

Debt: opportunity or risk?

Expert's opinion

Active loan management for a healthy economic system

Giovanni Marino

Director Grant Thornton FAS

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Overview

Financial restructuring of companies after Covid

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Focus on

From managing the business crisis to business management

Gabriele Felici

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To deal with this situation, the Government adopted various measures to contain the impact of the crisis and to reduce, at least in 2020 and 2021, the risk of insolvency. These measures concerned the containment of business costs through an extension of layoff bonuses and a support to liquidity through non-repayable transfers, postponement of tax social security contributions due, as well as a moratorium on bank loans.

Following these measures, bank credit to companies increased at a high pace in 2020, also thanks to Italy's Guarantee Fund for SMEs: the growth rate of loans granted to businesses reached 8.6 percent, against a substantial stability in the three-year period 2017-2019.

All the above measures will be inevitably – though gradually – reviewed and limited, given a hoped return to a normalized economic situation – also thanks to the ongoing vaccination plan.

Once the current critical situation ends, the economic consequences of the Covid-19 pandemic will determine a higher debt for businesses, implying an impact on their financial situation and their creditworthiness, as well as on their self-financing capacity and to make investment in the post-crisis phase.

In such a context, considered the termination of bank moratoriums, currently established at 30 June 2021 (even though there are some proposals to extend them at least up to 31 December), many companies will need to sharply and quickly adopt some measures to restructure their financial situation. Obviously, the nature and instruments to implement such restructuring actions will be different, depending on the health conditions of each company.

Those companies that were less impacted by the economic and financial crisis generated by the pandemic and whose wealth/financial situation is still acceptable will need to intervene on their financial structure through ad hoc actions coordinated by expert advisors who can support them in normalizing their situation in the medium term.



For some companies, an important instrument can also be the opportunity offered by the resources available within the Next Generation EU programme, formalized in the Italian Piano Nazionale di Ripresa e Resilienza (PNRR – recovery and resilience national plan), recently presented by the Italian Government to the EU. In fact, it is clear that besides an important general drive to economic growth, the PNRR will have a sharper and more direct impact for those companies operating in those industries concerned by the plan (such as, for example, investment in infrastructure).

Other companies, which suffered a more serious wealth and financial impact, but which are showing clear recovery signs – as regards both their activity and their growth perspective – will need to base their restructuring on insolvency or non-insolvency agreements with their creditors, allowing them to continue their activity.

Moreover, it must be specified that the timing of current insolvency procedures – also in the light of the instructions provided by the Italian code of business crisis that will come into force in September 2021 – is not compatible with the quick times required by the situation, or, if compatible (such as debt restructuring procedures), they are usually not very much usable by many struggling companies, given the fragmented structure of their creditor base. Over the next months, Italian businesses will have to face an important challenge, requiring – regardless of the particular instrument used – a quick execution and a clear action plan, also through the support by external advisors; otherwise, the going concern would be threatened, implying the risk of exit from the market.

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Which could be the effects on the banking system?

The industry is preparing for a new wave of non-performing loans (NPLs).

Moratoria and State aids have allowed the industry to cope, but now it risks having to face the fact that an increasing number of families and businesses are struggling to repay the loans granted to them.

In this context, a significant role will surely be played by the additional investments within the Next Generation EU plan; provided that resources will actually be destined to structural reforms (public administration, justice system, education system, inclusive growth for young people and women), then an economic recovery can be expected, able to increase loan collection rates with positive consequences for banks.



It is in any case crucial to introduce measures sustaining individual banks, since a high level of NPLs can represent an issue due to budgetary, profitability and capital constraints (if the 2009 crisis and the collapse of Lehman Brothers have taught us anything).

Advanced debt restructuring skills will be needed, with the adoption of a different approach depending on the type of impaired loan, whether it is an UTP - Unlikely to Pay (i.e. probable default, overdue debt, but still recoverable) or an NPL - Non-Performing Loan (i.e. bad loans, receivables from insolvent entities and only partially recoverable).





Which are the strategies for UTPs?

UTPs are more difficult for banks to evaluate compared to NPLs, since they are mainly receivables from big and medium enterprises and thus more complex than receivables originating from real estate assets. The management of UTPs implies high (industrial and financial) skills, but they have a high recoverability rate, if a prompt intervention is implemented, through a process including new financing and a restructuring plan (sometimes also with the involvement of external investors).

