The Institute for Turnaround

UK Corporate Funding: what to expect

Adapt. Transform. Succeed.

Contents

Foreword

Milly Camley
CEO
The Institute for Turnaround

Rob Asplin
Partner, PwC;
IFT board member

In the 15 years since the global financial crisis, the UK's business funding ecosystem has become more sophisticated, diverse and collaborative. The options facing companies and directors are wide-ranging, from traditional banks, through to specialist funders such as asset-based lenders (ABLs) and Peer to Peer (P2Ps), private credit funds and on to special situations and private equity investors.

This backdrop of funding sources greatly increases the options available to companies, both generally and in turnaround situations, but it also increases the decision-making complexity of selecting solutions. Turnaround directors must be aware of a significantly larger range of options, all with their own nuances, incentives and behaviours.

That is why we offer this summary as an insight into the state of the UK's business funding landscape as we approach the middle of the 2020s.

We would like to thank the many people who have contributed their expertise to this publication. This includes the team at Macfarlanes, who have provided expert and nuanced insights and with whom we have published preparatory articles.

All providers are undergoing a constant process of development of their own models, and their understanding, as they compete and co-operate with one another, and as they build relationships and seek long-term value, amid a volatile macro-economic backdrop.

Despite this heightened level of competition, the tone and ethos that has grown up within the UK turnaround community and the various funders in the landscape since the global financial crisis is broadly constructive, professional and focused on delivering value and, when required, working with peers across the market to achieve company success, for the benefit of all stakeholders.

Executive Summary

MARKET OUTLOOK

The business funding landscape in the UK is robust and adaptive, and has endured significant challenges in the past few years. The re-emergence of inflation and a rising rate environment in the recent period has put more pressure on indebted businesses, amid wider macro-economic instability.

In addition to these more cyclical challenges, the UK market has undergone more of a diffuse change, evolving from a system dominated by traditional banks, towards one with a much more diverse array of funding options. The result is a more complex but also more flexible funding environment for companies that require support to see them through periods of turbulence. The volatile macro-economic environment is providing a revealing test-case for how these players behave, co-operate and respond to more stressed periods of trading. Stakeholders including the Bank of England and the European Central Bank have also highlighted potential risks arising from aspects of the "shadow banking" sector where behaviour and liquidity is less tightly regulated than the traditional banking sector, and approaches of the sector are continually developing in response to both economic and political considerations.

Enter the credit fund

Private credit funds have emerged as a vital alternative to bank debt, contributing over £425 billion in lending since 2008. Despite challenges, the future outlook shows potential for continued growth, driven by falling inflation and interest rates, and significant amounts of undeployed private credit fund capital, and private credit funds are anticipated to continue to increase their activity over the coming period, driven by a cautious but optimistic outlook.

Among these funds, new credit strategies are emerging, such as strategic opportunities/credit solutions, Net Asset Value (NAV)-based lending, and specific asset-class strategies – each offering a different permeation of liquidity for businesses and investors that face cashflow constraints or that need liquidity support.

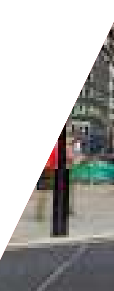
However, private credit funds must navigate financial stresses carefully. Strategies may include additional equity capital from sponsors, new loans, or amending cash pay interest to payment-in-kind (PIK).

The rise of 'operational real estate'

The real estate sector has been significantly impacted by macroeconomic events, leading to increased reliance on private credit fund lenders. The rise of operational real estate (OpRE), which includes asset classes like hotels and purpose-built student housing, is gaining favour due to its resilience in a high-interest rate environment. Private credit funds are expected to play a growing role in this space, offering flexible and creative financing solutions.

Inter-creditors: playing nicely

Well-drafted intercreditor agreements are crucial for providing comfort to debt syndicates and multi-creditor situations.



FUNDING TYPES

Knowing all the options is becoming a full-time job

Turnaround directors must understand the various types of funding available and the distinct structures, incentives, and behaviours of different players. At the one end of the funding spectrum, equity providers will want to maximise their upside and will be open to opportunity, while at the other, debt funders will protect their positions and plan their exits strategically.

But within this, there are many different preferences and approaches, which the effective board director will be sensitive towards. The ability to understand and manage different objectives for a common goal is at the core of the turnaround director skillset, whilst acknowledging that the pace of change has been particularly acute in recent years.

While all parties aim to support management to achieve business goals and long-term success, differing risk appetites and time horizons mean that identifying the right liquidity solutions and funding providers goes beyond mere number crunching.

This report provides an at-a-glance overview of the main funding options that should be part of the repertoire of every turnaround director.

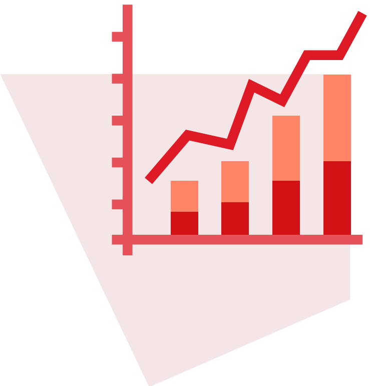
#General corporate funding

Traditional banking lenders will typically be the source of mainstream financing options, particularly for smaller businesses, such as overdrafts, revolving credit, and term loans. SMEs might use term loans for property and assets, and overdrafts or trade finance for working capital. Where a business goes through a period of turnaround, different teams will usually manage cashflow-based versus asset-based lending during recovery stages.

Like all funders in this report, lenders will seek to collaborate with management on a turnaround plan. Costs are usually a margin over the base rate, and, perhaps surprisingly, the rate may not differ much in situations of distress. They will not typically want a board representative and neither will they want to take equity positions, although they might consider distressed debt-for-equity swaps. They will typically seek to endorse the appointment of turnaround directors to support management early in recovery.

Banks will often use standard documentation, with covenants based on cashflow forecasts, leverage, and interest coverage.

The emergence of multi-creditor situations is proving a not-always-welcome complexity for more conservative high-street lenders.



Mainstream private equity

Private equity (PE) encompasses several different sub-categories, from venture capital through to management buyouts. In buyouts, PE firms typically take majority equity positions and will tend to seek an exit through full sale of the business within a 5-year window (and sometimes longer), although they will always be open to earlier opportunistic offers.

Private equity firms will usually appoint board directors, and their engagement can involve significant demands for data and insights on a frequent basis. However, they do not wish to be executive managers of businesses, preferring non-executive board positions. Mainstream PE will tend to focus on identifying operational support, with the intention of being hands off, and if they can be confident everything is running to plan, their preference will typically be for the executive team to continue independently.

