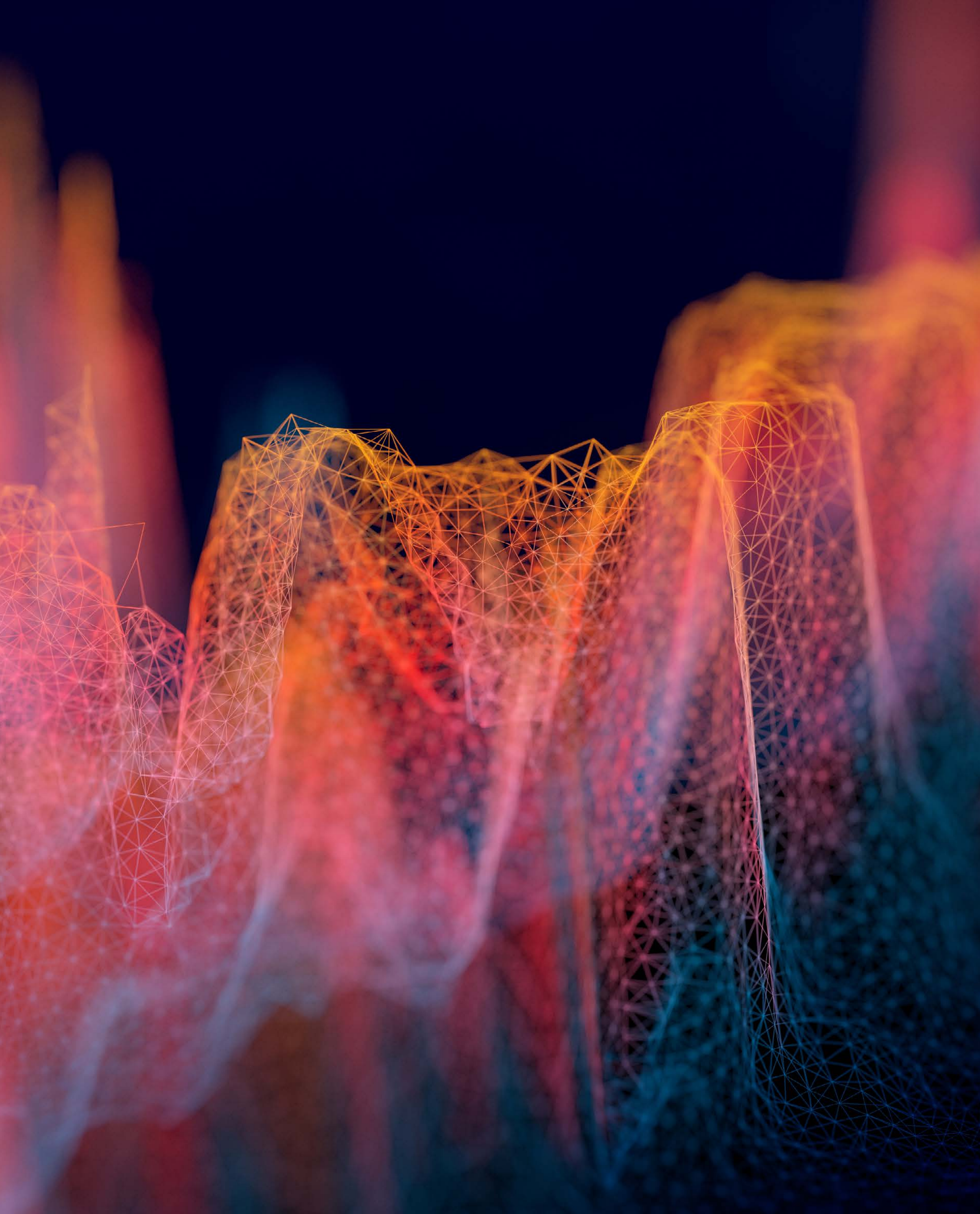
MinterEllison.

Distressed Debt and Special Situations: Succeeding in uncertain times

Creating value from capital flow

2020 - 2021

A study in conjunction with Acuris



Contents

Introduction

A global pandemic has made uncertainty the new normal and has impacted every aspect of our lives. While the short-term impacts on global economies are apparent, the long-term impacts and permanent changes to society can only be speculated.

Against this backdrop and without a marker to the finish line, Australian businesses are attempting to steer a course not only for survival but for the growth needed to be a viable long-term concern. But alongside uncertainty comes opportunity – especially for distressed debt and special situations investors.

In conjunction with Debtwire Asia-Pacific, in this report, we have explored the opportunities in a distressed market. Drawing on Debtwire's market intelligence and insights from our own thought leaders, we discuss the possibilities for companies wondering where to turn to shore up their balance sheets and for investors considering their next opportunity.

So where might these next opportunities be found? While the economic impact has not discriminated, it has certainly been felt in some areas more than others.

The mid market, for example, may be more vulnerable to exposure and find it harder to secure financing. However, non-bank lenders may offer an alternative pathway to secure funding.

In this special report we cover a range of industries from tourism, real estate and education to infrastructure, financial services and energy and resources. However, it's clear that no sector is left untouched.

Australian businesses are resilient and in the face of challenges they are currently facing, there are clear opportunities. The choices they make in the next few months may determine their long-term success.

Ron Forster, Partner

Caitlin Murray, Partner

Executive summary

As the economic impact of COVID-19 continues to affect Australian businesses across all industries, a range of temporary government measures may be delaying inevitable restructurings and insolvencies.

The general consensus among industry insiders and analysts is that stress levels will increase as we move through 2021 – particularly when the temporary changes to laws, enabling companies to avoid insolvency administration, expire.

As they look towards the medium term future, with the current high level of government assistance, distressed companies have a window of opportunity to prepare for both survival and future growth. Actions they take now will help them succeed in the uncertain time ahead.

Distressed companies need to act

Distressed companies should be exploring all sources of finance, including hybrids. Right now they may look to restructure their balance sheet, convert debt to equity and divest non-core assets. They may also want to raise equity among shareholders, or convert shareholder loans to equity.

Through temporary incentives and regulatory changes, distressed companies are buying time – and it's important that they use it wisely. The additional time they have been granted gives companies a window to set themselves up to be an attractive prospect for capital investment.

Careful consideration should be given to potential restructuring measures well before lending covenant breaches occur or repayments can't be met.