The key to the recovery will be exactly this: turning a threat, i.e. an UTP degrading further to become an NPL, into an opportunity, i.e. turning the UTP back into a recoverable receivable with positive effects on the banks' financial statements. In this case, a coordination between the various stakeholders will be crucial: the banks which will be investing issuing new finance and the distressed businesses which will need to submit suitable restructuring plans to obtain such finance.

A key role will be played by financial advisors, able to align the interest of the various stakeholders and to provide their distinctive expertise in extraordinary operations. On the one hand, financial advisors will have to assist businesses with the preparation of leaner business models with an improved cost structure, seizing the opportunity to introduce digital innovation, while on the other hand they will have to assist banks with industrial valuations and with devising interventions of third-party institutions or investors to turn businesses around. To this end, the response of public institutions is important.

To this end, a specific fund for businesses called *Fondo salvaguardia imprese* has been set up, i.e. a vehicle managed by Invitalia (the Italian agency for inward investment and economic development) with a budget of approx. Euro 300 million, aimed at acquiring minority shareholdings in the risk capital of distressed companies which propose a credible restructuring plan (also through the transfer of the undertaking) to guarantee the going concern and safeguard employment.

Which are the strategies for NPLs, instead?

These are bad loans, in a state of insolvency and only partially recoverable, which therefore require a different approach, aimed at their management in order to avoid that they affect the banks' financial statements with profitability risks and subsequent possible defaults (the 2009 crisis taught us that the economy as a whole depends on the banks' health).

In this case, the proposed solution to help the industry is the creation of an Asset Management Company (AMC) or a European Bad Bank, a public institution to which NPLS would be transferred for reasonable values (in order not to heavily affect the financial statements of transferring banks), and which would deal with getting rid of NPLs over time.

In order to prevent criticism to this mechanism, it could also be provided for that instead of transferring all bad debts without time limits, only NPLs resulting from contractual relationships entered into between the banks and their client starting from 31 January 2020 - i.e. the date of declaration of the state of emergency due to the Covid crisis - could be transferred to the AMC or Bad Bank.



The Bad Bank - which represents an effective tool, functional to the banking system, also limiting costs for the community - would essentially allow to prevent the effects of the economic downturn originated by the pandemic impacting the single banks and, in turn, citizens (which would suffer an inevitable credit crunch). In conclusion, we can assume that the resilience of the Italian system in the next few years

will mainly depend on how the challenge posed by the recovery plan (or, better, by its implementation) and future NPLs will be managed. It will be necessary to turn the threat of debit into an opportunity and in order to do so, a proactive management will be crucial, with the involvement of public institutions and financial advisors, which will have to be the link between distressed businesses and banks.

Bit of TopHic

BPM

Banco Bpm closed FY 2020 with a profit of ca. 21 million Euro, a result lower than the 797 million Euro of FY 2019. Among the items which weighted on the income statement are impairment losses on loans for 1.34 billion Euro (+71.7% compared to 2019), of which about 50 million Euro relevant to the Covid-19 emergency.

MPS

MPS closed FY 2020 with accounts in the red, with a loss equal to 1.7 billion Euro, impairment losses on loans equal to approx. 748 million Euro, of which 348 million Euro originating from the effects of Covid-19.



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The suitability of the organisational, administrative and accounting structures, also for this purpose, has become the new management paradigm, both as a legal obligation to which the liability of corporate bodies needs to be related in case of default and - more importantly - as an opportunity for the entrepreneur to guarantee the correct and efficient performance of operations, improving performances.

Of course, the legislator who worked on the new and laborious reform of Bankruptcy Law (Royal Decree n. 2626/1942) could not imagine that in the year of entry into force of the “Code of business crisis and insolvency” (Legislative Decree n. 14/2019) initially set for 15 August 2020 and now postponed to 1 September 2021, a pandemic would strike, disrupting the whole world in a few weeks.

In short, the rationale of the reform - already anticipating further postponements, amendments and updates - also with the implementation of the new (2019) EC directive on insolvency, is that of considering crisis as a physiological phase in the life of a business, to be detected before it degenerates into a pathological situation, considering that the sooner it is identified and dealt with, the higher is the possibility to overcome it and recover a going concern; the new regulation is thus based on prevention and alert tools, with a forward looking approach.

