an equity holder (given that lenders have an higher priority order than equity holders in case of bankruptcy). Furthermore, interests on debt are tax deductible (while dividends are not).

Debt: definitions



- Equity represent the ownership interest in a company and is the most junior class of financing in terms of priority order in case of bankruptcy.
- The risk associated with an equity position is reflected in the expected return from the shareholders.
- Common shares and preferred (or preference) shares have a different seniority (preferred shares have the right to be reimbursed before common shares), a different priority in the dividend distribution order and different voting rights (preferred shares don’t have any).

Debt: definitions



- Secured Debt – it's the debt backed by some sort of security, which will be used to repay the first lien creditors before and the second lien creditors thereafter (and to the extent that the first lien creditors are satisfied). Securities can be either in the form of assets, cash collateral or other sort of guarantees.
- Unsecured Debt – it's the senior debt which is not assisted by any form of security.
- Subordinated Debt (or Junior Debt) – it's the debt which has a lower priority order than senior debt. Mezzanine debt (hybrid form of debt) is always subordinated.
- PIK (Payment in Kind) Notes – bullet loans with interests repaid at maturity date.
- Shareholder Loans - is the most junior debt of the company's debt structure. As these loans belong to the shareholders, they are treated as equity,

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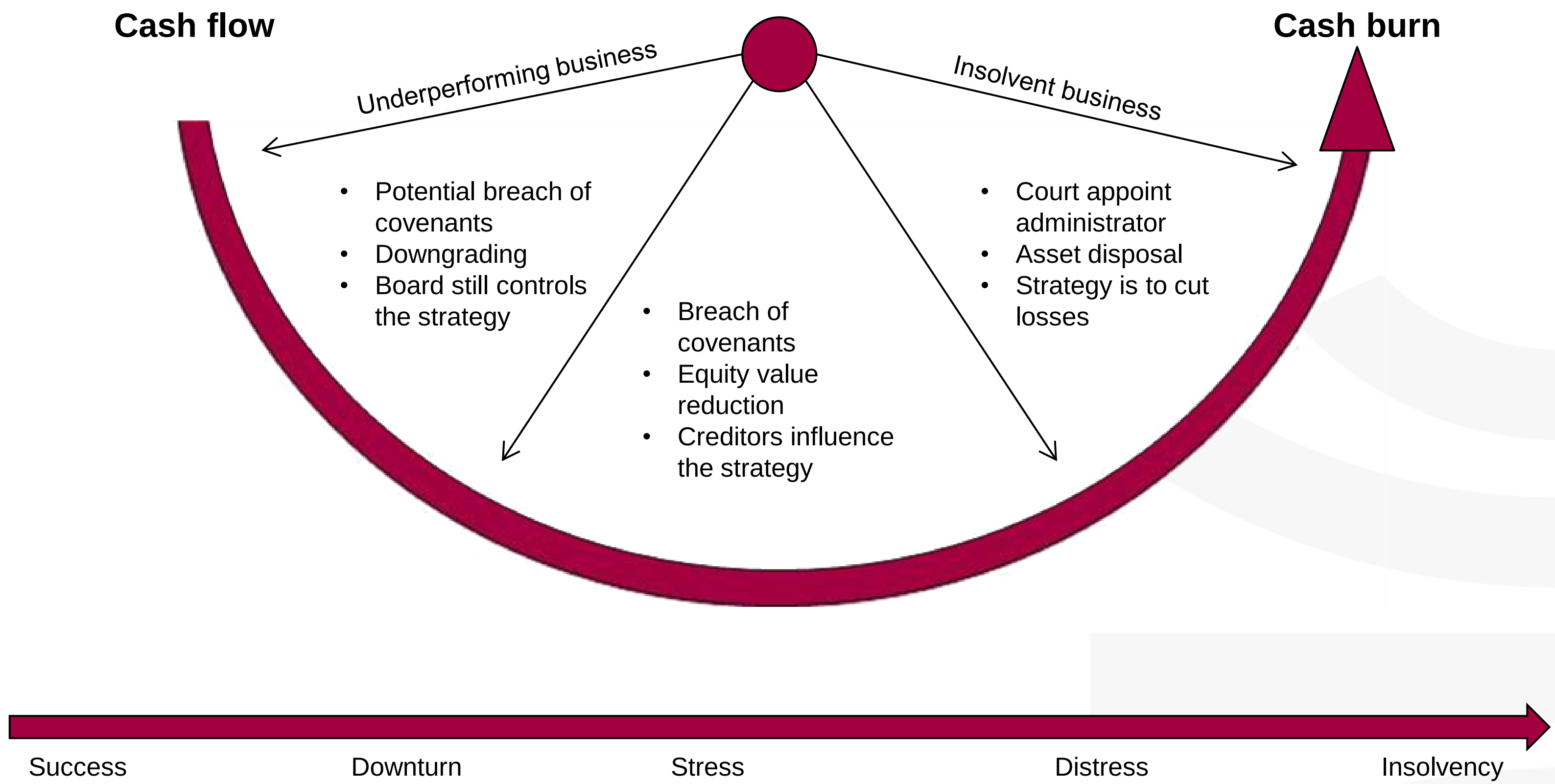
Financial covenants



What are the first signs of a disrupted capital structure?