Debt funds will offer a much-needed source of capital

While Australia's big four banks have provided unprecedented support to most borrowers, they will not be able to support the market on their own. This is where non-bank lenders and other alternative capital providers will play an important role.

In order to receive funding though, companies will need to demonstrate that they have a viable business plan going forward, and that future growth looks realistic and promising. Businesses may need to be recalibrated to achieve that.

Unique times call for unique actions

Distressed debt and special situations investors are facing an unprecedented time, and need to be cognisant of the opportunities for them to support organisations and industries that have long-term promise. Unique times call for unique actions, however, and there are a number of considerations that funds and investors need to consider:

- Act speedily – restructurings are getting faster. All parties involved aim to accelerate the process and complete the turnaround quickly to minimise disruption to the business and employees. Debt funds that are able to engage in a faster process both in terms of completion of due diligence and clearing all approvals to invest, are likely to be exposed to more opportunities.
- Get into the restructuring and turnaround process before external administrators are appointed. This ensures the best chance of success. Competition and interloper risk can increase when external administrators are appointed, because they have to run a formal process.
- Understand regulatory frameworks and government support in key Australian industries. There are a range of tax considerations and ASX, Corporations Act and Foreign Investment Review Board (FIRB) rules, which are critical factors in shaping how to inject capital into distressed companies.
- When buying into a syndicate, understand where the majorities sit. Coming into the process with other like-minded investors gives investors the ability to block competing proposals.
- Remember regional differences across Australia. Federal, alongside different State and Territory laws will often need to be factored into a restructuring or turnaround process. A thorough understanding of the range of regulatory regimes will expedite the process, avert breaches and non-compliance and provide a better outcome to the whole restructuring or turnaround.

Executive summary

Sector snapshot

Tourism and leisure

While the tourism and leisure industry has been hit particularly hard, the sector is attractive for the long term and will be held in high regard by investors and debt funds.

Domestic tourism will pick up as state borders reopen, and over the next few years, foreign tourists will eventually return.

Energy and resources

Uncertainty and lower energy demand, challenging oil and coal prices and the increasing focus on decarbonisation offers potential for distressed assets, consolidation and restructures – particularly for oil and gas and coal companies.

Education

Financial distress is creating short-term opportunities in higher education, specifically among private providers of education who cater to overseas students.

Real Estate

There has been an influx of capital partnering in all property sectors (including traditional financiers transitioning into equity providers) to diversify a landowner/developer's risk.

Infrastructure

State governments plan to fast track infrastructure projects as a means of stimulating the COVID-19 economy.

A depressed local contracting market may offer opportunities for tier 1 contractors or other local participants to purchase struggling sub-contractors and services businesses.

Financial services

Banks have ramped up their expected credit loss provisions in anticipation of greater distressed companies as stimulus packages expire.

Smaller ADIs, credit unions and mutuals may come under pressure due to current economic conditions, which may result in consolidations.

Australian market update: an unprecedented time

Setting the scene

These really are unprecedented and challenging times for businesses in Australia. Months in lockdown have challenged even some of Australia's strongest corporate performers and, across industries, there is a lack of confidence around how long it will take to fully reboot the economy. Geopolitical tensions and an increased focus on the domestic market mean the outlook for the rest of 2020 and into 2021 is uncertain.

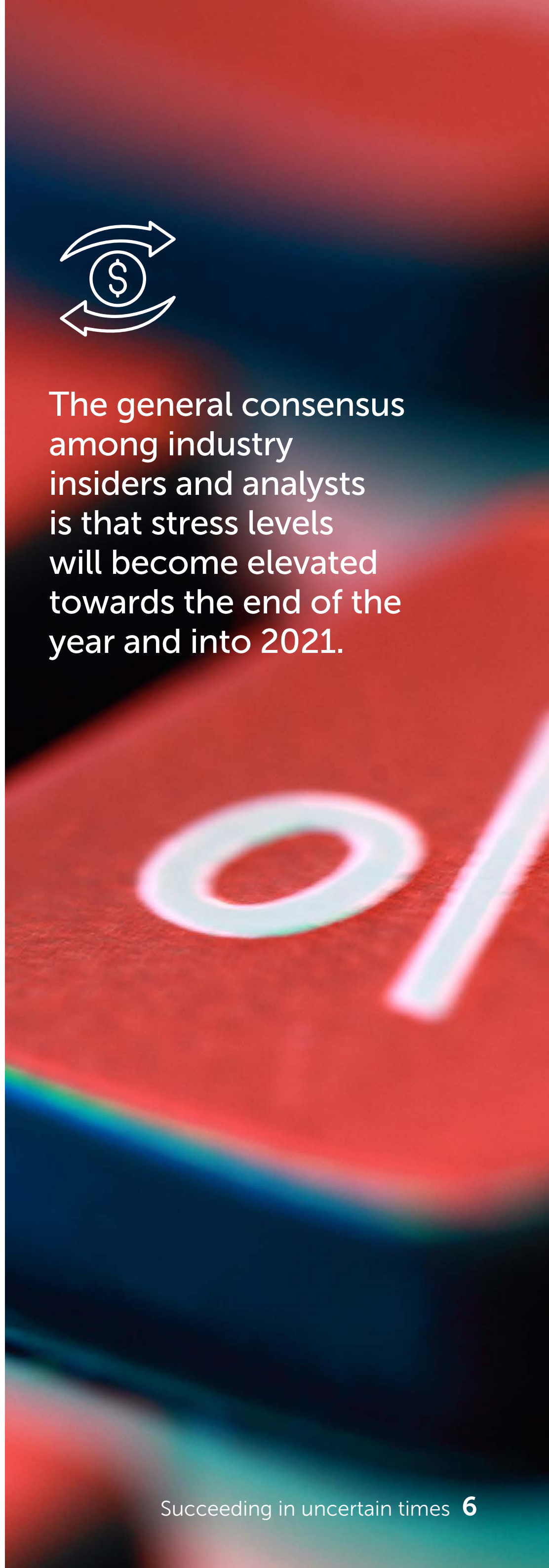
Even so, while the speed of declines in the market caught most businesses off guard, there have been relatively few credit opportunities or distressed situations so far. That could change in the months ahead as companies struggle to secure financial lifelines and turn around operations as they face long-term prospects in a post-COVID-19 world.

Stress and insolvencies: Fine for now?