Reputation is of critical importance to PE managers (who regularly raise fresh funds), so signs of stress or distress will be addressed very quickly and managed very discreetly.

Special situations private equity

Private equity firms that focus on turnaround situations do not structurally differ significantly from mainstream firms. However, they can be more hands-on and interventionist within the businesses. Even so, they will not wish to be long-term ‘managers’, and their first port-of-call under distress is often to assess or supplement key executives with others who will carry executive responsibility.

PE will often source turnaround directors from organisations like The IFT as well as their own networks, to address issues quickly, and to support the professionalisation of a business, particularly in family-owned situations, MBOs and carve-outs. Increasing numbers of professional firms now also hold a list or directory of appropriately skilled individuals, who bring both emotional detachment and the ability to drive change at pace, all the while managing external stakeholders.

#Leveraged lending

This form of funding is applicable to companies with dependable cashflow and a strong underlying trading model, as well as those that have an acquisition-oriented growth strategy. It is often used to finance management and private equity buyouts and buy-and-build strategies.

Lenders will focus on recurring revenues, cashflow, management quality, and growth plans. They may use standard Loan Management Association ("LMA") documentation, non-amortising term-loans, with flexible interest structures. Their exit horizon will often be tied to the business' (or owners') strategic goals. They may seek board observer rights, at most, and their downside will be protected with financial covenants.

They will often seek to support the appointment of turnaround directors in collaboration with business owners, using internal networks or organisations such as The IFT.

#Asset-based lending

ABL is suitable for SMEs with a solid asset base needing short-term cashflow or to manage the working capital implications of trading volatility. It is provided by traditional banks but, more commonly, by specialist lenders.

It differs notably from mainstream cashflow lending in its conspicuous lack of covenants (often there is just one), its focus on partnership and relationship banking, and the fact that the credit is revolving rather than fixed term. The available credit will be determined by the lender's regular assessment of the value of the company's collateral base.

ABL providers may seek approval rights for new turnaround director appointments and often seek board observer rights.

Conclusion

The UK's funding ecosystem has evolved into a diverse and sophisticated landscape, offering numerous options for companies in distress. While this provides greater flexibility, it also necessitates a deep understanding of the various funding sources and their specific requirements. Turnaround directors and stakeholders must navigate this complexity strategically to ensure successful outcomes.

Recent trends in funding

The funding ecosystem has been fundamentally transformed in recent years with the emergence of private capital funds and specialist direct lenders competing and co-operating with the incumbent banks. Such new-entrants have become major players, not only in the larger-end of the corporate market, but also in the mid- and lower mid-market too.

Today, directors looking to raise anything from sub-£1m, upwards, can look at mainstream banks but also invoice discounting, asset-based lenders, P2P lenders, private credit funds, mainstream private equity funding and special situations private equity firms and even funding from high-net-worth individuals (as a precursor to wholesale finance from banks). This represents a much broader funding universe than historically, and it is both varied and deep. It should be noted that, counter-intuitively perhaps, sourcing smaller amounts of business funding can sometimes present a more challenging proposition, particularly in the £1-10 million segment, given the time and effort involved is not materially less than that for diligence on significantly larger deals.

The drivers behind this explosion of variety are as diverse as the providers themselves. Regulation in the wake of the global financial crisis has played a role, as well as a general competitive trend towards specialisation. More recent geo-political developments and macro-economic changes have also revealed new opportunities for specialisation in lending markets, such as the growth in trade-finance driven by deglobalisation, supply chain inefficiencies and inventory overload.

But arguably the single biggest innovation to hit the market in recent years is the emergence of closed-ended private credit funds, which have appeared on the scene as alternatives to the highly-regulated clearing banks. Many of these have been setup by brand-name private equity asset-management firms, and they typically begin with a direct lending strategy, before expanding then into credit opportunity strategies, mezzanine strategies and special situations. This has impacted the level of recourse in the market when it comes to distressed or turnaround situations, with a shortage of suitably qualified/experienced resource, especially at the lower SME business range. This means that the ability and knowledge to spot a problem at an early stage is less prevalent than in previous periods.

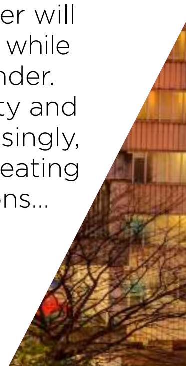
Turnaround processes

With all these options available, it is difficult for any individual to have all the answers 'at the drop of a hat'. That's why, for a turnaround director, the first consideration must always be... time.

Understanding the liquidity runway for performing any transaction is critical, and ideally, an adviser will have 6 to 12 months to plan and run an orderly and structured process. However, a distressed company facing a cash crunch with weeks or days will still have options.

Key to success is understanding the proposition from the perspective of the funder, whether a debt or equity provider. For equity, a principal consideration will be the likelihood it will hit their investment hurdle rate. From a debt perspective, consider how the lender would need to structure the funding to meet their own internal credit policy and their return hurdle. For both, the optics relating to their reputational risk and how a situation is managed is very important given funding cycles.

Every turnaround situation is unique, and there is no one 'playbook'. Sometimes an adviser will approach many parties and run an auction while in other cases they will select just one funder. Sometimes it will be a simultaneous equity and debt raise, others will be split. And increasingly, companies raise from multiple lenders, creating a whole new set of potential considerations...



Intercreditor agreements

Intercreditor agreement are contracts between institutions governing how they will work together. Such co-operation is a more recent development for the smaller SME market, and advisers have begun to adopt various strategies to account for this. For instance, they may try to pair institutions that have worked together before, who have a relationship and pre-existing, shared documentation.

Even so, good inter-creditor practice is rapidly emerging. For instance, negotiating terms upfront, particularly around 'standstill' provisions and first-loss structures, is key to making senior lenders comfortable. Meanwhile, in distress, the unitranche provider (subordinate to the super senior) should have the ability to buy-out the super senior piece.

In some cases, lenders work as a syndicate, each taking a piece of the same debt instrument and sharing the same level of risk in the capital structure against the same assets.

But the opposite instance is also possible: these are 'bifurcated transactions', whereby lenders team-up to fund different assets with different risk profiles for the same corporate debtor. This may increase the complexity of the transaction, given that each lender will have different attitudes to risk and pricing.

How lenders assess risk

Clearly, lenders of any type will typically assess the financial performance of the business and asset base. In normal trading, the emphasis will be more on the former, and in turnaround, more on the assets. However, all lenders will also take a keen interest in the management plan. For traditional lenders, this will also be with a view to building a long-term relationship with the business; for some closed-ended credit funds, the relationship-horizon will be more limited, given their need for a final exit.