Loan/bonds documents usually contain a set of covenants.
A covenant is a condition in a commercial loan or bond that require (or forbid) the borrower to do a certain action, or which restricts certain activities to a set of conditions.
Covenants have an important early warning function and maintain a line of communication between the borrower and the lender.
Covenants are tested on a periodical basis. The more frequently they are tested, the more effectively they work as early warnings of the soundness of the financial health of the debtor.

There are positive and negative covenants.

Positive covenants

Debt Service Coverage Ratio

It's the amount of cash flow (Net Operating Income) available to meet interest and principal repayments on debt, including possible commission payments.

$$\mathrm{DSCR} = \frac{\mathrm{NOI}_t}{\mathrm{K}_t + it + \mathrm{C}_t}$$

An annual DSCR lower than 1 means that the company is generating negative cash flows.

LTV (Loan-To-Value) Ratio

Especially important in asset based transactions, measures the ratio between the outstanding loan and the appraised value of the financed asset.

$$\mathrm{LTV} = \frac{\mathrm{Outstanding\ Loan}_t}{Asset\ Valuet}$$

Measure the equity contribution during the purchase and during the life of the loan. The higher the ratio, the riskier the loan.

Positive covenants

Debt to EBITDA

It's a leverage ratio which measures the company's ability to repay the debt. It determines the probability of defaulting on issued debt. Debt/EBITDA ratio can be used (especially by rating agencies) to compare the liquidity position of one company to the liquidity position of another company within the same industry.

$$\text{Debt-to-EBITDA} = \frac{\text{Liabilities}_t}{EBITDA_t}$$

A lower Debt-to-EBITDA ratio is a positive indicator that the company has sufficient funds to meet its financial obligations when they fall due. A higher debt/EBTIDA ratio means that the company is heavily leveraged and it might face difficulties in paying off its debts.

Debt to Equity

It's another leverage ratio calculated by dividing total liabilities by shareholders equity.

$$\text{Debt-to-Equity} = \frac{\text{Liabilities}_t}{Equity_t}$$

The ratio is very industry specific because it depends on the proportion of current and non-current assets. The more non-current the assets (as in the capital-intensive industries), the more equity is required to finance these long term investments. For most companies the maximum acceptable debt-to-equity ratio is 1.5-2 and less.

Positive covenants

Interest Coverage Ratio

It’s a measure of the company's ability to meet its interest payments. In particular the ratio measures the number of times the company can make the interest payments on its debt with its EBIT.

$$\mathrm{ICR} = \frac{\mathrm{EBIT}_t}{i_t}$$

The lower the interest coverage ratio, the higher the company's debt burden and the greater the possibility of bankruptcy or default. A lower ICR means less earnings are available to meet interest payments and that the business is more vulnerable to increases in interest rates. A ICR below 1.0 indicates the business is having difficulties generating the cash necessary to pay its interest obligations (i.e. interest payments exceed its EBIT).

Other positive covenants

Corporate Existence, Compliance with laws, Consents, Authorizations, Environmental and Social Compliance, Maintenance of Security, Pari Passu.

Negative covenants

Negative pledge
It's a clause stating that the company will not pledge any of its assets if doing so gives the original lenders less security.

Disposals
This covenant aims to avoid that the company, without the prior written consent of the lenders, enters into a transaction to sell, lease, transfer or otherwise dispose of the whole or any part of its assets.

Cross Default
A clause which operates by defaulting the borrower company under Agreement A when it defaulted under Agreement B even if the lender under Agreement B does not accelerate the repayment.

Cross Acceleration
A clause which operates by defaulting the borrower company under Agreement A when it defaulted under Agreement B and the lender under Agreement B accelerates repayment. A cross-acceleration provision effectively gives the lender under Agreement A the benefit of the default provisions in Agreement B.

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Liquidation vs. Restructuring

Managing the debtor’s crisis

In case of crisis of the borrower, creditors are confronted with a series of alternatives.
To begin with, it must be ascertained whether the crisis is temporary (because of lack of liquidity) and the company can be saved, or permanent (because assets are irreversibly lower in value than liabilities) so that liquidation should be considered.

- Restructuring
  - → Extrajudicial
    - → No success → Liquidation
    - → Success
      - → Debt/equity swap
      - → Rescheduling
      - → Compromise
  - → Judicial
    - → No success → Liquidation
    - → Success → Court supervised restructuring
- Liquidation → Dividends from liquidation paid according priority rules

Managing the debtor's crisis

Liquidation is a better choice that restructuring only if the company is worth more dead than alive, i.e. when the value of the company as a going concern is lower than if liquidated.

If L is the value of the company in case of liquidation and R is the value of the company after a restructuring (net of the relevant costs):

L > R → Liquidation
R > L → Restructuring
L = R → Indifference

Of course it's not that easy!
First of all, different classes of creditors may have different preferences on whether to liquidate or restructure a company depending on their exposure, their seniority. There are always many conflicts of interest.

Conflicts of interest and inefficiencies

Conflicts of interest may give rise to two kinds of inefficiencies:

- **OVERINVESTMENT**, i.e. the company is kept alive and continues to burn cash even when liquidation would be the best choice
- **UNDERINVESTMENT**, i.e. the company is liquidated when it would be better to restructure it instead.

