

M&A turnaround and negotiated composition

Expert's Opinion

Negotiated settlement: an innovative tool for insolvency

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Overview

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The key role of banks and turnaround funds

Giovanni Marino

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Overview

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The global Covid-19 pandemic suddenly caused various structural changes which impacted the entire global economic and competitive market, redesigning supply chains, changing the relationships between businesses and employees and, most importantly, overturning the businesses' approach to the market and clients.

All this obviously had a major impact on the cash flow dynamics of all companies, most of which found themselves dealing with one of the severest financial downturns ever and, moreover, in need to prioritise cash management over the management of operations. In a situation of distressed financial position, the ability to transform and adapt quickly to new conditions will be a key feature of businesses which intend to manage the crisis rather than suffering from it. There emerges the vital role of turnaround strategies, also through M&A operations, a tool increasingly crucial to face change and make businesses more resilient to the new context.

As far as the current domestic situation is concerned, according to a report by AIFI (i.e. the Italian association of private equity, venture capital and private debt) with the support of Back to Profit, in 2021 there were an estimated 1,700 potentially distressed businesses, corresponding to an aggregate turnover of 55 billion Euro and approx. 170,000 employees. These include businesses of various sizes which, despite their good operating performance (positive EBITDA), are beginning to suffer from an increasingly challenging indebtedness.

In these situations, timing is key and the possibility to successfully relaunch a business in a quick and effective way increasingly requires the involvement of specialised professionals who, besides having considerable capital, can also contribute standing, know-how and commercial networking capabilities. The presence of these players in Italy is growing, though still quite limited, partly due to the rigid legal and regulatory systems, still very complex, subject to interpretations and slow.

At the peak of the pandemic, i.e. throughout 2022, the turnaround segment maintained a niche position, with only 9 operations promoted by financial institutions for a value of 172 million Euro, compared to the 7 operations for a value of 96 million Euro in 2019, with a marked 80% increase on the previous FY. The average amount invested in turnaround deals in 2020 amounted to approx. 19.1 million Euro.



According to the AIFI report on the Italian private equity market, there were 6 investment operations promoted by turnaround investors in Q1 2021, for a total amount of 27 million Euro, with a significant increase compared to the same period of 2020, when only 1 turnaround operation was completed, for 1 million Euro. These data are highly significant if we keep into account the interruption of operations following the lockdown in the first half of 2020 and the subsequent disruption experienced by many businesses in the first half of 2021.

It is clear that an increase in the number of financially distressed businesses led to a parallel increase of M&A turnaround opportunities, thus considerably widening the market segment of a sector almost unknown so far.

In the next few years, this type of operations will become a financial strategy aimed at turning businesses around, relaunching their operations in difficult phases of their lifecycle. This will also be thanks to the new measures implemented by the government in the last few months to support businesses during the emergency phase and thanks to the new ways in which institutional investors can now support the Italian entrepreneurial fabric.

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This new procedure, entered into force on 15 November 2021, is a new tool, alternative to the current insolvency proceedings, available to distressed businesses which, in many respects, reflects the contents of EU Directive 2019/1023 on Insolvency dated 20 June 2019, whose provisions will have to be transposed by member States by 17 July 2022.



The procedure aims at bringing forward turnaround solutions, on a shorter timeframe compared to traditional insolvency proceedings, only when there are actual prospects of a direct turnaround or, if not possible, also through the disposal of a functioning business, i.e. as a going concern.

The negotiated composition is a voluntary, reserved and out-of-Court proceeding, which does not preclude to an arrangement with creditors under bankruptcy law and does not imply the divestment of assets and of the entrepreneur's management, although it is necessarily non detrimental for creditors (in case of a probable insolvency).



It is worth underlining that the advantages for businesses are significant, first of all the envisaged prevention of insolvency and the subsequent access to an insolvency proceeding, through a sort of voluntary mediation managed by an independent expert and aimed at reaching re-negotiation agreements of the debt position with creditors, with the possibility to continue the business activity without being subject to enforcement actions (in this case the Law Decree provides that a dedicated application be filed to the competent Court).

Who can access the procedure? All entrepreneurs, without distinctions (commercial or agricultural, either above or below specific thresholds).