Both equity and debt funders will proactively plan their exit. For creditors, this will be contractual, and around protecting their position in enforcement situations, and how they can bring the asset to market to achieve a solvent solution, rather than resorting to insolvency. For equity providers, the exit plan will be more strategic and tactical in nature.

What's the deal?

The terms and documentation of any financing will range from very standard and rigid documentation from mainstream high-street banks, towards more flexibility among most ABLs, and even greater flexibility among private credit funds, which tend to favour documentation that is on the whole shorter and more customised.

Covenants in use by various players are on a similar sliding scale, with more rigid covenants from banks, and much greater discretion and variation in terms among non-bank lenders such as credit funds. This can make fund lenders more nimble to deal with, and arguably offers them greater latitude to seek constructive solutions when faced with underperformance – although bank covenants are not necessarily enforced as-written either.

Appointing Turnaround Directors

Institutions will often look to select a director from among IFT members and their own network of professionals or an advisory firm. Some private equity firms will have operating partners with an in-house turnaround capability.

IFT membership includes individuals in private equity firms and special situations PE firms, which are important stakeholders in the IFT community. More broadly, IFT members assist PE firms on stressed and growth assignments, and to deliver specific strategies, as a hands-on director or a non-executive.

The role of a Turnaround Director

- Define the company's liquidity runway – how much time does it have?
- Understand the nuances of private credit, bank lending, and the role played by private equity sponsors.
- Talk to the current stakeholders – lenders, shareholders, and see what can be done internally. This might be the simplest option.
- It is difficult to have comprehensive insights into all the tools available in today's market. Assess your own skill-set and knowledge-base, and consider what support you may need as a complement.
- Ultimately, most successful turnaround solutions are grounded in businesses that have a good reason to exist and rational operating model. Therefore, whether the issue leading to distress is a bad balance sheet, liquidity issue or working capital squeeze, a turnaround director can make an asset most attractive to turnaround investors if they can articulate clearly what the issue is, how it can be overcome, and also that fundamentally it remains a "good business".

Know your funding options

To be effective, turnaround directors and advisers must have an understanding, not only of the types of funding available, but the different underlying structures, incentives and therefore behaviours of the various types of players.

Some lenders will focus more on financial performance and cash, while others will lean towards asset value. Typically, the more trading stress that a business experiences, the more a lending solution may need to lean on its assets.

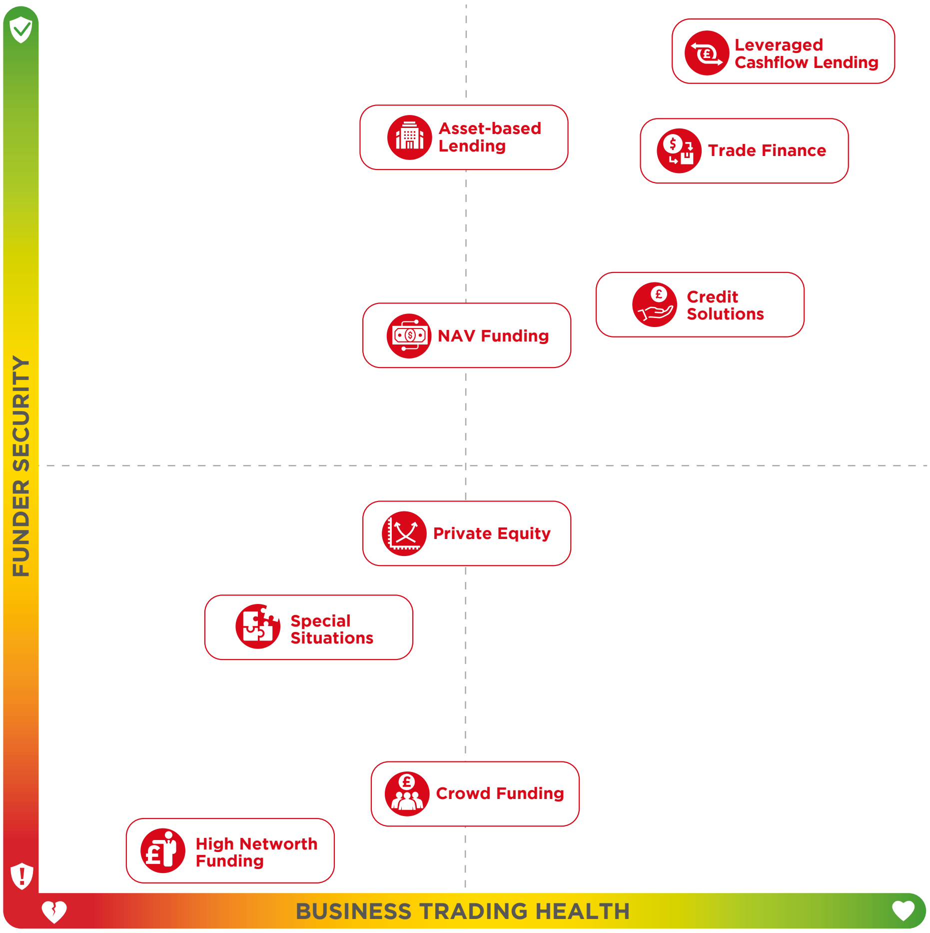
Equity funders prioritise potential returns on entry to a new investment and minimise losses in a distressed investment, while debt funders focus on protecting their positions and planning exits strategically.

Financing terms will vary widely, with banks typically offering rigid documentation and covenants, while private debt funds provide more flexible, customised solutions.

While most funders will be broadly aligned to the same outcomes - that of supporting the management team to deliver the business goals and long-term company success - risk appetites and time horizons vary widely. That means, for turnaround directors and advisers, identifying the right liquidity solutions and funding providers is very much more than a spreadsheet exercise. It requires knowledge, insight and judgement.

FUNDER PROTECTIONS VS TRADING HEALTH

Funding types:
company health vs
risk appetite



General corporate funding

Traditional banking lenders are a default option for companies seeking funding. High-street lenders offer a full spectrum of financing options, including day-to-day banking, overdrafts, revolving credit facilities, hedging instruments, and term loans. The solutions will be standard and largely vanilla, and this simplicity can be attractive.

Where it applies

SMEs typically use term-lending for property or asset-based purchases and working capital funding through overdrafts, invoice discounting, and trade finance funding. Structured lending involves cashflow and asset-based solutions (see below) with different teams engaging at various stages of a company's recovery.

Increasingly, SME businesses may be managed largely online by their banking business manager, while mid-corporate businesses may be managed in portfolios of 50–60 companies, and larger listed companies in portfolios of around 25.