Suppose that *i)* the company is in financial distress (assets < liabilities), *ii)* the creditors are banks with short term exposure (BANKS), *iii)* other creditors have their exposure both in the long term (LT CREDITORS) and in the short term (ST CREDITORS) (together the CREDITORS).

Two different scenarios:

1. The company is in financial distress (ASSETS < BANKS + CREDITORS) but it can still repay all of the short terms debt and invest in a project with the cost I

   ASSETS > BANKS + ST CREDITORS + I
2. The company is in financial distress and does not have the resources necessary to invest and repay the short term debt

   ASSETS < BANKS + ST CREDITORS + I

Liquidation vs. Restructuring

Conflicts of interest and inefficiencies

Under scenario 1, management will try to avoid an early declaration of the crisis and will try to keep the company alive even if the VAN of project I is negative. In facts, if the company is liquidated, management will loose everything. If the company is kept alive, management might even get a positive payoff. If the investment is made and the company looses value, the loss will be for the creditors.
This brings to a situation of OVERINVESTMENT.
The company should be liquidated, but it’s kept alive instead.

Under scenario 2, the company cannot invest anymore and must declare the crisis and either renegotiate its debt with the banks or obtain new finance.

Liquidation vs. Restructuring

Renegotiating the debt with banks

How does a bank choose between the alternative liquidation vs restructuring?
A bank will opt for restructuring over liquidation when the expected return of the restructuring (net of its costs) is bigger than in case of liquidation:

$L_B > R_B \rightarrow$ Liquidation
$R_B > L_B \rightarrow$ Restructuring
$L_B = R_B \rightarrow$ Indifference

But a bank might choose a liquidation over a restructuring even if $R_B > L_B$ if it has securities. This brings to a situation of UNDERINVESTMENT.
A bank might also choose a restructuring over a liquidation even if $L_B > R_B$ because a restructuring might enhance the value of the assets on which the bank has a security. This brings to a situation of OVERINVESTMENT.

If there are more banks, holdouts might complicate the process of reaching a deal.

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Meaning of the term restructuring

Typically, the term “restructuring” is used to mean a restructuring of the debtor’s financial obligations in response to a change in economic conditions.

A restructuring usually takes the form of a rescheduling, compromise, conversion of debt into equity or a combination of all three.

Restructuring ≠ Turnaround: Restructuring should be distinguished from the term “turnaround” which is a more pervasive reorganization of both the debtor’s financial obligations and operational processes.

In emerging markets where creditors’ rights are usually impaired, a turnaround is almost always unachievable unless there is a willingness by the borrower to do so.

Restructuring process overview

Phase 1

Financial Due Diligence
and Cash flow Projections

STANDSTILL

Assist to implement standstill so management can focus on managing the business and solutions can be developed.

Step 1

Assess Financial Models

Critique business and industry position

Assess future cash flows

Identify and assist creditor to select a restructuring solution

Step 2

Phase 2

High level negotiation &
Implementation

Negotiate selected restructure solution

Timeframe depends on the cooperation between all parties involved

Implement restructure and monitor performance

Timeframe depends on requirements of restructuring

Commercial Strategies and Fallback Scenarios

Negotiate/ prepare for fallback scenarios

Implement fallback scenarios

Steps in the restructuring process

In practice, some of the above steps may be either unnecessary, or unachievable in the circumstances.

Phase 1: Due diligence

Legal due diligence to assess

- Impaired claims
- Steps to safeguard creditors' rights
- Legal opportunities in case amicable settlement fails

Must consider the underlying credit documents and the legal regime of the debtor's jurisdiction

Financial due diligence to assess

- Current financial and organizational situation
- Cash flow projections
- Strong and weak points

Usually undertaken by external professional consultants, familiar with the industry and the jurisdiction

Phase 2: Standstill

Technique to provide sufficient time to stakeholders to assess the position of the business, the legal rights and to determine a restructuring strategy, without additional pressure created by precipitous creditors.

The finalization of the due diligence occurs in this phase.

Standstills can be arranged either formally or informally

- Formally – through the legal system
- Informally – requires a contractual agreement between the debtor and the creditors to not enforce their rights and to preserve the parties' respective positions for a period of time.

Phase 3: Development of a restructuring plan

A restructuring plan needs to deliver a financially better outcome for creditors than the cessation of business and the liquidation of its assets.

The financial parameters include:

- Recovery analysis by means of legal options (liquidation analysis)
- Cash flow projections analysis

The terms of a plan depend on a realistic assessment of creditors' rights and debtors' operational performance.

The restructuring plan identifies:

- ✓ What is available for creditors (business plan)
- ✓ How it will be distributed (intercreditor issues)

Phase 3: Development of a restructuring plan

Business plan

The business plan development will usually be undertaken by management, in order to identify the direction the organization intends proceeding, and the mechanics to achieve this.

If this is not possible, usually in the context of an uncooperative debtor, the creditors' financial adviser will need to develop the business plan.

