

XAIA INVESTMENT
Quarterly Letter
2024|02

French Kiss

In our last quarterly letter, we explained that restructuring activity is picking up in Europe and that aggressive deals are causing problems for credit investors. To better assess the risks to bondholders, it is important to understand the different European restructuring processes. In this letter, we use the example of the ongoing restructuring of the French IT company Atos to explain the French restructuring process and what we believe are the key implications for credit investors in Europe.

In recent years, we have seen a harmonization of restructuring processes across Europe. These streamlined processes provide companies with a fast and efficient tool to restructure their capital structure in close cooperation with their stakeholders. While negotiating the terms of the deal with stakeholders, the company can continue to operate its business.

The new laws have introduced schemes with lower voting thresholds than those set out in the bond documentation. In addition, under certain circumstances, a deal can be forced on dissenting stakeholder groups.

As a result, we see low recovery rates, particularly for unsecured creditors. In many restructurings, debt is partially or fully converted into equity. This could force investors who cannot legally hold equity or equity-like instruments to sell their bonds at very low prices. Unable to hold the restructured instruments, or unable to participate in new money facilities to increase their own claims, these investors may miss the recovery path of their debt altogether.

A deep understanding of the restructuring processes in different European countries and a flexible investment vehicle allow investors to take advantage of these situations rather than being forced to sell at the worst possible time.

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ATOS – Restructuring à la française

The restructuring of French IT consulting and services company Atos illustrates the pitfalls of credit investing in the current environment. Once an IG credit (the ECB holds 20% of its bonds) with a market capitalization of over EUR 10 billion, Atos is in the process of restructuring. After two messy years with several turnaround attempts, the company is facing the last resort of creditors taking the keys.

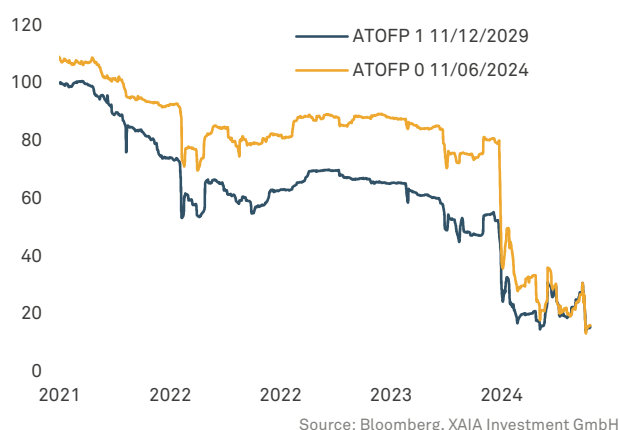
Credit investing typically evolves around changes in the (perceived) creditworthiness of debtors, so the best credit analyst should outperform over time. However, restructurings are multidisciplinary, involving not only credit analysis but also advanced legal analysis and even game theory, which makes the process intellectually rewarding, but also very relentless.

The Atos case follows the classic restructuring playbook. If a restructuring were a play, this particular one would be classified as a tragedy.

- › First, the company declines operationally. That's when the company tries to turn itself around operationally by selling assets to reduce debt and extend the runway. Usually that works and the company continues to operate.
- › Second, if the company can't turn around operationally and struggles to sell assets at the right valuation, we enter a limbo phase. Usually, front-end bonds outperform on optimism for early takeouts.
- › Third, the company announces that it has hired advisors, which essentially means that external advisors are putting together a plan for how the company will restructure. Bonds fall and the curve flattens (bond prices trade at similar levels across maturities).
- › Fourth, a restructuring plan is put together and executed. That's the part we're focusing on today.
- › Epilogue: The restructuring plan is implemented. This is usually the end. Sometimes there are (multiple) sequels, similar to successful movies ("The Empire Strikes Back").