What lenders look for

Lenders collaborate with company management to devise a turnaround plan. An array of options are considered, ranging from consensual soft-touch restructuring (alleviating immediate liquidity pressure by pushing out maturities or altering interest payment schedules, including potential PIK-conversion), through to more thorough capital structure reorganisations, such as court-sanctioned schemes (including UK Restructuring Plans), or debt-for-equity swaps.

What's the deal?

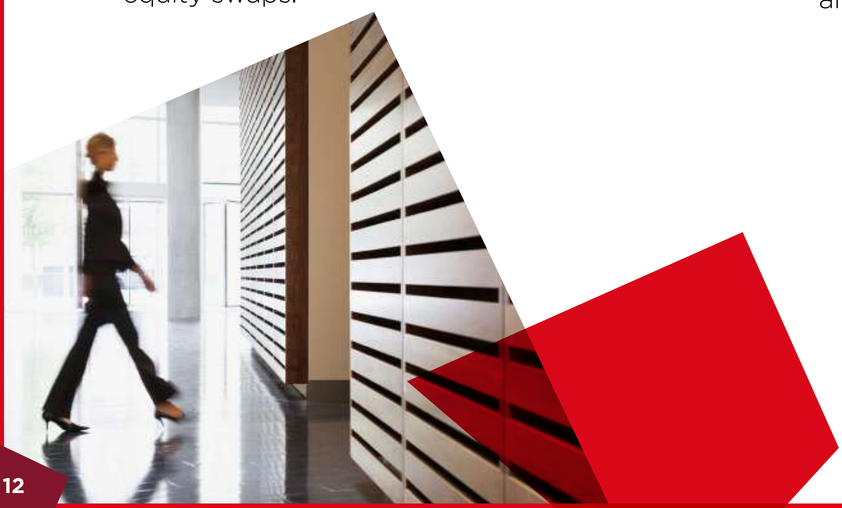
The cost of capital is spread over the base rate, and this may not vary significantly in distressed situations, given the banks' consumer considerations.

Rates will be a margin over the base rate. For banks, this can be anything between a 2% and 5% margin, while at the other end of the spectrum, private credit funds will look for an 8–12% total return.

For larger companies, Loan Market Association (LMA) standards are typical, with external advisors for each party. Banks will usually apply standard in-house documentation and terms for SME-lending.

Minimum liquidity covenants linked to short-term cashflow forecasts are common, tested against weekly forecast and actual balances. As companies recover, covenants shift towards leverage, interest, and cashflow cover. Quarterly tests, including year-end, are standard, while liquidity tests require regular short-term cashflow reports.

Banks and private credit funds prefer maintaining good dialogue with management rather than relying solely on strict covenants. This relationship fosters better management of the lenders' position and supports the company's recovery.



Board representation

Banks are generally reluctant to have employees as non-executive directors. In complex distressed scenarios, banks may consider board observers, particularly in syndicated lender situations. This mitigates the risk of being perceived as “shadow directors”.

Appointing Turnaround Directors

Turnaround Directors (TDs) play a crucial role in supporting management, especially in stressed situations. Banks generally prefer early involvement of TDs to educate and assist management through the recovery process.

TDs tend to be appointed when there has already been engagement with one of their panel firms. Companies can signpost to The IFT, Citizens Advice Bureau or Business Debtline. Signposting would most likely happen in a lender’s business support team, typically at the smaller end of the market – but might just be a addressing a skills gap rather than requiring a full time CRO.

Stress and distress

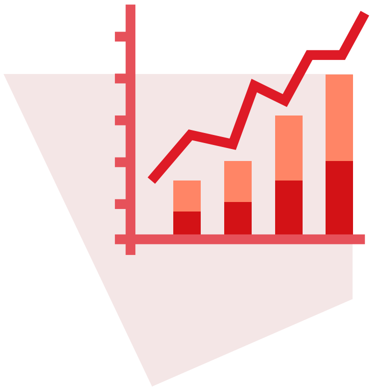
Since the global financial crash, good, constructive, if somewhat more non-interventionist, behaviour is the norm and to be expected, among the UK’s mainstream lenders in turnaround situations. Banks aim to improve, repair, and return companies to business-as-usual. They work alongside sponsors and shareholders to ensure alternative funding options are available if needed. Banks are cautious about taking equity positions. Distressed debt-for-equity angles are considered but remain a rarity, with banks tending to prefer to either exit at a discount or to simply maintain their position.

Intercreditor work-outs

The relatively recent emergence of private credit funds has increased complexity in work-out situations, particularly since their goals can be quite different from those of mainstream bank lenders.

However, properly drafted intercreditor agreements facilitate consensual solutions among funders.

For smaller and mid-sized companies, intercreditor situations are less likely.



Mainstream private equity

Private equity finance covers a range of sub-asset-classes, from venture and growth capital for younger, high-potential businesses, through to buyouts for more mature businesses. Venture investors will typically take minority equity positions, while private equity firms backing a management or leveraged buyout will seek control. Investors will back a management team to create value usually over a 3–5-year period, before seeking a full exit.

Where it applies

Private equity firms typically look for scalable businesses with low capital-intensity and high-quality cashflows that can support debt repayments in a leveraged structure. Many firms are organised along sector lines in order to differentiate and based on the experience of the investment team.

Target companies will often be leading players in their market, and the private equity firm will seek to strengthen the business during its holding period, often through a buy-and-build process of bolt-on acquisitions as well as organic growth, to consolidate its position and to expand into adjacencies or international markets.

Some private equity firms will advertise their operational expertise, but this does not equate to executive management – they will always look to actively support company leadership rather than becoming involved in day-to-day activities.

What's the deal?

Private equity firms are sophisticated users of debt and will often seek to optimise a company's capital structure through the judicious use of leverage in order to maximise returns. This creates a high-pressure environment, particularly for finance teams, even in very profitable businesses. The investor will take a control position and, if the business underperforms, they may seek to use their position to replace senior management.

Their investment case will usually consist of a 100-day plan, when much of the building blocks for the value transformation will take place, with a medium-term horizon for major strategic initiatives and bolt-on acquisitions.

If successful in the value creation plan, this will give the business time to demonstrate its growth before seeking a planned exit within 3–5 years, but investors will be opportunistically 'open to offers' at all times. They will seek a return upwards of twice their capital invested, and internal rate of return of 15–20% per annum. (Note: this is significantly lower than the targeted return for special situations PE, as below.)