FINANCIAL CONSTRAINTS

Inter-creditor issues

Determining how the funds available for distribution to creditors are split between the creditors sometimes gives rise to a variety of inter-creditor issues, such as:

- competition of secured and unsecured creditors
- rights of creditors against different group borrowers
- treatment of various classes of creditors, such as employees, trade creditors and related party debt

TO BE SOLVED BEFORE NEGOTIATING

Phase 4: Negotiation and implementation

Key issues for the negotiation process

Understanding the commercial strengths and weaknesses of the creditors' position	Developing leverage within the inherent constraints of the commercial weaknesses to achieve the desired commercial outcome
Identifying commercial issues that are of significance to the creditors and developing a consensus in relation to the issues	Leading the process by consensus

The restructuring process

Instruments to protect the creditors

Waterfall Structure

Restructuring costs
(advisors, creditors' expenses)

Operating costs

Debt service

New investments (CAPEX)

Excess cash sweep

Subordinated debt

Dividends

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Background to BTA's default

BTA was formed from the merger of Turan and Alem banks and privatised around 2000. BTA has expanded its operations both domestically and internationally to become the largest commercial bank in Kazakhstan.

In 2007 Kazakhstan experienced the effects of the Global Financial Crisis. Kazakhstan banks experienced a significant contraction in profitability during the period from 2007 to 2009, which was reflected in significantly increased levels in provisioning.

Additionally, BTA experienced an increase in bad debt provisioning:

- The rate of provision on BTA's loan book and off-balance sheet exposures increased from 6.6% in December 2008 to 45.8% in June 2009.
- Corporate loans increased almost eight-fold over the same period.

The blow out in bad debts has since been identified as a result of, in part, alleged fraudulent activity by the former management of BTA.BTA's former management are now in UK Courts facing criminal charges over fraud.

The Global Steering Committee ("GSC") comprised representatives of each of the major foreign-creditor groups, including Bondholders, Commercial Banks, Trade Finance Providers and the Export Credit Agencies

Case study: BTA bank

Background to BTA's default

The government of Kazakhstan invoked the Law on Financial Stability following a review conducted by the National Bank of the Republic of Kazakhstan ("NBRK") and required that the sovereign wealth fund Samruk-Kazyna ("SK") recapitalise BTA in February 2009.

- SK invested up to US$ 7 billion into BTA to support its liquidity and now controls a 75.1% stake in BTA.
- The management of BTA was changed following SK's investment.
- BTA's new management conducted further reviews of the loan portfolio resulting in additional provisions against the loan book being recognised for the period to 30 June 2009.

BTA defaulted on its obligations on 20 April 2009 resulting in the acceleration of certain debt held by international creditors.

The key commercial terms have been agreed amongst the GSC and BTA and memorialised in a document which became known as the Principal Commercial Terms Sheet ("PCTS") on 7 December 2009.

As with most emerging market restructurings, the agreement of the PCTS was only a step in the process, one of many that would eventually realise an agreed restructuring plan, but several months later and in a diluted form.

Case study: BTA bank

Background to BTA's default

By September 2009, provisioning for the loan portfolio had increased to a staggering average of 73.5%. At this point, BTA indicated its intention to restructure the loan book such that the impaired debt would be controlled by the Bad Bank, who would be tasked to effect recovery, to the extent possible, and return portions of the performing debt to the Good Bank by 2014.

BTA expanded the options for restructuring and proposed to offer creditors a choice between four options, being:

1. Buy-Back – cash buyback at a discount of 82.25%.
2. Medium Term Roll-Over – 7 year roll over including 5 year grace period at a 60% discount.
3. Long Term Roll-Over – 15 year subordinated roll over at no discount, but reduced interest rates.
4. Equity Conversion – equity conversion at 80% discount

In September 2009, BTA entered into a number of Memoranda of Understanding ("MOU") with SK, and the GSC. The MOU outlined the "Steering Committee Restructuring Plan Proposal", which included a proposal for the treatment of certain debt. The GSC's proposal included:

Option 1 – Cash plus a discounted debt instrument, equity and Recovery Notes.
Option 2 – ECA /Government related debt to be repaid over 8 years, with a 3-year grace period and a Government of Kazakhstan guarantee.

Case study: BTA bank

Background to BTA's default

Between September 2009 and May 2010, the restructuring plan was negotiated between the GSC and BTA with a view to resolving a number of issues, including key documentation, and the commercial outcomes. However, the final position remained a moving target, as a further assessment of the capital required for restructuring continued to grow as the loan portfolio was reviewed and found to be further impaired.

