A Restructuring Concept for Central and Eastern Europe

The Region
Although Central and Eastern Europe (CEE) is still viewed as a single region, substantial differences exist among its sub-regions, including European Union (EU) members, Central European non-EU members and the CIS countries.

Ten Central European countries have achieved EU membership status, with four of them (Poland, Czech Republic, Slovakia, and Slovenia) characterized as having established broad based economies and more highly evolved legal systems. While the financial crisis has affected these countries as well, its impact is expected to be less. The Baltic States (Lithuania, Latvia, and Estonia) and Hungary, however, are countries with smaller production base, significant over-leverage and lack of reform implementation (e.g. tax, pension, legal etc.) Finally, the most recent EU members (Romania and Bulgaria) are considerably less developed economically, politically and legally. Second sub-region consists of the former Yugoslavia (excluding Slovenia) and Albania. While there are differences within this group as well, these are all still structurally weak economies, at a fairly low stage of development.

The sub-region with the largest geography and population, the CIS countries, include commodity-based economies like Russia and Kazakhstan, undeveloped and/or dysfunctional countries like Ukraine or Moldova, and politically unacceptable countries like Belarus or Turkmenistan.
The one common theme throughout the CEE region is that restructuring (operational and financial) are typically avoided. Given the relatively recent emergence of most of the countries in the region from socialism and Soviet control, the region has not matured to the point where governmental actions have been effective in dealing with enterprise level distress. Political purposes, cronyism and outright corruption have typically prevented meaningful restructuring, and, will in the current crisis.

Specifics of the Crisis in the Region
The global financial and economic crisis has affected the region severely, as the countries saw huge declines in external demand. For many Central European countries, export represents over 70% of GDP, and in CIS countries the decline in commodity prices has had a major impact at the enterprise level. Moreover, credit in the region, especially Central and Southeast Europe, has been dominated by Western European banks (Austrian, German, Italian, and Scandinavian) and a large percentage of both corporate and consumer debt is denominated in Euros or other foreign currencies. The collapse of local currencies combined with a decline in asset values, especially regional stock markets and real estate values, has resulted in lower earnings to service foreign debt further exacerbating the crisis. As foreign banks moved to protect domestic balance sheets and repatriate capital, a liquidity freeze has resulted in the region. Virtually all foreign direct investment (FDI) has come to a halt. This has left enterprises throughout the CEE region stranded with a mountain of debt, no liquidity and unfunded operating losses.

Governmental Reaction to Date
Most regional governments have had few monetary or fiscal tools to try to reinvigorate their economies, and there have been more urgent issues that they have had to confront. Several local currencies were on the verge of a meltdown, including those in Russia, Hungary, and Baltic states. Russian central bank spent a third of its foreign currency reserves stabilizing the Ruble. The Hungarian Central Bank was forced initially to
increase interest rates to prevent massive outflow. Second, as lending ceased and rumors spread that Western banks could be pulling out of the region, preventing a run on the banks also became a priority. All regional governments at least doubled the amounts guaranteed by the state. Several countries, including the Baltic States, Hungary, Ukraine, Serbia, and Romania have received funds from IMF, EU and/or the European Investment Bank. Funding to-date has been primarily focused on easing the liquidity crisis.

**What Is Needed**

As a result, the corporate sector is clearly struggling and enterprise level governmental assistance has taken a back seat to the resolution of the monetary and banking crisis. There is increasing evidence that even many good companies in the region are experiencing difficulties in extending financing, rolling over lines of credit and are becoming illiquid. The most pressing need is for additional capital and the restructuring expertise to deploy it productively. Excluding fairly short term problems in the late 1990s, the region has not experienced an economic crisis since the collapse of socialism, and the region has been growing annually at 5% to 10% for the past decade. As a consequence, the restructuring expertise is still quite underdeveloped. There are few local turnaround firms and bank workout departments are substantially understaffed, inexperienced or nonexistent.

While most countries in the region have passed fairly good bankruptcy legislation, often modeled on the US Bankruptcy Code, its application has been very limited. Substantial effort is needed to develop the infrastructure to implement existing bankruptcy, collateral, creditors’ rights, and other related laws that currently exist but are rarely used.

**Proposal for the CEE Region**

The issues above are interlinked and thus should be dealt with in a comprehensive manner. We propose that a pool of restructuring capital be created, with the funds initially coming from multinationals such as EBRD, IFC, IMF, the World Bank and the European Investment Bank. To the degree possible, the funds could be matched by local
governments. As the program becomes established commercial investors could participate through the sale of credit enhanced offerings. This capital would be deployed through a newly created Regional Restructuring Finance Agency. The Agency would have the dual role of providing credit and deploying restructuring expertise. Local capacity building and ROI strategy and criteria development are important objectives as well, to create a successful and lasting impact. Given sub-regional differences (discussed above), the strategies should be adapted to at least three sub-regions: the EU members, non-EU CE countries, and the CIS.

The capital would be invested in three types of situations: as working capital for otherwise good companies as bridge until the liquidity environment is normalized. Second, it would be invested as restructuring capital contingent too fund approved turnaround plans. Finally, the capital would be positioned to rationalize “bubble” debt and equity investments primarily made between 2005 and 2007. New capital would be invested as debt, possibly ahead of existing senior positions. Investment would be based on meaningful operational and financial restructuring strategies and returns would be enhanced with PIK interest or warrants to compensate for risk. The program would be voluntary and focused on small and medium sized enterprises (SMEs). Large corporations would be eligible as well, provided they are independent from political interests and can be competitive if properly restructured. Key criteria would be that the companies have a viable core business, enlightened management and have a larger objective of building internal demand in local markets.

An alternative “entry” mode could be through non-performing loans (NPL). By purchasing NPLs, the Restructuring Agency would provide liquidity to local and foreign banks and bring restructuring discipline and expertise to deal more effectively with debtor companies. With the Agency in control of the debt, it can restructure for its own account.
**Process**
Debtor companies would make an application to the Restructuring Agency to participate in the program. A selection committee would evaluate the application and make an initial decision on supporting the applicant. It would also provide a preliminary concept of the restructuring plan for the company. Based on the above, a restructuring team would prepare a detailed operational and financial plan, together with company management. This plan would be approved by the selection committee, and presented to the company’s stakeholders for ratification.

Management, with assistance from the Agency’s restructuring team would be deployed to implement operational and financial restructuring. If equity and debt holders are unable to reach an agreement, a bankruptcy process would be controlled by the Agency’s senior creditor position. Having the ability to force an in court restructuring if a consensual deal cannot be reached, assures that companies in which the Agency invests, will not languish endlessly without resolution.

The Agency’s ultimate objective would be to exit investments within 12-24 months depending on the company’s status as well as the state of capital markets. Thereby, the CEE Regional Restructuring Agency would provide capital and restructuring expertise in these extraordinary times to stabilize enterprises and provide appropriate returns to its investors.