This with the express aim to preserve the value and the capacity to create value that businesses have, for the benefit of all the stakeholders involved and thus of the entire economic system.

It is worth reminding, nonetheless, that the postponement provided does not concern the provisions of Code of business crisis, already in force from 16 March 2019, i.e. since over two years, due to an initial exception to the general provision; among said provisions are the amendments to the Italian Civil Code (art. 375 and following articles of Legislative Decree n. 14/2019) such as, in particular, the business and corporate organisational structure (art. 2086, 2257, 2380-bis, 2409-novies and 2475 of the Italian Civil Code), Directors’ liability (art. 2476 and 2486 of the Italian Civil Code) and the appointment of supervisory bodies (art. 2477 of the Italian Civil Code).



In particular, the new para. 2 of art. 2086 of the Italian Civil Code on “Business management” provides for that an entrepreneur doing business as a company is liable to set up an organisational, administrative and accounting structure adequate to the nature and dimensions of the business, also with a view to a prompt identification of crisis and loss of the going concern, as well as to promptly adopt and implement one of the tools provided by the regulation to overcome the crisis and recover the going concern.

This provision has its effects on the topic of Directors’ and supervisory bodies’ liability, and there are already measures of the main Italian Courts sanctioning non-compliant businesses.

Therefore, if on the one hand the effects of the pandemic have led to the deferment of the introduction of alert measures and the remaining in force of the existing insolvency proceedings, on the other hand, they have set the conditions for a quicker enactment of the portion of the reform already in force and for the remaining portion.

This is particularly evident considering that in the current emergency phase, which has heavily impacted the financial and economic aspects within the management of businesses, companies needed to develop a contingency plan, implementing a planning tool and adopting strategies whose approach, techniques, and methodologies are adequate for a deep change of perspective imposed by the reform, to safeguard and reorganize companies in crisis, in order to take prompt actions and avert insolvency.

In the current context, it is clear that the requirement to promptly detect and notify the crisis is suspended, since every company is – or should consider itself – potentially in crisis and, therefore, should adopt and implement the instruments provided to overcome the crisis and safeguard the going concern, meant as capacity to create value; in a reorganization perspective and based on the relevant plan (if necessary, also supported by a proper procedure), the business model must be reviewed in the light of the changed context and different perspectives.

By revaluating the business model and the organizational structure, it is important to: elaborate strategies for the development of the business activity and the recovery of profitability, also by increasing the efficiency of business structures; re-formulate the financial structure, also through M&A operations; evaluate liquidating instruments, lacking any feasible alternatives. Therefore, in this phase, management strategies and instruments are necessarily those being typical of the reorganization and restructuring of companies in crisis.

In fact, the serious crisis caused by Covid has not yet led to insolvency cases, thanks to the combined effect of different government provisions supporting companies and the slowed down activity of courts.



According to a recent publication of the Bank of Italy, approximately 6,500 more bankruptcy procedures could be registered by 2022 compared to those registered in 2019 (and a large part of them are already expected in 2021).

According to the latest Cerved outlook, the number of companies at risk of becoming insolvent could reach 115 thousand at the end of 2021 (with projected job losses for 300 thousand people), with an estimated increase of the risk rate to 6% – compared to the estimated 4.5% in the pre-Covid era –, registering an increase by about 33%, which represents the prospective difficulties, which the entire system could incur.

However, further regulations, as well as tax and social security concessions have been introduced concerning business crisis settlement procedures and, particularly, with regard to arrangement with creditors procedure and to restructuring agreements (art. 3, para. 1-bis of Law Decree no. 125/2020 turned with amendments into Law no. 159/2020).

Amendments to articles 180 and 182-bis of the Italian bankruptcy law have been made, allowing the competent Court to approve the arrangement with creditors and debt restructuring procedures – by evaluating the higher advantage of the proposed procedure compared to bankruptcy – even lacking a vote or a consent by the Tax Authorities or by social security authorities, if their approval is necessary for the finalization of the crisis settlement procedure.

In conclusion, the current situation favours the adoption of a new qualitative approach in the management of businesses, which is the basis of the business crisis reform (adequacy of business structures), i.e. the shift from a traditional “how we performed / how we will perform” to a more developed “how can we perform better” way of thinking, and this will certainly award those companies that will be able to make this change, proving to be reactive and resilient, thus obtaining a competitive advantage and a preventively safeguard their corporate bodies against liabilities.

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