The debt package will be optimised across the capital structure, typically consisting of leveraged cashflow loans from mainstream lenders, and increasingly private credit funds, as well as subordinated debt tranches, often from specialist mezzanine and junior lenders. Large buyouts make greater use of high-yield capital markets, although this is more common in the US. Private equity firms are regular customers and therefore sophisticated users of leverage and will typically secure borrower-friendly terms, relative to the cycle. For larger transactions, PE houses can partner/pool

resources with other PE firms to reduce their individual exposure or extend the scale of opportunity.

Historically, private equity firms sold to corporate acquirers or a public listing. Today, a sale to another private equity firm is very common, particularly for SMEs/ mid-market businesses but also for larger transactions. A more recent innovation is where a private equity manager raises a separate ‘continuation fund’ that it also manages, in order to sell and re-acquire the business, thereby lengthening the period they are able to ‘own’ the business (while also allowing them to close-off their existing fund and realise returns.)

Appointing Turnaround Directors

For a mainstream private equity firm, reputation is everything given their need to periodically raise funds. Therefore, in any stressed or distressed situation, specialist advisers may be brought in from outside their immediate network, but this will be handled exceptionally discreetly.

However, their more intense financial monitoring relative to most lenders will typically mean private equity investors should take decisive action very soon after underperformance is detected to avert crisis or need for conventional turnaround and then resulting risk of a loss of control. As a result, for TDs, developing trusting relationships is critical.

Board Representation

Private equity firms will have board representatives, although this formal position is less important than the ongoing relationship, which can be very close with certain leadership roles, in terms of the investor’s requirements for data and insights about the company’s operating performance and strategic position.

How to keep private equity on-side

Private equity firms are full of bright financially literate people and often the deal executive responsible for day-to-day engagement with the CEO and CFO will be surprisingly young. Understanding their investment dynamics and adding value in the form of subject-matter expertise or sector-knowledge, will help to build trust and respect.

Special situations private equity

Special situations private equity typically involves investors taking a control-equity position, to rapidly rectify issues with management or urgent cash-needs. In situations of distress, private equity investors will be more ‘hands-on’ than in mainstream buyouts, but will still look to install management that can drive a business’ recovery.

Where it applies and what sponsors look for

Special situations private equity investment is suitable for companies with high potential for recovery and growth, and that may still be profitable but perhaps burdened by high-interest payments, an overleveraged balance sheet or require additional capital liquidity.

Special situations private equity firms are typically sector generalists and will seek to apply a turnaround tool-kit with significant involvement from their own representatives and third-party consultants.

What’s the deal?

Most private equity firms operating in turnaround situations will seek to take a majority equity position, reflecting their desire to be heavily influential in the business strategy in order to maximise their returns and manage their risk.

The investment will primarily consist of equity from the firm’s fund, which will often be a 5-year or a 10-year closed-ended vehicle (as with mainstream private equity) but they may be more flexible in time horizons for exits either earlier if the turnaround is delivered quickly, or longer than 5 years if the turnaround proves more complex.

Stressed private equity firms may also provide bridging finance in restructuring and insolvency processes. Some distressed investors will use “loan to own” strategies, but most will invest directly through a combination of equity and debt instruments.

A typical stressed (and mainstream) private equity structure includes equity that is partially structured as loan notes, which incur interest and fall under thin capitalisation rules. These loan notes sit behind the primary debt package. Loan notes previously had interest rates of 8%, although at the time of writing increased to 10-12% due to higher capital costs.

For the primary debt package, private equity firms will seek third-party providers, both mainstream and specialist fund lenders.

Private equity transaction agreements are bespoke and tend to be heavily lawyered. Since they will have a controlling interest in a business, managers will be held to regular performance targets rather than contractual covenants. Private equity firms will always seek to support and supplement management where possible but will maintain the option to replace key leaders outright, occasionally at the outset.

Private equity sponsors aim for a 3 to 5 times multiple return on money, and private equity directors are usually also incentivised via a time-weighted metric – the Internal Rate of Return (IRR).

Appointing Turnaround Directors

Special situations private equity firms often buy family businesses needing professionalisation, failed mainstream PE investments or carve-outs that require significant initial work. The need for TDs is assessed quickly during the investment decision.

In the case of divisional carve-outs from larger companies, TDs help fill gaps in management and assess long-term needs. Individuals with strong cashflow management and distressed situational skill and experience are highly prized, and these are typically valued higher even than sector knowledge.

TDs are often sourced through networks, organisations such as The IFT, or recommendations from previous projects.

Board Representation

Private equity firms almost always have a board representative. However, much of their engagement with the business will be informal and direct with management, especially in stressed situations.

They may appoint additional roles like a chair or non-executive directors. While they may be active at a strategic level, most will not wish to become 'managers', so ensuring the right leadership is in place, especially the CEO and CFO roles, and that they are sufficiently supported, is a key focus.

Stress and distress

Special situations private equity firms have strong in-house restructuring skills. They will not have a separate workout team – the same individuals will typically stay with the investment through 'rain or shine', leveraging expert support, internally or via third-parties, as needed.

How to keep special situations private equity on-side

Trust is crucial in private equity. Extensive communication is considered a virtue, especially about funding requirements and potential risks. Providing accurate information in a timely way builds trust and confidence with private equity investment committees.

It should be noted, too, that this relationship-management role applies equally to wider stakeholder groups, given the TD will have a legal duty to the corporate entity and all stakeholders, irrespective of ownership.

Leveraged lending

Leveraged lending is a popular instrument for companies with high-growth potential or at the other end, in turnaround situations. In recent years, new entrants, in the form of non-bank ‘fund’ lenders, have emerged as influential players, as traditional banks have sought to reduce their historical exposure to the market.

Where it applies

Leveraged lending supports a variety of complex financial events, including management buyouts/ management buy-ins, whether sponsored (private equity backed) or sponsorless; shareholder reorganisations; and buy-and-build strategies.

What lenders look for

Lenders assess the quality of recurring revenues and cashflow and take a view on the quality of the management team, the private equity firm’s track record, the sector, the company’s end-markets and the business growth plan overall.

What’s the deal?

Leveraged lending often employs standard Loan Market Association (LMA) documentation, including intercreditor provisions. Covenants generally cover leverage and debt servicing, with agreed-upon headroom based on market standards.

Typically, the maximum lending timeframe is seven years, with most businesses accelerating their growth and exiting prior to that.

The capital structure of senior subordinated and equity in a turnaround will be somewhat similar to a mainstream leveraged buyout, albeit with higher pricing, more frequent reporting requirements, and stricter covenants.