	USD Billion
Total Regulatory Capital @ 31/08/2010	(12.26)
RWA	13.52
Minimum total Regulatory Capital	1.35
Required Capital Injection	13.62
Impact of additional provisions	2.26
SK Capital increase	4.56
Minimum requirement from restructuring	6.80
Profit from Haircut	6.45
Conversion of Equity under JP2	0.35
Total Creditors' Contribution to Capital	6.80

Background to BTA's default

By June 2010, the final restructuring plan was presented to the broader creditor group, and received overwhelming creditor approval. The final commercial arrangements differed only marginally from the original plan set out in the MOU from September 2009, comprising:

		Senior & Junior Package - Instrument Allocation						Creditors' Contribution		
($ millions)	Principal & Interest	Cash	Senior debt (8 years)	OID (11 years)	Sub debt (15-20 years)	RCTFF	Equity	Write-off	Conversion	Total
Bilateral	1194	134	328		74			658		658
Syndicates	1116	130	318		72			596		596
Swaps	23	3	6		2			12		12
ECA, Non-eligible & Excess Eligle TF	1397	163	399		90			745		745
Senior Eurobonds	5307	570	1390		315			3032		3032
Sub-total (senior)	9037	1000	2441		553			5043		5043
Subordinated Debt	824						227	597	227	824
Dom Bonds - KPFs	202				186			16		16
Perp Eurobonds	448						120	328	120	448
Sub-total (junior)	1474				186		347	941	347	1288
Capped non-ECA TF	712					700		12		12
ECA & Excess Eligible TF	955			436	62			457		457
Sub-total (TF)	1667			436	62	700		469		469
Total	12178	1000	2441	436	801	700	347	6453	347	6800

Restructuring process

As you will appreciate, there are no fixed rules in relation to the consensual restructuring process that can be applied across all debtors. Whilst it may be trite, each restructuring process is unique and runs according to its own timetable. The critical issue for a successful restructuring is developing momentum in the process, and ensuring this momentum is maintained to a conclusion.

It appears that BTA was attempting to implement both a restructuring and a turnaround. The financial re-engineering of the balance sheet was a necessary pre-cursor to implementing the operational reform proposed in the turnaround. It is apparent that without a restructuring, the proposed turnaround is moot.

Restructuring process

The key steps in the BTA restructuring and turnaround were:

Standstill

Initially standstill achieved informally. Subsequently the standstill was effectuated by the Court restructuring process in Kazakhstan.
This is not unusual for emerging markets restructurings.

Due Diligence

The information gathering and due diligence exercises required several months to complete, given the size of the bank's operations, and were subject to several revisions due to a continued deterioration in the asset pool.
Information was distributed to creditors in the form of an IM, but was restricted during the restructuring process. This control over information flow is again, not unusual for emerging market restructurings. Creditors were not surprised by such tactics employed by the debtor, and developed strategies to address the issues, to ensure adequate information was available and momentum in the process maintained.

Restructuring process

Development of a Restructuring Plan

Two restructuring proposals were developed, one by each of BTA and the GSC. A compromise outcome was agreed in the September 2009 MOU, and became the foundation of the plan that was eventually implemented.

The final restructuring plan reflected an outcome far superior than the liquidation alternative, and as such was in creditors' interests. The plan also allowed for the re-establishment of BTA's capital structure, allowing for continued operations, which was in shareholders' interests.

Negotiation and Implementation

Negotiations between BTA and the GSC resulted in the development of a restructuring plan that reflected each party's commercial objectives.

Negotiations required patience on behalf of the creditor group, as BTA became unresponsive as some issues evolved with respect to their loan portfolio and the commercial requirements of the key stakeholders.

Statement of position

The starting point for any consensual restructuring process is to design a restructuring plan that delivers a better result to creditors than the immediate bankruptcy of the debtor.

BTA's statement of position is based on the book and carrying values of the 30 June 2009 unaudited financial accounts applying the priority payments under Kazakhstan Bankruptcy Law.

The statement of position indicates that the estimated return to ordinary unsecured creditors in the bankruptcy of BTA is 14.96%.

Restructuring options for creditors

The restructuring proposals put forward by BTA and the GSC were developed before the final results of due diligence became available, and there was a risk that the outcome proposals were sub-optimal.

BTA's Proposals:

- BTA presented four restructuring options which according to BTA have NPV equivalence, summarised below:

Terms	Option 1	Option 2	Option 3	Option 4
Description	Buy Back	Medium Term Roll Over	Long Term Roll Over	Equity Conversion
Discount to Face	82.25%	60.00%	0.00%	80.00%
Tenor (years)	NA	7	15	NA
Grace Period (years)	NA	5	10	NA
Interest rate	NA	Reduced	Reduced	NA
Maximum Participation	US$1 billion	NA	NA	NA
Participation Rate	55%	15%	10%	20%
NPV	17.75%	17.75%	17.75%	17.75%
Implied Discount Rate		12.31%	12.21%	NA

- Each of the options was eligible to participate in future recovery of BTA assets by way of recovery notes.

- Creditors who do not make an election for one of the four options were to have their claims automatically converted to equity (Option 4).

Restructuring options for creditors

GSC's Proposals:

GSC proposed an alternative restructuring plans based upon different assumptions as to BTA's financial position and the application of certain accounting principles.

The GSC restructuring plan aimed to generate sufficient capital to meet BTA's requirements, but also to maximise the outcome for creditors.

The GSC plan identified two options:

Terms	Option 1	Option 2
Description	Cash and discount debt	ECA/Official Government debt
Cash	US$1 billion (12.9% principal)	
Amount of Debt		US$1.2 billion
Tenor (years)	7	8
Grace Period (years)	2	3
Discount to face value	51.6%	0.0%
Interest rate	10%	3.6%
Participation rate	86.6%	13.4%
Discount rate	10092%	
Equity and Recovery Notes	Yes	Yes

Summary:

Significant divergence of views between BTA and the GSC in relation to the various restructuring options.