Towards the end of FY2020, many Australian companies have been able to meet their credit obligations despite a downturn in revenues. The exception has been a number of retailers going into administration, although most of these have only had debts of US$100m or less. As a result, there have been few large-scale restructurings this year as companies with negative cash flows draw down on unused portions of their loan facilities and standby letters of credit rather than enter administration. Likewise, banks have been exercising forbearance for businesses that are exposed.

Temporary amendments to the country's insolvency laws are also providing a lifeline. Through these protective measures, companies can continue operating even though they may be technically insolvent. While there remain concerns that the reforms will simply push credit risk down to suppliers and result in a further tightening of credit, for now, investors can take comfort that any directors appointed to Australian corporates will have a longer window to determine an appropriate response to the current challenges.

These actions, however, are relatively short-term solutions to deeper challenges. The general consensus among industry insiders and analysts is that stress levels will become elevated towards the end of the calendar year and into next year, with the anticipation default levels may rise.



Australian market update: an unprecedented time

Private debt: Limited lending and short-term opportunities

Lending from private debt funds has also been more constrained following the pandemic. Formerly active funds have been hesitant to deploy too much capital given recent uncertainties about how deep the hole was for the Australian economy. Now, there seems to be some visibility on a bottom, however, funds are still, quite understandably, taking a cautious and sensible approach.

Numerous opportunities – including refinancings, recapitalisations and those around distressed debt – could arise, and rapidly, as the dust settles. According to Debtwire intelligence and research, numerous early stage discussions between companies and funds for potential private debt deals have already commenced. However, these deals may be stalled until travel restrictions are lifted and fund managers and their teams can complete ground-level due diligence.

That being said, as cash flows are hit, opportunities ahead for the private debt space could be found in refinancing deals for mid-market companies.

Recapitalisation needs among these firms and businesses of all sizes are also expected in the coming months when there is a clearer picture on the scale of the pandemic and its impact, according to Debtwire intelligence.

Australian market update: an unprecedented time

Trade challenges

Trade tensions and an increased international focus on domestic opportunities may add to the already long list of challenges and complexities Australian businesses face going forward. For example, China attached levies on Australian exports to China (barley, beef and steel).

While a burden for companies, this could prove advantageous to funds and distressed investors. With the Foreign Investment Review Board (FIRB) scrutinising all foreign investments, such caution could limit the number of debt players in the market. This could pave the way for other funds to get involved and avoid the cumbersome process of a bidding war for assets.

The road ahead

While parts of Australia have started reopening, increased restrictions in others provide an uneven economic landscape. It is, therefore, impossible to predict when a true return to normality will happen. More importantly, it may be too soon to start assessing the real impact.

Government measures, while effective for now, are only temporary. Through the remainder of the year, we will likely get a truer picture of how much the pandemic has impacted businesses' bottom lines. For some companies, it may require a small amount of capital to breathe new life into the balance sheet. For others, full restructuring will be required.

Depending on how the next few months unfold, debt funds and special situations investors could find themselves with abundant opportunities as the universe of companies requiring equity or debt expands. Even so, competition in this space demands fast action. The ability to move quickly on these opportunities, as always, will be dependent on having the right team in place and the right intelligence to assess sectors in distress and which companies, while currently burdened with debt, will be able to survive the downtrends.

Depending on how the next few months unfold, debt funds and special situations investors could find themselves with abundant opportunities as the universe of companies requiring equity or debt expands.

Feature Q&A: Opportunities and challenges

Debtwire sits down with MinterEllison Partners Con Boulougouris, Ron Forster, Caitlin Murray, Stewart Robertson and Ben Cockerill and Senior Associate Michael Scarf to answer key questions around the trends, challenges and opportunities for debt funds and special situations investors in the Australian market.

Con Boulougouris, Partner

DW: Given rising financial pressures and the upcoming expiry of government support measures, what are the biggest opportunity areas for debt funds or special situations investors in Australia?

Stewart Robertson: We think there are opportunities for debt funds at present, especially the ones that have very wide ranging and flexible mandates. While Australia's big four banks have been given additional, cheap liquidity through government stimulus measures and have been initially supportive of most borrowers, they're likely to become more selective in which companies they'll continue to fund and will only provide lifelines to businesses they feel are viable. This will lead to some companies needing to turn to non-bank lenders and alternative sources of capital for financing.

Con Boulougouris: Also, changes to Australia's insolvency laws in response to COVID-19 have given companies a lifeline to avoid insolvency administration. The timing for this has been extended to the end of 2020. However, as we get closer to the expiry of these amendments there's going to be an increase in activity as businesses begin to look at alternative credit funds and longer-term debt solutions.

As the need for financing grows as government measures are scaled back, debt funds will have the advantage of being able to set their own terms during the deal process. There will also be opportunities to purchase secured debt at a significant discount. This ability to acquire secured debt, coupled with having greater influence in any subsequent restructurings of the asset, could provide significant opportunity to generate enhanced returns.

DW: What are some of Australia's key advantages that make it an ideal destination for debt fund and special situations investors, particularly offshore investors?

Ron Forster: Offshore debt funds are drawn to Australia given the number of opportunities but also because of the market's high-standing reputation. The legal system and courts, particularly with regard to insolvencies, are transparent and reliable, factors that create a high degree of certainty and confidence among investors. Equally, insolvency laws in Australia are highly favourable to secured creditors. Also, while Australia may not boast the high growth levels of other emerging markets in Asia, the regulatory landscape in Australia is easier to navigate than the sometimes opaque

> *"As the need for financing grows as government measures are scaled back, debt funds will have the advantage of being able to set their own terms during the deal process."*
>
> **Con Boulougouris, Partner**

Feature Q&A: Opportunities and challenges

enforcement regimes in higher growth markets.

These are all factors that haven't changed during the COVID-19 crisis and are unlikely to change anytime soon. International debt funds, especially those based in the US, are experiencing a high level of demand on their capital.

This means that Australian corporations will need to offer higher returns to be more attractive to these foreign funds who already have many opportunities in their home market.

Con Boulougouris: Some sectors will start to show signs of recovery since the Australian government's low debt levels allowed it to run a stimulus package that was more robust, allowing for the economy to bounce back quicker. Couple these two factors with the low Australian dollar and there are plenty of reasons why offshore debt funds will look to Australia in the months ahead.

Equally, while Australia's financial markets may not be as mature as those in New York or London, there are abundant arbitrage opportunities. However, arbitrage chasers will only benefit if they move quickly, utilising deal structures that have been implemented overseas with success.