The loan structures commonly feature non-amortising fixed-rate term loans, with the possibility of converting cash interest to Paid-In-Kind (PIK) interest (in order to conserve cash in the business) or to convert portions to loan-note instruments or equity-warrants.

Private credit funds may have the flexibility to draw down additional capital to fund expenditures, depending on where they are in their own fund-investment cycle.

Exits are typically triggered by the achievement of the business’ strategic goals, which will often be determined by a private equity sponsor’s exit horizons. Outperformance may accelerate this process.

Board Representation

In stressed and pre-stressed situations, lenders will typically seek Board observer rights. This allows active listening to Board conversations and ensures a deeper involvement in the business' affairs. Non-bank lenders may occasionally appoint board directors, when considered additive to the business context.

Appointing Turnaround Directors

The goal is to work collaboratively with the sponsor and management teams, assessing the adaptability of the management team, the sponsor's commitment, and any weaknesses in the management structure that may need augmentation. Sourcing TDs typically involves leveraging internal networks or organisations like The IFT.

Stress and distress

Intervention is triggered by breaches of financial covenants, liquidity issues, or stakeholder concerns. In such cases, supplementary help may be sought, often involving individuals with sector-specific or stakeholder management experience.

How to keep leveraged lenders on-side

Be proactive, ensure the finance team is providing detailed and timely financial updates, cash flow forecasts, and performance metrics. Engage in regular, honest discussion about challenges and strategies, seek their input on major decisions, and be responsive to their requirements for increased oversight and control.

Asset-based lending

Asset-based lending uses the (primarily physical) assets of a business as collateral to secure a loan. While ABL is long-established, it is somewhat less prevalent in the UK than in the US, where it is seen as part of the day-to-day financing mix for larger business with a significant asset-base. ABL is provided by both traditional and specialist lenders.

Where it applies

ABL is a popular financing option for SMEs that are fundamentally robust, have a decent collateral base and that wish to bridge a short-term cashflow requirement or ride-out a period of trading volatility. For asset rich businesses of any size, it can be a cost effective "all weather" form of financing.

What lenders look for

Most ABL is provided as revolving credit: more like an overdraft than the traditional term-loans provided by leveraged (cashflow) lenders. Where fixed assets (property, plant and equipment) are brought into the Borrowing Base an amortising Term Loan structure is usually added to the revolver. The nature of the facility will be based upon the appraised value of the company's assets.

Therefore, when assessing a lending opportunity – and throughout the life of a facility – ABL providers spend significant resources assessing asset cover, such as accounts receivables, inventory, and assessing, often with the use of third party appraisers, the liquidation value of property, machinery and other industrial assets, and pricing risk accordingly.

However, it's not all about collateral. Lenders will also seek to evaluate management and will be keen to pursue long-term partnerships rather than short-term insolvency-driven engagements.

Typically, ABL providers engage in refinancing and new money provision, and can work closely with clearing banks that may have reached their lending limits.

What's the deal?

ABL is, often incorrectly, seen as more expensive than the cashflow-based alternatives, but such analysis does not typically compare like-with-like. Perhaps adding to this perception are the ongoing monitoring fees charged by ABL providers, reflecting the resource-burden of dealing with physical assets, rather than a spreadsheet-based diligence. Origination fees can also be high for similar reasons.

Funding terms typically involve monthly cash interest payments. Lenders may be willing to 'overfund' to solve short-term cash flow issues, with non-amortising debt.

Many ABL providers will also offer a hybrid structure to maximise lending efficiency for both assets and cashflows. In such cases, a mix of collateral covenants and cashflow performance metrics, including profit & loss assessments, balance sheet evaluations, and inventory valuations, would be applied.

Lately, this blending of returns, plus the growing availability of wholesale lines of finance from investment banks, has further brought down ABLs' overall cost of capital.

ABL facilities typically involve very simple covenant terms (compared with term-loans), such as the ratio of EBITDA to interest payments. For more structured lends, there may be a 'fixed charge coverage' covenant, to tie the interest-repayments to cashflow.

Without a standard LMA equivalent, ABL providers typically use bespoke but standardised legal documentation.

The cost of capital typically ranges from low single figures over SONIA to 8-10% over SONIA, with no minimum return requirement. ABL facilities typically span 3-5 years, maintaining client relationships for as long as possible.

Most lenders will have a sharp focus on 'headroom', aiming for a viable plan even in the case of stress or covenant breach. While such breaches are obviously contractual, they are often viewed as discussion points rather than immediate enforcement triggers.

ABL providers work extensively with private equity, providing finance for acquisitions, add-ons, and often retaining clients after private equity has sold.

Most ABL providers embrace collaborative solutions, and often join with debt funds to maximise leverage while managing costs – and such collaboration has been facilitated in recent years by improvements in intercreditor agreements.

Stress and distress

ABL providers will often keep the same relationship managers through the life of the facility, even during work-out situations. ABL providers will provide funding over receivables and other assets, while taking first charges on remaining assets.

Because of the physical monitoring requirement of this type of lending, there is, anecdotally at least, a stronger relationship element between bank and borrower, that can prove helpful in finding constructive solutions during periods of underperformance.

Appointing Turnaround Directors

While ABL providers will not directly appoint turnaround directors, they may seek approval rights for new appointments, in order to support the introduction of the right advisers and TDs.

ABL typically seeks Board observer rights or monthly management information meetings.

How to keep ABLs on-side

Ensure finance is on top of asset values, inventory levels, and receivables. Engage in open communication and focus on maintaining the value and liquidity of collateral assets to reassure lenders and collaborate effectively to manage risks and navigate through financial difficulties.

Considerations for a Turnaround Director

Funding: The role of the Turnaround Professional

The funding of a business is key in a turnaround situation, both for short-term business survival as well as long-term transformation and growth. Providers of credit and equity are therefore crucial stakeholder relationships. As noted earlier in this report, the funding landscape has in recent years become increasingly complex and difficult for non-experts to navigate.

A turnaround professional, whether acting in an advisory role or as an independent director can play a key role in relation to funding. This can involve both supporting businesses to understand and navigate the funding options available to them and introducing funders and businesses to opportunities. There is a strong synergy here with the turnaround skill set, which previous research by The IFT has highlighted as demonstrating an agile and flexible approach, adept at managing and aligning stakeholders and working at pace to seek innovative solutions.

This report has provided an overview of the major types of funding in the current landscape and related approaches, both generally and in a turnaround context. Drawing from contributor commentary, this chapter summarises the key considerations and synergies for independent turnaround directors/professionals, which have been indicated by the above overviews: how to approach the issue of funding, what funders are looking for and questions to consider when speaking to existing or approaching new funders.