Restructuring options for creditors

The final negotiated position was closer to the GSC proposal, and is summarised as follows:

Terms	Option 1	Option 2
Description	Bi-lateral and Bonds	ECA/Official Government debt
Cash	US$1 billion (12.9% principal)	Nil
Amount of Debt	US$9.037 billion	US$955 million
Tenor (years)	8	11
Grace Period (years)	4	7
Discount to face value	73%	54.3% accrete to 100%
Interest rate	10.75% (2014 – 2014)	3.7% (2010 – 2017)
	12.50% (2015 – 2018)	3.3% (2018 – 2021)
NPV	40.75%	40.75
Discount rate	15%	15%
Equity and Recovery Notes	Yes	Yes

The objective of the final commercial position was to achieve NPV equivalence between the various forms of debt, whilst still accommodating the ECAs' requirements to achieve a full face recovery, and provide the capital contribution to BTA to maintain its operations.

SACE

Case study: BTA bank

Critical elements to restructuring

The critical issue for the successful restructuring was developing and maintaining momentum in the process.

High level of creditor coordination via the GSC allowed for all stakeholders' interests to be identified, and to the degree possible, accommodated in the final plan.

Implemented both a restructuring and a turnaround. This was necessary, but only achievable because of the high level of government involvement in the company.

Whilst there remain some questions over the integrity of the information provided by BTA, the creditors' advisers were provided with a high level of access to critical data in a reasonably timely manner which developed confidence in the process.

Communication from BTA was reasonably timely and open.

High level of Kazakh government support and involvement, reflected in part by a key adviser participating in the negotiation process. Also reflects the importance of BTA to the Kazakh economy.

Involvement of new, independent management allowed for a more transparent approach, which also supported confidence in the process.

Case study: BTA bank

Statement of position

The following should be noted in respect to the analysis of BTA's statement of position:

- The key driver to the analysis is the level of provisioning. BTA had an incentive to overstate the level of provisioning to set creditors' expectations of the likely recovery from the bankruptcy of BTA
- Whilst it appeared that BTA was seeking to be transparent in its analysis of provisioning, particularly with the use of external advisers (KPMG, PWC and Lovells), it was not clear that these advisers have undertaken any independent work, but rather seemed to rely on BTA management's estimates
- It is necessary to have an accurate assessment of the liabilities of BTA
- In terms of quantification of debt, it was necessary that the claims by creditors be independently confirmed, to ensure that there was no "double counting", set-off or error in calculation
- In terms of priority regime, the order of priority was governed by both the general law on bankruptcy and the banking law. The general law on bankruptcy does not afford special priority to either depositors or the SK debt. However, it appears that the banking law will afford qualified depositors priority over ordinary unsecured creditors.

The estimated return to ordinary unsecured creditors is 30.90%, which was over double the estimate based on BTA's order of priority.

SACE

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Case study: Telecom Argentina

History of a default

- April 2002 – Telecom Argentina (TA) announces the suspension of the debt service because of the Argentinean economical crisis
- November 2002 – 1° restructuring proposal: not accepted
- February 2003 – 2° restructuring proposal: not accepted
- December 2003 – 3° restructuring proposal of all the financial unsecured indebtedness, via the filing of an APE (Acuerdo Preventivo Extrajudicial, binding for everyone if approved by 66,6% of the creditors). This proposal was not acceptable as well: negotiations continued.
- May 2004 – Final restructuring proposal: APE.

The APE proposal

Creditors received, for every 1.058 unit of nominal value of the debt (amount determined including capitalized interests):

- OPTION A (100% nominal value) - 10 years "step up" notes (after 15/10/2008 interest increases from 5,53% to 8%); or
- OPTION B (94,5% nominal value) - 7 years "step up" notes (9% until 15/10/2005, 10% until 15/10/2008; 11% until 2011);

  or
- OPTION C (cash tender) – cash consideration for an amount between 80,34% and 69,94% of 1.058 units, to be determined with a "modified Dutch auction".

Creditors who elected to receive Option B consideration, had to accept that up to 37,5% of their credit could be prorated into Option C until the latter was entirely subscribed; therefore Option B was mixed with Option C.

Case study: Telecom Argentina

PV analysis

Option B – in spite of the 5,5% principal forgiveness – had an higher PV thanks to the higher interest rate.

Option C, even if cash, had a lower PV because the payment was going to be made at the closing of the APE (Dec. 2004).

	PV		
	12%	**13,50%**	**15%**
Option A	82,5	77,2	72,5
Option B	96,5	92,3	88,4
Option C	79,7	78,9	78,3

PV analysis with prorationing

The following table shows how Option B PV changed according to the *prorationing* into Option C or into both Options A and C.

Option B	PV		
	12%	13,50%	15%
Best case scenario No prorationing	96,5	92,3	88,4
Expected scenario Prorationing on Option C	90,2	87,3	84,6
Worst case scenario Prorationing on both A and C	89,5	86,5	83,6

According to this scenario, the final one, 37,5% of the creditors who elected to receive Option B consideration were prorated into Option C.