DW: Australia's mid-market lending opportunity – what are the trends and challenges in this segment of the deal market?

Ben Cockerill: There's a significant opportunity here because these mid-market borrowers, despite making up the bulk of Australian businesses, often find it difficult to secure financing or find it difficult to negotiate ongoing support from their current financier in the event that the business suffers from financial stress. Once a company is under the AU$200m threshold, terms from traditional lenders can start to tighten up and there may be less appetite to lend to newer market entrants with no relationship history or track record. There have been a number of new entrants – in the form of both new start-up banks and non-bank lenders – into the lending space looking to capitalise on this demand.

Even though there's demand for financing, there are still obstacles that may arise between mid-market borrowers and non-bank lenders. For example, some funds may not be interested in providing pure debt without the ability to also obtain an equity stake down the line. This may be met with reluctance from business owners; however, in distressed scenarios, business owners sometimes see real benefit in being able to refinance and offer an equity participation (or equity like upside) if personal guarantees (and personal assets) are not part of the financing package going forward.

During periods such as that we are experiencing now with COVID-19, there is a sense from some mid-market borrowers, particularly in sectors where there may be uncertainty about fundamental metrics going forward (e.g. the value of residential or retail property assets), that it is helpful to have a lender that is relationship focused and who is perhaps more predictable in terms of the support it may be prepared to offer. This is not limited to the major banks as there are now a number of non-bank lenders that have become more mainstream and take a similar approach.

Michael Scarf: Even though there's demand for financing, there's still obstacles that often arise between mid-market borrowers and non-bank lenders. Probably one of the greatest challenges involves willingness among business owners to give away a controlling stake in their companies. For some funds, those providing growth capital for example, this hasn't been too much of an issue. Although for the much larger funds,

> *The legal system and courts, particularly with regard to insolvencies, are transparent and reliable, factors that create a high degree of certainty and confidence among investors."*

Ron Forster, Partner

"Australia is a much smaller market than the US and Europe, and while we have relatively good insolvency laws, finding bargains and companies that fit with investment strategies can be difficult, particularly for offshore funds."

Caitlin Murray,
Partner

Feature Q&A:
Opportunities and challenges

Read our report, Debt restructuring in uncertain times.


Ron Forster, Partner


Caitlin Murray, Partner


Stewart Robertson, Partner


Ben Cockerill, Partner

however, pure debt without the ability to also obtain a significant equity stake down the line in the asset is going to be less attractive, and as a result the cost of capital is going to be a bit higher.

DW: What are the biggest challenges for debt funds or special situations investors in Australia?
Caitlin Murray: Sourcing deals and finding the best opportunities will be one area that debt funds and special situations investors find challenging. Australia is a much smaller market than the US and Europe, and while we have relatively good insolvency laws here – especially with the introduction of Safe Harbour – finding bargains and companies that fit with investment strategies can be difficult, particularly for offshore funds. Competition will also be a factor, since we're seeing growing interest from some of the larger international funds towards debt and distressed investments.

Valuations may also be a challenge in the current environment. Right now, it's almost impossible to come to a valuation that is agreeable to all parties given volatility and market uncertainties. I think once we begin to emerge from the COVID-19 crisis and have a clearer picture of the next six to 12 months, valuations will be easier and parties may be more willing to negotiate on terms.

DW: From a corporate perspective, what are going to be the biggest challenges for companies – and possible opportunity areas for investors?
Ron Forster: Restructuring the balance sheet is one of the biggest challenges for companies at present. Most are going to need to secure other sources of financing as government measures are scaled back, so they need to start thinking about where those funds are going to come from today and what other restructuring steps are needed.

These restructuring measures, in turn, are going to be challenging given the time and complexity of the process. Generally, it also requires involvement from several parties from within and outside the business.

Essentially, these businesses need to start thinking about implementing these restructuring measures as soon as possible given these time factors. Unfortunately, the concern now is that many companies are still in survival mode – that is, they're focused on the here and the now problems – and not looking further. They need to be putting restructuring plans in place today to deal with financial problems before they arise in a few months' time.

DW: When are we likely to see increases in distressed debt investments?
Caitlin Murray: Debt funds and distressed debt investors have been largely taking a wait-and-see approach until things calm down. I think when we get to the end of 2020 and into the first quarter of 2021, we'll see more activity as companies run out of existing financing options and begin to seek out new funding.

Is this going to result in a wave of investments and insolvencies? That remains to be seen. Some companies are going to be able to pull themselves through this crisis, using this situation as an opportunity to resolve challenges within the business and restructure. Others are going to find that more difficult and may become further distressed.

Opportunities for distressed debt funds will arise as a result of high demand for and limited sources of funding from the traditional credit providers. This funding will likely be more expensive and targeted to specific industries that have a lower risk profile. As Australian companies realise that they will need to spend significant amounts of money to re-establish themselves and the cost of funding operations increases, they are going to be looking for alternative and/or cheaper sources of debt and capital.

Tax challenges and considerations

MinterEllison's Adrian Varrasso discusses tax issues and implications likely to arise during a distressed debt or special situations investment and how investors can avoid pitfalls in this area.

Adrian Varrasso, Partner

DW: What are some of the typical tax issues that investors should consider when buying or holding distressed debt?

Adrian Varasso: Tax is definitely an area where issues can arise that adversely affect the economics of these types of transactions. Accordingly, it's imperative for all parties to take early advice in this area. As an example, even a simple case of a novation of a debt can give rise to a tax liability. In this scenario, an initial consideration would be whether the novation gives rise to an extinguishment of the debt and then whether that might give rise to assessable income as ordinary income. There may also be a need to consider Division 16E and the taxation of financial arrangement (TOFA) rules which affect the timing of income recognition.

An analysis would also need to be undertaken of Australia's commercial debt forgiveness rules. These rules differ to similar regimes in other jurisdictions that apply to give rise to an immediate tax impost, whereas these rules erode valuable tax attributes of the debtor, which may indirectly increase cash tax liabilities in due course.

Another trap which we often see is action taken by an investor to change the terms of the debt, resulting in a recharacterisation of the debt instrument. For example, the debtor and creditor may agree to reschedule the due date of certain payments by way of amending the contract and this can give rise to a material change to the arrangements and potentially a taxing event under our TOFA rules to the investor.

DW: Is there anything foreign investors should be particularly aware of regarding tax concerns in the distressed investing space?