How to access the procedure? From an operational point of view, the application for a negotiated composition is simple and quick, as per the legislator's intention to actively prevent and manage corporate crisis. In order to make things easier for businesses, the application can be filed through a national electronic platform (i.e. Unioncamere); it will then be examined by a committee set up at the local Chamber of Commerce where the business is located and, in case of a positive outcome, an expert will be identified (chosen from a list of professionals with expertise in corporate crisis) who, upon acceptance, will work together with the entrepreneur to evaluate the turnaround strategies available and meet the parties involved.

Which is the expert's role in the business management? With the appointment of the expert, the entrepreneur is supported by a "facilitator" who will be in charge of facilitating the negotiations between the entrepreneur and its creditors to identify a shared solution to the crisis. The expert does not replace the entrepreneur in the negotiations with creditors, but he offers support and makes his professional expertise and skills available, acting as a consultant to the debtor, as well as a guarantor to third parties. For the entire duration of the procedure the entrepreneur will remain in charge of the ordinary and extraordinary management of the business and accountable accordingly. In case of extraordinary administration operations and payments not consistent with the turnaround prospects, the entrepreneur is required to inform the expert, who, should he deem them detrimental for the creditors or for the negotiations underway, will have to notify the entrepreneur and the supervisory body in writing.

When the expert's engagement terminates? The engagement is considered as terminated after 180 days from his appointment, should the parties have failed to find a suitable solution to overcome the crisis, with the exception of those cases in which its continuation is functional to the entrepreneur's referral to the Court to obtain protective measures, to contract preferential claims or to transfer the business.



Which are the possible outcomes of the negotiations? Should a solution to overcome the crisis be identified, then the parties can enter into an agreement with one or more creditors, i.e. an agreement undersigned by the entrepreneur and the creditors such as the turnaround plan ex art. 67 of Bankruptcy Law (without need to have the plan certified by an independent professional as concerns the truthfulness of corporate data and its feasibility), or ask for the validation of a debt restructuring agreement pursuant to art. 182-bis of Bankruptcy Law. In case of failure of the negotiated composition, instead, the entrepreneur can access an insolvency proceeding. In particular, Law Decree no. 118/2021 allows entrepreneurs to access a new proceeding called “simplified” voluntary bankruptcy.

In this latter case, the entrepreneur, within 60 days from the negative conclusion of the negotiated composition, can file with the competent Court a proposal of bankruptcy agreement with assignment of assets and relevant liquidation plan. The proceeding introduced by the Law Decree is “simplified” compared to the proceeding regulated under bankruptcy law, since the creditors’ vote is not required, nor a minimum payment of unsecured creditors. In this case the Court, after assessing the validity of the proceeding, the compliance with preferential rights order and the feasibility of the liquidation plan, approves the liquidation plan, provided that it is not detrimental to the creditors, but rather implies a benefit to each of them.

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Closing remarks

Besides being a new tool to prevent insolvency, the negotiated composition offers various advantages to both the debtor and possible investors. The debtor will actually be able to benefit from the negotiation leverage and from the expert's advice, and have (should the procedure not have a positive conclusion) an additional protected timeframe before an insolvency proceeding, whereas the creditors will be able to acquire the business in a simpler way both during the negotiated composition and in case of a "simplified" voluntary bankruptcy.

Considering how this proceeding is structured, we believe that most probably it will be used by small and medium enterprises, whereas larger ones will keep on using the tools currently available under the bankruptcy law.

As mentioned above, the negotiated composition entered into force on 15 November 2021 and the first applications to access the procedure have been filed starting from mid-December 2021. Among the obstacles to its timely application are, on the one hand, the lack of experts (who, in order to qualify as such, need to attend a specific 55-hour course, which in some cases ended only in January 2022) and, on the other hand, the need to better understand how the new procedure works. Therefore, it came into full force only in February 2022.

In conclusion we can say that the efficiency and effectiveness of this new tool will depend on the coordination and attitude of all the subjects involved: entrepreneurs, who will have to pay more attention in advance to face and report corporate crisis and creditors, who will have to cooperate with entrepreneurs to find solutions to avoid insolvency. A significant role will also be played by professionals, who will have to correctly advise and guide creditors and debtors as concerns the new procedure.