Sovereign Debt Restructuring

Milan, February 28th, 2014

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The Paris Club: Description

What is the Paris Club

The Paris Club, established in 1956, is the informal multilateral forum of creditors. The 19 Paris Club permanent members are Governments with large claims on various other Governments throughout the world.

Aim

The Paris Club finds co-ordinated and sustainable solutions to the payment difficulties experienced by debtors: rescheduling and/or reduction.

Results

- The Paris Club has reached 420 agreements concerning 88 debtors.
- Since 1956, the total amount of debt covered in these agreements has been $552 billion.

The Paris Club: Participants

Creditor countries

Permanent Members	19 creditor countries	*Delegations are led by Ministry of Economy or Finance or Ministry of Foreign Affairs. The ECAs are part of the delegation.*
Invited Countries	Other creditor countries invited on a “case by case” basis and subject to the agreement of creditor countries	

Observers

- International Monetary Fund (IMF)
- World Bank (WB)
- Development banks (ADB)
- OECD
- EU

Recoveries within the Paris Club

The 19 Permanent Members

5 governing principles

1 *Case by case approach*
The Paris Club makes decisions on a case by case basis in order to permanently adjust itself to the individuality of each debtor country.

2 *Consensus*
No decision can be made if it is not the result of a consensus among the creditors.

3 *Conditionality*
Debt treatments are applied only for countries that implement reforms to resolve their payment difficulties. Conditionality is provided by the existence of an appropriate program supported by the IMF/WB, which demonstrates the need for debt relief.

4 *Solidarity*
Creditors agree to implement the terms agreed in the context of the Paris Club.

5 *Comparability of treatment*
The debtor country cannot grant to another creditor a treatment less favorable for the debtor than the conditions agreed upon in the Paris Club.

Recoveries within the Paris Club

Meetings

- The creditors meet 10 times a year: once a month (excluding February and August).

- Paris Club meetings may involve:
  1. Negotiations;
  2. *Tour d'horizon:* update on the situation of the external debt of debtor countries;
  3. Methodological issues: principles and procedures.

- Meetings are held in Paris. The Chairman is a senior official of the French Treasury.

Recoveries within the Paris Club

Phases of the process

Phase 1	Phase 2	Phase 3	Phase 4
IMF Involvement	Paris Club Analysis	Negotiations	Agreed Minutes

IMF involvement

The Paris Club offers a rescheduling of the external debt under the following two conditions:

"Need of debt relief"
The debtor country has a financial gap confirmed by the analysis of the WB and IMF.

Programme with IMF
The debtor country has adopted an appropriate recovery programme under the guidelines suggested by the IMF.

Once the IMF has validated that the financial deficit can be resolved by means of a debt restructuring, the debtor country formally request the Paris Club Secretariat to negotiate an agreement

Paris Club Analysis

- The Paris Club Analysis follows two steps:

Data collection by the Secretariat

Each creditor country provides the Secretariat with data on the credit towards the debtor country (e.g. borrower, period of the underlying transaction, tenor, amount, etc).

Data Analysis

On the basis of the outlook of WB and IMF and of the economic trend, creditor countries:

- reconcile the data;
- analyse the repayment capacity of the debtor country.

Paris Club Analysis: eligible debt

- Among the different types of debt, Paris Club agreements generally only apply to those which fulfil the following conditions:

A. Date	– *Credits granted before the Cut-Off-Date ("Pre COD), conventional date which corresponds to the day when the country has officially applied for a rescheduling under the Paris Club scheme*	Eligible Debt
B. Nature	– *Government loans may be under "Official Development Assistance" (ODA Credits)* – *Credits insured by the Export Credit Agencies in transactions with sovereign borrowers and guarantors ("non-ODA Credits")*	
C. Tenor	– *Medium long term*	

Negotiations

- Negotiations are structured under the following procedure:

The delegation representing the debtor country presents the economic situation of the country (per-capita income, level of indebtedness and of debt service) and the request for a rescheduling.

The delegation representing the debtor country leaves the forum and creditors draft a proposal.

The Secretariat negotiates directly with the debtor country updating creditors on the debtor's counter-proposal and requesting their approval.

Negotiations may take more than one day, depending on technical difficulties and the flexibility of the parties

Negotiations: debt treatment

- The Paris Club aims at producing agreements which lead to levels of payments which are sustainable for the debtor.
- Over time two trends have emerged in the terms of Paris Club agreements:

Rescheduling	*Extension of the repayment terms*	Terms of treatment
Cancellation	*Partial reduction of the debt*	

Recoveries within the Paris Club

Negotiations: recent trend

- Recently debtor countries, who had previously restructured their debt within the Paris Club, have requested an early repayment of the credit.
- The underlying reasons mainly are: easier access to capital markets, liquidity, etc.
- Early repayments are limited to countries with a positive *track record* of payments and a sustainable financial position, subject to consensus of all creditors.

Prepayment at par
The debtor country repays the nominal value
100% N. V.

Peru, Russia, Brazil, Algeria Macedonia

Debt buy back
The debtor country offers to buy back its debt at market value, i.e. present value of future cash flow (“PV”)
> < 100% N. V.

Poland, Gabon, Jordan

Agreed Minutes

- Negotiating creditors sign a multilateral debt agreement: the “Agreed Minutes” (or “Procès Verbal”).