AV: As a foreign investor, the main thing to keep in mind is that although Australia is a relatively small economy, by international standards, it has a sophisticated international and domestic tax system which may give rise to a significant number of material tax issues that invariably may mean that a commercial decision can give rise to a tax impost. To mitigate against this, it is critical that the post-tax treatment of any investment is understood and factored into the economics of the transaction.

Cross-border investment in distressed debts raises a number of issues. A key consideration is whether the arrangement is and continues to be, after any agreed amendments, a debt for Australian tax law purposes. Australia adopts a substance over form approach to debt characterisation and the outcome of this test has implications across a range of the tax rules, for example withholding tax. Another relevant consideration is whether an ongoing withholding tax cost arises under the arrangement and whether any changes to arrangements can trigger a withholding tax cost. We also regularly see issues with arrangements that might not require a payment of interest, but can still give rise to a 'payment' of interest for the purpose of the withholding tax rules, with the result that a withholding tax cost arises at a point where no cash moves between the parties. There are many other issues worth considering and discussing with an advisor.

DW: Are there any updates to Australia's tax regime that distressed debt investors should be aware of?

AV: Most recently, the Australia Taxation Office (ATO) released a taxpayer alert TA 2020/2 which has broad application to arrangements connected with foreign investment into Australian entities.

Given its breadth, it raises the question of whether it could have application to a distressed debt investor.

Tax challenges and considerations

Examples of where the taxpayer alert is said to have relevance is where:

- A foreign investor starts to participate in the management, control or capital as part of the investment, which may be the case with rights attached to the debt,
- The investment has features not consistent with a vanilla debt investment, which is commonly the case with a structured debt investment,
- The investment may provide a foreign investor with direct exposure to the economic return from a particular business or assets exploited therein, whether that's from ongoing profit or a gain on an exit event.

Also, it is highly likely that with distressed debt cross-border deals, approval will need to be sought from Australia's Foreign Investment Review Board (FIRB). All applications to the FIRB involve the FIRB liaising with the ATO, which at the least will involve investors being required to answer a series of questions from the ATO and providing necessary documentation that may result in further scrutiny by the ATO post completion of the investment.

Competition considerations: the approach to distressed assets

Australia's merger control regime prohibits the acquisition of shares or assets where that would have the effect or the likely effect of substantially lessening competition in a market in Australia.

The Australian Competition and Consumer Commission (ACCC) regulates the regime. Similar to tax issues, applications lodged with Australia's Foreign Investment Review Board (FIRB) involve the FIRB liaising with the ACCC.

An increase in distressed businesses as a result of the global pandemic means that it is more likely that merger parties will seek to rely on 'failing firm' arguments when engaging with the ACCC.

How are 'failing firm' scenarios assessed?

So-called 'failing firm' arguments involve the suggestion that, without the merger, one of the parties is likely to exit the market in the near future. This involves submitting to the ACCC that, without the merger, one of the parties is likely to exit the market in the near future.

An increase in distressed businesses as a result of the global pandemic means that it is more likely that merger parties will seek to rely on failing firm arguments when engaging with the ACCC. The ACCC has poured cold water on suggestions it may take a light touch approach to failing firm type arguments. It will carefully scrutinise these submissions and assess each deal on a case-by-case basis.

Even if the parties can show the target is a failing firm, clearance is not assured. The ACCC's scepticism of failing firm arguments is well known and it will consider a range of factors. For example, it will assess whether the market would be substantially more competitive if the remaining firms competed for the failed firm's customers (against a scenario where a single competitor acquires the customer base and assets).

Be prepared with evidence

The ACCC's attitude to 'failing firm' arguments mean that investors need to come prepared:

- Compelling evidence of imminent failure: The ACCC will expect to see extensive supporting material about the firm's financial position, including administrator reports, financial statements, forecasts, board papers and evidence of a thorough failed search for buyers. In the past, the ACCC has appointed a forensic accountant to test assertions about continued viability.
- Comprehensive efforts to restructure the business: The ACCC will expect to see evidence that performance is unlikely to be improved by the current owner or other potential shareholders if the proposed acquisition does not proceed. This was, for example, an influential factor in the ACCC's consideration of Virgin Australia's acquisition of 60% of Tiger Airways Australia in 2013.
- A thorough (failed) search for alternate investors that may raise fewer concerns: Even when a business is failing, a deal can be derailed by another investor. For example, the ACCC opposed the acquisition of Jewel Fine Foods (in administration) by its major competitor. Its view was that if the deal did not proceed then another buyer was likely to acquire Jewel and continue to compete.

"The ACCC has made it clear that parties should not expect a lenient approach to merger clearance because of the global pandemic."

Miranda Noble, Partner

Sector watch:
Opportunities and challenges in Australian industries

Debtwire's Asia-Pacific editorial team highlights sectors where new challenges and financing pressures could result in rising distressed debt and special situation opportunities.

Few industries have been spared the economic impact of COVID-19 geopolitical issues such as trade tensions and a global recession. Debtwire analysis and intelligence highlights several sectors where opportunities – both in sizeable, tradable debt and assets, as well as the mid-market lending space – could be found in 2020 and beyond.

Tourism and leisure

Australia's tourism industry has had a difficult run, facing the nationwide bushfires followed by the global pandemic. Mid-market companies in this space have been hit hardest as they struggle to secure short-term sources of financing. For these mid-cap firms, while smaller than the large-cap deals debt funds typically seek out, a lifeline may be all that's needed to stabilise the balance sheet until conditions improve and the business becomes profitable once again.

Larger financing needs, however, may be found among major hotel operators. As demand for accommodation has dwindled over the past six months, hotels are also feeling the pinch of declining tourism numbers and could provide opportunities for investors looking at distressed debt and property acquisitions.

As the economy starts to reopen in parts of Australia, restrictions on international tourists could put further strains on the industry. Such measures could be in place well into 2021.

Over the short term, tourism and leisure companies would be forced to rely largely on the domestic population. However, many Australians are already levered to the max, with household debt in Australia among the highest in the world. How much growth domestic demand is able to drive in the industry is uncertain. In that vein, restaurants, movie theatres and other entertainment venues are also facing immediate challenges as consumers reconsider their spending.

"There are plenty of good assets in the tourism space for debt funds to look at. While the industry has been hit particularly hard, taking a long-term view, the market will ultimately bounce back as domestic tourism picks up and, once borders are reopened, foreign tourists return, sensing that Australia is a safe place to travel and with a low dollar to the country's advantage."