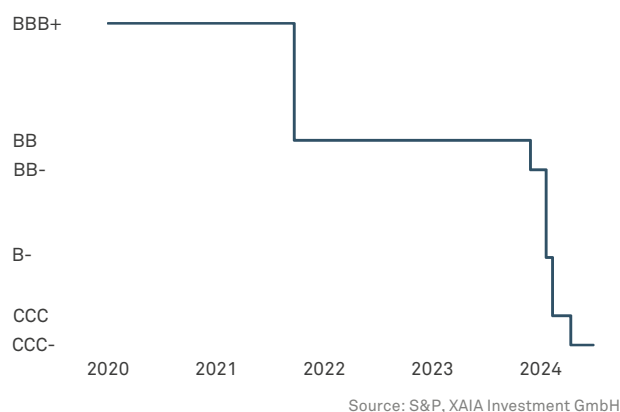
The working hypothesis on Atos until late last year was that the company would be able to sell assets and/or raise equity to repay the bonds. Short-dated 2024 convertible bonds traded at a higher cash price than longer-dated bonds due to the higher likelihood of repayment. However, as a restructuring became more likely earlier this year, the prices of the short- and longer-dated bonds began to converge (see Chart 1). The pitfall of owning short-dated bonds is that despite their high yield, they suffer from negative convexity. In a restructuring, shorter-dated bonds decline more than longer-dated bonds, resulting in greater losses for shorter-dated securities.

CHART 1: UNSECURED BONDS GETTING HAMMERED
Atos bond prices



In the case of Atos, we also see how quickly the credit rating can fall from BB to near default (see Chart 2). To understand the full extent of the risks involved in stressed investing, we outline the restructuring plan in France to understand the impact on Atos.

CHART 2: SLOWLY, THEN SUDDENLY...
ATOS RATING DECAY
S&P Credit Rating for ATOS SE



The French restructuring regime

Prior to 2020, creditors feared the French restructuring regime because it offered extensive protection to the company and shareholders. This changed with the harmonization of insolvency regimes across Europe and the introduction of a "new restructuring regime in France"¹, that shifted power to creditors. Recent restructurings show that lenders are finally able to take control from existing shareholders and unlock value.

Atos is the third high-profile restructuring following the overhaul of the restructuring regime in France. With Orpea and Casino both taking a similar approach to restructuring their debt in 2023, we expect Atos to follow the French pre-pack restructuring "blueprint". A pre-pack is a two-step restructuring process that is negotiated confidentially out of court prior to the commencement of in-court insolvency proceedings.

FRENCH RESTRUCTURING MECHANICS

Under French law, there are two main types of proceedings: amicable out-of-court proceedings and formal court-administered proceedings.

Amicable out-of-court proceedings

This category includes the "*Mandat ad hoc*" and "*Conciliation*" proceedings. If unanimous consent among affected stakeholders can be reached, a restructuring can take place without formal insolvency proceedings.

"Mandat ad hoc": A confidential out-of-court proceeding, in which a court appoints a restructuring practitioner to assist a debtor in confidential negotiations with some or all of its stakeholders under the supervision of the court's president.

"Conciliation": Also a confidential out-of-court proceeding, available to debtors that are solvent or have been insolvent for no more than 45 days. A court-appointed restructuring practitioner assists the debtor in confidential negotiations with its stakeholders under the supervision of the president of the court. It can last up to five months.

Formal court administered insolvency proceedings

This category includes "*Accelerated Safeguard*", "*Reorganization*", and "*Liquidation*" proceedings.

"Accelerated Safeguard": A formal court-administered proceeding which is available to debtors that are not cash-flow insolvent. This is the usual in-court procedure that companies choose. It can last up to four months.

"Reorganization" and "Liquidation": These must be initiated if the debtor is cash-flow insolvent according to the French insolvency test, which is defined as the debtor's inability to pay its debts as they come due with its immediately available assets.

¹ <https://www.banque-france.fr/en/publications-and-statistics/publications/speeding-process-harmonising-european-insolvency-law-strengthen-financial-integration>

FRENCH PRE-PACK IN A NUTSHELL

The process for French restructurings usually follows the same path. The company first enters into a pre-insolvency "*Conciliation*" to start negotiations with stakeholders. Advisors draw up various restructuring proposals and circulate them among themselves. During the four to five months of "*Conciliation*", the relevant stakeholders work with the company to develop a restructuring plan. The bondholders then sign a lock-up agreement that binds them to the terms of the restructuring. In the next step, the company enters an accelerated safeguard proceeding (insolvency proceeding) to implement the previously agreed transaction. Since virtually all restructurings have been implemented through Accelerated Safeguard, key concepts need to be introduced.

Class composition and voting on a plan

Voting classes in *Accelerated Safeguard* are formed on the basis of a "community of interest", which has historically resulted in a large number of creditor classes. Each class is asked to vote on the proposal, with a two-thirds (66.7%) majority in each class required for the plan to be approved. This is lower than, for example, the 75% approval threshold required for an English restructuring plan or the German StaRUG. Since there are usually more than two classes with divergent interests and each class must approve the plan, a consensual agreement is sometimes unlikely.