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Which are the risk factors? Although Law Decree no. 118/2021 provides for an active and informed involvement of banks, the risk is that their participation may not be sufficient, mainly because their involvement is subsequent to the drafting of a first hypothesis of turnaround plan, which is preliminarily assessed by the entrepreneur, its advisors and the expert. As mentioned above, the expert convenes the parties only if he deems the turnaround possible, i.e. when possible solutions to the crisis have already been devised; consequently, banks will not have many alternatives available, also considering that the 180 days term starts from the expert's acceptance of the plan and not from the convening of creditors. Of course, should this be the case, there is a high risk of a passive attitude of banks, leading not so much to the application of an out-of-Court negotiated composition, but rather to the alternative composition without the approval of the majority of creditors, i.e. the worst solution both in terms of preservation of the value of the business and of soundness of the economic system.

How to involve banks, then? The advisors and the expert play a key role in terms of an active involvement of banks. The expert will have to understand the value of the business, assessing whether the margins for a turnaround are present, also in the light of the grants obtainable from the banks, and be able to communicate the soundness of the business restructuring project in the most effective way.



It is crucial that the expert really play the role of a mediator (as he cannot be entrusted with drafting the plan or with financial planning) and be an impartial and equidistant figure who supports the plan suitability and reliability to attain the debt restructuring and turnaround. The expert thus facilitates the negotiations as he reassures the banks on the soundness of the plan: the more skilled the experts will be, the more effective the negotiated composition will be as a solution. Another key role for the successful outcome of the proceeding is that of turnaround funds, i.e. players specialised in corporate crisis matters which, thanks to the out-of-Court negotiated composition will have the possibility to enter into distressed companies more easily. Banks and entrepreneurs will be called upon to welcome these solutions and facilitate the access of funds, which, thanks to their specific expertise, will be able to support the recovery with a new governance and new targets, bringing them back to the market stronger and more structured.

Which is the new scenario for turnaround funds? Although the number of professionals specialised in this kind of interventions in Italy is still limited, the reasons which lead to their reduced presence seem to have been overcome with this new procedure, which gives strong feedback to the typical difficulties experienced by investors, i.e. the discrepancies in information and the timing characterising corporate crises. The reduced quality and quantity of data and information is a characteristic of Italian SMEs, due to a weak management control which implies significant due diligent efforts for potential investors.

Timing is another key factor: should analyses and negotiations not be carried out on a tight schedule and under defined conditions and contexts, there is a risk of compromising the situation and that negotiations are still underway while the business starts experiencing supply blockages, production shut-downs and trade unions unrests. All these factors, which normally take investors away from the typical acquisition processes, are overcome by the introduction of the new procedure of negotiated composition, which guarantees completeness of information (thanks to the expert and to the preliminary economic and financial analyses) and reduced timescale (with the introduction of the 180 days term for the definition and conclusion of the turnaround plan). By fixing these uncertainties, the negotiated composition will increasingly attract specialised investors, who will be more willing to offer a higher price for the acquisition of businesses or business units, aligning their interests with those of entrepreneurs and banks.

Will there be an increase in extraordinary operations? This will surely be a period in which turnaround operations will be increasingly necessary, also because the measures undertaken by the government in the last few months addressed debt, but debt will have to be repaid and there will be many restructuring processes as a result. Funds will play a crucial role by injecting liquidity in the system, also through turnaround financing which guarantees the necessary funds for the recovery, strengthening operating business models and supporting the entrepreneurial fabric.



In its recent intervention, AIFI (i.e. the Italian association of private equity, venture capital and private debt) also underlined the importance of investing in turnaround funds in order to prevent valuable companies to disappear from the market, launching a detailed study on the Italian turnaround market in collaboration with Back to Profit (as mentioned in the Overview) to understand how many companies are at risk of default and how subjects involved in turnaround processes are operating.

The other initiatives introduced by the government to this end have also been significant, first of all the setting up of a fund dedicated to safeguarding businesses in case of a corporate crisis, which is managed by Invitalia (i.e. the Agency for Inward Investment and Economic Development by the Ministry of Economics) with a provision of approx. 300 million Euro and which intervenes acquiring minority shareholdings in the risk capital of distressed businesses. Despite its recent setting up, the fund has already closed 5 turnaround operations by entering into Italian business with a strong growth potential (Canepa, Corneliani, Sicamb, Officine Cerutti, Walcor), which started a restructuring plan to guarantee their going concern and safeguard employment.



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