Michael Hughes, Partner

“

The Australian tourism space is highly fragmented and there are only a few companies that have consolidated to achieve the kind of size that many offshore debt funds might gravitate towards. However, there will be substantial opportunities in this space to provide capital solutions for companies in need – both to help those companies deal with short- to mid-term disruption to revenue, and to take advantage of good buying opportunities.”

Glen Sauer,
Partner

Sector watch:
Opportunities and challenges in Australian industries

Energy and resources

The most significant initial impact on the energy and resources sector of COVID-19 has been the fall in energy demand, impacting electricity demand and pricing for energy commodities around the world, particularly oil and coal. In some countries, COVID-19 outbreaks have forced mine closures.

In Australia, as an essential service, the energy and resources sector has been generally able to continue to operate, but there have been impacts on operations including some cutbacks in production (particularly in coal) and impacts on work rosters and staff movements arising from social distancing and border closures.

However, broadly the sector has responded well to the challenge and has weathered the initial impacts well.

Looking forward, the uncertainty and lower energy demand, and challenging oil and coal prices combined with the ever increasing focus on decarbonisation across economies, certainly presents a challenging environment particularly for oil and gas and coal companies. In these sub-sectors there is the potential for distressed assets, consolidation and restructures.

While globally energy investment is expected to reduce in the short to medium term, domestically Australia's renewable energy investment continues, albeit with infrastructure investment required and energy security challenges, which individual state governments are looking to alleviate by investing in the development of Renewable Energy Zones.

Longer-term demand for 'future minerals' is high, but there may be some distressed owners of quality assets which nonetheless have challenging investment and cash-flow positions.

"While globally energy investment is expected to reduce in the short to medium term, domestically Australia's renewable energy investment continues, albeit with infrastructure investment required and energy security challenges."

Simon Scott,
Partner

> *Airlines, tourism and retail have all been clearly hit hard in recent months. However, distressed debt investors should also look at other strong sectors where companies have faltered because of the general economic downturn, but they still have strong balance sheets."*

Ron Forster,
Partner

Sector watch: Opportunities and challenges in Australian industries

Retail

For retail, COVID-19 has accelerated the structural shift away from bricks and mortar and towards online. Now, with supply chains disrupted, lockdowns and closures of public spaces keeping customers away and the looming spectre of recession, many retailers are searching for a lifeline.

Distress in the industry has been an ongoing theme, with several Australian retailers going into administration or collapsing in recent years. That list includes Bardot (women's fashion), Topshop (fast fashion), Ed Harry (menswear brand) and Napoleon Perdis (cosmetics) in 2019 and into early 2020. In March 2020, Jeanswest joined the list of companies entering voluntary administration. As retail continues to face challenges, further insolvencies and restructuring may be expected, creating opportunities for distressed debt investors.

There are segments which will still thrive going forward if they are able to secure stable sources of financing. Businesses offering or accelerating the move to e-commerce, home delivery and Click and Collect may emerge as winners as buying behaviours continue to shift.

Sector watch:
Opportunities and challenges in Australian industries

Education

Australia's tertiary education institutions are finding the current climate challenging. Providers are having difficulty holding enrolments of existing overseas students, and there is significant uncertainty about whether the major intake for the first teaching period in the 2021 academic calendar will proceed. Much depends on a successful pilot for the return of international students, and creating a COVID-safe corridor for the large-scale return of students to key markets.

Private tertiary education institutions that primarily or wholly target and enrol overseas students are most impacted. As the largest source of international students, China's deteriorating relationship with the US, Canada, UK and Australia in particular adds a further layer of complexity in projecting the impact on the market.

There is also the possibility of large private providers in China seeking a foothold in Australia (a trend that had commenced pre-COVID-19, with some significant transactions in recent years) to vertically integrate their offering by creating 'finishing schools' in key markets in which their students are likely to show interest.

High barriers to entry and limited approvals to operate (and lengthy processes to obtain approvals) provides the incentive for private higher education providers to weather the storm. Refinancing, changing their operations and rethinking staff and offerings, has so far staved off the potential advances of private equity to acquire higher education assets to add to their portfolio. Time will tell if these defensive actions will be sufficient to sustain their existence or if, ultimately, this part of the sector succumbs to advances to sell their business before they lose value.

“

Financial distress is creating short-term opportunities in the education sector – particularly higher education – specifically among private providers of education who cater to overseas students. This sector has many advantages that may be appealing to investors, mainly that it has a high barrier to entry which limits competition. We're likely to see a range of opportunities arise as mid-market firms and larger institutions require financing to weather the months and years ahead."

Caitlin Murray,
Partner

“

Much depends on a successful pilot for the return of international students, and creating a COVID-safe corridor for the large-scale return of students to key markets."

Tom Fletcher,
Partner

Sector watch:
Opportunities and challenges in Australian industries

Real estate

In the face of significant challenges that are set to alter the trajectory of the sector going forward, the real estate industry overall is holding up.

Industrial real estate is performing well as it supports the Australian community's need for products and services manufactured locally and secure domestic supply chains and logistics.

Commercial property, however – particularly office buildings in the central business districts of Australia's major cities – has faced a hit as organisations manage social distancing and the increased need and desire to work remotely. Longer term, the sector is exploring new ways to bring people safely back to the office, with many looking at redesigning and redeveloping workplaces to reflect a post-COVID future.

There has been an influx of capital partnering in all property sectors (including traditional financiers transitioning into equity providers) to diversify a landowner/developer's risk. Organisations are moving away from the traditional model of buy, sell and own. Many are looking at selling and leaseback as a way of reducing risk.

The status of retail property is diverse. Many sellers are disposing of their large shopping centre assets, though they are not necessarily disposing of them for a bargain. Some are selling their 'low hanging fruit' but are reinvesting into other retail assets and repositioning themselves. For example, neighbourhood centres are an attractive proposition for retail, commercial and residential real estate to merge.

> *"Some property sectors such as logistics and parts of residential are performing or holding up well, however, large-scale retail and CBD office assets are facing challenges. There are opportunities in all sectors to deal, invest, develop, finance or refit these assets."*

**Carla Deluca,
Partner**

> *"A depressed local contracting market, with some international parties prospectively shut out due to FIRB regulations, may see opportunities for tier 1 contractors (Australian and others) or other local participants to purchase struggling sub-contractors and services businesses."*

Nicole Green,
Partner

Sector watch:
Opportunities and challenges in Australian industries

Infrastructure

State governments have been announcing the fast tracking of infrastructure projects as a means of stimulating the COVID-19 economy. The announcements haven't had a material impact on the activity levels in the infrastructure sector and we are lagging well behind the levels seen in 2019 and previous years.