What funders are looking for from turnaround experts

Experience with turnaround directors or turnaround support ranged from funders bringing in or appointing their own turnaround directors to liaising with turnaround directors or professionals who may already be working with a business or who have been brought in by another funder.

Some common, and unsurprising, themes in relation to what funders valued from turnaround support (and instances where they looked to appoint a TD/CRO) included the following:

- To increase management team capacity – the bolstering and stabilising of a (likely fatigued) management team. Turnaround professionals such as a CRO meet the need for fiduciary independence and provide a means of rebuilding trust between a funder and a business.
- To fill specific skills gaps – identifying and supplementing particular gaps in the Board/management team, such as financial skills, cashflow management, operational, sector knowledge.
- Experience with distressed and stressed scenarios – particularly where restructuring processes are being explored – supporting the board to have the right level of experience or access to the right advice for the situation.

The role of the turnaround professional and some of the key aspects valued by funders, are explored in more detail overleaf.

Assessing funding options

Turnaround professionals have experience of dealing with financially stressed businesses and know how to secure the relevant financial and legal advice to enable a full exploration of funding options. They will get business cashflow grounded immediately with a critical assessment of cash dynamics as part of their initial work.

Interviewees stressed that funding is a specialist area and expert advice should always be considered to navigate the complexity and understand what is right for a particular business at a particular stage of its life cycle. There is a broad range of solutions existing in the market with differing approaches and it was noted that it can be hard to get a handle on the range of tools (and funding combinations) out there to solve a business' particular capital issue.

The IFT facilitates access to an extensive network through which members and indeed external organisations such as businesses, funders and regulators can access expertise and advice.

Rapid evaluation of a business

Previous research by The IFT on the competencies and drivers of turnaround directors highlighted their ability to quickly assess a situation with an analytical and flexible approach. A theme from the interviews for this report included the day-to-day access and in-depth knowledge that a turnaround professional brings to enable a solid understanding of the business: its cash, balance sheet, the financial performance, the underlying operational business and asset base.

Interviewees highlighted how much they valued getting as clear a picture as possible on the financial position, what quantum of funding might be needed, why it is needed and as much clarity as possible around this and any risks or concerns about whether this may change, including the available runway, which can impact the ability to source funding. Funders highlighted that this helps to build trust with funders and can support further funding requests.

Stakeholder management

The role of a turnaround director in supplementing a management team whilst also working with funders – which may have appointed or brought in the turnaround professional – was clear from the interviews. It was recognised that this can mean difficult discussions with management and others about the realistic funding options available. This is part of the underlying skillset of a turnaround director or CRO, who is used to asking difficult questions and seeking further information as required, as well as stress testing management assumptions and plans. One interviewee referenced the value that this "external perspective and challenge" can bring to a business and its management team.

Interviewees highlighted the importance of the TD/CRO in understanding and managing different stakeholders, and in providing clarity on aims and aligning objectives. Interviewees emphasised that in the current funding landscape turnaround professionals need to take into account the different positions and drivers of the various funders, such as between ABLs and private equity, and how these interact, with added complexity of multi-creditor and multi-level agreements. Nowadays funders will be looking at a minimum - even for owner-managed businesses - for an understanding of private credit and private equity sponsors to support the management team of a business and professionalising arrangements. Auditors were also noted as representing an additional stakeholder in distressed scenarios when looking at issues such as levels of headroom. The ability of independent advisers such as members of The IFT to build relationships and act as a trusted and honest broker can be particularly valuable around the negotiating table.

Consideration of the long-term strategy

Whilst immediate funding needs must be addressed, interviewees also drew attention to longer term and strategic objectives of funders, where filling an urgent gap should be combined with modelling of longer-term funding sensitivities and requirements. Turnaround professionals will have experience of thinking more widely and considering the longer-term view as well, combining traditional "turnaround" measures with long-term transformation, and the support of a TD with helping to assess "the right longer-term answer" was referenced. Interviewees also referenced awareness of wider trends in particular industries or sectors and whether a business requires repositioning or other new strategies.

Key Questions to Consider

Below are some questions which turnaround professionals may wish to consider when considering funding arrangements or speaking to funders.

These are indicative only and not exhaustive and should be supplemented by any additional questions required by the specific business model or situation but can provide a starting point for thinking about the requirements or approaches of different funders.

- Do we fully understand the cash dynamics and future requirements of the business? (To understand the funding model of the capital provider.)
- Is this a timed fund heading towards the end of its investment cycle, a traditional lender, or distressed debt fund?
- Is the lender a recent funder to the business or has it been with the company for a long-haul?
- Where do they rank in the debt stack?
- Do they use LMA (Loan Market Association) standard debt documents wording?
- If not, what do they use (or add to the LMA document)?
- What is the covenant suite and typical headroom %?
- What inter-creditor arrangements exist with the working capital providers?
- What is the standstill period in a covenant breach?
- Is there a workout team?
  - If yes, what is their approach to workout?
  - If no, what is their alternative strategy?
- Do they ever sell distressed debt?
- What is appetite to extend maturity of debt in times of distress?
- Pricing – risk vs reward view
- Can they take share ownership in a restructure?
- What is the attitude to board representation?
- What (if any) restrictions are there on follow-on lending in a stressed/distressed situation (e.g. fund fully invested, fund maturity due/overdue, etc) and could this affect decision-making?
- What other considerations drive lender behaviour (e.g. reputational risk in a restructure /job preservation/fundraising dynamics)?
- For ABLs, what do they do in a distressed scenario – restructure or exit?
- For other lenders, how do they underwrite deals? What do they use?

Contributors

We spoke to a number of members, partners and other stakeholders who provided invaluable support and advice in relation to the format and content of this report.

In particular we would like to thank the following for their advice and support with the report:

Rob Asplin, PwC, IFT Board Member
Dave Amber, IFT Independent Member
Jon Norton, Crestline Limited
Katherine Hensby, Jatinder Bains and colleagues, Macfarlanes

We carried out a number of interviews with lenders, funds and advisers, a number of which were on an anonymous basis and others which are referenced below. We would like to thank all interviewees for their time and insights. Thank you also to IFT Board Member Nick Alexander and Chris Hawes, PwC, for their comments on an early draft.

Interviews

- Shaun Holmes, Stephens Investment Bank
- Tony Young, Secure Trust Bank
- Tom Weedall, Blazehill
- Niamh Buckley, Endless
- Chris Edwards, Teneo
- Andy Foster, Sandton Capital
- Josie Richardson, IFT Independent Member
- Rob Hanley, TDC
- Adam Horey, PwC
- Beechbrook
- Dr Iain MacRitchie, MCR Pathways and IFT Fellow
- Colin Wray, IFT Independent Member and Fellow

Glossary

ABL (Asset-Based Lending): A type of debt financing where a loan is secured by the borrower's assets rather than its cashflow.