- The Agreed Minutes may include the following:
  - brief reference to the economic performance of the debtor;
  - information on the outstanding debt;
  - terms of debt treatment (repayment terms, repayment profile, cancellation, etc.);
  - phases of the agreement (if any);
  - clause on comparability of treatment;
  - technical annexes.

The Agreed Minutes is not legally binding to creditors, but it is a recommendation to Governments to endorse the Agreed Minutes with a Bilateral Agreement.

Contents

Bilateral Agreements

In application of the Agreed Minutes each Government shall sign a Bilateral Agreement with the debtor.

Reconciliation of debt lists → **Draft Agreement** → **Definition of interest rates** → **Bilateral Agreement**

Variable to be negotiated by the parties

The Bilateral Agreement is legally binding to the Governments

Contents

The non Paris Club debts

Non Paris Club debts may be:

Debts of countries without access to Paris Club for a number of reasons:
- absence of an agreement with IMF;
- limited number of external creditors
  (e.g. Aruba, Suriname, Ajman Emirate)

Portions of debt of countries with access to Paris Club (Cuba), but not included in the agreements (e.g. short term).

Recoveries outside the Paris Club

Differences with respect to Paris Club credits

Weaknesses

- Absence of an institutional forum for negotiations
- Limited number of creditors

Low pressure at international level

Strengths

- More flexibility for SACE
- SACE can act individually

Preservation of rights

- In order to preserve SACE's rights and maintain the credit valid it is necessary to avoid limitation of the credit.

The option of legal action is a leverage

- **The limitation period and the subsequent actions of preservation of rights** shall be assessed on a case by case basis, according to the applicable law of the underlying contract (loan agreement in the case of buyer's credits; commercial contract in the case of supplier's credits):
  - Italian law: 10 years;
  - English law: 5 years.

Preservation of rights

- Possible actions for preservation of rights:

In the case of lack of cooperation from the debtor country
Legal actions (e.g. issuance & service of claim forms, judgment in default, etc.).

In the case of cooperation from the debtor country
Written acknowledgement of debt:

> "WITH THIS LETTER, I signify that the Government of ….. confirms and acknowledges its Debt towards SACE and that it constitutes a valid and binding obligation of the Government of … in all respects and effects."

Recoveries outside the Paris Club

Agreements

1. Consolidation Agreement → *Rescheduling*
2. Cash Settlement → *Up-front down payment*

- Recovery can be also a combination of 1 and 2

Agreements: consolidation agreement

Rescheduling of the credit at terms and conditions to be defined (repayment term, grace period, repayment profile, interest rate, applicable law).

Downside

- Risk of new *default*
- Potential request to modify terms and conditions

Upside

- No cancellation of nominal value of the credit
- Repayment profile tailored to the repayment capacity of the country

Adequacy: on the basis of the PV of the restructured credit

Agreements: cash settlement

Up-front down payments or payments in more than one tranche may be considered.

Downside

- It generally implies partial cancellation (no payment at par)

Upside

- Closure of credits towards countries with high political and economical uncertainty

Contents

The HIPC initiative

General Framework

- **The HIPC Initiative** calls for coordinated action by the entire international financial community, including multilateral institutions, **to reduce the external debt burden of the low-income countries (HIPC countries) to sustainable levels.**
- Proposed by the WB and the IMF, the HIPC Initiative was **launched in 1996** and **enhanced in 1999.**
- **40 countries are potentially eligible for the Initiative.** The eligibility/progress under this Initiative is assessed by the IMF and the WB.

Paris Club Role

- Each step of the HIPC Initiative corresponds to a **particular debt treatment granted by the Paris Club** through:
  - Agreed Minutes with the Paris Club;
  - Bilateral Agreements with each creditor.

The Paris Club's involvement in the HIPC initiative

Preliminary Period

To qualify for assistance, a country must adopt adjustment and reform programs backed by the IMF and the WB and implement these programs satisfactorily for a period of time. During this period, it continues to receive debt relief from Paris Club creditors. The preliminary treatment is granted under the so called "Naples terms", i.e. 67% of amounts due under debts non ODA are cancelled and the remaining amounts are rescheduled over 23 years with a 6 year grace period.

Decision Point

At decision point, the IMF and WB Executive Boards formally decide whether a country qualifies for HIPC relief and the international community undertakes to provide sufficient assistance through completion point so that the country can achieve sustainability of the debt calculated at decision point. The Paris Club usually grants interim relief between the decision point and the expected completion point (i.e. during the Interim Period) under the so called "Cologne terms", i.e. cancellation of the maturities falling due during the Interim Period.

Completion Point

The remaining assistance necessary to reach debt sustainability, as defined at decision point, is provided at completion point. The Paris Club reduces the stock of eligible debt in net present value terms provided that there is fair burden sharing i.e. that other creditors provide at least a comparable treatment.

Steps of the HIPC initiative

Country potentially eligibile for the HIPC Initiative

Pre-Decision Point

Decision Point

Interim Period

Completion Point

Post Completion Point

Agreement of partial debt cancellation

Agreement of total debt cancellation

The Italian Government exceeds the Paris Club terms providing bilaterally 100% debt cancellation

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