Prior to COVID-19, we had a number of unresolved structural issues that were impacting investor and contractor confidence. Obviously we are now in a recessionary environment and the key considerations around how projects will be funded and the level of risk parties are willing to take on are now more acutely in focus.

Australian superfunds, traditionally strong investors in infrastructure projects (directly and indirectly), had struggled to deploy funds in a saturated domestic market. They had increasingly looked offshore but COVID-19 may force a shift in strategy.

Just as the European infrastructure investment market has seen a rise in core+ investment (such as renewable energy assets, data centres, smart metering), we may see Australian funds increasingly doing the same in their own domestic market.

A depressed local contracting market, with some international parties prospectively shut out due to FIRB regulations, may see opportunities for tier 1 contractors (Australian and others) or other local participants to purchase struggling sub-contractors and services businesses. We may also expect contractors with financing arms and other holders of PPP assets to be looking to offload their current holdings.

Whatever transpires, we do know that there is a wall of capital looking for a safe home in viable infrastructure assets.

Sector watch:
Opportunities and challenges in Australian industries

Financial services

The green shoots of economic recovery following the easing of COVID-19 restrictions across Australia in June were severely set back following the second wave of cases in Victoria. The re-introduction of a lockdown and the closure of state borders has negatively impacted confidence and economic recovery.

APRA has extended the loan deferral program for an additional four months on an individual basis, and the government has recently announced a second phase of the JobKeeper and JobSeeker stimulus programs with new tiers and eligibility. This will be in place until March 2021.

Significant numbers of customers have elected to take up the repayment pause. With rising unemployment, a decline in property prices and the now delayed economic recovery, there is an increasingly strongly held view that the extension of the stimulus packages will 'kick the can temporarily down the road' and that the hardship reflected in the repayment pause will lead to credit losses. Not surprisingly, banks have ramped up their expected credit loss provisions in anticipation.

Superannuation funds are facing financial loss due to lower member contributions, lower returns on investments, the two waves of early withdrawal of super, reduced business cash flow and employer insolvencies and defaults. This is particularly the case for funds that cater for members who are employed in industries most affected by COVID-19 and social distancing restrictions.

In response, most affected super funds are reconsidering how, and how often, they value their unlisted assets, with some redeeming major holdings in unlisted assets. Less affected funds with available liquidity, are finding opportunities to invest in quality assets that may not otherwise have become available but for the crisis. Superannuation funds may also have a role to play in investing in infrastructure as a way of helping to kickstart the Australian economy.

The sector, still in a post-Royal Commission period, is likely to see mergers in order to remain sustainable. Super funds and health insurance are two examples of where we may see mergers occur. In addition, as banks continue to divest their life insurance and wealth businesses, there will be restructuring, recapitalisation and acquisition opportunities, particularly for insurance companies looking to expand and private equity firms looking for opportunities.

Rahoul Chowdry, Partner

"Smaller ADIs, credit unions and mutuals may come under pressure due to the current economic conditions, and accordingly, we are likely to see consolidation in this part of the financial services sector. In addition, fintech or other niche lenders that have specialised in industries affected by COVID-19 may face difficult times ahead."

Victoria Allen, Partner

Feature Q&A: Restructuring and turnaround best practices

Debtwire sits down with MinterEllison Partners Michael Hughes and Glen Sauer to discuss best practices in managing a successful restructuring or turnaround amid market volatilities and uncertainty.

DW: How will restructurings and turnarounds in the current environment be different than completing such actions in the past?

Michael Hughes: There's going to be a greater emphasis on speed with most upcoming restructurings as all parties involved aim to accelerate the process. The rationale behind this will be to complete the turnaround and transact quickly so that employees can continue to work. Assets are going to be exposed to the market over much shorter timeframes, as will the process of identifying preferred bidders and then closing the process and transacting with the most likely buyer.

Another trend we're likely to see is proper use of loan-to-own – and I think this is where the distressed debt funds will come in. If these funds can take out a trading bank facility that is fully secured against the assets of the company at less than par, they can then have a very powerful position in the process once the company goes into administration. This is because they can vote their entire debt in support of their proposal, and their position as a secured creditor gives them the right to veto any competing proposal, which they cannot be bound into. Then once creditors vote to accept the proposal, there's a separate process where these funds can apply to the court to have the shares in the company vested on them on the basis that the only alternative to the proposal is liquidation, and in that scenario the shares have no value.

DW: What are the key risks debt funds face when participating in these kinds of financings? How can they mitigate these risks?

Michael Hughes: Having an unsecured position is a major risk these funds need to be mindful of since, ideally, they want to be in a position where they can move into restructuring with a secured debt position. This will allow them to have greater influence in the process and outcome.

Another potential risk is that when funds are buying into a syndicate, they need to understand where the majorities sit. As is common around the world, a lot can be done by agreement between company and two-thirds of lenders, so if you buy into the debt and are part of the other third, you have to watch out you don't get dragged along. This raises several economic questions, such as "What are you buying into?" and "How much are you buying?" Are you able to come into the process with other like-minded investors so you at least have the ability to block competing proposals?

Glen Sauer: If possible, debt funds like to get into the restructuring and turnaround process before external administrators are appointed. Competition and interloper risk can increase when external administrators are appointed, because they have to run a formal process. We saw this happen when CBS unexpectedly beat other bidders, including offshore credit funds, for Network 10. There is potentially more scope for structuring a deal in a bilateral negotiation while the company is still solvent.

Feature Q&A: Restructuring and turnaround best practices

DW: What type of due diligence should investors carry out with distressed investments? How do they prioritise when they're in a race against the clock to restructure and turnaround a distressed firm?
Glen Sauer: Financial due diligence will obviously receive the most time and attention, but investors also need to spend considerable time on the legal and tax considerations of the deal. Understanding regulatory frameworks around key Australian industries and the government support provided in these sectors (particularly those impacted by COVID-19) is also going to be increasingly important.