Amortising Loan: A loan where the principal amount is paid down over the life of the loan, typically through regular payments.

Bridge Finance: Short-term financing used to cover immediate expenses until long-term funding is secured.

Buy-and-build: A private equity strategy where a firm acquires a company and then makes additional acquisitions to create value and grow the business.

Covenants: Clauses in a loan agreement that require the borrower to meet certain conditions or prohibit specific actions, typically to protect the lender's interests.

Debt-for-equity swap: A restructuring method where a company's debt is exchanged for equity, often used in distressed situations to reduce the debt burden.

EBITDA (Earnings before interest, tax, depreciation, and amortisation): A measure of a company's overall financial performance and profitability.

Equity-warrants: Financial instruments that give the holder the right to purchase the company's stock at a specific price within a certain time frame.

High-yield capital markets: Markets where companies can issue debt in the form of bonds that has a higher risk of default than 'investment grade' but offers higher returns to investors.

Intercreditor agreement: An agreement between multiple creditors that defines their respective rights and obligations in relation to the borrower and each other.

Internal Rate of Return (IRR): A metric favoured by private equity firms to measure the return-on-investment, representing the annualised rate of return. This is also used to calculate individual private equity performance-based rewards.

Leveraged buyout (LBO): The acquisition of a company using a significant amount of borrowed money to meet the cost of acquisition.

Loan Market Association (LMA): An organisation that produces standardised loan documentation for the syndicated loan market.

Management buyout (MBO): Similar to an LBO, but typically a smaller business, where the investment-case is built around a specific (incumbent) management team.

Net asset value (NAV): The value of a company less its liabilities.

Paid-In-Kind (PIK) interest: Interest payments made in the form of additional debt or equity rather than cash.

Panel firms: Firms that are pre-approved by lenders or investors to provide specific services, such as turnaround management or consulting.

Pre-pack administration: A type of insolvency procedure where a company arranges to sell its assets before appointing administrators, allowing for a quicker and more efficient sale process.

Private credit funds: Investment funds that provide debt financing to companies, which can take on higher risk for potentially higher returns.

Private equity funds: Investment funds that provide equity finance to companies, typically taking majority or control positions, to drive value and exit their position within a few years.

Revolving credit facility: A credit line that allows a borrower to draw down, repay, and redraw loans repeatedly up to an agreed limit.

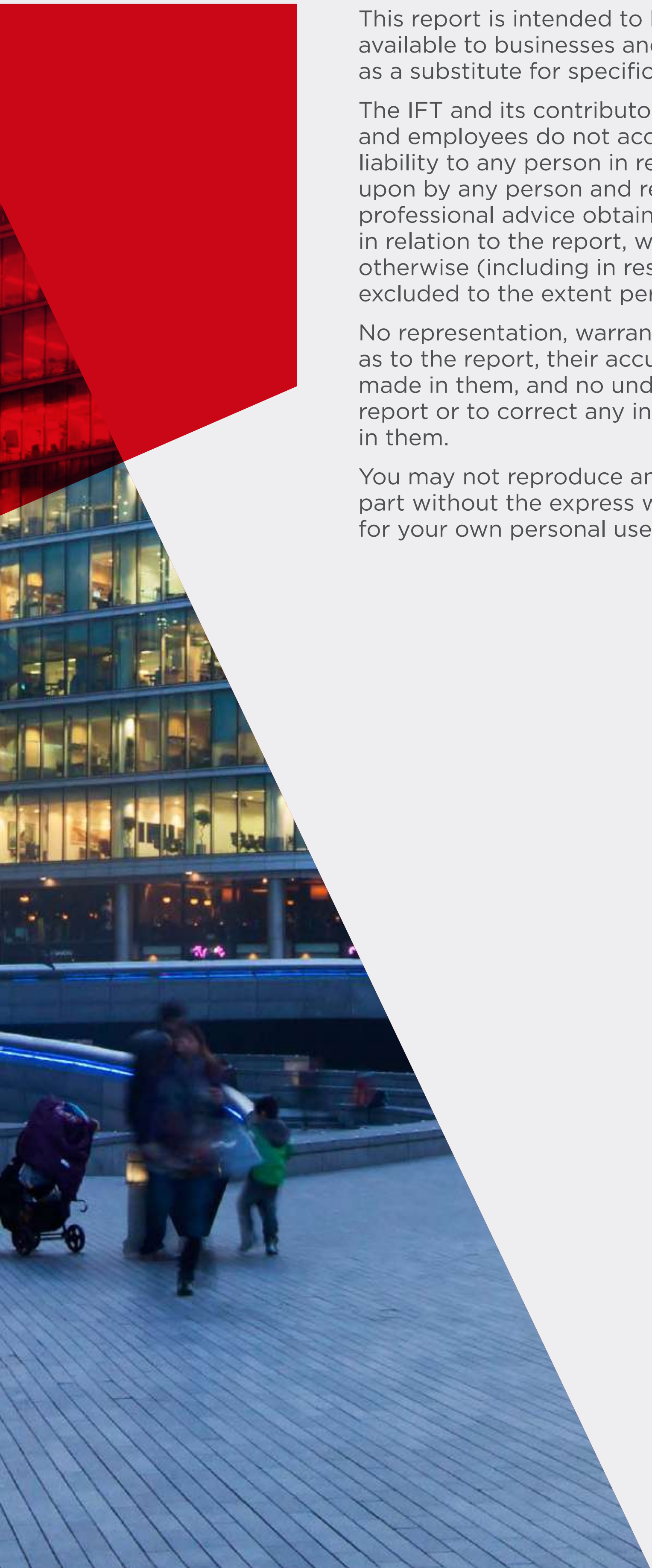
SONIA (Sterling Overnight Index Average): A benchmark interest rate for loans in British pounds, reflecting the average of overnight interest rates in the Sterling market.

Stressed/distressed situations: Financial scenarios where a company is experiencing difficulties meeting its obligations, potentially leading to restructuring or insolvency.

Term loan: A loan with a fixed maturity date and repayment schedule, typically used for long-term investments.

Turnaround Director (TD): A specialist brought in to help a company recover from financial distress, often by restructuring operations and finances.

Venture capital: A type of private equity financing provided to early-stage, high-potential growth companies. It typically falls under the wider rubric of ‘private equity’.



dapt. Transform. Succeed.

www.the-ift.com