The tyranny of the majority – cross class cram-down

If a restructuring is not approved by all classes of creditors, the restructuring can still be forced on dissenting creditors (cram-down) and bind all creditors. The cross-class cram-down must comply with the absolute priority rule (APR). This means that senior classes must be repaid in full before junior classes. A cross-class cram-down may be applied if a senior class has voted for the plan and the adversely affected creditors are not worse off than in liquidation (best interest test).

New money privilege

An important innovation is the introduction of the "post-money" privilege in French law in ordinance 2021-1193. If existing investors provide new financing after the restructuring ("super-priority ranking"), they receive preferential treatment on their existing debt compared to other creditors. This puts flexible accounts in a very advantageous position, as they can usually provide all types of debt and equity financing.

The French pre-pack restructuring procedure (*Conciliation* + *Accelerated Safeguard*) sports various advantages:

- Restores balance between debtors and creditors
- Quick and straightforward process
- Significantly reduces the value-destroying effect and loss of confidence of the debtor's customers and suppliers
- In the absence of unanimous consent, a plan may be imposed on junior creditors against their will

ATOS – RESTRUCTURING IN THE MAKING

Atos is in the process of reaching an agreement with its creditors. The creditors will convert part of their debt into equity and thereby take control. In the process, existing shareholders' equity will be diluted and therefore worth close to zero. In addition, the creditors benefit from the "post-money" privilege, where they can provide additional financing with a higher priority and attractive pricing. In addition, post-money creditors will see some of their existing debt elevated. Non-participating creditors will see a higher proportion of their bond holdings converted into equity at a worse conversion rate and the remaining debt converted into more junior debt.

In the case of Atos, bondholders and bank lenders worked very closely together, as both bonds and bank debt are *pari passu*. They are acting as one group and therefore a restructuring deal is only possible with their consent. There is no class with higher seniority that could cram down this class. This is very positive for the potential recovery. However, investors who can't participate in the new money, due to tight investment guidelines (e.g. no equity allowed) are worse off.

Atos compared to Casino and Orpea

Before their restructurings, Casino and Orpea both had a secured layer of debt in addition to unsecured debt. This allowed the company to reach an agreement with the secured creditors to impose the restructuring terms on the dissenting (unsecured) creditors using the cross-class cram-down. Similar to Atos, in the Orpea case, investors providing new financing fared better. Given that Casino needed a large equity injection, unsecured creditors recovered 0c and secured investors recovered about 50c on the dollar, and an external investor (Kretinsky) had to provide new money in the form of equity financing.

Comparison with US restructuring practices

The U.S. is the "frontrunner" in legal innovation in the area of restructurings. One example is the so-called "uptier transaction", where a majority group of lenders agrees to a restructuring in which a new "super-priority" layer of debt is created. The majority group of lenders swap their debt holdings into the "super-priority" debt, while the remaining creditors see their debt subordinated. In the Atos case, essentially the same thing happens, as the new money lenders get super-priority debt, while the remaining creditors see their debt getting primed.

Main takeaways for investors

- › When a restructuring is imminent, the level of uncertainty increases significantly. In many cases, we have seen bond prices fall abruptly, with no major bounce.
- › The changes in the legal framework and the more aggressive approaches by various stakeholders have led to a different investment environment in credit. Some of the bond documentation has been rendered virtually worthless due to court-administered restructurings often having lower voting thresholds than stated in the bond indenture. If there is no consensus, dissenting creditors can ultimately be crammed down. As a result, unsecured recoveries in secured/unsecured capital structures are often very low.
- › In order to achieve higher recoveries, investors should seek to (i) own higher seniority debt, (ii) be able to participate in new money facilities and/or (iii) build large positions to influence conversations with the debtor. In structures with a main layer of pari passu debt, as in the case of Atos, bondholders enjoy significantly more bargaining power than outside parties seeking to participate in equity injections.
- › A key takeaway is that investors with a flexible mandate are able to extract more value out of distressed situations. It is beneficial to be able to build substantial positions to ensure a seat at the table throughout the process. Investors, who provide new money and who can own complex debt or equity instruments in their funds significantly increase their prospects for recovery.
- › While these restructuring situations present attractive investment opportunities for large, flexible distressed accounts, we often see trading opportunities in the space of credit default swaps (CDS). In the context of CDS, it is crucial to understand the timing of potential trigger events and the expected recovery values. While each restructuring may take a different path, the French scheme provides multiple trigger opportunities throughout the restructuring timeline.

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