Using warranty and indemnity (W&I) insurance can help mitigate risk for these deals and we expect to see more debt funds using W&I insurance on distressed deals in the months ahead. However, W&I insurance requires an even more extensive and thorough investigation of the relevant business, and won't help mitigate against events that occur after completion (e.g. further COVID-19 related impacts). Funds need to be speaking with industry experts and professionals who understand the business and industry to gain a comprehensive understanding of the business and risks associated with it, including how COVID-19 has impacted it and may impact it in future.

DW: Is there a role for advisors to assist debt funds in the restructuring or generally for distressed debt investments?
Glen Sauer: One of the key advantages of consulting advisors is that these experts provide ground-level insights and experience on navigating the regulatory environment that offshore investors may not have. Indeed, whenever dealing with listed companies, there are a range of ASX and Corporations Act rules, not to mention FIRB rules, which are critical factors in shaping how to inject capital into distressed companies (and this involves equity or debt).

Even in the unlisted company space, to successfully compete with other debt providers and provide a financing package that is attractive for an Australian borrower, advisors provide the market insight into rules, procedures or 'market practice' which can assist in achieving an optimal outcome.

Michael Hughes: You also can't underestimate that there are significant regional differences across Australia, so it's important to have advisors on the ground within these regions to advise on best practices, looking at assets and the overall business environment, and manage relationships between parties. These insights into the local environment and applicable business laws that are specific to Australia, and different markets within it, can prove invaluable in terms of expediting the process, averting breaches and non-compliance and providing a better outcome to the whole restructuring or turnaround.

"*Having an unsecured position is a major risk these funds need to be mindful of since, ideally, you will want to be in a position where you can move into restructuring with a secured debt position and thus have greater influence on the process and outcome.*"

Michael Hughes, Partner

“Understanding regulatory frameworks around key Australian industries and the government support provided in these sectors (particularly those impacted by COVID-19) is also going to be increasingly important.”

Glen Sauer,
Partner

Conclusion

Uncertain times often generate a level of inertia or indecisive action – or even no action at all.

As we face the immediate impacts of a devastated global economy, the long-term consequences and permanent changes to society can still only, to a large extent, be speculated. However, there are critical actions that companies and funds can take now that will prepare them for opportunities and challenges that the future may bring – even if the precise nature of them is unknown.

For example:

- **Review, reorganise and recalibrate now.** In order to receive capital funding or investment, companies need to demonstrate that they have a viable business plan going forward. Restructuring and refinancing decisions need to be made now to ensure companies' ongoing viability and resilience.
- **Recognise the different pathways across industries.** The Australian industries we have outlined in this report offer a diverse cross section of opportunities and challenges, with recovery and permanent change expected on different timeframes. Detailed industry knowledge, including government regulation and incentives, will help funds and investors understand how to maximise their chances of success.
- **Understand Australia's changing regulatory framework.** COVID-19 has brought with it new complications such as Foreign Investment Review Board criteria changes and additional tax considerations. ASX and Corporations Act rules, for example, are critical factors in shaping how to inject capital into distressed companies. An early understanding of how to operate within this framework is key to ensuring a successful outcome.

Australia, like the rest of the world, is currently facing uniquely challenging circumstances. While we may not know where the finish line will be, as we navigate this uncertainty, there is a lot to be optimistic about. Decisive, informed and proactive action will help companies and funds take strong steps towards a strong, sustainable long-term future.

Get in touch

To email any of the contacts below: name.surname@minterellison.com

Adelaide
Andrew Corletto, Partner
+61 8 8233 5420

–

Brisbane
Brendan Clark, Partner
+61 7 3119 6455

Tom Fletcher, Partner
+61 7 3119 6372

Simon Scott, Partner
+61 7 3119 6153

Melinda Smith, Partner
+61 7 3119 6145

Michael Vickery, Partner
+61 7 3119 6185

–

Canberra
David Moore, Partner
+61 2 6225 3044

Mellissa Lai, Senior Associate
+61 2 6225 3287

Melbourne
Nick Anson, Partner
+61 3 8608 2167

Geoff Carter, Partner
+61 3 8608 2090

Ben Cockerill, Partner
+61 3 8608 2909

Alberto Colla, Partner
+61 3 8608 2754

Carla Deluca, Partner
+61 3 8608 2397

Geoff Earl, Partner
+61 3 8608 2531

Andrea Frank, Partner
+61 3 8608 2492

Kate Koidl, Partner
+61 3 8608 2089

Ben Liu, Partner
+61 3 8608 2898

Catherine Macrae, Senior Associate
+61 3 8608 2061

Miranda Noble, Partner
+61 3 8608 2489

Adrian Varrasso, Partner
+61 3 8608 2483

Brendon Watkins, Partner
+61 3 8608 2601

Perth
Shaun McRobert, Partner
+61 8 6189 7935

Gemey Visscher, Partner
+61 8 6189 7865

–

Sydney
Wissam Abwi, Partner
+61 2 9921 4475

Victoria Allen, Partner
+61 2 9921 4567

Con Boulougouris, Partner
+61 2 9921 4368

Taline Chater, Special Counsel
+61 2 9921 8613

Rahoul Chowdry, Partner
+61 2 9921 8781

Shaun Clyne, Partner
+61 2 9921 4265

Matt Cunningham, Partner
+61 2 9921 4230

Ron Forster, Partner
+61 2 9921 4293

Nicole Green, Partner
+61 2 9921 4739

Michael Hughes, Partner
+61 2 9921 4647

Stuart Johnson, Managing Partner, Capital Markets Corporate
+61 2 9921 4907

Michael Lawson, Partner
+61 2 9921 4554

James Mok, Partner
+61 2 9921 8612

Caitlin Murray, Partner
+61 2 9921 4279

John Mosley, Partner
+61 2 9921 4428

Stewart Robertson, Partner
+61 2 9921 4962

Keith Rovers, Partner
+61 2 9921 4681

Glen Sauer, Partner
+61 2 9921 4540

Michael Scarf, Senior Associate
+61 2 9921 4045

Louella Stone, Partner
+61 2 9921 4575

International
Jeremy Blackshaw, Managing Partner - International
+61 3 8608 2922

Lloyd Kavanagh,
Partner - New Zealand
lloyd.kavanagh@minterellison.co.nz
+64 9 353 9976

Nicola Marley,
Partner - United Kingdom and Europe
+44 20 7429 2786

George Tong,
Partner - Hong Kong
+852 2841 6836

MinterEllison

A study in conjunction with Acuris